FISCAL POLICY: AFTER THE FALL-II

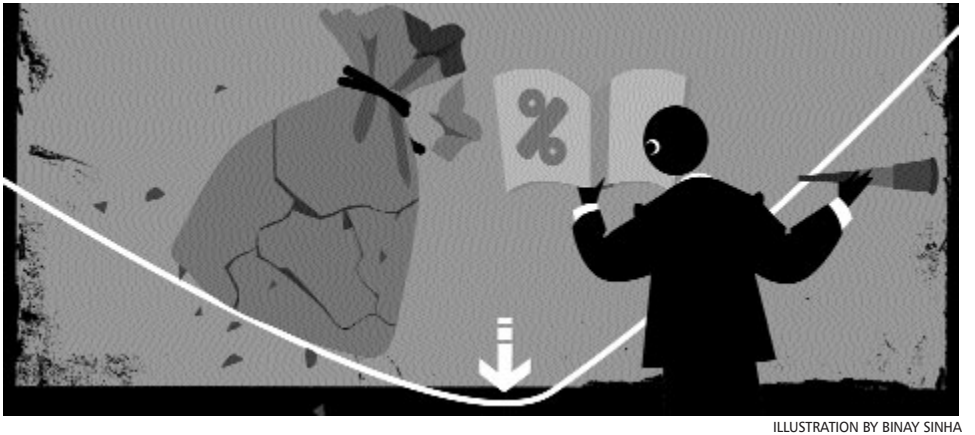
Not only is the current US financial crisis not solved, the seeds are there for even more serious crises in the future, says DEEPAK LAL

In this column, I discuss the role fiscal policy has and can play in dealing with the Fisherian consequences of a debt deflation in the global financial crisis, as well as the limits imposed by past entitlements.

For countries with a low or no structural deficit, raising aggregate demand in the face of a severe financial crisis by running a temporary budget deficit, above that resulting from automatic stabilisers, makes sense. This was the policy adopted by many of the emerging markets, notably India and China, which have got back on to their high growth paths.

The US has an arguably unmanageable structural deficit. Moreover, the stimulus package it adopted in 2009 has not achieved its objectives, by failing to adopt the obvious means to restore household and firm balance sheets: a massive across-the-board tax cut accompanied by an equivalent fiscal deficit. It is argued that most of this extra income will be saved not spent. But this is to be bewitched by the wholly inappropriate Keynesian income-expenditure analysis, which fails to deal with balance sheets. If this Fisherian aftermath of a Hayekian recession is caused by attempts to reduce unsustainable debt, the "savings" generated by the tax cut (i.e. reducing liabilities to the government) will allow the necessary deleveraging, without a downward spiral in income and increased bankruptcies. By facilitating households to pay off their mortgage and credit card debts, it will prevent further impairment of bank assets.

The parts of the Obama stimulus package that have worked were the "fast acting tax breaks and transfer payments [which] largely explain why disposable income rose 2.9 per cent from January to May (2009), even as earned income fell 0.7 per cent, allowing the savings rate to rise without a collapse in spending" (*FT*, July 9, 2009). If the whole of the $787-billion stimulus package had consisted of an across-the-board tax cut, there would have been a large deleveraging of the economy with an increase in private savings without an equivalent cut in private spending. The increased private savings being matched by public dis-savings reflected in the increased budget deficit. Also the tax cut could be reversed once the economy recovered, providing an easy "exit strategy" from the fiscal stimulus.



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This inept fiscal stimulus was followed by the misguided health-care reforms, adding significantly to the US structural deficit. This makes any further fiscal stimulus politically impossible, whilst aggravating the problems with any further monetary actions through "quantitative easing (QE)", making a double-dip recession more likely, if the extant monetary easing proves insufficient.

In the UK, with a large structural deficit fuelled by increased welfare spending by the Labour government, there is little space for any further fiscal expansion. The new government is, therefore, right to create more fiscal space by a sharp cutback in public spending, by rolling back the unsustainable welfare state. But it has been wrong in keeping the 50 per cent tax on higher incomes instituted by the previous government, and also in raising VAT. If the spending cuts are made, they will give the Bank of England sufficient fiscal space to undertake any further monetary easing through QE.

In the eurozone, the ECB rightly undertook QE during the crisis, whilst urging reduction of fiscal deficits. Germany's success from following this advice reversed the stalling in its GDP. The eurozone problems now concern financial stability related to the Greek debt crisis. As many of the banks in the non-Club Med members of the zone are exposed to Greek sovereign debt, a Greek debt default would lead to a serious eurozone banking crisis. To avoid this, an IMF-type stabilisation programme has been imposed on Greece by the ECB and the IMF. But, unlike similar stabilisation programmes in developing countries, two essential elements are missing: a large devaluation and a restructuring of the country's debt. The former is precluded by the fixed exchange rate of the euro, the latter by the external holdings of Greek sovereign debt by European banks.

But the alternative imposed on Greece of a large internal devaluation to engineer a large fall in domestic wages and prices through a massive deflation is politically unsustainable. A Greek default and exit from the euro seems the most likely outcome. The other Club Med countries should, however, be able to politically manage the fiscal retrenchment required in their less indebted economies.

The financial crisis has ultimately been caused, like so many past crises, by the particular country's past dirigisme. Most government interventions in the economy are equivalent to taxes and subsidies. The implicit or explicit subsidies create politically determined income streams for various favoured groups which then have to be paid for by others through implicit or explicit taxes, with governments naturally favouring implicit taxes which cannot be easily monitored by the geese to be fleeced. But in time the expansion of these entitlements leads to tax resistance and a fiscal-cum-debt crisis.

In the case of the US sub-prime mortgages — the proximate cause of the crisis — there has been a commitment by the government since the Great Depression that home ownership should be increased. Various subsidy programmes have been created. There has been no reform of these entitlements to housing. If they are to continue, it would be best to make the implicit subsidy, given through the now nationalised and insolvent Freddie mortgage twins, explicit through the budget.

The crisis has shown that politically determined entitlements — which are explicit in the welfare states of Europe — are becoming unsustainable, as shown vividly by Greece. They inevitably lead to a fiscal crisis and a debt crisis whose resolution requires their rescinding. The UK has now bit this particular bullet. Greece and other Club Med countries are being made to do so by their actual or incipient fiscal crises.

The US, however, is still in denial. Instead of rescinding past politically determined entitlements, President Obama has enlarged the health entitlement, seen by the US Comptroller General David Walker in August 2007 as the main cause of its unsustainable structural deficit of $500 billion at the time. The projected deficit is now in the trillions. As Walker emphasised, even the smaller deficit in 2007 could not be cured by growth, ending the Iraq (and Afghan) wars or cutting defence expenditures, or letting the Bush tax cuts expire. The very policies Obama is hoping will reverse exploding deficits. Thus, not only is the current US financial crisis not solved, the seeds are there for even more serious crises in the future.