



Re-thinking fiscal policy: Constrained activism

Anders Borg
Minister of Finance, Sweden

Paper presented at the Rethinking Macro Policy II: First Steps and Early Lessons Conference
Hosted by the International Monetary Fund
Washington, DC—April 16–17, 2013

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Rethinking Fiscal Policy: Constrained Activism

Anders Borg*

The theme of this conference is rethinking macro policy, and I would like to outline some important lessons from the crisis for the design of fiscal policy, drawing on my experience as minister for finance in Sweden and as a member of the Ecofin Council over the last six years. I will focus on the current role of fiscal policy and a number of important lessons the crisis has taught us, and will conclude with a discussion of the problems Europe has to tackle. This speech has three basic messages:

- First, fiscal policy should be used as a stabilization tool. It is very important to realize that the institutions have to be reformed so that fiscal policy can play an active role in stabilizing the economy.
- Second, debt is important. High debt is a constraint on rational economic policy.
- And third, the main difference between fiscal policy views in the United States and Europe has to do with the fact that the European problems are fundamentally structural. This does not mean there is no demand shortage in Europe, but the problems are to a larger extent structural than those in the United States.

I will begin with a brief description of my view of the current situation.

The Current Situation

If we take a longer view of this crisis, one stylized fact is that Europe has actually grown slowly—less than half a percentage point over the last six or seven years. Even in a 10-year perspective, Europe has growth of close to 1 percentage point. So, fundamentally, there is a long-term not a short-term problem in Europe. This has also fed into unemployment. Unemployment in the euro

*The author would like to thank Philip Löff for his help in drafting this speech.

area is now close to 12 percent. The employment rates in the United States and Europe are at least 5 to 10 percent lower than they should be in a well-functioning economy. And on top of that we have a very heavy increase in the debt level (see figure 1). So, what might be the appropriate fiscal stance in these circumstances?

Fiscal Stance

We should be very cautious about assuming that this crisis is over. There is still a need for both fiscal and monetary policy to remain expansionary. At present, fiscal policy considerations involve striking a difficult balance among the need for consolidation of public finances, supporting growth, and tackling persistently high unemployment. In striking this balance, it is imperative that governments do not lose the confidence of market actors, businesses, and citizens. This policy balance will obviously vary from country to country. Let me illustrate what I mean.

Italy and Spain and other countries under considerable pressure from the markets must meet their fiscal policy commitments at a sufficient pace to restore market confidence. There is a clear risk that backtracking on measures already decided could lead to a return of market uncertainty. But it could be argued that weaker growth than expected should not be met with additional consolidation measures.

Countries in a somewhat stronger position but still facing considerable challenges, such as France and the U.K., should let automatic stabilizers work fully. It is clear that the French government will need more time to reach the 3 percent deficit level. This is a reasonable position on the part of the French government and the European Commission. Letting the automatic stabilizers work fully at this time is a sound approach. It is also important to implement structural reforms to increase competitiveness and improve the functionality of the labor market to boost growth.

For countries with sufficient margins in public finances, an active fiscal policy to support recovery is desirable. I would argue that the situation in my own country, Sweden, calls for an expansionary fiscal policy. In Sweden the debt level is about 40 percent of GDP, public finances are

in structural balance, and there is a high degree of long-run sustainability. But at the same time, Sweden has high unemployment due to the crisis. In these circumstances it seems reasonable to continue to take measures on both the expenditure and the revenue sides to stimulate the economy.

The situation is different in Germany. Germany has an 80 percent debt level, and unemployment is around 5 percent. On top of this, there are some long-term issues concerning public finances. If there is fiscal space in Germany, I would argue that a substantial part of this space should be kept as a buffer—a safety margin—for two reasons. One is that there might be other countries in the euro area that will need new programs in the short or medium term; therefore, the anchor of the whole euro system must be on the safe side and on dry ground. There might also be a need to build a fuller banking union, which could have fiscal implications. A major part of the fiscal space in Germany should be used as a safety buffer, either for use in future programs for countries in difficulty or as part of a backstop arrangement, rather than arguing for short-term stabilization policy in Germany. However, there are also arguments to consider as to whether Germany and others can do more to increase growth. From a general perspective, lower taxes for low income earners and increased spending on growth-friendly expenditures, such as education and infrastructure, could be considered.

What Has This Crisis Taught Us About Fiscal Policy?

Fiscal Policy Is Important for Stabilizing the Economy

The crisis has shown the importance of fiscal policy supporting monetary policy in counteracting significant downturns, particularly when there are large gaps and the policy interest rate approaches zero. This is especially true for European economies with deep structural problems and ongoing private sector deleveraging. However, the ability to use fiscal policy effectively is dependent on whether fiscal policy is deemed credible by the public and the financial markets. Long-term

sustainability of public finances is therefore crucial if fiscal policy is to play a larger role in stabilizing the economy.

It is a somewhat ironic conclusion that while we are now convinced that fiscal policy should be used actively, many countries have debt levels that do not permit such actions. If you believe that fiscal policy has a role to play, it should be very clear that in the long run we need to bring down debts to a level that enables an active role for fiscal policy.

When it comes to the traditional view of stabilization through fiscal policy, the general conception has been that measures should be temporary, targeted, and timely. I see fiscal policy somewhat differently. Fiscal policy has three main targets: distribution, stabilization, and growth. Fiscal policy should deal with all three of these targets at the same time. Particularly in European countries with structural problems, it is very important that short-term measures aimed at stabilizing the economy also support increased long-term growth. When it comes to discretionary measures, temporary measures are preferable in theory; in practice, however, there are substantial risks that temporary measures will become permanent, so they should be used with caution.

Fiscal Policy Has Its Own Problems

If we are going to use fiscal policy, we need to realize that fiscal policy is a difficult animal to live with. One of the key difficulties of fiscal policy is that it is preceded by long decision lags, particularly regarding structural reforms. Structural reforms are often complex and demand long preparation. One can take the Swedish budget for 2013 as an example. Given the weaker growth in the euro area and clear downside risks, together with increased international competition for the large Swedish export sector, there was a strong case for including structural measures to support growth. After the budget for 2012 was presented to the Riksdag (the Swedish parliament) in September 2011, the Ministry of Finance started to consider appropriate measures to strengthen the economy. In November, the basic elements of the reform agenda were chosen; the three main components were increased spending on infrastructure; increased spending on research and

development; and cutting corporate taxation and broadening the tax base by reducing interest rate deductions. The tax proposal then had to be prepared by a government commission and was subsequently assessed by our legal counsel before it could be presented to the Riksdag. It took until April before there was a clear view on how this proposal would work and what it would cost. In August we decided how large the tax cut would be.

If you want to combine fiscal policy with structural measures, you need to set up an adequate planning framework. You need to decide a year ahead what the basic proposals in the budget will be and you need to work with scalable measures that can be adapted to changes in the amount of room for reform.

In contrast, changes in monetary policy are decided and implemented almost instantly. This is a fundamental difference between fiscal and monetary policy. It is therefore important to think through how to deal with the long decision lags. Many of the political economy issues that you normally encounter with fiscal policy can be circumvented and solved by setting up institutions that are well equipped to handle long-term decision making. One important feature is to avoid automatic indexing of expenditures; for example, transfers that are fully indexed to wages. In Sweden, we have reduced the automatic adjustment of expenditures over the past 20 years. This reduction has served us well. Fully indexed expenditures tend to lead to uncontrolled expenditure growth and ultimately to budget problems. Such a feature also reduces the pressure for change in the public sector and ties the hands of democratically elected politicians to set priorities in the annual budget. A prudent trend for expenditures also makes sense in terms of stabilization policy. If expenditures are reduced semi-automatically, it is more credible that fiscal policy will return to a sustainable path when the economy recovers.

There is something deeply democratic about fiscal policy. Fiscal policy is about negotiations and reconciling conflicts between different principles. It has to deal with different interest groups. Interest groups represent ways of channeling different points of view in the debate and are a part of

a well-functioning democracy. Economists have to accept that there is a need see fiscal policymaking as a negotiation process in which democratic forces play a central role. However, it is also clear that when setting the framework for those negotiations, you are affecting the end results. With a well-organized negotiation process and a well-organized budget process, conflicts between principles and interests are much easier to solve. This leads me to my lesson about credibility.

Credibility Is Key

My final lesson is that credibility is key for successful economic policy. I will make a different argument than is normally made about credibility. Modern societies are built on trust. Citizens must be able to rely on the social contract between individuals and the state. The social contract is based on every individual in society being able to rely on the fact that his or her contribution to society will yield a return when needed. This must apply in both the short and long term. This is particularly the case in Sweden, where fiscal policy has a profound influence on citizens' life situations, given the substantial public provision of welfare services. Take, for example, health care or education. Regardless of the business cycle, you as a citizen must be confident that if you have a heart attack you will get good health care and when your children go to school they will get a good education.

If there is uncertainty about the ability to handle fiscal policy in a welfare state, citizens will have trust problems. Countries that increase deficits and debt will create credibility problems that risk breaking down this trust. If we believe that a welfare state is more successful in creating good living conditions for people, it is more important to deal prudently with deficit and debt issues. In this way, European countries differ significantly from countries with substantially lower levels of publicly financed welfare provision, such as the United States.

Europe's Problems Run Deep

Where does this leave us in terms of the euro crisis? As I see it, how countries emerge from the crisis is not primarily about short-term stabilization but rather about the long-term prospects for growth and social cohesion. It is important to acknowledge the structural differences between the U.S. and European economies. These differences are probably one of the main reasons for the polarized views on stabilization policy, both within academia and among policymakers.

If you take stock of the U.S. economy, it is very hard to see any fundamental labor market problems. U.S. unemployment will probably go down to 5 or 6 percent again without any major structural reforms. There might be some problems with hysteresis in the labor market, but the fundamental factors—product market regulation, employment protection, unemployment benefits, marginal taxes, wage setting—all point in the direction of a low structural unemployment level. This is not true of many countries in Europe. The structural unemployment level in the euro area is probably slightly below 10 percent, and there are strong fundamental arguments for this high level. In Europe, markets generally are much more regulated. Also, the tax rates and unemployment benefits are higher (see figure 2).

My argument is not that we should transform the European economies to be like that of the United States in every respect. I tend to like the social market economy and the welfare state. Europe needs to reform, but the reforms should be in line with the European social model. However, it is important to realize that under these circumstances there is a much higher risk of high structural unemployment. If you evaluate structural public finances, it is also much more likely that the United States will lower its deficit level and, therefore, deal with its debt problem automatically when the economy is reinvigorated. This is not the case in Europe.

Given the problems of high indebtedness, low long-run growth, and high structural unemployment, the bulk of fiscal measures in Europe, especially in the euro area, need to address these problems. We need to confront the fundamental structural problems in the euro area—first and foremost, the functioning of the labor market. If we are going to use fiscal policy, it's important

to keep in mind that fiscal policy has goals for distribution, growth, and stabilization. When dealing with stabilization issues, we should also try to do things that stimulate growth in the long term. Rather than being temporary and timely, measures should be directed toward confronting more fundamental issues that will truly determine long-term growth prospects and the scope of our European social model. So, we should use fiscal policy, but it must be a constrained activism that inspires credibility not only among markets but also in terms of the trust of society.

Conclusion

- Fiscal policy should support monetary policy, particularly in dealing with specific structural and distributional problems. But fiscal policy has its own set of problems, particularly long decision lags inherent in structural reforms.
- Long-term sustainable public finances are a fundamental condition for conducting fiscal policy and maintaining confidence, especially for countries with high welfare ambitions and less effective labor and product markets.
- Europe must maintain its focus on structural reforms and tackle the fundamental issues that affect long-term conditions for growth, increased social cohesion, and increased confidence.

Figure 1. Key indicators for the United States, Japan, the euro area, and Sweden

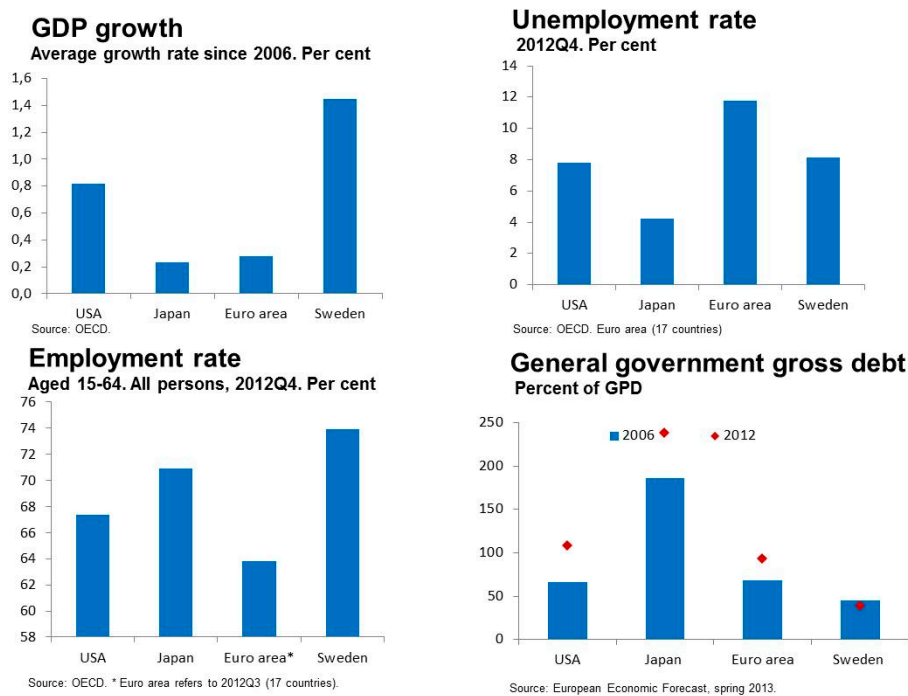


Figure 2. Differences between the U.S., Japanese, and European economies

