

The Relative Costs of Fiscal Policy Instruments, 1973-1995¹

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Paper prepared for the ECPR conference in Marburg, 18 – 21 September 2003, Section 4 'Political Economy', Panel 4.6 'Macroeconomic Consequences I'. Second Draft. Please do not circulate or quote without the permission of the authors. Comments are welcome!

¹ Comments by Robert Boyer, Eric Seils, Wolfgang Streeck, and Kathy Thelen are gratefully acknowledged.

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1. Introduction

The comparative literature which analyzes the fate of the welfare state in our economically ‘dire times’ started with the assumption that an increasingly internationalized market will force the generous welfare states of the western world into a common downward movement. Yet, today it seems that the advanced OECD-economies have maintained their ability to ‘tax and spend’ to a surprising degree. What is most remarkable from the viewpoint of the early pessimistic predictions is that the welfare state basically survived (Kuhnle 2001) rather than proved to have outlived itself (second most remarkable is that we today don’t know anymore if this unexpected survival should really cheer us up).

Basically three types of explanations have subsequently been put forward to account for this finding. The first explanation highlighted efficiency arguments (e.g. Garrett 1998; Boix 1998), the second emphasized institutional inertia (especially Pierson 1998, 2001), the third stressed the importance of political-partisan choice (e.g. Iversen/ Wren 1998; Esping-Andersen 1990, 1999; Huber/ Stephens 2001). In our view all three accounts come with their own problems.

The efficiency argument seems to have only very restricted applicability, given that the praised and idealized Keynesian Welfare State (KWS) which supposedly succeeded and still succeeds to make large scale redistribution compatible with the imperatives of the international market has only rarely been observed outside Sweden - and maybe also Austria. Yet beyond these cases of ‘coherently’ Keynesian welfare states (Garrett 1998: 14-15, 19-20, 26-50) efficiency arguments do not seem to do a good job when one wants to explain welfare state stability – as the ‘frozen landscapes’ of the crisis-ridden

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continental welfare states remind us. It is here where institutional inertia arguments come in. They have been most eloquently stated by Paul Pierson (1994, 1998, 2001).

Yet, if we were to follow his lines we would *generally* expect welfare retrenchment to be very unlikely given that cuts in spending programs are *generally* very unpopular.³ For Pierson, all welfare states are by and large ‘immovable objects’ due to electoral ‘short-termism’ combined with the political support that social spending programs generate among those that benefit from them – an argument that follows the Olsonian diffuse costs/ visible gains logic. Yet, in the wake of the economic pressures and challenges of the 1980s and 1990s we *did* observe instances of substantial welfare retrenchment that – from time to time - even could count on impressive electoral approval. To put it bluntly: while welfare retrenchment may be unpopular, the ever increasing tax- or debt-burdens caused by uncontrolled spending dynamics may be just as unpopular. It seems that we need much more fine grained ‘blame avoidance’ arguments if we want to account for the varying reform trajectories in the OECD since the mid-1970s.

It is therefore *variance* not overall (downward) *convergence* or general *inertia* which calls for an explanation. With respect to this mixed picture there is a third theoretical explanation in the offering which explained the different reform paths as the expression of political will, as deliberate partisan-political choice out of a set of distinct distributional outcomes (cf. Iversen/ Wren 1998; Esping-Andersen 1990, 1999; Huber/ Stephens 2001). According to this view, Liberal, Social-Democratic, and Christian-Democratic parties (i.e. their respective electorates) hold different preference orderings with respect to the partly conflicting goals of full employment, balanced budgets and income equality. Different parties then simply picked different distributive equilibria when the slowdown of economic growth made it impossible to have full employment, price stability, balanced trade and a balanced budget plus wage compression all at the same time. Whereas this approach does indeed perform well empirically because it

³ Within the institutionalist framework à la Pierson we would expect inter-program or inter-(welfare state)sector variance, that is *intra*-regime but not necessarily *inter*-regime variance. It remains to be shown that Pierson’s ‘new politics of the welfare state’ perspective is capable of providing us with a convincing explanation for the divergent social reform trajectories of different political economies in the OECD - that it works also beyond the simple two country comparison (Pierson 1994). It is not accidental that Pierson prefers to analyze secular trends rather than the divergent reform experiences of the advanced welfare states.

explains both ‘continuity’ in the continental and Scandinavian countries and ‘discontinuity’, i.e. deregulation and cutbacks, in the liberal world, it incurs certain theoretical problems. Particular problematic in our view is its conception of how political preferences should have translated into distributive outcomes or institutional design. Especially vague is the reference to the impact of abstract worldviews like ‘liberalism’, ‘socialism’, and ‘conservatism’ (cf. Esping-Andersen 1990). But also much more down-to-earth versions of the argument that refer to differences in the political composition of governments are not without their problems. Detailed econometric analyses show that a distinct partisan-political impact on welfare state spending has largely vanished over the course of the 1980s and 1990s (*inter alia* Kittel/ Winner 2001; Huber/ Stephens 2001; Plümper/ Troeger/ Manow 2003). But how should then partisan political choice should have influenced the different national adjustment strategies in a time period in which the distinct influence of parties seems to have largely vanished?

‘Institutions’ seem to provide the answer (Scharpf 2000) and these institutions, in turn, can of course be interpreted as the manifestations/ sediments of *past* political will (Huber/ Stephens 2001). Yet, how could those institutions have remained stable which lost most of their partisan support and did not perform well in the 1980s and 1990s - in other words, those institutions that should have lost both their power-distributional as well as their functionalist foundation?

Given these problems of a political-partisan interpretation we propose to understand the observable variation in distributive outcomes among the major OECD-countries not so much as ‘politically derived’ than as ‘institutionally derived’. This paper echoes an argument that has repeatedly been made in the literature: namely that governments’ choice of political instruments as well as the choice of reform packages implemented in case of economic crises are largely influenced by the institutional setting and path-dependent. Our paper not only claims that institutions matter. Rather, it identifies the institutional logic behind the choice of instruments with which governments attempted to react and respond to the new economic challenges since the mid-1970s. We demonstrate how and why governments significantly have varied in their choice of these instruments. The argument starts from basic assumptions. Governments essentially could respond in three ways to the fiscal stress caused by diminished growth combined with increased

spending demands: they could cut costs, run a higher debt, or increase revenue. We argue that these basic strategies were associated with varying political costs depending on how the welfare state is financed in a given country and depending on the degree of independence of a country's monetary policy (for the details of the argument see the subsequent section). Given these varying costs, national adjustment strategies differed. Countries responded with different policy mixtures to fiscal stress. Some countries amassed huge public debts, others substantially increased revenue, others were more successful in containing costs. As a consequence, in crucial dimensions the political economies of the OECD have become more diverse, more dissimilar from each other after more than two decades of welfare reform and welfare retrenchment. Yet, many comparative analyses implicitly start with the present diversity in mind, interpret it as politically intended and then analyze 'backwards' and thereby infer motives and causes from outcomes.

2. Revenue, Debt, Expenditures

The trivial starting assumption of our analysis is that politicians will reform the welfare state only in case that this promises to be less damaging for their re-election prospects than any other coping strategy would be. True, politicians will be reluctant to engage in profound welfare retrenchment (cf. Pierson 1994, 1996, 1998), given that cuts in social benefits do not make for a very popular policy. Yet, welfare retrenchment is only one among several political options. Politicians can react to economic slumps or to sustained periods of low growth by either cutting (social) spending, rising taxes (included herein: by increasing social insurance contributions), or by running a higher state debt. Today simple legislative inactivity is not an independent option any more since it would lead unavoidably to either higher taxes or higher debt. *All* of these measures are unpopular, so that simple 'blame avoidance' arguments (Weaver 1986, 1988a; Pierson 1994) do not help us much analytically. Should we then expect that politicians employ a random policy mix among more or less equally unattractive alternatives? We argue that different political opportunity structures have rendered the one or the other choice out of the 3-course policy menu (cut costs, raise taxes, run a higher debt) politically less or more expensive.

In this respect we want to highlight two particularly crucial dimensions of variation among the OECD countries, which in our view have been – at least partially - responsible for the marked differences in the response of these countries towards the new situation of diminished growth and high unemployment since the mid-1970s. First, we hold that it is important whether an independent central bank inhibits the central government from amassing a large fiscal debt and from reacting flexibly to economic shocks. Second, we claim that it is of importance whether the welfare state is financed predominantly by contributions or by taxes.⁴ These dimensions, we hold, have as yet not attracted sufficient scholarly attention in the analysis of the OECD-countries' economic response pattern since the 'end of the golden age'.⁵ The first point is straightforward. A central bank committed to a non-accommodating monetary policy reacts to an increase in the public debt with retaliatory interest rate hikes. This makes the 'debt-option' as compared to the other two options - raise taxes or cut costs - relatively less attractive (Eijffinger/ de Haan 1996; Masciandaro/ Tabellini 1988). Therefore it is no surprise that the literature regularly finds a “fairly strong negative relationship of CBI to debt” (Franzese 2002: 146-147). This also means that a government can not respond flexibly with a loose fiscal or monetary policy to economic shocks (these costs of 'monetarist credibility' are discussed in the economic literature under the header of the *sacrifice ratio*; cf. Ball 1994; Jordan 1997). Of course, if the instruments of monetary and fiscal policy are not at government's full disposal, the welfare state as an absorber of economic shocks gains in importance. It is here where the second argument comes in.

It holds that a welfare state financed predominantly by contributions (Bismarckian-type/ social insurance-type welfare state) offers to the state the opportunity to raise revenue less visibly as compared to predominately tax-financed welfare states. A number of

⁴ This correlates with a welfare state's performance/ output side: does it emphasize transfers or the public provision of welfare services - including prominently active labor market policies; Huber/ Stephens (2001, 2001a)?

⁵ Central Bank Independence has been primarily studied in connection with national systems of wage bargaining (see the work of Scharpf 1991, Iversen 1998, Iversen/ Soskice, Hall 1994, Franzese, Hall/ Franzese 1998, Way 2000 and others), but not in connection with welfare state/ public spending. Welfare state spending (the fiscal structure of the welfare state) has been primarily studied as a dependent variable, but not as an independent variable that itself may explain different patterns of public debt growth or welfare retrenchment.

arguments support this claim. First, most tax increases have to be legislated, while social insurance contributions most often adjust automatically whenever revenue falls short of expenses ('automatic government'; Weaver 1988). Moreover, increases in contribution rates often can be better legitimized due to their strong nexus with entitlements – higher revenue promises higher expenses *from which the contributing person itself can expect to benefit* (Hibbs/ Madsen 1981: 418-423). Harold Wilensky speaks of the “illusion that social security taxes ... are paid for benefits duly and directly received, while an income tax is lost to the winds” (Wilensky 1975: 61). But the perhaps most important difference between taxes and contributions is that financial questions in tax-financed welfare states are dealt with in the annual budget-process, decided by the cabinet with a more or less influential role of the minister of finance, whereas in contribution-financed welfare states usually the minister of finance not only has no formally guaranteed right to be heard in questions concerning welfare state finance, but also has no immediate interest in the ‘social budget’ (cf. Strauch/ von Hagen 2000; Hallerberg/ von Hagen 1999; Hallerberg/ Strauch/ von Hagen 2001; Hallerberg 2003). Here most often a minister of labor and/ or social affairs is responsible – and (s)he is usually a minister with a pro-spending bias.⁶ In other words, the political capacity to cut costs as well the political interest in retrenchment are generally lower in Bismarckian welfare states. In the jargon of the Common Pool Resource Problem (CPR) approach: contribution-financed welfare state quite automatically establish the ‘fiefdom’-mode of fiscal governance (Hallerberg 2003: 17-38).

The flipside of this politically important separation between the welfare state- and the general-budget is that the state is also continuously tempted to shift social spending out of the public budget - financed by taxes - and into the special budgets of the welfare state - financed by contributions. This is all the more so if an independent central bank exerts strong pressures to observe strict fiscal discipline. Cost externalization is of course only a viable strategy if big contribution-financed transfer programs exist that can accommodate cost shifts which would provide substantive fiscal relief for the central state’s budget. In sum, our argument claims that we can expect social insurance contributions to increase in

⁶ Given that in some countries welfare state revenue from social insurance contributions amount to more than 40 % of total government revenue, it seems necessary that the literature on ‘fiscal

relative importance (i.e., as a share of GDP) in countries with a Bismarckian welfare state as a reaction to economic slumps.⁷

Needless to say, if welfare state revenue arises from contributions rather than from taxes, welfare state expenditures are quasi-earmarked to honor the entitlements ‘earned’ by these contributions. Such a welfare state is much less free to put its revenue to use, it is much less flexible to target its resources according to need or criteria of maximal efficiency and it is much more inclined to follow a reactive, post-factum approach with a heavier reliance on compensation of income loss instead of human capital investments and labor market activation policies and with a stronger emphasis on transfers than on welfare services (Garrett 1998, Boix 1998, Huber/ Stephens 2000; Scharpf 2001). Moreover, as has been often observed, in times of crisis the necessity to honor the entitlements earned by previous contributions even crowds out all measures (like active labor market policies) that cannot legitimate themselves with a tight contribution-benefit nexus – despite the fact that these are the very measures that would be particularly needed in times of economic shocks (Schmid et al. 1992). This would mean that the response pattern of social insurance type welfare states is influenced in a double way: on the one hand, states face massive fiscal difficulties to cope with an economic crisis by way of temporarily expanding (targeted) fiscal policy. At the same time these states face systematic incentives to cover the increasing revenue/spending gap in times of sluggish growth via contribution rate hikes especially if an independent central bank prevents to increase the public debt.

From this follow the subsequent predictions: If indeed these two dimensions of institutional variation are of importance for the response pattern of modern political economies and mature welfare states towards a much more unfavorable economic environment we should be able to observe that in crucial dimensions the OECD countries headed into different directions after they woke up from the ‘dream of permanent

constitutionalism’ more systematically takes into account the welfare state budget process.

⁷ While it is often claimed that in economic terms there is not much of a difference between taxes and social insurance contributions, in fact there are some economically profound differences: social insurance contributions are usually levied from a much smaller proportion of the population than taxes, usually only from those ‘dependently employed’, and they are usually deducted only from wages, not from other sources of income. Often they are also much more regressive, i.e. start from much lower levels of income than taxes.

prosperity' in the mid-1970s. More specifically, we expect those countries with a high degree of CBI and a dominant role of contributions in welfare state finance to tend to cover their rising welfare state bills mainly out of increased contributions with some emphasis on expenditure cuts, whereas those countries with a high degree of CBI and a predominant role of taxation should be those countries that have rather followed a policy of welfare retrenchment and cover the remaining gap between revenue and welfare state expenditures by tax hikes. In countries with a low degree of central bank independence an increase in the public debt is a less costly option and it should thus be more pronounced than in those countries with a high level of CBI, with the countries with a Bismarckian-type welfare state at the same also delegating a rising fiscal burden to the welfare state, whereas countries with a tax-financed welfare state are expected to employ a mix of retrenchment and tax-hikes.

To emphasize it again: our argument generates expectations about the *relative weights* with which countries employ different policy options. Clearly, in absolute terms almost all OECD countries since 1970 have increased spending, debt and revenue at the same time (Franzese 2001; see below Table 1). Moreover, given that each of the three basic responses to fiscal stress comes with increasing political costs, we would expect that over time the relative weights given to certain policies shift and that initially 'dominant strategies' may later become 'dominated strategies'. Moreover, it should be kept in mind that the relationship between the three options is not simply one of substitution. While the basic policy options are partially substitutes for each other, especially in the short run (e.g., if you can run a higher debt, you feel less pressured to raise taxes), they can also be complements to each other, especially in longer perspective (e.g., increasing debt service may force you to raise revenue). This suggests that the policy-mix will not remain stable over time and that – over a longer time period - countries do not differ so much with respect to these policy mixes but with respect to the *order* in which they employ and thereby possibly ruin their basic policy options.

Finally, countries may change strategy also because the institutional matrix that attaches costs to strategies itself does not remain stable over time. In the time period under inspection especially central banks independence has significantly increased in almost all OECD-countries. Countries do not inevitably have to choose the single 'least costly'

option among the feasible set of policies, but they can also – to a certain extent at least – alter the basic institutional setting within which they make this policy-choice. As a self-binding strategy a country may, for instance, foreclose for itself a certain strategy by rendering it too costly. Yet, that all this in the end has not simply resulted in convergence is proved by the different ‘mixtures of malaise’ to which the different response sequences have led. Obviously, some sequences were more economically advantageous than others. The following section will ask if there is sufficient empirical evidence in support of these predictions. First we will provide the reader with a descriptive overview with respect to the development of revenue, expenditures and debt in the OECD since the early 1970s until the mid-1990s. The chosen time period begins with the onset of the first oil crisis which had heralded the next 30 years of sluggish growth, and it ends in the mid-1990s with the accomplishment of European monetary union, which profoundly altered the parameters of monetary and fiscal policy for an important subset of the OECD-countries. Subsequently we will ask if the basic assumptions of our argument are corroborated by a statistical analysis.

3. Dilemmatic Choices

To start with, table 1 provides a brief overview over the development of taxes, social insurance contributions, debt and expenditures for 17 OECD countries from 1972 to 1995.

Table 1: Expenditures, Revenue, Debt, 17 OECD countries 1972-1995

	Total Expenditures	Total Tax Revenue	Social Security Contributions as a % of GDP	Debt as a % of GDP
USA 1972-1995	33.1 - 35.6	27.7 - 28.7	5.7 - 7.8	40.4 - 63.1
Canada 1972-1995	37.2 - 48.1	33.1 - 40.4	3.0 - 6.3	52.1 - 100.5
UK 1972-1995	39.2 - 44.2	33.6 - 35.5	5.2 - 6.3	68.6 - 59.7
Netherlands 1972-1995	44.9 - 54.2	40.3 - 43.9	14.1 - 18.4	46.0 - 78.5
Belgium 1972-1995	39.6 - 54.6	37.0 - 46.5	11.7 - 15.4	62.0 - 131.2
Italy 1972-1995	37.0 - 51.8	28.5 - 41.3	11.2 - 13.1	49.3 - 124.3
Finland 1972-1995	32.4 - 59.1	33.9 - 46.5	4.4 - 12.9	13.1 - 58.1
Sweden 1972-1995	45.5 - 67.0	44.2 - 49.7	8.5 - 14.5	30.7 - 80.1
Norway 1972-1995	45.0 - 48.9	48.2 - 41.5	12.7 - 9.8	42.4 - 43.1
Denmark 1972-1995	40.4 - 61.6	42.9 - 51.5	1.7 - 1.6	17.6 - 73.6
Australia 1972-1995	26.5 - 37.3	24.9 - 30.6	0 - 0	31.3 - 43.4
France 1972-1995	37.3 - 54.1	35.6 - 44.5	14.7 - 19.3	30.8 - 60.1
Switzerland 1972-1995	27.2 - 36.6	23.9 - 33.7	5.6 - 12.6	24.6 - 37.1
Spain 1972-1995	22.5 - 45.3	18.5 - 33.9	7.5 - 12.3	14.7 - 71.0
Portugal 1972-1995	22.5 - 45.3 (1992)	22.5 - 34.9	6.4 - 9.4	17.5 - 69.2
Germany 1972-1995	38.8 - 49.2	37.3 - 41.2	12.1 - 15.4	18.5 - 62.2 (1990: 45.5)
Austria 1972-1995	35.6 - 51.5	37.2 - 44.0	9.3 - 15.4	17.1 - 69.3
Minimum - maximum 1972	22.5 - 44.5	18.5 - 48.2	0 - 14.7	13.1 - 68.6
Minimum - maximum 1995	35.6 - 67.0	28.7 - 51.5	0 - 19.3	37.1 - 131.2

Source: IMF OECD

The first finding is that of substantial and (in absolute terms) increasing differences among the OECD countries in the dimensions under investigation. The countries entered the crisis on quite different grounds, and variation had even increased by 1995. Table 1 also lends first evidence to our argument by revealing a high degree of *systematic* variation along the two dimensions that our argument highlights: conservatism of monetary policy and the financing mode of the welfare state. For instance the group of countries with a low degree of central bank independence and Bismarckian welfare states (France, Belgium, Italy, Spain, Portugal) exhibit – as expected - the strongest increase of public debt (grey shaded cells). Similarly, Scandinavian countries like Sweden and Denmark increased tax-revenue most from already high levels (red cells), whereas traditional Bismarckian countries with a non-accommodating monetary regime were those countries in which contribution rates increased most over the time period that is under inspection here (blue cells). Expenditure dynamics seem to be least developed in those anglo-saxon countries that combine tax-financing of the welfare state with monetary conservatism (green cells). financed welfare state and a rather loose monetary policy (e.g., Sweden or Finland) combine strong increases in debt with strong increases in tax revenue.⁸ But this is impressionistic evidence derived from pure data inspection and Table 1 contains evidence contradicting our general expectations as well. This is so because the above formulated qualifiers (catch up effects, diminishing returns, long-term complements, changes in the institutional matrix) make it highly unlikely that we can *directly* find confirmation for our theory in the data.

In order to test for our hypotheses we have to take a more thorough look at the empirical evidence. Therefore we have computed a set of variables that measures the deviation of national policy choices from the OECD mean. The rationale behind the transformation of raw data is to isolate the information on the *relative importance* of instruments from the general trend in the OECD world and from level differences between the OECD countries. Both aim can be reached by a straightforward double transformation, where we at first ‘z-transform’ the data according to

⁸ It has to be mentioned, though, that by ending observations in 1995 we get an especially unfavorable view on Finland and Sweden, both hit hard by recessions in the first half of the 1990s. Debt and growth have significantly improved since then.

$$\frac{x_{i,t} - \bar{x}_t}{\mathbf{s}_t} \equiv x_{i,t}^z \quad (1)$$

where $x_{i,t} - \bar{x}_t$ measures the difference between country i 's use of policy instrument x (x stands for debt, social security transfers and tax revenue, respectively), and \mathbf{s}_t measure the sample standard error of x at time t . The superscript denotes that the data is z -transformed. As a result, $x_{i,t}^z$ is a de-trended measure of country i 's deviation from the mean OECD country's use of the policy instruments in a particular year t .

In a second step, we have normalized the data according to

$$\frac{x_{i,t}^z - x^{\min}}{x^{\max} - x^{\min}} \equiv x_{i,t}^{zn} \quad (2)$$

which eliminates time trends in the data. The superscript zn stands for a z -transformed normalized data.

Thirdly we have simply computed the relative national share of the policy instruments by

$$\frac{x_{i,t}^{zn}}{\sum_1^3 x_{i,t}^{zn}} \quad (3)$$

The variable can easily be interpreted as relative use of the three policy instruments under consideration, where data is a) de-trended, and where b) sectoral variance in the *aggregated* use of the policy instruments has been eliminated.

What we have left over is only the variance in the weight each country gives to the particular instruments. In other words: The sum of the variable values is 1.0 for each single country and in each year, the perfect all-time OECD-median would in every year employ the three basic policy options with a (0.33; 0.33; 0.33) weighted mix. The relative importance of each instrument, however, varies a lot between countries and is also not perfectly stable over time. Obviously, we have eliminated variance. Therefore, the question naturally emerges what we have won by doing so.

The answer to this question is rather simple: We have eliminated the overall increase in the use and misuse of the three policy instruments, because we are *not* interested in explaining why governments have largely increased redistribution over the post-war period. And we eliminated cross sectoral variance in the aggregate use of the three policy instruments, because this paper does not intend to explain why some countries were less

disposed to spoil the government's budgets as others were. Of course, both questions are interesting and important to devote time and effort. But these two variances veil the question we are most interested in: the dependence of policy instruments' relative attractiveness on the institutional setting.

Once we have isolated the relative use of instruments, it is straightforward to account for path-dependency: The following table regresses the relative use of two out of three policy instruments on absolute changes in the other policy instruments. If we observe positive coefficients, governments balance the use of their instruments; if we observe negative coefficients, governments have a strong preference for that policy instrument, which have more heavily used in the past. Therefore, our theory predicts negative signs in the regression of changes in one instrument on the measure of relative importance of the other instruments.

Table 3: TSCS-regression with panel corrected standard errors and correction of serial correlation in the errors, 17 OECD Countries, 1974-1995

Independent variables	<i>Model 1</i> Dependent variable: ? debt β -coefficients (z-statistic)	<i>Model 2</i> Dependent variable: ? tax β -coefficients (z-statistic)	<i>Model 3</i> Dependent variable: ? ssc β -coefficients (z-statistic)
z-transformed and de-trended debt	-	0.57 (0.77)	-0.93 (-3.93)
z-transformed and de-trended tax	-0.076 (-4.62)	-	-0.37 (-2.98)
z-transformed and de-trended ssc	-0.054 (-3.69)	-0.16 (-0.46)	-
Growth	-0.21 (-5.96)	-0.44 (-0.19)	-4.19 (-5.05)
Unemployment	0.001 (4.14)	-0.03 (-1.96)	-0.01 (-1.84)
Openness	0.004 (0.44)	-0.23 (-0.96)	-0.07 (-0.47)
Left	-0.003 (-0.99)	0.08 (0.56)	-0.01 (-0.20)
Constant	0.05 (3.39)	0.40 (1.19)	0.71 (6.82)
R ²	0.18	0.03	0.14
N obs.	392	392	392
Rho	0.713	0.13	-0.13
estimation procedure	xtpcse, c(ar1)	xtpcse, c(ar1)	xtpcse, c(ar1)

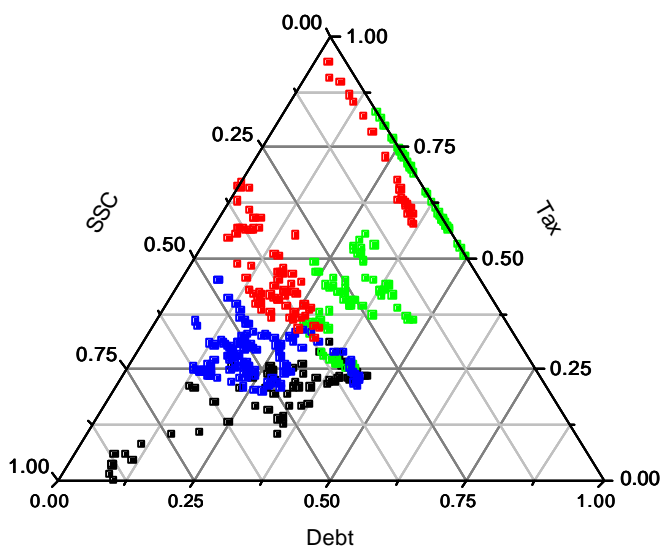
As table 3 exhibits, regressions analyses by and large support our theory. Note that the results are not sensitive to running a fixed effects model or to account for serial correlation (coefficients not reported here). With the exception of *Model 2* we do observe stable and significant inverse relations between our three variables of interest. *Model 2* suggest that over the entire period a rising public debt service more often forced countries to *increase* revenue than bringing fiscal relief: Furthermore, regressions which restrict attention to certain time periods (not reported here) reveal that throughout the 1980s taxes, social insurance contributions and public debt indeed were substitutes for each other, whereas in the 1970s for almost the entire decade their relation remained positive. The 1990s provide us with a rather mixed-pattern, in which signs change from negative to positive and back. This suggests that countries initially responded to the crisis in a rather

experimental fashion by employing ‘everything they had’, which presumably was motivated by the hope to be able to ‘dive through’ the crisis in a Keynesian mode. Only later it had to be painfully acknowledged that the economic slowdown was more than a temporal phenomenon.

We have demonstrated the existence a significant path-dependency in the choice for policy instruments. In what follows, we demonstrate that the patters we have observed are systematically related to the institutional variables our theory holds responsible for government behavior.

Figure 1 displays the relative importance of policy instruments in all OECD countries of our sample over the entire period under observation.

Figure 1: Ternary of relative importance of policy instruments, 17 OECD countries 1972-1995



In Figure 1, we show how four groups of countries (Scandinavian = red, Anglo-Saxon = green; Continental = blue; Southern Europ. = black), that are closely associated with our two dimensions of institutional variation, differed in their economic and fiscal adjustment strategies since the mid-1970s. Figure 1 reveals that typically Anglo-Saxon countries that

combine tax-financing with conservative monetary regimes have used taxes as political instrument. The Scandinavian countries that mostly combine dependent central banks with a tax-based social security system have employed - similarly to their Anglo-Saxon counterparts - taxation as the privileged policy instrument. However, Scandinavian countries are more balanced. Furthermore, countries of continental Europe highlighted by the blue colour, combine contribution based transfers with central bank independence. These countries are characterized by large transfer systems. Finally, the South European countries denoted by the *black* colour combine transfers and central bank dependence. This cluster, as expected, is biased towards the use of debt.

4. Conclusion

We have proposed to analyze the economic adjustments of the OECD countries in response to a much more unfavorable economic environment since the mid-1970s in the light of the three basic options that a government has when confronted with an increasing gap between revenue and expenditures: increase taxes, cut expenditures or run a higher public debt. We have suggested that these basic options are of varying attractiveness depending on the institutional context in which a government has to employ the one or the other policy. In this context we have emphasized the importance of two variables – 1) the level of central bank independence, and 2) the financing structure of the welfare state. In particular, we have argued that a political strategy that combines fiscal conservatism with passive welfare state policies is a 'natural outcome' within a setting with strong central bank independence and a welfare state financed by contributions instead of taxes – a combination classically represented by the German political economy and her 'continental/ conservative' welfare state.

We claim that this paper's argument has several merits.

First, it allows going beyond the simple insight that welfare retrenchment might be unpopular. By analyzing welfare retrenchment in connection with the other basic policy

options we can, we claim, formulate more precise, institutionally informed ‘blame avoidance’ arguments. These proved to have substantial explanatory value when confronted with the data. Crucial is, we hold, to change the level of analysis from welfare *programs* and their political opportunity structures (cf. Pierson 1994) to entire welfare state *regimes* plus political economies and their political opportunity structures.

Secondly, this also means that one should not base the analysis of welfare retrenchment exclusively on expenditure data, as still many contributions to the field do. Instead the argument calls for an integration of expenditure with tax- and debt-data. Thirdly, this paper emphasized the interplay between monetary and fiscal policy and its varying impact on welfare state finance. In the comparative political economy literature central bank independence has mainly been analyzed in connection with wage bargaining, not with social policy. Yet, we argued that monetary policy exerted an important impact on social policy by determining the degree to which a government can resort to a higher public debt when confronted with an adverse economic environment. Fourth, this paper suggested that the marked differences in distributive outcomes between the OECD-countries are *not* primarily caused by differences in voters’ political preferences about these outcomes, be they past or present preferences (Esping-Andersen 1990; Iversen/Wren 1998). Rather, we have argued, different political costs attached to different political strategies must be hold responsible for the observable pattern of systematic variation within in the OECD-world. This explanation allows combining an institutionally informed perspective with a realistic conception of politics, in particular with realistic rationality assumptions. This would also explain why a measurable political partisan influence vanished in most of the econometric analyses over the 1980s and 1990s, whereas the countries largely remained on their distinct adjustment paths.

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Appendix: