

Re-thinking fiscal policy: constrained activism

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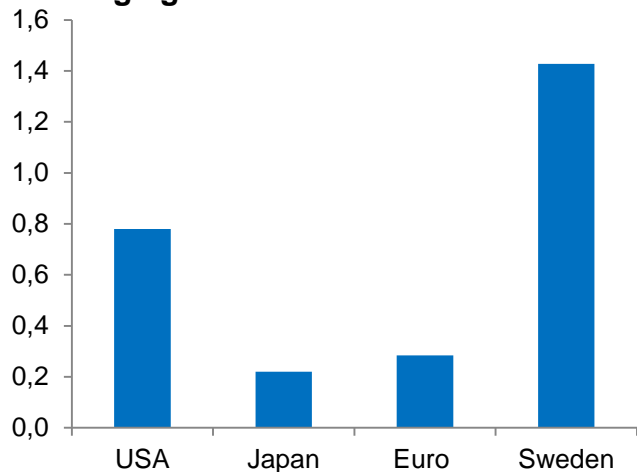
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Global economic prospects

- **Meagre prospects for the global economy in 2013**
- **Fifth consecutive year of financial and sovereign debt crisis**
- **Global slowdown**
- **Downside risks remain large**
- **Long way to go for Europe**

GDP growth

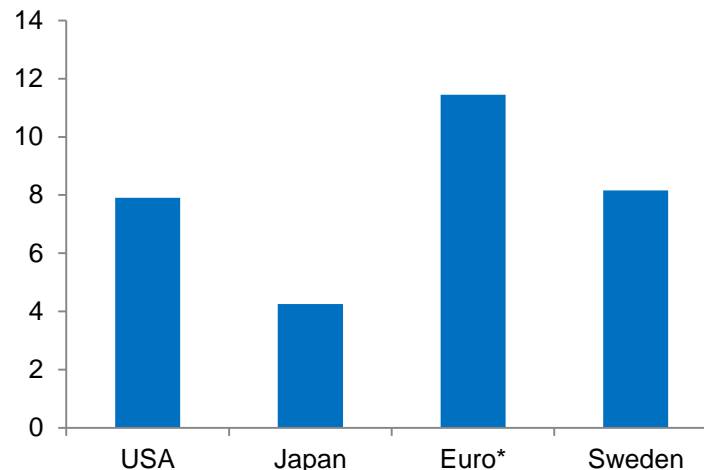
Average growth rate since 2006. Percent



Source: OECD.

Unemployment rate

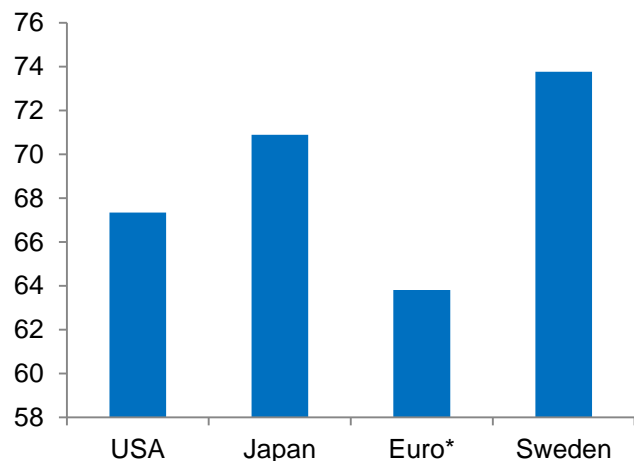
2012Q4, Percent



Source: OECD. * Refers to 2013Q3.

Employment rate

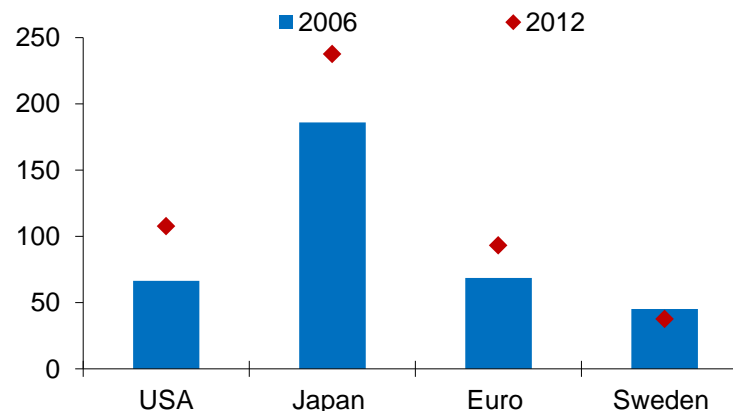
Aged 15-64, All persons, 2012Q4, Percent



Source: OECD. * Refers to 2013Q3.

General government gross debt

Percent of GDP



Source: European Economic Forecast Winter 2013.

Fiscal Stance

- **Countries under market pressure**
 - Must meet their fiscal policy commitments
- **Countries in a stronger position but with significant challenges**
 - Should let the automatic stabilisers operate freely
 - No room for active fiscal policy measures
- **Countries in a relatively strong position**
 - Important to maintain necessary safety margins
 - Still elevated risk levels
- **Opportunities for large-scale expansionary fiscal policy are limited in virtually all industrialized countries**

Lessons from the crisis

Lesson 1

Fiscal policy important

- **Fiscal policy should support monetary policy**
 - Particularly when there are large open gaps and the interest rate approaches zero
 - Fiscal policy is however dependent on whether it is deemed credible by the public and the financial markets
- **Long-term sustainability of public finances is central if fiscal policy is to play a large role in stabilization policy**
 - The risks of excessive indebtedness have become clear during the crisis
- **Fiscal policy can also address specific structural problems**

Lesson 2

Fiscal policy has its own problems

- **Political decisions are always taken in conditions of considerable uncertainty**
- **Long decision lags**
- **Structural reforms are often opposed by lobby groups defending insider interests**

Lesson 2 cont.

Institutions can alleviate problems

- **Disciplined budget process**
- **Well-designed and transparent fiscal policy frameworks with expenditure ceilings and medium-term budget targets**
 - Can manage deficit bias
 - Create conditions for structural reforms
 - Contribute to more effective fiscal policy

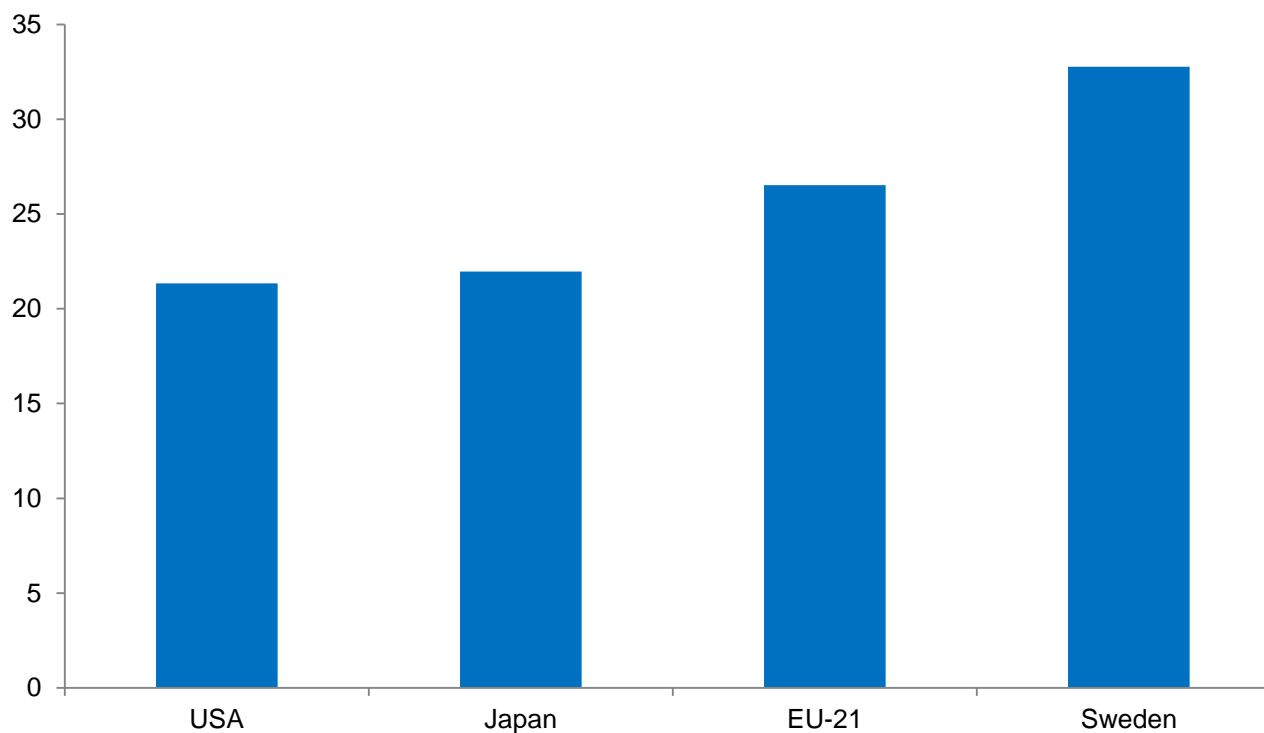
Lesson 3

Credibility is key

- **Social contract must apply**
 - The welfare state model builds on redistribution primarily over the life cycle but also between individuals
 - Every individual in society must be able to feel confident that their contributions to society will yield a return
- **Structural problems inherent in high welfare ambitions must be managed**
- **Long-term sustainable public finances are a fundamental condition**
- **Build up buffers in good times**

Welfare spending

Percent of GDP, 2007



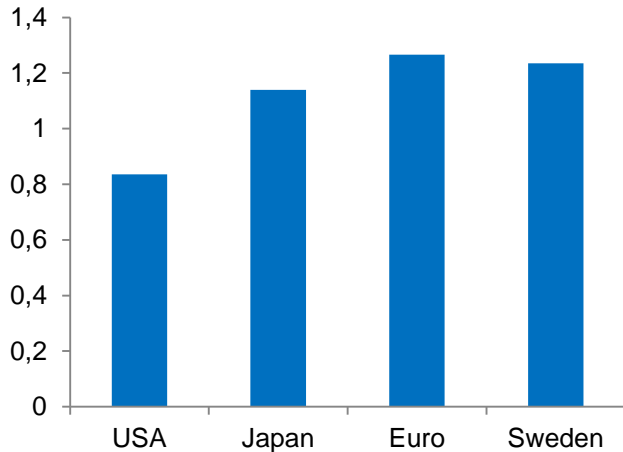
Source: OECD Social Expenditure database, OECD Education database.

*Welfare spending includes, health services, education services, family services, services to the elderly, other social services and Cash transfers

A challenging time for Europe

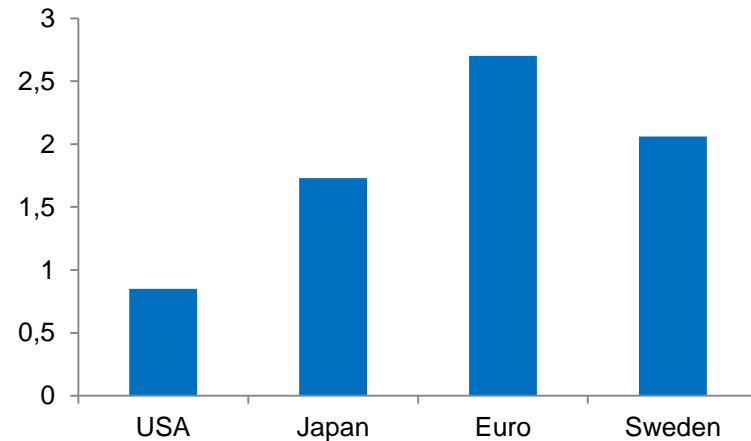
- **Debt crisis continues to weigh on recovery**
 - Continued need for fiscal consolidation and private sector deleveraging in many countries
- **Banking sector risks remain**
- **Need for reforms that improve long-term conditions for jobs and growth in Europe**

Product Market Regulation



Source: OECD and own calculations. OECD overall product market regulation indicator 2008, index scale 0-6 where 6 is the most restrictive. Euro refers to a weighted average with GDP-weights (2011).

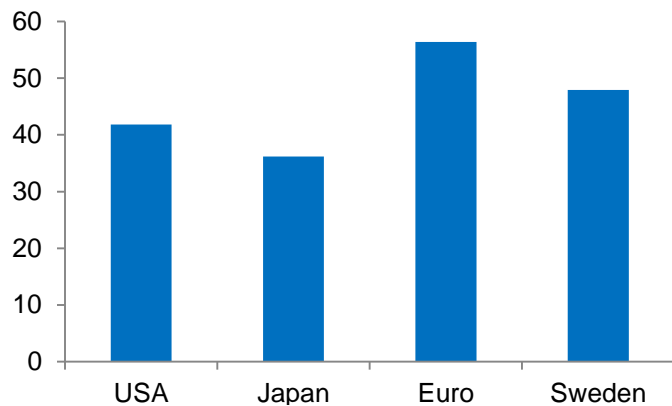
Strictness of employment protection



Source: OECD and own calculations. OECD Strictness of employment protection indicator 2008, index scale 0-6 where 6 is the most restrictive. Euro refers to a weighted average with GDP-weights (2011).

Marginal tax rate

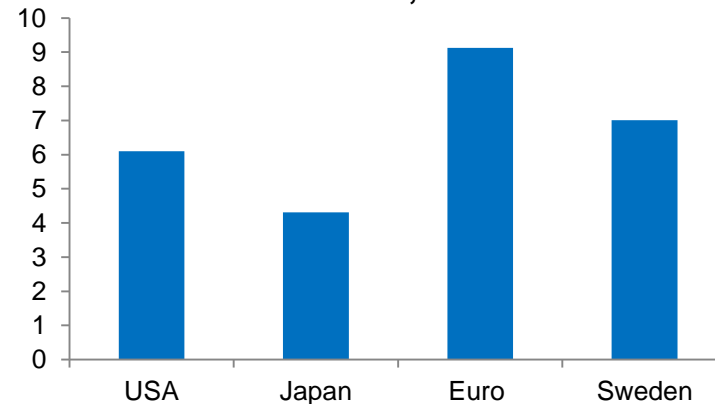
Marginal tax wedge: Principal earner, percent



Source: OECD. Euro refers to a weighted average with GDP-weights (2011).

Structural unemployment rate

Percent of labour force, 2012



Source: OECD Economic Outlook 2012

Confront fundamental structural problems (I)

- **Europe must address sovereign debt problems**
 - Disciplined budget process
 - Strict budgetary policy framework
 - Flexibility to let automatic stabilisers function and conduct active stabilisation policy
- **Create credibility**
 - In the eyes of both citizens and markets
- **Structural reforms that strengthen public finances**
 - Pension reforms and social reforms – strengthen public finances in the short and long term
 - Increased domestic competition –no adverse impact on public finances or domestic demand

Confront fundamental structural problems (II)

- **Europe must tackle labour market problems**
 - Less regulated labour market
 - Make work pay
 - Increase working hours for women
 - Involve social partners
 - Create stable wage setting process
- **Increase growth**
 - Free and open global trade
 - Increased domestic competition
 - Deregulation of national monopolies
 - Deregulation of product markets and regulated sectors, not least domestic service sectors

EU institutional framework redrawn

- **Strengthening of the Stability and Growth Pact**
- **Banking union**
- **Economic union**
- **More policy coordination and centralization of power**

EU institutional framework redrawn (II)

- **Must deal with structural fundamentals**
- **First priority is effective implementation of already agreed measures**
- **Markets signals important**
- **New measures should contribute with clear value-added**
- **National ownership of reforms is central**
- **Democratic legitimacy and accountability must be safeguarded**

Summary

- **Fiscal policy should address specific structural and distributional challenges**
 - Europe must stay focused on structural reforms and tackle the fundamental conditions for growth
- **But fiscal policy has its own problems**
 - Long decision lags, particularly concerning structural reforms
 - Structural reforms opposed by strong lobby groups defending insider interests
- **Long-term sustainable public finances are an essential condition for conducting fiscal policy**
 - Central for maintaining confidence
 - Particularly important for countries with high welfare ambitions
- **Disciplined budget process and strict budgetary policy frameworks are important instruments**