Coen Teulings

WHY POLITICIANS PREFER AUSTERITY TO LONG-TERM FISCAL REFORM

Long-term structural reforms may be exactly what Europe's economies need, but elected officials find them hard to carry out. A Taylor rule for fiscal policy could help to change that.

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Some months ago, I attended a conference in Stockholm on the euro crisis. It was organized jointly by the IMF and the Swedish Ministry of Finance and drew a large group of ministers, civil servants from the European Commission and from several member states, heads of fiscal-watchdog groups, and economics professors from both sides of the Atlantic. Throughout the two-day conference, most of the economists argued against trimming budgets in the short run, fearing that such measures would lead to further weakening of demand in an already weakened economy. In their view, the budgetary problems should be solved by a long-run policy of structural reforms of the labor market, health care, and the pension system.

In the final panel of the conference, Anders Borg, the Swedish minister of finance, challenged this common wisdom. In his view, the carefully researched pleas for postponing belt tightening neglected the political reality: such consolidation must be done straight away because delaying it would just spoil the opportunity for budgetary reform. Politicians lack the ability to commit today to austerity measures to be implemented tomorrow. Hence, the only option is to take action straightaway. All arguments in favor of longer-term structural reforms were merely theoretical games not suited to the rude reality of politics. In contrast to most of the economists, the politicians among the audience agreed.

Clearly, despite all their research and evidence, the economists failed to convince the European politicians. Why? I offer three explanations.

First, the experience of the 1970s is still fresh in the memory of most European politicians. After the first oil crisis, in 1973, growth declined structurally. Many policy makers misinterpreted the structural decline as just a cyclical phenomenon that could be addressed with a standard Keynesian expansionary policy. Half a decade later, growth still had not returned to its pre-crisis level. Instead, sovereign debt had exploded. When the second oil crisis hit, in 1979, most countries had no fiscal space left for a new round of Keynesian spending. The result: most European economies experienced a deep recession. Out of fear of repeating that mistake, politicians today prefer to rein in budgets and address the fiscal gap immediately.

A second, related reason is that economists have failed to adequately address this worry on the part of politicians. For quite a while, the topic of fiscal policy and fiscal multipliers received little attention. Only after the Great Recession that followed the demise of Lehman Brothers did research into this area once again begin to flourish. By and large, that research shows that fiscal multipliers are big—much bigger than we thought previously, providing a strong argument for avoiding fiscal tightening. The only problem is that it does not provide an answer to this simple question: if it's a mistake to tighten today, why wouldn't the same argument apply tomorrow, and the day after tomorrow, and so on, postponing budget tightening forever? Economists have created the Taylor rule for monetary policy, which provides a simple formula: increase the interest rate by more than one percentage point for every percentage point that inflation rises above the target rate. Strangely, economists have not yet developed an equivalent for fiscal policy, though CPB Netherlands Bureau of Economic Policy Analysis is currently working on one. That rule will likely stipulate that budgetary policy should sail between the Scylla of having to consolidate during a recession and the Charybdis of an exploding sovereign debt. As long as such a rule is missing, politicians won't trust advice to postpone austerity, because they do not understand why the same advice would not apply tomorrow.

The third reason that politicians do not want to rely on advice advocating structural reforms to improve the long-term sustainability of the government budget is more complicated. Short-term consolidation is easy to explain and appears to provide results that are easily verifiable by voters. Voters understand that a budget deficit requires fiscal tightening, so pursuing such a policy adds to the credibility of a politician: "These are harsh policies, but they are needed to clean up the mess left by our predecessors." Voters reward politicians who do not mess up the government budget.

The beneficial effect of structural reforms on an economy is much more difficult to monitor for voters. First of all, the effect takes more time to materialize than the effect of straightforward fiscal consolidation. Moreover, it is less certain, since it depends on behavioral responses of individuals to these reforms. For example, raising the official retirement age might raise future employment, but it might also just increase unemployment or early retirement. The size of these behavioral responses is often hard to predict.

But the biggest problem of structural reforms is that even if they have a positive effect on the economy, they may not reduce the government's budget. Reforms that remove barriers to entry in a particular market, such as licenses for driving a cab, are a good example. These licenses allow incumbent cab drivers to capture rents at the expense of the employment of other cab drivers as well as the price customers have to pay. However, that is only part of the story. Since a cab license is an admission ticket to a pool of rents, it can be traded on the market. The price of a license is equal to the net discounted value of all future rents. Hence, by selling it, the current owner of the license extracts the current value of all future surpluses, from the moment of sale to infinity. The buyer has little to gain from his monopoly power: he captures rents, but these rents are just enough to cover the capital cost of his investment in buying the license.

Now, consider a politician who wants to make markets more competitive by removing entry barriers to specific markets. He liberalizes the cab market. This is in effect a transfer of wealth from the current pool of cab drivers to all future generations, who don't have to pay as much for their taxi services and who can benefit from greater employment in the taxi industry. Quite often, removing entry barriers is therefore equivalent to a transfer of wealth from current to future generations. In that sense, this policy has the same effect in the intergenerational distribution of wealth as raising taxes today to reduce the sovereign debt. Like abolishing barriers to entry, raising taxes is a transfer from current to future generations, since it reduces the implicit tax liability of future generations. The reverse of this argument might also explain why entry barriers are installed so often, time and again: they are an easy way to relax the budget constraint of the current generation by extracting wealth from future generations.

There is a limit on how much pain politicians can inflict on current generations. In the end, these are their voters. Since both consolidation of the government budget and structural reforms (by removing barriers to entry) are transfers of wealth from current to future generations, they can do either the one or the other, not both. Consolidation can be monitored by voters more easily and will therefore be better rewarded by voters. The benefits of structural reform, meanwhile, are more difficult to assess and as a result voters will be less enthusiastic about pursuing them. Faced with this choice, politicians will pick consolidation over structural reform, even though structural reform is likely to be more conducive to future growth. ■

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