Realistic Recovery

Why Keynesian Solutions Will Not Work

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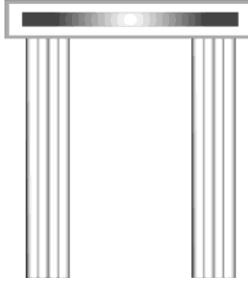

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I
Tackling the Economic and Fiscal Crisis
Debate and Reality

The financial, economic and fiscal crises (often known as the Great Recession) that rocked many, especially European, countries in the years after 2007, prompted some unexpected reactions from economists and policymakers. The *discretionary* or *active* fiscal policy (as distinct from the passive one associated with the automatic responses of so-called *built-in stabilizers*) lost much of its allure among academic economists (less among politicians) after the decade of the 1970s. Recently it was quickly resuscitated and promoted. This often happened with almost religious zeal, by some highly vocal and well placed economists and financial columnists such as Paul Krugman, Larry Summers, Jean Pisani-Ferry, Christina Romer, Martin Wolf and others. Discretionary or active fiscal policy is the one associated with 'fiscal stimuli'. It requires specific policy action by governments to change public spending or tax revenue. Some international institutions, including the IMF, advocated this policy at the beginning of the crisis. However as time passed, they became more cautious in their statements.

Several countries soon discovered the limitations of *discretionary* fiscal policy, when they had to deal with increasing 'spreads' and had to face the unpleasant reality that if their governments wanted to spend more money than they had, they would need to have access to additional credit at reasonable rates; they needed the equivalent of a 'rich uncle' willing to finance their need for additional resources. This reality applies for both individuals and governments.

Because of their high fiscal deficits, several though not all countries were soon faced by high *and rising* interest rates in the middle of a credit glut financed by the expansionary monetary policies of central banks. The high and rising rates put limits on the use of expansionary fiscal policy for some of the countries. Ironically, when a discretionary expansionary fiscal policy might have seemed most needed, it became more difficult to use, at least for several European countries.

This study will first consider the original formulation of the Keynesian fiscal policy to highlight some of its limitations. It will then discuss the context in which that policy was originally formulated, while identifying some of its implicit, but often ignored, assumptions. Finally, it will address the question of what realistic strategies ('exit strategies') the countries undergoing the fiscal crises could adopt if they are to escape their current predicaments. It will argue that the proponents of those policies mentioned above along with some others have ignored the assumptions and the limitations implicit in the use of Keynesian policy.

II
A Keynesian Solution? Theory and Practice Today

The use of discretionary, or active, budgetary policy to counter the economic and social effects of recessions was proposed by J. Maynard Keynes 76 years ago. It has been intensely debated since 2008, after the Great Recession started. Some participants in the debate (which has involved economists, policymakers, civil servants, financial reporters, union leaders and citizens) advocated and continue to advocate a relaxed fiscal stance (one that would maintain or even increase the already high fiscal deficits). In their view, this policy would help sustain aggregate demand, thus maintaining higher employment and economic activity.

Some of the observers have lamented that the 'stimulus packages' enacted by the governments in the early years of the crisis were not large enough to do the job. Others have complained that the stimuli were not maintained long enough and that governments started too soon to consider the reduction of fiscal deficits and to stop the rise in public debts, arguing instead for continued high fiscal deficits until unemployment and economic growth return to 'normal' levels. The most outspoken proponent of this view has been Paul Krugman, who won the Nobel Prize in economics and writes regularly for *The New York Times*, and increasingly Martin Wolf at the *Financial Times*.

On the other hand, many other economists and observers who include Edmund Phelps, Kenneth Rogoff and Alberto Alesina have worried about the sharp rise in interest rates and the increasing 'spreads' that have been experienced by several European countries; about the fast growth in the public debts of many countries, including the UK and the USA; and about the long term fiscal sustainability of several countries, especially when the costs of anticipated demographic trends and ageing are added to the current developments. They have therefore advocated fiscal restraint and even reductions in fiscal deficits over the medium term. Many countries already concerned about their deteriorating fiscal situations have taken action to bring their fiscal accounts under better control; or have at least started to discuss the need for action, including Italy and the UK.

There have also been strong pressures on the European Central Bank and on other central banks from the politicians and columnists in newspapers such as the UK's *Financial Times*, France's *Le Monde*, and Italy's *La Repubblica* to play the role of the rich and generous uncle by buying, directly or indirectly, the government bonds of countries inside and outside the euro area, in the belief that this would keep interest rates paid by EMU governments low, without creating inflationary pressures.

Some economists have continued to believe that the high unemployment rates that are now common in most countries, and the excess capacity that prevails in some sectors, will prevent prices from rising. The pressure exercised on (independent) central banks has had some success in inducing them to facilitate, directly or indirectly, the sale of public bonds by governments**.** The ECB and other central banks have acquired from the secondary market huge amounts of government bonds and have made large resources available to private banks, thus allowing them to buy government bonds.

There have also been pressures on the few remaining European countries that still have AAA ratings, and especially on Germany, to create 'fire walls' around the EMU countries in fiscal difficulty, by assuming some of the risks toward creditors who are lending or have lent to the affected governments. There has also been pressure for the issue of Eurobonds and for Germany to pursue expansionary policies. Economists including Hans-Werner Sinn, Daniel Gros, Jean Pisani-Ferry, and some of his associates at Bruegel, (a research institution in Brussels), have urged Germany to pursue expansionary and inflationary policies. In their opinions these expansionary policies by Germany would reduce the competitive advantage that it has acquired,over the years, vis-a-vis southern EMU countries, thus facilitating the economic situation of the latter countries.[1]

To evaluate such an approach, certain factors must be considered. This piece will focus mainly on two. The first is whether, before the 2008 crisis, the fiscal accounts of the affected countries had been in reasonably good shape. The second is whether the crisis that hit the countries in 2008 and in subsequent years was of the traditional business cycle variety implicitly assumed by Keynesian economists. Both of these factors are relevant in determining whether ample scope for the use of an active fiscal policy after the crisis started existed.

Provided a country has had a *prudent and sustainable* fiscal situation at the outset, characterized by low fiscal deficit, low public debt, and a modest and easily sustainable tax burden; and provided there is a *traditional* recession, one characterized by the 'weakening of animal spirits' which has led consumers to spend less and enterprises to invest less, a stimulus fiscal package could (and many would argue should) be relied upon to help alleviate the short-term effects of the recession. Such a package would inject some necessary additional demand and would assist the automatic fiscal stabilizers which do not require an *active* governmental intervention. Provided these conditions existed there would be a reasonable expectation that an (active) fiscal stimulus would be helpful.

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[1] See for example Jean Pisani-Ferry, Andre Sapir and Guntram B. Wolff, 'The Messy Rebuilding of Europe', *Bruegel Policy Brief*, 2012/1, (2012).

If used, an active fiscal stimulus should be pursued with *reversible* increases in public spending and/or with *reversible* decreases in taxes. Built-in automatic fiscal stabilizers, activated by the weakening of the economy, would assist the *discretionary* fiscal action. Furthermore, the (Keynesian) *multiplier effects* would enlarge the total impact of the initial fiscal action on the economy especially if the economy is not excessively open and if most individuals do not base their spending decisions on their *permanent* incomes. This is the general position and one implicitly assumed by the traditional Keynesian stabilization policy. It is the textbook version of active counter-cyclical fiscal policy that economics students learn at school.

In fact, well before the 2008 crisis the fiscal situation of many countries was already precarious especially when taking account of the impact of demographic trends. Many countries had already high and difficult-to-increase average tax ratios, high and growing public debts, and significant fiscal deficits, within a context of relatively low economic growth. Indeed, there had been a growing possibility of an impending fiscal crisis, on account of fiscal developments in several countries. These developments had been evident several years earlier and signalled the possibility of a coming fiscal crisis.[2]

The Great Recession was not a recession of the traditional variety, associated with 'weakening animal spirits' (spirits that could reverse themselves in a country that does not have significant bubbles or major distortions). It was rather a crisis associated with major misallocation of resources which had created bubbles, which subsequently burst as a result of *unsustainable* imbalances. This was the prevailing situation before 2008. Very high current account deficits, that in some countries had reached ten per cent of GDP, could not have been sustainable. The bubbles were concentrated in one or several large sectors of the economies. In the period before the Great Recession, the bubbles which were largely financed by cheap, often foreign loans had been concentrated in sectors such as: housing and more broadly construction; in sectors associated with that industry; in finance; in the auto industry; and in some others. Bubbles are normally accompanied by large imbalances in the external sector, especially when the financial market is global. They may affect several countries at the same time, thus creating cross-country spillovers and some difficulties in coordinating policies among countries.[3]

A crisis that does not originate in the 'weakening of animal spirits', – a weakening which for often unexplained psychological reasons can also occur in a country in

[2] See for example Vito Tanzi, 'The Return to Fiscal Rectitude After the Recent Escapade', *Rivista di Politica Economica*, 100 (2011), pp.253-277; and 'To Scrap Fiscal Prudence Would be a Mistake', 12 August 2003, *Financial Times.*

[3] Vito Tanzi, 'International Coordination of Fiscal Policies: Current and Future Issues' in M. Monti (ed.) *Fiscal Policy, Economic Adjustment, and Financial Markets*, (Washington, 1989).

which the allocation of resources has been broadly correct and bubbles had not developed – but originates from the pre-crisis, major misallocation of financial and real resources and of workers, will present the authorities with particular problems. For example, the existence of the bubbles is likely to have inflated the country's pre-crisis growth rate, as well as the country's tax revenue, because of the incomes created and the windfall taxes generated by the bubbles. These can create the perception that before the crisis the economic and fiscal situations were sounder than they actually were. In fact this seems to have been the prevailing view until 2007 in several European countries and in the United States. As a consequence, it becomes more difficult to determine correctly the magnitude of variables, such as the 'structural deficit' and the 'potential income', needed to determine the size of a 'required' fiscal expansion or fiscal correction.

Besides reducing the countries' saving rates by increasing spending by households, the pre-crisis bubbles also created excess supplies of some products and activities (houses, shopping centers, equipments and supplies for furnishing houses, real estate agencies, cars and car dealerships, some financial services, retail outlets, etc.). Major asset price effects were generated by the capital gains linked to high house prices and other assets. The excess supplies of *some* goods and services will remain for some, possibly a long, time after the bubbles burst. However, the asset price effects that created the capital gains will reverse themselves. The large capital gains before the crisis will become large capital losses after the crisis. Many new houses and commercial buildings will remain empty, pushing down the value of the whole housing stock (including the old houses) and of the commercial buildings.

In the United States, Spain, Ireland and several other countries the excess supply of houses, at the time the bubble burst, was enormous. Millions of newly-built houses remained unsold and some were subsequently vandalized. Millions of workers who had been employed through these lost their jobs. Because of the fall in personal wealth and the associated fall in income and consumption, many retail shops were forced to close. Many new cars remained unsold, thus the value, not only of the new cars but also that of the total existing stock of cars, was reduced as had happened on a larger scale for houses. To provide an idea of the magnitude of some of these stock effects, since 2006, US homeowners have lost an average of $122,000 per household.[4] This has occurred at the same time as the US *gross* public debt rose from 61.1 percent to 100 per cent of GDP, creating enormous future tax liabilities for American households. These effects will not disappear for years to come and may even rise.

The excesses in the supply of some goods and services also influenced *downward* the indices used to measure inflation, leading some economists to express fears about

[4] Reported in the *New York Times*, 8 April 2012, p.10, using *Moody's Analytics* U.S. Census and Bureau of Labor Statistics data.

deflation. Housing contributes a large share of the basket used to measure price indices. The perceived fear of deflation has led some economists to push for more expansionary fiscal and monetary policies and some central banks to increase enormously their balance sheets, despite the inflation indices continually exceeding the levels that the central banks had considered consistent with price stability. This has happened in spite of a downward bias and has especially been a problem in the UK.

The consequences of these stock effects on economic activities could not fail to reduce the demand for workers, leading to higher unemployment especially among the workers employed in the sectors affected most by the bursting bubbles. Millions of these workers had been employed to produce new houses or the materials and equipment to fill them; many more had been employed to process and sell the mortgages for such new houses.

In addition, the difficulties in these sectors could not fail to have major consequences for fiscal policy. A first consequence is that a *discretionary* fiscal expansion is likely to have less of an impact on an economy which has experienced a bursting of bubbles than when a recession is of a more traditional type. This is due to the problem of more time being needed for the unemployed workers to be fully redeployed in sectors *different from* those in which they had been employed before the crisis. For example, workers who had lost their jobs in the housing or the financial sectors would need to move to new jobs, perhaps in green energy production. These new sectors would require different skills and might be located in different geographical areas. The countries' economies are therefore likely to perform at less than full capacity for some time. During this period – which might extend over many years – economic growth will be lower than before the crisis, and unemployment higher. By reducing tax revenue and by increasing some spending (as for unemployment or for earlier retirement) such low economic activity would inevitably have a negative effect on the fiscal accounts, that will remain precarious and continue to be cause for concern. Public debts will keep rising as shares of GDPs, and would signal rising future costs because of the higher debt and of the likely future higher interest rates.

A second consequence is that a discretionary or active fiscal expansion is not likely to help the economy much, especially if its immediate and medium term effect is to increase interest rates, fiscal deficits and public debt, and if the reallocation of resources across sectors faces inevitable and significant friction. This is especially true given that the excess supplies of goods and services are highly concentrated in some areas and in some sectors. They are not spread widely as might be expected in traditional Keynesian recessions. Increases in interest rates and continued high unemployment have been common in various countries.

A third consequence is that large fiscal deficits and rising public debts *are likely to* create inevitable and damaging *psychological* reactions on the part of investors (both

domestic and foreign) and on the part of consumers because they raise concern about the long term consequences of the current fiscal policies. The role of the media in generating such negative psychological reactions has become more pronounced, partly on account of the tendency to highlight 'bad news' compared with 'good news'. Such psychological reactions are likely to encourage investors to wait before committing resources to new real investments, or before hiring new workers, even when they have the financial means to do so.

An aspect of the recent recession that has attracted comments in financial publications has been that large amounts of financial assets, some in the form of significant undistributed profits, that have been available to private enterprises in some countries but have not been used to make real investments or to hire new workers. Reports from the US suggest that companies have more than two trillion dollars of cash on hand which are not being invested or used to employ new people. The *value of waiting* has definitely risen and entrepreneurs and consumers have become more careful in their spending. They worry about the sustainability of the fiscal policies, fearing that the fiscal imbalances will in time lead to higher taxes, higher interest rates and, if the situation becomes precarious, in some countries, even to defaults. Waiting has become a rational reaction.

If fiscal deficits remained high while economic growth remained low, the share of public debt into GDP would inevitably keep rising as it has been doing. This growth would attract increasing attention and negative media attention, which in turn would reinforce the negative psychological reactions. Recent research, including that reported by Carmen Reinharts and Kenneth Rogoff, has shown that high public debts (above 90 per cent of GDP) tend to have a negative and long term impact on economic growth. It would therefore require a 'suspension of disbelief' to believe that negative developments in the fiscal accounts would have no negative impacts on the investors' propensity to invest, and on the individuals' propensity to consume. Keynesian economists ignore or minimize these reactions.

There are, therefore, strong reasons to assume that when a recession is due to the bursting of bubbles, as was the case in many countries in the Great Recession, the goal of discretionary fiscal policy, *in the short term,* might have to change**.** Instead of the traditional, Keynesian policy of sustaining aggregate demand, a change should be made to one of protecting, where necessary, the most vulnerable citizens that are affected by the crisis with *temporary* public assistance. At the same time, exit strategies such as those reported below should be contemplated and followed. This fiscal goal is different from the traditional one. It is one that can and should only be limited in time.

It might not therefore be wise for policymakers to wait for the economic situation to return to 'normal' before introducing policies aimed at *reducing* the size of the fiscal

deficit and at containing the rise in the level of public debt. For the medium term, the ‘new normal’ is likely to be one of low growth and high unemployment as discussed above. Maintaining the fiscal deficit at a high level, or increasing it, as some economists suggest, would do little to change this reality and would more likely make the longer term situation worse.

Other potential problems that arise in the use of traditional, Keynesian fiscal policy should also be born in mind. Some became obvious over the last half century since the 1960s, when public spending and public debt grew considerably in several countries and such growth occurred in a normal period, rather than in wartime.

The first of these problems could be called *policy asymmetry*. A basic, implicit, assumption required by counter-cyclical fiscal policy is that policymakers who take the policy decisions: (a) do not have biases; (b) have the information and the power to change the fiscal policy in both directions; and (c) when they make mistakes, such mistakes will be random, rather than systematic, ones. They will be as ready and capable to pursue expansionary fiscal policies as they will be to take restrictive fiscal actions. However, the evidence from most countries indicates that, in practice, asymmetry in the pursuit of fiscal policy often exists and can play a significant role.

Policymakers who make the decisions are often more favorably disposed to pursue expansionary fiscal policies. They often have greater freedom to increase public spending, and to a lesser extent to reduce taxes, than to do the opposite and they have a political interest in doing so. This bias has been strengthened by the views of economists who believe that countries grow faster when their economies are being pushed by fiscal deficits than when the public accounts are in equilibrium, or even in surplus. In the decades since the late 1940s, when Keynesianism became popular, many countries experienced a high growth in public spending and in public debt, in the absence of major wars, that could have explained or justified that growth.[5]

Other asymmetries which contribute to similar results should be noted, including *bureaucratic asymmetries* and *citizens’ asymmetries*.

The *bureaucratic asymmetry* has two characteristics. First, heads of government offices or agencies may press for the expansion of the budget and the responsibility for their offices, often to extend their role and salary, which can reflect the size of their office. The role of bureaucracies in the growth of public spending has received some attention in the public choice analyses.[6] Secondly, higher public expenditure is

[5] See Vito Tanzi, *Governments Versus Markets: The Changing Economic Role of the State*, (Cambridge, 2011).

[6] See, for example: Dennis Mueller, *Public Choice III*, (Cambridge, 2003); Alan Peacock, *Public Choice Analysis in Historical Perspective,* (Cambridge, 1992); and William A. Niskanen, *Bureaucracy and Representative Government*, (Aldine, Atherton, 1971).

often linked to an increase in public sector jobs and improved terms for government employees, including higher salaries and more generous pensions. It is not coincidental that the European countries in fiscal difficulty had, in the years before the crisis, significantly increased the benefits of their public employees. Some, for example Greece, had done so at a very high rate.[7]

Major fiscal retrenchment may, in the first instance, affect public employees who may suffer benefit reduction as a result of austerity policies. Public sector employees will have an interest in trying to neutralize such policies in various ways, e.g. explicitly with strikes or work slowdown; or more subtly through various kinds of passive resistance. Recent examples from a number of countries illustrate this.

There may also be *citizens' or voters' asymmetries*. Because fiscal policy often focuses on specific sub-sectors of the population (pensioners, specific categories of taxpayers, etc.), more than on the general population, those more negatively affected by the fiscal retrenchment are likely to react more forcefully. It is rare that the effects of both lax fiscal policies or restrictive fiscal policies are proportionally spread throughout the whole population. Their impact is almost always selective and focused on particular groups. This gives the affected groups a strong interest in organized resistance to defend their higher benefits, or against the spending cuts or the higher taxes which affect them. Such likely reactions, over the years, have contributed to the asymmetry of the fiscal policy and to the growth of public spending and public debt now evident from many countries.

[7] See Michael Lewis, *Boomerang*, (Allen Lane, 2011); Giordano Raffaella, et al., 'The Public Sector Pay Gap in a Selection of Euro Countries', *ECB Working Paper Series*, 1406 (2011).

III
Developed Economies and the Labour Market

As countries become richer and more developed, they require more human capital, and more specialized human capital. When economies grow smoothly and have flexible labour markets with good educational and training systems, the labour force adjusts automatically and continually to acquire the skills that the market requires. Workers become progressively more specialized in the jobs that they occupy. Outside their own specializations, they become progressively less fungible. (They cannot be easily transferred from one job to another that requires different skills. Labour is not like money that can be used to buy any kind of good or service. It is not as fungible.)

When bubbles develop in some sectors (finance, housing, others) and generate high incomes that attract workers to those sectors over several years, more people, over time, will specialize in the skills needed in those sectors. The longer an economy experiences bubbles in particular sectors, the greater will be the number of specialized workers who will gravitate to them. One illustration of this is the attraction of the financial market over the past two decades. Business schools tended to attract increasing numbers of students who acquired the skills in demand by financial institutions. When the bubbles burst many specialized workers lost their jobs. However, the skills that they had acquired were unlikely to be easily useable in other sectors; and when other jobs could be found they would not command incomes equivalent to earnings in such sectors

Government action with stimulus packages rarely create jobs that match the skills of the workers who have lost their jobs. There can also be problems not just of matching skills but of job location. The new jobs might be created at some distance from the previous employment. Transaction costs associated with moving can contribute further to the skills mismatch. This implies that *when the recessions are due to the bursting of unsustainable bubbles*, stimulus packages will be less successful in reducing unemployment in the short and medium term than in traditional recessions.

Under such circumstances, unusual developments can result in high unemployment existing at the same time as significant numbers of job vacancies which cannot be filled because of the lack of workers with the right training. This aspect is generally ignored by traditional Keynesian economics which assumes that workers are broadly *fungible* and can be used wherever there are jobs available. However, there is evidence from the Michigan Rustbelt, where many workers had lost their jobs and the unemployment rate was very high, that there were vacancies but not the skilled workers to fill them, a phenomenon that had become more acute during the recovery.

The analysis was illustrated by a recent report by Deloitte for the Manufacturing Institute, based on a survey of manufacturing, which found that as many as 600,000 jobs are going unfilled.[8]

There is also a demand side to the problem because some who lose their jobs search for equally well-paid jobs in order to go back to work. A fiscal expansion cannot generate such jobs. The result is that in these crises many workers drop out of the labour market. In the USA the ratio of employment to population has fallen from 62.7 per cent at the end of 2007 to 58.6 per cent at the beginning of 2012. This is partly due to the recession but partly due to the difficulties encountered by workers in finding jobs in the same sectors as before.

In conclusion: in modern economies labour is becoming less and less fungible; and recessions due to the bursting of bubbles reduce disproportionately the demand both for labour in some sectors and for certain skills. Fiscal expansions may create jobs in sectors where available skills are not abundant; as long as the fiscal expansion does not lead to the psychological, negative reactions, as discussed above, or to increasing interest rates. However, fiscal expansion, even when it has some positive impact, should not be expected to reduce unemployment quickly.

To the extent that the fiscal expansion may generate higher demand for workers with skills that are not easily available, it may also create some price pressures in particular sectors so that the inflation rate will tend to fall less than expected. Under particular circumstances, this may set in motion some inflationary pressures, even with very high unemployment. It should be a concern to policymakers that the unemployment rate of 10.8 per cent for the Eurozone, in February 2012, went along with an inflation rate of 2.6 per cent, above the traditional definition of price stability. What would happen to the inflation rate if the unemployment rate fell to, say, five or six per cent? The Keynesian view that fiscal policy can have some workers digging holes and others filling them belongs to the museum of old and wrong ideas.

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[8] It was reported that '…the jobs are already [there]. What is missing are the skilled workers to fill them,' and it was also reported that the phenomenon 'became more acute during the recent recovery'. *The Washington Post*, February 20, 2012.

IV
How to Get Out of the Fiscal Crisis

The Great Recession started as a financial crisis, morphed into an economic crisis and in several countries became a fiscal crisis. The economic and fiscal crises are far from over and their effects are likely to be felt for several years, partly because of their impact on the public finances of many countries. The debate on what to do about high unemployment rates and the fiscal imbalances meanwhile continues. Some economists want to maintain countries' expansionary fiscal policies *for the time being* or even to make them more expansionary '*until the economic situation returns to* n*ormal*'. Others are concerned about the cumulative fiscal effects of the current policies. The latter worry about the growing public debts and their possible impact on growth, interest rates and on inflation.

Although the broad facts are generally known, it might be beneficial to consider the latest statistics on the current fiscal position in some countries. For the 17 members of the EMU, the average government deficit rose from 0.7 per cent of GDP, in 2007, to 6.2 per cent of GDP in 2010. The share of public debt into GDP rose from 66.3 per cent, in 2007, to 87.4 per cent of GDP, in the third quarter of 2011. For the 27 members of the European Union, a group that includes the United Kingdom, the government deficit increased from 0.9 in 2007 to 6.6 in 2010, while the public debt rose from 59.0 per cent of GDP, in 2007, to 87.2 per cent of GDP, in the third quarter of 2011.

In 2010 the fiscal deficits of the four largest European countries, as shares of GDPs, were 4.3 for Germany, 4.6 for Italy, 7.1 for France, and 10.3 for the United Kingdom. It should be noted that the fiscal deficits of Germany and the UK are being kept low in part by the very low interest rates that are paid on their public debt, though it is difficult to say how long this favored situation will last. For the third quarter of 2011, the latest date for which information is available, the shares of the public debts into GDPs were respectively 81.8 for Germany, 119.6 for Italy, 85.2 for France, and 85.2 for the United Kingdom. Among the four largest European countries, over the 2007-2011 period, the biggest increase, in the share of public debt into GDP, took place in the United Kingdom. Its public debt rose from 44.4, in 2007, to 85.2, in the third quarter of 2011. At such a pace it would take just a few years before the UK's public debt caught up with that of Italy. Both the shrinking of the economies (because of the recession, that also set in motion the automatic countercyclical stabilizers) and the reaction by governments to the recession, with the discretionary 'stimulus packages', explain these extraordinary fiscal deteriorations.

Reductions in public revenues, at least as expressed by their shares in the countries' GDP, played almost no role in the fiscal deterioration of the four largest countries mentioned above. During the 2007-2010 period, the share of public revenue into GDP stayed broadly unchanged in all four countries, as it did in the EMU and EU countries taken as groups. What changed significantly were the shares of public spending into GDP. They increased by 4.4 per cent in Germany, 2.7 in Italy, 4.0 per cent in France and 6.5 per cent in the United Kingdom. They increased by five per cent of GDP in the 27 EU countries and by 4.2 per cent of GDP in the EMU countries. For some smaller countries, the increases were much larger.

In most European countries before the crisis tax ratios had been very high and there had been pressure to reduce them. In some countries tax revenue had significantly increased because of the effect of the bubbles. In view of the above, it seems reasonable to assume that future policies aimed at bringing the fiscal accounts under some reasonable control, should be focused mainly on the spending side of the public budget, the side that had experienced the large increases.[9]

Some observers, including Mario Draghi, the head of the European Central Bank, have raised the question of whether the European 'welfare system' can survive the impact of the Great Recession in its present form, Questions about the long term affordability of the European welfare system had already been raised in the years preceding the crisis. That system had become expensive because of its increasing generosity over the years and on account of the expected impact of demographic changes. It required progressively higher spending and higher taxes or borrowing that were believed by some economists negatively to affect the growth rates of European countries. These questions have become more pressing today and more uncomfortable, given the belief of many that the European system of social protection should be considered as one of the great civil conquests of the modern world, a conquest that would merit protection at any cost.

Such issues lead to that of the 'exit strategies' which could be followed by the countries now facing difficulties. In theory, there could be several possible exit strategies. In practice the choices are much more limited.

A first strategy would be that of *doing nothing* while waiting for some miracle to happen, such as a significant pick up of the economic growth rates. It would have to increase automatically tax revenue and reduce public debt to GDP ratio**.** The current debate between austerity and growth seems to imply that a growth strategy could be chosen while downplaying the need for austerity. Unfortunately miracles may be as

[9] See Vito Tanzi, 'The Role of Fiscal Imbalances and Their Consolidation' presented at the European Commission Forum on 'Tax Policies Under a Common Currency', Brussels, 5-6 March 2012.

rare in economics as they are on the road to sainthood. Few economists are likely to believe that growth could automatically increase fast enough in the absence of austerity measures to become a solution to the current economic and fiscal difficulties. In fact the longer it takes the growth rates to pick up significantly, the greater will be the cumulative deterioration in the fiscal accounts and the (needed) future growth rate, because the shares of debt into GDP are rising at a rapid rate in many countries. The higher these shares become, the more difficult it will be to deal with them. Furthermore, a return to a 'normal' economic situation, one that would bring increased demands for credit for private investments and for consumption, would have an impact on real interest rates (unless financial repression kept them artificially down). The interest rates would rise in most countries, making the servicing of the debt more costly.

A second strategy recommended by some convinced Keynesian economists would be *to introduce additional 'fiscal stimulus packages',* in an individual or coordinated manner, in the hope of shaking up the economies, towards higher growth rates. Both Paul Krugman and Larry Summers have advocated this course of action recently.[10] However, if fiscal deficits as high as ten per cent of GDP in some countries including the USA and the UK have not done the trick, it seems improbable that even higher deficits would have the hoped for effects on their economies. Furthermore, the negative impact of precarious fiscal conditions on the psychology of investors and consumers would most likely neutralize whatever positive effect on growth might result from a Keynesian push.

The only strategy that seems realistic is the difficult one of carefully re-engineering the role that the state plays in the economy. The goal would be to try to continue pursuing important government objectives in terms of social protection, but to do so more efficiently and in a more focused manner so as to lower public spending. When possible, policy instruments other than public spending could be used. The reduction in public spending, to be achieved *over the medium term*, should be large enough to wipe out the fiscal deficits and initiate a trend toward the reduction of public debts to bring them to more sustainable levels. Such a reduction would require, and must be accompanied by, major structural reforms, aimed at making the economies more flexible and more efficient. In many countries there are major obstacles to growth that can be removed by intelligent structural reforms.

Some may judge this strategy as a 'pipedream'. However, there are examples of several countries, including Canada, Sweden, Finland, and the Netherlands, that succeeded, within relatively few years, in drastically reducing the share of public

[10] See Paul Krugman, *End the Depression Now*, (Norton Company, New York: 2012); Larry Summers 'Growth not Austerity is the Best Remedy for Europe', *Financial Times*, 29 April 2012.

spending and public debt into GDP.[11] In some cases the reductions in these shares exceeded ten per cent of GDP. These countries were able to correct large imbalances in their fiscal accounts and to reestablish higher rates of growth. What is remarkable about these experiences is that these countries returned relatively quickly to growth and managed to retain the highest ratings in the Human Development Index, the index estimated by the United Nations, that to some extent measures social goals. In other words, the important social objectives of these countries and their growth rates were not compromised by the spending cuts and by the structural reforms that accompanied the cuts. The view that social objectives are always damaged by expenditure reductions is simply not correct.

[11] See Vito Tanzi, *Government versus Markets*, (Cambridge, 2011). See also Philip Rother, Ludger Schuknecht, Jurgen Stark, *More Gain Than Pain: Consolidating the Public Finance*, (Politeia, 2011).

V
Public Sector – Private Providers?
The Case for Change

One central aspect of public spending which may be relevant to the 'exit strategy' is the past spending behaviour in some, though not all, government programmes. That behaviour has tended to be so regular and so predictable that it could be seen as reflecting an economic trend in public spending growth, bearing some similarity to 'Wagner's Law'.[12] The trend may explain why the economic role of the state in its entirety grows over time and helps to illustrate Wagner's Law: most government programmes, especially those without clear sunset provisions, tend to grow and become more expensive over the years.[13] In general, the longer the programmes remain in existence, the more expensive they become. They may start slim but tend to accumulate fat. There are at least three main reasons for this expansion.

First, over the years, the public programmes, especially those targeted at a certain group, rather than seen as universal, had, when initially created, aimed at assisting or protecting a *limited* and *well defined* group of individuals, (say, people with *significant* handicaps or people in *extreme* poverty). However, over time cover expanded and new beneficiaries were added who did not meet the initial conditions, and would not initially have been eligible. Lobbying by interested groups, corruption by some public officials, individual fraud, and other factors can contribute to expansion in the numbers covered. The increase in costs therefore comes in the first place mainly from the addition of users to the programmes.

Second, benefits or services provided to the users by programmes have expanded, as have the numbers of employees providing these. (This applies also to services intended from the outset as having universal coverage, such as educational services for certain age groups or universal health services.) The increase in costs is not due to the increase in numbers of *users,* but to the increase in the number of employees or *providers* engaged in providing the services to the citizens. In the example of schools or of universal health services (intended as universal in their coverage from the outset), the numbers of public employees paid to provide the services and the costs have increased with the addition of administrators, advisors, managers and others to the payroll. For example, in the US public schools the number of employees dealing with sport-related and social activities (which have little to do with education strictly defined), or the number of child psychologists or specialist professionals for problematic pupils has grown in addition to that of the general administrators. So

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[12] Wagner's Law or Principle suggests that as industrial economies develop, public spending increases.

[13] See Vito Tanzi, *Government versus Markets*, (Cambridge, 2011), pp. 7-8, and 121-22.

those who benefit from the government programmes *as providers* (who often enjoy better working conditions than they would in private sector jobs) grow with the passage of time, often leading to significant increases in the costs of the programmes.

The third reason is that most public programmes, whether universal or not, (with the exception of limited activities e.g. the relatively labour-unintensive activity of paying pensioners' cheques), tend to develop forms of *technical* inefficiencies**.** These inefficiencies imply *waste* in the programmes because the output or services could be produced at lower costs. *Technical* inefficiencies result from the absence of a competitive environment in which public employees operate: without the profit motive or competition to guide an operation, those involved tend to lack the incentive to work to the best possible standard and to do the work as efficiently or cheaply as possible.

The evidence for such a conclusion and the three reasons for ever expanding costs can be found in a number of countries. For example, the growth in the cost of individual programmes attributable to such causes, has been reported for disability pensions where the number of claimants has increased dramatically in many European countries and in the United States. In the US applications for disability benefits have increased by 30 per cent since 2007. In the case of food stamps in the US the number of claimants has also increased significantly over the years (see below), as has the number of individuals claiming public pensions.[14] In these, the range of claimants has been extended considerably; and in the absence of reform, both the number of beneficiaries and the costs of the programmes have increased almost continuously.

An extreme example of this trend comes from Greece where the pension retirement age for jobs classified as arduous had been 55 for men, and 50 for women**.** Such favourable treatment for arduous jobs prompted a progressive reclassification of many professions as arduous over the years: Lewis has reported that six hundred jobs are so classified, including hairdressers, radio announcers, restaurant waiters, and musicians.[15] Another illustration is from the US food stamps programme, started by President F.D. Roosevelt in 1939 to help only *the poorest* people. By 2011, 45 million people, or one in seven Americans, received food stamps at a cost of $72 billion, and between 2007 and 2011 the number of beneficiaries on this programme in the USA had grown by 70 per cent though the number of very poor people is unlikely to have increased to such an extent. In Washington D.C. one of the cities with the highest per capita income in the world, one in every five inhabitants now gets such food stamps.

[14] Known as benefits in the UK.

[15] Cited in Michael Lewis, *Boomerang*, (Allen Lane, 2011), p.45.

The same process led to an increased number of those who receive public pensions in countries such as the United States, Italy and some others.[16]

In such cases the numbers of providers in public programmes has increased, along with the inefficiency that often characterizes public programmes. Such inefficiency normally develops when institutions find themselves in positions of monopoly or do not face the pressures of a competitive market.[17] Some of these inefficiencies can originate in the working rules promoted by organized labour or they can be due to lax controls.

Recognizing the existence of this general trend and doing something about it can go a long way towards making governments more efficient and fiscal accounts more sustainable over the medium term. That aim may need a return to the original intentions of the programmes. It may also require moving some programmes completely out of the public sector. We should recognize that differences in public spending of up to 20 per cent of GDP exist among industrial countries. One might compare for example Australia, Switzerland, Japan, and Korea on one side, with Italy, Belgium, France, Greece and some others, on the other. Such large differences in public spending are not associated with equivalent differences in the welfare that governments provide to their citizens. If the first group of countries can manage so well with spending levels less (often much less) than 35 percent of GDP, why should other countries need as much as 45 or even over 50 percent of GDP? This question should be addressed all the more urgently when restoring order to the public accounts has become a fundamental aim for many countries.

[16] For details on the process in Italy see Daniele Franco, *L'espansione della spesa pubblica in Italia*, (Bologna:il Mulino, 1993).

[17] A. Afonso, L.Schuknecht and V.Tanzi, 'Public Sector Efficiency: Evidence for EU Member States and Emerging Markets', *Applied Economics* 42 (2010) which aims to measure these inefficiencies for a number of countries.

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