Dealing with fiscal deficits

Sharing the pain

Increasing budget deficits and rising government debts are likely to entail fierce political battles—not least between taxpayers and public-sector workers

Mar 4th 2010 | From *The Economist* print edition

WHEN times are hard, many people are tempted to let their credit cards take the strain for a while. And when economies fall into recession, many governments are happy to let their budget deficits widen, to tide the economy over.

Sensible as this may be, deficits in several countries have increased so much and so fast during the economic crisis of the past 18 months or so that it is generally agreed that remedial action will be needed in the medium term. Deficits of 10% or more of GDP cannot be sustained for long, especially when nervous markets drive up the cost of servicing the growing debt.

Market pressure explains why deficits have come to the fore in southern Europe. Greece and Portugal, in particular, have seen a sharp rise in their cost of finance and some investors have questioned their ability to roll over their debt. But deficits will also be at the centre of the forthcoming British election campaign, and in America the “tea party” movement has launched a populist campaign against rising government spending.

There is no absolute rule on when deficits or public debts are too high relative to an economy's size. Prior to the crisis the general consensus was that rich countries could safely have public debts worth 60% of GDP. Yet although Japan's debt has exceeded its GDP for many years, the government has yet to suffer a financing crisis, perhaps because it has a large number of willing domestic buyers of its bonds. But when the markets do lose confidence in a government's fiscal rectitude, a crisis can arise quite quickly, forcing countries into painful political decisions.

Plainly, economic growth makes policymakers' lives much easier. Growth reduces deficits automatically by increasing tax revenues and cutting spending on unemployment benefits and so forth. As the economy grows, deficits fall, debts become more sustainable, lightening the adjustment burden and reassuring investors.

Nations have recovered from huge debt burdens in the past, often in the aftermath of wars, when men and resources were released from conflict and put to more productive work. When politicians turn to today's deficit problems, it is vital that they choose policies that enhance long-term growth prospects. They will not lack opportunities: in several countries, for example, increases in statutory pension ages and other reforms that make labour markets more flexible are anyway overdue.

It would, however, be unwise to assume that a burst of rapid and prolonged growth is imminent in many rich economies. Ageing or even shrinking populations make sluggish growth more likely. Growth also tends to be weak in the aftermath of financial crises. In a recent book on sovereign debt, "This Time is Different", Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard conclude that "the evidence offers little support for the view that countries simply grow out of their debts."

So, short of debt default or implicit default via inflation, that leaves two other ways of closing the deficit. Spending must be cut or taxpayers must pay more. Many political battles of the next few years will be fought on these simple lines, with taxpayers on one side and the beneficiaries of public spending on the other. One imminent battle will be between taxpayers and public-sector workers. In some countries, one party can be seen as representing taxpayers (the Conservatives in Britain and the Republicans in America) and the other the workers (Labour and the Democrats, respectively).

Another of these fights will be between generations. In America the biggest medium-term budget busters are pensions and health care for the old. A big deficit may ease the economic pain in the short term but risks saddling the next generation with a growth-sapping burden of higher taxes and interest payments. The battles are also intertwined: taxpayers finance the pensions of public employees which are, by and large, more generous and predictable than in the private sector.

The outcome of these battles will vary from country to country. Both sides have potent weapons. Many of the biggest taxpayers are political donors and have access to people in power. If they are ignored, they may pack up and move to a more friendly jurisdiction. In Europe especially, public employees, together with recipients of public services, probably have numbers on their side. They are certainly better organised, via their trade unions, and they are political donors too. As French workers have often shown, public-sector unions can intimidate governments with strikes and demonstrations. Their Greek brethren have been trying to emulate them.

The case for cuts

Closing the gap

Past examples of deficit-cutting

Country	Period	Change in: Tax revenue	Public spending	Fiscal balance
		as % of GDP		
Britain	1931-34	-0.1	-3.7	3.6
Britain	1975-79	-2.2	-5.1	2.9
Britain	1982-88	-4.9	-9.2	4.3
Canada	1992-99	3.7	-5.8	9.5
Finland	1994-2000	5.3	-6.7	12.0
Germany	1996-2000	0.7	-3.9	4.6
Ireland	1985-96	-3.7	-14.3	10.6
Netherlands	1993-97	-2.5	-3.9	1.4
Sweden	1993-2000	7.0	-7.8	14.8

Source: Policy Exchange

Experience suggests that governments should focus on spending cuts rather than tax increases. An NBER study of 1996 concluded that "fiscal adjustments which rely primarily on spending cuts and the government wage bill have a better chance of being successful and are expansionary. On the contrary, fiscal adjustments which rely primarily on tax increases and cuts in public investment tend not to last and are contractionary." A paper by António Afonso of the European Central Bank and Davide Furceri of the OECD found that increases in government spending as a proportion of GDP tended to be correlated with slower economic growth. And a paper published by Policy Exchange, a right-of-centre British think-tank, concluded that successful debt consolidations had put 80% of the emphasis on spending cuts (see table).

Some of the more successful deficit-cutting programmes were accompanied by falls in inflation and interest rates. These made it easier for economies to rebound and helped shore up governments' electoral support. But today inflation is already low, as are most countries' bond yields. So cutting spending may not bring much reward from the markets in the shape of lower interest rates. Yet the thought that spending might not be cut may bring punishment in the form of higher ones.

Cutting public spending is, however, a hard slog. Spending on welfare rises automatically in a recession; pension payments continue to grow as the population ages. Western countries used the end of the cold war to slash defence budgets in the 1990s, but given continued military action in Afghanistan and the threat of terrorism, further big reductions are hard to envisage. Nor are there the easy, one-off gains to be made through privatisation of big industries pioneered in Britain in the 1980s under Margaret Thatcher.

Barack Obama's promise to freeze discretionary spending (excluding defence and homeland security) saves $250 billion over ten years—not much when annual deficits

are $1 trillion or more. So government will have to tackle much more politically sensitive areas. Changes to Social Security (pensions), which are not part of discretionary spending, are likely to form part of any fiscal reform in America. Should the Conservatives win the British election, they may change eligibility for welfare payments.

Many governments have boxed themselves in by rewarding their own supporters with jobs or subsidies. In Greece, the right-wing New Democracy party came to power in 2004 pledging a liberalisation of the economy. When it left office in 2009, it had more civil servants than when it started. Such "clientilism" tends to lead to an ever bigger presence for the state in the economy, with more and more citizens depending on the government for employment and income. These people then vote in favour of the status quo. It may take a crisis to force governments to act in ways that hurt their core supporters.

When a crisis does occur, the markets tend to insist on public-expenditure cuts as a kind of test of the government's machismo. In a recent paper Ms Reinhart and Mr Rogoff say: "Even countries that are committed to fully repaying their debts are forced to dramatically tighten fiscal policy in order to appear credible to investors and thereby reduce risk premia."

Governments may thus find their political decisions driven by the need to keep markets onside. That is why the choice is so stark for the southern European countries, which are tied into the single-currency zone. No longer do these countries have the option of devaluing their currencies, which they have resorted to many times in the past. Nor can they combine tighter fiscal policy with loose monetary policy, because they do not control the latter.

Voters or creditors?

If the cuts demanded are particularly painful, governments may simply be unwilling to bear the political cost of pushing them through. A classic example occurred in 1931 when Britain was trying to remain on the gold standard. The then Labour government was told that cuts in the budget deficit, in particular unemployment benefits, were required to appease the markets; otherwise the Bank of England's gold reserves would run out in two weeks. The cabinet split. Ramsay Macdonald, the prime minister, took charge of a (largely Conservative) coalition and has been reviled in left-wing circles ever since. And after all that effort, the austerity plan failed to do the trick; Britain left the gold standard within months.

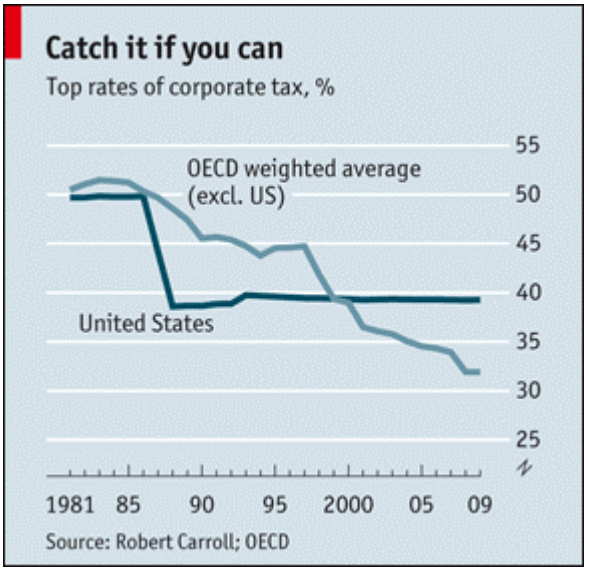
The 1931 episode was viewed in Labour Party history as a "bankers' ramp" in which financiers tried to bounce a government into hurting the poor. Modern governments can also be tempted to blame "speculators", a category covering everyone from bankers to hedge-fund managers, for their own failings. The idea that creditors might be concerned about the governments' ability to pay their debts—and thus insist on a higher interest rate—seems to be hard for politicians to accept. At the Davos economic forum in January George Papandreou, Greece's prime minister, said: "This is an attack on the euro zone by certain other interests, political or financial, and often countries are being used as the weak link, if you like, of the euro zone."

Even so, the Greek government has accepted that its deficit needs to be trimmed. In the politics of deficit reduction Mr Papandreou has some crucial advantages: opinion polls suggest that Greeks accept the need for austerity; he won a substantial election victory last year; the opposition is being supportive; and his Pasok party has strong links with the trade unions. It may be easier for a left-wing party to push through budget cuts.

Supportive social cohesion may explain Sweden's successful fiscal tightening after the banking crisis of the early 1990s. The Social Democratic government turned a budget deficit of 9.3% of GDP in 1994 into a surplus of 1.2% by 1998. Spending fell by more than five percentage points as a proportion of GDP and tax revenues rose by almost as much. Growth averaged 3.2% in 1994-98 and unemployment was lower at the end than at the start—surely a political as well as an economic boon.

Politics within the government can help or hinder deficit reduction. Canada had three failed attempts at fiscal reform before a successful austerity programme was unveiled in the Liberal Party's budget in 1995. Earlier efforts had been blocked by government departments. On the fourth attempt departments were encouraged to suggest sacrifices—and told that budgets would be cut by 10% across the board if they failed to agree. Cuts were made in several areas, including defence, farm subsidies and unemployment benefits. The budget went from a deficit of 6.7% of GDP in 1994 to a small surplus in 1997.

It may be that tax hikes, particularly for the better off, are politically necessary to ensure popular acceptance that pain is being shared. But big tax increases can do economic damage. In the 1990s some of the more remarkable success stories were associated with countries that reduced taxes in order to attract business and capital. Ireland, which became known as the Celtic tiger because of its growth rate, has a corporate-tax rate of just 12.5% and chose not to raise it when it tightened its belt last year.



The corporate-tax trend over the last 30 years has been remorselessly downward. A survey by Robert Carroll of American University in Washington, DC, found that the top rate in OECD countries (excluding America) had fallen from 51% in the early 1980s to 32% by 2009 (see chart). If businesses are attracted by low taxes, they may leave if rates rise.

High-tax European governments have complained in the past about competition from countries like Ireland; the current crisis may lead to more calls for co-ordination of tax policies. Indeed, many countries will be raising taxes simultaneously, which may reduce the temptation for businesses to shift. Much depends on where countries start; it should be easier for those with lower tax burdens to increase their take.

High earners can also be mobile. So many French professionals moved to London in the past decade that Nicolas Sarkozy, France's president, pleaded with them (and offered tax deals) to come back. Britain is gradually losing its appeal to high-earning foreigners. Calculations by PricewaterhouseCoopers, an accounting firm, show that British authorities will take a bigger tax bite out of the pay packet of a married executive earning £250,000 ($373,000) than any other G20 nation except Italy.

The need for countries to maximise their take from their citizens has caused a renewed interest in preventing tax evasion. Countries in the G20 have been pushing hard for low-tax countries such as Switzerland to provide information on foreign depositors. Nevertheless, there are plenty of legitimate ways for businesses and individuals to move to countries with more favourable tax regimes.

So the temptation will be to impose taxes that will be difficult to escape, in particular sales or value-added taxes. The political drawback of such levies is that they fall more heavily on the poor than the rich. This will be unpopular, especially because many people regard this crisis as the fault of high-earning bankers. Furthermore, if higher taxes eat into demand, economies may slip back into recession. A Japanese consumption-tax increase in 1997 is still blamed for derailing its recovery.

European governments have accordingly produced a mix of measures in their austerity packages. Greece, Ireland, Portugal and Spain have all promised to attack the public-sector wage bill by cutting or freezing wages or by reducing the number of staff. Greece announced a new round of cuts on March 3rd. But the packages have also contained tax rises (motorway tolls in Portugal, fuel taxes in Greece) and assaults on tax evasion.

In Greece, tax evasion seems to be rife among the professional classes, with very few citizens declaring high incomes; one response from the government has been to try to encourage the use of receipts. High earners claiming the personal tax allowance of €12,000 ($16,270) will need to provide receipts of at least that value.

Despite this attempt to spread the pain, the Greek government has been confronted with a wave of strikes by public-sector workers. Governments can use outside financial pressure as an excuse to push through reforms that might otherwise be politically unacceptable. But it is a fine balance. Voters may be more resistant if harsh measures are seen as being dictated by foreigners, whether from the EU or the IMF.

The people aren't revolting

Lord Salisbury, a British prime minister, and other 19th-century conservatives feared that democracy would lead to the overthrow of private property rights. Debtors tend to outnumber creditors, and thus can outvote them.

Such pessimism has yet to be proved right. Sometimes, irresistible force meets immovable object. In California, for instance, voters have the right to vote on specific fiscal policies in referendums. The result has been a cap on taxes with no apparent limit on spending. Iceland is about to provide a specific test of this theory in a referendum, in which voters are being asked to accept or reject the terms for compensating foreign depositors in failed Icelandic banks.

However, the efforts of Canada and Sweden suggest progress can be made, if the crisis is acute enough. And dictatorships are unlikely to be better than democracies. Military regimes in Latin America (except Chile) had poor economic records; they saw the state as a source of cushy jobs for officers and subsidies for arms factories. In addition, their very lack of legitimacy may tempt autocracies to bribe influential sections of the electorate.

Nevertheless, democracies face awkward decisions in the years ahead. One of the biggest problems is pensions, which will dwarf the cost of the recent bank bail-out. When state pensions were introduced in 1889 by Otto von Bismarck, the German chancellor, life expectancy was 45; the idea was to provide an income for those who simply could not work any longer. Women who make it to 65 these days can expect 20 years of retirement.

Even that tricky calculation relies on people working to 65 in the first place. Many employers, particularly in the public sector, developed the habit of letting workers retire in their late 50s or early 60s. Germans, who will soon face a state retirement age of 67, will resent being asked to bail out Greeks, who are only just being asked to work to 63.

In Britain, most public-sector workers are still members of final-salary, or defined-benefit, schemes, whereas new employees in private companies are usually placed in defined-contribution schemes with uncertain benefits. The difference in cost may be as much as 30% of payroll.

Raising the retirement age, probably to 70, and cutting the public-sector pension bill will deliver only modest savings in the short run, but will immensely improve the long-term picture. It will, however, be staggeringly unpopular. The proportion of the population in or nearing retirement is increasing; and older people are much more likely to vote than younger citizens. Without reform, however, those apathetic young voters face a crippling tax burden.

There are many battles over deficits to come: taxpayers against public-sector workers; old against young. Well-chosen policies that foster growth may make them less fierce. They may be bloody even so.