The Employment and Fiscal Crisis

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The financial crisis has shaken beliefs in markets. The causes of the crisis are attributed to market failures and excesses, and market economies have proven not to be crisis-free. Moreover, the economic consequences of the crisis are unequally distributed, with a large share falling on individuals with no stake in the causes of the crisis. This is both posing a political problem but also pointing out that existing mechanisms for risk diversification are insufficient.

Accordingly, there has been strong pressure for government intervention. This applies both in respect to specific issues on the regulation of financial markets and institutions in particular, but also more widely in terms of the social safety net. In the immediate aftermath of the crisis, it was widely perceived that the social safety net was incapable of coping with the consequences of the crisis. Institutions like the IMF and the OECD recommended improvements in the social safety net, and no less than 15 OECD countries took steps to improve income support for the jobless (OECD 2009). On top of this there were several discretionary fiscal policy initiatives to counter the effect of the crisis, and in particular to avoid a steep increase in unemployment. In short, there have been numerous calls for the public sector to step in where markets have failed.

This situation soon changed as public finance problems surfaced, and for many countries the financial crisis is now associated with a fiscal crisis. Rather than being part of the solution, the public sector seems to be part of the problem. Large deficits, high debt levels and not least looming budget pressures due to ageing has shifted the agenda from a focus on activist measures to cope with the financial crisis to a focus on consolidation of public finances, which in turn has led to tax increases and/or spending cuts. Debates on the need for activist measures and the need to fine-tune exit strategies have thus been overtaken by more acute needs to address public finance problems. A number of countries face the twin problems of high unemployment and public finances under severe pressure. Although there is substantial variation across countries, the importance of the problem is reflected by that fact that no less than 24 EU countries have a recommendation within the excessive deficit procedure of the Stability and Growth Pact.[1]

Paradoxically in a situation where economic development calls for an activist fiscal policy, the remedy is the exact opposite in many countries. This is a very difficult political situation, and to the general public the remedies appear unjust. They face the consequences of the financial crisis and now also the burdens for fiscal adjustments.

The fiscal crisis reflects both political and market failures. Insufficient attention has been paid to public finances due to political myopia and inaction. In theory, financial markets should produce warning signs on this, but no such signals were generated before the crisis, whereas the response of the market after the crisis has been very strong.

While the financial crisis has had a significant negative effect on public finances in most countries, it remains the case that the source of public finance problems is not the financial crisis. Via public budgets it is possible to spread and diversify shocks, and even rather larger shocks can be absorbed without jeopardizing fiscal sustainability provided that public finances are in order prior to the shock. A change in the public debt level of say 10 percent of GDP will only affect fiscal sustainability by 0.15 percent if the growth corrected real rate of return is 1.5 percent. That is, a modest permanent budget improvement is needed to diversify a shock causing a 10-percent increase in the debt-to-GDP ratio. Hence, the public budget has a large potential in diversifying shocks over time.

The current public finance problems originate in failures to consolidate before the crisis (the backward problem). For euro countries the average debt level

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[1] See http://ec.europa.eu/economy_finance/sgp/deficit/countries/index_en.htm.

was about 70 percent of GDP in 2007 prior to the crisis; almost the same level as in 1995. No consolidation was undertaken in rather favourable years. Moreover, most countries have failed to address budget pressures arising from changing demographics (the forward problem), that is, reforms of pension schemes and retirement ages have been insufficient.

The combination of the backward and forward problems has implied that the fiscal position of a number of countries has been very fragile and hence the fiscal crisis was released by the financial crisis. However, this also underlines that a fiscal crisis would have surfaced also in the absence of the financial crisis. This is brought out clearly in Figure 1, showing the most recent assessment of fiscal sustainability for all EU countries (note that not all crisis responses are included). The figure shows the so-called sustainability indicator (S2) giving the permanent budget improvement in percent of GDP needed to ensure that the inter-temporal budget constraint for the public sector is met. As seen, more than half of the EU countries face a need to improve public budgets permanently by at least 5 percent of GDP, and for some more than 10 percent of GDP! The fiscal adjustment burdens are huge.

It is worth noting that there is no clear pattern between the size of the public sector and the sustainability problems. It is thus not the case that the forces leading to a large public sector also lead to a deficit and debt bias. Quite the contrary, one finds northern European countries with large public sectors among the countries with the smallest sustainability problems. It is a striking observation that Denmark and Sweden with large public sectors are also among the countries which prior to the crisis did the most to consolidate public finances and, employing a forward perspective, address the ageing problems.

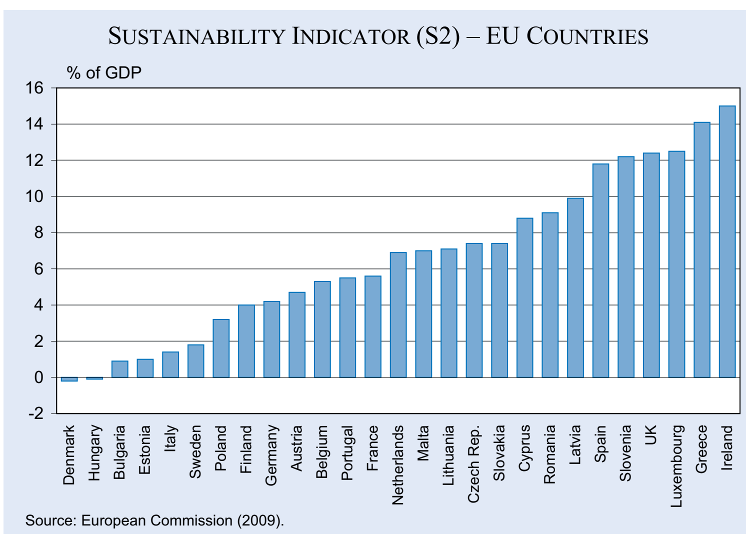
The crisis teaches one clear lesson. The countries whose public finances are in order have been able to let automatic stabilizers work and also undertake discrete fiscal policy changes to mitigate the consequences of the crisis. To safeguard the social safety net and social balance in a crisis, it is critical to ensure that public finances are in a position where there is room for these mechanisms to work. The basic functions of the public sector in absorbing and diversifying shocks from private markets require that the public sector from the outset is not plagued by financial imbalances. It is sometimes argued that a focus on prudent budget policies is a disguised agenda for a leaner welfare state. Recent experience seems to suggest exactly the opposite. Countries with fiscal problems are faced with the need to introduce austerity packages which tend to reinforce the implications for social balance and distribution already released by the crisis. This is a source of dissatisfaction. Individuals carry too large costs and consequences of changes which are beyond their control and influence, and this is reinforced by needed fiscal adjustments.

Automatic stabilizers

An important source of risk diversification at the aggregate level occurs via the so-called automatic stabilizers. This is absorbed in budget changes thereby diversifying shocks over time and generations. In the macroeconomic literature automatic stabilizers are praised. They are rule-based and require little information, and are therefore superior to discrete fiscal policy. The prevailing stabilization consensus recommends that fiscal policy be restricted to the automatic stabilizers except in very special situations, leaving further stabilization to monetary policy. Strong automatic stabilizers are therefore desirable.

However, the size of automatic stabilizers is not a result of macro-design but rather a consequence of the design of labour,

Figure 1



Source: European Commission (2009).

social and tax policies. The contingencies build into these policies sum to give the automatic stabilizers at the aggregate level. This is clearly reflected in the fact that countries with the most extended welfare arrangements also tend to have the strongest automatic stabilizers. However, in recent years, policy debates and reforms have not focused much on the implications for the automatic stabilizers despite their popularity. The primary focus has been on incentives, with the result that reforms have strengthened incentives without much consideration of the implications in terms of weakened insurance and thus the automatic stabilizers. Somewhat paradoxically automatic stabilizers have been praised at the aggregate level but disregarded at the micro level in relation to structural reforms.

The key issue here is the balance between incentives and insurance in the design of a social safety net. The ultimate reason for such arrangements is the insurance they provide for individuals. However, such insurance may distort incentives, and there is thus a non-trivial question of how to strike a balance between the two considerations. While it is usual to highlight this trade-off, it may be questioned whether economic analyses and policy advice have had much to say on this issue. Most work is cast in deterministic settings, implying that there is an extensive focus on various incentive effects or distortions arising from public intervention. The distortions are clearly relevant and important, but it is only one side of the story. Analyses of the social safety net have thus mainly considered it from the perspective of how it affects incentives to work and search for jobs etc. However, the social safety net is there to provide insurance, which not only has a direct welfare effect but may also be conducive to behaviour and flexibility. The welfare state in general and the social safety net in particular is not only about redistribution but also about collective risk sharing. Similarly, in respect to taxes, it may be argued that the traditional focus on distortions tends to neglect both the insurance element in taxation, and also that overall implications cannot be assessed independently of what taxes are financing.

Is it possible to strengthen automatic stabilizers without jeopardizing incentives?

One way to maintain incentives in a tight social safety net is by attaching employment conditionalities to the social safety net, that is, the right or entitlement to a transfer is accompanied by a duty or requirement to participate in certain activities to receive the transfer (workfare). In this way the economic compensation (insurance) is maintained, but a stronger incentive mechanism is generated. Such conditionalities serve to reduce both moral hazard and adverse selection problems.

Including a workfare element into the scheme implies higher opportunity costs from claiming benefits, which makes the unemployed search more for the basic reason that employment becomes more attractive for given benefit levels. Therefore, such conditionalities serve to maintain incentives in the labour market and thus support high employment despite a high level of income insurance (replacement rate). Equally important it affects wage-setting. All wage models imply that the outside option in one way or another affects wage formation. That is why it is often proposed to reduce benefit levels to induce wage moderation and thereby support employment creation. However, employment conditionalities work in the same way but without the implied economic deprivation following from lower benefits and without a weakening of automatic stabilizers. The important point is that incentives can be strengthened without necessarily deteriorating the level of support offered by the social safety net. Economic deprivation is not necessary to create incentives!

Automatic stabilizers can also be strengthened by building business cycle contingencies into the social safety net. A relevant case is unemployment insurance where e.g. the benefit level or the benefit period can be made dependent on the business cycle situation in a counter-cyclical way. This would strengthen insurance when the need is largest, and restrain it when the need is smaller. Moreover, this may lower distortions since generous benefits may be more distortive in a boom than in a recession (see Andersen and Svarer 2010). Actually such contingencies are known from the United States and Canada.

Consolidation – how?

The theoretical debate on consolidation has been much focussed on whether expenditure cuts or tax increases are the most effective and durable solutions. There is a large empirical literature that seeks to identify which procedure is the most successful. The strong emphasis on the sharp distinction between expenditure and revenue instruments seems to grow

out of simple and stylized macro models. However, this line of reasoning may miss the most important type of reforms, namely structural reforms aiming at increasing employment. The matter of the fact is that reforms addressing the employment problem will also have large budgetary effects. This is illustrated by Figure 2, which shows for all OECD countries that a change in the employment rate will have a significant effect on public finances. The reason is straightforward: higher employment implies both lower expenditures on various forms of social transfers and higher tax revenue. Clearly the employment-to-budget effect is larger the more extensive the welfare arrangements are, since this tends both to increase social transfers and taxes. These mechanisms produce the automatic stabilizers important in a business cycle context (see above). However, they also point to the importance of the strong relation there is between the structural (private) employment rate and public finances.

In a medium-term perspective an improvement in employment is thus a very robust way of ensuring a consolidation of public finances. In this way, the solution of the (un)employment and public finance problems go hand in hand. The difficult problem is how to trigger an employment increase. While the current unemployment level has a large business cycle component, there is also a large structural component. Hence, it is also necessary to consider structural reforms.

Since structural reforms mainly work from the supply side, it has been common to advocate a two-handed approach, that is, structural reforms should be accompanied by an expansionary fiscal policy to boost demand and job creation in the short-run, in order to ensure that the reforms translate into higher employment. The dilemma is that the current fiscal situation makes it impossible for a number of countries to pursue a two-handed approach.

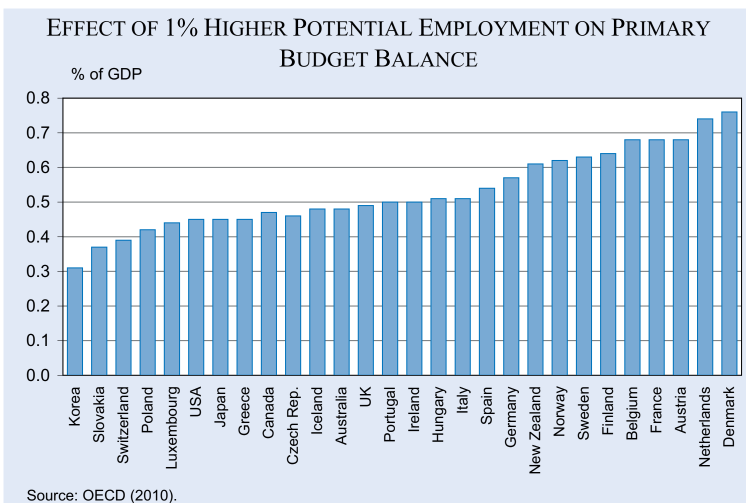
Since a significant part of the fiscal policy problem is forward looking due to demographic changes, there is not necessarily a conflict between short-run demand considerations and the medium-run supply effects. For some type of reforms it may be the case that they both strengthen employment and public finances in the long run, and aggregate demand in the short run.

An important policy issue is how to address the changing demographic structure, and therefore retirement and pension reforms are on the agenda in most countries. It is possible that a well-structured retirement reform not only improves public finances in the medium to long run and thus fiscal sustainability, but it may also lead to an increase in aggregate demand and thus increases in employment in the short run (Barell *et al.* 2009; Andersen 2010). If there are policy reforms that bring about such a double dividend, they are clearly attractive since they will escape the tension between short- and long-run considerations underlying the debate on exit strategies.

Consider a reform that increases the statutory retirement age (possibly gradually). If tax financed pensions are provided from the statutory retirement age, it follows that the pension expenditures decrease and tax revenue increases, and hence fiscal sustainability is improved. This is a straightforward implication of changing the balance between the number of years of contributing to and benefitting from the scheme.

The individual response to this depends crucially on whether the actual retirement age is determined by the statutory retirement age. If this is the case, the incentive to save is reduced since more labour income will be earned over a life-time (and this may also possibly increase contributions into labour market pensions) – see Andersen (2010). Younger cohorts planning to retire at the statutory retirement age will therefore need to save less, and, as a consequence, consumption and thus aggregate demand will increase. This is illustrated in Figure 3, based on a simulation of an overlapping

Figure 2

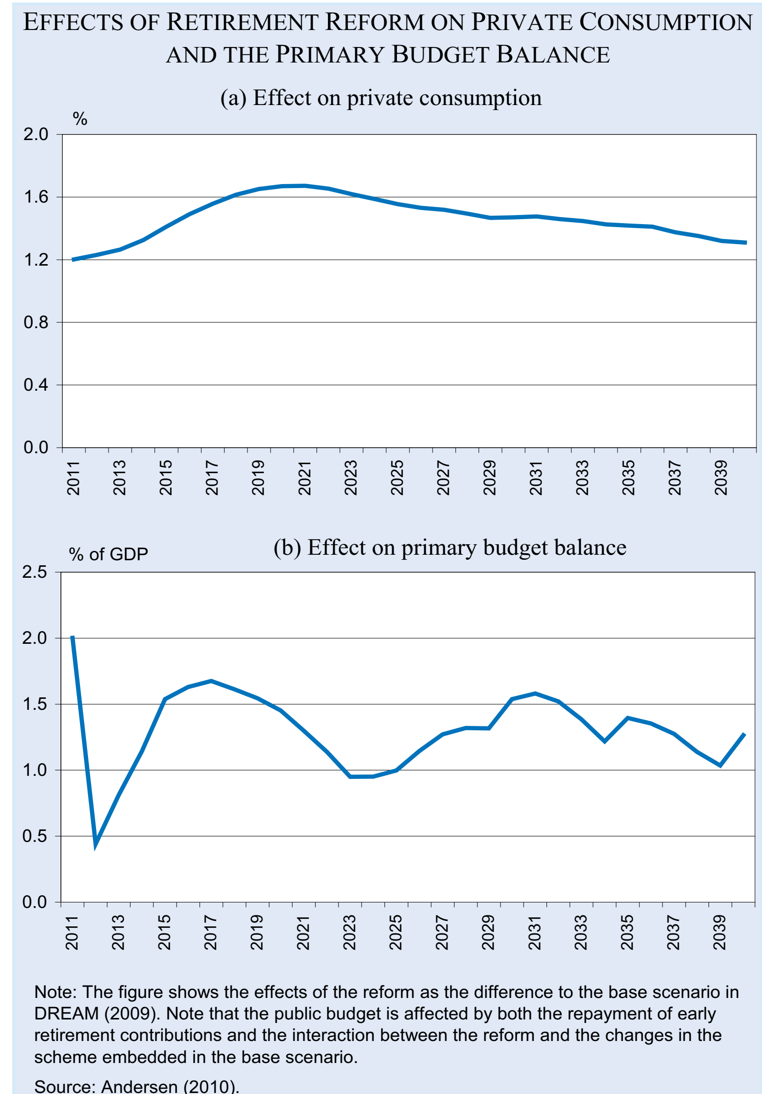


Source: OECD (2010).

generation model for Denmark.[2] For illustrative purposes the figure shows the consequences of a hypothetical reform where retirement ages are increased by closing the early retirement scheme from 2011.[3] Panel (a) in Figure 3 shows the effects of such a reform on aggregate private consumption, and panel (b) the effect on the public budget relative to the base scenario.

For countries under acute financial market pressure, a credible reform addressing the sustainability problem may have the positive side effect of reducing interest rates. Lower interest rates will provide some relief to public budgets in the short run, but may also strengthen aggregate demand by reducing fear of future policy changes.

Figure 3



Note: The figure shows the effects of the reform as the difference to the base scenario in DREAM (2009). Note that the public budget is affected by both the repayment of early retirement contributions and the interaction between the reform and the changes in the scheme embedded in the base scenario.

Source: Andersen (2010).

Conclusion

With regard to the debate on state vs. markets, the financial crisis offers several lessons. Markets are exposed to cycles and crises, and the public sector holds some potential of muting and diversifying the consequences. However, room for manoeuvre requires that public finances are in order. Moreover, the long-run financial balance of an extended public sector or welfare state depends critically on maintaining a high employment rate in the private sector. Hence, the issue of market vs. state is not an either-or issue.

While the financial crisis impacted most countries, the development since then has displayed much more diversity mainly because the public finance situation has been very different. Prior to the crisis there was much debate about whether globalization would force a convergence upon countries, leading to a retrenchment of public involvement in the economy. The crisis seems to imply more divergence. Some countries with large public sectors and public finances in order have been able to cope with the crisis with only small changes in policy, while some countries with smaller public sectors and larger public finance problems have been forced onto a retrenchment path.

[2] The so-called DREAM model – see DREAM (2009).

[3] This scheme allows early retirement at the age of 60, while the official pension age is 65. The early retirement scheme is contribution based but includes significant tax subsidies.

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