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## **Fiscal Activism in Booms, Busts, and Beyond**

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### **ABSTRACT**

*This paper discusses activist fiscal policies during good times, the crisis period and for the post-crisis period. The study argues, first, that fiscal policies were overly imprudent during the boom phase preceding the crisis. This was due to excessive expenditure growth and problems with measuring the output gap and fiscal stance. Second, during the crisis, too much emphasis was placed on the need for (activist) fiscal demand support despite demand excesses in the boom years in several countries. Fiscal activism focussed less (and less strongly than needed) on the balance sheet nature of the crisis and the significant misallocation of resources. Third, and given strong increases in public expenditure ratios in the crisis, timely fiscal exit strategies need to bring these down to sustainable levels so as to regain fiscal sustainability and to create an environment conducive to consolidation and growth.*

Key words: Fiscal activism, booms and busts, consolidation, expenditure policies.

JEL classification: E62, E63, H62.

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\* The views expressed are the authors and do not necessarily represent those of the ECB. I am grateful to Vilem Valenta, Geert Langenus and to participants of the Banca d'Italia 2010 workshop in Perugia for very helpful comments.

**RESUMEN**

*Este documento analiza las políticas fiscales activas durante el período de auge, durante el período de crisis y durante el período posterior a la crisis. El estudio argumenta, en primer lugar, que las políticas fiscales fueron demasiado imprudentes durante la fase de auge anterior a la crisis. Esto se debió al crecimiento excesivo del gasto y a problemas con la medición de la brecha del producto y la posición fiscal. En segundo lugar, durante la crisis, en varios países se puso demasiado énfasis en la necesidad apoyo fiscal (activista) a pesar de los excesos de demanda en los años de auge. El activismo fiscal se centró menos (y menos fuerte de lo necesario) en la naturaleza de balance de la crisis y en la mala asignación de recursos. En tercer lugar, y teniendo en cuenta los fuertes incrementos en las tasas de gasto público durante la crisis, estrategias de política fiscal tienen que llevar el gasto público a niveles sostenibles con el fin de recuperar la sostenibilidad fiscal y crear un entorno propicio para la consolidación y crecimiento.*

Palabras clave: Estabilizadores automáticos, progresividad impositiva, seguro de desempleo, políticas fiscales discrecionales, Instituciones Fiscales Europeas, Pacto de Crecimiento y Estabilidad.

Clasificación JEL: E62, E63, H62.

*“Even the most practical man of affairs is usually in the thrall of the ideas of some long-dead economist”* KEYNES.

*“Today, the long dead economist is Keynes” [... ] “The policy mistake has already been made – to adopt the fiscal policy of a world war”* NIALL FERGUSSON, in FT 30/31 May 2009.

**I. INTRODUCTION**

The financial crisis has changed both the intellectual environment and the outlook for fiscal policies strongly. Before the financial crisis, the consensus appeared to be that discretionary fiscal policies were normally not desirable for demand management (ECB, 2002). Automatic stabilisers in Europe were seen to be large and better targeted and timely for this purpose. Discretionary policy changes would be applied to attain consolidation objectives—which were to be in line with the SGP and structural changes which aimed to boost growth.

With the intensification of the financial crisis in autumn 2008, a renaissance of Keynesian thinking gripped not only much of the economic profession but also many policy makers of all colours. The crisis was declared a demand shock which was argued to require a demand stimulating response (Freedman et. al, 2009). While the duration of the renaissance in Keynesian thinking is unclear the much-deteriorated outlook for fiscal sustainability associated with it is certainly a huge challenge for many years to come.

The quick succession of concerns about the economic meltdown followed by concerns about too early or too late fiscal consolidation drowned out a number of very important questions for the handling of this crisis and beyond: what role have fiscal policies played in the boom period and what can be learned? Have fiscal responses in the crisis been adequate and really addressed the key issues? And, on this basis, what should fiscal exit strategies take into account? These are the questions that this study focuses on. Activism, first, refers to active fiscal policy interventions (as opposed to automatic stabilization) that change the fiscal stance with the objective of fiscal expansion and consolidation.<sup>1</sup> Second, I will also call activism those fiscal policies that aim to preserve fiscal sustainability given uncertainty about the economic situation and outlook in real time. The study focuses mainly on euro area countries but occasionally also makes reference to and comparisons with other advanced economies.

While the study aims to provide positive analysis, the objective is distinctly normative. Moreover, technical sophistication and depth is sacrificed to allow a broad coverage of the subject within the scope of one paper. The study argues, first, that fiscal policies were overly imprudent in the boom-phase, partly due to real time measurement problems. Second, in the bust phase, analysis into the roots of the crisis should have been deeper and too much emphasis was placed on the need for (activist) fiscal demand support. Although the balance sheet nature of the crisis was little acknowledged, significant fiscal measures to support balance sheets were introduced. Little attention has so far been paid to the fiscal dimension of restructuring of sectors and down-scaling of demand that had reached unsustainable dimensions in the boom. Third, fiscal exit strategies are being prepared and implemented in light of unsustainable fiscal balances. However, attention is only slowly focussing on the underlying strategy and this study argues the case for expenditure reform.

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1. Recall that automatic stabilizers lead to changes in the deficit mainly as a result of “automatic” changes in revenue over the cycle rather than active or discretionary policy decisions. They leave the underlying balance unchanged.

The study draws three lessons for activist fiscal policies: First, apply prudent expenditure policies during boom years and improve the measurement of the fiscal stance. Second, target fiscal policies to the true causes of a crisis: support demand via fiscal stimulus only during the deep crisis phase and only to the extent that it does not reflect a correction of excess demand in the boom; help balance sheet repair; and allow the adjustment of unsustainable boom structures. Third, do not procrastinate in correcting fiscal imbalances and focus on reverting unsustainable expenditure ratios. This would contribute to a virtuous cycle of more economic dynamism facilitating fiscal adjustment and balance sheet repair.

## **II. FISCAL ACTIVISM IN THE BOOM PERIOD**

The experience of the past economic boom suggests that the main challenge for fiscal policies in good times lies in preventing an imprudent expansionary fiscal stance. This is, first, because the measurement of the cyclically adjusted balance and its change tend to suggest an overly favourable underlying position and an adjustment mirage. Second, this and the strong growth during the boom which can persist much longer than during normal business cycle upturns, tempts policy makers to decide on an expenditure path that looks broadly reasonable *ex ante* but proves unsustainably expansionary *ex post*.

### **II.1 Measurement problems in the boom**

In order to decide on the appropriate degree of fiscal activism or automatism, the economic and fiscal position in the business cycle and the impact of the cycle on the fiscal balance need to be known. This, however, is a major challenge (Cimadomo, 2008). First, especially the end of a boom period tends to be characterised by significant downward revisions in the output gap as subsequent busts/downturns are never anticipated. This is illustrated in Table 1 which reports estimates of output gaps for 2007, the final boom year. In real time (autumn 2007), the output gap was seen as broadly closed in the euro area. Several countries, such as Spain, Ireland or the UK, were seen as having a slightly negative gap even after a decade of boom. The experience of the financial crisis changed this picture dramatically and the euro area was seen to have had a positive output gap of 2.5% in 2007 from the perspective of the autumn 2009 forecast. Revisions for Ireland exceeded 5pp and for some others 3pp of GDP. This is the result of an overestimation of trend growth during the boom years.

The revision of output gaps coincided with a revision in cyclically adjusted balances. While the euro area was seen only in slight deficit (-0.7%) in 2007 for 2007, the underlying balance was seen at -1.8% two years later. The change is around 1pp for most countries and almost 3pp for Ireland. If this mis-measurement had not occurred, the riskiness of the pre-crisis fiscal position would have been apparent and would have suggested action much earlier.<sup>2</sup>

The measurement problem of the output gap has been made worse by another, by now well-known, problem that concerns the measurement of the elasticity of the cyclically sensitive revenue and expenditure items. As early as 2002, Eschenbach and Schuknecht argued that in boom periods the elasticity of revenues can be much higher than expected if stock market or real estate price gains result in extra revenue from wealth effects on consumption, valuation gains notably in corporate balance sheets or higher asset market turnover. Jaeger and Schuknecht (2004/2007) found that the budgetary elasticity to GDP changes during asset price boom and bust periods is on average twice as high as during more normal times. In the meantime, many further studies on this matter have emerged and broadly confirmed that the related revenue windfalls in booms can result in a consolidation mirage (e.g., Girouard and Price, 2004; Kremer et al, 2006; Morris and Schuknecht, 2007; Martinez Mongay et al, 2007; European Commission, 2009; Tagkalakis, 2009). By the same token, in a bust “unexpected” revenue shortfalls can make the deficit deteriorate much faster and the cyclically adjusted balance worsen much more than discretionary measures would have suggested.

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2. A first glance at Commission data and a simple OLS regression for EU countries suggests a correlation between output gap revisions and macroeconomic imbalances (as reflected by the current account or the size of the construction sector). Dependent variable: output gap revisions between autumn Commission vintages for 2007 and 2009. Independent variables: A 1 pp higher [share in construction/% of GDP; current account deficit] in 2007 suggests an output gap revision of [1/3 pp, 0.2 pp].

**Table 1**  
**Output gap and cyclically adjusted balance, for different vintages**

A) OUTPUT GAP 2007			B) CYCLICALLY ADJUSTED BALANCE 2007		
	Vintages autumn 2007	Vintages autumn 2009		Vintages autumn 2007	Vintages autumn 2009
<b>BE</b>	-0.2	2.4	<b>BE</b>	-0.2	-1.5
<b>ES</b>	-0.5	1.5	<b>ES</b>	2	1.2
<b>DE</b>	0.3	2.7	<b>DE</b>	-0.1	-1.2
<b>IT</b>	-0.8	2.8	<b>IT</b>	-1.9	-2.9
<b>FR</b>	-0.3	1.9	<b>FR</b>	-2.4	-3.6
<b>PT</b>	-1.7	0.6	<b>PT</b>	-2.2	-2.8
<b>NL</b>	-0.4	2.8	<b>NL</b>	-0.2	-1.3
<b>AT</b>	0.4	2.5	<b>AT</b>	-1	-1.7
<b>IE</b>	-0.7	4.9	<b>IE</b>	1.2	-1.7
<b>FI</b>	0.4	4.6	<b>FI</b>	4.4	2.9
<b>LU</b>	0	5.3	<b>LU</b>	1.2	1
<b>GR</b>	1.3	3.4	<b>GR</b>	-3.4	-5.1
<b>SI</b>	0.9	5.5	<b>SI</b>	-1.1	-2.6
<b>CY</b>	-1.1	1.9	<b>CY</b>	-0.6	2.6
<b>MT</b>	-0.6	1.3	<b>MT</b>	-1.6	-2.6
<b>SK</b>	1	7.5	<b>SK</b>	-3	-4
<b>Euro area</b>	-0.2	2.5	<b>Euro area</b>	-0.7	-1.8
<b>GB</b>	-0.1	2.6	<b>GB</b>	-2.7	-3.8
<b>EU27</b>	-0.1	2.7	<b>EU27</b>	-1	-2.1

Source: European Commission.

This assessment is broadly confirmed by econometric estimates of asset price related revenue elasticities for the euro area and a number of its member countries as reported in Table 2, by Morris and Schuknecht (2007). In 2002, for example, conventional calculations of the change in the cyclically adjusted balance would have suggested a loosening while an asset price adjusted calculation suggests a tightening in several countries and for the euro area as a whole.

**Table 2**  
**Impact of asset prices on structural budget balances**  
**(as a percentage of GDP)**

## A) CHANGE IN CYCLICALLY ADJUSTED BALANCE

	Belgium	Germany	Spain	France	Ireland	Italy	Neth'nds	Finland	Euro area	
1999	-0.38	0.54	1.18	0.36	-0.79	0.83	0.47	0.05	0.51	
2000	-0.19	-0.54	-0.29	-0.5	1.17	-1.27	0.46	4.74	-0.42	
2001	0.98	-1.58	0.46	0.07	-3.12	-1.23	-1	-1.28	-0.7	
2002	-0.08	-0.24	0.68	-1.06	-1.06	0.71	-0.49	0.01	-0.12	
2003	0.55	0.28	0.62	-0.5	1.6	-0.08	-0.21	-0.83	0.03	
2004	-0.52	0.13	0.14	0.45	1.75	0.15	1.24	-0.32	0.23	
2005	-1.7	0.65	1.47	1.16	-0.15	-0.04	1.72	0.45	0.67	

## B) CHANGE IN CYCLICALLY ADJUSTED BALANCE NET OF ASSET PRICE EFFECTS

	Belgium	Germany	Spain	France	Ireland	Italy	Neth'nds	Finland	Euro area	
									[1]	[2]
1999	-0.25	0.2	0.88	-0.09	-1.28	0.68	-0.33	-0.38	0.18	0.2
2000	-0.05	-0.7	0	-0.64	1.11	-1.56	-0.04	2.41	-0.62	-0.61
2001	1.69	-0.92	1.19	0.59	-2.23	-1	-0.25	-2.4	-0.17	-0.27
2002	0.43	0.26	1.12	-0.66	-0.65	0.71	0.19	2.25	0.21	0.26
2003	0.35	0.14	0.03	-0.73	1.29	-0.31	-0.08	-0.08	-0.12	-0.15
2004	-1.27	0.11	-0.53	0.23	1.5	-0.05	1.38	-0.3	0.07	0.08
2005	-1.91	0.4	0.7	0.98	-0.31	0.05	1.45	0.38	0.44	0.47

Sources: Morris and Schuknecht, 2007. [1] Estimated [2] Weighted average of country estimations.

## II.2 Expenditure trends in the boom

If trend GDP growth, the underlying fiscal balance and adjustment efforts tend to be overestimated in booms it is no surprise that governments get tempted into expenditure trends that are seen as “reasonable” and in line with “automatic stabilisation” ex ante while proving destabilizing ex post. A simple simulation can illustrate this point. Assume a “light” business cycle as in scenario 1 of Table 3 (average growth of 2% with 3% during the upswing and 1% in the downturn). Revenue is assumed to grow in line with GDP. If automatic stabilizers are allowed to operate and, as assumed here, expenditure growth simply follows trend growth, the expenditure and balance ratio would rise and



fall symmetrically over the cycle. However, if as in scenario 2, the economic upswing leads to stronger revenue growth and governments believe that revenue and trend GDP growth have increased permanently they would also argue that a higher spending growth rate can be maintained. If this assumption on growth and revenue turns out to be an error, two things happen: the expenditure ratio at the end of the upswing remains higher than warranted, revenue windfalls would reverse more strongly than anticipated during the downturn. This, in turn, would result in a worse fiscal balance and higher expenditure ratio at the end of a full cycle as reflected in the second scenario. With such a policy error in the boom, a return to the starting fiscal position at the end of the full cycle would then require pro-cyclical tightening in the downward phase.

**Table 3**  
**Simulation of revenue, expenditure**  
**and fiscal balance ratios to GDP**

**SCENARIO 1: NORMAL CYCLE**

<b>Time</b>	1	2	3	4	5	6	7	8	9
Growth Y	2%	3%	3%	3%	2%	1%	1%	1%	2%
Growth T	2%	3%	3%	3%	2%	1%	1%	1%	2%
Growth G	2%	2%	2%	2%	2%	2%	2%	2%	2%
Rev ratio	45	45	45	45	45	45	45	45	45
Exp ratio	45	45	44.6	44.1	43.7	43.7	44.1	44.6	45
Def ratio	0	0	0.4	0.9	1.3	1.3	0.9	0.4	0

**SCENARIO 2: REVENUE CYCLE CUM EXPENDITURE ACCELERATION**

<b>Time</b>	1	2	3	4	5	6	7	8	9
Growth Y	2%	3%	3%	3%	2%	1%	1%	1%	2%
Growth T	2%	4%	4%	4%	2%	0%	0%	0%	2%
Growth G	2%	2%	3%	3%	3%	3%	3%	3%	3%
Rev ratio	45	45	45.4	45.9	46.3	46.3	45.9	45.4	45
Exp ratio	45	45	44.6	44.6	44.6	45	45.9	46.8	47.7
Def ratio	0	0	0.9	1.3	1.8	1.3	0	-1.4	-2.8

Source: Author's own calculations.

The second simulation scenario illustrates the experience of several euro area countries over the pre-crisis boom period rather well. Real expenditure growth for the average of the area and several countries was well above trend growth for the 2000-2007 period (Table 4). Just to illustrate, a 1pp higher annual expenditure growth for an expenditure ratio around 45% of GDP for a period of seven years makes a difference of about 3% of GDP in the expenditure ratio at the end of this period. For the euro area average, the excess expenditure growth was perhaps half that figure.

**Table 4**  
**Real expenditure versus trend GDP growth**

	REAL EXPENDITURE GROWTH			TREND GDP GROWTH		
	2000-05	2006	2007	2000-05	2006	2007
SPAIN	4.1	4.1	3.3	3.2	2.2	1.8
GERMANY	0.8	0.5	1.9	1.2	0.9	0.9
ITALY	2.7	1.8	2.4	1.1	0.5	0.3
FRANCE	1.9	2.4	2.5	1.9	1.5	1.3
NETHERLANDS	3.1	1.8	1.6	2.2	1.7	1.7
AUSTRIA	1.6	1.6	2.1	2.1	1.8	1.6
GREECE	3.3	3.1	3	3.7	3	2.6
EURO AREA 12	2.1	1.9	2.3	1.8	1.3	1.1

Source: Ameco, autumn 2009.

**Table 5**  
**Compensation per public and private employees**  
**1999-2008 accumulated% growth in nominal terms**

	COMPENSATION PER GOVERNMENT EMPLOYEE	COMPENSATION PER PRIVATE EMPLOYEE	COMPENSATION PER EMPLOYEE, TOTAL ECONOMY
<b>EURO AREA 12</b>	35.3	23.7	25.3
<b>BELGIUM</b>	38.2	31.5	33
<b>GERMANY</b>	16.6	12.2	12.4
<b>IRELAND</b>	99.4	70.5	76.6
<b>GREECE</b>	107.3	74.1	79.5
<b>SPAIN</b>	51.9	27.7	36.5
<b>FRANCE</b>	32	32.7	32.4
<b>ITALY</b>	41.8	24.9	27.9
<b>LUXEMBOURG</b>	53.7	37.7	38.7
<b>NETHERLANDS</b>	33.2	40.8	39.5
<b>AUSTRIA</b>	28.4	25.7	25
<b>PORTUGAL</b>	52.2	38.4	40.1
<b>FINLAND</b>	41.6	39.3	40

Source: OECD Economic Outlook database November 2009 Issue. Missing government employment data for Germany, Greece and Austria have been taken from the Spring 2006 (1998, 1999) and Spring 2007 (2000-2006) issues.

The relatively strong expenditure growth in the boom years reflects underlying policy decisions. Public wages, for example, grew very strongly in a number of countries in the boom and notably in Ireland and Greece but also in Spain, Luxembourg and Portugal. These growth rates were much above the euro area average and above private wage growth in these countries (Table 5). Public employment was also imprudently buoyant in the boom years, notably in Spain, the Netherlands and Ireland (Table 6).

**Table 6**  
**Public employment in selected OECD countries**

PUBLIC EMPLOYMENT GROWTH (%)		
	1991-1999	1999-2007
<b>ESP</b>	16,5	36,8
<b>DEU</b>	-12,7	-5,4
<b>ITA</b>	-3,2	2,3
<b>FRA</b>	5,6	7
<b>NLD</b>	-0,6	13,1
<b>AUT</b>	-3	-5,9
<b>IRL</b>	8,9	46,5
<b>EA12</b>	-0,1	7,3
<b>GBR</b>	-10,2	14,1
<b>US</b>	9,5	9,4
<b>JAPAN</b>	5	-1,3

Source: OECD.

As a result of these trends, public expenditure ratios in the later boom years changed very little in the euro area, except for Germany (Table 7). A number of countries even saw their expenditure to GDP ratio rise, notably Ireland. But many countries did not experience a decline in the expenditure ratio commensurate with the economic environment and the operation of automatic stabilisers.

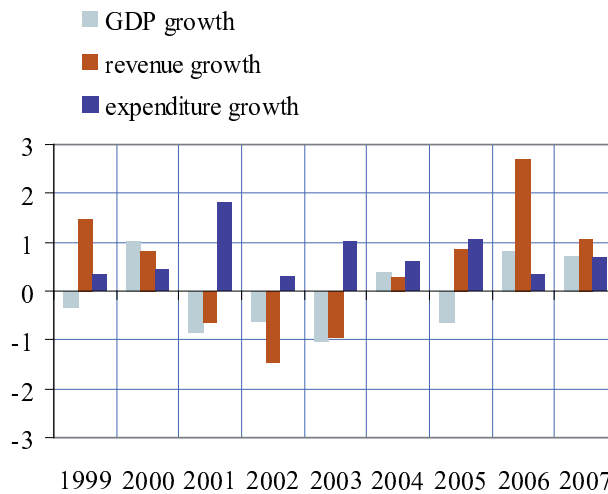
An important reason for imprudent expenditure trends in the euro area were not ex ante plans but slippages in the budget execution. On average, public expenditure in the euro area increased by more than 1/2pp faster than planned between 1999 and 2007 for the average of the euro area (Chart 1). This may reflect two important factors: first, plans may not have been consistent with commitments arising from policy choice. Second, slippages may also reflect poor budget execution due to weak expenditure rules.

**Table 7**  
**Public expenditure developments in selected countries,**  
**2004-2007 (% of GDP)**

<b>COUNTRY</b>	<b>2004</b>	<b>2007</b>
<b>BELGIUM</b>	49.3	48.4
<b>GERMANY</b>	47.1	43.7
<b>IRELAND</b>	33.5	38.4
<b>GREECE</b>	45.5	44.1
<b>SPAIN</b>	38.9	39.2
<b>FRANCE</b>	53.2	52.3
<b>ITALY</b>	47.7	47.9
<b>NETHERLANDS</b>	46.1	45.5
<b>PORTUGAL</b>	46.5	45.7
<b>FINLAND</b>	49.9	47.3
<b>EURO AREA</b>	47.6	46.1
<b>SWEDEN</b>	55.3	52.5
<b>UNITED KINGDOM</b>	42.9	44
<b>JAPAN</b>	37	36
<b>UNITED STATES</b>	36	36.7

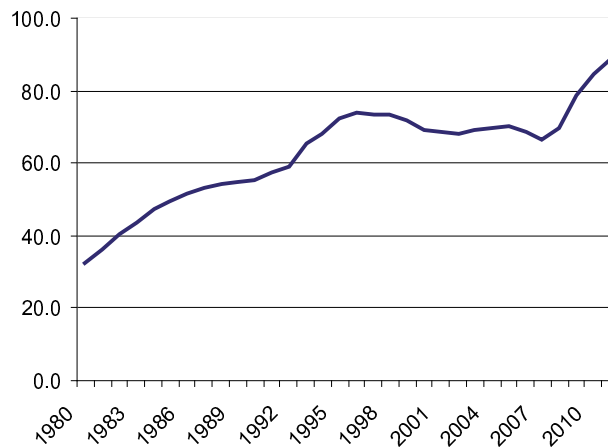
Source: Commission, Autumn 2009.

**Chart 1**  
**Deviations from stability programme targets (euro area 12 aggregate)**  
**(annual percentage points)**



Sources: AMECO, stability programmes and ECB calculations.

**Chart 2**  
**Public debt developments in the euro area,**  
**1980-2011 (% of GDP)**



Source: AMECO (based on Commission 2009 autumn forecast).

All in all, measurement problems and expenditure developments are the main reason for a relatively weak starting position of public finances in the euro area before the crisis struck. The average euro area deficit ratio still posted a deficit in 2007 and the public debt ratio in the euro area only improved by 8pp since the mid-1990s peak of 74% of GDP and by 3pp between 2003 until 2007 when it stood at 66.4% of GDP. In fact, public debt has been rising much more strongly in downturns than it has been falling in upswings for the past three decades (Chart 2).

The lesson of this experience is twofold. First, the measurement of the underlying fiscal balance and stance needs to improve. Additional indicators to check the robustness of output gap estimates such as current account imbalances, capacity utilization or real estate prices and the inclusion of further variables such as asset prices in the stance measurement may be considered. Several of the quoted studies have pointed to ways to improve the measurement of the fiscal stance.

Second, and given that measurement problems can probably not be excluded in the future, it is advisable to follow what I would call “activist prudence” in good times. This should ensure that expenditure dynamics remain sustainable which, in turn, helps mitigate the risk of unsafe positions at the end of a boom. Three elements are important to consider: i) trend growth assumptions need to be prudent and the baseline expenditure scenario should be built on this (any expenditure consolidation needs should then be deducted from this scenario); ii) expenditure commitments need to be consistent with the desired expenditure growth path and policy changes should be implemented where needed (Tanzi and Schuknecht, 2000); and iii) expenditure rules may need to be improved if slippages are the result of undue leeway in budget execution (European Commission, 2007). Automatic stabilizers may then normally operate more “safely” around the resulting spending and deficit path.

### III. FISCAL ACTIVISM IN THE CRISIS

The experience of the financial crisis suggests two main questions which could have been examined with more care from the outset: i) what is the underlying problem of the steep decline in demand in late 2008 and how much of that should be addressed by what type of fiscal policy? And ii), how much deterioration of the fiscal balance can and should we afford from a short and long term perspective. This study will only deal with the first issue in detail. I will argue that indeed there appears to have been a

Keynesian-type demand shock after the Lehmann default. However, too much attention has been focussed inappropriately on the demand-stimulating role of fiscal activism. The crisis was and is mainly a balance sheet crisis where excessive private debt accumulation (to finance excess private demand in the boom) had to be followed at some point by a phase of more subdued demand so as to allow balance sheet repair. Moreover, the boom period with excess demand “naturally” resulted in excess supply in the “profiting” sectors, in particular construction/real estate and finance. On this basis one could have argued for fiscal activism to support balance sheet repair and the structural rebalancing of economies. But on the demand side, the issue is complex and the Keynesian argument for more stimulus is countervailed by the structural argument of lower equilibrium output and demand.

### III.1 The Keynesian crisis (phase)

In the autumn of 2008, after the collapse of Lehman, calls for activist fiscal policies emerged very quickly. In retrospect, the concerns about the demand outlook underlying these calls appear at least partly justified. Euro area GDP fell by almost 2% in the fourth quarter of 2008 and by another 2 ½% in the first quarter of 2009. The European Commission called for activist measures to be targeted, temporary and timely (TTT) so as to minimise the risk of repeating the mistakes of the seventies and early 1980s when fiscal activism was often late (and hence pro-cyclical), poorly targeted and non-reversible, thus leading to a permanent worsening of fiscal balances and structures. Moreover, it was pointed out that large automatic stabilisers in Europe were already contributing significant support to demand.

Table 8 shows that of the likely worsening of the fiscal balance in 2009 by about 4 ½% of GDP more than half came from automatic stabilizers (cyclical effect) and another quarter from the reversal of revenue windfalls discussed in the previous section (part of “residual change”). Only one quarter was due to discretionary fiscal loosening. However, this assessment hinges on the fact that there will be no major further ex post downward revisions of the output gap and trend growth during the crisis which would drive up the discretionary component of the budget deterioration.

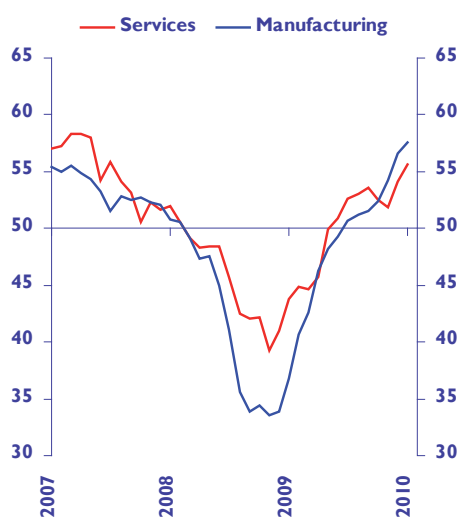


**Table 8**  
**Fiscal deficit changes in the financial crisis**  
**in the EU and euro area**

	TOTAL CHANGE IN THE DEFICIT WITH RESPECT TO PREVIOUS YEAR	OF WHICH:			
		CYCLICAL EFFECT	BUDGETARY IMPACT DISCRETIONARY	RESIDUAL CHANGE IN THE PRIMARY CYCLICALLY- ADJUSTED	BUDGETARY IMPACT CHANGE IN THE INTEREST EXPENDITURE
<b>2009</b>					
EA-16	-4.4	-2.4	-1.1	-0.9	0
EU27	-4.6	-2.4	-1.3	-1	0
<b>2010</b>					
EA-16	-0.5	0	0.1	-0.3	-0.2
EU 27	-0.6	0	0.2	-0.4	-0.2
<b>2011</b>					
EA-16	0.4	0.2	0.4	0	-0.2
EU 27	0.6	0.2	0.4	0.2	-0.2

Source: Commission autumn 2009 forecast.

**Chart 3**  
**Purchasing Managers' Indices (PMIs) for the euro area**  
**(monthly data; seasonally adjusted)**



Source: Markit.

With this caveat in mind and while it is too early to come to an overall judgement, the strong role of automatic stabilizers for boosting demand appears appropriate from this perspective. One could probably also argue for a discretionary fiscal demand boost during the immediate deep crisis phase from a demand management perspective.

But there are several reasons to be sceptical about the overall fiscal strategy pursued. The deep crisis phase when arguably a demand and confidence boost was warranted only lasted a short period. Already in the second quarter of 2009, survey indicators pointed to much less negative growth in real time and positive growth (as later confirmed) resumed in the third quarter in the euro area (Chart 3). Further arguments relate to political economy factors as experienced in the 1970s. First, little analysis was undertaken as to where and how much demand shortfall was emerging. Consequently, targeting was partly poor. In Germany, for example, a demand shock in the export sector was met with an investment programme directed at a construction sector that was fully employed. Stimuli were also captured by special interests that would not have stood a chance in normal times. VAT reduction for German hoteliers may be an example. Second, in many instances, timing was poor and much of the stimulus took time to take effect. In fact, in countries such as the Netherlands, Germany or Austria, the fiscal stimulus continued well into 2010 when activity has already been recovering for quite some time. Third, a number of countries also introduced measures that are hard to reverse such as public wage or benefit increases. Immediate tax rebates, VAT cuts and to a certain extent also car wrecking premia may have been the best measures from a TTT perspective.<sup>3</sup>

Moreover, it may turn out that part if not much of the demand fall in the crisis was not a negative demand shock but the reversal of excess demand during the boom linked to unsustainable wealth effects in many countries cum a supply shock due to mis-allocated resources. Then perhaps activist demand stimulation or even the full operation of automatic stabilisers would not have been justified and certainly not for the time after the deep crisis phase. This issue will be discussed in more detail in section 3c.

### III.2 The balance sheet crisis

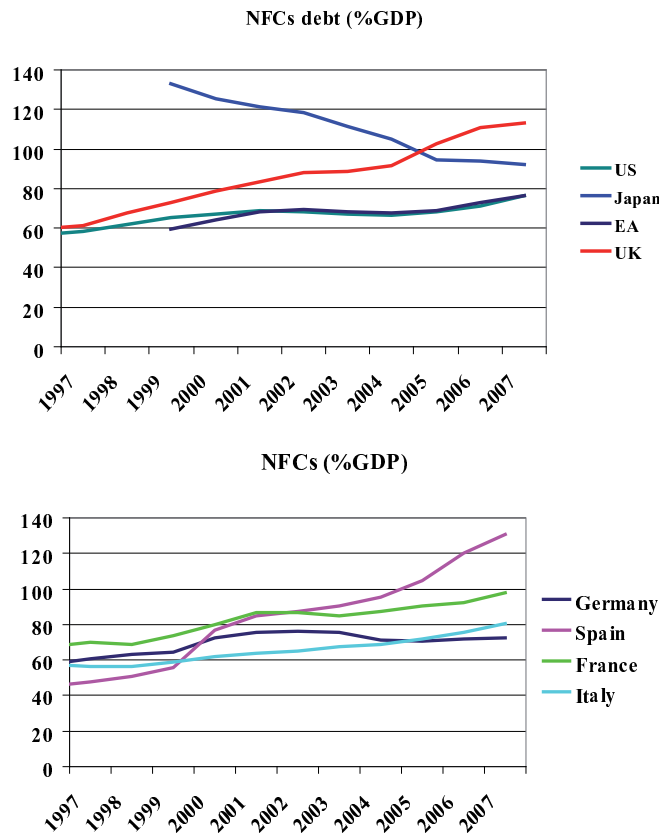
A main cause of the financial crisis was growing leverage in the private sector in the boom years. Rising asset prices and wealth allowed rapid

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3. There are also substantial knowledge gaps as regards size and functioning of fiscal multipliers. This makes it very difficult to deliver well-targeted fiscal stimulus measures (Bouthevillain et al., 2009).

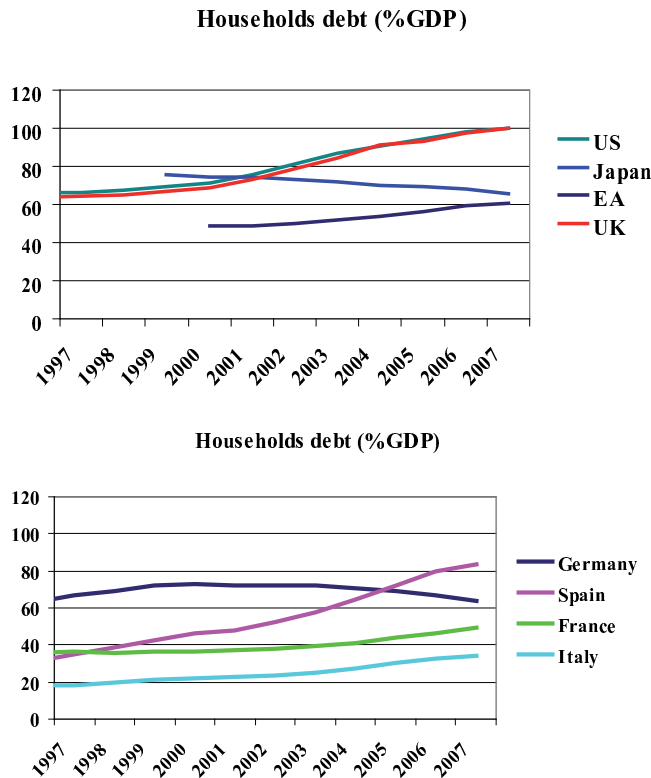
consumption and debt growth. Chart 4 on household and corporate debt developments in a selection of industrialized countries illustrates the growing indebtedness, except in Japan and Germany. Ultimately, however, asset prices started to reverse on the back of housing over-supply and debt overhangs emerged. Part of the crisis-related slump in consumer, investment and credit demand can in fact be related to the desire by agents to deleverage and reduce their own default risk after they recognised that real estate prices were not sustainable and, thus, debt too high. However, notably after the Lehman default this risked to become a disorderly process with a financial-economic downward spiral.

**Chart 4**  
**Household and corporate debt**



Source: ECB.

**Chart 4**  
**Household and corporate debt (continued)**



Source: ECB.

Governments responded swiftly to this impending risk of a downward spiral of financial and non-financial bankruptcies and balance sheet repair-induced demand loss. After the insurance of most or all deposits, governments introduced guarantee schemes, injected capital and took a number of other measures to secure the stability of the financial system. The impact of these measures on public debt was important. It averaged 3.5% GDP for the euro area and much more in some countries by mid 2009. In addition, contingent liabilities with a ceiling of about 20% of GDP for the euro area were accumulated (Table 9).<sup>4</sup>

4. These measures were complemented by liquidity enhancing measures, interest rate cuts and further enhanced credit support measures by the European Central Bank.

**Table 9**  
**Cumulative financial sector interventions and fiscal impact (2008-2009)**  
 (as a percentage of 2009 GDP)

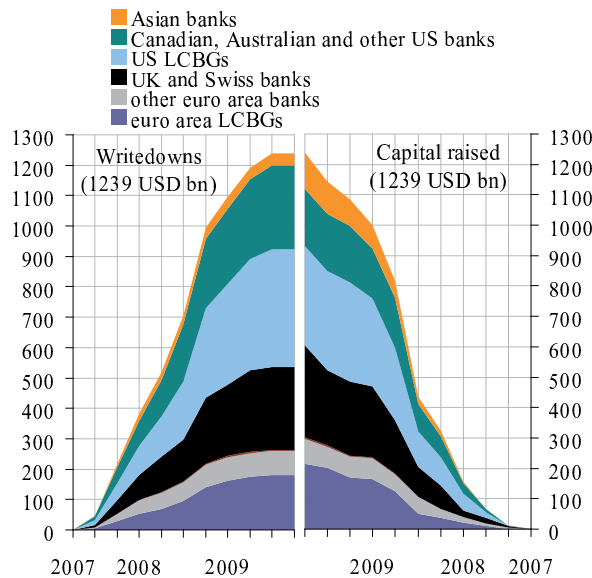
	GUARANTEES	CAPITAL INJECTIONS		ASSET PURCHASE	ASSET SWAPS / ASSET LENDING	DEBT ASSUMPTIONS / CANCELLATIONS	OTHER MEASURES	GOVERNMENT DEBT	GOVERNMENT CONTINGENT LIABILITIES	
		ACQUISITION OF SHARES	LOANS						PROVIDED	CEILING
<b>BELGIUM</b>	2.1	4	2.1	0	0	0	0	7.4	2.1	34.6
<b>GERMANY</b>	6.3	1.3	0	1.7	0	0	0	2.9	6.3	18.7
<b>IRELAND</b>	214.8	4.2	0	0	0	0	0	4.2	214.8	242
<b>GREECE</b>	0.6	1.6	0	0	1.8	0	0	1.6	0.6	6.1
<b>SPAIN</b>	3.1	0	0	1.8	0	0	0	1.8	3.1	18.9
<b>FRANCE</b>	1.1	0.8	3.2	0	0	0	0	4.1	1.1	16.8
<b>ITALY</b>	0	0	0	0	0	0	0	0	0	0
<b>CYPRUS</b>	0	0	0	0	0	0	0	0	0	0
<b>LUXEMBOURG</b>	12.8	8.3	0	0	0	0	0	8.3	12.8	0
<b>MALTA</b>	0	0	0	0	0	0	0	0	0	0
<b>NETHERLANDS</b>	5	6.5	7.6	3.9	0	0	0.2	18.2	5	35
<b>AUSTRIA</b>	6.6	1.7	0	0	0	0	0	1.7	6.6	27.8
<b>PORTUGAL</b>	3.8	0	0	0	0	0	0	0	3.8	12.4
<b>SLOVENIA</b>	0	0	0	0.4	0	0	3.6	4	0	33.2
<b>SLOVAKIA</b>	0	0	0	0	0	0	0	0	0	0
<b>FINLAND</b>	0.1	0	0	0	0	0	0	0	0.1	28.1
<b>EURO AREA</b>	7.5	1.3	1.2	0.9	0	0	0	3.4	7.5	19.9

Source: ECB Monthly Bulletin, July 2009.

Further ad hoc measures were introduced in many countries to support balance sheets and reduce the risk of disorderly deleveraging in the private non-financial sectors (households and corporations): governments “organised” mortgage loan rescheduling, deferral of payments, lending programmes for the unemployed and guarantee and credit programmes for corporations. These programmes provided balance sheet support to households and corporations and prevented bankruptcies and fire-sales of assets. Tax cuts and rebates probably also reduced household balance sheet problems indirectly (even though they had a more Keynesian motivation).

The magnitude of the debt-overhang at the time of writing of this study is not known. However, the huge magnitude of losses that accumulated in the financial sector as the crisis unfolded is an indication (Chart 5). Moreover, significant balance sheet problems remained at the time of writing of this study and significant further financial sector losses were seen to be in the pipeline (Chart 6). At the end of 2009, the household debt to disposable income ratio only stabilised at a very high level in the euro area (Chart 7).

**Chart 5**  
**Financial sector writedowns**



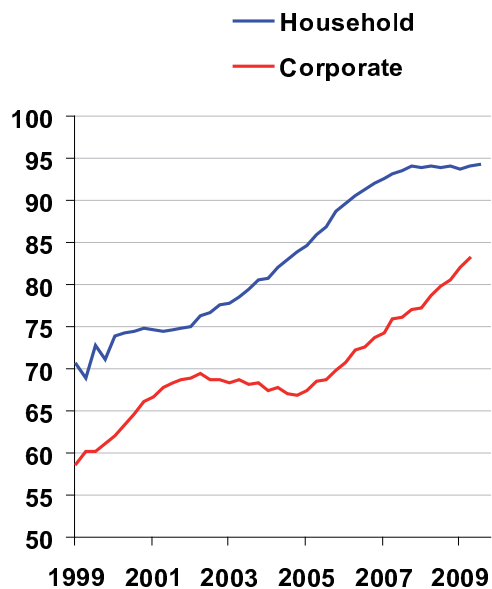
Source, ECB Financial Stability Report, December 2009.

**Chart 6**  
**Expected financial sector losses**

	ESTIMATED EXPOSURE	IMPLIED WRITE-DOWNS 2009 DECEMBER FSR	ESTIMATED LOSS RATE (%)
<b>CASH AND SYNTHETIC STRUCTURED</b>			
CREDIT SECURITIES	1122	169	15.1
OTHER SECURITY HOLDINGS	1717	28	1.6
<b>LOANS</b>	11424	355	3.1
<b>TOTAL</b>	14263	553	3.9

Source: ECB, Financial Stability Report, December 2009.

**Chart 7**  
**Household and corporate indebtedness**  
 (Percent of gross disposable income for households; of GDP for corporations)



Sources: ECB and Eurostat.

Abstracting from any potential “collateral damage” via more moral hazard, less competition and special interest capture of the support, the government role in mitigating balance sheet risks and preventing disorderly balance sheet adjustment can probably be called rather successful. Although no “scientific” assessment is yet available, the speedy and targeted action is likely to have prevented a much deeper financial and economic crisis.

### **III.3 The “crisis” of economic structures: adjusting excess supply and demand**

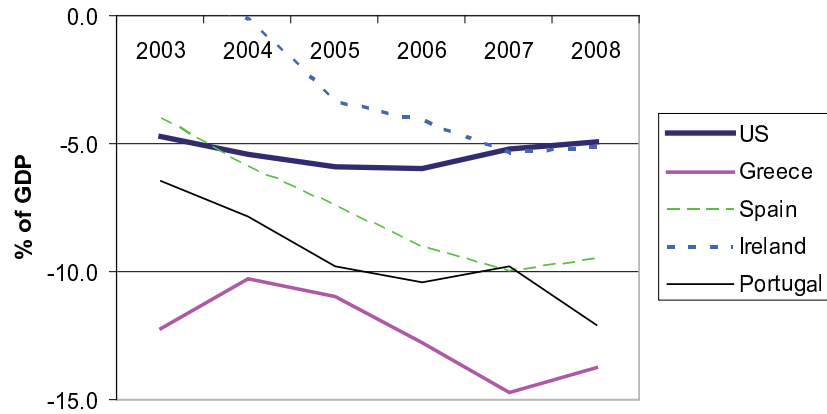
Finally, the importance of excess demand and structural resource misallocation in the boom phase is relevant for evaluating the fiscal policy response to the crisis (see also Tanzi, 2009). A number of countries experienced a strong expansion of certain sectors in the boom. If such expansion turns out unsustainable, a significant physical and human capital re-allocation and a downward shift in the level of potential output would be implied. At the same time, demand levels in the boom phase may have been exaggerated and unsustainable. In fact, this is the origin of the private sector debt increase mentioned above. It is also reflected in the large and persistent current account deficits in a number of euro area and other advanced economies (Chart 8).

Current account balances had deteriorated significantly in a number of euro area countries plus some other advanced economies during the boom phase, suggesting excess demand in the economy. In Spain, Portugal and Greece, current account deficits were near or above 10% of GDP towards the end of the upswing.

A cursory look at some structural changes over the boom phase is also worthwhile. Chart 9 reports that a number of countries had seen a major shift in the output composition towards finance (in the broadest sense, including financial services, real estate, renting and business activities) and construction. It is not clear what share of output is sustainable. But it is unlikely that a mature economy with relatively limited growth, an excess housing stock and an aging population (like Spain) can sustain a construction sector much above the average for industrialized countries. This seems to be around 5% of GDP rather than the 14% reported for Spain in 2008. Similarly, there seems to have been a general relative output shift towards finance with an average around 25-30%. It is not clear that the 45% figure for the UK is sustainable even with London continuing to be a major global financial center.

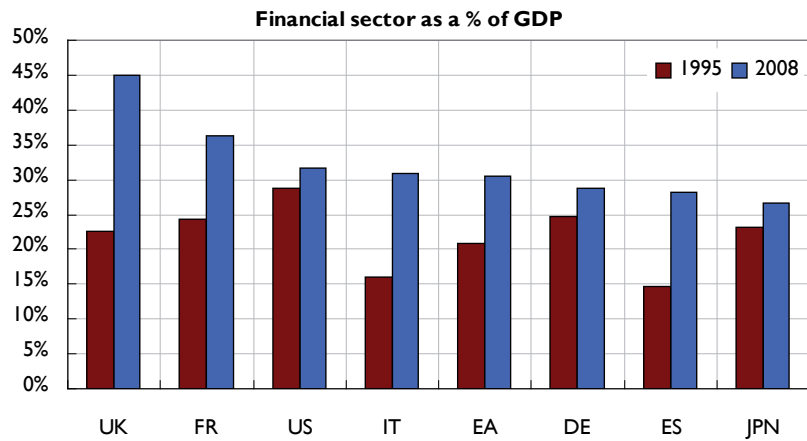


**Chart 8**  
**Current account imbalances, selected countries**



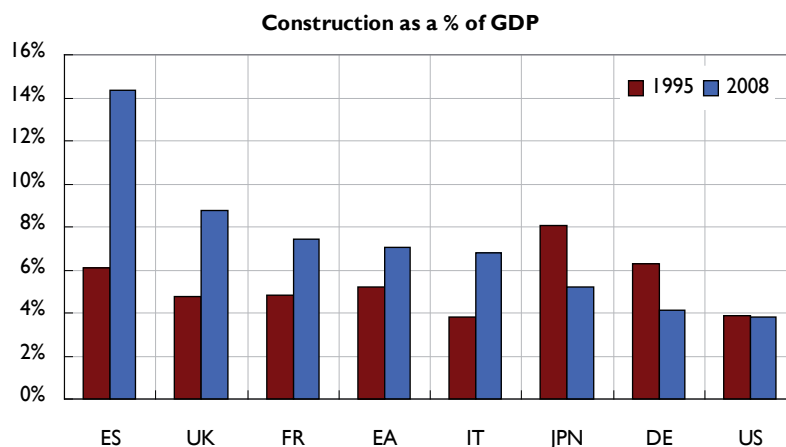
Source: Commission, Ameco autumn 2009.

**Chart 9**  
**Contribution of finance and construction to GDP**



Source: European Commission, Ameco.

**Chart 4**  
**Household and corporate debt (continued)**



Source: European Commission, Ameco.

What would be the implications of this? First, if equilibrium output and demand were lower than the actual level at the end of the boom, the crisis phase may have mainly been an (admittedly very abrupt) correction of imbalances and not a Keynesian demand shock. Second, especially wages and benefits in the private and public sector adjusted little (and as mentioned even at times significantly increased). They will need to adjust to the new demand-supply equilibrium as lower profits can most likely not fully and permanently absorb the adjustment. One could then argue that even the operation of automatic stabilizers may have unduly kept demand at an unsustainable level and delayed economic restructuring, thus, undermining also the path of future output and demand growth.<sup>5</sup> For example, if the fiscal response to the crisis implies continued public wage and benefit growth along the pre-crisis output path this would also push up private wage growth and reservation wages more than sustainable and desirable. This would reduce employment and growth. At the same time, one could also argue that some smoothening of demand and adjustment via fiscal stabilisation was warranted until potential output has caught up again. In particular in countries with significant structural resource

5. Koopman and Szekely, 2009 provide an excellent overview over the factors that could be detrimental to the recovery of the output level and trend growth. These factors include the locking in of resources in unproductive activities, the disincentives and lack of opportunities to find new jobs (and the related destruction of human capital) or the adverse effect of credit constraints on investment.

re-allocation needs, this would cushion the social costs and support the human capital re-allocation via unemployment benefits, education and retraining.

When seeing the crisis from this perspective, these considerations speak against much of a fiscal stimulus. They would possibly even argue against a far-reaching shielding of much of the population against the impact of the crisis via automatic stabilisers. The risk is great that economic dynamism is reduced and demand is stabilised too much above equilibrium. It would then take a very long time for equilibrium output to catch up with a level of government commitments that can be financed. The consequence is high and persistent deficits and rapidly rising debt. This raises the risk of a public balance sheet crisis (which in fact had already gripped and risked to spill over to others at the time of writing of this study).

Second, the need for economic restructuring is too much on the back-burner of the crisis debate. On the supply side, few banks and car factories have so far closed shop in Europe (in contrast to the US where this figure is much larger also due to the earlier start of the crisis). On the other hand, construction firms do not seem to be kept alive and significant bank restructuring is taking place, not least due to the European Commission.

All in all, what are the record and lessons for fiscal activism in this crisis? First, analyse the origins of the crisis properly as this points to the desirable remedies. Second, address the right problem with the right measures in a targeted and timely manner. The record of fiscal activism has been mixed: i) there has clearly been too much emphasis on Keynesian-type demand support and perhaps even for automatic stabilisers; Keynesian support should have probably ended in the summer of 2009 at the latest if warranted at all; ii) governments appropriately supported balance sheet repair even though the balance sheet nature of the crisis was not fully appreciated in many quarters; and iii) there has been little focus on facilitating economic restructuring and too little acknowledgement of the need for a downward adjustment of aggregate demand at least in some countries.

## **IV. FISCAL ACTIVISM BEYOND THE CRISIS**

### **IV.1 Deficit and debt dynamics**

In light of the earlier considerations, it is worth taking a closer look at the fiscal fallout of the crisis from two angles: first, what activist policies are needed to return to fiscal sustainability, and second, what should be the underlying strategy, notably as regards expenditure and revenue reform?

The first issue can be dealt with very briefly as it has received significant attention elsewhere: it is undoubted that fiscal trends as projected by the European Commission in its autumn forecast would be unsustainable. A deficit ratio between 6 ½ and 7% of GDP in 2009-11 on a no policy change assumption would bring the average public debt ratio to 90% of GDP in 2011 and on an explosive path. Aging, potential further financial sector bailout costs due to unrepaired private balance sheets, and lower trend growth would exacerbate this picture. This poses great risks to the long term outlook for fiscal sustainability and would not facilitate the future task of the European Central Bank.<sup>6</sup> Even if debt sustainability concerns can be contained, there is little fiscal leeway for another major crisis if the debt increase of this crisis is not reversed.

It is therefore undoubted that fiscal activism in the coming years means fiscal consolidation: euro area countries need to pursue an ambitious and determined fiscal adjustment strategy. The December 2009 package of Excessive Deficit Procedures under the Stability and Growth Pact for 11 euro area countries required a start of fiscal adjustment in 2010/11 and a correction of excessive deficits in most cases in 2013 (Table 10). On average, annual adjustment efforts would have to be near 1% of GDP. Even if these recommendations were fully implemented, the euro area deficit would fall below 3% only in 2013 and the debt ratio would stabilise near 90% of GDP. A return to pre-crisis debt ratios in the euro area would take until the 2020s. These parameters suggest that the package is ambitious but it is clearly the minimum needed.<sup>7</sup>

Finally, there is the issue of timing. Given fickle markets which can lose confidence very quickly and which have tested a number of governments over the crisis, there is a clear reason to err on the cautious side, notably for large countries. Procrastination would not only result in further debt increases with adverse effects on confidence by the public. A small country can, if needed, be supported by the deep pockets of other governments or the IMF (as in the case of Greece). However, this is most probably not the case for major economies.

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6. High public debt ratios also risk undermining automatic stabilisation as rising deficits and debt would be increasingly countervailed by Ricardian saving (Nickel and Vansteenkiste, 2009).

7. The 2009/10 update of countries' stability programmes is broadly in line with these parameters which is a first good sign, even though in many instances the underlying strategies and measures have not been carefully designed.

**Table 10**  
**Excessive deficit procedures in euro area countries**

	<b>BUDGET BALANCE 2010 (% OF GDP)</b>	<b>CONSOLIDATION START</b>	<b>DEADLINE</b>	<b>RECOMMENDED AVERAGE STRUCTURAL ADJUSTMENT (IN % OF GDP)</b>
<b>BELGIUM</b>	-5.8	2010	2012	0.75
<b>GERMANY</b>	-5	2011	2013	>0.5
<b>IRELAND</b>	-14.7	2010	2014	2
<b>GREECE</b>	-12.2	2009	tbd	tbd
<b>SPAIN</b>	-10.1	2010	2013	1.5
<b>FRANCE</b>	-8.2	2010	2013	1
<b>ITALY</b>	-5.3	2010	2012	>0.5
<b>MALTA</b>	-3	2009	2010	-
<b>NETHERLANDS</b>	-6.1	2011	2013	0.75
<b>AUSTRIA</b>	-5.5	2011	2013	0.75
<b>PORTUGAL</b>	-8	2010	2013	1.25
<b>SLOVAKIA</b>	-6	2010	2013	1
<b>SLOVENIA</b>	-7	2010	2013	0.75
<b>EURO AREA</b>	-6.9			

**Table 11**  
**Public spending in the euro area, 2007-2010**

<b>EURO AREA 12</b>	<b>2007</b>	<b>2010</b>	<b>2007-2010</b>
<b>TOTAL EXPENDITURE RATIO</b>	46.1	50.6	4.5
<b>TRANSFERS</b>	15.9	17.8	2
<b>GOVERNMENT CONSUMPTION</b>	20.1	22	1.9
<b>AD MEMORIAM: FISCAL BALANCE</b>	-0.6	-6.9	-6.3

Source: European Commission, Ameco.

#### IV.2 Expenditure dynamics and reform

Finally, and in light of the fiscal outlook, which consolidation strategy should be applied and, more specifically, what role should expenditure and revenue adjustment play? There are three arguments why this can only come through an emphasis on reducing unsustainable expenditure dynamics. First, expenditure reform is needed to correct the increase in relative public and private sector wages over the crisis that would otherwise result in less incentives to work (via higher reservation wages), drawing talent away from the private sector (via higher public wages) and reduce investment (via excessive wages/low profits and disincentives to adjust human and physical capital). When looking at the fiscal balance deterioration of roughly six percentage points of GDP in 2007-2010, it is noteworthy that three quarters of this reflects an increase in the expenditure ratio (Table 11). Most of this increase is on government consumption (including public wages) and transfers. These two expenditure categories continued to grow broadly in line with pre-crisis trends while real output is about 3% lower in 2010 than in 2007. This is important because it confirms the earlier conjecture that governments have fully shielded large parts of the population from the impact of the crisis. A return of spending on public wages and transfers to pre-crisis ratios seems, hence, reasonable from a structural and distributional perspective and it would eliminate most of the deficit problem.

The second argument for expenditure-based consolidation derives from the fact that the optimal size of government is much smaller than the average post-crisis spending ratio of over 50% of GDP. This ratio is now near or above its historical record in many euro area and other advanced economies (Table 12). It is much higher than the pre-crisis ratio of about 45% and way beyond the 30-40% ratio that some literature typically sees as necessary to attain core public sector objectives or that attains an optimal degree of stabilisation (Tanzi and Schuknecht, 2000 and 2005; Buti and Van den Noord (2005).

**Table 12**  
**Public expenditure in the euro area in historical perspective**  
 (% of GDP)

COUNTRY	HISTORICAL PEAK	YEAR	2007	2010
BELGIUM	63.8	1983	48.4	53.8
GERMANY	50.2	1996	43.7	48.3
IRELAND	56.2	1982	38.4	49.1
GREECE	46.6	2000	44.1	49.4
SPAIN	47.6	1993	39.2	45.6
FRANCE	55.4	1996	52.3	55.1
ITALY	57.7	1993	47.9	50.8
NETHERLANDS	58.3	1983	45.5	50.9
PORTUGAL	47.7	2005	45.7	51.5
FINLAND	55.4	1996	47.3	55
<b>EURO AREA</b>	<b>52</b>	<b>1993</b>	<b>46.1</b>	<b>50.6</b>
SWEDEN	73	1993	52.5	55.6
UNITED KINGDOM	50.7	1981	44	52.1
JAPAN	41	1998	36	41.6
UNITED STATES	37.2	1992	36.7	43.8

The third argument is linked to revenue developments over the crisis and the aggregate revenue ratio in the euro area. In fact, it appears inconceivable that for the average of the euro area, the revenue ratio could be raised by 5 percentage points and reach 50% of GDP to close most of the budget gaps via tax increases. As it stands, the revenue ratio did not decline much over the crisis (Table 13). Most of the fall has affected corporate income taxes due to a reversal of windfalls from previously booming asset markets, balance sheet losses and a decline in profits). Indirect tax revenue fell due to VAT cuts and possibly the downturn in the construction sector but more analysis would be needed.

Some modest adjustment is likely to come from the revenue side as temporary tax cuts are reversed, corporate income tax revenue recovers somewhat from the crisis trough and some indirect taxes are likely to be raised. However, an increase by 5 percentage point would imply that

personal income taxes have to increase by half (50%!) from less than 10% to close to 15% of GDP. Or receipts from social security contributions would have to increase by about one third. However, marginal and average tax rates in Europe are mostly already very high (Table 14). Further significant increases would be rather detrimental to employment and growth. Moreover, the literature has shown that mainly tax-based consolidations tend to be less successful (e.g. Guichard et al. 2007, Afonso et al. 2005).

**Table 13**  
**Total public revenue in the euro area**  
(% of GDP)

	2007	2010	2007-2010
<b>TOTAL REVENUE</b>	45.5	43.8	-1.7
<b>DIRECT TAXES</b>	12.5	11.3	-1.2
THEREOF: CORPORATE	3.3	2.2	-1.1
<b>INDIRECT TAXES</b>	13.5	12.7	-0.8
SOCIAL CONTRIBUTIONS	15.2	15.4	0.2
OTHER	4.4	4.4	0.1

Source: Commission autumn forecast (corp tax=unweighted average).

**Table 14**  
**Marginal tax rates in industrialised countries, 2007**

	MARGINAL TAX RATE	
	SINGLE EARNER, NO CHILDREN, AVERAGE INCOME	MARRIED, 2 CHILDREN, INCOMES OF 100 AND 67% OF AVERAGE INCOME
UNITED STATES	43.3	34
JAPAN	33.2	30.5
UNITED KINGDOM	40.6	46.5
GERMANY	66.5	63.4
FRANCE	55.8	52
ITALY	52.7	52.7
SPAIN	45.5	45.5
<b>EURO AREA (EU-15)</b>	52.8	52.3

Source: OECD, 2008.



More concretely what does this imply? Expenditure ratios are currently unsustainable and need to come down significantly. Relative public wage and benefit levels need to decline and the public sector reduce its commitments. A cut in total public expenditure by 10% would yield savings of about 5% of GDP; a cut in 20% over time would be hardly unreasonable for a country with a deficit of 10% of GDP and an expenditure ratio of 50%.

Linking these claims with the findings of the second section, it should be recalled that expenditure adjustment needs to be based on the appropriate baseline. If indeed the crisis has reduced economic growth dynamics, even a real expenditure freeze may hardly generate enough adjustment and real if not nominal expenditure cuts will be needed. Assume a country with a 50% expenditure ratio and 1 ½% trend growth. A real expenditure freeze would only yield about ¾ pp of adjustment per year and a 5pp adjustment would take seven years. A nominal total expenditure freeze would yield about 1 ½ pp adjustment per annum. However, care needs to be taken that underlying commitments are cut commensurately via actual policy reforms.<sup>8</sup>

## V. CONCLUSION

As to the experiences with fiscal activism in boom, crisis and beyond, the following simplified conclusions can be drawn: first, fiscal policies were overly imprudent in the boom-phase preceding the financial crisis, partly due to real time measurement problems. In the bust phase, analysis into the roots of the crisis should have been deeper and too much emphasis was placed on the need for (activist) fiscal demand support. Although the balance sheet nature of the crisis was little acknowledged, significant fiscal measures to support balance sheets were introduced. Little attention has so far been paid to the fiscal dimension of economic restructuring and down-scaling of demand that had reached unsustainable levels in the boom. While at the time of writing, fiscal exit strategies have been prepared and, in some countries, implemented in light of unsustainable fiscal balances, little attention has been paid so far to the importance of expenditure reform.

The previous discussion suggests a number of policy lessons and recommendations for fiscal activism:<sup>9</sup>

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8. Assuming inflation in line with the ECB's definition of price stability. Fiscal rules that maintain sustainable expenditure trends and underpin adjustment could increase the credibility of exit strategies (European Commission, 2007; Hauptmeier et al. 2010).

9. There is also an important fiscal structural dimension for preventing future boom bust cycles the discussion of which goes beyond the scope of this paper. Fiscal policies should in particular not

- In booms, remain actively prudent. Hence, anticipate measurement problems and base expenditure plans on prudent economic growth assumptions, underpinned by appropriate rules and commitments.
- In crisis, target the underlying problems. Provide a stimulus only in the deep crisis (demand shock) phase but weigh this against the risk of maintaining demand at unsustainable levels (especially if there were excesses in the boom). In fact, this risk may argue against much of a stimulus and even against the full operation of automatic stabilisers in certain cases. Provide balance sheet support in an appropriate manner. Support rather than prevent the restructuring of sectors that had reached unsustainable dimensions in the boom (e.g., construction/real estate and finance).
- Beyond the bust, implement appropriate fiscal exit strategies. As expenditure ratios have become unsustainable, given already high taxes and adverse growth implications, secure major reductions in the expenditure ratio. Adjust relative public wages and benefits and reduce other commitments of government commensurately. Build adjustment on an appropriately prudent baseline macro scenario.

Many observers have suggested implementing the fiscal exit rather later than too earlier. This approach is risky especially for large countries as it could make the global system uninsurable. It is also likely that many observers will emphasise the political difficulties of implementing an ambitious expenditure-based exit strategy. However, many countries have already gone through even greater, drawn out adjustment periods with primary expenditure cuts by more than 5% or even 10% of GDP in the 1980s and 1990s. The experience has in fact been rather positive and virtuous cycles of fiscal adjustment, higher growth and faster balance sheet repair can emerge (see Hauptmeier, Heipertz and Schuknecht, 2007).

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set undue incentives to invest in construction as crisis following real estate booms have proven to be particularly costly (Agnello and Schuknecht, 2009; Alessi and Detken, 2009). Moreover, fiscal policies should not encourage undue indebtedness and leverage in the household or corporate sector (IMF, 2009; Commission 2010). A gradual change in incentives in this regard would reduce the risk of future crisis.

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