

Norman Schofield · Gonzalo Caballero · Daniel Kselman *Editors*

## Advances in Political Economy

Institutions, Modelling and Empirical Analysis

This book presents latest research in the field of Political Economy, dealing with the integration of economics and politics and the way institutions affect social decisions. The focus is on innovative topics such as an institutional analysis based on case studies; the influence of activists on political decisions; new techniques for analyzing elections, involving game theory and empirical methods.

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shrink government. On December 21 Congress did approve a temporary spending bill up until March 2011.

On December 18, the “Dream Act” to allow illegal immigrant students to become citizens failed on a Senate vote of 55–41, but the Senate did vote 65 to 31 to repeal the “Don’t Ask, Don’t Tell” legislation, making it possible for gays to serve openly in the military. The House had previously approved this repeal by 250 to 175.

On December 20, the Senate voted 59 to 37 to reject an amendment to the new arms control treaty, New Start, with Russia. The amendment would have killed the treaty because any change to the text would have required the United States and Russia to renegotiate the treaty. Two days later the Senate voted 71 to 26 for the treaty. This treaty was seen as the most tangible foreign policy achievement of President Obama’s administration. Thirteen Republicans joined a unanimous Democratic caucus to vote in favor, exceeding the two-thirds majority required by the Constitution.

As Obama said:

I think it’s fair to say that this has been the most productive post-election period we’ve had in decades, and it comes on the heels of the most productive two years that we’ve had in generations. If there’s any lesson to draw from these past few weeks, it’s that we are not doomed to endless gridlock. We’ve shown in the wake of the November elections that we have the capacity not only to make progress, but to make progress together.

However, the Democrats in Congress increasingly represent the richest and the poorest constituencies, while the Republican Party is no longer the party of the wealthy but of the disillusioned middle class and the ultra-wealthy. Given the results of the 2010 elections, it is no surprise that a highly divided Congress and increasingly activist driven politics has resulted in escalating partisan conflict in the run up to the 2012 election.

### ***5.1 Gridlock in the 112th Congress***

One of the first moves by the House in the 112th Congress was to vote, on January 19, 2011, to repeal the Health Care Bill by a margin of 245 to 189. However, this repeal was not able to pass the Democrat majority in the Senate and would obviously not be signed by President Obama.

In early April, 2011 a shutdown of the government was only just averted by a compromise that cut the budget by \$38 billion. After much wrangling, the House passed legislation on April 14, to finance the federal government for the rest of the fiscal year. The final House vote was 260 to 167, with 59 members of the House Republican majority and more than half the Democratic minority voting against the legislation. The bill also passed the Senate, 81 to 19, again with many Republicans opposed. On April 15, the House voted 235 to 193 to approve the fiscal blueprint for 2012, drafted by Representative Paul D. Ryan, Republican of Wisconsin and chairman of the Budget Committee. The blueprint proposed a cut in expenditure of \$5.8 trillion over the next decade.

1381 By July, it seemed that the political system was again in gridlock with the parties  
1382 completely polarized over the question of the US public debt. The debt ceiling  
1383 was at \$14.3 trillion and the current US Treasury debt was \$14.29 trillion.<sup>45</sup> Re-  
1384 publicans demanded a reduction in spending and the maintenance of tax cuts, while  
1385 Democrats basically wanted the opposite, continued spending on social programs  
1386 and tax increases on certain segments of the population.

1387 The House on Friday July 29, finally approved a plan for a short-term increase  
1388 in the debt ceiling and cuts in spending. The vote was 218–210, with 22 Republi-  
1389 cans unwilling to support the efforts by House Speaker, John A. Boehner, to get a  
1390 bill approved. This ended a week of intense fighting among Republicans. The game  
1391 then shifted to the Senate which tabled the House proposal. On August 1 the House  
1392 of Representatives passed a compromise bill, 269–161, supported by Democrats,  
1393 increasing the debt ceiling by \$400 billion, with an additional \$500 billion through  
1394 February, with spending caps of over \$900 billion. A newly designed joint commit-  
1395 tee was vested with the responsibility of determining future cuts of over \$1 trillion.  
1396 The Senate passed the bill 74–26 on August 2 with 19 Republicans, and 6 Democrats  
1397 and one independent voting against. President Obama immediately signed the bill  
1398 into law. Despite the eventual compromise on the debt ceiling, on August 5, 2011  
1399 Standard and Poor, the credit rating agency, downgraded US Federal debt from AAA  
1400 to AA+, and the Dow industrial index dropped about 20 % in the following days.  
1401 However, demand for US Treasury Bonds increased.

1402 On September 13, President Obama acted on the economic turmoil set off by  
1403 the Debt Ceiling debate, Standard and Poor downgrade and continuing European  
1404 debt crisis by sending a \$447 billion jobs bill to Congress. Initial reaction from  
1405 Republicans indicated a willingness to accept some measures of the bill, coupled  
1406 with an insistence on keeping tax cuts for the wealthiest and resistance to closing  
1407 corporate loopholes. On November 21, however, the Joint Committee to reduce the  
1408 deficit announced that it could not come to any agreement, but declared: “We remain  
1409 hopeful that Congress can build on this committee’s work and can find a way to  
1410 tackle this issue in a way that works for the American people and our economy.”  
1411 The Dow closed down about 2 % for the day.

1412 The debate over the jobs bill highlights the fact that, despite media attention to  
1413 the contrary, Obama has attempted to attract and retain pro-business social liberals  
1414 with his response to the economic crisis. In addition to naming General Electric  
1415 CEO Jeffrey Immelt as Chairman of the President’s Council on Jobs and Competi-  
1416 tiveness, the President’s second Chief of staff was former Commerce secretary and  
1417 bank executive William Daley. These steps, along with his massive budget propos-  
1418 als providing relief to banks and other businesses in order to address the economic  
1419 down-turn, has angered many in populist circles. Meanwhile, insistence on closing  
1420

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1421  
1422 <sup>45</sup>Of this \$6.2 trillion is held by the US government, \$2.7 trillion in the Social Security Trust  
1423 Fund, \$1.9 trillion in other government agencies and \$1.6 trillion in the Federal Reserve. China  
1424 and Hong Kong hold \$1.3 trillion, other countries hold \$3.2 trillion, the remaining \$3.6 trillion is  
1425 held by pension funds etc.

1427 corporate tax loopholes and the spectre of increased financial regulation, has eroded  
1428 business support for the President.

1429 This lack of support in both the populist and cosmopolitan quadrants leaves  
1430 the President and his party vulnerable to attacks by traditionally conservative Re-  
1431 publicans as well as to the more populist demands of the Tea Party. As a result  
1432 of persistently high unemployment rates, populist anger has spiked and it is and  
1433 even spawned a second, distinctly liberal-minded populist group, the “Occupy Wall  
1434 Street” protesters. It is possible that the Republican Party will gain votes from the  
1435 blue-collar voters who are suffering the most from the economic collapse. Should  
1436 the Republican party cater to the traditional populist demands expressed by those  
1437 in the Tea Party, they will be hearkening back to an era of old-style populism as  
1438 expressed by William Jennings Bryan: anti-Wall Street, anti-banking, anti-Detroit,  
1439 anti-immigration, and pro-evangelical religion. This will result in a party realign-  
1440 ment to a situation where the socially liberal and economically conservative “cos-  
1441 mopolitan” Democrats are opposed to populist Republicans. That is, the Republican  
1442 Party may begin to move to the lower left quadrant of the policy space, while some  
1443 business interests in the upper right quadrant will switch to the Democrats.<sup>46</sup> Over  
1444 the long term, the partisan cleavage line may rotate further in a clockwise direction.  
1445  
1446  
1447

## 1448 **6 Conclusion and 2012**

1450 Money has made US politics irrational. With legal barriers falling and money  
1451 playing an increasingly large role in recent elections, this irrationality and non-  
1452 convergence to the electoral center is likely to persist. The 2012 election cycle  
1453 highlights the role of money and non-convergence. Early Republican Presidential  
1454 frontrunners included Tea Party darlings Representative Michele Bachman, Rep-  
1455 resentative Ron Paul, and Governor Rick Perry along with seasoned conservative  
1456 ideologues former Senator Rick Santorum and former Speaker of the House Newt  
1457 Gingrich. Comparing himself to the other Republican candidates, Former Governor  
1458 Mitt Romney initially admitted to seeking a more centrist route to the nomination,  
1459 but facing activist money such as the PAC “Make Us Great Again” which supported  
1460 Rick Perry to the tune of \$55 million and billionaire Sheldon Adelson who pro-  
1461 vided tens of millions in support of Newt Gingrich, Romney was forced to adopt  
1462 increasingly conservative policy positions. By the end of the primary campaign,  
1463 some Republican strategists were publicly declaring concern that Governor Rom-  
1464 ney had taken such radically conservative positions in the primaries that it might be  
1465 hard for him to appeal to moderate voters in the general election. All the while, new  
1466 legal precedent allowed the Federal Election Commission to turn a blind eye to the  
1467 creation of candidate Super PACs, such as “Make Us Great Again” for Republican  
1468

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1470 <sup>46</sup>For example, on April 28, 2010 Arlen Specter, the Senator from Pennsylvania, shifted his alle-  
1471 giance from the Republican Party to the Democrats.  
1472

1473 Rick Perry and “Restore Our Future” for Republican Mitt Romney. Even President  
1474 Obama’s PAC “Priorities USA” plans to raise \$100 million for the 2012 election.

1475 Utilizing the model we have presented, we contrast the current situation with the  
1476 1960s. After Kennedy was elected President in 1960 (by a very narrow margin of  
1477 victory against Nixon), he delayed sending a Civil Rights Bill to Congress, precisely  
1478 because of the possible effect on the South (Branch 1998). To push the Civil Rights  
1479 Act through in 1964, Johnson effectively created, with Hubert Humphrey’s support,  
1480 an unstable coalition of liberal northern Democrats and moderate Republicans, with  
1481 sufficient votes in the Senate to effect ‘cloture’, to block the southern Democratic  
1482 filibusters.<sup>47</sup> This was the first time since Reconstruction that the Southern veto was  
1483 overwhelmed. The danger for Johnson in the election of 1964 was that a Repub-  
1484 lican candidate could make use of the fact of Republican party support for civil  
1485 rights to attract disaffected social liberals. Traditional Republican Party activists  
1486 were thus in an electoral dilemma, but resolved it by choosing the southern social  
1487 conservative, Goldwater. The present gridlock between the legislative and executive  
1488 branches is more extreme than in 1964 because there are now no moderate Republi-  
1489 cans to join the social-liberal coalition. The electoral pivot line has rotated so that  
1490 all Republicans are located in the socially conservative half of the policy space. In  
1491 addition money has become more important and has made US politics “irrational”.  
1492 With money playing an increasingly large role in recent elections, this electoral irra-  
1493 tionality and non-convergence to the electoral center is likely to persist. Moreover,  
1494 powerful activist groups in the cosmopolitan and populist sectors have the potential  
1495 to draw in politicians and shift the partisan cleavage line between parties. Were it  
1496 not for the resources the activist groups provide it would be irrational for politicians  
1497 to move toward these activist bases. Simply put, activists influence politicians so  
1498 they adopt policies that would be electorally irrational, were it not for money.

1499 Popper (2008) argued that plurality electoral systems, otherwise known as “first  
1500 past the post” were to be preferred to proportional electoral systems because they  
1501 gave voters a clear choice. As we have seen, the constitutional structure of the US  
1502 polity, coupled with the influence of money has recently tended to gridlock. Al-  
1503 though there is the appearance of choice for the voters, Government has been unable  
1504 to come to grips with the severe quandaries briefly mentioned in the introduction.  
1505 The absence of effective choice by the US increases uncertainty in policymaking  
1506 thus creating a difficult situation for business and international leaders attempting  
1507 to make long-term investments and policy decisions. Indeed, Posner and Vermeule  
1508 (2011) argue that the United States needs to reconsider its constitutional separation  
1509 of powers in the presence of such gridlock and uncertainty.

1510 On the other hand, the recent European debt crisis has led to the fall of govern-  
1511 ments in the multiparty systems of Ireland (February, 2011) Finland (2011), Por-  
1512 tugal (June 2011), Denmark (September, 2011), Slovakia (October 2011), Greece,  
1513 Italy and Spain (November 2011). The model presented here and developed further  
1514

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1515 <sup>47</sup>Caro (2012: 568) describes the drama of the cloture vote of Jun 10, 1964 after a filibuster of 57  
1516 days with 27 Republicans and 44 Democrats voting aye. The bill passed on June 19 by 73 to 27.  
1517 The voting Rights Act of 1965 passed again after a long fight by Johnston against Congress.  
1518

1519 in Schofield and Gallego (2012) suggests that in fragmented or multiparty systems,  
 1520 based on proportional representation, small parties will adopt radical policies far  
 1521 from the electoral center, thus inducing coalition instability. This phenomenon cou-  
 1522 pled with a fragile fiscal system based on the euro also has created difficulties in  
 1523 dealing effectively with the fall-out from the recession of 2008–2009. At the time  
 1524 of writing this euro crisis has not been resolved.

1525 A general perspective on recent events is provided by Lind (2012). He suggests  
 1526 that in order to maintain a post World War II international economic system to facil-  
 1527 itate growth and oppose the Soviet Union the US maintained its hegemonic power  
 1528 by its willingness to accept mercantilistic trade strategies by its allies Germany,  
 1529 Japan. In the first 30 years until the oil crisis of the 1970's this system could be  
 1530 maintained without great cost. Indeed economic growth in the US was maintained.  
 1531 Although Nixon tried to limit this mercantilism by coming of the gold standard in  
 1532 1973, Finance capital exerted pressure to sustain this system of US dominance. Af-  
 1533 ter the fall of the Soviet Union, it seemed attractive to allow China to institute trade  
 1534 mercantilism, allowing it to grow very rapidly. As Keynes saw back in 1945, such  
 1535 a system is inherently unstable. The resulting “globalization” (and increased trade  
 1536 flows) has led to the massive US trade deficits of the last thirty or forty years, and  
 1537 the loss of much of the manufacturing capacity of the US. While increased trade  
 1538 has contributed to an increase in global GDP, it has forced down unskilled wage  
 1539 rates in the US. It is for this reason that the US has become such an unequal econ-  
 1540 omy (Stiglitz 2012), making the conflict between labor and capital more intense.  
 1541 High artificial savings by China and its willingness to fund US debt (both necessary  
 1542 components of its mercantilism) disguised the costs to the US, but also provided  
 1543 the financial basis for the extreme form of speculation that came to dominate the  
 1544 market. Capital benefited from globalization and was able to fund political support  
 1545 for the maintenance of this hegemonic system. Stiglitz adds that the current mode  
 1546 of oligopoly rent seeking in the US is consistent with the external pattern of hege-  
 1547 mony and sustains both inequality and underprovision of social public goods such  
 1548 as innovation. Since the most important global public good is prevention of climate  
 1549 change, the severe costs of this potentially unstable political economic system will  
 1550 burden future generations.<sup>48</sup>

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 1552

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1560 <sup>48</sup>Israel (2012) has pointed out that the modern period since 1700 witnessed a conflict between  
 1561 a Radical Enlightenment espoused by Condorcet, Jefferson and Paine, in support of reason and  
 1562 equality and opposed to monarchy and hierarchical hegemony, and the compromising Moderate  
 1563 Enlightenment of Hamilton and Burke.  
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# Sub-central Governments and Debt Crisis in Spain over the Period 2000–2011

Fernando Toboso

## 1 Introduction

Since the financial crisis erupted in the fall of 2008, the government borrowing sector has been in turmoil in almost all western developed countries. The present chapter focuses on the quantitative evolution of sub-central, as well as central, government borrowing in Spain, a country that is being experiencing serious problems at this respect. Because an intense process of political and fiscal decentralization has taken place in Spain since the mid eighties, the chapter examines whether this drive to decentralization has been paralleled by any fiscally undisciplined behavior on the part of sub-central governments over the periods 2000–2007 and 2008–2011. The empirical analysis will be based on the internationally comparable public finance provided by the OECD, the Eurostat and the Bank of Spain. As regards the breakdown by governmental subsectors, the National Accounts criteria<sup>1</sup> require the government sector to be broken down into four sub-sectors: central, state, local and social security funds. Concerning public debt, central governments usually are by far the most important debt holders, owing more than half of total debt in most cases, as we are going to see also in the case of Spain. Of course, Spain enjoys some singular organizational characteristics regarding intergovernmental relations

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<sup>1</sup>S.N.A. 93 has recently been updated to S.N.A. 2009. These criteria are fully compatible with those of E.S.A. 95.

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A previous version of this chapter was presented at the International Conference on Political Economy and Institutions held in May 2–4, 2012, Baiona, Spain. I thank participants in the conference, as well as anonymous referees, for helping me to concentrate on what we all consider to be the key issues.

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and debt issues that will have to be addressed in the paper, including legal controls on borrowing by sub-central governments.

It is worthy to mention here also that Spain represents a country that has experienced both a relatively rapid economic growth till 2007 and a policy of significant political decentralization since democratic transition in 1978. Seventeen regional-state parliaments and executives were created from the outset in their own political and electoral processes from 1979 to 1982. Each regional-state government autonomously enjoys now even more public policy responsibilities than the Länder in a traditional federal country such as Germany.<sup>2</sup> Central-managed public expenditure went from 87 per cent of total expenditures in 1983 to about 45 per cent in 2011. Sub-central governments' share in public expenditures went from 13 per cent of total in 1983 to about 54 per cent in 2011. Concerning tax powers and other autonomous sources of income at sub-central governments' disposition, several reforms have also taken place to increase their financial autonomy, with intergovernmental grants already representing less than 40 per cent of total income for regional-state governments in 2011. A significant devolution of the power to tax, not just the centrally collected tax revenue, to each regional-state government has also taken place since the 1980s.<sup>3</sup> All these figures already indicate that Spain has become a politically and fiscally quite decentralized country. Particularly, regional-state governments are now key policy actors as their autonomous regulatory powers have also increased substantially and their share in sub-central expenditure already reached 70 per cent of total sub-central expenditures in 2010. That is why regional-state parliaments and executives are already treated as states are in federal countries, with their public finance figures being classified as such for the reasons already mentioned.

Of course, all these figures represent a rough estimate of political decentralization because they do not take into account many relevant qualitative aspects such as, for example, the degree of discretion governments have regarding each type of expenditure, or the exact degree of regulatory power each sub-central government enjoy. Some of these expenditures may be financed from conditional grants or earmarked grants, for example. But this is not an issue to be addressed in the present paper. The issue of how are figures internally consolidated among subsectors will not be addressed either because the impact of this aspect on global percentages is irrelevant for the research purpose at hand.<sup>4</sup> Local governments' public finances figures that will be used include the spending, revenue, debt, etc by municipal and provincial governments, as well as by other governmental agencies created by each municipality or related public enterprises, as it is typically done when elaborating National Accounts statistics.<sup>5</sup> The same comments apply to the central and regional-state levels of government. In the case of subsectors, debt issued by social security

<sup>2</sup>On this comparison see Toboso (2006a), (2006b) and (2010).

<sup>3</sup>On this see Toboso (2005), Toboso and Scorsone (2010).

<sup>4</sup>On these and other measuring problems see Martinez-Vazquez and Timofeev (2010), Toboso (2006a) and Toboso and Scorsone (2010).

<sup>5</sup>A different issue that will not be addressed in the paper is that in Spain as elsewhere there are several public services whose management has been externalized to private or public enterprises,

93 funds will appear included at the central level as it is the central government who  
94 decides upon this debt in Spain.<sup>6</sup> Figures referring to “all governments” are consol-  
95 idated among subsectors, as it is done in National Accounts.

96 Therefore, to accomplish its purpose, the present chapter is organized as follows.  
97 Following introductory remarks, in Sect. 1 I briefly review some of these key gen-  
98 eral contributions to the topic being investigated in the present paper. In Sect. 2 an  
99 empirical analysis is conducted for the period 1996–2007 on the Spanish case using  
100 National Accounts multilevel public finance figures in order to show the evolution  
101 of sub-central as well as central debt before the world financial crash. In this section  
102 the paper emphasizes some singularities regarding key aspects of the multilevel or-  
103 ganization of government that exists in Spain, including legal details in place over  
104 the period concerning the ability to incur in deficit and to issue debt by sub-central  
105 governments. In Sect. 3 the same is done as regards to the 2008–2011 period that  
106 followed the said financial crash. This section will show that Spain has experienced  
107 a considerable increase in public deficit and debt since 2007, mainly at the central  
108 level. It also points to the current economic recession and the initial counter-cyclical  
109 measures adopted by all governments, including the increase in public expenditure  
110 needed for bailouts in the financial sector, as key factors leading Spain to exceed  
111 during this second period the limits on public deficit settled in the European Stabi-  
112 lity and Growth Path. Section 4 concludes by emphasizing that economic conditions  
113 seem factors more relevant for explaining the evolution of central and sub-central  
114 debt in Spain than factors linked to political and fiscal decentralization arrange-  
115 ments. As stressed in Sects. 3 and 4, the above statement is not to claim that debt  
116 limits, as well as some other public sector regulatory details and behavioral political  
117 practices, are irrelevant. The chapter also leaves for future econometric research the  
118 task of assigning numbers to the relative magnitude in which each of these impact  
119 factors have influenced the evolution of debt at the different tiers of government.  
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## 122 **2 What Are the Main Factors Influencing the Evolution** 123 **of Sub-central Debt that Are Being Emphasized** 124 **in the Literature?** 125 126

127 Before examining what has happened with sub-central, as well as central, debt we  
128 need briefly investigate which are the main factors influencing this evolution that are  
129 often stressed in the literature. Rodden and others<sup>7</sup> have made outstanding contribu-  
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131 to mixed consortiums, to public-private partnerships, etc. When these organizations belong to the  
132 business sector their activities are not directly accounted as part of the “general government” activ-  
133 ities (central-regional-local-social security funds) but indirectly following National Account rules.

134 <sup>6</sup>This is not the case regarding multilevel public finance statistics provided by the IMF. That is why  
135 the percentages that follow are not strictly comparable with IMF based percentages. The OECD  
136 databases do not provide desegregated figures for social security funds debt for all countries.

137 <sup>7</sup>See Rodden (2002), Rodden and Wibbels (2002), Rodden et al. (2003), Rodden (2006).  
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