PowerPoint for

The Return to Fiscal Rectitude After the Recent Departure*

by

Vito Tanzi

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The Return to Fiscal Rectitude After the Recent Departure

I. The 2008-2009 Crisis and the Public Finances Starting with some “truths”:

1. Before the crisis many countries had already major disequilibria in their fiscal policies.
2. Considering expected demographic changes, the current policies would be unsustainable over the long run.
3. There were strong pressures to reduce taxes.
4. Without the 2008-2009 crisis, many countries would have been forced to adjust their fiscal accounts over the medium run.
5. Tax increases would have been difficult because of “fiscal termites” and other restraints.
6. Pre-crisis bubbles had inflated tax revenue and economic growth rates in several countries and increased risks.

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- The fiscal deterioration in 2008-2009 was due to the direct impact of the crisis on the economy, to the change in the composition of the output, and to stimulus programs.
- Under normal business fluctuations the direct, automatic fiscal deterioration would reverse itself, once the economy returned to normal.
- The effect of the stimulus programs might not.
- The 2008-2009 crisis was not a normal one.
- It was due to the bursting of bubbles, created by bad policies and misguided incentives. The crisis was similar to that of Japan, in late 1980s and 1990s.
- These structural crises do not respond well to fiscal expansion.

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- The fiscal relaxation should have been limited to the automatic stabilizers that were important.
- Talks about a looming “Great Depression” encouraged large stimulus packages.
- They led to huge fiscal imbalances. The fiscal deficits went sharply up, and the public debts started rising fast.
- The fiscal stimulus packages (FSPs) gave the impression that the governments were “socializing the economies”.
- These policies attracted a lot of negative reactions.

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- The fiscal stimulus packages contributed to the raising of economic uncertainty and anxiety.
- The FSPs raised concerns about fiscal sustainability.
- Frequent references to the Great Depression did not help.
- Failure to understand that in 2008- 2009 the economies were very different from those in 1929.
- These differences sharply reduced the probability that the crisis could become a “depression”.
- During the 2008-2009, the central banks injected huge amounts of money in the economy. They became de facto “off-budget” budgets.

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- The “Great Recession” of 2008-2009 obliterated the traditional distinction between fiscal and monetary policies.
- The actions of the central banks became largely fiscal in nature.
- Thus, the true status of the “fiscal” stimuli became difficult to assess.

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- Uncertainty was injected in the already highly precarious fiscal situations.
- Future fiscal developments became very difficult to predict.
- It would take a “suspension of disbelief” to assume that these developments did not have negative psychological impacts on individuals and market operators.
- These negative impacts could easily overwhelm the direct positive effect (through the multipliers) that might be coming from the fiscal expansion.

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- Uncertainty is also promoted by concerns about the future behavior of interest rates and prices.
- Absence of movements in these variables at this time may lead to bad policies. The future is highly unlikely to be a continuation of the present.
- "Contingent liabilities" and "moral hazards" associated with the recent policies have also contributed to make the future more uncertain.
- Uncertainty has been pushing financial assets towards government securities and toward the creation of new bubbles.And away from real investments.
- Changing interest rates by a few basis points, the declared role of Q.E. cannot change this situation.

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- The crisis has also reduced potential output.
- This has reduced the present value of future tax revenue and has increased the severity of future fiscal problems.
- Fiscal policy has different effects:

  (a) when crises have traditional Keynesian characters; and

  (b) when they are associated with major macroeconomic imbalances and the bursting of bubbles.

  (c) the crisis is not limited to single countries.

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Expansionary, or countercyclical policy is likely to work best when:

(a) before the crisis the fiscal accounts have been broadly in balance.

(b) the downturn is the result of underconsumption or underinvestment.

(c)the crisis is limited to a single country.

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- The 2008-2009 crisis did not satisfy these conditions. Far from it.
- Thus, fiscal policy (especially discretionary fiscal policy) could not be expected to be as effective.
- Bubbles had created windfalls for tax revenue before the crisis.
- This had made the fiscal accounts and the economy, before the crisis, look better than they were.
- Post-cycle potential bubbles have created greater uncertainty.

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- The large, automatic fiscal deficits were made worse by the discretionary fiscal policy.They created distortions in the economies in addition to increasing uncertainty and concerns.
- They encouraged individuals and enterprises to play safe.
- The attention that they received from the media aggravated these effects.
- Thus, “discretionary” fiscal policies should not be maintained for too long.
- Countries should not wait for the return to pre-crisis growth and unemployment rates before considering “exit strategies”.The recession ended a long time ago.

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The fiscal policies that have been pursued by various countries call attention to some potentially important economic relations:

(a) between high public debts and growth;

(b) between growth and unemployment;

(c) between fiscal and monetary developments and inflation and interest rates;

(d)between cross-countries difficulties.

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- Recent research has shown the existence of a negative relation between economic growth and high levels of public debt.
- Past experiences, in Latin America and Europe, suggest that high fiscal deficits and large monetary expansion normally lead to inflation.
- Theory and past experiences also suggest that large demands for loans by government lead to higher interest rates, unless a "Japanese-style" situation develops.
- All these relations are not instantaneous. They require time to make the relations operate. These lags can send wrong signals in the short run and lead to bad policies.

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- A potentially dangerous development , one that could be prevented by the enactment of reasonable, well-timed and well-articulated "exit strategies" can be described by the following relationship:

  Fiscal imbalances before the 2008-2009 crisis +

  The fiscal automatic costs of the crisis +

  The costs of the fiscal stimulus packages+

  The fiscal costs due to the reduction in potential output+

  Potential future costs from increasing interest rates +

  Increasing costs due to demographic changes=

  Future fiscal crises.

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- The probability of future fiscal crises can be reduced by introducing soon adequate "exit strategy" policies.
- Waiting that growth and unemployment return to the pre-crisis level would be dangerous, because of the implications of the fast rising public debts.
- Past exit strategies have generally relied on inflation or on fast economic growth. These strategies are not likely to play a large role this time.

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- The only safe and realistic “exit strategy” is that of generating a virtuous trend by rethinking what role the government and the market should play in the economy.
- Much of the adjustment must come, over the medium run, from the expenditure side of budget.
- “Fiscal termites” and other obstacles to tax increases are likely to limit what the revenue side can contribute to the exit strategy.

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- There had been an enormous expansion in public spending in advanced countries over past half century.
- There is also a lot of evidence that significant inefficiency in the use of public resources exist in many countries.
- Some countries – Switzerland, Australia, some others – achieve high socio-economic indicators, or Human Development Indices, with public spending levels that are 15-20 percentage points of GDP less than those of many European countries.
- Countries should be able to satisfy the truly social public needs with levels of spending in the 30-35 of GDP range.

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- Objections to the above exit strategy are two:
  (a) strong political opposition;and
  (b) fear of negative impact on the economy.
  Political opposition must be fought
  and resisted.

Fear of negative impact on the economy is misguided.

Some countries have followed this strategy in the past without damaging results.

Some examples:USA in the 1940s.Sweden in the 1990s.Others.