Booms, Busts and Fiscal Policy:

Public finances in the future

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Preface[1]

The financial crisis which became a deep economic recession after the Lehmann bankruptcy in October 2008, followed a long boom period in most Western economies between the late 1990s and about 2007. During that time rising house and stock prices left both the banking sector and households more highly leveraged and vulnerable to a turn in the asset price cycle. The depth of the bust in housing and stock markets, its virulent interaction with the financial sector, economic activity and demand post-Lehmann, also had an adverse effect on public sector accounts in a very short period of time. Pressure on public balance sheets has become more and more visible in the very large public deficits and rapidly rising debt ratios, in the very strong increase in the public expenditure ratio, and in the significant contingent liabilities from government rescue packages for the financial sector. This is in addition to the considerable existing deficits and debt stocks at the end of the boom in many advanced economies and the looming costs of population ageing.

If unchecked and uncorrected, these fiscal developments are unsustainable. A vicious circle looms especially if adverse debt dynamics are compound by the adverse growth and confidence effects from higher spending and future ageing costs.

The study considers four central issues which those responsible for policy will need to tackle:

- First, the significant fiscal consolidation which will be needed to bring deficits and debt back on a sustainable path.
- Second, the consolidation which has to come largely from the expenditure side of budgets, thereby reversing the recent increase in public spending ratios. This would also help re-invigorate long term economic growth.
- Third, the social security reform which will be needed to contain fiscal pressures arising from the cost of population ageing.
- Fourth, the structural reforms including in the fiscal area which are needed to reduce incentives for the recurrence of booms and busts.

Central to these challenges is the task of reforming public expenditure. It is virtually inconceivable that fiscal sustainability and dynamic growth can be regained without

[1] The views presented in the study are purely the author's and do not reflect ECB opinion or policy.

major expenditure cuts in virtually all advanced economies. Public expenditure ratios will average broadly around 50 per cent of GDP after the crisis in most industrialised countries. This contrasts with a desirable reduction to below 40 per cent and ideally even further to 30-35 per cent of GDP in the future. Such a level would suffice to reach the core objectives of governments. The evidence is that reforms to bring spending down have brought much benefit at limited costs in the past, as Vito Tanzi and I argued in an earlier publication in this series (Schuknecht and Tanzi, 2005). However, for many countries, even a return to pre-crisis spending ratios will be a major challenge and will require much political determination.

This study opens by considering what went wrong in the boom years in most Western economies (Chapter I). It explains that in the run up to the present crisis, the credit-financed housing boom precipitated a very large private sector debt built up. During this period public finances and underlying policies were also insufficiently prudent so that fiscal imbalances quickly became enormous when boom turned to bust. The boom legacy contributed to distorted economic structures which will require a reallocation of resources away from the boom's main 'profiteers', such as finance, real estate and construction. All this is likely to weigh on economic prospects in the coming years. The study continues with a discussion on where we stand (Chapter II). It sets out the options for governments in the Western economies (including the UK and Eurozone) to deal with the main government finance-related policy challenges in the post-boom, post-bust decade (Chapter III).

I

What Went Wrong? Boom, crisis and consequences

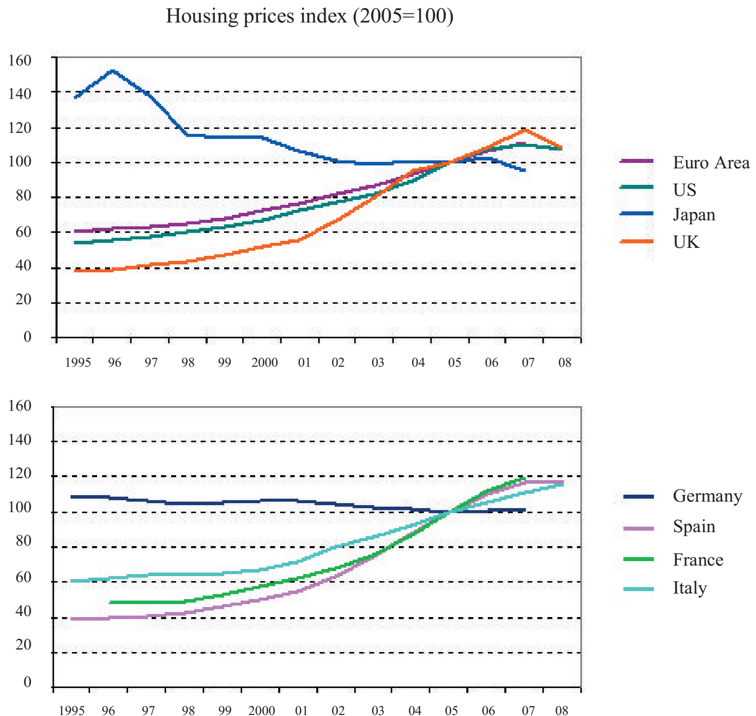
a) The private sector in boom and crisis: transient wealth, lasting debt

The period from the late 1990s up to 2007/08 was characterised by a dramatic rise in house prices in many industrialised countries, along with associated growth in credit and debt to finance the housing boom. By 2007/8 the trend of rising prices was reversing, leaving a highly indebted and less wealthy private sector in its wake.

Since the start of the financial turmoil or shortly thereafter, many industrialised countries have been in a period of asset price and notably housing bust. This has followed an extended period of boom from the late 1990s up to broadly 2007.

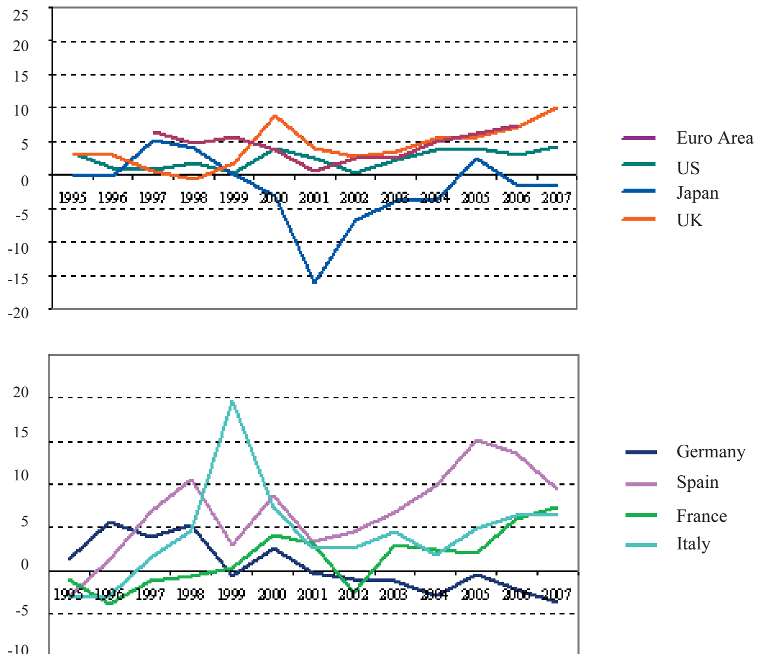
Chart 1: House price and credit developments in selected advanced economies

Housing prices index (2005=100)



(Chart 1 Continued)

Credit growth (real)



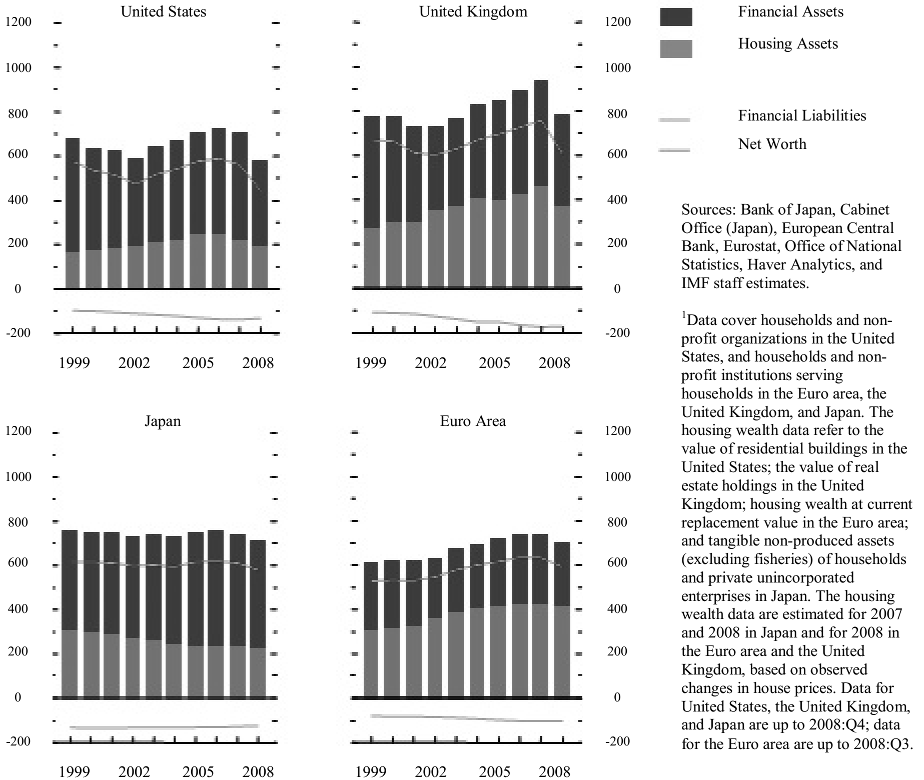
Source: ECB; Credit growth refers to real credit growth (nominal growth adjusted by inflation)

In the boom period, many industrialised countries saw house prices double or even triple within a decade (Chart 1). The only notable exceptions among the larger countries were Japan and Germany where real estate prices were more or less flat. The British and Spanish booms were amongst the most pronounced.

The boom appears to have been built on a strong expansion in credit. In fact, real credit growth was rather high in all booming countries while it was relatively low and for several years even negative in Japan and Germany. With the housing boom, housing wealth became the most rapidly increasing component of household wealth in

the large advanced economies, i.e. the euro area, UK and the US (Chart 2). Again Japan and Germany (not indicated separately) were the exceptions. Financial wealth also increased, briefly interrupted by the stock market bust of the early 2000s.

Chart 2: Household Assets, Liabilities and Net Worth[1] (in percentage of gross disposable income)



The strong credit growth which financed ever more costly housing contributed to a much increased household debt ratio in 2007 compared to a decade earlier. Household debt to GDP amongst the represented economies was largest in the US, UK and Spain in 2007 (Chart 2 and 3). But not only household debt increased: debt of non-financial corporations (NFCs) also went up strongly in a number of countries and, amongst large advanced economies, most strongly in Spain, France and the UK. Japan and Germany, by contrast, saw little change in household and corporate indebtedness as share of GDP since the mid-1990s.

By 2007/08, the housing boom started to reverse, earlier in the US and the UK and generally later in the other affected European countries. Real and even significant nominal house price reductions started to emerge and continued into 2009. This went

and France reported deficits near the EU's 3 per cent of GDP reference value which is considered excessive even in less good times. Public debt had declined somewhat in some of the boom countries but had increased in Germany and Japan (which, as mentioned, did not experience a boom over this period) and even France (Table 1).

Table 1: General government balance and debt, per cent of GDP

	Government balance (%GDP)			Public Debt (%GDP)		
	1995	2007	2010	1995	2007	2010
United States	-3.1	-2.8	-14.2	71.3	63.1	91.1
Japan	-4.7	-2.1	-8.7	87.6	173.6	194
United Kingdom	-5.9	-2.7	-13.8	50.7	44.1	81.7
Germany	-3.2	-0.2	-5.9	55.6	65.1	78.7
France	-5.5	-2.7	-7.0	55.1	63.9	86.0
Italy	-7.4	-1.6	-4.8	121.5	104.1	116.1
Spain	-6.5	2.2	-9.8	62.7	36.2	62.3
Euro area 12	-5.0	-0.6	-6.5	73.8	66.1	83.8

Source: European Commission 2009 spring forecast

To understand the origin of the poor starting position of public finances at the end of the boom, one has to consider public expenditure dynamics. Public expenditure had reached historic highs in most advanced economies at some point in the 1980s or early/mid 1990s before many countries introduced major expenditure reductions (Schuknecht and Tanzi, 2005). The average peak for euro area countries had been a staggering 53.7 per cent before reforms in the 1980s in some countries and in the 1990s in others brought the average spending ratio down. Euro area spending, consequently, declined to about 47 per cent of GDP in 2000—6 percentage points below the average all time highs in individual countries. By 2007 the spending ratio in the euro area had been brought down slightly further which was mainly due to reforms in Germany and Austria (Table 2). In the high-growth countries, the expenditure ratios should have come down as tax revenue was booming while spending commitments, for example, for the unemployed, even declined. [2] But they did not because governments became more generous and adjusted spending and benefits to the higher growth rates.[3] While Spain's spending ratio went down minimally, that of France, the Netherlands and Ireland even increased. Moreover, in many euro area countries, fiscal

[2] This effect would be reached through the dampening effect of the so called automatic stabilisers alone. Expenditure tends to grow more slowly than GDP in boom times; hence the denominator of the expenditure ratio grows more slowly than the numerator. At the same time, tax revenue booms in line with GDP, hence the ratio stays constant. As a result, the deficit falls. The reverse holds during busts when spending ratios rise because expenditure grows faster than GDP and taxes grow in line with or even less fast than GDP.

[3] Governments had been tempted to believe that high economic growth during the boom years was a permanent phenomenon so that more dynamic public expenditure growth seemed financeable but many observers had also warned about these temptations and dynamics (e.g., European Commission, 2006).

outcomes were often less prudent than fiscal plans due to chronic expenditure overruns in the 'good times' up to 2007 (ECB, 2008).

Table 2: Total public expenditure % of GDP and change in percentage points of GDP

	2000	2007	2010	2010-2000	2007-2000	2010-2007
Spain	39.2	38.8	47.1	7.9	-0.4	8.2
Germany	47.6	44.2	49.0	1.4	-3.4	4.8
Italy	47.3	47.9	51.1	3.8	0.6	3.2
France	51.6	52.3	56.4	4.7	0.7	4.1
Netherlands	44.8	45.3	50.2	5.4	0.5	5.0
Austria	52.4	48.5	52.1	-0.3	-3.8	3.5
Ireland	31.5	35.7	49.1	17.7	4.2	13.4
Euro area 12	47.3	46.1	51.1	3.8	-1.1	4.9
UK	36.8	44.0	52.4	15.7	7.2	8.5
US		37.4	43.7			6.3
Japan		36.4	46.7			10.3

Source: European Commission 2009 spring forecast

An even less favourable picture emerges for the US and the UK. The UK had reduced its public expenditure ratio hugely until the late 1990s but then reversed a significant share of that gain over the boom years with spending ratios reaching a level not much below the euro area average. The US spending ratio in 2007 was relatively close to its peak of recent decades. Overall, this reflects rather imprudent spending policies in many countries in the boom period. This kept expenditure ratios high and fiscal balances rather unfavourable so that public finances were not prepared when the housing bust and the economic downturn struck.

Table 3: Employment developments in selected OECD countries

	public employment growth (per cent)		private employment growth (per cent)	
	1991-1999	1999-2007	1991-1999	1999-2007
Spain	16.5	36.8	17.0	49.8
Germany	-12.7	-5.4	0.4	2.3
Italy	-3.2	2.3	-1.5	21.1
France	5.6	7.0	9.7	9.6
Netherlands	-0.6	13.1	16.2	4.4
Austria	-3.0	-5.9	6.4	7.6
Ireland	8.9	46.5	48.1	36.7
Euro Area 12	-0.1	7.3	5.6	13.6
UK	-10.2	14.1	11.1	7.0
US	9.5	9.4	16.3	10.5
Japan	5.0	-1.3	6.7	4.4

Source: OECD

It is worth dwelling further on one element of expenditure policies. Table 3 shows that public employment policies in many countries had been very prudent in the 1990s

reflecting their expenditure reform strategies. However, in the period 1999-2007, cautious employment policies continued in fewer countries, and notably in Austria, Germany and Japan. At the same time, Spain, the Netherlands, Ireland and the UK started hiring strongly in the public sector so that public employment grew by more than private employment in these countries (with the exception of Spain, where private employment grew even more than the huge gains in the public sector).

c: Economic structures in boom and crisis: growing distortions hampering output prospects

The boom period has led to an over-allocation of resources to the financial and housing related sectors in many countries. This contributed to higher growth in the boom years. But the crisis has revealed that these sectors have to change through a lengthy and costly re-allocation of resources. This is dampening growth in the crisis and will continue to do so looking forward.

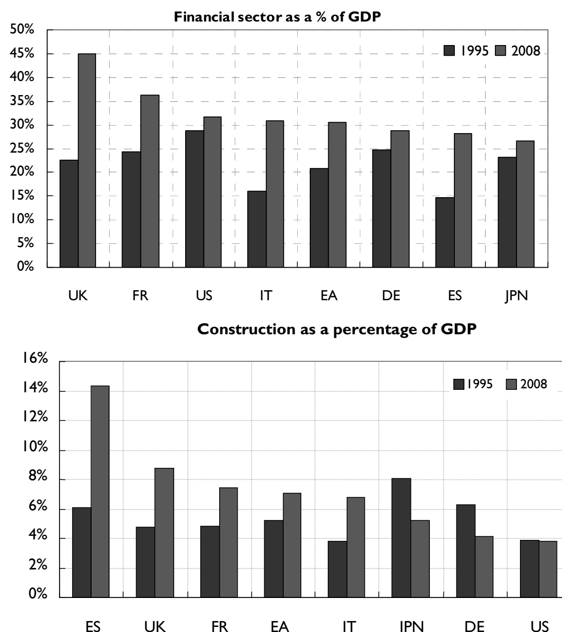
In the late 1990s and early 2000s, the boom in the financial sector, in real estate and related services and in construction drew an increasing share of national resources into these sectors. While the measurement of output is difficult, notably in the financial sector, Chart 4 nevertheless provides an illustration of this re-allocation. The share of the broader 'financial sector' (financial services, real estate, renting, business activities) has increased strongly in most advanced economies. Only in the two non-boom countries, Japan and Germany, plus also the US was this increase relatively limited. These three countries were also those least affected by a shift of resources into construction where notably the share of Spain's and the UK's output increased strongly since the mid-1990s.

The boom-related growth of the financial and real estate sectors have contributed significantly to the above-trend output growth during that period. However, given that this growth was unsustainable, it will not persist and probably at least partly reverse. It is also noteworthy that a disproportionate share of profits (and thereby tax revenue) was generated in the financial sector over that period in some countries. As the financial sector will need to restructure and equally high profits may not return this will adversely affect the government revenue outlook as well. Or in other words, the boom years have created a growth and fiscal revenue illusion.

As a result of the resource mis-allocation, the economic prospects for advanced economies are likely to be hampered (see also European Commission, 2009a). Part of the capital in these sectors will have to be written off or re-allocated as the sectors are not likely to re-gain their pre-crisis importance. Workers will need to find new jobs which will take time and re-training. Difficulties in the financial sector and increased risk aversion may reduce the speed at which resources are re-allocated and may impede new investment, thereby, adversely affecting growth and innovation in the

economy. Moreover, the need to reduce debt in the private sector should imply lower consumption and investment in the future as households and firms repair their balance sheets. This should negatively affect consumption and investment for some time to come—with some potential adverse impact on the economic growth outlook as well. All in all, one could argue that not only the level but also the speed of output expansion may be lower due to boom-related distortions and their unravelling in the crisis.

Chart 4: Share of financial and construction sector in selected advanced economies



Source: Eurostat, ECB, Global Insight for the US and Japan. Financial sector data includes financial services, real estate, renting and business activities.

II
Where do we Stand? Public finances at risk

Advanced economies are seeing a major deterioration of public finances with double-digit deficits and a doubling of public debt ratios projected in some countries. This is due largely to increasing expenditure ratios rather than to a fall in revenue. Meanwhile public liabilities will be exacerbated by the impact of bank rescue operations and the additional costs of an ageing population. This puts the sustainability of public finances at risk.

The worsening in fiscal balances in the wake of the crisis that the EU Commission spring forecast projects by 2010 are staggering. Fiscal deficits will increase by about 6 per cent of GDP in the euro area and Japan and by over 10 per cent of GDP in the US and UK unless countries still undertake consolidation measures (see earlier Table 1). The increase in deficits sets in motion a very strong increase in the public debt ratio which is compounded in particular in 2009 by the expected strong decline in GDP. Within only 3 years, public debt is projected to increase by about 30 per cent of GDP in the US, almost 40 per cent in the UK, and about 20 per cent of GDP in Japan and the euro area. Moreover, as will be shown later, debt dynamics thereafter continue to point steeply upward unless recent deficit increases are reversed.

The rise in deficits is mainly due to an increase in public expenditure ratios. This is partly the result of imprudent spending policies during the boom as countries got used to more buoyant expenditure growth. It also reflects the impact of automatic stabilisers and, in addition, most countries undertook activist measures such as public investment programmes, subsidies for scrapping cars or employment-related spending. As a consequence, expenditure ratios started to increase very strongly. Tax revenue fell broadly in line with economic activity even though in some countries the fall in financial and housing sector related taxes also put pressure on public revenue. These factors and limited tax cuts also contributed to somewhat lower revenue ratios and higher deficits.

Table 2 reveals that the public spending ratio will go up by on average 5 percentage points of GDP in the euro area, 6 per cent in the US and 8-10 per cent in Japan and the UK. Not one country in this list will still have public expenditure ratios below 40 per cent in 2010 while most of them will be near or above 50 per cent of GDP. Or in other words, many more countries and the whole of the euro area will need to be considered economies with 'big government' by 2010 (Tanzi and Schuknecht, 2000).

The policy challenge of reverting to sustainable public finances with reasonable public expenditure ratios will be compounded by two further factors: the potential impact of bank rescue operations and population ageing. Since the Lehmann bankruptcy, governments have extended significant financial support to the financial system. This includes guarantees, capital injections, asset purchases and selected other measures (Table 4). Up to the summer of 2009, their impact on public debt had been 3.3 per cent of GDP in the euro area and 6.9 per cent in the UK. At that time, the ceiling for further liabilities in the euro area was set at 20 per cent of GDP contingent, for example, on guarantees being called. This figure was much higher for the UK with guarantees alone amounting to about 50 per cent of GDP. Although it is likely that only a limited share of these liabilities is going to materialise it is nevertheless adding to already significant fiscal risks.

Table 4: Cumulated interventions and their fiscal impact
(as a percentage of 2009 GDP)

	Type of intervention							Fiscal impact		
	Guarantees	Capital injections		Asset purchase	Asset swaps / asset lending	Debt assumptions / cancellations	Other measures	Government debt	Government contingent liabilities	
		Acquisition of shares	Loans						Provided	Ceiling
Belgium	21.0	4.0	2.1	0.0	0.0	0.0	0.0	7.4	21.0	34.6
Germany	6.3	1.3	0.0	1.7	0.0	0.0	0.0	2.9	6.3	18.7
Ireland	214.8	4.2	0.0	0.0	0.0	0.0	0.0	4.2	214.8	242.0
Greece	0.6	1.6	0.0	0.0	1.8	0.0	0.0	1.6	0.6	6.1
Spain	3.1	0.0	0.0	1.8	0.0	0.0	0.0	1.8	3.1	18.9
France	1.1	0.8	3.2	0.0	0.0	0.0	0.0	4.1	1.1	16.8
Italy	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Cyprus	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Luxembourg	12.8	8.3	0.0	0.0	0.0	0.0	0.0	8.3	12.8	0.0
Malta	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Netherlands	5.0	6.5	7.6	3.9	0.0	0.0	0.2	18.2	5.0	35.0
Austria	6.6	1.7	0.0	0.0	0.0	0.0	0.0	1.7	6.6	27.8
Portugal	3.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	3.8	12.4
Slovenia	0.0	0.0	0.0	0.4	0.0	0.0	3.6	4.0	0.0	33.2
Slovakia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Finland	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	28.1
Euro area	**7.5**	**1.3**	**1.2**	**0.9**	**0.0**	**0.0**	**0.0**	**3.4**	**7.5**	**19.9**
United Kingdom	50.6	5.4	1.1	0.1	13.2	2.0	−1.7	6.9	63.8	78.7

Source: ECB, 2009c

As regards population ageing, new projections by the European Commission and the Economic Policy Committee of the EU's ECOFIN Council show that the long term burden of population ageing is very significant unless further decisive social security reforms are undertaken. Without further reforms, public expenditure would increase by about 5 per cent of GDP in euro area countries and the UK half of which would come from pension and the other half from health care and long term care (Table 5). These figures are conservative. Less favourable assumptions and the impact of the financial crisis could drive them considerably higher. Ageing costs for the US and Japan are also potentially very high, notably in the area of health and long term care.

Table 5: Expected increase in public expenditure due to population ageing, per cent of GDP

	Pensions change 2007-60	Healthcare change 2007-60	Long-term care change 2007-60	Total change 2007-60
Germany	2.3	1.8	1.4	4.8
Spain	6.7	1.6	1.7	9.9
France	1.0	1.2	0.8	2.7
Italy	-0.4	1.1	1.3	1.6
Netherlands	4.0	1.0	4.7	9.4
Euro area	2.8	1.4	1.4	5.2
United Kingdom	2.7	1.9	0.5	5.1

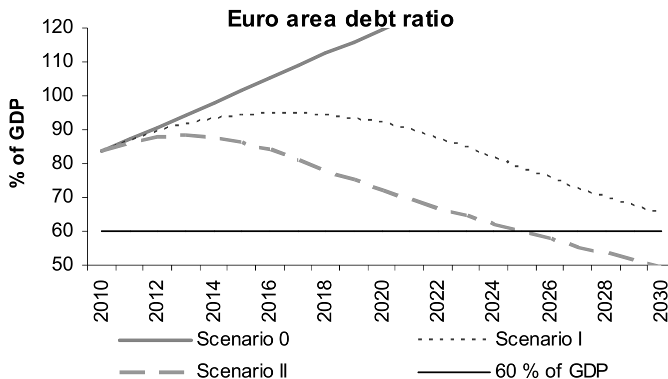
Source: European Commission and EPC (2009).

III
What Needs to be Done? The challenges and policy options

Against a background of rising public expenditure, deficits and debt and potentially low economic growth for some time to come, the future course of policies must now be considered. Four key policy challenges follow from the discussion above. In particular and as a matter of urgency, decisions will be necessary on how to revert to sustainable public finances.

The first challenge must be the ambitious correction of fiscal deficits so that debt dynamics do not explode. Scenario 0 in Chart 5 represents public debt developments in euro area countries without any fiscal adjustment in the coming years. Given the higher deficits notably in the UK and the US in 2009-10, their dynamics could be even less favourable. The dotted line reflects the prospects for public debt if the euro area deficit on average declines by ½ per cent of GDP per year until it is in balance (in about 2020).

Chart 5: Simulation of euro area debt ratio under different consolidation scenarios[4]



[4] Assumptions: All 2010 values from European Commission Spring 2009 forecast
Nominal Euro area GDP growth at 3.7 per cent between 2011-2030
Nominal interest rates on outstanding government debt constant at 2010 level as forecast by the Commission
Scenario 0: Unchanged primary balances
Scenario 1: Minimum consolidation of primary balance by 0.5p.p. of GDP each year until the total budget deficit reaches zero and then kept constant; structural consolidation is equal to nominal consolidation as growth is assumed to be at trend throughout: debt ratio reaches 94.6 per cent of GDP in 2016
Scenario II: Consolidation of primary balance by 1p.p. of GDP each year until the total budget deficit reaches zero and then kept constant: debt reaches 88.3 per cent of GDP in 2013.

While this scenario would be consistent with a very minimalist interpretation of the Stability and Growth Pact it is not comforting either: public debt in the euro area would continue increasing until 2016 when it would peak near 100 per cent of GDP. Debt figures could be even higher if trend growth turned out to be lower or interest rates higher and if significant further costs of banking support arose. Only an ambitious correction of deficits by 1 per cent of GDP or more per annum (and significantly more in countries with very high deficits) would bring the euro area back on a declining debt path relatively quickly. But even in that scenario, a balanced budget for the euro area average would only be reached in about 2015 and for the UK even later. A reasonably safe debt ratio below the maximum value of 60 per cent of GDP that all EU members have signed off to in the Maastricht Treaty would on average not be reached before the year 2020 even in the best scenario.

Bringing down deficits and debt and returning to sound public finances will inevitably require a long process of fiscal belt tightening. The options are either higher revenue or lower spending (or a combination of the two).

Table 6: Marginal tax rates in selected advanced economies

	Marginal tax rate	
	single earner, no children, average income	married, 2children, Incomes of 100 and 67 per cent of average income
United States	43.3	34.0
Japan	33.2	30.5
United Kingdom	40.6	46.5
Germany	66.5	63.4
France	55.8	52.0
Italy	52.7	52.7
Spain	45.5	45.5
Euro Area (15)	52.8	52.3

Source: OECD

If a country wants to go the first route it needs to generate a high revenue ratio (meaning average taxes must rise). And this also typically implies a higher marginal tax rate on each additional Euro, pound or dollar earned which has a significant impact on the decision to work, innovate and invest. This is illustrated by Table 4, where the countries with (formerly) low spending ratios also typically feature lower distortive taxes. For example, marginal household income tax rates for the represented income groups exceed 50 or even 60 per cent in the traditional high spending continental European countries, while these rates are 'only' 30-45 per cent in the US,

UK, Japan and Spain. However, with spending ratios in these economies to approach the euro area average, it is hardly conceivable that revenue ratios can be brought up to such levels without significantly increasing the tax wedge. Or in other words, all big spenders will also need to be high tax countries if they want to maintain fiscal sustainability without cutting spending. However, if history is a guide, mainly tax-based consolidation has little chance of success.

Given the potentially dire consequences of much higher taxes, the second, and probably pivotal, challenge is to reduce again the public expenditure ratio. This should bring spending ratios at least back to pre-crisis levels but in many countries it would be desirable to reduce public expenditure even further. Experience has shown that a ratio below 40 per cent and ideally 30-35 per cent is sufficient (Tanzi and Schuknecht, 2000). Governments have been well able to produce good outcomes in terms of functioning markets, equal opportunity for market participants, essential public goods and services, infrastructure, economic stability and income distribution with public spending in this range. This study will not consider the detailed possibilities for the reforms needed in individual countries and spending categories to reach lower spending ratios. But the evidence is that reducing spending on public employment and other public consumption, on transfers and on subsidies have proven to be most beneficial for successfully bringing down public spending. [5]

Expenditure reform is pivotal because, first, deficit reduction and expenditure reform would be fully complementary objectives. And second, expenditure reform could have a positive effect on trend growth via lower tax and spending-related disincentives to work and invest and less rent seeking. This, in turn, would speed up deficit and debt reduction—a virtuous cycle could emerge.

Expenditure reform is also key to the third (fiscal policy) challenge which relates to the future fiscal costs of population ageing. Although reforms over the past decade have reduced the scope of future problems in some countries, welfare state-related spending now ‘eats up’ the lion share of public budgets in many countries. And, under unchanged policies, the fiscal burden would grow further in the future. The prospect of lower trend growth and the fallout of the crisis on employment and fiscal balances are not facilitating the absorption of the costs of population ageing (European Commission, 2009b).

[5] A more in-depth discussion of experiences from past reform strategies can be found in Tanzi and Schuknecht (2000), Schuknecht and Tanzi (2005), Hauptmeier, Heipertz and Schuknecht (2007). European Commission (2006) reviews the literature on more versus less successful consolidation. Afonso, Schuknecht and Tanzi (2005) measure the efficiency of public expenditure, notably in relation to the size of total government spending and its components.

Many useful reforms have been identified in a vast literature to deal with population ageing. An important element of reform would be an increase in the statutory retirement age. Even if this were accompanied by a corresponding increase in pension entitlements it would help indirectly because a larger labour force would allow a bigger GDP from which pensions will have to be financed. An increase in the effective retirement age through an elimination of early retirement incentives would directly (through lower spending) and indirectly reduce the future fiscal burden of pension systems. As regards public health, increased competition, more co-payments, more prioritisation of services and international trade in health services are only some elements of reform that could help contain costs. Non-fiscal measures such as labour and product market reforms and the facilitation of private social insurance could also reduce sustainability risks from population ageing through higher growth.

As a fourth challenge, fiscal and other policies should be reformed so as to reduce the likelihood of future booms and busts (see e.g. Wolswijk, 2009). While fiscal policies may not be the most important policy domain for reducing asset price cycles, they can nevertheless play a role. In many countries, for example, the deductibility of mortgage interest payments from income tax is raising the incentive for households to indebt themselves. Similarly, tax policies have been found to encourage debt rather than equity financing of firms. When such measures are introduced they are likely to boost real estate (and possibly other asset) prices, and when they are abolished the reverse happens, thus potentially contributing to the volatility of asset prices. Changes in national fiscal institutions that contribute to saving rather than spending the fiscal 'rents' of good times are also likely to contribute to moderate boom bust cycles. In particular, Germany and Switzerland have introduced fiscal rules in recent years that aim to keep fiscal positions sound while permitting some cyclical fluctuations. Such improvements in national rules would also make it easier to attain sound public finances and comply with the EU's Stability and Growth Pact.

Of course, fiscal policy is not the only area where important reforms are needed.[6] But all in all, fiscal policies and reform must be central to the policies that restore economic fitness in the post-boom, post-bust economies. Re-establishing sound public finances with lean government will be pivotal to regain economic stability and dynamism.

[6] Discussing other reform areas which are key for mitigating the risk of future boom bust cycles goes beyond the remit of this study.

IV
Conclusion

As western economies decide on their future policy course, their central task will be to return to healthy and stable economies with sound and sustainable public finances. The best way to do this is by reforming public expenditure. As matters stand, public deficits and debt trends risk being unsustainable; meanwhile government obligations related to financial sector support and population ageing are looming large. Expenditure ratios will average about 50 per cent of GDP in most industrial countries. Unless there are major fiscal policy reforms and spending is reduced significantly, neither fiscal sustainability nor strong economic growth is likely to be regained. This means that four central issues must be tackled.

First, deficits and debts must be returned to a sustainable path. Only if deficits are reduced by 1 per cent of GDP or more per annum (and significantly more in countries with very high deficits) will debt stabilise and decline relatively quickly. Even then, a balanced budget would only be reached in about 2015 for the average of the euro area and even later in the UK.

Second, much lower spending is needed if deficits and debt are to be reduced and sound public finances restored. Given the magnitude of deficits, a country would need to raise average and marginal tax rates enormously if it wanted to consolidate significantly via higher taxes. This would most likely have very adverse consequences for growth. The historical evidence is that mainly tax-based consolidation has little chance of success.

Spending ratios should be brought back at least to pre-crisis levels. Even this will be difficult and much will depend on political determination. But there is a case for many countries to reduce more. A ratio below 40 per cent of GDP and ideally 30-35 per cent should be sufficient and allow good outcomes in the areas judged to matter in western economies: functioning markets, equal opportunity for market participants, essential public goods and services, infrastructure, economic stability and income distribution. The evidence is that ambitious reforms that reduce government spending obligations on public employment and other public consumption and on transfers and subsidies, is the best and most successful way to bring down public spending at little cost to economic growth and well-being.

In fact, reducing deficit and reforming expenditure are complementary objectives. Expenditure reform can have a positive effect on long term growth via incentives to

work and invest, rather than to 'seek rents'. This in turn speeds up deficit and debt reduction and allows a virtuous cycle to emerge.

Third, social security reform should also be introduced to contain fiscal pressures arising from ageing populations. Despite some reforms, welfare state-related spending continues to absorb a major share of public budgets in many countries. Unless policies change, a growing tax burden or a crowding out of other spending is inevitable. For example, increasing statutory retirement age and eliminating early retirement incentives will be important. Health and long term care reforms should also contribute to the affordability of services in the future.

Fourth, structural reforms including those in the fiscal area are needed to reduce the likelihood of future booms and bust. Fiscal policies, though not the most important way to reduce asset price cycles, can play a part by eliminating undue incentives to take on debt and by avoiding stoking housing markets that are already buoyant.

In addition, changes in national fiscal institutions that contribute to saving rather than spending the fiscal 'rents' of good times can also help: they can contribute to moderate boom bust cycles, healthier public finances and compliance with the EU's Stability and Growth Pact. These national rules could include, for example, the fiscal rules introduced in Germany and Switzerland to keep fiscal positions sound while permitting some cyclical fluctuations.

All in all, although fiscal policy is not the only area where important reforms are needed, fiscal policy reforms are central to restoring economic fitness in the post-boom, post-bust economies. Re-establishing sound public finances with lean government will be pivotal to regain economic stability and dynamism.

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