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From Austerity to Expansion?
Consolidation, Budget Surpluses, and the Decline of Fiscal Capacity

Lukas Haffert and Philip Mehrtens

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Abstract

In the wake of the financial crisis, most developed countries have entered a period of prolonged budgetary austerity. While the success of austerity programs is still unclear, it is also an open question what success would mean for activist government in the long run. This paper rejects the progressive belief that successful fiscal consolidation will lead to a strengthening of fiscal capacity, arguing that consolidations transform the political context in which fiscal policy is made. By analyzing the evolution of public expenditure in six countries with sustained budget surpluses, it shows that while surpluses were mostly achieved through expenditure cuts, they were predominantly used for cutting taxes. While fiscal crises abated, their collateral damage to public expenditure remained. This result is further elaborated by a case study of the Swedish budget surplus. The paper concludes that consolidations can create a specific type of fiscal regime and thus have long-term consequences for the fiscal capacity of the state.

Zusammenfassung

Angesichts der Schuldenprobleme in vielen entwickelten Ländern befinden sich die meisten von ihnen in einer Phase lang anhaltender Austerität. Und während noch völlig unklar ist, ob die Sparprogramme Erfolg haben, werden sie immer wieder mit dem Versprechen verbunden, erfolgreiche Konsolidierungen würden zu einer Wiedergewinnung staatlicher Handlungsfähigkeit führen. Diese Studie verwirft diese „progressive Konsolidierungsthese“ auf Basis einer theoretischen und empirischen Analyse. Ihr Argument lautet, dass Haushaltskonsolidierungen den Kontext, in dem Fiskalpolitik gemacht wird, dauerhaft verändern. Zwar erhöhen sie fiskalische Spielräume, zugleich aber schränken sie politische Spielräume ein. Anhand von sechs Ländern mit dauerhaften Haushaltsüberschüssen wird gezeigt, dass diese Überschüsse durch Ausgabenkürzungen erzielt, aber für Steuersenkungen verwendet wurden. Die Kollateralschäden der Konsolidierung blieben über Jahre in den Budgets sichtbar. Dieses Ergebnis wird von einer Fallstudie zu den schwedischen Haushaltsüberschüssen bestätigt. Das Fazit der Untersuchung ist, dass Konsolidierungen zu einem Wechsel des fiskalischen Regimes führen können, wodurch die staatliche Handlungsfähigkeit langfristig beschränkt wird. Überschüsse sind insofern nicht Ausdruck wachsender Gestaltungsfreiheit, sondern schrumpfender Ambitionen des Staates.

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From Austerity to Expansion? Consolidation, Budget Surpluses, and the Decline of Fiscal Capacity

1 Introduction

Democracy is about making choices. When the political room for making choices becomes smaller and smaller, this can thus be seen as a serious challenge to the democratic polity. A powerful driving force behind such developments can be fiscal stress (Schäfer/Streeck 2013; see also Cordes 1996). This is the case when the fiscal space[1] for new policy initiatives is squeezed between downward pressure on tax rates and upward pressure on social expenditure and other forms of mandatory spending, in particular interest on government debt. The recent financial crisis massively exacerbated this trend in most developed economies.

Against this background, proponents of an activist role of the state pin their hopes for overcoming the need for austerity on consolidating public budgets:

> … Progressives have more at stake in developing a long-range balanced budget than do Conservatives precisely because we believe that government has a positive role to play in modern life. If we do not develop a path to a sustainable federal budget, there will be no room left for government to invest in new opportunities that could make people and our country better off. (Taylor 2012: ix)

Already in the 1990s, progressive political leaders all over the world, from Bill Clinton in the United States to Göran Persson in Sweden, shared this belief. They suggested that temporary austerity was necessary for rebalancing the budget and for returning to a more activist fiscal policy afterwards. We call this approach the *progressive consolidation view*. In this view, consolidation is not an end in itself but a means to regain fiscal capacity. Its importance is stressed by the new growth theory (Romer 1990) in economics and by the concept of a "social investment welfare state" in political science (Esping-Andersen et al. 2002; Morel/Palier/Palme 2012). Both literatures argue in favor of increased public investment, hard and soft. This raises the question of where the necessary resources for these investments are to come from, given the precarious state of public finances. It is here that the progressive consolidation view seems to offer a way out.

We would like to thank Daniel Mertens and Jiska Gojowczyk for their many helpful comments and suggestions.

1 In this paper, we use the term *fiscal space* for referring to an available potential. The degree to which this potential can actually be activated is termed *fiscal capacity*. Thus, fiscal space is a necessary condition for fiscal capacity.

In this paper we argue that it is unlikely that this strategy will be successful. Sustainable consolidation requires the creation of a new fiscal policy regime which remains effective even after consolidation pressures have receded. To be successful in the long run, consolidation measures need to go beyond technical adjustments. They have to be embedded in a set of institutional, ideational, and political changes that together constitute a break with the existing fiscal paradigm. These changes have an enduring impact and place a powerful constraint on post-consolidation fiscal policy. A return to more fiscal policy discretion would thus require another change of course, which is politically costly and unlikely to happen endogenously.

To substantiate this claim, we analyze countries running budget surpluses for an extended period of time and ask how they made use of these surpluses. We show that these countries had additional fiscal room for maneuver but that this room was not used for wide-ranging new spending initiatives. In particular, those budget items that were affected most by consolidation benefitted least from surpluses. Instead, most governments focused on cutting taxes and thus restricted the fiscal capacity of the state even further.

We elaborate on this result with an in-depth study of the Swedish case. Sweden faced a deep fiscal crisis in the early 1990s to which it responded with massive fiscal consolidation. Since 1998, the country has generated almost uninterrupted budget surpluses. We show how balancing the budget replaced balancing the economy as the predominant goal of fiscal policy and interpret Sweden as a prototypical case of a *surplus regime.*

In the end, we conclude that proponents of the progressive consolidation view may become victims of their own success. The more effective they pursue austerity, the greater the chances that austerity will persist. Consolidations have long-term effects on fiscal policymaking, long after their initial motivations have disappeared.

2 The argument

At the core of the progressive consolidation view is a prediction about what will happen after a successful budget consolidation. This view sees austerity measures as temporary, as a necessary adjustment to rebalance the budget and regain fiscal capacity. Afterwards, it envisions a return to a more ambitious fiscal policy. This argument entails the assumption that post-consolidation policies are independent from preceding consolidation policies. The idea is that consolidation increases fiscal space but does not impose restrictions on its use.

A similar view is put forward in much of the work found in comparative political economy. Studies taking budget balances or debt levels as explanatory variables for state activity rarely differentiate conceptually between deficits and surpluses (rising or falling

debt); instead they view them as symmetric. Starting with the often confirmed result that fiscal stress results in a contraction of public spending, which hurts different policy fields unequally (e.g., Obinger 2012; Breunig/Busemeyer 2012), they suggest that, by implication, abating fiscal stress will result in a renewed increase of those expenditures that were cut during consolidation. For example, Boix (1997) regresses public investment on a set of variables, including the budget balance of the previous year, and calculates one and the same coefficient for both deficits and surpluses. The results let him conclude that "a socialist cabinet increases public investment … more than a conservative government for each percentage point of budget surplus. Conversely, a budget deficit depresses the public investment rate under a socialist government rather rapidly" (Boix 1997: 831).

We take issue with both approaches to post-consolidation fiscal policy. Neither are post-consolidation policies independent from preceding consolidation policies, nor are they their mirror image. While it is true that rising fiscal stress reduces fiscal capacity, a decline of fiscal stress does not necessarily lead to a reversal of budget trends. We argue that it is necessary to look at both the consolidation and post-consolidation periods and to investigate the mechanisms linking them.

Our argument takes up a set of core tenets of Historical Institutionalism, particularly its arguments about path dependency, policy feedback, and policy legacies (e.g., Thelen 1999; Pierson/Skocpol 2002). Following this literature, the argument is based on Schattschneider's dictum that "new policies create a new politics" (Schattschneider 1935: 288). Today's fiscal policies, we suggest, structure the conditions under which tomorrow's fiscal policy decisions are made, even if their original causes have long disappeared. Trying to explain post-consolidation fiscal policy without taking into account what happened during consolidation is thus bound to fail because both processes are deeply intertwined. The measures taken to overcome fiscal crisis continue to structure the political, ideational, and institutional context in which fiscal policy is made afterwards.

Examining the appropriateness of the progressive consolidation view thus requires a long-term perspective. This limits the applicability of many studies on fiscal consolidation. These typically treat consolidations as a matter of technical adjustment and restrict their analysis of consolidation sustainability to a two-year window (e.g., Von Hagen/Hallett/Strauch 2002; Alesina/Ardagna 2012) or, at maximum, a three-year window (e.g., Alesina/Perotti 1995; Wagschal/Wenzelburger 2008). Such a short-term perspective does not allow us to figure out how much discretion policymakers have after consolidation. Furthermore, this literature is almost entirely concerned with the causes or the macroeconomic effects of fiscal consolidations but not with their political effects. Hence, it has little to offer for an assessment of the progressive consolidation view.

Instead, we turn to the concept of a fiscal regime as developed by Paul Pierson (1998; 2001). Pierson defines a fiscal regime as "the configuration of political interests, institutions, and policy arrangements that structure conflicts over taxes and spending. … At the height of a particular fiscal regime, the critical components – policies, politics, and

institutions – will be mutually reinforcing" (Pierson 2001: 56-57). At the core of a fiscal regime there is a set of slow-moving macro trends all pointing in the same direction. Therefore, such a regime does not change on a year-to-year basis but persistently shapes the context in which fiscal policy decisions are being made.

A persistent change of the fiscal policy context is what lasting consolidation efforts are all about. Hence, successful austerity measures will typically involve a fiscal regime change. To ensure that there is no return to deficit finance afterwards, fiscal policy must undergo a change of its core paradigms. During such a transformation, all three dimensions of the fiscal regime – policies, politics, and institutions – are modified. These changes of the political setting remain effective beyond the consolidation itself because fiscal regimes are both difficult to build and difficult to reverse.

Building a new fiscal regime requires the rare combination of a fundamental delegitimization of the old regime and the political will to invest large amounts of political capital in often unpopular reforms. The collapse of an old regime is often triggered by a severe fiscal crisis. This crisis may be the result of the gradual erosion or the rapid deterioration of public finances, for example, in the wake of a bursting bubble. In both cases, the old fiscal regime appears to be fundamentally exhausted and unable to offer an effective response to the crisis. This collapse of the old regime is not only visible in deficit and debt ratios but is typically accompanied by high current account deficits, a massive fall in the exchange rate, spikes in interest rates, credit-rating downgrades, and other crisis symptoms. These dramatic events open a policy window for institutional reforms that would have been inconceivable in pre-crisis times. However, while fiscal crisis is necessary if regime change is to occur, it will not be a sufficient cause by itself. Without a strong commitment to consolidation by the relevant political actors, it could not happen. Only the combination of a fiscal crisis and the political will to impose austerity makes a fiscal regime change possible.

Reversing a new regime is even more difficult, as new regimes create self-reinforcing effects. First of all, these effects show up in specific *policies*. Under prolonged austerity, all public policy becomes "fiscalized": whatever the substantial merit of a program, it is primarily evaluated by its budgetary impact. As White and Wildavsky pointed out with regard to the US budget struggles of the 1980s:

> Political time is counted not in years but in issues; a political era is defined by the concerns that dominate debate and action, so that about other issues we ask: How does that affect———? … Now we are living in the era of the budget. … Virtually all other issues are discussed and decided in terms of impacts on the deficit. (White/Wildavsky 1991: xv)

In such a climate, all spending initiatives that might contribute to new deficits are judged critically. This particularly restricts investment, which used to be debt financed but has to be funded from current revenues under the new circumstances. Also, long-term commitments to new programs are hard to make, as they have an adverse effect on the budget outlook. Instead, politically smart governments may opt for "end-of-year

spending sprees" that can result in a pattern of – sometimes quite large – one-time measures, but relatively few long-term commitments. These developments on the expenditure side are often supported by changes in the tax code, such as the abolishment of bracket creep or a shift from income taxation to indirect taxes on consumption. Such changes tend to make the tax code less progressive. They also put an effective lid on raising more revenue. Without bracket creep, an increase in revenue requires raising tax rates – something that is politically difficult at any time, and particularly after consolidation, when fiscal stress cannot be cited as an argument any longer.

The *politics* of fiscal policy are affected on three levels: First, the specific interests of important constituencies change when fiscal policies change. Second, consolidation reduces the political clout of some constituencies and strengthens others. Third, political parties adapt their electoral strategies to the new fiscal environment. The first effect arises because austerity affects the position individuals have in a political economy. This happens, for example, when the state pulls out of previously important policy fields. By reducing the public sector involvement in the provision of certain goods – e.g. by privatizing their production – the state weds their consumers to the market, to use Esping-Andersens (1990) memorable terminology. When middle classes no longer receive essential services like health care or education through the public sector and have to purchase them on the market, disposable income becomes increasingly important to them. Hence, middle class constituencies become relatively more supportive of tax cuts compared to expenditure increases. The same mechanism holds for the privatization of public housing stocks, which makes new homeowners increasingly conscious of interest rates and changes their preferences regarding social spending (Castles 1998; Schwartz 2012).

The reason for the second effect is that austerity does not affect all budget areas equally. While some items are cut massively, others suffer only symbolic retrenchment or none at all. This differential rate of contraction triggers a reconfiguration of the relative power resources of interest groups and policy coalitions. For example, public sector unions lose political influence when the public sector shrinks and fewer and fewer voters are employed directly by the state. More generally, tax-cut coalitions tend to benefit from consolidation, while spending coalitions are weakened as consolidation moves individuals from being net beneficiaries of fiscal redistribution to being net contributors to it. This affects both the defenders of existing spending programs and the proponents of new spending initiatives.

The third effect occurs because consolidation programs also have an impact on partisan politics and the strategic considerations of both government and opposition parties. Solving a debt crisis comes at great political cost as governments usually face vigorous resistance to cuts in public spending. Hence, to solve the fiscal crisis, it is necessary to invest a lot of political capital. At the same time, balancing the budget is a huge political victory, which is why successful consolidation governments are often re-elected (Brender/Drazen 2008). Consequently, re-elected governments are unwilling to risk their hard-won image as responsible guardians of the public purse once the crisis has

been overcome. Reversing their own policy legacy would devalue their invested political capital stock. At the same time, opposition parties are eager to show that they are as fiscally responsible as the government, in particular when they can be blamed for being in government during the preceding fiscal crisis. Thus, they are reluctant to argue for a return to a more activist policy stance. This bipartisan commitment to tight fiscal policies is further underwritten by the general economic climate. Successful consolidations typically coincide with a general improvement of economic conditions: growth picks up, unemployment figures drop, and the current account deficit disappears (e.g., Perotti 2011). While these economic achievements are as much a cause as an effect of the successful consolidation, they lend substantial political legitimacy to continuing the austerity course (for opposing positions see Alesina/Ardagna 2009; Guajardo/Leigh/Pescatori 2011).

Besides policies and politics, *fiscal institutions* are profoundly transformed by a crisis-induced regime change as well. The budgetary framework is changed toward a more permanently austere design. Typical instruments are the introduction of a – politically or even legally binding – surplus target or a "debt brake." Some countries also introduce legislated expenditure ceilings that limit the available financial resources for policymakers during the annual budgeting process (Ljungman 2008). These ensure that higher-than-expected revenues are not used for new spending but for reducing the debt. At the same time, they can be used for tax cuts and tax expenditures, as these are not counted against the ceiling. Such reforms are often complemented by the creation of new institutions to enforce fiscal discipline, like fiscal councils, or by transferring competencies to independent central banks. In the same spirit, new transparency requirements for fiscal policymakers can be introduced (Lienert 2010). Finally, governments may resort to deliberately pessimistic forecasting methods to make sure that budget plans have only upside but no downside risks (O'Neill 2005). These institutional changes remain in place when the consolidation is over. While their purpose in times of consolidation is to *force* politicians' hands to cut expenditure, they now *bind* politicians' hands, preventing them from engaging in substantial new initiatives. The effect is that political space remains restricted, even if fiscal space increases.

Talking about a fiscal *regime* emphasizes that these transformations reinforce each other and become interlocked: institutional reforms affect the policies that are being introduced, new policies alter the composition of political interests, changing interest structures affect party strategies that in turn lead governments to adopt new institutional reforms, and so on. This does not mean that regime changes are irreversible. A regime can be brought down by exogenous shocks like a financial crisis or by endogenous erosion. For example, the economic rationale behind the regime may disappear when all public debt is paid down or when pre-saving for demographic change ceases to be necessary. Nevertheless, in the immediate aftermath of a successful consolidation, austerity will be firmly entrenched.

These theoretical considerations make us deeply skeptical about the predictions of the progressive consolidation view and about the assumption that surpluses and deficits can be treated as symmetric. In the rest of the paper, we substantiate this skepticism empirically. We analyze countries where consolidations were followed by a decade of almost uninterrupted budget surpluses. In principle, these countries did have fiscal space for active policy measures, but they made little use of it and kept a tight lid on spending. Hence, the predictions of the progressive consolidation view do not hold. Just having a surplus does not change the underlying institutional and political commitments to austerity which made the surplus possible in the first place.

We argue that what arises from the ashes of the old regime is a specific variety of an austerity regime (Pierson 2001) that we call a *surplus regime*. In the ideal typical surplus regime, attaining a budget surplus is defined as the dominant goal of fiscal policy, and policymakers behave accordingly. This is not caused so much by an affirmation of surpluses but by a rejection of deficits. This is what makes the preceding crisis so important: it creates an ideational resistance to deficit-financed spending within the polity and determines macroeconomic priorities. Balancing the budget replaces balancing the economy as the most fundamental goal of fiscal policy. Generating a surplus every year becomes the new normal, and all political parties commit themselves to this goal. While there is disagreement between the parties about the use of the surplus, no one questions its existence. The institutional reforms, political commitments, and ideational changes related to the goal of fighting the deficit remain in place, exactly because these reforms were instrumental in overcoming the deficit. The combination of these mutually reinforcing trends makes the surplus regime durable and also influences the political discourse. Consequently, the fiscalization of public policy does not disappear, and new policy initiatives remain on the defensive.

3 Research design and case selection

To examine the empirical validity of the progressive consolidation view, we look at those countries that have been running budget surpluses for an extended amount of time. These countries generated fiscal room for maneuver that was – at least theoretically – available for new policy initiatives. This is also why we do not look at all consolidation episodes but only at those leading to surpluses: a consolidation that just reduces the deficit to a lower number may indeed ease the pressure on fiscal space but will not increase it again. Even if it causes the debt-to-GDP ratio and the relative interest burden to shrink, additional room for maneuver is only gained at a painfully slow pace. In contrast, a surplus generates “free cash flow” that can potentially be used to reverse

the decline of fiscal discretion.[2] The selection of budget surpluses in a set of 19 OECD countries results in 21 instances of countries achieving a surplus between 1980 and 2010 (Appendix 1).[3]

As we are aiming for a long-term perspective, we restrict the selection of cases to those countries where the surplus was retained for an extended amount of time. As consolidation efforts typically go on for several years, post-consolidation developments should also be evaluated in such a medium-term timeframe, especially because the task of expanding public infrastructure and developing a social investment welfare state takes several years. Of the surplus cases identified, all except six maintained surpluses for five years or less, and the six countries maintained them for ten years or more.[4] It is these six countries with sustained surpluses that we focus on (Table 1; Appendix 2 shows the development of budget balance and net debt by country). Because they developed more or less in parallel during the second half of the 1990s, they are as causally homogenous as is possible in such comparisons. The other cases of surplus can also be excluded on the grounds of the internal logic of the progressive consolidation view, which posits that balanced budgets are a means to increase fiscal capacity. As these countries lost their surpluses quickly, the necessary condition for the progressive consolidation view was not fulfilled. The same holds true for consolidations without surpluses. If these countries were able to increase discretionary spending, it was not by running balanced budgets, but by ceasing to do so.

By analyzing these six countries, we take successful and sustained budget consolidations as the scope condition and not, as the consolidation literature would do, as the *explanandum*. We intentionally leave aside the reasons for running surpluses and focus instead on their consequences. In other words, the endpoint of the consolidation literature, which tries to explain the success of budget consolidations, is the starting point here. We ask whether the availability of fiscal space does indeed lead to a reassertion of fiscal capacity. Surplus countries are an ideal test case for the idea that bringing down the public deficit is a way to overcome the need for fiscal austerity and to return to a more activist fiscal policy stance. With healthy surpluses and very low debt-to-GDP ratios, these countries were relatively immune to financial market pressures often cited as a source of austerity policies (Streeck 2013: 117ff.). Furthermore, the available fiscal

2 This is also why we look at overall budget balances and not primary balances. The symbolic importance of staying in the black also indicates the need to distinguish between a primary surplus and a proper budget surplus.

3 We exclude Ireland, Luxembourg, and Norway from the analysis, although all three countries had substantial surpluses. However, the Irish surplus was just an artifact of an overheating economy (as we know today, the cyclically adjusted balance was in deficit most of the 2000s, although this was perceived differently at the time). Luxembourg and Norway benefit from unique geographical/geological circumstances.

4 We exclude Finland in the 1980s to ensure comparability, both because of the peculiarities of the Finnish political economy at that time and in order to restrict the inquiry to the parallel consolidation efforts of the 1990s and its aftermath. In particular, the Finnish surplus did not follow a consolidation period.

Table 1 Additional fiscal space in six countries in percent of GDP

Country	Surplus starts in	Average surplus	Net Debt		Interest payments	
			in t–1	in 2007	in t–1	in 2007
Australia	1998	0.86	21.2	–7.3	2.6	0.6
Canada	1997	0.98	68.5	22.4	5.3	0.6
Denmark	1999	2.39	35.1	–3.8	2.7	0.4
Finland	1998	3.48*	–14.6	–72.6	1.8	–0.6
New Zealand	1994	2.68	50.5	–5.0	3.2	0.1
Sweden	1998	1.23	24.6	–22.4	3.0	0.7
Average		1.94	30.9	–14.8	3.1	0.3

* Includes a social security surplus of 2–3 per cent of GDP.
Source: OECD Economic Outlook Database.

space allowed them to decide whether they would cut taxes, increase spending, or repay the public debt and accumulate assets. According to the progressive consolidation view, these countries should have used the newly won fiscal space to increase discretionary spending quite substantially again.

As Table 1 shows, the increase in fiscal space in these countries was indeed sizable. Not only did they have the annual surplus available for political decision making, they also turned from a net-debtor to a net-creditor position.[5] The resulting decline in the interest burden opened up considerable new space in the budget. How this space was used is the main question of interest here. Before we answer it, a note on the arithmetic of budget surpluses: by definition, the budget balance is a residual number, defined as the difference between public revenue and public expenditure. Thus, "using" a surplus, either for cutting taxes or for increasing expenditure, technically makes it disappear. We apply the term "use" here to refer to budget decisions made in surplus years. The idea is that the "use" of a surplus can be examined by following the development of public revenue and expenditure.

We begin our examination of the validity of the progressive consolidation view with a quantitative analysis of the six cases. In this analysis, we focus on their commonalities, not on their differences. We ask how major forms of expenditure developed during and after consolidation as well as what happened to taxation. After that, we elaborate on the quantitative results with an in-depth case study of the Swedish budget surplus. Sweden was governed by one of the main proponents of the progressive consolidation view, the Social Democrats, from 1994 until 2006. The Social Democrats designed the fiscal consolidation of the mid-1990s and had almost ten years to determine the allocation of the surpluses. Furthermore, Sweden is seen as the incarnation of the Social Democratic welfare state and has a very strong tradition of an ambitious and interventionist fiscal policy with a high propensity to invest in public infrastructure, soft and hard. Sweden is thus a *most likely case* (Rohlfing 2012) for the progressive consolidation view.

5 Net debt, with all the difficulties of measuring it, is still a better measure than gross debt, as surplus countries typically refrain from paying down all their outstanding gross debt but keep it at a constant level. For example, Australia kept gross debt at 15 percent of GDP while accumulating net assets in the so-called "Future Fund."

4 Comparative results

We start by describing the developments in the six surplus countries in very broad strokes. The main question is how different budget categories developed relative to each other during consolidation and during the surplus. We first look at the consolidation periods that preceded the surpluses.

Generally, the budget consolidations were heavily focused on the expenditure side of the budget. Table 2 shows changes in cyclically adjusted current revenue and cyclically adjusted current expenditure between the year when the deficit peaked and the first surplus year. While the improvement in the budget balance could partially be attributed to better economic conditions, in particular in Sweden and Finland, structural adjustments accounted for the majority of improvements. On the structural side there is a marked difference between revenue and expenditure: revenue stayed almost flat during the consolidation, while expenditure was cut dramatically.[6] This is especially true for Canada, Finland, New Zealand, and Sweden, less so for Denmark. The only exception to this pattern is Australia, where most of the consolidation was revenue driven. This has to do with a changing government: the Labor government, in power until 1996, tried to balance the budget on the revenue side, while the incoming National government focused on the expenditure side. All expenditure savings happened between 1996 and 1998.

We suggested above that consolidations would not affect all budget areas equally. Following Castles (2007), the most encompassing measure to test this argument is net core expenditure: public expenditure net of interest payments minus social expenditure. Column (4) shows the share of net core expenditure in total net expenditure:

$$\frac{\text{net core expenditure}}{\text{net core expenditure} + \text{social expenditure}}.$$

If this share falls, the share of social expenditure rises by definition. On average, the share of net core expenditure declined during the consolidation period, confirming the result that the traditional welfare state was relatively protected on the aggregate level (e.g., Castles 2006). Finally, column (5) shows the development of (hard) public investment, measured as gross fixed capital formation as a percentage of GDP. Nowhere was investment higher than 4 percent of GDP, hence an average retrenchment of 0.3 percent of GDP is quite substantial, again in line with the existing literature (e.g., Breunig/Busemeyer 2012). Altogether, the consolidations in surplus countries conform to the stylized facts of the empirical literature on successful budget consolidations: they are expenditure driven; they cut core expenditure more than social expenditure; and relative to their budget shares, investment is cut more than consumption expenditure.

6 There has recently been well-justified criticism of using cyclically adjusted budget data for classifying consolidations (Guajardo/Leigh/Pescatori 2011). However, these authors' narrative method confirms the results of Table 2 for Australia, Canada, Finland, and Sweden. New Zealand is not part of their dataset, and Denmark's role is somewhat ambiguous, which is in line with our table.

Table 2 Consolidations preceding surpluses, in six countries

		Δ Budget balance	Δ Cyclically adjusted revenue	Δ Cyclically adjusted expenditure	Δ Share of net core	Δ Gross fixed capital formation
		(1)	(2)	(3)	(4)	(5)
Australia	1992–1998	6.9	3.8	–1.1	–7.2	–0.5
Canada	1992–1997	9.3	0.3	–6.5	–0.3	–0.6
Denmark	1993–1999	5.2	1.0	–1.5	0.1	–0.2
Finland	1993–1998	9.8	–0.4	–4.4	–0.3	0.1
New Zealand	1990–1994	7.2	–1.6	–6.6	–3.4	0
Sweden	1993–1998	12.1	1.2	–4.1	–3.4	–0.6
Average consolidation		8.4	0.7	–4.0	–2.1	–0.3

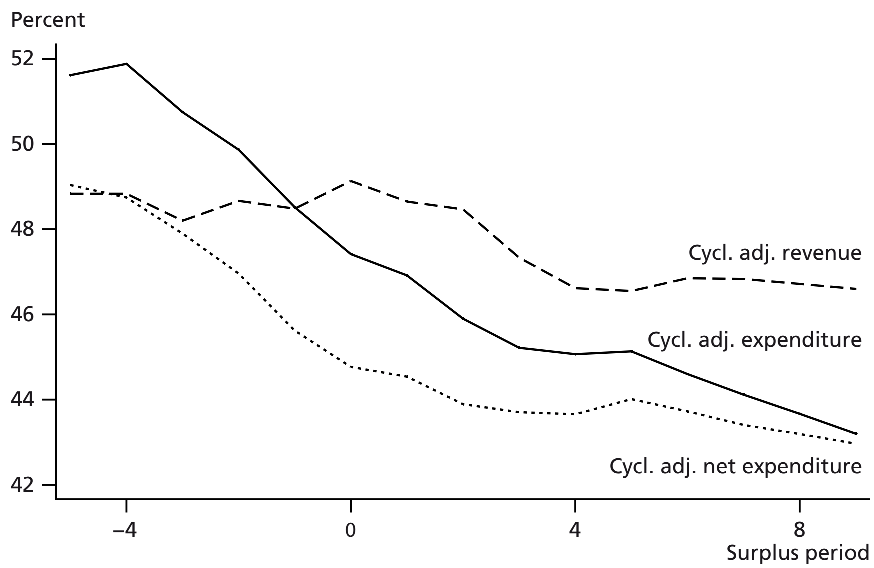
Source: OECD Economic Outlook Database.

We now proceed to examine the progressive consolidation view's promise that consolidation will result in greater fiscal capacity afterwards. A first look at the most general budgetary categories reveals that proponents of activist fiscal policy face an uphill battle. As Figure 1 shows, total expenditure kept falling during surplus years, even if interest payments are excluded. Whereas the progressive consolidation view would predict that net expenditure converges upwards toward gross expenditure with a falling interest burden, the opposite happened: gross expenditure converged downwards toward a further falling net expenditure. Revenue also started to decline, indicating a political preference for tax cuts over discretionary spending. While it is not surprising that fiscal policy was kept tight during surplus years (because otherwise there would have been no surplus), it actually tightened even further. The additional money for public investment thus had to come from other expenditure items.

Again, the broadest measure of fiscal capacity is the development of core expenditure. Figure 2 plots the relative shares of core expenditure and social expenditure in total net expenditure over time. As the figure shows, core expenditure kept falling throughout large parts of the surplus period, with only a slight uptick at the end. Still, after ten years of surpluses, core expenditure still accounted for a lower share of net total expenditure than at the beginning of consolidation. The larger part of the parallel decline of net total expenditure by more than 6 percent of GDP was thus suffered by core expenditure.

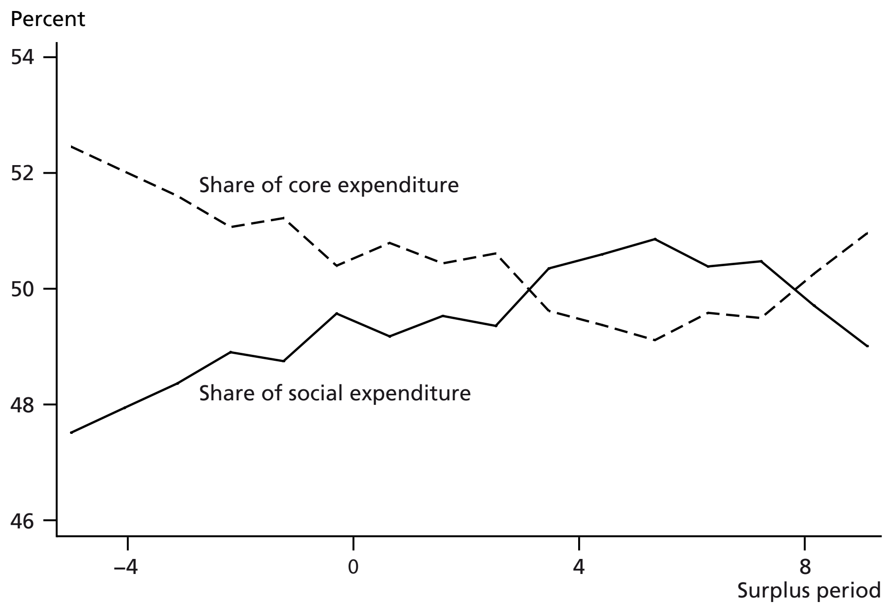
Aggregate expenditure is an extremely abstract measure of state capacity. Proponents of the progressive consolidation view may argue that under the surface of a declining aggregate there could be a shift in budgetary priorities toward investment. This view is confirmed somewhat by a look at gross fixed capital formation, though not by education, the most important form of soft public investment (Figure 3). There is no reversal of the decline during consolidation; if anything, education expenditure declined even further. Even hard investment stayed depressed for several years before its share of GDP started to rise again. It took nine years in surplus before it had reached pre-consolidation levels again – on average.

Figure 1 Cyclically adjusted revenue and expenditure as percent of GDP



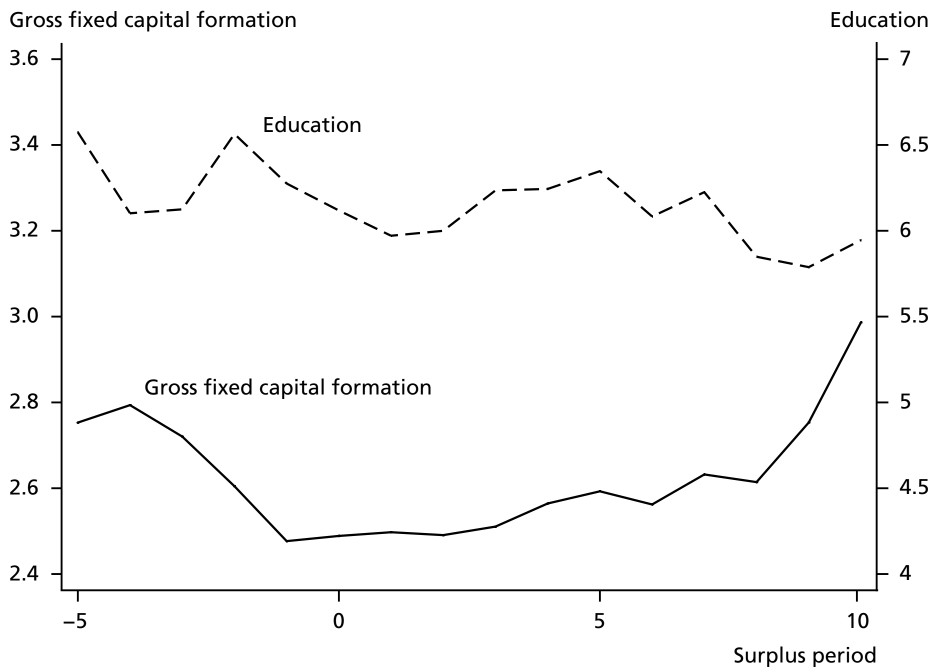
"0" is the first year in surplus per country.
Source: OECD Economic Outlook Database.

Figure 2 Cyclically adjusted revenue and expenditure as percent of GDP



Source: OECD Economic Outlook Database.

Figure 3 Gross fixed capital formation and education expenditure as percent of GDP



Source: OECD Economic Outlook Database.

So far, we have only looked at averages. However, these are not the random outcome of six totally divergent developments but usually a pretty good representation of all cases. Appendix 2 shows the different indicators country by country. There is one important exception, which is hard public investment. As can be seen in Figure A2-6, the surge in gross fixed capital formation is almost entirely driven by New Zealand, where its share of GDP almost doubled. In the other five countries, it stayed flat or rose only slightly. The easiest way to make sense of New Zealand's exceptional performance is that it had a particularly high pent-up demand. New Zealand traditionally had the biggest public capital stock in the OECD and thus had correspondingly high replacement needs. Still, the observed pick-up was not enough to reverse the consolidation effects: Kamps (2006) estimates that New Zealand's government net capital stock declined from 102 percent of GDP in 1990 to 75 percent in 2001.

The descriptive evidence presented so far underlines our skepticism toward the progressive consolidation view, although it does not constitute a proper refutation. After all, it is based on just six cases, and there may be other reasons for the disappointing development, such as partisan preferences, globalization pressures, or slow economic growth. It is therefore necessary to control the development in surplus countries for these factors. To this end, we return to the work of Boix (1997). Boix regressed public investment on the budget balance of the previous year and found a significant positive coefficient for the interaction of deficits and left governments. In this, he treated deficits and surpluses symmetrically. He also derived a similar result for education, using different methods.

Table 3 Regression results

	Netcore	Gfcf	Educ	Ca_rev	Tax	Tax_ip
Balance t–1	0.162***	0.017***	0.009	–0.052**	–0.060***	–0.042**
	(0.018)	(0.004)	(0.005)	(0.017)	(0.015)	(0.013)
Growth t–1	–0.120**	0.013	–0.016	0.104**	0.123***	0.128***
	(0.043)	(0.008)	(0.012)	(0.037)	(0.031)	(0.025)
Gov_left t–1	–0.002	–0.000	0.000	–0.000	0.001	0.001
	(0.001)	(0.000)	(0.000)	(0.001)	(0.001)	(0.001)
Trade	0.000	–0.001***	–0.000	0.000	–0.000	0.001
	(0.001)	(0.000)	(0.000)	(0.001)	(0.001)	(0.001)
Kaopen	–0.058	–0.037*	–0.015	–0.058	–0.009	–0.027
	(0.106)	(0.019)	(0.022)	(0.067)	(0.065)	(0.035)
Log_gdpc	0.344	0.025	0.217**	–0.336	–0.351	–0.078
	(0.347)	(0.059)	(0.079)	(0.244)	(0.193)	(0.172)
Int_r	0.097**	–0.001	0.017*			
	(0.033)	(0.005)	(0.008)			
Netcore t–1	–0.081***					
	(0.018)					
Gfcf t–1		–0.055***				
		(0.016)				
Educ t–1			–0.036*			
			(0.014)			
Ca_rev t–1				–0.007		
				(0.007)		
Tax t–1					–0.003	
					(0.009)	
Tax_ip t–1						–0.003
						(0.008)
_cons	–1.546	0.082	–1.989*	3.441	3.238	0.405
	–3.740	(0.610)	(0.805)	–2.475	–1.932	–1.674
N	497	530	430	517	532	532
r2	0.195	0.119	0.097	0.110	0.123	0.127

Panel-corrected standard errors in parentheses. The dependent variable is the annual change. The variables are explained in Appendix 3.
Source: See Appendix 3.

In a first step, we perform a regression along similar lines for net core expenditure, education, and public investment, using data from 19 OECD countries between 1980 and 2010 (Table 3, columns 1–3). Using a panel design, we regress the annual change of the dependent variables on their lagged level, the budget balance of the prior year, and a set of control variables, including growth, GDP per capita, interest rates, government partisanship and economic openness. In such a regression, we do indeed find a significant positive effect of the budget balance for all expenditure categories: the more positive (less negative) the budget balance, the more spending is increased as a share of GDP.

Note that our purpose here is neither to offer a full analysis of the determinants of public spending nor to evaluate the significance of specific explanatory factors. All we intend to show is that a fairly standard model does indeed uncover a statistically significant correlation between deficits and the relevant expenditure categories. This is highly significant for net core expenditure and gross fixed capital formation while marginally insignificant

Table 4 Average residuals of regression for 68 surplus country-years

Variable	Average residual	Standard error of residual	p-value
Net core expenditure	–0.4950	0.0761	0.0000
Gross fixed capital formation	–0.0300	0.0198	0.1339
Education expenditure	–0.0991	0.0343	0.0054
Cyclically adjusted revenue	0.0644	0.1136	0.5729
Tax revenue	–0.0114	0.1029	0.9118
Taxes on income and profit	0.0314	0.1087	0.7735

Source: See Appendix 3.

for education expenditure. These results are robust to a variety of model specifications, including a specification with country and time fixed effects. While these results seem to confirm Boix at first, our argument is that using these results to forecast the development of public spending in surplus years produces overly optimistic predictions.

To show this, we analyze the residuals of the predicted values of the regression. By definition, the average residual is zero. However, it may be significantly different from zero for specific subgroups. For these subgroups, the regression either under- or over predicts the annual expenditure changes. Hence, in Table 4 (rows 1–3) we look at the average residual for the cumulative 68 years our six countries spent in surplus. It shows a systematic overprediction of all three spending categories in surplus countries: on average, net core expenditure grows by almost 0.5 percent of GDP per year less than predicted by the regression. For gross fixed capital formation, the respective number is 0.03 percent of GDP, though this is marginally insignificant. For education expenditure, it is 0.1 percent of GDP, again highly significant. Thus, while the regression results seem to confirm the progressive consolidation view at first glance, a closer inspection shows that the result breaks down exactly where it is most important. This is not to say that budget balances have no effect on expenditure in surplus countries. If we repeat the regression for surplus years only, we still get a significant positive effect of the budget balance: the higher these countries' surplus, the more they spend. But this effect starts from a significantly lower level.

If surpluses were not used for higher spending, where did they go? To answer that question, we look at the development of taxation during the surplus period (Table 3, columns 4–6). Looking at the effect of the lagged budget balance, we see again a highly significant effect: *ceteris paribus*, higher deficits are followed by higher taxes. In Table 4, we analyze the residuals of this regression. In contrast to the expenditure categories, there is no systematic bias present. Revenue categories behave symmetrically during deficits and during surpluses. The tax-cutters' equivalent to the progressive consolidation view is indeed confirmed.

Overall, fiscal trends from consolidation continued during surplus years. Fiscal space, while created on the expenditure side, has mainly been used on the revenue side. Although governments were able to slightly reincrease public investment, there are no

signs of a general reassertion of fiscal capacity. In other words, budgets reacted asymmetrically to the growth and decline of fiscal stress. States shrunk during consolidation and stayed lean during surplus. While taxes were cut as expected, expenditure remained subdued to keep the budget in surplus.

5 The Swedish case up close

As noted above, Sweden can be regarded as a most likely case for the progressive consolidation view. However, the quantitative comparison above already suggests that our results tell a different story. The following case study deals with the political-economic processes and reforms that lie behind this result. The analysis exemplifies how a surplus regime was created in Sweden, how it has structured the country's policies, politics, and fiscal institutions in the last two decades, and what the consequences are for the Swedish polity.

The following sequence of fiscal-regime change occurred in Sweden: First, a severe fiscal crisis put enormous pressure on political leaders to cut spending and implement far-reaching austerity measures. This crisis can be seen as a critical juncture in the development of Swedish fiscal policy. Second, Swedish politicians successfully pushed through a consolidation program. Thereby, new fiscal institutions and logics of a different fiscal regime were created. Third and finally, in the post-crisis years, the newly established surplus regime became embedded in the political discourse and the fiscal culture of the country.

Sweden experienced a severe multilayered crisis at the beginning of the 1990s. Public finances, the economy, the banking system, the exchange-rate regime, and the housing market were all in a state of emergency. The annual deficits reached double digits, and the public debt ratio almost doubled from about 45 percent of GDP in 1990 to over 80 percent in 1994 (OECD 2012a). The whole political-economic system was at stake, and the entire population had an intense feeling of national crisis.

Political leaders in both political camps reacted with an extensive reform program to restructure public finances and get the financial and economic crisis under control. The consolidation measures comprised drastic expenditure cuts and targeted tax increases. By April 1995, the austerity measures of the anti-crisis packages added up to 8 percent of GDP (Henriksson 2007: 6). The massive crisis was the trigger that made a paradigmatic shift of the Swedish fiscal regime and a wider political turn in many policy areas possible.

We now turn to the specific changes that helped establish and maintain a surplus regime. In the dimension of *policies*, all public programs have tended to become "fiscalized." In such a context, government activities in general and new spending initiatives in particular are mainly evaluated by their budgetary impact and not by other criteria. Furthermore, nearly all of the extensive expenditure cuts made during the crisis years have not been reversed since the crisis was over – although the fiscal space for new spending has been available for many years.[7]

Two major reforms during the 1990s have been particularly decisive in establishing the new fiscal regime: on the revenue side, the tax reform of 1990/91 and, on the expenditure side, the pension reform of 1994/98. The tax reform is often called the "tax reform of the century" because it was the most far-reaching tax reform in any industrialized country in the postwar period (Agell/Englund/Södersten 1996). Important features of the reform were the end of bracket creep, massive cuts of marginal income taxes, the introduction of dual income taxation on wages and capital, and a broadening of the tax base by eliminating loopholes and tax expenditures and by increasing consumption taxes.

Altogether, the reform of the tax system had regressive effects and lowered the tax yield. The official evaluation of the tax reform concluded that it was underfinanced and at first exacerbated the fiscal crisis (Agell/Englund/Södersten 1998). Furthermore, it had far-reaching, long-term implications that have been manifesting themselves only gradually over time. In particular, the elimination of bracket creep may have seemed unimportant in the short run, but it has had great impact on the development of public revenue in the long run. Since the great tax reform, Swedish tax policy has continued in the same vein. The new conservative government that took office in 2006 lowered tax rates further or abandoned some taxes completely. For example, the property tax was abolished in 2008. However, the tax relief never went so far as to threaten the budget surplus. For the election year 2014, the government has recently announced it will cut income taxes once more. It would be the fifth time since coming to power, and the tax relief would add up to 15 billion Swedish kronor.

The great pension reform of 1994/98 established a new pension system. A funded scheme was added to the widely reformed pay-as-you-go system. The reform meant "headway toward neoliberalization" with the intent to establish a "mass investment culture" in Swedish pension savings (Belfrage/Ryner 2009). Since the reform, the Swedish pension system has been completely independent financially from the budget. There is no longer any cross-subsidization from the public purse to the pension funds. Only the revenues raised by the pension system will be paid out. Considering the demographic development of an ageing population, it is very likely that the pension level will fall. If the contributions decline, the pension benefits will be automatically adjusted downward.

7 The only major exception is the increase in income replacement rates from 75 to 80 percent in 1997. However, the replacement rates were not fully restored to the pre-crisis level of 90 percent.

Faced with the choice of lowering pensions or increasing social expenditure, Swedish politicians chose the first option, even in times of surplus. Although public finances are in a very good shape and practically all Swedes are affected, the pension benefits were lowered in 2010. Projections say that this trend will be reinforced in the future.

The positive development of Swedish public finances and the ongoing budget surplus have changed Swedish *politics* and the debates on fiscal policy as well. It has become very difficult to support even a temporary return to deficit finance. Voices calling for increased public spending in line with the progressive consolidation view can hardly be heard in post-crisis Sweden. Running a surplus has acquired huge symbolic importance. All parties try hard to avoid the impression that they are behaving financially irresponsibly.

Therefore, government and opposition are outbidding each other in a race to see who can save more public money and spend less. This trend has intensified since debt crises have occurred in many other European countries. For instance, during the debates on the budget proposal for 2012, the social democratic shadow minister of finance, Magdalena Andersson, demanded more fiscal restraint from the government. The Social Democrats made a budget proposal that would have saved an additional 5 billion Swedish kronor compared to the government's budget (Gmeiner 2013: 12). This stance was also conveyed in personal interviews with social democratic politicians who are generally in favor of higher investment but not at the cost of increased public debt. An example is Leif Pagrotsky (2011), former minister for industry and trade:

> [W]e should talk about other things like savings, investments, and the like and assess them in the light of other priorities. Should Sweden take the Norwegian way of big public funds investing in the world or should we do other investments? But I do not want to see a return to higher debt levels. Low debt levels are an advantage.

A new logic of blame avoidance appears to be at work in Swedish politics, where no politician wants to be judged as profligate. There is consensus on running a surplus that is not seriously contested in either political camp, the media, or the electorate at the moment. For many years there has been no argument about the desirability of a surplus. The assumption that having a surplus is the hallmark of fiscal responsibility has remained basically unquestioned. Another reason why the surplus itself has never been called into question seems to be that, in the current fiscal environment, no one can profit from criticizing it. Running budget surpluses every year has become the new normal in Swedish fiscal policy.

These developments in Swedish public policies and politics are underpinned by a tight fiscal framework and fiscal *institutions* that foster budget discipline and strengthen the politics of running a surplus. Three major reforms will be discussed here: the new budgetary process with an expenditure ceiling as the core element, the surplus target, and

the prohibition of municipal deficits. These reforms have been embedded in a wider institutional configuration that benefits the creation of surpluses as well. Sweden joined the European Union in 1995 and has implemented all EU fiscal rules, like the Stability and Growth Pact with its Maastricht criteria. Furthermore, Sweden has given its central bank more competencies and independence from the government, thereby decreasing the likelihood of monetary policy accommodating fiscal policy. In 2007, a fiscal policy council was founded that advises the government and evaluates the state of public finances. Many fiscal policy decisions are now in the hands of experts and bureaucrats and can no longer be altered by elected politicians. A massive rebuilding of fiscal institutions has taken place in Sweden in the last two decades.

After the crisis, the Swedish budgetary process was fundamentally transformed. In the past, the budget had only covered the next fiscal year. However, since 1997, it has been planned for three years in advance and become much more hierarchical (top-down approach, Ljungman 2007: 3). The core element to enforce fiscal discipline is the rolling expenditure ceiling that sets binding limits for the nominal total government expenditure of the central state and the pension system. It is rolled each year, which means that – unless exceptional circumstances prevail – the ceilings for the first and the second year of the decision period are inherited from the previous year's decision (Molander 2001: 35). In other words, the aggregate spending decisions of the government have already been made when the annual budget is discussed. Furthermore, the parliamentary voting order on the budget has changed. Members of parliament are required to make an aggregate decision prior to allocation choices (Wehner 2007: 320). Once the overall spending level is fixed, budgetary items can only be increased if others are lowered to the same extent. The Riksdag cannot adopt a budget bill with higher government expenditures than the original proposal by the government (Persson 1996: 9). However, taxes can be cut further, as the ceiling only affects expenditure but not revenue. Of course, the government can spend even less than stipulated by the ceiling. For example, the incoming conservative government lowered the existing ceiling after taking office in 2006 (Ljungman 2008: 47).

Another important institution in Swedish fiscal policy is the surplus target, which stipulates that the Swedish central state has to run an average budget surplus of 1 percent of GDP over the business cycle. In 1997, the surplus target was introduced on a trial basis, and since 2000, it has been an official policy guideline for the government. In 2011, the surplus target was tightened once more. Since then it has become legally binding (OECD 2012b: 233). Experts judge the surplus target as the most important and most powerful fiscal institution to guarantee fiscal discipline (Finanspolitiska rådet 2009: 20). In practice, Swedish governments have even outperformed the legal regulations and saved more money than legally required. In the last two decades, Sweden has not only generated an average surplus over the business cycle, but has had structural budget surpluses in every phase of it – even in times of recession.

The last fiscal rule that strengthens the surplus regime is the prohibition of municipal deficits for consumption. It was adopted in 2000 and requires that all municipalities restrict their expenses or raise their revenues so that they can always show a balanced budget sheet (Finanspolitiska rådet 2012: 9). With such tight budgetary institutions, the Swedish government hardly has any discretion left for new spending initiatives. It is legally obliged to run a budget surplus under nearly all circumstances.

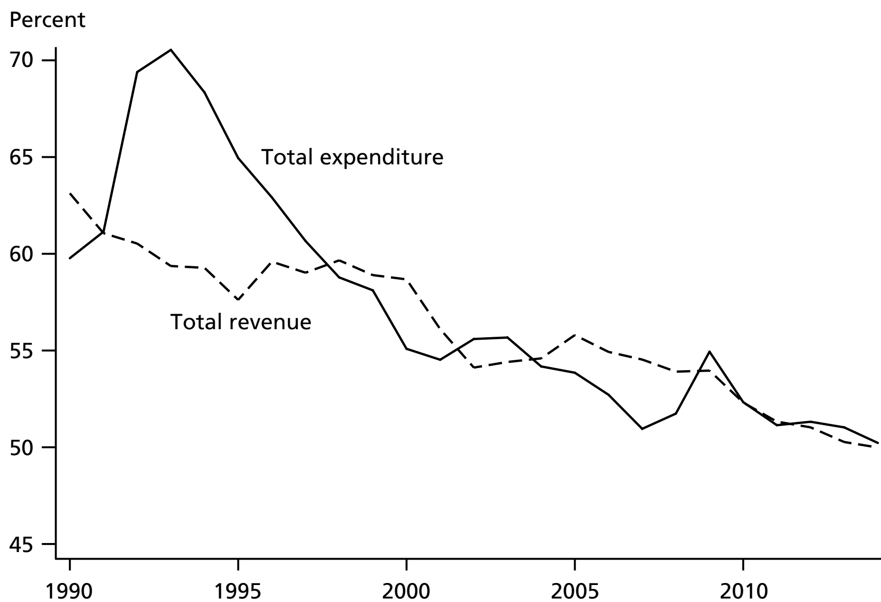
Summing up, a new durable fiscal paradigm that we call surplus regime has been established in Sweden since the great crisis of the early 1990s, with all its consequences for policies and society. Sweden has moved from a very expansionary fiscal regime to one of the most austere regimes in the developed world. All important dimensions of a fiscal regime have changed: policies, politics, and institutions. These trends in the political setting are likely to remain powerful in the foreseeable future: fiscal regimes are difficult to build because they require investment of political capital and overcoming stakeholder resistance. They are also difficult to reverse because of self-reinforcing effects, the sluggishness of institutions, and legally binding rules. The fiscal environment in a surplus regime imposes tough constraints on government activity and strongly defines Swedish politics.

So far the toughest test of the persistence of the surplus regime has been the deep recession of 2009. As a small and open economy, Sweden was hit hard by the global financial and economic crisis. That year the Swedish economy shrank by 5 percent (OECD 2012a). It was a sharper decline in economic growth than in any year of the 1990s crisis. However, sound public finances and not the stabilization of the economy remained the top policy priority of the Swedish government.

In 2009 Sweden experienced – for the first time in many years – a small budget deficit of less than 1 percent of GDP. The reasons for the insignificant deficit were less revenue, due to the economic slump, and higher expenditure, due to automatic stabilizers triggered by, for example, rising unemployment. It was not caused primarily by a government-induced and deficit-financed fiscal stimulus. The cyclically adjusted budget for 2009 showed a huge structural surplus (Calmfors/Wren-Lewis 2011: 679). The government did not significantly change their fiscal policy goals at the height of economic recession. It stuck to the surplus target and met the expenditure ceiling in every single year. Even the experts of the Swedish fiscal policy council criticized the government's policy and stated:

> It is our opinion that the expenditure ceiling should not be defended at any price during a deep recession. The expenditure ceiling has no value in itself. … If in a deep recession the regulatory framework instead limits the policy so that it is obviously ineffective, the short-term cost of keeping the ceiling, no matter what the economic situation, is too high.
> (Finanspolitiska rådet 2009: 14)

Figure 4 Public revenue ratio and public expenditure ratio in Sweden as percent of GDP



Source: OECD Economic Outlook Database.

However, if we look at the future trajectory of public finances, the path taken will most likely be continued. The medium-term financial forecast of the Swedish government for the years 2013–2015 projects a debt level of 30 percent of GDP for 2014 and 26 percent for 2015 (Maastricht accounting standards). The estimated annual surplus is up to 3 percent of GDP. The improvement of the budget balance would be achieved solely by expenditure cuts and not by revenue increases (OECD 2012b: 231).

The first political-economic consequences of two decades of surplus policy can already be observed. Although the Swedish state levies more revenue than it spends each year, the public revenue ratio and the public expenditure ratio have been shrinking constantly since the 1990s crisis. There is a steady decline of government activity in Sweden. The change of the fiscal regime is not only indicated by different policies, politics, and fiscal institutions, but by the spending numbers themselves, as Figure 4 shows. A clear and enduring decrease of spending and taxing can be seen. Public revenue and public expenditure have fallen by more than 10 percentage points in the last 20 years. Expenditure has fallen even faster than revenue, thereby generating the surplus.

Section 4 showed that core public expenditure was cut back to a greater extent than social expenditure. It has fallen from more than 35 percent to less than 25 percent in the last 20 years. In particular, important indicators for the progressive consolidation view, like spending on education and gross fixed capital formation, declined during consolidation and were not increased again in times of surplus. In Sweden, *soft public investment* has decreased more than in other advanced economies (Streeck/Mertens 2011).

While the biggest cuts were made on core expenditure, the effects of the continuous existence of the surplus regime did not spare the welfare state. The new fiscal regime has made it possible to retrench the very popular, universal, and generous welfare state that was once described as a practically "immovable object" (Pierson 1998). The Swedish welfare state is still one of the biggest in the world, but it has been slowly and gradually transformed. If this trend continues – which is likely – the Swedish welfare system will move more and more in the direction of a liberal model with basic public security supplemented by private topping-up (Mehrtens 2013).

The partial privatization of welfare services in combination with the lowered tax structure means a "great risk shift" (Hacker 2006) from the public to the individual and has already affected the socio-economic conditions in the Swedish society. One of the most obvious developments is the dramatic rise in inequality. The Gini coefficient increased from 0.19 in the 1980s to 0.26 in 2008. In the last 10 years, income inequality has risen faster in Sweden than in most other industrialized countries:

> The latest trends in the 2000s showed a widening gap between rich and poor … for the first time … in traditionally low-inequality countries, such as Germany, Denmark, and Sweden …, where inequality grew more than anywhere else in the 2000s. (OECD 2011: 22)

6 Conclusion

The fiscal crisis of the United States and the euro area foreshadows a period of prolonged budgetary austerity. Whether austerity programs will be successful remains to be seen, and if they are, it is uncertain what the long-term impact on the role of the state in the economy will be. Reformers adopting the progressive consolidation view promise that painful reforms will help reinstall the state's capacity for promoting economic welfare, but the empirical validity of this promise is unclear. The evidence presented here suggests that, even if (or especially if) austerity is successful in its own terms, there is reason to expect that its collateral damage to the expenditure side of the budget will remain in place.

This is not to deny that there are real benefits to running surpluses: countries with surpluses pay very low interest rates and are relatively well prepared for the ageing of their populations. Some of them enacted big stimulus programs in the extraordinary circumstances of the financial crisis in late 2008 – although not without hesitation. With regard to the central question of this paper, they have indeed been able to stop the drain on their investment expenditure. While being able to avoid further market-enforced retrenchment, they did not, however, systematically reincrease the activities of the state. The idea that surpluses are basically a mirror image of deficits proved to be unfounded.

Instead, where countries decided to allocate surpluses to political initiatives, they primarily opted for tax cuts. Sweden is a prime example of these developments. The public spending ratio has been falling for two decades, the tax burden has been lowered, and even the universal and generous welfare state has not remained unaffected. Especially in the social service sectors, a clear trend toward privatization and liberalization can be observed.

Furthermore, the analyzed countries achieved their surpluses exactly by cutting those spending areas that are generally perceived as crucial from a social investment perspective. The consolidation efforts in the 1990s were expenditure-led in all six countries, with sometimes harsh cuts to core spending areas. While the consolidation literature argues that expenditure-led consolidations are more likely to succeed than revenue-led consolidations (e.g., Alesina/Ardagna 2012), this paper shows that this success comes at a price, and that euphoria about a growing capacity of the state is certainly unjustified. Our medium term framework reveals that budget surpluses and shrinking debt are embedded in the political and institutional context of a surplus regime, which makes an activist use of the newly opened fiscal space rather unlikely.

We have argued that this regime is based on self-reinforcing processes which strengthen its foundations over time. However, the longer such a regime exists, the more it will also produce self-undermining tendencies: the progressive commitment to surpluses may be questioned when the collateral damage of low public investment becomes increasingly visible. The conservative commitment may be challenged when all public debt is paid off and the state becomes an important player in the private economy by investing its surpluses in financial assets. This opens up two potential avenues for a breakdown of the surplus regime. Structural deficits may return when expenditure is finally raised or when tax cuts become too big. At this point, it is purely speculative which result is more likely. Yet, we would argue that the recent debt crises in several advanced economies have helped prolong the life-span of surplus regimes at least over the medium term. As long as they remain entrenched, surpluses may not be a sign of the growing capacity of the state but rather of its shrinking ambition.

Appendix 1

Table A1–1 Budget surpluses in OECD countries, 1980–2010

Country	Budget surplus	Cyclically adjusted surplus
Australia	1998–2007	1988 ; 1997–2007
Austria	–	–
Belgium	2006	–
Canada	1997–2008	1997–2007
Denmark	1986–1989 ; 1999–2008	1986–1990 ; 1999–2008
Finland	1980–1990 ; 1998–2008	1980–1990 ; 1998–2008
France	–	–
Germany	2000 ; 2007–2008	2000
Iceland	1999–2000 ; 2004–2007	1999–2000 ; 2005–2007
Italy	–	–
Japan	1988–1992	1985–1991
Netherlands	1999–2000 ; 2006–2008	2000; 2005–2006
New Zealand	1994–2008	1993–2008
Portugal	–	–
Spain	2005–2007	2005–2007
Sweden	1987–1990 ; 1998–2008	1986–1990 ; 1998–open
Switzerland	2006–	2006-open
United Kingdom	1999–2001	1999–2001
USA	1998–2000	2000

Source: OECD Economic Outlook Database, European Commission.

Note that the definitions of budget balance used by international data providers do change frequently. For example, a surplus of the Swedish pension system was reclassified as part of the private sector in 2007, lowering the Swedish budget balance accordingly. The OECD today reports small deficits in Sweden in 2002 and 2003. However, European Commission documents from the time report surpluses.

Appendix 2

Figure A2–1 Development of budget balance as percent of GDP, by country

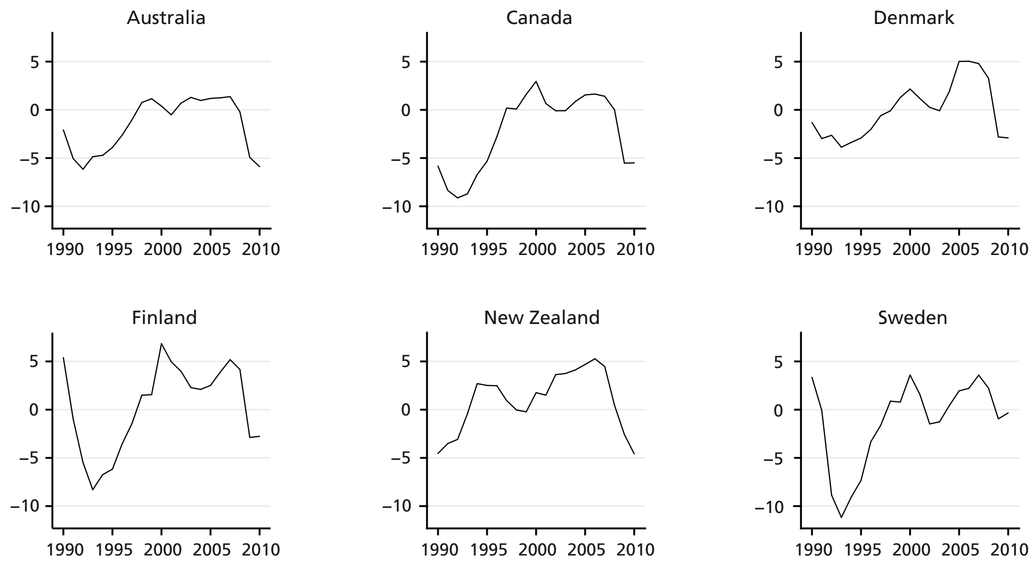


Figure A2–2 Development of net public debt as percent of GDP, by country

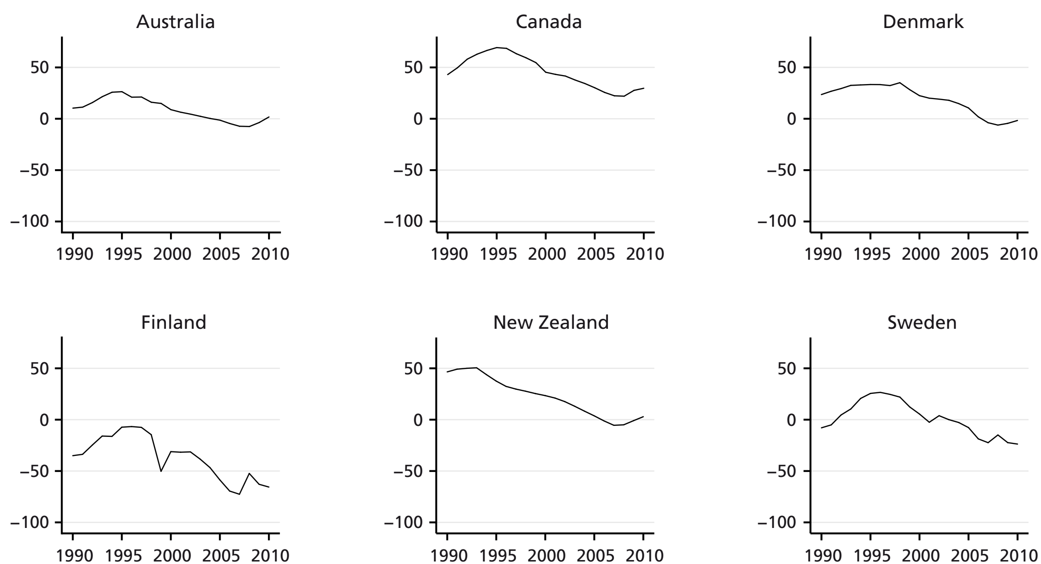


Figure A2–3 Development of cyclically adjusted revenue and expenditure as percent of GDP, by country

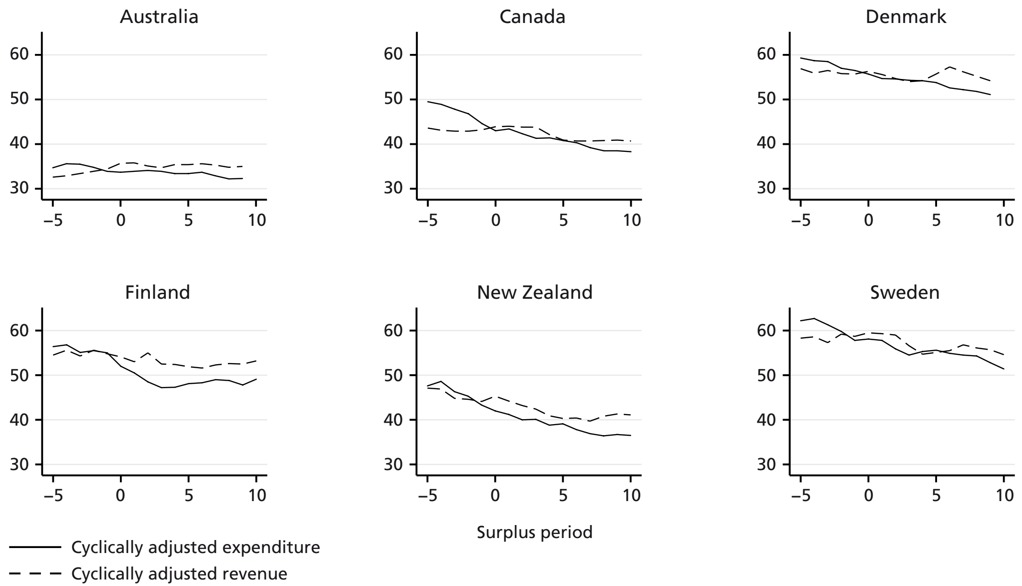


Figure A2–4 Development of cyclically adjusted net expenditure as percent of GDP, by country

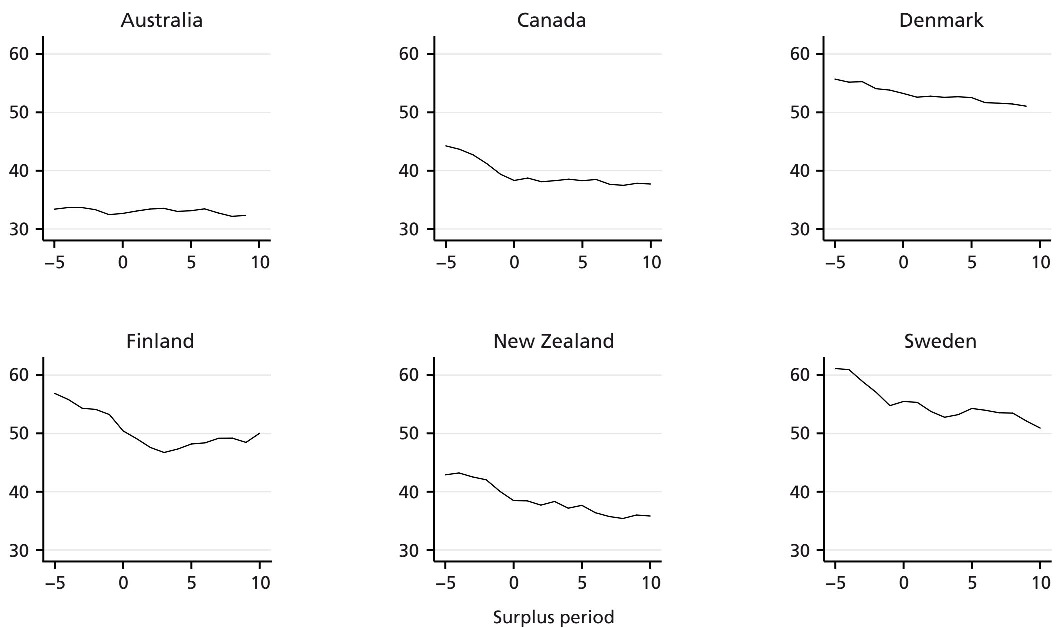


Figure A2–5 Development of net core expenditure as percent of GDP, by country

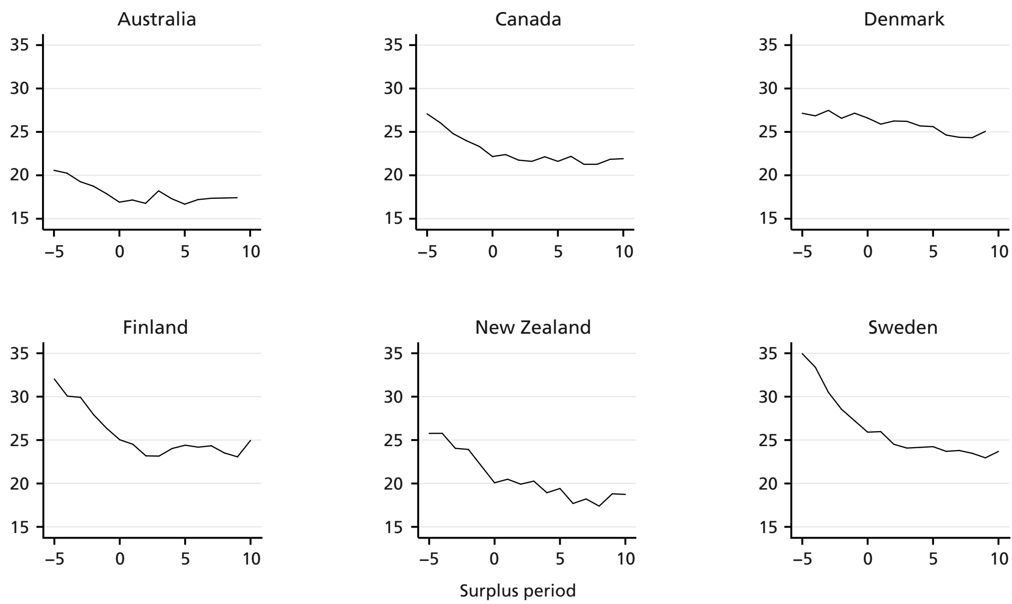


Figure A2–6 Development of gross fixed capital formation as percent of GDP, by country

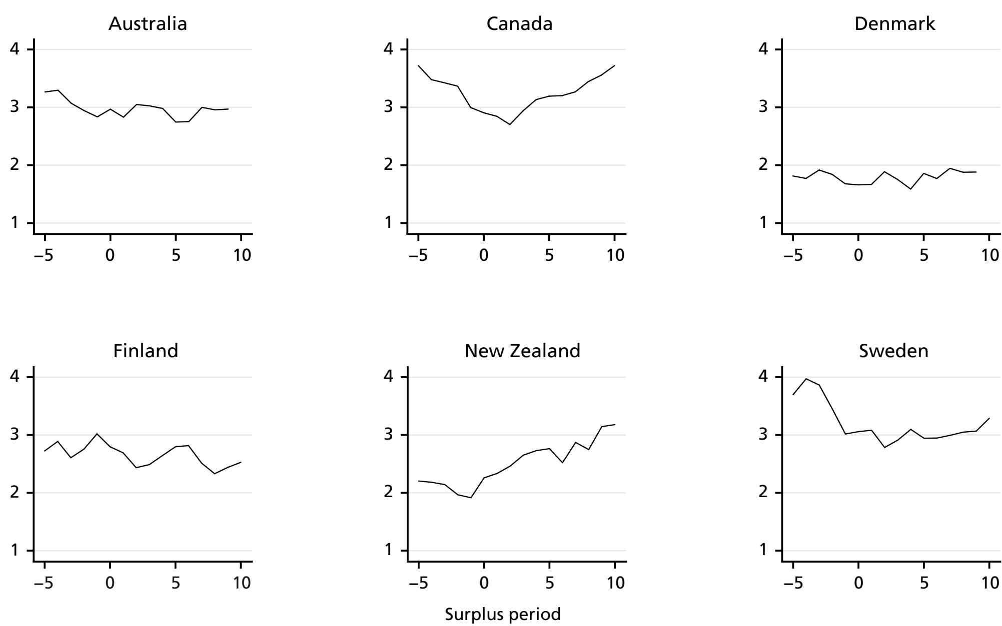
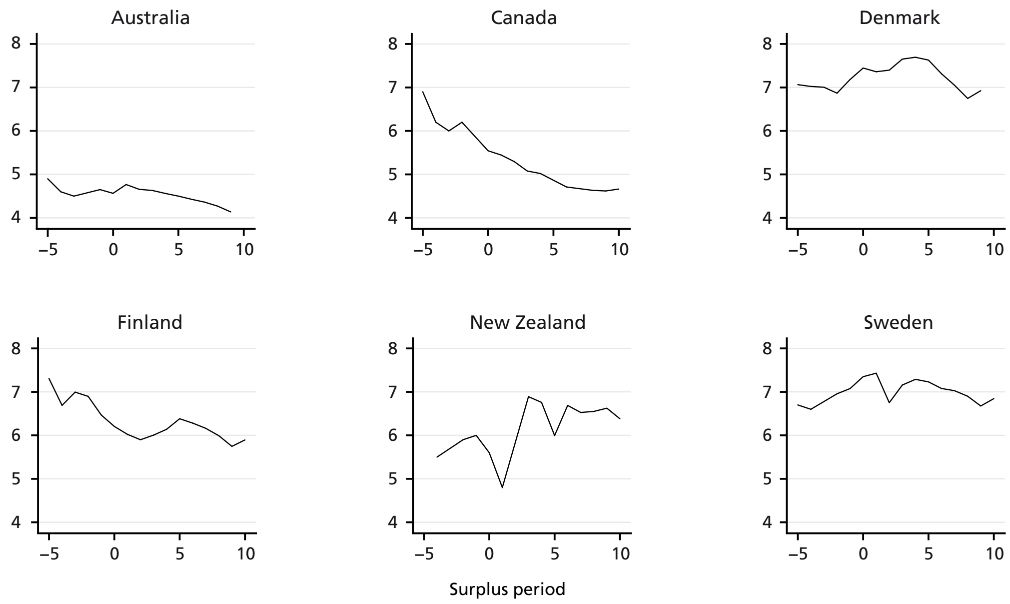


Figure A2–7 Development of education expenditure as percent of GDP, by country



Appendix 3

Variables used in regression for Table 3

Variable name	Definition
Balance	General government budget balance
Ca_rev	Cyclically adjusted current revenue of general government
Education	General government spending on education
Gdpc	Gross domestic product per capita
Gfcf	Gross fixed capital formation by general government
Gov_left	Share of left parties in cabinet
Int_r	Long-term interest rates on government bonds
Kaopen	Index for the extent of openness in capital account transactions
Netcore	General government public spending minus social expenditure minus interest payments
Tax	Tax revenue of general government
Tax_ip	Revenue from taxes on income and profit of general government
Trade	Total trade (sum of import and export)

Most variables are taken from the OECD Economic Outlook Database No. 92. Education data is supplemented with data from Marius Busemeyer (personal communication). Gov_left and Kaopen are from Armingeon et al. (2012).

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