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Convergence and Divergence in Public Finance

The current crisis has led to an almost instantaneous convergence on the view that fiscal policy needs to be used vigorously to mitigate the impact of the financial crisis on the real economy. This convergence of view is global. Governments on all continents have recently announced large stabilisation packages, with little opposition from economic experts. There are serious arguments for this sudden conversion to the view that the government must intervene to sustain demand: official (central bank) interest rates are rapidly nearing zero almost everywhere, implying that monetary policy might have become ineffective. Moreover, with interest rates apparently at historically low levels on most maturities most models indicate that fiscal policy should be particularly effective in stimulating demand since under the present circumstances higher deficits apparently no longer crowd out investment or other expenditure through higher interest rates.

This sudden preference for an active fiscal policy is thus usually motivated by the need of the present exceptional circumstances. However, a closer look at the data suggests that there have been some important shifts in public finance that started well before the financial crisis became the dominant theme. Moreover, it might well be that it will be more difficult than currently anticipated to reduce government expenditure once the crisis is over. The share of the government in the economy might thus increase on a longer term basis.

Anglo-Saxon public finance used to reflect the Reagan/Thatcher legacy of small government and low taxation. However, the difference between Anglo-Saxon and (continental) European public finance has been changing gradually over the last decade as expenditure has trended upwards in the USA and the UK, whereas it has been under control in most of continental Europe. In this sense there has been convergence. The convergence in expenditure patterns will actually accelerate as the result of a shorter term divergence which concerns the response of fiscal policy to the financial crisis: fiscal deficits are increasing much more in the Anglo-Saxon world than on the continent. The key reason for this latter difference might lie in the dif-

ferent financial situation of Anglo-Saxon households. The remainder addresses these three issues in turn.

Convergence of Expenditure Ratios

A key indicator of the present and future tax pressure is the ratio of total public expenditure to GDP because all expenditure has sooner or later to be financed by taxation. On this account the USA and the UK started ten years ago with a strong advantage as their expenditure ratios were below 40% of GDP, compared to close to 50% in the euro area (and Germany), giving the UK an advantage of more than 8 percentage points and the USA one of close to 14% of GDP. This advantage has been completely lost in the case of the UK (in whose case one can use the 2009 projections from the Commission as the fiscal response to the financial crisis has been more on the revenue side (e.g. VAT reduction in the UK)) and has been almost entirely lost in the case of the USA. In the UK general government expenditure is now at 47.2% of GDP, slightly higher than on average in the euro area. This implies that the UK has de facto to become a high tax country. The deterioration is even more pronounced relative to Germany which over recent years has decisively cut back on public expenditure, from slightly above the euro area value to around 44% of GDP today, about 4 percentage points below the UK value. In this sense Germany has positioned itself as a future low tax country within Europe (at least until the most recent stimulus package was decided).

For the USA it is more difficult to get precise numbers, but the intention of the Obama administration seems to be to increase public expenditure massively. It is thus likely that the USA will soon have a government that has about the same economic role in the economy as in Germany. Sooner or later taxes will thus have to increase to the German level.

Moreover, the share of the government in GDP also indicates roughly the importance of the automatic stabilisers. With this convergence in expenditure patterns automatic stabilisers have also become roughly similar on both sides of the Atlantic.

Table 1 illustrates these trends allowing for a comparison of present expenditure patterns with those of about ten years ago (around the start of EMU). As the fiscal plans are constantly changing, the numbers for

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Table 1
Total General Government Expenditure
in % of GDP

	(A) Average 1997/2001	(B) 2009/10	(C) Change (B)-(A)
Germany	47.4	45	-2.4
Euro area	47.7	48	+0.3
UK	39.1	49	+9.9
France	52.5	55	+2.5
USA	34.8	42	+7.2

Sources: Ameco; own estimates.

2009/10 can be only rough estimates based on the published stimulus packages in different countries.

Divergence (in the Fiscal Policy Response to the Crisis)

The deterioration in Anglo-Saxon finances is immediately apparent from the numbers for the deficits. Here again the deterioration set in well before the current crisis: over the 5-year cycle 1997-01 the UK and the USA had a deficit about one full percentage point below that of the euro area. In 2007, thus even before the financial crisis hit the UK and the US economies particularly hard, this had already changed completely with both Anglo-Saxon countries running a deficit just below 3% of GDP, two percentage points above the euro area value. Compared to the euro area the deterioration was thus equal to three percentage points of GDP – over a period during which the Anglo-Saxon economies were widely assumed to be performing much better, supposedly because of their more innovative financial markets.

Given the large fiscal stimulus packages, again in both Anglo-Saxon countries (already decided in the UK, still to be formalised in the USA) this trend is set to continue over the next years. For 2009 the Anglo-Saxon deficits are now projected at around 9% of GDP and 2010 is anybody's guess.¹ By contrast, the deficit for the euro area can be expected to be closer to 4% of GDP, a gap of five percentage points.

As an aside one might note that this implies that deficits of this magnitude are clearly not sustainable. At some point in the not so distant future the UK and the USA will thus have to undertake a massive fiscal retrenchment. This will be a challenge from both the economic and political point of view as growth is likely to remain weak under the combined influence of a weak housing and financial sector.

What is the reason for this striking difference in the response of fiscal policy to the looming recession?

¹ Currently it is expected that the deficit will increase even further in both the UK and the USA.

Table 2
Fiscal Deficit in % of GDP (General Government)

	Average 1997/2001	2007	2009 expected November*	2009 expected early 2009**
Germany	1.6	0.2	0.2	2.9
Euro area	1.6	0.6	1.8	4.0
UK	0.6	3.8	5.6	8.8
France	2.1	2.7	3.5	5.4
USA	0.4	2.8	7.2	8-10

Sources: *Ameco; **Commission forecast of January 2009.

Most predictions for 2009 imply currently that the loss of growth should be fairly uniform across Europe, mostly in the 4-5% range as growth goes from about 2.5% to minus 2% almost everywhere. It is widely expected that the recession will actually be somewhat shorter in the USA. Predicted growth rates for the USA are somewhat higher for both 2009 and especially for 2010.

The key reason for the difference in the revealed preference of governments in terms of the use of fiscal policy is probably very simple: there are important differences in economic structures which make fiscal policy much more effective under the current circumstances in Anglo-Saxon countries. To put it succinctly: tax rebates and transfers can help the insolvent Anglo-Saxon household to maintain consumption. But the solvent German household is likely to add any additional income, which is known to be temporary, to its already considerable savings.

Differences in the Financial Situation of Households and the Effectiveness of Fiscal Policy

Many discussions about fiscal policy remain abstract and national "stimulus" plans are usually reported in terms of one headline figure, namely the increase in the budget deficit that is expected from them. However, the effectiveness of a stimulus plan should not be measured by the increase in the deficit, but the increase in overall demand it provokes.

The most direct way for governments to increase demand is to buy goods and services directly from the market. However, it is not widely recognised that it is difficult to obtain a large boost quickly in this way since most European governments spend very little this way. Table 3 documents this for the major expenditure items.

Governments spend about one fifth of GDP on consumption of goods and services. However, this expenditure category cannot provide a sustained boost to the economy since one cannot stock these items for future use. This leaves public sector investment as

Table 3
Expenditure of General Government as % of GDP

	Final consumption	Social transfers	Investment
EU27	20.6	15.3	2.6
EU 15	20.8	15.4	2.5
Euro Area 16	20.3	16.0	2.6
United States	16.6	19.0	3.4
Germany	17.6	16.5	1.5
France	23.0	17.4	3.2
Italy	20.5	17.7	2.3
Spain	19.3	12.6	4.0
UK	21.4	10.0	2.0

the most often mentioned expenditure category, which has the added advantage that higher public sector investment today should lead to higher productivity tomorrow.

However, one has to keep in mind that public sector investment represents only 2-2.5% of GDP and is difficult to increase quickly since the large projects, which make up the bulk of the expenditure, take often a decade or more to realise. Even if governments were able to increase public investment by 20% in one year this would result in a fiscal impulse of less than 0.5% of GDP. In the USA public sector investment is expected to increase by about 40%, from 2.6 to 3.6% of GDP (in 2009).

In reality fiscal policy must thus, if it wants to be effective immediately, work through transfers to the private sector, either via lower taxes or via higher transfers to households. The key problem here is that under the present circumstances of extreme uncertainty households might just save any increase in their disposable income. How likely is this to happen? A key factor will be the financial position of households themselves: households that depend on credit to finance their consumption will be most affected by the credit crunch and are thus most likely to react to a tax cut by maintaining their consumption. For this type of household a tax cut (or an increase in expenditure) will thus be an effective tool to prevent an even sharper drop in consumption. However, for households which do not depend on credit the situation is quite different. Households that are saving anyway will probably at present just increase their savings in response to an increase in their disposable income which they know to be temporary.

This implies that the effectiveness of fiscal policy will vary greatly across the EU. Table 4 shows that in only two of the larger member countries are households on average net borrowers. Not surprisingly this is the case in Spain and the UK. In these two countries (with

Table 4
Net Lending of Households

	Euro billion	% of income
Germany	+ 144	9
Spain	- 27	-5
France	+ 66	5
Italy	+ 63	5
UK	- 97	-8

Source: Ameco.

the largest housing bubbles) fiscal policy should thus be effective. However, in the three other large member countries households are on average net savers. In these countries, and in particular in Germany where households are net lenders to the tune of about 10% of their disposable incomes, fiscal policy will not be effective as households can just increase their lending in response to a tax cut. The experiences of the USA and Japan point in a similar direction. In Japan the government has been running very large deficits, but an increase in private savings has completely offset this, leaving domestic demand flat for a decade. Even in the USA, where the private savings rate has been close to zero, households still choose to save a large part of the tax rebate implemented in the early summer of 2008.

Concluding Remarks

With the global economy in an unprecedented recession it is natural that attention is focused on the various fiscal stimulus packages enacted almost everywhere, in Europe, the USA and even China. This contribution argues that there had already been some convergence in the share of the government between Anglo-Saxon and continental European countries even before the increases in public sector expenditure programmed now. Germany in particular stood out until recently as moving towards the lowest public expenditure share in GDP, lower even than the "Anglo-Saxon" average.

The strong financial situation of households in most of continental Europe (and, again, particularly in Germany) suggests that tax cuts and increases in transfers will have only a rather limited impact on private demand. The actual impact of the recently enacted stimulus packages in Germany and elsewhere in Europe might thus be quite limited. By contrast, one would expect that the over-indebted households in the USA and UK will react much more to similar measures. Fiscal policy should thus be much more effective in the Anglo-Saxon world, which might be why this is also where the call for a fiscal stimulus started and where the deficits are now the highest.