PAPER SUMMARY

Belgian public finances caught up in a war of attrition

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Abstract

Fiscal problems are typically traced back to the motivations of opportunistic policymakers and hyper-active governments. In this paper, I am going to question this standard explanation by revisiting the story of Belgium's fiscal woes since the mid-1970s. The war of attrition model – originally developed by Alesina and Drazen (1991) – is used as a heuristic device that describes fiscal problems as a result of social conflict. It can grasp that it is the inability of different groups in Belgian society to renegotiate the rules governing redistribution that has been at the heart of the long-term deficit problem. While this finding may not be terribly original, the formal modelling reveals an alternative interpretation that has important implications for the theory of policymaking as well as for policy approaches to deficits. The model is based on the realization that deficits often arise from a combination of past decisions and exogenous shocks (i.e. a drastic change in the policy environment) rather than from suboptimal policy decisions in the present. Consequently, it puts emphasis on inaction – the inability to fix the lack of fit between old policies and new circumstances – and on the underlying causes rather than on motives behind socially harmful policy decisions. Hence, it traces fiscal problems back to fundamental divisions in society and assigns less importance to governments and politicians and their motivations.

The purpose of the paper

Fiscal problems – deficit and debt accumulation – their sources and possible ways to keep them under control have received much scholarly attention in the past few decades, to a large extent because of the increased urgency of such issues for many developed countries since the 1970s (e.g. Nordhaus 1975, Buchanan and Wagner 1977, Hibbs 1977, Cukierman and Meltzer 1989, Roubini and Sachs 1989, Carlsen and Pedersen 1989) Most of the theories that have been advanced trace the problem back to the interests of governmental actors that are at odds with the interests of the members of the polity as a whole[1]. This paper tries to investigate the potential of an alternative theory, that claims that the source of the problem is to be found in conflicts of interest among groups within the polity and their inability to resolve these conflicts in cooperative ways, rather than in the perverse incentives of policy makers.

A game theoretic model based on this alternative approach was developed by Alesina and Drazen in 1991, but while it had a seminal effect on the abstract modelling of fiscal policy decisions (e.g. Spolaore 2004, Hsieh 2000, Grilli and Drazen 1993, Bertola and Drazen 1993, Martinelli and Escorza 2006), its empirical application

[1] The different theories give different explanations for the discrepancy between the interests of policy makers and the electorate as a whole. "Political business cycle" models (Nordhaus (1975); Hibbs (1977); Carlsen and Pedersen (1989)) emphasize the motivation of governments to run deficits to engineer a temporary growth in income for their electorate to gain votes even though the temporary growth causes welfare loss in the longer run. "Common resource pool" models (Weingast, Shepsle and Johnsen (1981); Hagen and von Harden (1996)) explain the growth of public spending – even beyond available public revenues – by the drive of politicians to squeeze such public expenditure items into the budget that selectively benefit their constituents at the expense of public revenues paid equally by all citizens.

and testing has been sporadic and often compromised[2] by the lack of available data to test its validity in large-n studies (e.g. Alesina et al. 2006, Woo 2003, Padovano and Venturi 2001). This paper attempts to take a step towards the empirical application of the model by mapping its abstract variables onto empirically observable phenomena of the politics of fiscal policy – using the specific case of persistent deficits and ballooning debt in Belgium since the 1970s as a "pilot" case. The paper examines the nature of fiscal policy of the past four decades in detail – the size, structure and composition of public expenditures and revenues – as well as the political background of policy making, in order to establish patterns that can then be used to evaluate the merits of this alternative approach to fiscal problems in this specific case. A single case study obviously cannot serve as a test of the theory. Rather, this paper uses the example of Belgium to experiment with ways of applying this highly abstract game-theoretical model to elucidate concrete cases. In other words, it is using the model to develop an analytic narrative (Bates et al, 2003) in an effort not only to explain why Belgium was trapped in a fiscal quagmire for decades but also to develop a way to translate the abstract causal mechanism described by the model to a concrete case.

Belgium is a suitable subject for such an exercise for two reasons. On the one hand, it was an obvious problem-case for decades and therefore it allows for investigating persistent deficits under changing economic and political circumstances (i.e. under different cyclical and external economic conditions and changing governments). On the other hand, Belgium's improved fiscal performance under the effect of fiscal rules and institutions introduced by Maastricht – and later carried on by the Stability and Growth Pact – has been used by scholars advancing certain government-centred theories (Hallerberg 2000 and 2004, Bogaert et al 2004) as evidence for the claim that institutional settings that force governments to align their interests with those of the polity as a whole can lead to improved fiscal performance. Therefore, the Belgian case appears to be a challenge for a theory that denies the central role of the government and its special interest in the persistence of fiscal problems.

The alternative theoretical approach and the war of attrition model

The starting point of the alternative approach is that fiscal problems do not necessarily need to originate from within the policy making process, but could be caused by some exogenous factor. Most items of public revenues and expenditure are not budgeted on a zero-base each year, but are carried on from previous years, so if economic conditions change – for example long term growth slows, unemployment rises or interest paid on outstanding debt increases etc. – deficits can arise exogenously. Therefore, the key to understanding why some countries are plagued by persistent deficits is not finding out why these deficits arose, but investigating what prevents the adjustment of old policies to the new economic conditions, that could eliminate the gap in public finances and its potential negative consequences: higher inflation, high interest rates, economic instability etc.

[2] Compromised in the sense that these tests often oversimplify the model or modify its original key variables in an effort to find data for the tests.

The war of attrition model traces this delay in adjustment to the inability of groups within the polity to agree on who should bear the burden of the adjustment. Since closing the gap entails either cutting expenditure or increasing taxes, any specific adjustment package (a mixture of expenditure cuts and/or the raising of certain taxes and contributions) requires sacrifices from one or more groups within the polity for the sake of better general economic conditions. If the incidence of all possible adjustment packages is relatively uniform across groups represented in the policy making arena, the decision about the specific mix of tax raises and expenditure cuts is unlikely to be too contentious and thus stabilization is expected to be swift. However, if it is possible to design adjustment packages that allow any group with access to the policy making arena to free-ride at the expense of burdening other groups disproportionately, the representatives of such groups will try to influence policy making in a way that their constituency is exempted from contributing to stabilization. If all groups insist on trying to free ride, stabilization is delayed.

Thus, the likelihood that deficits persist (i.e. the likelihood of a considerable delay in fiscal stabilization after an exogenous negative shock to public finances) depends on two factors. On the one hand, it depends on the polarization of preferences with respect to the specific mix of tax raises and/or expenditure cuts – in other words, on the extent to which the divergent preferences can be clustered into distinct groups where the preferences within the groups are relatively homogenous, while the groups are far from each other. The higher the degree of polarization, the likelier the appearance of an entrenched conflict over the form of adjustment. On the other hand, the polarization will only cause disruption in policy making, if the conflict of interest between the groups is reflected in the policy making arena, too. For this to happen, the groups on each side of the conflict either have to approximately coincide with the constituencies of influential parties – that are likely to be coalition partners or form blocking minorities – or they need to be represented in alternative ways – for example through institutions of social partnership – in the policy making process.

In a sense, the war of attrition model is a version of the veto actor approach, because it traces the persistence of deficits to the resistance of different groups within the polity to specific ways of adjustment that assign too much of the burden to them. However, while the veto actor framework is static in the sense that the set of possible outcomes for a give constellation of opposing interests is fixed, in the war of attrition game, the determination of groups to block certain ways of stabilization changes with time. Since the negative effects of deficits grow larger, the longer they persist, the trade-off between being exempted from contributing to stabilization and having to live in an unstabilized economy changes. Therefore, after a while, even ways of adjustment that were blocked in the past might become viable as actors become willing to lift their veto. Thus, stabilization will happen in finite time, but it is delayed until at least one adjustment package gets a green light.

As long as the delay lasts, the government deals with the gap in public finances the best way it can. It can borrow money to cover it, it can monetize it to limit debt growth or it can cut expenditure on collective

consumption[3] and public investment – items that are less contentious than tax raises or entitlement cuts, because they affect private consumption to a lesser degree. All of these decrease the welfare of the members of the polity as a whole and this loss of welfare increases with time. The conflicting groups might suffer from the different ways of dealing with the delay to different extent. (For example, if the income of most members of a group is fixed in nominal terms, the group will suffer more from monetization than a group whose members' income grows with inflation etc.) As the welfare loss increases with time, each group has to decide whether the possibility that the other group might concede in the next moment is sufficient compensation for enduring the increasing welfare loss yet another moment longer.

According to the model, whichever group suffers the greatest welfare loss from the same level of inflation, cuts in public consumption etc., will come earlier to the point where it finds it better to give in and take a disproportionate burden of stabilization. If reliable information was readily available about the relative losses suffered by each group from the different ways of dealing with the delay in stabilization, the group that suffers the largest loss would find it in its interest to concede to bearing the larger share of stabilization right away, because it would be convinced that it will anyway be the one to make the concession and the earlier it gives in, the less welfare loss it has to endure from the delay in consolidation. However, in the absence of such information, the only way for each actor to test its chances to free-ride on other groups' efforts is to wait and see. It is this waiting that leads to the persistence of the deficit and the associated negative consequences.

According to the model, the length of the delay depends on

- the degree of asymmetry in the share of the burden to be borne by the different groups (i.e. the more polarized the polity is on how to share the burdens of stabilization, the longer the delay)
- the speed at which the problem escalates (i.e. the higher the interest rate at which the debt is compounded, the shorter the delay) and
- the welfare loss that the worst affected group suffers from the ways of dealing with the fiscal gap until long term stabilization becomes possible.

Stabilization can happen earlier than the time determined by these three parameters, only if the temporary ways of dealing with the problem become infeasible. This could mean an inability to borrow more, or to further cut public investment and collective consumption, but in a broader sense, such an "emergency scenario" can be interpreted as an escalation of the problem to a level which is perceived to severely threaten the future viability of the economy as a whole.

The Belgian case[4]

The fiscal history of Belgium since the 1970s corresponds on many points to the story told in abstract by the war of attrition model. First of all, the role of exogenous shocks in creating the deficit problem is obvious.

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[3] I use this term to mean „goods and services that are consumed simultaneously by a group of consumers or by the community as a whole: for example, defence services provided by the state" as defined by OECD. (See: http://stats.oecd.org/glossary/detail.asp?ID=5739)

[4] The statistical data quoted here are found on the Belgostat website.

Belgium's fiscal track record until the mid-seventies was not significantly worse than that of other European countries. All through the sixties, the financing requirement of the Belgian state barely ever exceeded 2% of the GDP and in the years preceding the first oil shock, the debt to GDP ratio was steadily declining. After the oil shock, however, deficit exploded and debt started to mount as the social security system - that had been considerably expanded in the high-growth years of the post-war decades – was flooded with a quintupled number of unemployed and early pensioners. This led to a rapidly widening gap in the social security budget, that reached 11.2 per cent of the GDP by 1981. The fact that the total primary deficit amounted to 7.5 per cent of the GDP in the same year shows the significance of the tippling of the balance of the social security sector and thus the effect of the economic crisis triggered by the oil price shock. This exogenous shock was compounded by the increase of world real interest rates around 1979-1980 (Barro and Sala-i-Martin 1993), which is partially responsible for the more than doubling of interest expenditures as a percentage of the GDP in the first half of the 1980s. This second shock was reversed from the second half of the nineties, when real world interest rates decreased considerably. The beneficial effect of this development was reinforced by the narrowing of the spread on the interest rates paid by prospective EMU-members over more favourable German rates. It is to a great extent this favourable exogenous shock – and the resulting 8 percentage point drop in interest expenses as a proportion of the GDP over the course of the nineties – that allowed Belgium to return to balanced budgets by 2000. The question is, why the budget was allowed to stay in the red for over twenty years.

Despite the obvious significance of the imbalance of the social security system for the fiscal problems of the country, little was done to restore the balance. By 1990, the gap of social security narrowed to 7.2 per cent, but this happened mostly exogenously as the country recovered somewhat from the worst of the crisis and the number of unemployed decreased – although it remained three-four times higher than in the early seventies. Since 1990, the gap has been opening again and amounted to 8.7 per cent of the GDP in 2007. Ever since the start of troubles in the mid-1970s, the sector saw little policy change in terms of cutting entitlements or increasing contributions. This is especially conspicuous in light of the enormous effort to contain the problem in the rest of the fiscal sphere. Non-social security expenditure was cut by 11 per cent of the GDP in the 1980s, which overcompensated its growth during the seventies by more than half. Over the course of the eighties, Belgium moved from spending on public consumption and investment on par with countries of similar levels of development[5] to spending the least on public consumption and by far the least on public investment (IMF 1998). Despite these efforts to cross-subsidize the social security gap by cuts in other sectors in the absence of tax and contribution raises and/or cuts in entitlements, considerable part of the problem overflowed into debt accumulation. Debt as a percentage of the GDP was continuously growing through the 1980s.

The policy-passivity in the social security sector displayed by the figures conceals considerable efforts by consecutive governments to address the issue. The period between 1980 and 1990 saw four attempts to reform entitlements, while the years between 1993 and 1996 saw another three to cut entitlements or raise revenues. Out of these seven attempts, only two (in 1982 and 1993) achieved any visible results. These results were

[5] The IMF's table of comparison lists Denmark, France, Germany, Italy, the Netherlands, the UK and the US.

admittedly too small to change the fiscal dynamics of the social security system, but these two instances are in any case important for the fact that the government was able to enact and execute reforms affecting entitlements, taxes and social security contributions in a meaningful way. All other attempts were botched either by intragovernmental veto (and the subsequent fall of the government – in 1981) or by strong opposition from trade unions accompanied by intense strike activity – in 1983, 1986, 1993 and 1994 (Anderson et al 2006, Kuipers 2006, Marier 2008).

Both of the relatively successful instances happened under strong external pressure that seemed to jeopardize the long term competitiveness of the Belgian economy in the international markets. In 1982, Belgium received an ultimatum from members of the EMS that it can only stay within the system despite the devaluation needed to end an ongoing currency crisis, if it took significant steps towards controlling its explosive fiscal problems (McNamara 1998, Hemerijck et al 2000). This ultimatum triggered the start of the effort that led to the 11 percentage point reduction of collective consumption and public investment expenditure mentioned above, but at the same time it also allowed for achieving some changes in pension entitlements. In 1993, the fear of not making the EMU-deadline acted as a similar trigger for similar results. (Kuipers 2006) Apart from these two instances, the rest of the attempts were essentially abandoned in the face of resistance by government factions or social partners.

The observed policy paralysis in the face of an escalating deficit problem originally triggered by an exogenous shock conforms to the mechanism described by the war of attrition model. So does the pattern of failure of repeated attempts to resolve the situation in the face of vetoes by groups whose interests would be harmed by the adjustment, with resistance being suspended in cases of "emergency". The crucial question, however, that remains to be answered is why one side – on government for most of the period under consideration – kept proposing solutions that would invariably be turned down by the opposite side and why compromises are only possible in the case of a perceived emergency. The war of attrition model predicts that such a situation arises when the polity is deeply divided politically – with the consequence of little space for the formation and reformation of policy coalitions – and the dividing lines coincide with lines delineating polarized positions on the fiscal consolidation question. Historically, there have been more than one deep cleavages in Belgian society that pit different groups within society against each other. By the time of the oil shock, a religious cleavage had lost its importance, but the class cleavage was still strongly relevant, which is also evidenced by the continued institutional importance of the social partners. This cleavage explains the conflict between Christian-Democrats and Socialists (1981), between Christian-Democratic-Liberal governments and trade unions (in 1983 and 1986) as well as between Christian-Democrats and trade unions (in 1993 and 1994).

At the same time, the situation is complicated by the emergence of a new cleavage – between the two regions (and the respective linguistic communities) of the country – which emphasizes the differences between the interests of a prosperous and economically competitive Flanders and an ever poorer Wallonia with little hope to get economically revived. On the one hand, this cleavage has been made more important by the economic developments of the 1980s, when Flanders rebounded from the economic setback caused by the oil shock,

while Wallonia turned out to be economically debilitated for the long term, due to its outdated heavy industrial structure. On the other hand, however, the strengthening of this cleavage was also in the interest of the Flemish Christian Democrats, who – while being the strongest party both in Flanders and on the federal level – felt increasingly threatened by the conflict between labour and capital over the social security issue, since they are equally dependent on both classes for support. Therefore, the Flemish Christian Democrats started to focus their attention on the regional division, which led to a state reform in 1989, separating Flemish budget from the Walloon one for certain government functions and to repeated calls for the social security to be similarly separated. The latter were put on ice for a while – as long as getting into the EMU required coordinated effort from all levels and divisions of the government – but they were at the forefront of attention during and after the last election. (The question of the new state reform prevented government formation for almost a year.) Although mostly motivated by the electoral interests of the Flemish Christian democrats, the shifting of emphasis from the class cleavage to the regional cleavage could also have the beneficial side effect in the longer term of leading the way out of the policy impasse over the consolidation of the social security system. This however, could only be a solution for Flanders, because if the social security system is split into a Flemish and Walloon part, the financing gap will remain on the Walloon side (due to a high number of entitlement receivers and low proportion of net contributors). At the same time, the regional allocation of the problem can mean a solution if a Walloon-only social security gap is unlikely to trigger a new war of attrition due to a lack of polarization on the issue in Wallonia.

Conclusions

This paper demonstrates that the war of attrition model can serve as a useful device in disentangling an intricate set of factors leading to persistent deficits. On the one hand, it emphasizes the role of social cleavages and polarization, as factors that encourage groups within the polity to try to free-ride on other groups' contributions to fiscal stability. On the other hand, it sheds light on the calculation of the trade-off between welfare losses from deficits and the sacrifices needed for the elimination of deficits in terms of giving up entitlements or paying higher taxes and on the way this calculation depends on parameters and the passage of time.

The discussion also shows why the empirical testing of this model in a large-n setting is very difficult. Given that the nature of policy polarization and social cleavages differ for different countries depending on historical developments and other idiosyncratic characteristics (for example the presence or absence of regional and ethnic divisions), it is difficult to create reliable and comparable indicators for the central variables of the model.

Finally, the model and the analysis of the Belgian case focus attention on the importance of government weakness in the face of socio-political conflict and thus questions the validity of theories that concentrate on governments' incentives and constraints when trying to discover the sources of persisting fiscal problems.

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