Comments on Recent Fiscal Developments and Exit Strategies

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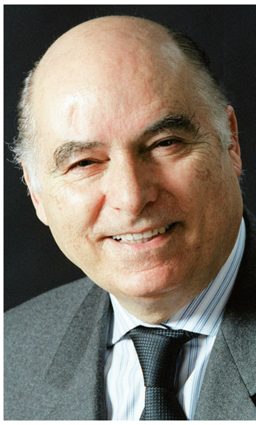

General background

In a note published in *The Financial Times* of 12 August 2003, the author of this comment advanced the hypothesis that the world might be moving towards a future fiscal crisis. The reasons for such a prediction were three-fold. Firstly, significant structural fiscal deficits and high public debts characterized many countries (including six of the G7 countries) at that time. Among the G7 countries, the only exception was Canada. Secondly, widely anticipated demographic developments would become significantly unfriendly to the countries' public finances by around 2010. These demographic changes would require important and painful reforms in public pensions, health care, care for the aged and other welfare programs. These reforms would be politically unpopular, as President George W. Bush quickly discovered when he attempted to reform the US social security system in 2005. Third was a development that had attracted little attention but that, a few years earlier, had inspired a cover story in *The Economist* of 6 June 1997. The story had the catching title of 'The Disappearing Taxpayer'. This hypothesis was associated with the existence of 'fiscal termites'. It argued that globalization of economic activities and financial markets, combined with ongoing technological developments (internet-use, trading in non-tangible goods, etc.), was making it progressively more difficult for countries (and, *ceteris paribus*, especially for high-tax countries) to raise tax levels, or even maintain the high levels reached in past years. Some observers had dismissed the hypothesis. However, the latest data available for OECD countries indicate that, in the first decade of this century, the ratio of taxes to GDP fell in most of them, and even in those countries that, because of high fiscal deficits, would have been expected to increase taxes. A talk with any country's tax administrator would provide strong support for this hypothesis. *Ceteris paribus* taxes are always more difficult, politically, to increase than to cut. On the other hand, public spending is always easier to increase than to reduce. These important asymmetries should not be forgotten in the pursuit of fiscal policy.

The 2003 Financial Times note had been written at a time when the economies of many countries were doing relatively well, and governments were not facing urgent 'exit strategies'.

The crisis and the response to it

In 2008 there was the unwelcome visit of a major financial crisis, and, in late 2008 and especially in 2009, that of an economic crisis. The financial crisis had not been as unanticipated as generally reported – see, for example, Tanzi (2007a). The huge economic imbalances that had accumulated among countries and the ongoing bubbles in some sectors within countries had been sending strong warning signs that should have been listened to. Most countries felt the full impact of the crisis in 2009. At that point, concerns that might have existed about future fiscal developments – because of the anticipated demographic changes as well as theoretical and practical doubts that had been raised over the years about the effectiveness of discretionary fiscal policy (such as the existence of various lags, possible 'Ricardian equivalence' reactions, impacts of high debts and high fiscal deficits on the confidence and the psychology of investors, questions about future fiscal sustainability, etc.) – were pushed aside or ignored. Closet Keynesians came out of the closets and some became very vocal in encouraging or, better, in pushing governments to increase public

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spending to fight the crisis, or to take advantage of it to promote public sector activities that they had wanted to see promoted. Some did this with the same degree of spending enthusiasm shown by sailors, when they go on shore after having spent many months at sea.

The calls by some articulate and well-placed economists became loud and even shrill. These calls were supported, and amplified, by similar calls coming from international institutions including the IMF. Those advocating counter-cyclical Keynesian fiscal policies were not satisfied with letting the automatic stabilizers do their work. Because of the severity of the crisis, and especially because of its impact on the incomes of sectors that (partly because of bubbles) had contributed significantly to tax revenue (especially the financial industry), without any discretionary action by governments, the fiscal deficits would still have increased rapidly and significantly, and would have provided some large, automatic stabilization to the countries' economies. The calls were for additional, discretionary fiscal stimulus directed especially towards higher public spending. There was a repeat of the calls, in the 1990s, on the Japanese government to increase Japan's fiscal deficit to fight that country's undergoing financial crisis. Those calls made a mess of the Japanese fiscal accounts but contributed little or nothing to economic growth (see Tanzi 2008). It was forgotten that a fiscal expansion, which starts when the fiscal accounts are already out of balance and already face large future problems, is less likely to be effective than when it starts from balances and sustainable fiscal accounts.

It was argued that the larger the fiscal stimulus, the better it would be in fighting the crisis. Large fiscal stimuli were presumably needed to 'prevent another Great Depression', a possibility assumed to be very likely without additional public spending. There were frequent references, by the supporters of large fiscal stimulus packages, to abysses being faced and to the need to step back from them with the help of higher public spending.

These calls ignored many significant differences between the current situation and that of the 1930s. During the 1930s, for example:

- Government expenditure and taxes were very low (as shares of GNP). In the United States, for instance, general government expenditure was only 9.9 percent of GNP in 1929, while general government receipts amounted only to 10.9 percent of GNP. Federal expenditure and receipts were respectively only 2.5 and 3.7 percent of GNP in the same year (see Stein 1984). In other countries these ratios were not much higher.
- Consequently, there were hardly any automatic stabilizers during the Great Depression.
- Fundamental errors (such as letting the money supply fall sharply, engaging in protectionist 'beggar thy neighbor' policies, and others) were committed. These errors contributed to transforming the 1930s crisis into a Great Depression.
- Bank deposits were not insured, making runs on banks a common experience.
- Only few individuals received pensions or other fixed incomes.

The situation during the current crisis was dramatically different. Public spending and tax levels were much higher, in many countries well over 40 percent of GDP. These levels provided major automatic stabilizers that would increase the fiscal deficits during the crisis without discretionary fiscal stimulus packages. Central banks were ready to intervene, and they did intervene, to inject huge amounts of liquidity in the system, and to rescue 'too-big-to fail' financial institutions in difficulties with their loans and their purchases of toxic assets. To a large extent central banks became large 'off-budget budgets'. Protectionist tendencies were largely contained by better collaboration among G7 and G20 countries. Most bank deposits were insured, preventing runs on banks. Many individuals depended on pensions and on other fixed incomes (for example, salaries from public employment) that were not, or were not much affected, by the downturn in the economy. Furthermore, in several countries, and especially in the United States, there was no convincing evidence of 'under-consumption' or of 'excessive saving' that is a major justification for Keynesian policies. Even during 2009 the United States continued to run very large trade deficits and to have personal saving ratios close to zero.

The current economic crisis was thus not a classical Keynesian crisis of deficient aggregate demand (as might have been the Great Depression). Therefore, it could not be corrected by demand management and by an injection of fiscal stimulus. Rather, it was a crisis created by monumental structural imbalances, especially in the United States, imbalances both in current accounts and among sectors within the countries. The imbalances had been created, or had been stimulated, by inadequate policies, both monetary and fiscal, in recent years. These imbalances required special attention. They required policies specifically directed to the causes that had led to the crisis.

The imbalances were particularly pronounced in foreign trade and among important sectors, such as housing, the automobile industry and, of course, the financial sector. In the United States the financial sector had seen its share of total profits rise from about 5 percent in the 1940s to more than 40 percent in this decade. Thus, the cost of financial intermediation for the economy had increased phenomenally, inviting the important question as to the value the financial market was contributing to general welfare to justify such a large share of total profits. Some sectors, and especially the housing sector, had grown far too much because of the actions of the financial market. It needed to be scaled down to reduce the imbalances. The right policy should have been to reduce the bubbles and to correct the structural imbalances and not to follow policies that would allow these sectors to maintain their inflated incomes or claims on total resources. But this is largely what current expansionary policies have tried to do.

An important point to make is that, while automatic stabilizers expand (automatically), during an economic slowdown, and can thus be expected to reverse themselves (automatically) when, and if, the economic situation returns to normal, fiscal stimuli, created discretionally, require legislative changes, both to create them and to undo them. Unless these changes have clear and inflexible (that is politically resistant) sunset provisions, and unless they have been specifically directed at correcting the structural imbalances (rather than at just injecting money in the economy), they are likely to make the long-run fiscal situation worse. Often they do not correct the structural imbalances but allow them to continue in the future, making 'exit strategies' in the fiscal area more difficult.

This happened in Japan in the 1990s, where the fiscal expansion created many useless government programs strongly defended by interest groups. It is now happening in the United States, where the huge fiscal stimulus package of February 2009 will allow some clearly unproductive activities or some overgrown sectors (car industry, housing and financial market) to continue to operate at excessive levels. Some of the policies being followed make no sense in terms of correcting the existing structural imbalances.

As Pearlstein (2009) put it, politicians in Washington are proposing to spend a lot of money that they do not have, in ways that will not work, to help too many people who are neither desperate nor deserving. He listed among 'the idiotic ideas' the bipartisan push to re-inflate the housing bubble, and called 'this $10 billion boondoggle' a giveaway to the real estate industrial complex and one of those strategies that are as nonsensical in theory as they are in practice. The bill passed in the US Senate on a 98 to 0 vote! This shows the power of lobbyists in determining the details of fiscal policies and why an exit strategy for the fiscal sector will be difficult to devise.

Confusing what was largely a structural crisis with a traditional Keynesian under-consumption crisis has led to policies that have created a fiscal mess and that are likely to prolong the existence of structural imbalances and to reduce potential economic growth in future years.

A character in Charles Schultz' popular 'peanuts cartoons' used to say that with enough ketchup, he could eat anything. It seems that many policymakers (and some vocal economists) believe that with enough public spending, any country can be rescued from any economic crisis, even when the crisis is structural in origin and has been created by poor and unsustainable policies. The existence of high unemployment is assumed to guarantee that the huge injections of liquidity in the systems by central banks, and in part by the large fiscal deficits (indirectly finance by the central banks) will not lead to inflation. In this connection two comments may be worthwhile:

Firstly, Morgan (1947, 84) states that "it is possible that increases of private or public expenditure will lead to sharp price rises in given areas or occupations, while there is still heavy unemployment elsewhere. An increase in the hiring of labor in Massachusetts will not diminish unemployment much in California and a road building program may not much alleviate distress in the local textile industry". We find here another important asymmetry. Prices tend to increase more easily than they tend to decrease. This point is particularly important when the crisis is structural and has thus a geographical or sector-specific impact. We tend to forget that the mobility of factors like labor is limited even in the

United States where people are supposed to move more readily than elsewhere. People will not move from Massachusetts to Arizona to occupy houses left empty by the housing bubble; or from the automobile industry in Michigan to Texas where jobs may be more abundant in the oil industry.

Morgan's sixty-year old view is clearly relevant today, when the economic crisis has a major structural dimension. Because of this, it is puzzling to listen to the statements made by Governor Ben Bernanke and others that high unemployment guarantees that inflation will not become a concern – in spite of the huge expansion which has taken place in bank reserves and the huge fiscal deficits which, to some extent, are being or will be indirectly financed by the actions of the Federal Reserve.

Secondly the view that inflation cannot coexist with a high unemployment rate is not consistent with much historical evidence from other countries. For example, anyone who worked in Latin America in the 1970s and 1980s would know better: in the 1980s Argentina experienced one of the certified 'great depressions' of the twentieth century. It happened with huge inflation and enormous falls in output (Tanzi 2007b). It would be wise to keep these experiences in mind.

Exit strategies

Let me now turn briefly to the exit strategies. We are told (for example, by the Managing Director of the IMF and by others) that they should be prepared now but should not yet be acted upon. As Strauss-Kahn said in a speech in London on 23 November 2009, "it is too early for a general exit [and] exiting too early is costlier than existing too late".[1] One is reminded of Saint Augustine who asked God to give him chastity, but not yet. Thinking of exist strategies from the current fiscal mess one is tempted to recall a story about an Irishman who got lost in a backward, rural area of Ireland. When he asked someone how he could get to Dublin, the answer he got was: 'mister, if I were going to Dublin, I would surely not want to start from here'. If we wanted to move toward genuine, sustainable fiscal situations in the future, we would not want to start from where we are now. Unfortunately, there is no choice.

Three comments could be made in connection with exit strategies from the fiscal mess. First, the longer exit policies are postponed, the larger will the public debts become that will, in turn, send negative signals to economic operators in general. Thus waiting is not a neutral policy. Second, if economic growth remains week, there may never be an ideal, or even good, time to exit. The time of exit will become the subject of political discussion as it became in Japan. Third, the more time passes, the stronger will become the vested interests that protect the new spending programs introduced. Also, the idea of developing and announcing the exit strategies now but waiting until the right moment to enact them would be an invitation to all the lobbies of this world to organize themselves to prevent the needed changes.

Those economists who contributed to pushing the countries into the current fiscal mess, believing that they were rescuing them from a great depression, are not likely to have fully appreciated how difficult the exist strategies will be in the fiscal area. This area requires political decisions and coordination among various institutions and political groups at each junction. In this respect exit strategies in the monetary area are much less demanding because they require far fewer political decisions. The exit strategies will be especially difficult for countries that went into the crisis with already high public debts, large fiscal deficits and worrisome demographics. Obviously, the few countries that started with better fiscal situations, Canada among them, will have an easier, though still tough time. It will not be a walk in the park for any country.

The IMF (2009) has provided useful, but obviously tentative, estimates for G20 countries of the fiscal effort that they will need to exit from the fiscal mess. Reminding readers that many advanced economies entered the crisis with relatively weak structural fiscal positions, this report highlights the fact that government debt in advanced G20 economies would amount to 118 percent of GDP in 2014, even assuming some discretionary tightening the following year. According to this report, Japan, Britain, Ireland and Spain would require the largest fiscal adjustment, and across the G20 the average overall deficit would reach 7.9 percent of GDP in 2009. This is surely an extraordinary level. In the advanced economies the structural primary balances would deteriorate by 4 percentage points of GDP between 2007 and 2010.

[1] See *The Financial Times*, 24 November 2009.

It should be added that the above estimated deficits have not been inflated by the interaction of inflation and high public debts, as so often happened in past episodes. It is well known that this interaction can distort and inflate conventional measures of fiscal deficits. The current deficit estimates basically assume zero inflation. Thus, in some sense, they have greater 'density' (are greater per percentage unit of GDP) than were the deficits in past years in countries that had significant public debts and some inflation.

The exit strategy, defined as one that brings government debt-to-GDP ratios below 60 percent (the original Maastricht level) by 2030 for advanced countries "would require steadily raising the structural, primary balance from a deficit of 3.5 percent of GDP in 2010 to a surplus of 4.5 percent of GDP in 2020 – an 8 percentage point swing in one decade – and keeping it at that level for the following decade" (IMF 2009, 23). The required adjustment between 2010 and 2020 amounts to 13.4 percent of GDP in Japan, 12.8 percent in Britain and 11.8 percent in Ireland, followed by 10.7 percent in Spain and 8.8 percent in the United States. In Canada, the necessary adjustment is a more modest 3.1 percent of GDP. Only Canada would be within reach of the famous Maastricht criteria that had been considered too strict and were consequently relaxed some years ago.

This adjustment would come at a time when demographic developments will become particularly unfriendly and when growth rates (and tax revenue) are likely to be lower than in recent years. The reason for the expected lower growth rates is that the crisis must have reduced potential growth rates of countries by (a) lowering investment during the crisis years, (b) increasing unemployment, and (c) lowering labor force participation caused by the difficulty in finding jobs. It could be added that recent years' growth rates had been artificially inflated by existing bubbles, and the demographic trends will contribute to the reduction of the working-age population.

The estimated fiscal adjustment required reflects relatively optimistic developments on the financing front. Many observers expect that interest rates will increase due to the pressures coming from high fiscal deficits to be financed and high public debts to be serviced (in practically all countries), and the reversal of 'quantitative easing' policies carried out by central banks. Should interest rates begin to rise, the required fiscal adjustment could easily become much larger than that estimated by the IMF.

Past adjustment experiences

The IMF (2009) also shows that in past years some countries had been able to significantly improve their cyclically-adjusted primary balances, expressed in terms of a percentage share of GDP, over periods that extended from 3 to 15 years. In other words, this study stresses that large fiscal adjustments are possible. This is obviously an important message. However, a few comments may be appropriate regarding this matter.

First of all, the argument refers to experiences of single countries operating in isolation. Unfortunately, this finding does not adequately reflect collective experiences within similar global developments. Furthermore, for the reasons mentioned earlier, the fiscal deficits had probably been inflated somewhat by the interaction of inflation (and increased nominal interest rates) together with significant public debts.

Second, large reductions in public debts and in fiscal deficits can be possible or easier to achieve by four developments: (a) significant falls in real interest rates, (b) rapid economic growth, (c) unanticipated inflation and (d) major reforms that redefine the proper role of the state in the economy and that lead to large reductions in public spending (or to some increases in the level of taxation).

The first two of these developments are unlikely to characterize future developments. It is unlikely that the present, extremely low real interest rates could fall even more or that the growth rate could be significantly higher in the next several years. The third (higher inflation) may play a role, just like in the past, as a consequence of the large injection of liquidity made by central banks. The expectation and the hope is that central banks will have the tools, the independence, and the political courage not to allow inflation to become a serious problem. However, what economists call the 'time consistency' temptations could play a role, as they have occasionally done in the past. Some governments are likely to push central banks to inflate, especially if the maturity of the public debts is significant. However, in several countries that maturity was reduced recently to benefit from lower rates on shorter maturity instruments.

The last alternative is clearly the most desirable, although it is not an easy one. Because of the difficulties and the economic cost in raising the level of taxation in today's world, the better strategy would be one that required a significant rethinking of the spending role of the state – a rethinking aimed at significantly reducing the now much inflated level of public spending (see Tanzi 2009). A few countries successfully followed this strategy in the past two decades. These countries have shown that it is a possible, though not an easy strategy, and that public welfare does not suffer as a consequence.

Conclusion

The exit strategy and the kind of adjustment that will be needed by many of the G20 countries in future years will require very difficult choices and great political determination. It cannot be based on the often-heard, recent slogan of 'less market and more state'. Future reforms and a sustainable exit strategy should rather be guided by the slogan: 'more efficiently regulated markets with less, but more efficient, public spending'. Reducing the level of public spending and making it as efficient as possible would have the double objective of allowing a reduction in the fiscal deficit and promoting growth. This would be an effective exit strategy. A better-regulated private market would facilitate the reduction in public spending by making it possible to shift some current government functions to the private sector. Also, to the extent that there are possibilities for introducing taxes on harmful activities, including environmental charges, they could be relied upon. An immediate introduction of these reforms is recommended.

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