COALITION GOVERNMENTS AND FISCAL POLICY IN THE NETHERLANDS

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1. Introduction

In 1994, when public finances appeared to be under control again, the Dutch government introduced a trend-based budgetary policy. This policy regime features medium term ceilings for government expenditures and - to some extent - tax smoothing on the revenue side. It aims at structural reduction of the share of government expenditure in GDP, a transparent and orderly budget process, and automatic stabilisation with regard to the business cycle. The new Kok administration that took office in the summer of 1998 continues this fiscal policy regime, with a few modifications. Despite some features of the system that may be sub optimal, the policy regime has been very successful in terms of lowering budget deficits and government debt since 1994. In this paper we will discuss various features of the fiscal policy regime of the Kok administrations in a historical perspective of Dutch fiscal policy after 1945. In particular, a comparison is made with an earlier version of trend based fiscal policy.

Overlooking the post War period, an important turning point in the orientation of Dutch fiscal policy is the introduction of a policy of fiscal consolidation in 1982. Prior to 1982 fiscal policy was predominantly directed towards macroeconomic demand management. Two more or less conflicting explanations of this change in fiscal policy emerge in the literature.

On the one hand it seems likely that the urgency of consolidating public finances reduced disagreement among political parties in the Netherlands over priorities in public finance. Consequently, this enabled the first Lubbers administration (1982-1986) to embark on a tighter fiscal policy than its predecessors, aiming at a considerable drop in the budget deficit. This explanation can be based on the assumption that in “normal” times a bias exists in favour of politically motivated excessive budget

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deficits[1] that can only be redressed by a crises in public finances that necessitates fiscal consolidation. This theory is in accordance with the simultaneous shift to similar policies in other OECD countries facing sharp increases of deficits (OECD, 1988). However, it fails to explain why a gradual build-up of deficits has not re-emerged after the financial crises was averted.

On the other hand there is the view that underlines the relevance of socio-political institutions and concomitant budgetary rules for the explanation of both evolution and inter-country differences of public deficits[2]. Dur and Swank (1998) and Dur (2000) have made an interesting contribution to this literature that seeks to explain the change in Dutch fiscal policy after 1982. They claim that the increased significance of coalition agreements as a commitment device for participating political parties has facilitated the forming of coalition governments with a programme targeted at deficit reduction. A weak point of this line of thought is that no coinciding changes in socio-political institutions in other countries can be identified that might account for the simultaneity of the change in politics in OECD countries mentioned above.

This paper presents a synthesis of both views that can explain both the simultaneous appearance of a shift in fiscal policy in favour of sound public finances in the Netherlands in the early Eighties and the continuance of such policies after the deficit returned to more sustainable levels. It is beyond the scope of this paper to assess the extent to which the synthesis presented here can also contribute to an understanding of similar patterns in other OECD countries.

2. Structural Dutch Fiscal Policy after 1945

In the 1961 Budget, finance minister Zijlstra tried to circumvent the problems of Keynesian fiscal activism that prevailed during parts of the 50's by introducing his so-called structural fiscal policy[3]. The 1961 type of

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1 This policy can be explained by a majority of myopic voters that "normally" favours an increase of the budget deficit over an increase in taxes to finance additional spending.

2 See e.g. Alesina and Perotti (1995) and Grilli, Masciandaro and Tabellini (1991).

3 In terms of it's stabilizing effect on the economy, this policy showed a number of drawbacks, including (i) inflexibility of a large part of public outlays in the short run (especially downwards), (ii) problems in assessing the timing of cyclical upturns and downturns, and (iii) (irregular) time (continues)

structural fiscal policy is characterised by two main features[4]. First, the so-called structural government budget deficit is introduced. This concept is related to cyclical neutrality. In its fourth report the Study Group on the Budget Margin (Studiegroep Begrotingsruimte)[5] explicitly related the size of the structural government budget deficit to the structural current account position. The Study Group argued that, in absence of cyclical disturbances, the current account should show a small structural surplus enabling the donation of capital transfers to developing countries. Applying the well-known macroeconomic identity the size of the structural budget deficit can be related to the cyclically neutral savings balance of the private sector and the desired current account surplus.

The second feature of the structural fiscal policy in the 60's was the extrapolation of government revenues on the basis of the structural or trend growth rate of the economy, rather than the actual growth rate anticipated. Moreover, as the structural deficit was considered constant relative to GDP, the absolute size of the deficit was also allowed to increase proportionally to the trend growth rate. The increase in next year's government expenditure, including spending on lower tax rates, was set equal to growth of both revenues and the absolute size of the structural deficit. As tax revenues were allowed to reflect actual rather than trend growth rates, the budget deficit acted as a built-in stabilizer. In this way, structural fiscal policy managed to circumvent the timing problem that encountered the activist Keynesian policy in the 50's. Moreover, the trend based growth rate of both revenues and the absolute size of the structural deficit enabled the estimation of the total means available for spending in future years. Consequently, structural fiscal policy also provided for a multi year framework to assess budgetary proposals.

By and large the system performed rather well until the Seventies. The economic slowdown that occurred in the early 70's was considered to be temporary. Because the trend growth rate of the economy was not adjusted, the extrapolation of structural tax revenues based on illusory

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lags between the implementation of fiscal policy and the desired outcome in terms of aggregate output and employment. Moreover, in strongly emphasizing the use of fiscal policy in stabilizing the macro economy, interest in the allocative aspects of the budget is lacking.

4 This part is primarily based on Sterks, 1982 , pp. 148-213.

5 The Study Group on the Budget Margin (*Studiegroep Begrotingsruimte*) is an advisory council of high-level civil servants. Among the members of the Study Group is a director of the Dutch central bank and CPB's managing director.

high growth rates resulted in steadily increasing budget deficits. Moreover, as estimation of the cyclical component of unemployment became indefinite as the economy entered a period of considerable turbulence , the procedure used by the Study Group to assess the size of the structural deficit became rather hazardous.

2.1 Intermezzo: 1982-1994

In the early Eighties the "old" structural fiscal policy was abandoned. By then, fiscal policy had got seriously out of hand and priority was given to the reduction of the actual budget deficit of general government that amounted to almost 7% of GDP in 1982[6]. The focus on the evolution of the actual budget deficit was motivated in particular by imminent adverse debt dynamics resulting from interest rates in excess of GDP growth rates. However, the new direction of fiscal policy necessitated by exploding deficits had a number of drawbacks. One serious complication was the pro cyclical nature. In order to meet deficit goals, the government had to make additional budget cuts in cyclical downturns. Moreover, it lacked the multi year quantitative framework for fiscal policy that was the implied gain of structural fiscal policy. By the time the deficit had reached a more sustainable level, a return to a type of structural fiscal policy that successfully disposed of the problems of the old regime was widely considered desirable.

2.2 Structural Fiscal Policy after 1994

The structural fiscal policy adopted by the first Kok administration in 1994 differed from the former type in a number of ways. First, the size of the structural deficit was no longer related to the assumed structural savings surplus of the private sector. As we will argue below, this partly reflected an important change in the underlying considerations derived from economic theory. Secondly, the new fiscal policy tried to overcome the problem of the assessment of the structural growth rate of the economy by relying deliberately on a cautious economic scenario. In this way, the

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[6] The deficit concept used here is the so-called EMU deficit that is referred to in the Maastricht Treaty. It excludes financial transactions of governments. Actual net borrowing of government, at that time a politically more relevant concept, amounted to 9.5% of GDP in 1982 and was expected to rise even further.

risk of exploding deficits as a result of too high estimates of structural economic growth rates was minimized.

As has been argued above, the 1961 type of structural fiscal policy was strongly rooted in the belief that high public deficits had to offset notorious low private expenditure. This conclusion accounted partly for the traditional Keynesian flavour of the 1961 structural fiscal policy. At present it is widely recognized that economic theory cannot offer a normative conclusion on the size of the budget deficit. In fact, it is implicitly denied that only a particular size of the budget deficit of government can be reconciled with cyclical neutrality in the medium run.

The new fiscal policy rules reflect this changing view. Therefore, it tries to identify normative restrictions on the size of the budget deficit that are not derived from economic theory. Here, we will discuss two limitations on the structural fiscal position of Dutch government that are widely recognized[7].

One restriction results from the 3% EMU upper ceiling for the fiscal deficit that is included in the Maastricht Treaty. As cyclical fluctuations affect the fiscal deficit, the actual deficit must be lower in order to minimize the risk of a violation of the ceiling. Another normative implication for the budget deficit is derived from the prospect of an ageing population. Sustainability of present arrangements for the elderly can be established by smoothing overall public expenditure in future decades. According to recent CPB research this implies that the present deficit has to turn into a surplus in the course of the coming decade[8]. The resulting reduction of interest payments creates room for higher expenditure due to ageing.

In the next subsection we will deal in rather more detail with fiscal policy in the Netherlands after 1994. In particular we will address some changes in the fiscal policy of the Kok II administration compared to the rules that prevailed under the Kok I administration.

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7 See tenth report of the Study Group on the Budget Margin (*Studiegroep Begrotingsruimte*), 1997.

8 See H.J.M ter Rele, 1997, p. 21.

3. Trend based fiscal policy of the Kok administrations: some more detail

The Kok I administration (1994-1998), based on a coalition of Social Democrats (PvdA), Liberals (VVD) and Left Liberals (D66), adopted a trend based fiscal policy. To allow for tax smoothing and automatic stabilisation, the spending side was disconnected from the revenue side of the budget. For expenditure fixed numerical ceilings were set for the period 1994-1998 for the three main categories of public expenditure: social security, health care and the central government budget. As a rule, expenditure overruns had to be redressed by budget cuts within the category in which excess spending occurred. Lower expenditure levels than allowed by the ceilings would feed into a lower deficit or lower tax rates. Irregular revenues from selling state owned enterprises and (part of) natural gas were excluded[9]. A considerable part of these latter revenues was used to fund investment in economic infrastructure. Public investment outlays funded in this way were also not included.

The fiscal deficit was allowed to absorb temporary tax revenue fluctuations due to cyclical factors, subject to a pre-set fixed ceiling. Consequently, the system provided for fluctuations of tax revenues as a built-in stabilising factor.

3.1 Fiscal policy 1994-1998

Fiscal policy of the first Kok administration has contributed strongly to the consolidation of Dutch public finances in the 1994-1998 period[10]. However, it must be recognised that the new rules met with favourable conditions. The budget projections and expenditure ceilings were based on a cautious economic scenario, which assumed a moderate growth of only just over 2%. Actual growth in the 1994-1998 period amounted to 3.25%. Thanks to this favourable macroeconomic performance, and supported by social security reforms, the number of social benefits paid to people under 65 dropped from 2.1 million in 1994 to 1.9 million in 1998. This together with the sharp fall in interest rates - and therefore debt service - enabled

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[9] The expenditure ceilings are defined in net terms, e.g. gross outlays minus non-tax revenues.

[10] See "Consolidating Public Finances: the Dutch Experience", CPB Report 1996/3 and "Towards Sustainable Public Finances", CPB Report 1997/3.

the previous administration to accommodate notorious spending overruns in health care. Also expenditure on education and crime prevention was increased and social benefits improved. Even then expenditure stayed below the ceilings, except for 1998. Next to accelerating the reduction of the deficit, the favourable budget realisations have been used for an additional reduction of tax rates. So, also on the revenue side the government did not live up rigidly to its own rules. Tax smoothing was only partially adhered to.

The favourable macroeconomic conditions enabled a further consolidation of Dutch public finances than envisaged in the budget outlook made at the start of the coalition government in 1994 (see table 2)[11].

Table 1

Aggregate overrun of spending ceiling 1995-1998
(current prices, billions)

	1995	1996	1997	1998
Total	- € 0.9	- € 2.0	-€ 0.2	€ 0.2

Source: Macroeconomic outlook 1999, CPB

3.2 *Fiscal policy of the present government*

The new administration, based on the same coalition that took office in 1998 by and large continued the successful fiscal policy of the previous administration. However, some modifications have been made. In 1998 the Kok II administration introduced, next to ceilings for public expenditure, also reference levels for public revenues (taxes)[12]. To avoid intricate

[11] The remarkable fall in public debt (% GDP) is partly due to consolidation of social security funds in the public debt.

[12] Here taxes are considered to include social security premiums.

Table 2

Consolidating Dutch Public Finances 1994-1998
(percent of GDP)

	1994	1998 estimate in 1994	1998 outcome
a. Net Government Outlays	50.2	47.2	39.8
b. Taxes and Social Security Premiums	46.0	44.3	40.5
c. Government Deficit[13]	4.3	2.3	0.7
d. Government Debt	80.5	81.0	66.6

Sources: Macroeconomic outlook 1995 and 2001, CPB

political discussions in later stages, it was already lead down in the coalition agreement, what should be done with deviations in tax revenues from this reference path. As long as the budget deficit is within the range of 0.75-1.75% of GDP, it was agreed that 75% of the deviation will be absorbed by the deficit. The complementary 25% will be covered by a change in tax rates[14]. Outside this range the deficit will absorb only 50% of the deviation; the rest must be accommodated by a change in taxes. The rules only apply to a state in which the actual deficit does not exceed the EMU deficit ceiling of 3%.

[13] The government deficit presented here reflects the so-called EMU definition of the deficit. In compliance to the latter definition, a number of outlays and revenues that are part of net government outlays are excluded (e.g. revenues of the sale of publicly owned shares). Also in compliance with the EMU-definition is a different registration of taxes and social security premiums than presented in the table under b. As a result, the government deficit cannot be computed straightforward using the data on net public outlays and revenues from taxes and social security premiums.

[14] The range is set symmetrically around the deficit of 1.25% of GDP in 2002 that was anticipated in the budget outlook underlying that coalition agreement of the summer of 1998.

The fixed expenditure rules have been generally maintained. A novelty concerns the treatment of so-called macroeconomic shocks. This is to allow for particular sensitivity of some types of spending for changes macroeconomic variables like wages and interest rates. For instance, the health care sector is known to be very sensitive to wage increases. On the other hand, lower interest rates almost exclusively benefit central government. Therefore, it was decided in the event of such macroeconomic shocks to allow compensation of spending overruns in one sector by lower spending of another sector.

Moreover, the spending limits that prevail during the period 1998-2002 enclose a total spending margin increasing to 1 billion guilders in 2002. This margin is considered to accommodate small spending overruns that otherwise necessitate instantaneous political debates on spending cuts. Finally, it has been decided not to spend windfall gains resulting from favourable macroeconomic conditions the early years of the 1998-2002 period. They are considered an extra spending margin to counter possible adverse economic conditions.

In the first two years of the new government economic conditions again turned out to be favourable in comparison to the cautious reference path. As a result, in the spring of 2000 it was envisaged that spending would remain markedly below the spending limits for 2000 and 2001 (see CPB 2000b, p. 30). Subsequently, the cabinet has agreed on additional spending on (notably) education and health care *vis à vis* spending levels intended in the coalition agreement 1998-2002[15]. Also tax revenues develop favourably; they are expected to arrive at € 11 billion in excess of the reference path in 2001 (CPB 2000a, p. 151). Despite the obvious success of the budget rules there are a couple of points which give rise to discussion and are worth considering in more detail. We will deal with some of these issues in the text box below.

[15] This decision is not without risk. Although favourable economic conditions tend to mitigate real spending growth initially (notably through lower interest outlays and unemployment benefits), increased real wage growth due to lower unemployment levels might subsequently lead to increased real government spending growth (notably due to the link between wages and social security benefits in the government sector with wage growth in the private sector). (For an analysis along these lines see CPB, 1997b).

Some points for discussion

Van Ewijk and Reininga (2000) discuss a number of drawbacks of the present fiscal policy regime that have been pointed at. First, it has been claimed that the regime fostered only a modest reduction of the structural deficit in the recent past (see e.g. OECD 1999, p. 223). *It has to be underlined, however, that the assessment of the structural fiscal position is a rather hazardous task. In CPB (2000b, p. 33) estimates of the cyclical component of the budget balance in 2001 range from 0.5% to 2.5% of GDP. Therefore, it was concluded (CPB 2000b, p. 33) that, given an expected actual surplus of 0.8% of GDP in 2001 by then, an unambiguous assessment of the structural fiscal position was not possible.*

Another drawback of the present regime includes the limited effectiveness of built-in automatic stabilizers, as the rules with respect to deviations of revenues from the reference levels discussed above imply possible pro cyclical adjustments of tax rates. Next, the use of a cautious scenario has caused credibility problems as the economy shows considerably higher growth rates in 1999-2001. Two of the participating parties (Social Democrats en Left Liberals) express increasing dissatisfaction with the prevailing regime, which leads – in their view unnecessarily –to only limited budgets to cope with the challenges in health care and education. Finally, the use of real expenditure ceilings implies the possibility of a violation of a smooth and orderly budgetary process aimed for by disruptive price shocks to the public sector constitutes another drawback of the present system. To illustrate: in the spring of 1999 CPB's macroeconomic forecasts implied a negative price shock to the public sector for the budget year 2000 of € 1,75 billion (1.2% of the overall budget), which would have necessitated substantial spending cuts. Only a few months later, a revision of the macroeconomic projections implied only a negative price shock of € 0,75 billion. After successive projections, the final estimate of the price shock showed a favourable price shock of € 0.2 billion.

4. Continued consolidating of public finances in the Netherlands and the coalition agreement

The period of office of the first Lubbers administration (1982-1986) marks a major reorientation of Dutch economic policy. Broadly speaking, the “new” economic policy featured a shift from the emphasis on macro economic demand management towards a more market based orientation. By then, the majority of policymakers considered the steady increase in unemployment rates since 1972 not primarily as reflecting weak demand conditions. Rather, structural imbalances in the Dutch economy were considered to be at the heart of unfavourable economic conditions. The reorientation included a policy of fiscal consolidation aimed at a recovery of sound public finances.

Of course, the severe depression of 1980-1982 constituted an important trigger for the Lubbers administration to embark on a new course. In 1982, the coalition government of Christian democrats and liberals found the economy on an unsustainable path with sharply rising unemployment levels and high and rising budget deficits, despite the relatively high tax burden[16]. High nominal interest rates, together with the already high level of public sector debt, contributed to expectations of adverse debt dynamics leading to unprecedented levels of public deficits.

By now, it is widely recognized that the continuation of the market oriented approach, has contributed strongly to the marked improvement in labour market performance. To illustrate, in the nineties average annual employment growth reached 2¼%, well above the growth rate in the EU. Moreover, participation rates went up from 62% in 1990 to an expected 74% in 2001 and unemployment has reached very low levels that are reminiscent of the golden “sixties”(see CPB, 2000a, pp. 206-207). The concomitant policy of consolidating public finances has also been successful: in 1999 - for the first time in 25 years - the fiscal balance showed a surplus of 1% of GDP. Besides, public debt as a percentage of GDP dropped from an all-time high 81.3% in 1993 to an expected 52.0% in 2001. Finally, labour market performance is thought to benefit from a

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[16] Unemployment rates more than doubled in 1979-1982: from 5.4% in 1979 to 11.4% in 1982 (OECD standardized measure). In 1982 an all-time high EMU-deficit (net lending of the public sector) emerged: 6.6% of GDP. By 1982, the borrowing requirement of central government was expected to rise to 12% of GDP in 1983, despite the relatively very high burden of taxes and social premiums (OECD, 1988).

drop in the tax burden from 48.8% of GDP in 1988 to an expected 39.5% in 2001 (CPB, 2000a, p. 130).

In the rest of this section we will focus on the reorientation of fiscal policy. It has to be underlined, however, that the policy of fiscal consolidation introduced in 1982, although initially aimed primarily at preventing public finances getting out of hand, constituted a natural part of the market-oriented economic policy. As the latter approach emphasizes the cost of government intervention in terms of reduced private economic activities (dead-weight loss), it follows quite naturally that the relatively large size of the government sector in the Netherlands was considered a core obstacle for economic recovery. In particular, increasing average tax rates, relatively already at a very high level, were considered detrimental to economic performance, as they would contribute to high real wage growth and concomitant low investment and employment growth. In turn, poor economic performance would lead to tax revenues falling short, necessitating a further increase on tax rates. As we will see, the slow adaptation by policymakers and the general public of this view of the interrelationship between worsening labour market performance and deteriorating public finances was at the heart of the rather late change in course of economic policy.

Although the change in fiscal policy can thus not be separated from the shift to a more market-oriented approach, still two questions arise almost inevitably from the history of Dutch fiscal policy in 1980-1982. First, why did it take until 1982 for fiscal policy to change course, while indicators of unsustainable public finances were available well before 1982? Second, why did a situation of high public deficits and sharply increasing public debt not reoccur after 1982?

4.1 Why was the change in fiscal policy delayed?

Looking back at the late Seventies and early Eighties it is hard to understand why a redirection of fiscal policy was delayed as public finances deteriorated strongly in the early Eighties. In 1982 the borrowing requirement of central government increased sharply to 8.3% of GDP, and was estimated in September 1982 to rise to 12% next year. (In fact, the borrowing requirement in 1983 turned out to be 8.9% of GDP.) The sluggish policy response is all the more remarkable, as early indicators of

an unsustainable continuation of poor economic performance and corresponding increasing public deficits were available.

As early as 1974, analysis of the Netherlands Bureau for Economic Policy Analysis (CPB) showed that increased real labour costs are detrimental to business investment and structural employment (CPB, 1975). Despite this warning, government continued to foster rising real labour costs by the "inexorable rise in the size of government share in the economy and the corresponding tax burden" (OECD, 1988, p. 92). As a result net operating surplus of manufacturing dropped to unprecedented levels by 1982. Still, the detrimental effects of this evolution to employment seemed almost absent at the surface, as private sector employment dropped only slowly due to government regulations concerning labour shedding and the simultaneous increase in public sector employment. This constituted an important factor that fostered the delay of the adaptation of economic policy.

The fact that the interaction of rising taxes, increasing real labour costs and deceased profits was unsustainable emerged not until the 1980-1982 period, as unemployment increased markedly in the aftermath of the second oil crisis (1979). Again, at least initially, a policy response was delayed. Two related explanations can be given:

1. The trend based fiscal policy that was developed in the early sixties was considered to have contributed to the relatively favourable economic conditions prior to the second oil crises. This view reflected the prevalence of a strong trust in Keynesian fiscal policy, with its fixation on negative macroeconomic demand shocks that are supposed to be at the heart of most economic problems. Consequently, at the time, no undisputed alternative macroeconomic view was available can could underpin a shift from Keynesian demand management towards a more market-oriented approach[17].

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[17] Toirkens (1998, pp. 53-58) shows that members of the first Van Agt government (1977-1981) - like the Lubbers administration a coalition of Christian democrats and liberals - differed markedly on the appropriate course of fiscal policy. In particular, the ministers of Social Affairs (Albeda) and Education (Pais) opposed a policy of fiscal consolidation, as it would be detrimental to employment. Still, as the administration did embark on a policy of stabilizing the tax burden and reducing the relative size of the public sector, some authors (e.g. Knoester, 1989) do consider the first Van Agt administration as a pioneer of the market-oriented approach of the Eighties. However, due to lack of full political support within the coalition parties, the Van Agt administration did not succeed in fiscal consolidation.

2. There was a lack of a political majority in favour of such a reorientation in fiscal policy. The *ex ante* uncertainty concerning the identity of winners and losers of such a shift that prevailed at the time constituted an important determinant of inadequate political support[18]. Toirkens (1988, chapter 4) provides ample evidence that ministers of the first Van Agt administration (1977-1981) were worried about the possible detrimental effects of a policy of fiscal consolidation to particular groups in society (e.g. households on welfare).

Not until 1982, when exploding deficits and concomitant fears of adverse debt dynamics made a continuation of the fiscal policy that was in place intolerable, a reorientation of fiscal policy towards fiscal consolidation was introduced. The precarious situation at the time fostered political support for such a policy. As underlined above, the redirection of fiscal policy is part of a shift from the macro-oriented economic policy of the Seventies to a more market-oriented approach.

4.2 Why did high public deficits not reoccur?

After the successful completion of the policy of fiscal consolidation in many OECD countries in the nineties, there seem to be no indications that high deficits will reoccur in the near future. With the notable exception of Japan, OECD countries have sound fiscal positions, in the neighbourhood of fiscal balance (CPB, 2000a). Although, the present period of favourable economic conditions may obscure the incidence of still high structural fiscal unbalances, it seems unlikely, given the initial fiscal positions, that the next economic downturn will show marked increasing deficits reminiscent of the early Eighties. Here, we focus on the Dutch case.

A natural starting point to explain the persistence of fiscal consolidation would be to analyse the institutional setting of the budgetary process to identify possible changes in the budgetary institutions that might explain that high deficits have not reoccurred in the nineties. To this end, the analysis of Hallerberg and Von Hagen (1998) provides a general framework in which different electoral systems and concomitant features

[18] See Fernandez and Rodrik (1991) on the issue of the *ex ante* uncertainty of the distribution of future benefits resulting from a reorientation of (fiscal) policy and political deadlock. See also Dur (2000) and Dur and Swank (1998).

of government (coalition government or single party government) interplay with budgetary institutions and outcomes. They argue that - given an electoral system - the government is restricted in choosing an appropriate institutional framework for the budgetary process. In particular, they argue, the desired centralisation of the budget process – witch enhances a proper evaluation of the expected benefits of extra government *vis à vis* the extra funding needed (either extra taxes or debt financing) – can be accomplished by using either of two institutional designs of the budget process. First, in countries with single party governments the institutional solution to budgetary "free riding" is the delegation of strong powers with respect to all stages of the budgetary process (design, determination and execution) to the finance minister (delegation model). In countries with multiparty governments a "strong" minister of finance is not an attainable solution, as it would imply strong powers of the minister of finance of a particular party over the ministers of other parties. In that case, the authors show, the proper institutional arrangement to foster budgetary discipline is a commitment to fiscal targets agreed upon by the coalition parties (commitment model).

For the Netherlands, with its coalition governments and a commitment model, Dur (2000) and Dur and Swank have pointed at the role of the coalition agreement in breaking political deadlock that has prevented the reoccurrence of unsustainable fiscal positions. Their analysis builds both on studies that underline the negative effect of fragmented party systems on political support in favour of fiscal consolidation (Alesina and Drazen (1991), Grilli, Masciandaro and Tabellini (1991)) and the work of Fernandez and Rodrik (1991) on the potential failure of governments to adopt policies that are generally seen as Pareto-efficient. The latter analysis rests on the *ex ante* uncertainty about the consequences of political reform at the individual (voters) level. As promises to compensate losers from the reform are not time consistent, *ex ante* uncertainty on the distribution of gains and losses might lead to political deadlock.

Dur and Swank introduce the Fernandez-Rodrik argument into a multiparty framework. In this setting the *ex ante* uncertainty about the distribution of winners and losers of a policy proposal over the voters of political parties may block agreement on the implementation of the proposal under consideration. Again, it is assumed that the policy proposal is welfare improving *ex post* and that compensation of losers by the

winners is not credible. The authors suggest that proposals for structural reform in the late Seventies and early Eighties very likely lacked majority support in parliament for this reason. We agree with the conclusion of Dur and Swank in this respect. Proposals for tax reform and reforms in social security and health care are bound to have effects on income distribution that are both very uncertain at the individual level and a very sensitive topic in politics. Therefore, it seems likely that political parties were very hesitant to adopt such reforms and, consequently, an undesirable bias towards *status quo* prevailed.

Dur and Swank continue by showing that voting on a package of political reforms reduces the likelihood of such a political deadlock. Intuitively, this results stems from the fact that the adoption of a reform that *ex ante* harms the voters of coalition party A and benefits the voters of coalition party B (although *ex post* Pareto-efficient) might still be approved by party A if it is compensated by the adoption of another reform that has *ex ante* the opposite distribution of benefits and losses. More formally the argument can be stated as follows:

- given a three party system (A,B,C);
- A and B form a coalition government, both A and B have 40 percent of the votes, C has the remaining 20 percent of the votes;
- parliament is assumed to mirror the electorate;
- the government proposes a policy reform to parliament that is welfare improving *ex post,* with the following *ex ante* effects on income distribution:
- the project yields a certain benefit of β to the constituents of party A;
- the project yields a certain loss of λ to the constituents of party C;
- the constituents of party B do not now *ex ante* whether they will end op being losers or winners. Each constituent faces a probability of ρ of gaining β and a probability of $(1-\rho)$ of losing λ.
- it is shown that *ex ante* support for the proposal is only warranted if:

$$\frac{\lambda}{\beta} < \frac{\rho}{(1-\rho)}$$

This condition states that the proposal is accepted by parliament if the expected gain of the proposal for the voters of B exceeds the expected

loss. Given the model, this means that the reform is excepted if all voters of B will be in favour of the proposal. Otherwise, all constituents of B will be against the reform and the proposal is rejected. Dur and Swank show that the condition for *ex ante* support for a package of two proposals – with the second proposal featuring symmetric opposite *ex ante* effects on income distribution with respect to the constituents of party A and B – can be shown to be:

$$\frac{\lambda}{\beta} < \frac{(1+\rho)}{(1-\rho)}$$

The latter condition is clearly less restrictive than the condition if only one reform is proposed. Not surprisingly, the possibility of compensating an expected loss of one project by the (certain) gain from the other project increases the probability to agree upon the package. Generalising this result, Dur and Swank conclude that the condition for *ex ante* approval will be less restrictive the larger the number of proposals.

The Dur and Swank argument can explain the inclination of Social Democrats and Left Liberals in the Netherlands to stick to fiscal consolidation laid down in subsequent coalition agreements. Although, fiscal consolidation – at least in the short run (!) – is at odds with their pronounced pleas in favour of increasing budgets for education and health care, apparently they are afraid of putting parts of the agreement which they favour at risk if they do not stick to the rules agreed upon.

However, it is not at all clear, as Dur and Swank claim, that the particular role of the coalition agreement also might explain the delay in the fiscal response in the early Eighties. Their argument critically depends on the implied assumption that coalition agreements in the Netherlands prior to 1982 – as opposed to the 1982 agreement and after - lacked certain necessary features to break political deadlock. In my opinion, Dur and Swank do not give a well-founded explanation for this dichotomy.

Contrary to the Dur and Swank argument, to me the most fundamental explanation of the prevailing view that fiscal consolidation should be continued, is the wide adaptation of a market-oriented approach. The concomitant emphasis on economic incentives and potentially damaging government intervention on private economic performance leads quite naturally to an inclination of downsizing the public sector. Besides, no longer the fear of immanent low spending of the private sector leads to

a call for countervailing public sector deficits. The success of the market-oriented approach in terms of employment and GDP growth and the consolidation of the fiscal position of the government can explain this broad support, including almost the entire political spectrum in parliament. Again, the Fernandez/Rodrik argument can be used to explain the support for the present *status quo* of fiscal policy.

This is not to say, that the changes with respect to the institutional setting of the budget process since 1994 documented above have had no impact on budgetary outcomes. As has been discussed, new structural fiscal policy adopted since 1994 had beneficial effects on the fiscal position. Only, the underlying force that fostered this outcome is the gradual change from old-fashioned Keynesian views that eventually contributed to unsustainable fiscal positions towards the adaptation of a more neo-classical framework. In the words of the master (Keynes, 1936, p. 384): "..But soon or late, it is ideas, not vested interests, which are dangerous for good or evil…".

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