Symposium “Structural Reforms and Fiscal Consolidation: Trade-Offs or Complements?”
Federal Ministry of Finance, 25 March 2015
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Dear Reader,

On 25 March 2015 senior representatives from finance ministries, research institutions and academia gathered in Berlin at a symposium entitled “Structural Reforms and Fiscal Consolidation: Trade-Offs or Complements?” hosted by the International Monetary Fund and the German Federal Ministry of Finance. A discussion on successful strategies to bring structural reforms and fiscal consolidation together was urgently needed. Many countries, especially in Europe and the eurozone, face difficult challenges: growth rates are low and deficits and debt levels are high. Those countries need to achieve sustainable public finances and at the same time create the basis for solid growth by implementing structural reforms.

Country representatives from Canada, New Zealand, Spain, Sweden and Ireland shared their experiences with structural reforms and fiscal consolidation. Their experience shows that targeted reforms and fiscal consolidation lead to higher growth and employment and lower deficits and debt levels.

Canada achieved strong GDP growth by implementing structural reforms in the late 1980s and early 1990s including the introduction of a value added tax, the elimination of a distortive manufacturing tax and reforms to the employment insurance program. These reforms brought about growth and supported far reaching consolidation measures.

New Zealand also implemented comprehensive reforms in the 1980s and 1990s by e.g. liberalizing the financial sector, deregulating product markets and carrying out reforms of the labour market and the tax system. Reforms were accompanied by fiscal consolidation, especially in the early 1990s.
Following reforms and consolidation, both countries experienced a strengthening of economic growth and a steady decline in the public debt-to-GDP ratio.

Spain responded to the steep rise in public deficits and debt during the crisis by committing to a consolidation path that included a frontloaded fiscal effort. At the same time, pension reforms, labour market reforms, a new framework for regional budget execution and numerous other measures were introduced. Moreover, with support from the ESM the Spanish banking sector was recapitalized which was also accompanied by structural reforms.

Ireland also experienced a rapid increase of public debt during the crisis, ultimately leading to a temporary exclusion from private capital markets. Ireland reacted by following an impressive, heavily frontloaded consolidation path. The consolidation was accompanied by structural fiscal reforms, notably rationalization of government and pension reforms, product market reforms and labour market reforms.

As a result of their efforts, both Spain and Ireland are now the members with the highest growth rates in the eurozone. Unit labour costs and unemployment decreased, deficits were reduced substantially and public debt-to-GDP ratios are on a downward trend.

Sweden countered the crisis of the early 1990s by, inter alia, implementing a tax reform, deregulating product and service markets and introducing a new monetary framework. The structural reforms were complemented by the introduction of a new fiscal framework and a comprehensive and frontloaded consolidation strategy. As a result, public debt declined significantly, employment increased and growth picked up.

The example of Germany also shows that comprehensive structural reforms and fiscal consolidation can go hand-in-hand. Beginning in 2003, Germany embarked on wide-ranging labour market reforms, liberalized a large number of trades, streamlined the public sector and modernized the welfare system. At the same time, the structural deficit declined and the quality of public spending increased by gearing it towards more investment in infrastructure, education and research.

So let me give an answer to the question posed in the title of the conference: structural reforms and fiscal consolidation clearly complement each other. I would even say they are two sides of the same coin. Of course, there is no one-size-fits-all approach, but if governments set the right priorities, reforms will lead to stronger growth and have a positive impact on public budgets. It is key in this regard that reforms are geared towards the main weaknesses and bottlenecks of an economy. Most of the time, there is a need to reform labour markets, enhance competitiveness, slim down and modernize public administrations, and cut red tape.

I would like to thank the International Monetary Fund for co-organizing this symposium and all participants for their valuable contributions. I am confident that we took the issue of structural reforms and fiscal consolidation forward.

I hope you will enjoy the read.

Ludger Schuknecht
Introductory presentation and discussion
With Ludger Schuknecht (moderator), Vito Tanzi and Servaas Deroose
Moderator’s summary
by Ludger Schuknecht

In times of low economic growth, high debt levels, and the need to unburden central banks from responsibilities that might conflict with their original mandates, the debate about structural reforms and fiscal consolidation is a highly relevant one. How to package and sequence reforms and fiscal consolidation is key in this regard. A lot can be learnt by country experiences which were discussed in the two panels later described in this report.

The introductory presentation and discussion shed light on the broader conceptual framework of structural reforms and fiscal consolidation. The presentation concluded that there are several obstacles to an efficient economy that need to be tackled with structural reforms, such as a rigid labour market, a dysfunctional banking sector, over-regulated public administrations or an ill-designed educational system. Indeed, many of these reforms would not come at fiscal costs. It was further acknowledged that countries’ initial fiscal positions do matter when deciding what kind of reform is most pressing and whether there is room to increase public expenditure. Countries facing fiscal pressures should focus on those structural reforms that do not further burden public finances. A wide range of possible reforms are available to those countries including increasing labour market flexibility, cutting red-tape, tackling corruption, and improving tax systems.

It was agreed that fiscal prudence and structural reforms are essential elements for sustainable growth and that they have long-term benefits also for public finances. However, it was pointed out that difficulties in implementation could occur from a political economy point of view and that some reforms could come with fiscal costs in the form of unintended side effects of reforms or a potential dampening impact on investment.

Different views were expressed on the appropriate timing of fiscal consolidation, the scope of monetary policy, and the framing of structural reforms. Some saw the risk that postponing necessary consolidation now would mean even more reform need in the future, also on the structural side. Others warned against the risk of ever repeating boom-bust cycles and distortions caused by a long-lasting low interest rate environment. The importance of credibility was also mentioned. A reform program could be done step-by-step but in order to be fully effective, there needs to be a reasonable expectation that it will in fact be carried out comprehensively and decisively.

In conclusion, while there were different nuances on the appropriate sequencing and framing there was agreement that fiscal consolidation and structural reforms can indeed complement each other.
Objective and informed observers would probably agree that, in several countries, and especially in several members of the European Monetary Union, impediments to private investments and to other desirable economic actions had reached worrisome levels over the years due to the existence of inefficient structural policies. Structural reforms are, therefore, badly needed if these countries are to return to sustained growth, in a world that is becoming more demanding and more competitive. Those observers would also agree that in several countries public debts, public spending and fiscal deficits have continued to exceed prudent levels, not to mention the agreed Maastricht rules. The Maastricht rule on public debt was largely ignored over the years. In different ways, the above factors are likely to have become impediments to economic activity and to economic growth. Policies that reduced both the structural impediments and the fiscal imbalances would make the countries’ economies grow.

However, some well placed and vocal economists have continued to promote the view that, because of continued high unemployment and low or no growth, the countries might ignore the reforms mentioned above and take advantage of two free lunches. The first is the one offered by a fiscal stimulus, one that would get rid of “austerity”, and engage in additional public spending. They believe that such additional spending, magically and regardless of the existing structural impediments, and of the precarious state of their fiscal accounts, would generate growth and increase public revenue. For these economists the connection between the abandonment of “austerity” and the resumption of growth seems to be a simple and obvious matter. Only “economic stupidity” is preventing policymakers from seeing that connection, and from taking the right steps! These economists blame lack of adequate public spending and policies of “austerity” for the economic stagnation, not the structural impediments and the precarious fiscal situations.

Given the danger that some observers now see as coming from possible deflation – a term that no longer means what it used to mean; that is, it is no longer defined as a sustained fall in the average price level, but, rather, as a price level that does not grow at an annual rate of near 2% – the second free lunch can come from central banks making available to the economies huge amounts of money through new, highly unorthodox policies called quantitative easing. A lot of nonsense is being written these days about deflation and its presumed effects, even by serious newspapers such as the Financial Times. On those presumed effects see Bachmann, Berg and Sims, 2015.

1 For the complete paper please see Annex on page 42.
The quantitative easing policies, which are de facto largely fiscal policies in disguise, make loans available at zero, or even at negative interest rates, to privileged sectors of the economy, and not to everyone who wishes to borrow. They make it possible for (some) governments to borrow, directly or indirectly, from the central banks, a policy that used to be considered a taboo. For many centuries, at least since Cicero's time, public debt and borrowing by governments had been seen as sins or vices. Prominent figures of the past, such as George Washington, Napoleon, David Hume and others, had considered borrowing by governments as clear sins to be avoided. However, in a trend that became popular in our times, Keynesian economics converted what was a sin into a virtue. It is no surprise that the world is now drowning in debt. See McKinsey Global Institute, 2015.

These two free lunches, if they truly existed, would make it possible for a country to spend more, possibly borrowing directly or indirectly from central banks at very low or zero rates, promote growth with the extra spending, and repay the borrowed money at a later time, all effortlessly and without problems. Such a wonderland or marvellous new world, if it existed, would be a truly nice one to live in, for ministers of finance and for policymakers in general. It would certainly be different from the world of the past. For sure, that world requires that economists suspend much of the economic knowledge that they had learned from past centuries (from “dead economists”?) and relearn new economics. See Tanzi, 2015a. One must wonder if “dead economists” are always necessarily dead wrong!

Some would make this world even more attractive for the countries now in difficulties within the European Monetary Union, by asking that those countries that are in better economic conditions provide fiscal transfers to the countries facing difficulties. See Tanzi, 2013 and 2015b. These transfers could be made either through debt cancellation, through sharing of risks on new debt, or even for some countries, such as Germany, engaging in policies that would increase their public spending and their rate of inflation, making them less competitive in comparison with other EMU countries. Just make Germany more sinful and the other EMU countries would be better off!

If the world described in the last paragraphs reflected the current reality, then the countries facing economic difficulties could be encouraged to try to promote structural reforms while ignoring Maastricht rules and other impediments, or even by spending more while making those reforms. These policies would be consistent with the belief that it is the short run that must receive attention, because, as is stated ad nauseam, “in the long run we are all dead”.

The author of this paper still has doubts as to whether we have truly entered this new, pleasant world. He is reminded of what the Austrian economist Von Mises wrote decades ago, in reaction to the Keynesian view that “in the long run we are all dead”. As he put it, the trouble with that view is that “nearly all of us outlive the short run and ... spend decades paying for the easy money orgy of a few years”. As Greek and other policymakers have discovered, it is far easier to accumulate public debts and far more difficult to deal with them, unless rich uncles are willing to step in to pay for them.
The keynote speech by Vito Tanzi provided thought-provoking insights, with a rather orthodox view seen through the Italian prism. Three elements can be highlighted in response. First, the keynote speech made a number of correct points. Second, a number of critical nuances are warranted. Third, there is a need for more fundamental EMU deepening to build the foundation for further development of fiscal policy and structural reforms in the euro area.

1. Areas of agreement

Initial fiscal positions do matter indeed, and structural rigidities also do matter. And they matter in relation to each other.

Firstly, initial conditions certainly make a difference when it comes to designing adjustment strategies. The EU policy framework clearly embodies the notion that the size and urgency of policy efforts should be proportionate to the actual degree of the imbalances or policy errors. This is reflected in the different degrees of stringency in our procedures (SGP, MIP), such as preventive and corrective arms.

Secondly, one can obviously agree that both sound public finances and deep structural reforms are essential to support sustainable growth and employment. Moving towards more resilient product and labour markets and adjusting more quickly to shocks in turn also serves to support sound fiscal positions. But if inefficiencies are high and the economy adjusts more slowly, budgetary positions increasingly come under pressure.

Thirdly, the importance of public administrations and judicial systems deserves particular attention. One could say that these factors are essentially the prerequisites for most other structural reforms, be it in the labour or product markets.

2. Some critical nuances

Some critical nuances are, however, in order.

Firstly, we are often told about a trade-off between so-called “austerity” and economic growth. Others see a trade-off between structural reforms and growth. The truth is that there is

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no point in postponing structural reforms. On the contrary, at the current juncture it is essential to accelerate structural reforms, in particular those aimed at raising productivity, so as to transform the current cyclical rebound into a durable recovery. Admittedly, some structural reforms can have some adverse effects on growth and inflation in the very short run. But the size of these effects crucially depends on the pace and the composition of reforms. Any deflationary impact should be addressed by an appropriate macroeconomic policy stance.

A “political capital” argument is based on the premise that policymakers cannot fight on all fronts for fear of a popular backlash that would compromise the entire adjustment strategy. However, experience suggests that countries which undertake stronger fiscal consolidation are also those that implement far-reaching structural reforms. Conversely, those that have difficulties in consolidating and complying with the SGP are also witnessing less progress on structural reforms.

Secondly, the product market dimension is somewhat missing in the keynote speech and, in particular, the interaction between, and sequencing of, product and labour market reforms.

Thirdly, we should pursue a three-pronged strategy, comprising responsible fiscal policy, stability-oriented monetary policy, and rigorous structural reform at the same time. I would even be inclined to see a four-pronged strategy, complemented by the crucial element of further EMU deepening.

The Juncker Commission has identified fiscal responsibility and structural reform, together with investment, as the cornerstones of its policy strategy. It has provided guidance on how to make the best use of flexibility in an interpretative Communication. The Commission has brought clarifications on how structural reforms can be promoted in line with fiscal responsibility as prescribed by the Pact.

President Juncker’s “Investment Plan for Europe” will also play an important role. The Investment Plan is not only about mobilising additional funds and targeted investment initiatives. The third major, and potentially the most important, strand of the Investment Plan is to provide greater regulatory predictability and to remove bottlenecks to investment.

Fourthly, we need to tackle both the supply and demand sides. In this context, it is fully justified that the ECB makes use of all its available instruments to achieve its mandate and ensure price stability. These instruments include conventional and unconventional monetary policy tools and the ECB has been very careful and vigilant in determining the timing and choice of instruments. It goes without saying that quantitative easing comes with certain risks and side effects but it is also clear that

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doing nothing also carries a considerable risk – in fact, inertia can turn out to be more costly than taking action.

Fifthly and finally, Germany has been rightly insisting on the importance of structural reforms but its own track record has been somewhat limited in recent years.\(^8\) Reforms are needed to strengthen investment, on the private side by reviewing taxation and the intermediation function of the financial sector, and on the public side by investing in infrastructure, education and research. Germany can increase the volume of work and labour income by addressing the large tax wedge, reducing work disincentives for second earners and revising the fiscal treatment of mini jobs. Sectoral reforms would help with improving competition in services and railways as well as consolidating the financial sector, all with the potential to unlock productivity growth and boost further investment. Even if some of these efforts may come at a cost, Germany has the fiscal space to invest in the future.

3. EMU deepening

Coming back to the fourth element of the four-pronged approach, the further deepening of EMU is as relevant as ever when reflecting on fiscal policy and structural reforms. The crisis has revealed a number of weaknesses which need to be addressed to make sure that the EMU framework is fully compatible with the requirements of sharing a common currency.\(^9\) There is a need to move gradually towards “concrete mechanisms for stronger economic policy coordination, convergence and solidarity”, as called for by the Euro Summit of 24 October 2014.

As regards fiscal policy management, the fiscal framework with its focus on the country level does not pay sufficient attention to the euro-area aggregate level, in light of the stabilisation function of fiscal policy. While the overall fiscal stance has been broadly appropriate, its allocation is subpar and could be better coordinated. Automatic stabilisers should be allowed to work also in good times, building buffers for more difficult times. In the future, stabilisation could be further facilitated by moving from a purely rules-based system to a more institutional approach, potentially including a euro-area fiscal capacity. This would also help to avoid overburdening the ECB in managing the overall policy mix.

As far as structural reforms are concerned, the EMU governance framework has not been successful enough in promoting deep structural reforms which ensure adequate adjustment capacity in the monetary union. Persistent divergences and considerable imbalances have arguably contributed to the depth of the crisis in several countries. Furthermore, a lack of economic convergence risks undermining the cohesion of EMU and its long-term viability. Some have argued in favour of strengthening incentives and ownership of reforms at Member-State level, supported by decentralised institutions such as national competitiveness councils. Others have called for more centralisation and intrusiveness in the surveillance and implementation of structural reforms, emphasising the common interest in shared sovereignty in the light of spill-overs and EMU functioning.

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Panel I: Country experiences – international
With Gerd Schwartz (Moderator), Jean-François Perrault, John Janssen, Vitor Gaspar
Moderator’s summary
by Gerd Schwartz, Deputy Director,
Fiscal Affairs Department, IMF

Background

Are fiscal structural reforms and fiscal consolidation complements or substitutes? This session provided interesting insights and lively discussions, drawing mainly from the experiences of Canada and New Zealand.

In the context of high debt, tepid growth, and monetary policy constrained by the “zero lower bound” in many advanced economies, fiscal policy can provide support for structural reforms. In most cases, fiscal consolidation and structural reforms are complements. This was clearly evident from presentations that were made on Canada and New Zealand, and also in the comments on these presentations.

Many areas of structural reforms do not have substantial economic or fiscal costs. Clear examples include product market reforms, trade reforms and financial sector reforms. But structural reforms and fiscal consolidation are often also complementary in other areas.

Structural fiscal reforms can be implemented to make tax and expenditure policies more growth-friendly. Improving the design of labour taxes and social benefits strengthens incentives for labour force participation and work. Reforming capital income taxes in order to tax rents reduces distortions and encourages private investment. Efficient public investment, especially in infrastructure, can raise the economy’s productive capacity, although, often, more needs to be done to strengthen public investment management frameworks. More equitable access to education and health care can contribute to human capital accumulation. More generally, strengthening fiscal frameworks can also help to support growth.

When structural reform comes with short-term economic costs, as is often the case with labour market reforms, fiscal policy can play a role in encouraging structural reform to strengthen medium-term growth. Fiscal policy can help bring about political consensus for reforms by compensating groups adversely affected by the proposed structural reforms. Fiscal policy can also mitigate short-term costs, buying time for the long-term benefits to materialize.

1 Summary also prepared by Lorenzo Forni.
The reform experience of Canada and New Zealand

Canada and New Zealand introduced wide-ranging structural reforms in the 1980s and 1990s, and the presentations on these countries highlighted key elements in a comprehensive fashion. Both countries deregulated goods and labour markets, introduced tax reforms, reduced subsidies, and reformed the financial system. Both countries moved first with structural reforms to improve the economic performance and let fiscal policy accommodate initially. In a second stage, when growth was stronger, they tackled the widening fiscal imbalances. These were addressed starting from the early 1990s in New Zealand and mid-1990s in Canada and entailed a wide range of fiscal reforms that helped the economy to be more efficient. In Canada, measures included employment insurance and pension reforms, and a comprehensive program review of all key departmental programs.

Overall, the wide range of reforms implemented starting from the 1980s strengthened the resilience of these two economies, from both a macroeconomic and a public finances perspective. This was evidenced by their relatively good performance during the global financial crisis.

Lessons from the experience of Canada and New Zealand

The discussions of the presentations highlighted a number of lessons that can be drawn from the experience of these two countries.

New Zealand’s experience with fiscal adjustment and structural reform suggest that, if monetary policy is not constrained by the zero lower bound, then structural reforms can concentrate on potential growth and fiscal adjustment on risk management and stability.

Canada’s experience shows clearly that sequencing matters, as fiscal consolidation is easier when there is strong growth. Staggering structural and fiscal reforms helps to mitigate reform fatigue. Another lesson is that fiscal consolidation through rational expenditure cuts is preferable when taxes are high. For a sustainable impact, expenditure cuts need to be structural, for example, pension reforms or employment insurance reforms.

What about the interaction between fiscal adjustment and structural reform at the current juncture for countries at the “zero lower bound,” such as euro area countries and Japan? The combination of high debt and tepid potential growth underscores the urgency of structural reforms, not only to support stronger growth, but also to restore healthy public finances.
Canada’s federal government faced significant fiscal challenges in the early 1990s. Due to large and persistent deficits, the federal debt-to-GDP ratio had risen markedly from under 20% in 1974 to nearly 70% by 1994.

The federal government responded with a bold set of measures to improve Canada’s fiscal balance, largely focused on strategic expenditure consolidation.

As a result, the federal government eliminated a significant structural deficit in only three years and returned to a balanced budget in 1997–1998. Thereafter, the Government of Canada recorded a surplus for 11 consecutive years. By 2007, at just over 29% of GDP, the federal debt had been halved relative to its peak.

**Structural Reforms to Support Economic Growth**

Canada’s successful fiscal consolidation took place in an environment of strong real GDP growth that averaged almost 4% per year. This robust growth reflected in part structural reforms undertaken in the late 1980s and early 1990s, including:

- the Canada-US Free Trade Agreement (1988);
- the introduction of inflation targeting by the Bank of Canada (1991);
- the establishment of a value added tax (the GST), and the elimination of a distortive manufacturing tax (1991);
- the North American Free Trade Agreement (1994); and
- significant reforms to Canada’s employment insurance program (1994).

These structural reforms helped boost potential growth and created an environment where Canada could maximize the benefits from rapid labour productivity growth and strong external demand.
Lessons from the Canadian Experience

The Canadian experience provides two key lessons.

First, the timing and sequencing of structural and fiscal reforms matter. Ambitious structural reforms undertaken in the late 1980s and early 1990s facilitated the subsequent fiscal consolidation by improving Canada’s growth prospects.

Second, reallocation and efficiency improvement in expenditures can be particularly effective relative to increases in taxes. The Government of Canada’s fiscal balance improved by 6.5% of GDP between 1994 and 2000, of which 5.4 percentage points were due to reductions in expenditures largely attained through a fundamental re-evaluation of all federal spending. This focus on structural reduction in expenditures as opposed to tax increases allowed Canada to improve the fiscal balance and led to sustained decreases in public debt without increasing economic distortions.

In recent episodes of fiscal consolidation, Canada has implemented a similarly balanced approach by combining a plan to return to balanced budgets with targeted measures to support growth and structural measures to increase potential growth. This approach has been successful, leading Canada to record one of the best economic performances in the G7 during the recovery and placing us on track to achieve a budgetary surplus this year.
The New Zealand Experience
by John Janssen, Principal Advisor, New Zealand Treasury

The pace and nature of structural reform in New Zealand has varied over time, with significant episodes of reform in the 1980s and 1990s. An assessment of this earlier period by the OECD (1999) identifies (with the benefit of hindsight) a range of issues and considerations. In particular, some commentators have argued that the sequencing of reforms was less than optimal. Stabilisation and liberalisation in the domestic economy was undertaken after liberalisation of the external sector. Inconsistent progress towards fiscal consolidation, combined with rigidities in the labour market and non-traded sector meant that monetary authorities faced a difficult challenge in reducing inflation. However, there were a number of arguments in support of advancing reform rapidly (e.g., to respond to the crisis, to take advantage of reform support and reduce rents and vested interests, and to correct a history of poor policy credibility). Proceeding with reform in one area was likely to raise the pressure and momentum for necessary reform in other areas.

While New Zealand policy makers may have underestimated the time needed for adjustment, the OECD (1999) acknowledge the challenges in reaching definitive conclusions about why economic recovery was slow in coming in the face of large policy changes. This partly reflects the challenge of identifying the relevant counterfactual. In addition, numerous factors were influencing the economy, including: the lags between policy implementation and their full effects; the 1987 stock market crash; entrenched inflation expectations; constraints on export market access; and limited economies of scale, given the small domestic market.

The reform process was motivated by a widespread recognition that New Zealand’s economic performance was lagging behind that of other OECD economies. The OECD (1999) concluded that although support for the reforms sometimes waned, the reform process remained largely intact through successive governments. This conclusion remains broadly appropriate today, albeit that the types of reforms needed now and the political context differs to that of the 1980s and 1990s.

Fiscal policy has seen a consistent emphasis on maintaining relatively low levels of public debt. While the fiscal framework has no legislated numerical rules, there has been strong political commitment to self-imposed fiscal targets. Moreover, the flexibility of the framework allows governments to set broadly similar debt objectives with somewhat different preferences for the size of the government. Some commentators have seen the latter as a weakness and argued for a legislated expenditure rule (see Wilkinson, 2004). However, the pros and cons of such

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1 This paper is based on the presentation given at the symposium. It incorporates comments from the panel moderator, the panel discussion, and subsequent feedback from symposium participants. Thanks also to Oscar Parkyn, Renee Philip and Tim Ng (all New Zealand Treasury) for comments. The full paper is available at www.bundesfinanzministerium.de/janssen

2 The sequencing issues were particularly relevant to the path of the real exchange rate and the performance of the tradable sector. See the relevant chapters in the volume edited by Silverstone, Bollard and Lattimore (1996).

3 For example, in 1996 New Zealand shifted from a first-past-the-post electoral system to a mixed-member proportional system. Coalition governments have since been the norm.
an approach are complex (see Mears, Blick, Hampton and Janssen, 2010; Ter-Minassian, 2014). In practice, fiscal consolidation has primarily relied on changes to structural expenditure, with the caveat that assessing the overall structural fiscal position is challenging in New Zealand given the influence of fluctuations in the terms-of-trade and labour supply via net migration.

Indeed, these latter influences were present in the last cycle. The economic expansion from 1998 to 2007 was long and large by New Zealand’s post-war standards, with average annual GDP growth of 3.6% and strong employment growth. The unemployment rate fell from 8% in 1998 to around 4% by 2007. Domestic demand was underpinned by a large increase in net migration, rising house prices, and a lift in key export commodity prices. There was strong growth in public and private consumption, as well as housing construction. The cycle was associated with a range of emerging domestic and external imbalances: average house prices grew faster than rents and incomes; domestic credit growth was rapid; the current account deficit widened; and the exchange rate appreciated above its long-term average (see the Treasury, 2014).

There are lessons to be learnt from this period and the global financial crisis. While New Zealand’s low public debt helped in coping with the crisis, in hindsight, fiscal policy settings may have been too loose before the crisis. Strong revenue growth kept the government in fiscal surplus, yet growing public spending put upward pressure on inflation. This meant that monetary policy had to be tighter – and interest and exchange rates higher – than they otherwise would have been.

A range of steps have been taken to increase the resilience of the banking sector. These include: adopting tougher international capital adequacy standards; developing an additional tool for the resolution of troubled banks; and introducing regulation that can help prevent the build-up of risks across the financial sector. Many of these changes are primarily about reducing the risks of future financial crises. However, some tools also have the potential to help smooth cyclical fluctuations in economic activity (e.g. loan-to-value ratios (LVRs)).

New Zealand’s experience also highlights how the initial conditions that influence trade-offs can evolve through time and interact with the specific characteristics of shocks faced by the economy. For example, New Zealand’s fiscal position in the mid-1990s, while improving, did not yet have sufficient fiscal space to allow for the full operation of automatic fiscal stabilisers in response to the Asian financial crisis. In contrast, during the post-2008 period a more measured approach was feasible. In the event this was important given the wide range of short- and medium-term influences on the fiscal balance (e.g. terms-of-trade movements, the earthquake rebuild, changes to potential output).

The pace of the subsequent fiscal consolidation has been influenced by specific considerations, including the appropriate level of prudent debt and the interaction of fiscal multipliers with monetary policy conditions. Wider policy responses have been oriented toward rebuilding fiscal buffers and raising potential growth. The responses comprise a mix of macroeconomic, public sector, and micro reforms. They include: enhancements to the fiscal framework and macro-prudential policy; a direct/indirect tax switch; partial sale of state assets; labour market and welfare reforms; specific targets for public services; a wide-ranging micro reform programme; and an independent institution to investigate and research productivity (the New Zealand Productivity Commission).

References
Are fiscal reforms complements or a substitute for structural reform? Jean-François Perrault and John Janssen provide interesting and useful insights into this question drawing on their first-hand experiences as policy makers.

Janssen's discussion of New Zealand's experience with fiscal adjustment and structural reform suggest that, if monetary policy is not constrained by the zero lower bound in an inflation targeting regime, then structural reform can concentrate on potential growth and fiscal adjustment on risk management and stability. Perrault draws two main lessons from Canada's experience. First, sequencing matters, also as fiscal consolidation is easier when there is strong growth. Second, fiscal consolidation through rational expenditure cuts is preferable when taxes are high.

What about the interaction between fiscal adjustment and structural reform at the current juncture for countries at the "zero lower bound," such as euro area countries and Japan? The combination of high debt and tepid potential growth underscores the urgency of structural reforms, not only to support stronger growth, but also to restore healthy public finances.

Structural fiscal reforms can help build sound, strong, resilient and growth-friendly fiscal institutions. One example is provided by letting automatic stabilizers – the fiscal automatic shock absorbers – work in both directions to help smooth fluctuations in economic activity. Increased stability, in turn, has a surprisingly strong impact on supporting economic growth. The April 2015 IMF Fiscal Monitor finds that, if an advanced economy raises its fiscal stabilization coefficient – measured as the sensitivity of the overall budget balance to the output gap – from the average level to that in the top third of countries, output volatility falls by about 15%, with a growth dividend of 0.3 percentage points annually.

Structural fiscal reforms can be implemented to make tax and expenditure policies more growth-friendly. Improving the design of labour taxes and social benefits strengthens incentives for labour force participation and work. Reforming capital income taxes in order to tax rents reduces distortions and encourages private investment. Efficient public investment, especially in infrastructure, can raise the economy’s productive capacity, although, often, more needs to be done to strengthen public investment management frameworks. More equitable access to education and health care can contribute to human capital accumulation.

More generally, strengthening fiscal frameworks can help to support growth. They are a crucial part of macroeconomic risk management. They help control expenditure over the cycle and ensure continued access to financing. This in turn promotes fiscal stabilization and the associated growth dividend. They also anchor fiscal policy and support debt sustainability. Prudent conduct of fiscal policy is a cornerstone for stable and sustainable growth.
Fiscal policy can also provide support for structural reforms in other areas. In most cases, fiscal policy and structural policies are natural complements. This was clearly presented in the New Zealand and Canada examples. Many areas of structural reforms do not have substantial economic or fiscal costs. Some can even result in short-term gains in output. Examples include product market reforms, trade reforms, and financial sector reforms.

However, there are cases where structural reform is associated with short-term costs for economic activity and for the budget. Two examples come to mind. Pension reform can adversely affect fiscal balances. Indeed, the European Commission explicitly takes into account such costs when assessing compliance with the Stability and Growth Pact. A second example is labour market reform, discussed in greater detail below, drawing on the analysis of the October 2014 IMF Fiscal Monitor.

When structural reform comes with short-term economic costs, fiscal policy can play a role in encouraging structural reform to strengthen medium-term growth. First, structural reform can use fiscal instruments for its implementation. Second, fiscal policy can help bring about political consensus for structural reform. Third, fiscal policy can help manage the timing of the benefits of reform, facilitating the transition. Labour market reform, one of the most costly types of structural reform, can be used to illustrate these three roles.

Labour market reform can use fiscal instruments. Reducing labour taxes and social security contributions can positively impact employment and economic activity. While there are direct budgetary costs, these can be reduced by targeting reductions to specific groups. Germany and Sweden provide examples of the effectiveness of targeted employer social security contributions, where growth of elderly employment in the case of Germany and youth employment in the case of Sweden outpaced that of the broader population.

Fiscal policy can also be used to compensate groups adversely affected by the proposed structural reform. A typical example occurs when changes in employment protection are bundled together with measures that benefit employees. For example, in the 1990s, Sweden and Finland enacted labour tax cuts in parallel with reductions in employment protection.

Fiscal policy can also mitigate short-term costs, buying time for the long-term benefits to materialize. For example, reduction in employment protection legislation can be particularly costly in terms of output losses. In the short-run, demand support to mitigate output effects can be achieved through efficient public investment, as outlined in an upcoming IMF paper on “Making Public Investment More Efficient”. This is especially appropriate at the zero lower bound, when fiscal multipliers are larger and the potential adverse impacts of some reforms may also be more pronounced. Reducing the upfront “pain” of reform may reduce political resistance to its implementation.

What conditions must be in place for fiscal policy to provide a supporting role to structural reforms? Four basic principles can be advanced. First, fiscal policy must ensure debt sustainability and market confidence. Second, there must be a credible commitment to see the structural reform through to fruition. This in turn is necessary to protect credibility. Third, there needs to be a good estimate of the costs and benefits of the reform and how they will materialize over time. Fourth, an overall assessment of the macroeconomic situation and prospects is required. These are clearly difficult and complex issues that we will continue to explore in order to fully take advantage of the potential complementarities between fiscal and structural policies.
Panel II: Country experiences - Europe
With Quentin Peel (moderator), Carla Díaz Álvarez de Toledo, Frederik Bystedt, John McCarthy, Daniel Gros
Spain, Ireland and Sweden are very interesting and informative examples of countries that experienced a severe crisis and responded by employing decisive fiscal consolidation and targeted structural reforms. Spain and Ireland moreover resorted to official sector funding which provided the necessary breathing space for reforms and consolidation. All three countries undertook a frontloaded consolidation effort in order to show their resolve to overcome the challenges and to build credibility and restore confidence.

The discussion highlighted the importance of a targeted and country-specific package of reforms. Another lesson that can be drawn is that national ownership of the reform agenda is crucial for its success. Moreover, official sector funding can be very helpful if the relief and time provided by it is used for decisive measures.

The examples of Spain, Ireland and Sweden thus clearly show that fiscal consolidation and structural reforms indeed complement each other.
When the real estate bubble burst in 2008, several vulnerabilities that had been accumulated in the Spanish economy during the previous decade were brought to everyone’s attention. Public finances had looked solid, with consistent fiscal surpluses and one of the lowest debt-to-GDP ratios in the Eurozone. However, what had been ignored was the strong cyclicality of revenues linked to the real estate sector. When these disappeared, compounded with a strong surge in unemployment, the mismatch between expenditures and revenues exceeded 9% of GDP in 2010. The economy entered into a deep recession, unable to continue growing based on the non-tradable sector, and investors started questioning the capacity of Spain’s highly leveraged private sector to service its debts. Uncertainty on the real exposure of Spanish banks led to a confidence crisis. How was Spain’s government, with such battered finances, ever going to be able to face an uncertain amount of additional capital needs in its banking sector?

When at the end of 2011 a new government came to power with an absolute majority, Spain could count on an asset which other countries in difficulties lacked: political stability. This would enable the new government to put in place a comprehensive strategy, building on reforms already implemented by the previous one, to tackle the different imbalances in the Spanish economy: high public deficits and an increasing level of debt-to-GDP that raised doubts on its sustainability; the need to clean up the banking sector in order to restore lending to the economy; and correcting the accumulated loss of competitiveness. This would help redirect capital and labour to the tradable sector, in order to restore sustainable growth in the Spanish economy.

The first and most urgent task was to restore credibility in the Spanish economy. To this effect, the authorities committed to a consolidation path that would enable the stabilization of the public debt ratio and eventually its decrease from 2016 onwards. In 2016, the deficit will be below the 3% threshold of the Stabili-
In view of the difficult market conditions that prevailed in 2012, the authorities secured up to €100bn from the EFSF and then the ESM to fund the recapitalization of its banking sector, thus reassuring investors that enough funds would be available. Together with the European envelope, of which just EUR 41bn were used, came a credible restructuring plan for the banking sector and an in-depth analysis of its balance sheets. Finally, with the transfer of real estate assets to SAREB, the asset management company established to this effect, uncertainty on future additional provisions was eliminated. After successive provisioning efforts in Spanish banks, which increased the coverage ratio of doubtful loans from 36% in 2012Q1 to 47% by 2014Q3, and €100 bn in capital increases and voluntary liability management exercises, banks can now focus again on their main activity, which is lending to the real economy. This restructuring of the Spanish financial sector was indeed essential to redirect capital to the tradable sector which is now becoming one of the engines of growth for the economy. Recent data show that loans under € 1 million, typically taken by SMEs, are increasing. What is more important, due to the return of confidence in the Spanish economy, lending rates are now converging to those in other European countries, thus repairing a source of competitive disadvantage for Spanish corporates.

However, Spanish banks have reduced their size to levels not seen since the ’90s, both in terms of number of branches and number of employees. To ensure that the Spanish economy attracts the capital it needs, additional measures were needed to facilitate non-bank access to finance for SMEs. Here come the new capital market for medium-sized enterprises (MARF), which reduces the administrative cost of issuing debt while at the same time protecting the interests of investors, a new law on crowdfunding, or the reform of the insolvency framework to facilitate agreements with creditors and enable economically viable businesses to continue their activity.

On top of the reallocation of capital, labour needed to shift as well to the new sectors that would drive growth in Spain. Unemployment had dramatically risen in Spain, due to the destruction of jobs in labour intensive sectors. Rigidities in the labour market also favoured an adjustment in quantities instead of prices. The challenge was to reduce an unacceptable level of unemployment without undermining the productivity gains in the Spanish economy. An expanding tradable sector required that unit labour costs (ULC) be kept under control, so as to regain the competitiveness that had been lost since the creation of the Monetary Union, without devaluing the currency. This would also contribute to reduce the external leverage of the economy.

An ambitious labour market reform was then implemented, aiming at the main shortcomings of the Spanish labour market: high structural unemployment, high youth unemployment, duality, high employment volatility and wage indexation which limited gains in competitiveness. For the first time, reforms in collective bargaining were introduced, favouring flexibility at the level of the firm. External flexibility was also enhanced, thanks to a clearer framework on fair dismissals. This has enabled the Spanish economy to start creating jobs at an earlier stage in the economic cycle: the threshold of economic growth for positive employment creation has been reduced by 1.5%, and employment creation lags economic growth by just one quarter (instead of four as in the 1990s). Most recent data for the last quarter of 2014 show employment growing at an annualized rate of 2.53%. This has been achieved without undermining productivity gains, and ULC have decreased since their peak in 2009 and are now at similar levels to 2007.
On the back of these gains in competitiveness, exports have replaced investment as a source of growth, thus favouring the external deleveraging of the economy. Exports now account for 32% of GDP vs 22% in 2009, with greater diversification in terms of number of exporting firms and markets. Dependency on the European market is down to 48% of exports from 60% in the pre-crisis years. Investment (which includes construction), for its part, is now close to the European average at 19.6% of GDP, down from close to 32% in 2009. Investment is therefore now more aligned to savings in the Spanish economy, and for the second consecutive year, Spain was in 2014 a net lender to the rest of the world with a current account surplus. This should start a process of external deleveraging.

Deleveraging is in fact progressing at a rapid speed in the private sector. Non-financial corporates are switching from debt to equity and are using their savings to reduce debt, so that their indebtedness has been reduced by close to 24% of GDP since the peak. Households as well are deleveraging, with their debts down by 12% of GDP. There remains the challenge of reducing leverage in the public sector. With primary surpluses expected as soon as 2016, this process should start in the foreseeable future.

The Spanish economy is therefore set on a path to reduce its imbalances. Although the flows have improved, the stock of accumulated imbalances is still large and there is no room for complacency. The combination of a credible fiscal path and reform measures aimed at Spain’s main imbalances has restored credibility in the Spanish economy. However, we need to bear in mind that Spain is part of a wider market. Efforts at the European level to deepen the single market, not only for goods and services, but also for capital, such as the effective implementation of the banking union and of a capital markets union are also essential to consolidate these achievements.
The Irish Perspective\(^1\)

by John McCarthy, Chief Economist, Department of Finance, Ireland

The recent fiscal crisis in Ireland was one of the most severe in the developed world. The collapse in the taxation base together with the expenditure associated with recapitalising the domestic banking system\(^2\) resulted in a circa 100 percentage point increase in the public debt-to-GDP ratio over a relatively short time horizon. This rapid accumulation of public indebtedness, together with a significant increase in contingent liabilities,\(^3\) in an environment of heightened global risk aversion, ultimately led to the Irish sovereign’s exclusion from private capital markets.

Official sector funding was therefore required in order to provide the necessary breathing space to close the fiscal deficit and put the debt-to-GDP ratio on a downward trajectory. Fiscal consolidation and structural reforms formed, as is the norm, part of the conditionality associated with such funding. In this sense, the Irish experience over the past couple of years provides a good case study in attempting the answer the question of whether fiscal consolidation and structural reforms are complements or trade-offs.

Fiscal consolidation 2008-2014

The emergence of a large structural deficit at the tail-end of the last decade necessitated a decisive policy response in order to address solvency concerns. Between mid-2008 and 2014, ex ante fiscal consolidation amounting to around 18% of GDP was implemented. An important element of this was the considerable front-loading of the adjustment, with significant consolidation undertaken in the pre-programme period. Ultimately, this front-loading was one of the main reasons for the strong domestic ownership of the joint EU/IMF programme. This front-loading was also important from a demonstration perspective – it sent an important signal to market participants that Ireland was serious about putting its fiscal house in order.

Much of the consolidation was implemented at a time when economic activity was contracting, or when the economy was operating well below its potential. In other words, fiscal policy was pro-cyclical during the period; however, this was simply unavoidable given the need to address market concerns regarding Ireland’s creditworthiness at the time.

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1 Views expressed are those of the author and not necessarily those of the Minister or of the Department. The full paper is available at www.bundesfinanzministerium.de/mccarthy

2 The bail-in framework now in place at a European level did not exist at the time.

3 In order to address what was perceived at the time to be a liquidity crisis, the State guaranteed the liabilities of the domestic banking system in September 2008.
The quality of consolidation is generally deemed to have been good and in line with what is seen as best practice. In this sense, there was a bias towards expenditure reductions, with roughly two-thirds of the adjustment on the expenditure side of the accounts. Moreover, almost all aspects of public expenditure were on the table – in effect there was a “no sacred cow” approach. Given the scale of the fiscal adjustment needs, policy could not rely exclusively on the expenditure side of the accounts, with revenue increases also needed. Because the origins of the fiscal deficit were, in large part, to be found in the erosion of the taxation base, the overall approach to consolidation on the revenue side centred on reconstructing the taxation base and the taxation of property was moved closer in line with international norms.

**Structural reforms in Ireland**

Firstly, important reforms were undertaken on the fiscal side. An independent comprehensive review of expenditure (CRE) was undertaken in 2011 for the purpose of identifying those areas of public expenditure where savings could potentially be made over the period 2012-2014.¹ Perhaps the most important fiscal reforms took place in the areas of pensions, with legislation enacted to provide for a phased increase in the eligible age for the state pension over the next two decades, taking effect from January 2014. Public sector pensions have also been overhauled – for new entrants to the public sector, retirement earnings will be based on career-average earnings while retirement earnings will be indexed to price rather than wage inflation. Actuarial assessments suggest that these pension reforms will result in an accrued liability reduction of about 35% relative to the counter-factual situation where no reforms were implemented.

The second area of reform relates to the institutional framework within which fiscal policy is set. The over-riding objective of these reforms was to enhance the credibility of policy, to increase transparency and to improve fiscal governance and oversight. An independent fiscal watchdog was established on a statutory basis – the Irish Fiscal Advisory Council.² The budgetary architecture was further enhanced through the introduction of multi-annual ceilings on expenditure, both current and capital. Finally, a constitutional referendum was held to provide for the requirements of the ‘fiscal compact’.

The final reform area relates to microeconomic reforms. While these were not the main focus of the programme – research from the OECD, the European Commission and others tends to show that product and factor markets in Ireland are reasonably flexible – a number of important reforms were central. The overall objective of these structural reforms was to boost the potential growth rate of the economy, to enhance its shock absorption capacity and to improve competitiveness.

On a more general note, in Ireland and elsewhere, structural reforms are often difficult to implement, given political economy concerns as well as sometimes powerful vested interests. Communication is therefore an important consideration when undertaking reforms. To demonstrate the positive impact of a suite of reforms (including inter alia a revenue-neutral shift from labour to property taxation, greater dependence on environmental taxation, more effective labour activation policies, strengthening competition in the non-traded sector) the Department of Finance published³ results of model simulations

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¹ A second CRE was undertaken in 2014.

² Entrusted to independent fiscal bodies under the so-called “two-pack” of legislative reforms that apply to euro area Member States.

³ "Quantification of the economic impacts of selected structural reforms in Ireland", Department of Finance, July 2014
– using a large-scale structural model of the Irish economy\textsuperscript{4} – which show that national income would be around 1¼ percentage points higher over the medium term, with positive implications for both the labour market and the public finances.

**Economic recovery and restoration of market access**

Repairing the public finances and steadfast implementation of important structural reforms were vital ingredients in the rapid and large internal devaluation in Ireland following the onset of the crisis. This internal devaluation is most evident from the adjustment in unit labour costs in Ireland; unit labour costs rose more rapidly in Ireland than in other so-called peripheral economies in the decade leading up to the crisis. Once the crisis hit, the adjustment in Ireland was rapid and substantial, with unit labour costs falling by around 13 per cent between 2008 and 2013, a much larger fall than elsewhere.

The substantial improvement in competitiveness has facilitated a rebalancing of the economy and a shift of capital and labour from the non-traded sector to the traded sector, with exports now 30 per cent higher than the pre-crisis peak. Indeed, on the basis of reasonable projections for short-term GDP growth, the level of GDP is likely to revert to its pre-crisis level this year, with the exporting sectors leading the charge. It is clear, therefore, that the strong and decisive policy response in the fiscal and structural reform space has laid the foundations for economic recovery in Ireland.

**Conclusion**

Market access on reasonable terms is ultimately a function of fiscal sustainability. When confronted with a severe economic shock that exposes a large structural deficit, consolidation is an absolute necessity to ensure sustainability, even if this implies a pro-cyclical stance.

But the Irish experience also demonstrates that market access is also a function of how markets perceive short- and medium-term economic growth prospects. This highlights the importance of consolidation being implemented in a growth-friendly manner; in particular, permanent, targeted and well-designed consolidation measures can limit the drag on economic activity.

The Irish experience also demonstrates that reforms aimed at unlocking the growth potential of the economy and enhancing the capacity of the economy to respond to shocks have a positive impact on fiscal sustainability, with knock-on effects for market perceptions of creditworthiness. Reforms in the fiscal area – improvements to the fiscal architecture as well as measures that address longer-term considerations such as pension reforms – are especially important and go hand-in-glove with growth-friendly fiscal consolidation.

In conclusion, the evidence from the Irish crisis suggests that fiscal consolidation and structural reforms are complementary rather than substitutes.

\textsuperscript{4} The ‘HERMES’ model of the Irish economy maintained by the independent Economic and Social Research Institute.
It is one of the most amazing skills of top politicians that they are able to comment on discussions and conferences that they have not even participated in. I too am always happy to take on this intellectually appealing task.

Today’s meeting looked for an answer to the question whether structural reforms and fiscal consolidation are trade-offs, or if they complement each other. And I can in fact easily answer this question, even though I didn’t participate in the discussion: They complement each other.

Experiences in many countries – including Canada, New Zealand, Spain, Sweden, Ireland, and Germany too – show that they do indeed complement each other. If governments set the right priorities, reforms can lead not only to stronger growth, but can also have a direct positive impact on public budgets. In particular, reforms on the expenditure side have positive short-term effects on households and growth.

But what is even more important is that structural reforms must be aimed at improving the economic conditions, including, most importantly, making an economy more innovative. That’s why we have structural reforms. It doesn’t just mean having more flexible labour markets or future-proof social security systems. Rather, it means improving education and training.

In this respect, increasing the number of university graduates is not the most important thing. Rather, it’s about increasing the number of skilled workers who have been well trained, both in practice and theory, within a dual system of education and vocational training. Such workers are enormously important, especially for small and medium-sized enterprises, because they are able to integrate innovations into workflows and to develop their own innovations within workflows.

Structural reforms to promote the capacity for innovation also mean, just as urgently, improving the institutional framework conditions. Efficient and effective administrations that are free of corruption, and a judicial system that works quickly, make it much easier to found new companies. Where the public sector is excessively large, this hampers growth. Targeted reforms aimed at modernising and streamlining public administrations can also lead immediately to savings in public budgets.

Ultimately, structural reforms to promote the capacity for innovation mean improving the framework conditions for the financing of business ideas – especially high-risk business ideas. We are doing that now with the capital markets union and with the promotion of capital-market-based corporate financing in general.

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1 Check against delivery.
Let's take a look at the reforms that Germany implemented starting in 2003: We made the labour market more flexible, especially when it comes to temporary contracts; we eased the restrictions on redundancies; we liberalised a large number of trades; and we streamlined the public administration. The duration of unemployment benefits was shortened and social benefits were reduced. Incentives to take on work were increased. And indeed employment began to rise. The number of public service employees was reduced by several hundred thousand. In fact the federal administration is now leaner while serving 80 million people than it was before German unification with 60 million. We modernised the social welfare system by cutting health care spending, reducing pension benefits, and raising the retirement age. And we allocated more money for education, child care and investment. 

Unbeknownst to many, our structural reforms went hand-in-hand with fiscal consolidation: Our structural deficit declined. From 2002 to 2007, public spending – excluding interest payments – rose at a nominal rate of less than 1% per year. The decline of the structural deficit was not enough to meet the conditions of the Stability and Growth Pact, at least not at the beginning. But Germany’s violation of the Stability and Growth Pact had nothing to do with a trade-off between fiscal consolidation and economic reforms: Without reforms, the deficit would have been significantly higher.

It took Germany some time before it started to reap the rewards of our reforms. But as a result we were able to cope with the financial market crisis and the ensuing recession without suffering a large rise in unemployment. Growth resumed quickly after the crises and has been respectable since, despite the strains of the euro crisis.

In short, our structural reforms laid the foundation for a return to economic growth and higher employment in Germany. What should not be overlooked is that consolidation went hand-in-hand with an increased quality of public spending geared towards more investment in infrastructure, education, and research and development – a policy which our government is determined to continue.

But it was thanks to the accompanying fiscal consolidation that we regained confidence on the part of the people and markets, and maintained resilience and our anchor role for Europe in the financial and fiscal crisis.

Yes, it is true: Change is more difficult than some macro-economists may think. It is naive to believe that one country’s reforms can simply be copied one-to-one elsewhere. For economic reforms to be effective, changes in rules and regulations have to trigger changes in cultural attitudes as well. Culture matters! Changes in culture take time. But they are possible: Germany has changed, Sweden has changed, New Zealand has changed, all the countries you have discussed today have changed a lot, and they continue to change.

You probably heard today that Spain’s labour reforms gave companies more flexibility to set wages themselves rather than through sector-wide bargaining. Those changes, supported by a deal between unions and employers, tempered wage growth that had previously far outstripped gains in productivity.
All these reforms put countries on track towards growth. Labour market reforms, reforms in financial markets, and reforms of the public sector – targeted reforms yield higher growth and employment. And the associated increase in government revenue has a positive impact on public budgets. This combination of reforms is already beginning to have an effect in Spain, in Ireland, and in Portugal. All of these countries have significantly consolidated their structural balances. Unsurprisingly, all of them now register stronger growth than most of their European peers.

To cut a long story short: There is no trade-off between fiscal consolidation and structural reforms, particularly labour market and welfare reforms. On the contrary, they typically complement each other. But there is an obvious trade-off between fiscal consolidation and the other alleged method for achieving growth, namely excessive deficit spending.

I hope that you came to the same conclusion at the meeting today, even if I wasn’t there to help persuade you.
Agenda

**Symposium**

9:00 – 9:10 a.m. **Introductory remarks** by Ludger Schuknecht, Federal Ministry of Finance, Germany

9:10 – 10:00 a.m. **Introductory presentation and discussion**

Moderator: Ludger Schuknecht, Federal Ministry of Finance, Germany
Presenter: Vito Tanzi, economist and former Undersecretary for Economy and Finance, Italy
Discussant: Servaas Deroose, European Commission

10:00 – 10:30 a.m. **Coffee break**

10:30 – 12:00 p.m. **Panel I: Country experiences - international**

Moderator: Gerd Schwartz, IMF
Presentation on experiences in Canada: Jean-François Perrault, Department of Finance Canada
Presentation on experiences in New Zealand: John Janssen, The Treasury of New Zealand

12:00 – 1:00 p.m. **Lunch**

1:00 – 2:30 p.m. **Panel II: Country experiences - Europe**

Moderator: Quentin Peel, The Royal Institute of International Affairs, Chatham House
Presentation on experiences in Spain: Carla Díaz Álvarez de Toledo, Ministry of Finance, Spain
Presentation on experiences in Sweden: Fredrik Bystedt, Ministry of Finance, Sweden
Presentation on experiences in Ireland: John McCarthy, Department of Finance, Ireland
Discussant: Daniel Gros, Director, CEPS

**Public plenary**

3:00 – 3:10 p.m. **Address** by Federal Minister of Finance Minister Schäuble

3:10 – 4:00 p.m. **Discussion**

Moderator: Angela Wefers, Börsen-Zeitung
Wolfgang Schäuble, Federal Minister of Finance Germany
Vitor Gaspar, Head of IMF Fiscal Affairs Department
Vito Tanzi, Economist and former State Secretary in Italy
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Annex

Crises, Initial Conditions and Economic Policies
by Vito Tanzi

1. Introduction

Classical economists, development economists and most economists would agree that economic growth, defined as the rate of change of an economy over some significant period of time, depends on the quantity and the quality of the factors of production available to a country. Most economists would also agree that, given those factors, a country's policies and possibly some cultural factors that are typical of that country can influence the way in which the factors are used. The country's current policies, its culture, and other potential obstacles, introduced over many years, can influence both the pace at which the factors are created and the efficiency with which they are used. Therefore, they can increase or decrease the country's potential output and the rate at which that output grows over time.

Keynesian economists would not disagree with the above statements; however, they would add that, because aggregate demand occasionally falls below the level needed to keep the economy of a country fully employed, economic slowdowns or recessions may occur and, as a consequence, some of the potential output that could have been created would not be produced. Some workers would lose their jobs, profits would fall, and some enterprises would be forced to close down. Keynesian economists maintain that, in these circumstances, a higher aggregate demand, promoted by governmental intervention, can help restore the lost output.

In a Keynesian version of events promoted by economists such as Paul Krugman, Joseph Stiglitz, Larry Summers, and some others, insufficient aggregate demand, by itself, seems to be considered sufficient to provide much of or the explanation for the prolonged slowdown that has been experienced by many countries after the 2008 financial crisis. In the view of these economists, the needed corrective policy is elementary: it is a sustained fiscal injection, which would restore the countries' demands to the level needed to bring their output close to their potential. In this narrative, the structural impediments in the countries' economies and the conditions of the countries' fiscal accounts seem to play no role, in determining the needed policy which is: Just push the foot on the fiscal accelerator and keep it down until the economies reach their potential. As Stiglitz put it, in sharp terms, a recent article, (20 January 2015), “policy stupidity” is the only obstacle to full recovery.

The questions to be addressed in this paper are essentially two: the first is whether structural reforms should play a role in the policies that countries need to get out of their current stagnation; the second is whether the current conditions of the fiscal accounts, (what we shall call the initial conditions), should influence the extent to which the countries could rely on the fiscal expansion recommended by Stiglitz and the other above mentioned economists. These economists give the impression that the structural conditions are not important and that the initial fiscal conditions do not matter. They seem to believe that the recommended fiscal expansion can take place ignoring both structural needs and initial fiscal conditions.

The paper will also address the related question, of whether there should be some relation between the structural reforms that countries’ policymakers promise to make and the consolidation of their fiscal accounts that they should undertake. Putting it differently, does the need to make structural reforms, or

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1 Paper to be presented at the International Conference on "Structural Reform and Fiscal Consolidation: Trade-Offs or Complements?", German Federal Ministry of Finance, Berlin, 25 March 2015.

the promise by countries’ governments to make them, reduce the need for fiscal consolidation, in countries that have precarious fiscal accounts.

2. On the Importance of Structural Reforms

Like individuals, countries grow and develop in different ways. Some grow without developing major structural difficulties; others develop structural obstacles that over the years can become progressively more damaging to their economic activities and can reduce their rates of growth. Some countries manage to keep their fiscal accounts under reasonably good or sustainable conditions; others allow them to get out of balance, raising concerns about their sustainability. Often, though not always, countries that do not develop serious structural problems also maintain their fiscal accounts in better shape. The above distinction leads to a key question: when faced with stagnating economies, as some countries are now, do the policymakers in the two sets of countries have the same capacity and the same degrees of freedom to use the expansionary fiscal policy that the Keynesian economists demand? Or are different policies needed?

Consider first the structural obstacles that can be present. These obstacles come in various forms and shapes, and some are more significant than others. The more important among them are likely to be the following:

(a) The labour market can have become progressively more rigid leading to increasing unemployment, reduced labour force participation, and reduced flexibility for employers to adjust the number and the characteristics of the workers that they employ. The rigidity of the labour market also reduces workers’ ability to change jobs over their working life, in order to find employment in jobs in which they have more ability, and in which they can be more productive and even happier. This must have been a significant problem in several European countries where, because of labour market rigidity, many workers must have been forced to spend much of their working lives working in the same jobs, because of the difficulties in moving to different jobs.

(b) The banking systems can undergo stress and become dysfunctional. Some of the loans that banks make may end up following political or other non-market incentives or pressures, increasing the share of nonperforming loans in their portfolios. This creates difficulties for some banks and risks converting them into zombie banks. Several banks in European countries have been suffering from these problems. See the recent IMF paper by Jassaud and Kang, 2015, on Italy.

(c) The public administrations may create too many regulations and too much “red tape”, reducing economic efficiency and encouraging corruption. Red tape and the corruption that often accompanies it increase the time, the difficulties, and the costs of making investments or initiating new activities. It stops many economic actions from taking place. When it combines with other factors, such as high tax rates or damaging regulations, red tape can force some activities into the black economy. This has been a problem in several European countries, especially in some of the countries undergoing difficulties.

(d) The tax system can become complex and inefficient, increasing compliance costs, for taxpayers, and administrative costs, for tax administrations, and tax evasion, which contributes to fiscal disequilibrium.

(e) There may be too many inefficient public enterprises, at both national and sub-national level. They restrict competition and require public subsidies. See Stagnaro, 2013, for Italian examples.
The pension system may have become overly generous, as it became in Greece and other countries, allowing workers to retire too early in spite of rising life expectancies and fiscal difficulties.

For some of the above reasons, or for other structural problems not mentioned above, public revenue may end up being used in an inefficient way, thus wasting precious resources and generating less desirable socio-economic indicators than could have been generated. See Tanzi and Schuknecht, 2000; and Afonso, Schuknecht and Tanzi, 2005.

The above and other structural problems not mentioned are not abstract problems. They exist and have been playing large roles, over the years, in several European countries, as reports by the OECD and by other institutions have shown. American economists, who have not been exposed, or have been exposed less, to these structural obstacles, tend to ignore or to give little importance to them. In some of the European countries now facing economic difficulties (Greece, Spain, Portugal, Italy, France and some others), structural obstacles had become increasingly more damaging with the passing of the years and had significantly reduced efficiency in the use of productive resources and economic growth. This had happened even before the effects of the recent crisis were felt.

An important and less understood, or less noted, aspect connected with the structural problems mentioned above, an aspect ignored by American economists and by economists with a predominantly macro orientation, is that the structural obstacles not only reduce the potential supply of an economy but, in often less transparent, but still important, ways, they reduce the potential aggregate demand in the economies most affected by these problems. If entrepreneurs or individuals who wish to make new investments, or to start new activities and to hire
workers that would create demand for goods and workers, are prevented, discouraged, or delayed by structural obstacles from doing it, then the structural obstacles become problems not just for the supply side of the economy but also for the demand side. Therefore, removing, or relaxing, some of the structural obstacles can have the same (but possibly a more durable) expansionary impact on the economy as would a traditional Keynesian fiscal expansion. This is an aspect of structural reforms that receives less attention than it merits.

In conclusion, structural reforms can be very important, especially in some countries. Such reforms cannot be assumed to be less important than expansionary fiscal policy in pulling countries out of stagnation. The need to make structural reforms in countries where structural problems are important cannot be minimized and cannot be delayed, waiting for a better time, because a better time may never come. We turn next to macro aspects of fiscal policy.

3. On the Importance of the Initial Fiscal Conditions

Countries that over recent years accumulated high public debts while still running significant fiscal deficits (especially in spite of high tax burdens) are inevitably more exposed to the dangers and the consequences of their fiscal conditions. The servicing of the high public debt competes, and will continue to compete in the future, with other demands for the use of available public revenue. Some empirical evidence has indicated that countries that have high public debts are likely to reduce public investment, to make space for the interest payment on the debt. See Tanzi and Chalk, 2000. In 2014, the share of interest payments on public debts in countries’ GDPs was 2.8% for the whole euro area. It was 5.1% in Italy, 4.5% in Iceland, 4.4% in Ireland and Portugal, 4.2% in Greece, 3.5 in Spain, and 3.4% in Slovenia and Cyprus, in spite of a very low inflation rate and low nominal interest rates. Clearly the interest payments had implications for what the governments could do with their public revenue.

Under normal circumstances, the interest rates (and the spreads) can be expected to be higher for countries that are highly indebted. Higher spreads and expected future high interest rates create policy uncertainty and discourage some private investments while they create incentives on the part of domestic banks to use their available funds to buy “safer” government bonds, rather than risk lending to riskier, private borrowers.

In highly indebted countries, the policymakers are often more distracted than those in less indebted countries by the recurrent need to refinance sovereign debt that is reaching maturity. The lower the average maturity of the public debt, the greater and more frequent will be the need to refinance the debt, and thus the distraction. Yearly refinancing needs can become very high. The always-imminent danger that the spread might increase, as happened in Italy and other countries in 2010-2011, increases the uncertainty and risks for the future. In Italy, between 2010 and 2012 interest payments on the public debt increased by almost 1% of GDP. In Spain and in Portugal it increased by much more than one percentage point of GDP. The servicing of the debt makes it more difficult for governments to focus on some potentially positive actions (for example, spending more on needed public investments, or reducing damagingly high marginal tax rates).

Once created, high public debt will inevitably have some influence on the economy. Investors will be less likely to commit themselves to real investments that require several years to generate profits, because of fear of higher taxes and higher future rates, and consumers may expect higher future taxes. In some countries there will be pressures to give favourable tax treatment to those who buy government bonds, as Italy did in
the past, to encourage them to buy more public bonds. This will distort the allocation of the countries’ saving in favour of the public sector. There will be pressures on central banks to keep monetary policy more accommodating, making monetary policy increasingly more dependent on fiscal policy. Or it may even lead to the replacement of fiscal policy with monetary policies, as quantitative easing has been doing to some extent.

Policies of quantitative easing are able to increase the reserves available to private banks but cannot reduce the banks’ risk of lending to particular private sector activities; or the risks that private investors take when they make real investments. These risks increase when the country’s fiscal conditions are not good, so that “fiscal uncertainty” grows. These risks increase more in some sectors of the economy than in others. Even when the central banks may be lending at rates close to zero, the cost of borrowing for some less privileged sectors will remain very high. It may even increase, because of the high risks of not being repaid that the banks assume in lending to them. These risks tend to be lower for loans to sectors that can pledge collateral, such as real estate, construction and sale of new cars, than for sectors that cannot make such pledges. This distorts the allocation of resources in countries and not necessarily in a desirable direction.

In a recent BIS paper, Cecchetti and Kharroubi, 2015, have argued that less productive sectors tend to be favoured by quantitative easing policies than more productive sectors, partly because of the role of collateral. Therefore, even when central banks may be lending at zero interest rates to banks and/or to the governments, some potentially productive sectors get cut out by the banks. The cost of getting personal loans and loans not backed by real assets has remained remarkably high, in spite of all the talk about zero interest rates and deflation.

Quantitative easing policies make the income distribution less even, because of the differentiated and negative impact that they have on the middle classes. Generally, middle class households, especially those closer to or over the retirement age, which in the past had depended for part of their consumption on interest incomes received on past savings accumulated in financial wealth, saw their incomes fall dramatically in recent years, because of the negative impact of monetary policy on interest incomes. In the United States, for example, between 2007 and 2014 the share of interest income in the total personal income of households fell by more than 3 percentage points, surely a large fall. See Tanzi, 2015.

For all the reasons mentioned above, it could not be concluded that the initial conditions of the fiscal accounts of countries do not matter, when the countries are encouraged and are pushed to enact fiscal stimulus programs. It is difficult to believe that, regardless of the initial conditions, governments could simply borrow and spend their ways out of a crisis; or that they could simply delay the needed structural reforms; or promise to introduce them without at the same time improving the fiscal accounts.

Some economists and some policymakers have been calling for an end to “austerity” (defined as not engaging in higher public spending) even though in many countries public spending and public debts are at high levels and in some they are at probably unsustainable levels over the longer run. See Tanzi, 2015a.
4. What Policy Actions Should Countries Take?

From the above observations it would seem logical to conclude that the countries that over the years had allowed fewer structural obstacles to develop, and that had kept their fiscal accounts in better shape, would be better prepared to resist random economic shocks and the stagnation that accompanies them. They will be freer to take fiscal expansionary actions when such actions seem warranted. These countries would have more fiscal space and policy capacity to deal with the shocks and high unemployment. It cannot be assumed that, regardless of initial conditions, all countries have the same fiscal space to deal with economic slowdowns.

Dealing with high unemployment may require not just the countercyclical policy emphasized by the Keynesian economists but also significant structural reforms. The worse the initial fiscal conditions, and the more constraining the structural obstacles of a country, the more need there will be to both reduce fiscal imbalances and remove the structural obstacles. Delaying the time for making the needed corrections may simply increase the cost of making them at a later time. Greece and other countries discovered this in recent years.

Countries with flexible labour markets and fewer structural obstacles (such as the USA, the UK, Canada, Ireland and others) have been better able to absorb more quickly, in new expanding activities, the workers who had lost their jobs during the sub-prime crisis, than countries with rigid labour markets (such as Greece, Italy, Portugal, Spain and some others). Countries that had had better-controlled fiscal accounts could rely more easily and with more confidence on a fiscal expansion to try to raise aggregate demand. In these countries, investment and other economic decisions by private operators collided less against both the structural and the psychological obstacles (uncertainty and worries about the future) created by policies that some observers considered damaging and unsustainable. See Tanzi, 2015a.

Even in countries where structural obstacles seem to have been less significant, as in the United States and the United Kingdom – where, for example, labour market rigidity and red tape are less serious constraints – policy mistakes can occasionally lead to economic difficulties. In the United States, a monetary policy that became too accommodating for too long (now recognized by many as having been a clear policy mistake) encouraged excessive investment in housing and bubbles in some other areas (such as finance). The results were huge current accounts deficits and very low rates of saving. “Irrational exuberance” by investors, who had come to believe that the good times (and high and increasing housing prices) would continue forever, combined with the mistaken monetary policy to lead to the crisis. See Shiller, 2014. Many had believed that monetary policy conducted by wise policymakers (the “maestros”) had banned cycles forever.

The monetary policy mistake before the financial crisis, mainly by the US Federal Reserve, led to the financial and economic crisis that, initially, could not be blamed on lack of aggregate demand. Before the 2008 crisis, the US personal savings rate had been reduced to very low levels, the current account deficit in the balance of payments had become very large, and private and public debts were growing at fast rates. The bubble had also increased public revenue in the US and other countries, making the fiscal accounts look better than they were. See Tanzi, 2012. By any measure, the United States and some other countries were spending more than they were producing. This could not be defined as a situation where demand was lacking! The same could be said for several European countries, including Spain, Portugal, Ireland and some others. The economic situations in
these countries could not be taken as indicating lack of aggregate demand in those years. It is thus important to distinguish structural from demand-induced cycles. The cycles and the stagnation that follows them are likely to require different policies, and structural policies may be important.

Once the crisis came, the prices of houses and other assets fell, investment and private spending collapsed, many individuals lost their jobs and resources became unemployed. This led some to conclude that lack of demand had been the main problem and to call for fiscal stimulus programs. In some sense, low demand had become a factor, but it had resulted from the mismatch between the production of too many goods (that had kept too many peoples building houses or processing loans) and what the population wanted to buy, once the “irrational exuberance” was over. It would take time to rebalance the supply with the wishes of consumers, as Austrian economics would stress.

After the financial shock, the United States was able to enact a large fiscal stimulus package, assisted by very accommodating and highly unorthodox policies by the Federal Reserve. The Fed’s actions became more and more fiscal in spirit if not in name and the distinction between fiscal and monetary policy became opaque. See Tanzi, 2013. Both the government and the Fed’s policies aimed at generating demand, but the monetary policy created more demand for existing assets than for newly produced goods. The monetary policy had the additional objective of saving some of the same financial institutions that had contributed to the sub-prime crisis with their behaviour.

Because of its better structural policies, which facilitated the reallocation of resources across sectors, a sustainable (at least in the short and medium term) fiscal situation, and the highly accommodating monetary policy followed by the Federal Reserve, which made the fiscal expansion less costly for the government, the US policies, after some years, produced some beneficial results in terms of employment and growth. The same was largely the case in the UK. Of course, nobody knows what would have happened without those policies. To a large extent, recessions create antibodies that, in the absence of significant structural impediments, tend to bring back normal times, as has happened many times in the past.

Several European countries did not have the same structural or fiscal conditions as the United States and the United Kingdom. Some had significant structural impediments, developed over many years, which had become increasingly constraining. In a world that was becoming more globalized and that required increasing adaptability and flexibility, these impediments could not fail to affect the external situations of several countries where the structural obstacles had significantly reduced the economic efficiency of the factors of production. As an example, the “total factor productivity” of the Italian economy, in the years before the crises of 2008, had become negative. In Italy there had been little or no economic growth for several years. At the same time the fiscal accounts, which had been a cause for concern for a long time, had become more precarious. The Italian situation was far from unique. Several other countries had experienced similar conditions. Their existing structural and fiscal situations had created less resistance to crises and greater difficulties in dealing with crises when they came.

Structural obstacles reduce the rate at which the potential labour force of a country can be absorbed in productive jobs, and also the rate at which a country’s savings can be directed towards genuinely productive investments. Experience indicates that countries that develop these structural problems are more likely to allow their fiscal accounts to develop undesirable features, both quantitatively and in terms of transparency, especially when fiscal rules are in place and countries attempt to
satisfy the rules by massaging the data. See Chapter 6 of Tanzi, 2013. In these countries, public debt is likely to grow, tax levels become more burdensome, and tax systems become more complex. Also, fiscal deficits, especially when measured correctly, without the massaging that they receive, are likely to exceed desirable levels, or levels determined by agreed rules, be these national or extra-national rules.

The above fiscal developments reduce the flexibility that governments have and should have in making needed changes in the economy and generate, on the part of some policymakers, negative political reactions against the fiscal rules that, they claim, tie their hands. They also raise questions, in the minds of economic operators, about the sustainability of the fiscal policies, because of the uncertainty they create about the future level of taxes and of spending programs. These conditions are not favourable to decisions by private economic agents related to long-term real investments. See Baker, Bloom and Davis, 2013, and Tanzi, 2015a on the question of the likely impact of policy uncertainty.

Given the above situations, when a crisis arrives, possibly imported from abroad, as the last one came to Europe, it may find the countries broadly separated into two groups: one group with fewer serious structural obstacles and with fiscal accounts that are, if not in equilibrium, at least in better shape; and the other group with serious structural difficulties and with more worrisome fiscal accounts. For this latter group, the crisis and the stagnation that follow are likely to require actions in both the structural and the fiscal areas to make them less constraining and more sustainable.

The question that we shall address in the next session is whether, regardless of the initial structural and fiscal conditions, these two groups of countries can react to the crisis in the same way.

Are the authorities of both of these two groups of countries in a position to abandon the “stupid [fiscal] policies”, often described as “austerity” by critics, and simply engage in spending programs, as some highly vocal and well placed economists continue to insist that governments do? To spend or not to spend, that is the question that the governments of several countries face.

5. Initial Conditions and Possible Policies

We start with fiscal policy. The question to be addressed is whether, regardless of what we have called initial conditions, governments can keep, or even press, the foot on the fiscal accelerator, while ignoring the “structural trees” that may have fallen on the road and that are blocking the forward movements of their economies. Can a fiscal stimulus that would increase shockingly high fiscal deficits and public debts, say in Greece, make a country’s output move closer to the estimated “potential” and reduce unemployment? Does a country’s economy respond to the fiscal acceleration regardless of its initial conditions? We shall ignore the other related question, of where the financing for the fiscal stimulus would come from, a question that is also important.

Two policy reactions are debated in Europe. The first, consistent with the “non-stupid” policy that Stiglitz and others advocate, is that, regardless of the initial conditions (regarding both structural problems and fiscal accounts), the governments should push the foot on the fiscal accelerator and spend more, abandoning “austerity”. This is what the newly elected government of Greece and some other governments might like to do, given the choice. They would increase productive or unproductive spending; or they might follow Summers’ wiser call to use the additional spending to repair and build infrastructure, taking advantage of the low interest rates that QE has made possible. In doing this, the EMU countries would have to ignore the Maas-
tricht rules and leave for a later time, or for later governments, the need to reduce fiscal imbalances.

The economists that advocate this policy believe that the fiscal stimulus would increase the rate of growth of the countries and, by so doing, might even contain, or reduce, the growth in public debt and in fiscal deficits that the additional spending might generate. The QE policies followed by the ECB and by other central banks have made this course of action easier, by dramatically lowering the borrowing rates for loans to governments. While the countries' governments would keep the foot on the fiscal accelerators to sustain aggregate demand, they would hopefully initiate structural reforms, as the Italian and the French governments have been promising and started to do, and as the Spanish, Irish and Portuguese governments have been doing.

The second policy reaction would be for governments to seriously focus on the needed structural reforms while, at the same time, doing their best to respect the Maastricht agreements on fiscal imbalances and to begin to correct their fiscal imbalances. This second course of action is necessarily more demanding, both politically and in terms of the needed policy actions, also because of the belief on the part of some policymakers, including those of France and Italy, that structural reforms are inevitably costly in fiscal terms. Therefore, it is more difficult to make them while at the same time trying to control or reduce the fiscal deficit.

As is often the case in economics, the correct choice may depend on several, country-specific factors. They include: first, whether it is true that the structural reforms necessarily require (much) spending; second, on the impact that the structural reforms would have on economic activity, and how soon that impact will be felt; third, on how imbalanced the fiscal accounts are initially, and how much uncertainty or concerns those imbalances have created. Finally, it will also depend on the effect that the quantitative easing policies have on the behaviour of governments and private economic operators. They might generate moral hazard for governments and difficult-to-predict reactions by the private sector.

The rest of this paper deals with these rather complex issues, recognizing that, politically, some alternatives are easier for governments to follow than others.

6. Structural Reforms without Fiscal Consolidation

Consider first the case of countries that decide to promote structural reforms without at the same time pursuing fiscal consolidation. Start with a country that has kept its fiscal accounts in reasonably good shape (which does not mean in equilibrium) before the economic slowdown. The public debt is at a manageable level; the tax burden is sustainable and is not creating significant disincentives for employment and economic activities in general; the fiscal deficit is easily financeable; and the country has broadly satisfied agreed fiscal rules. Given these conditions, the country could react to the economic slowdown or recession by pursuing an expansionary fiscal policy while, at the same time, it could attempt to remove some of the major structural obstacles, to make its resources more productive. The available fiscal space, made possible by the good fiscal behaviour before the crisis, would allow the country to use a fiscal stimulus without fear of negative market reactions.

The country could: reduce marginal tax rates; increase public investment; assist individuals who have been hit hard by the crisis; strengthen training programs for workers who have lost their jobs or who are looking for their first job; finance programmes that would make it easier for women with young children to work, and so forth. The structural reforms would aim
at making the economy more efficient over the medium run, while the additional public spending, or the reduction in taxes, would inject additional demand in the economy, without raising major concerns about the sustainabilility of the fiscal policy. Given the described situation, the need for fiscal consolidation would not be an immediate imperative, and a Keynesian stimulus package could be part of the package of policies that the government could adopt. In this case, a Keynesian expansion and structural reforms would complement each other.

Consider next the less favourable case of a country that really needs structural reforms (say Greece, Italy and some other European countries), but which before the crisis had allowed its fiscal accounts to become sufficiently imbalanced to have raised attention and concerns for some time. The situation could be even less favourable if, due to poor structural policies, the country’s economy had been growing at a low rate in the years before the crisis, or had not been growing at all. The high public debt had exposed the country to the vagary of changing spreads, with the potential to precipitate a fiscal crisis. The country may also have been using some tricks to make its fiscal accounts look better, as some European countries had been doing after the Maastricht rules had been introduced. See Chapter 6 of Tanzi, 2013. The tax level had become burdensome, especially on sectors not able to avoid or evade taxes; and spending on public investment and essential public goods had been reduced.

Given the situation described above, could a rational policy reaction to the crisis be that of focusing only on the structural obstacles, while leaving for a later time the need to deal with the fiscal imbalances? Or, as some have suggested, could it be to abandon “austerity” and adopt spending policies which ignored fiscal constrains? The supporters of this course of action argue that: (a) to deal with structural obstacles requires money; (b) the fiscal expansion will make the countries grow and will thus take care of the macroeconomic, fiscal problem; and (c) in any case, the ECB has made borrowing costless and because of deflationary dangers the ECB will continue with its highly unorthodox monetary policies, keeping low the costs of financing fiscal deficits, in the immediate and medium term.

7. Structural Reforms and Fiscal Consolidation

Let us comment first on statements made by some governments that they intend to pursue structural reforms but that to do so, they need to delay fiscal consolidation. They need some fiscal flexibility, because structural reforms require public spending. Some structural reforms may indeed need money. However, many reforms require more political courage than money. In any case, the pursuit of structural reforms may not reduce the need for fiscal consolidation when such a consolidation is required. However, it may justify some adjustment in the speed at which the fiscal consolidation is pursued.

This section will mention examples of structural reforms that require little money and some that may require some spending. Italian examples will be used, not because they are unusual but because the author is more familiar with them. Examples from other countries could have been used.

We shall start with structural reforms that put the emphasis on public investment, because many seem to believe that public investment is the natural path to higher growth. Spending on public infrastructure has attracted particular attention on the part of the European Commission and of some economists, including especially Larry Summers in the USA, and Mario Monti, the former prime minister of Italy. Over the years, some economists have asked that spending on public investment be excluded from the calculation of the fiscal deficits that would satisfy the Maastricht rules. Against much empirical evidence to
the contrary, there continues to be a belief that more spending on infrastructure automatically leads to growth. Such spending may facilitate future growth but it does not lead to it.

Structural reforms aimed at building large infrastructure projects do require money. This is the kind of spending, recommended by Keynes in the years of the Great Depression, and made by President F.D. Roosevelt, and by President Hoover before him, in the United States. See Wapshott, 2011. Infrastructure projects can be costly, they may require several years to complete and become productive, and they require long term financing. Inevitably they increase public deficits and public debts, at least in the short and medium run. Therefore, when public debt is already high and fiscal deficits already exceed levels that raise concern, great care should be taken before a country that is already facing fiscal difficulties decides to engage in them. Because this kind of spending is now being pushed by some vocal economists and by policymakers, it may deserve some additional comments.

First, given the precarious situation of the public accounts in many countries, it would seem advisable to avoid projects that require large amounts of money and many years before they can be completed and become productive, unless the costs can be shifted to someone else. During the construction phase, the building of these large projects often becomes a drag on the potential of the economy, because of the disruption that it creates. Especially when the fiscal situation invites prudence in public spending, it may be preferable to delay, until better times, projects that are expensive and slow-to-become useful and that would increase fiscal deficits and public debts.

Second, projects that are attractive in terms of political prestige but that are uncertain in terms of economic profitability, such as, for example, the bridge that would connect Sicily with Italy, may tend to be given priority by some governments, in spite of their questionable merit on purely economic terms. These projects in particular should be avoided, or at least delayed until better times. A time characterized by fiscal concerns would not be the right one to build what may be largely political monuments.

Third, if an infrastructure project is truly attractive economically, it might be possible to encourage some private concern to undertake it, through public-private partnership (PPP) arrangements. PPPs do not require public spending, at least not initially. In recent decades these arrangements have become common in many parts of the world. There are specialized private concerns that operate globally and that could undertake projects that have good potential. If well planned, PPP arrangements may permanently reduce public spending, while at the same time they may contribute to the supply and the demand side of the economy. However, governance issues have often arisen in connection with these projects. Therefore, there is great need for transparency in the agreements, especially in countries where corruption is not rare. These projects can at times put governments at risk. See Polackova Brixi and Schick, 2002.

Fourth, it is essential that only projects that have been subjected to, and have passed, a competent and rigorous evaluation of cost-benefit analysis should even be looked at. Public investments are often pushed by special interest groups and promoted by political considerations, rather than by their intrinsic value.

Fifth, especially when the public accounts are in a precarious condition, it becomes even more important than in other times that the decisions involving these projects are made corruption-free. Unfortunately, corruption has been a faithful companion of public investment projects and has added large percentages to the costs of these projects in many countries. See
The reform of the public administration, to reduce red tape and administrative impediments to economic activities, would be important in countries where red tape has been a major obstacle to economic activity and to growth, as reports by different organizations and especially by the OECD and the World Bank have shown. Red tape provides employment to public employees, both at the national and the local government level, to essentially impede economic activity. The removal of these obstacles would make economies more efficient and more dynamic. It would also boost demand, because many activities have been stopped, or have been slowed down and made more expensive, by red tape. With the removal of red tape, these activities would become free to be started, creating both additional demand and employment. Countries with significant problems of red tape are likely to have backlogs of potential private projects waiting to be started. Administrative reforms would also reduce corruption. These reforms might also reduce the number of public employees who are now in charge of administering red tape. They would thus reduce public spending.

Closely connected with the need to reduce red tape is the need to reform justice systems that have become dysfunctional in many countries. Some Italian studies have shown that the more lawyers and employees there are in the justice system of a region, the less efficient is the work of that system in dealing with judicial processes (bankruptcy, enforcement of contracts, settlement of disputes, and others). See Sileoni, 2013, D’Ambrosio, 2005, and Tanzi, 2015c. The reform of justice systems should be a priority for countries and should not require much public spending. Rather, it would require better rules, better administration, more efficiency and better monitoring, as well as the introduction of incentives to encourage better performance.

Sixth, when truly necessary, it should be possible in some countries to consider financing new public investments by privatizing some public enterprises, or by selling some public assets that are not productive. In this way, the "net worth of the public sector" could be maintained, while the items that make it up would change, making it more productive. This would help prevent the rise of public debt.

Reforms of labour markets should not require money, or much money. If they succeed in generating new employment and do so in relatively short periods of time, they may even contribute to raising public revenue. Rigid labour markets reduce employment opportunities for potential workers and tend to raise labour costs for employers. They also stimulate underground economic activities that, by increasing tax evasion, reduce the public sector’s revenue. They restrict the share of the population that makes up the labour force. Rigid labour markets reduce both the rate of growth of an economy and the revenue that the government receives and, probably, end up increasing public spending. However, a more flexible labour market would allow some employers to fire workers with greater facility than in the past. Therefore, in the short run, it might require some time-limited safety nets for individuals who were dismissed from their jobs. These additional costs are likely to be counterbalanced by the positive effects of a flexible labour market on the economy. The Renzi government in Italy is introducing what could become an important reform in the labour market.

Tanzi and Davoodi, 1998. In 2012, the Italian Corte dei Conti estimated that corruption had added on average about 40 percent of the total cost of public investment projects. Clearly corruption had reached levels that were important in macroeconomic terms. Recent scandals have indicated that the estimate by the Corte dei Conti was not an exaggeration.
Health systems are also often in need of reforms to make them less costly and more efficient. In Italy, for example, there are wide differences in the performance of the health system between some regions of the North, especially Lombardy, and some regions of the South, especially but not only Sicily and Campania. Similar levels of spending seem to produce far better results in some Northern regions than in some Southern regions, even though, overall, the Italian public health system produces relatively good results, in terms of life expectancy and other relevant indices. Once again, the reform of this area of public sector activity should not necessarily require more public spending but better organization, accompanied by the introduction of better incentives and controls.

The same may be true for the educational sector. Lack of competition among schools and among school districts, lack of modernization of curricula, lack of incentives, inadequate preparation on the part of teachers, and attempts to bring schools to the doors of students, rather than the other way around, have created great disparity in the quality of the educational output and in the ratios between students and teachers across areas and regions. In this sector, reform might require some additional spending, because of the need to modernize school buildings, to introduce modern equipment, such as computers, and to bring new and better-prepared teachers, including foreign language teachers. Adjusting the working days per year and the working hours per day, letting go of outdated and inefficient teachers, closing schools with too few students, and bringing the curriculum up to modern needs may require additional money and better organization. Bringing more competition into the system, especially at the university level, and encouraging more experimentation by schools would help. The work by the OECD has provided useful information for possible reforms.

In some countries, such as Italy, the reform of the architecture of the public sector (elimination of provinces, reduction of number of municipalities, reduction of the number of members of parliament, reduction in the number of public museums and similar institutions), may also be a fruitful road that could reduce public spending and generate savings. Also the reduction of many unproductive rituals from government activities may help. See Tanzi, 2015c.

In conclusion, intelligent structural reforms can have an important impact on economic activity and many of these reforms do not necessarily require much additional public spending but would require full government attention. The initiation of some of these reforms should not be used as an excuse to delay or to ignore the need to take better control of fiscal accounts when those accounts are still so imbalanced as to create concerns and uncertainty for private operators. At the same time and in particular cases, there might be some trade-offs between the pace at which the structural reforms are actually introduced (as compared with promised) and the adjustment of the fiscal accounts.

8. General Conclusions

Objective and informed observers would probably agree that in several countries, and especially in several members of the European Monetary Union, impediments to private investments and to other desirable economic actions had reached worrisome levels over the years due to the existence of inefficient structural policies. Structural reforms are therefore badly needed if these countries are to return to sustained growth, in a world that is becoming more demanding and more competitive. Those observers would also agree that, in several countries public debts, public spending and fiscal deficits have continued to exceed prudent levels, not to mention the agreed Maastricht rules. The Maastricht rule on public debt was largely ignored over
the years. In different ways, the above factors are likely to have become impediments to economic activity and to economic growth. Policies that reduced both the structural impediments and the fiscal imbalances would make the countries' economies grow.

However, some well placed and vocal economists have continued to promote the view that, because of continued high unemployment and low or no growth, the countries might ignore the reforms mentioned above and take advantage of two free lunches. The first is the one offered by a fiscal stimulus, one that would get rid of “austerity”, and engage in additional public spending. They believe that such additional spending, magically and regardless of the existing structural impediments, and of the precarious state of their fiscal accounts, would generate growth and increase public revenue. For these economists the connection between the abandonment of “austerity” and the resumption of growth seems to be a simple and obvious matter. Only “economic stupidity” is preventing policymakers from seeing that connection, and from taking the right steps! These economists blame lack of adequate public spending and policies of “austerity” for the economic stagnation, not the structural impediments and the precarious fiscal situations.

Given the danger that some observers now see as coming from possible deflation – a term that no longer means what it used to mean; that is, it is no longer defined as a sustained fall in the average price level, but, rather, as a price level that does not grow at an annual rate of near 2% – the second free lunch can come from central banks making available to the economies huge amounts of money, through new, highly unorthodox policies, called quantitative easing. A lot of nonsense is being written these days about deflation and its presumed effects, even by serious newspapers such as the Financial Times. On those presumed effects see Bachmann, Berg and Sims, 2015.

The quantitative easing policies, which are de facto largely fiscal policies in disguise, make loans available at zero, or even at negative interest rates, to privileged sectors of the economy, and not to everyone who wishes to borrow. They make it possible for (some) governments to borrow, directly or indirectly, from the central banks, a policy that used to be considered a taboo. For many centuries, at least since Cicero’s time, public debt and borrowing by governments had been seen as sins or vices. Prominent figures of the past, such as George Washington, Napoleon, David Hume and others, had considered borrowing by governments as clear sins to be avoided. However, in a trend that became popular in our times, Keynesian economics converted what was a sin into a virtue. It is no surprise that the world is now drowning in debt. See McKinsey Global Institute, 2015.

These two free lunches, if they truly existed, would make it possible for a country to spend more, possibly borrowing directly or indirectly from central banks at very low or zero rates, promote growth with the extra spending, and repay the borrowed money at a later time, all effortlessly and without problems. Such a wonderland or marvellous new world, if it existed, would be a truly nice one to live in, for ministers of finance and for policymakers in general. It would certainly be different from the world of the past. For sure, that world requires that economists suspend much of the economic knowledge that they had learned from past centuries (from “dead economists”?) and relearn new economics. See Tanzi, 2015a. One must wonder if “dead economists” are always necessarily dead wrong!

Some would make this world even more attractive for the countries now in difficulties within the European Monetary Union, by asking that those countries that are in better economic conditions provide fiscal transfers to the countries facing difficulties. See Tanzi, 2013 and 2015b. These transfers could be made either through debt cancellation, through sharing of risks on
new debt, or even for some countries, such as Germany, engaging in policies that would increase their public spending and their rate of inflation, making them less competitive in comparison with other EMU countries. Just make Germany more sinful and the other EMU countries would be better off.

If the world described in the last paragraphs reflected the current reality, then the countries facing economic difficulties could be encouraged to try to promote structural reforms while ignoring Maastricht rules and other impediments, or even by spending more while making those reforms. These policies would be consistent with the belief that it is the short run that must receive attention, because, as is stated ad nauseam, "in the long run we are all dead".

The author of this paper still has doubts as to whether we have truly entered this new, pleasant world. He is reminded of what the Austrian economist Von Mises wrote decades ago, in reaction to the Keynesian view that "in the long run we are all dead". As he put it, the trouble with that view is that "nearly all of us outlive the short run and ... spend decades paying for the easy money orgy of a few years". As Greek and other policymakers have discovered, it is far easier to accumulate public debts and far more difficult to deal with them, unless rich uncles are willing to step in to pay for them.

9. References


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