FISCAL POLICY IN DEBT-RIDDEN COUNTRIES

Carlos Mulas-Granados
Director of IDEAS Foundation and Prof. of Economics at UCM
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1. Introduction

The financial crisis that started in the US in 2007 became an economic crisis that has severely damaged the European economy since 2008. As a result, most advanced countries have accumulated large budget deficits and have increased their public debts dramatically. The debt crisis that impacted Europe at the end on 2009, demonstrates that accumulated imbalances are like energy: they can be transformed but not eliminated. The private debt of households and corporations as a consequence of the real estate housing bubble of the nineties became a problem for the banking sector in 2008 and was then transferred to the public sector in 2009.

This is a connection which is well known in the literature of financial crises. Typically, banking crises generate debt crises and eventually a currency crisis. For the time being, the EU has gone through tow of these three phases, but the recent problems in the eurozone are putting at risk the whole project of monetary union and the euro has lost in few weeks most of the value that it had accumulated during the past decade.

In this context, Europe has decided take new steps towards more and better economic governance, which in my opinion were sufficient to stop the Greek crisis, but which are still clearly insufficient to prevent any other major problem from arising in any other country. And, in addition, the EU has decided to launch a simultaneous fiscal adjustment in the major countries to prevent the possibility of debts spirilling out of control and to send a clear signal to the markets of rigorous economic orthodoxy.

In anycase, the debate has just started. The decision of applying a fiscal adjustment is showing that the eurozone prefers stability to growth (in case both are not possible at the same time). The fact that the US has opted for now the other way around (giving priority to fiscal stimulus until growth can be generated on its own by the private sector), clearly opens up the debate of whether this is reflecting different economic approaches, or this is just due to the underlying differences in the structure of economic governance. In my opinion, a different structure of economic governance would have produced a different policy decision in Europe. A single Treasure and an stronger federal budget in Europe, with some ex ante provision for fiscal solidarity between euro-member states would have prevented the debt crisis that we are now suffering, and fiscal stimulus packages could have continued until growth had consolidated the path towards economic recovery.

But since we have to accept reality, the policy discussion in the months to come is going to focus on the strategy of fiscal adjustment. Therefore, in this conference I will cover this topic, by answering to three blocks of questions:

- What is a debt-ridden country? Is it a problem of public debt alone?

- What are the alternative fiscal adjustment strategies? Are ideological approaches relevant at all? (I will refer briefly to the Spanish case)
- And, finally, what is the fiscal adjustment strategy that has a higher probability of success in debt-ridden countries?

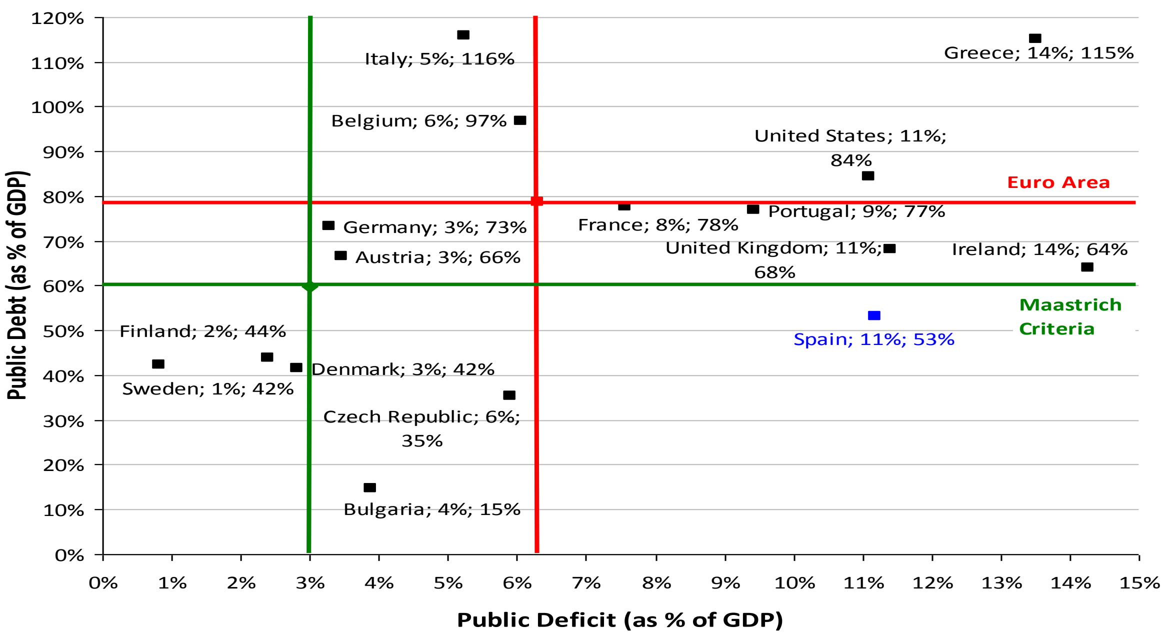
The different sections of this note are divided accordingly to respond to those questions.

2. What is a debt-ridden country?

This question seems to have a simple answer. For the EU, and according to the Stability and Growth Pact (1997), any country with a public debt above 60% of GDP may have problems. The IMF seems more realistic and opens of the range allowing for wider intervals: 60-80% for advanced economies and 40-50% for emerging market economies (see Cottarelli and Viñals, 2009; IMF, 2010).

But reality is not as simple. Markets have perceived that some countries with lower debt-to-GDP ratios than the EU average are at serious risk of default. This has clearly been the case of Spain, which has a public debt ratio more than 20 points below the Euro area average (with a public debt of 53% of its GDP). Spain is only 14th in the ranking of public indebtedness of advanced economies. In a much worse situation than Spain we can find countries such as Austria (66%), the UK (68%), Germany (73%), France (78%), the US (84%) or Italy (116%) (see Figure 1 below). But these countries have not had any problems with sovereign debt markets to far. Probably structural deficit and the composition of public spending also matters in these cases, but again Spain is not in a much worse situation than other major economies.

Figure 1. Public Deficit and Public Debt in Europe, 2010



Source: IDEAS Research. Data from Eurostat

The point that I want to raise is that in advanced economies, the level of private debt, the composition of foreign vs. domestic debt and the share of short-term vs. long-term debt matters as much as public debt levels. These are all important aspects that define debt-ridden countries. And this is what explains the Spanish case. This country has a private debt which almost triples the amount of public debt (the debt of households is above 170% of GDP and that of corporations is close to 280%). The share of external debt is important and the markets expect strong problems to refinancing the Spanish short-term debt.

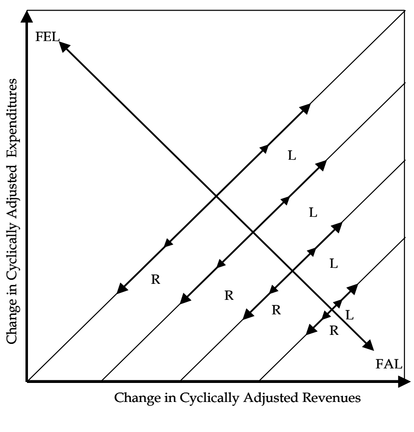
3. What are the alternative fiscal adjustment strategies? Does ideology play any role?

Any government willing to reduce the public deficit has five possibilities: (S1) to increase revenues more than what it increases expenditures; (S2) to increase revenues and freeze expenditures; (S3) to increase revenues and reduce expenditures; (S4) to freeze revenues and reduce expenditures; or (S5) to reduce revenues less than what it reduces expenditures, then the "partisan strategy of fiscal adjustment" can be defined in terms of these choices. A purely revenue-based strategy of adjustment would be any strategy like S1 or S2. A purely expenditure-based strategy of fiscal adjustment would be any strategy like S4, or S5. And, finally, S3 could be defined as a "mixed-strategy".

Because S1 and S2 are strategies that despite the consolidation effort still increase the role of the public sector in the economy, one could expect left-wing governments to be associated with those strategies. Left-wing governments would prefer revenue-based strategies because their preference for equality and for bigger presence of the state in the economy increases public expenditures that call for higher revenues in order to consolidate the budget. By contrast, because S4 and S5 imply a decrease in the size of the public sector and its coverage, one could expect that these strategies should be preferred by right-wing governments. S3 is a middle-strategy that could be chosen by both social democratic and conservative governments, and most likely by coalition governments with "mixed" ideologies.

The previous hypotheses about the relationship between fiscal adjustment strategies and the color of governments can be represented more formally in a graph like the one in the figure below. One would expect all governments undertaking a fiscal adjustment to place themselves to the right of the 45° line, when the FEL (Fiscal Expansion Line) becomes the FAL (Fiscal Adjustment Line). And at each level, one could expect leftist governments to choose those strategies that imply both positive changes of public revenues and public expenditures (to the right of FAL). Similarly, preference for a weaker public sector should place right-wing governments on the other side.

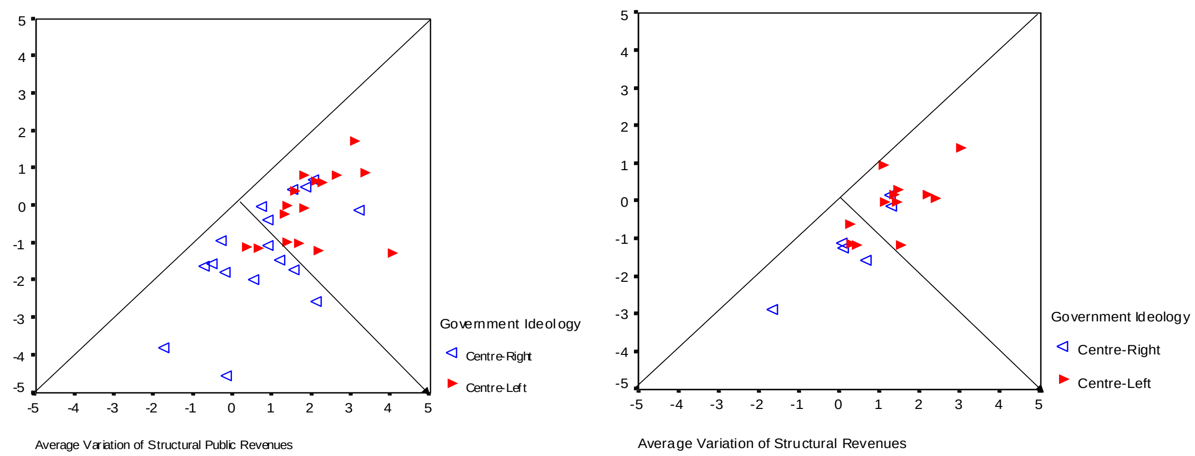
Figure 2. Strategies of Fiscal Adjustment. Ideal Types



Simple plotting of cases, labeled by the ideology of the party in government that undertook the adjustment, gives an idea of how well the data fits the partisanship hypothesis, for the years previous to the signature of the Maastricht Treaty. The comparison between the revenue-based fiscal adjustment launched by the socialist government of Guterres in Portugal and the expenditure-based-fiscal adjustment applied by the conservative government of Aznar in Spain, can be a good example of the explanatory power of this partisanship hypothesis.

But after that, since the mid-nineties onwards, the role of ideology seems to fade away in Europe. This may be explained by the fact that during the nineties, the strongest fiscal adjustments were taken by leftist governments. This makes the comparison more difficult, since the number of adjustments held by leftist governments doubles the number of adjustments held by rightist ones. Moreover, the fact that some rightist governments followed revenue-based strategies of adjustment (France 1995-96 or Portugal 1992-93), and some leftist governments followed expenditure-based ones (Denmark 1996-99 and Sweden 1995-98), adds some additional confusion to the pictures.

Figure 3. Strategies of Fiscal Adjustment between 1960-1991 and 1992-2000



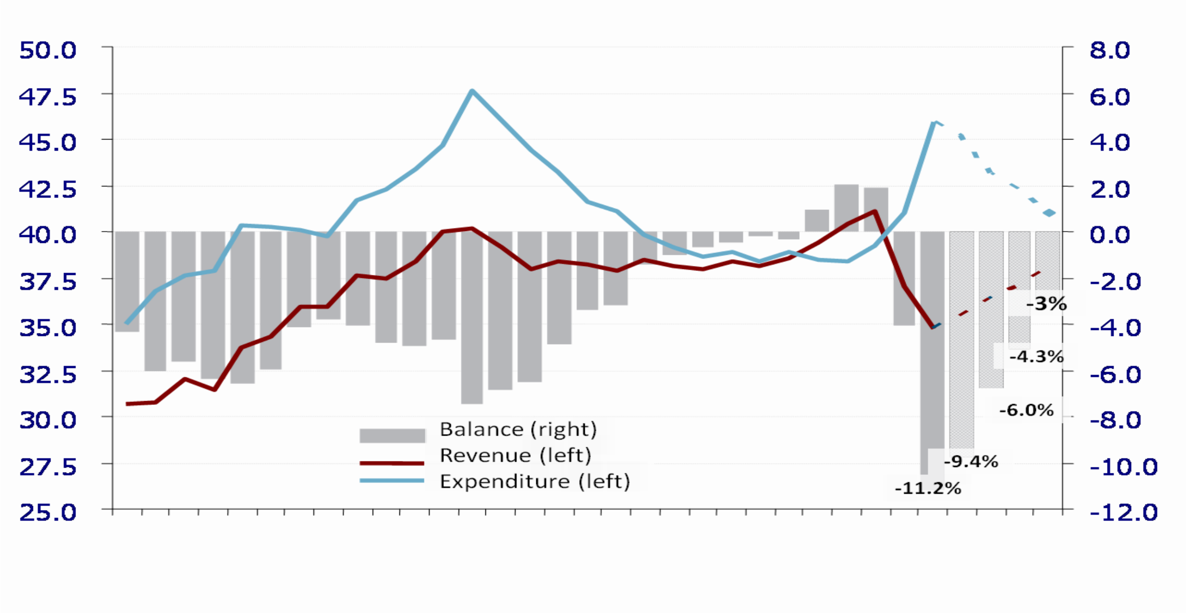
Since the core countries joined the euro at the end of the nineties, we have lived in a decade where no major fiscal adjustments occurred in Europe. And when necessary (for example in France and Germany after they broke the limits of the SGP in 2003) fiscal adjustments have always been based on a mixed strategy that combined small increases in revenues and small cuts in spending.

The mixed strategy seems to be the preferred one again in the current context. Most countries have announced fiscal adjustments that affect both sides of the budget. This is true for Greece, Germany, Italy, the UK and Spain.

4. The fiscal adjustment in Spain

Spain´s ongoing fiscal adjustment has also followed a mixed strategy, although the latest package (the strongest-one) is merely based on spending cuts (see Figure 5).

Figure 4. The fiscal adjustment in Spain, 2010-13: a mixed strategy based on spending cuts



Source: IDEAS Research. Data from Spanish Ministry of Economy and Finance

The first wave of measures to control the deficit was launched in September 2009 and mostly affected the revenue-side. There were the three major measures:

- Elimination of a 400 euros rebate in personal taxes (from January 2010).
- Rise in the VAT tax rate, from 16% to 18% (from July 2010).
- Small increase in income tax, in the flat rate applied to sources of income linked to capital from 18% to 19% (From January 2010)

The second set of measures focused on ending some stimulus programmes and was announced in March 2010. The most important decisions were:

- Savings of around 5 billion euro through cuts in the number of new public sector/civil servant positions.
- Reduction in the number of public companies (by 29) and public positions (by 32), amounting to annual savings of 15 million euro.
- New plan for fighting fiscal fraud.
- Plan to introduce savings in pharmaceutical and medical expenditure, coordinated with regional and local administrations (2 billion euro).

And in the midst of heavy speculation around Spanish sovereign debt titles in the markets, the government decided to announced a third package at the end of May of 2010. It was passed in the Parliament by only one vote and implied strong cuts in structural spending for the second half of 2010 and all 2011, in order to cut spending by another 15billion. The most relevant measures were:

- Reduction of salaries of civil servants (5% on average in 2010 and general freeze in 2011)
- Reduction of cabinet members and high civil servants´ salaries by 15%.

- Suspension of the revalorization of pensions in 2011, excluding minimum and non-contributory pensions.
- Elimination of 2.500 euros new-born child benefits from January 2011.
- Reduction in prices of some medical treatments and drugs.
- Elimination of dependency benefits together with the reduction in the times of applications´ resolution.
- Reduction of Official Development Aid by 600 million euros between 2010 and 2011.
- Reduction in public investment projects by 6 billion euro between 2010 and 2011.
- Additional savings of up to 1.2 billion euro in regional/local expenditure.

5. Prospects of success

In conclusion, Spain´s fiscal adjustment strategy started tackling some revenues but then became decidedly based on spending cuts. The objective is to cut the deficit from 11,5% to 3% in only four years, which would be one of the strongest adjustments undertaken by any advanced economies in recent decades. The expected impact of this fiscal contraction in the economy is a decrease in GDP of 0.5 percentage points, what would clearly delay a recovery that was just starting. The government hopes to compensate this contraction in internal demand, by a growing contribution of exports (which would be more difficult now that Germany has also announced a contraction), and a series of reforms on the labor and capital markets that could expand the aggregate supply (but only in the medium term).

It is true that Spain was late in accepting the depth of the crisis and has been postponing structural reforms for years, but it is also true that was faster than any other country in launching a comprehensive fiscal adjustment strategy. After Spain, countries such as Germany, Italy and the UK announced very similar measures. The fiscal adjustment packages in all countries included cuts in public salaries, freeze in investments, cuts in redundant social subsidies and different measures to control pension expenditures. On the revenue side, most decided to increase VAT taxes and only few decided to act on income and wealth taxes (given the size, these decisions were merely populistic measures with no major impact on revenue collection).

The question is now whether such a mixed strategy of fiscal adjustment is the proper adjustment strategy to be followed in debt-ridden countries in general. We will have to wait until we can reach definitive conclusions this time. The only empirical evidence that we have so far comes from a paper that is to be published soon by the IMF (see Baldacci, Gupta and Mulas-Granados, 2010). There, we analyzed the experience of 99 countries in restoring fiscal sustainability after a financial crisis during 1980-2008. We found that debt reduction was more likely when countries implemented bold fiscal measures in post-financial crisis years. In particular, expenditure-based measures that tackled public wages and current spending proved necessary for successful debt reduction. While these results are consistent with the existing literature on factors contributing to fiscal consolidation, unlike previous studies, we show in that paper the role of revenue-raising measures for supporting fiscal consolidations, together with growth-promoting reforms. The combination of both would shorten the time needed to lower debt to prudent levels again.

In order to be consistent with this historical empirical evidence, the EU member states may have to think about new ways to increase public revenues, because until now they have done very little. Given the weakness of consumption and investment, and the need to generate new conditions for growth, an increase in the rates of traditional direct and indirect taxation may not be a good idea. The only field where there is some room of maneuver is in the areas of ecological and financial markets taxation. If new taxes were introduced at a coordinated EU level in these two fields, there would be potential gains in terms of higher revenues and the reduction of negative externalities for all. This would require as well the full development of the Strategy 2020 for prosperity and sustainability that the European Council has to approve before the end of this month. Growth enhancing measures will require major structural reforms to increase the productivity of the EU, and also important investments in human capital and R&D.

But most important of all, the end of the debt-crisis and the impulse of an innovative growth agenda in Europe need to be accompanied by strong measures to move towards a European Economic Government. Only if we decide to eliminate definitively the existing asymmetries in the governance of the European Monetary Union (centralizing the coordination of fiscal policies and continental economic reforms) we could be sure that the euro will survive for many decades and that the economic crisis will soon be over.

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