Avoiding decades of distributional conflict
Recovery, fiscal adjustment and socio-economic renewal

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The world is in the midst of the most serious economic crisis since the 1930s. The downturn has been longer and deeper than any recession in 75 years, and it has affected almost every developed, emerging, and developing economy.

Even more troubling, recovery from the Great Recession has been limited and halting. Europe is now in its second recession in five years, with skyrocketing unemployment in some countries and generalised stagnation in the region as a whole. The United States is doing better, but even there the improvement in economic conditions has been very weak.

This does not seem to be a typical cyclical recession – and it isn’t. The world is suffering through a series of interrelated debt crises. And debt crises are different from cyclical recessions, for both economic and political reasons. We have already lost one decade to the current crisis, as the economic gains of the 2001-2007 have since been erased. If we are to avoid another lost decade, we need to understand how this crisis is different, and what can be done to limit its negative effects. Indeed, as events of the past couple of years show, the danger is not just of losing another decade, but of spending the remainder of this decade in a near-constant state of crisis and stagnation, with the threat of a truly global depression not so distant on the horizon.¹

The crisis is the result of a decade of debt-financed consumption. In some countries, this was led by the public sector, with large-scale deficits. In other countries, the borrowing was largely or entirely private, typically by or through the financial system. In virtually all cases, borrowing was not associated with increased investment, public or private, but rather with increased consumption. This expansion of consumption led to a boom – especially in asset and housing markets – and then a bubble, which eventually burst.

Such a debt crisis leaves a very difficult economic and political residue. On the economic front, it saddles society with a serious debt overhang that hampers recovery. Debtors, burdened with more debts than they can easily service, need to reduce consumption and increase savings in order to mobilise resources. Creditors, encumbered with trillions in debts they know to be bad or fear may be bad, have to struggle to adjust their balance sheets to compensate for expected losses. On both sides, then, growth is constrained by limited spending and limited lending. Indeed, in the major debtor nations in the United States and Europe, adjustment has not proceeded at anything like the pace necessary to restore balance. It will undoubtedly be several

years before we see American and European consumers spending in the usual ways, and before we see the American and European financial systems playing their appropriate role as intermediaries between savers and investors.

**The many faces of distributional conflict**

Politically, debt crises lead to conflict over the distribution of the adjustment burden. When, as in the current case, cross-border debts are at issue, there are two dimensions of conflict. First, creditor countries and debtor countries square off to see which will undertake the bulk of the costly adjustment: creditors demand debtor austerity to maintain debt service, while debtors demand a debt restructuring to make the debt more manageable. Typically, some compromise is worked out – after all, both sides have an incentive to reach agreement – but the battle over the compromise can be hard-fought and drawn out.

A second dimension of conflict erupts *within* countries, over who domestically will be asked to contribute to deal with the debt overhang. In creditor countries, for example, the question might be whether it will be financial institutions or taxpayers. In debtor countries, the issue is the distributional incidence of the austerity measures necessary to maintain debt service: taxpayers or beneficiaries of government services, workers or managers, the private or the public sector. Debt crises are never resolved easily; they always lead to substantial international and domestic political tension. The current crisis and its aftermath have been no exception, and in some instances the tension has only begun to manifest itself.

The crisis and its aftermath present the countries of the West with serious economic and political problems – both short-term and long-term. In the short run, the overriding imperative is to rekindle economic growth. Ironically, given the debt-overhang problem, this almost certainly requires stimulative fiscal policy. One saving grace is that at this point many governments are able to borrow at such low interest rates that it is almost certainly the case that the social cost of public borrowing is far outweighed by the social benefits of the stimulus. So we should have no compunction about insisting that so long as unemployment remains unacceptably high, and recovery lags, governments should pursue aggressive monetary and fiscal policies to speed growth.

There is another aspect to recovery, related to the heavy debt burden that weighs on economies. Simple fiscal stimulus will help, but it will not do much to address the very substantial debts that are slowing economic activity. Recovery will be retarded so long as these trillions of dollars in bad and questionable debts continue to constrain both creditors and debtors. This calls for a substantial restructuring of existing debts, such as takes place in virtually every debt crisis. There is no doubt that where debts cannot be serviced as contracted, it is in the interest of both creditors and debtors to find a resolution that allows a resumption of normal financial relations – after all, that is what bankruptcy proceedings are for.
In some instances, debts can be restructured by negotiation. The current round of sovereign debt crises in Europe may fall into this category: there are a few debtors, and a (relatively) few creditors, so negotiation is an option. However, most of the troubled debts today are of households, not sovereigns, and it is not feasible to plan a negotiated restructuring of tens of millions of mortgages and other household obligations. This suggests the value of a traditional way of reducing the real burden of accumulated debts: inflation. Several years of modest inflation, in the 3-5 percent range, would substantially reduce the extent to which debts foul the balance sheets of households in Europe and North America.

Debt restructuring is highly political, for whatever resolution is worked out – whether by explicit negotiation or by inflation – will harm some more than others. The crux of the problem is the asymmetry of the adjustment burden. Debtors have no choice but to adjust, inasmuch as they face grave difficulties with further borrowing; so creditors can insist that debtors do most of the sacrificing. But this inflames debtors, and often ends up with an explicit refusal to service debts. More generally, the result typically throws debtors and creditors into a game of Chicken, which can lead to a dramatic exacerbation of the political conflict. It also can cause grave delays in settling the issue, and delay only raises the cost of a debt crisis. Europe, of course, finds itself deeply embroiled in this characteristic, dangerous tug of war.

**Walking the spending tightrope: growth and debt restructuring**

So the immediate need in both Europe and the United States is for stimulative measures to rekindle economic growth, and systematic plans to restructure household and sovereign debts. Both sets of policies are highly controversial, involving as they do major conflicts of interests. But without both, the current recession is certain to lead to another lost decade as economies continue to stagnate and debts continue to hang over national economies.

Growth in and of itself is not enough: even with a rapid return to the growth rates of the ten years ago, many industrial societies would still be hampered by outstanding debts. For some, accumulated public-sector debts will seriously restrict the ability of governments to address national problems. For others, the debt burden weighs most heavily on households, and growth will not sufficiently ease this burden to allow households to return to normal spending patterns. Even in creditor countries, financial institutions are unlikely simply to be able to “grow out” of their problems without artificially restraining their lending in ways that themselves will limit economic activity. Governments will have to work both to rekindle growth, and to reduce the debt overhang.

However, there are longer-term problems that Western governments need to address. Most OECD countries face serious fiscal choices over the next couple of decades. Government revenues will not keep up with the demands of retirement and health-care programmes in most of the developed world. This is part of a more general phenomenon that afflicts many rich economies, the political difficulty of getting populations to agree to pay for the social and other programmes they want. In its basic form, this is not a question of how much governments should spend on social insurance, the military, or education, but simply how they will pay for
the things that voters want and are unwilling to see cut. For much of the past twenty years, governments have run deficits rather than fund their current expenditures, but deficit spending at these levels is unlikely to be feasible for the next twenty years. This is due both to the scale of the current financial crisis, and to the inexorable increase in spending as populations age. So one long-term problem is the need to find a way to square governments’ retirement and health-care commitments with their fiscal positions.

Fiscal pressures on governments are likely to become more binding; but future prosperity also depends upon expanding other important government programmes, and these in turn are sure to require more spending. Virtually all observers believe that the developed countries need substantial increases in the quality of their educational systems and economic infrastructures. This is particularly pressing as the pace of international competition quickens, inevitably, as the easy exports and easy consumption of the past decade fade into a distant memory. Economic growth will require substantial productivity advances, and this in turn requires a more highly skilled labour force, a more efficient economic infrastructure, and a more welcoming environment for technological innovation – all things that take money, including public money. This creates yet another long-term problem, for the appetite for more expansive public spending now seems very limited.

If, as is likely, it is economically or politically impossible to both sustain current levels of spending on social insurance, especially for retirement and health-care benefits, and increase spending on education and other productivity-enhancing public programs, there is likely to be conflict between those on either side of this tradeoff. The prospect is not a happy one, as we would all like to be able to satisfy both sets of needs; but the current financial and fiscal climate is such that we will undoubtedly have to make some hard choices along these lines. To some extent this involves intra-generational distributional issues – which retirees get what, which health-care benefits are cut – and to some extent it is inter-generational – whether we focus on care for the infirm and elderly now, or on increasing future prosperity. The tradeoff is not quite so stark, and most Western societies are rich enough that they can do both, but still there are choices to be made – which implies that there are political conflicts ahead.

Indeed, the political challenges are daunting. In the short run, governments need to stimulate economies with monetary and fiscal policies, and to undertake an aggressive restructuring of sovereign and household debts, whether by negotiation or inflation. In the long run, governments need to cover the large and increasing costs of their generous retirement and health-care programmes, and to expand expensive public programmes to enhance education and economic infrastructure. None of these policies presents insurmountable technical difficulties. All of them face extraordinary political obstacles, which may indeed prove insurmountable.

Attempts to pursue more stimulative fiscal policies run up against opposition from wealthier taxpayers, who have been much less seriously affected by the crisis and who understand that they will bear the principal burden of future taxation to service the debts that are incurred. Measures to restructure debts, whether by negotiation or by inflation, confront the hostility of
creditors in the financial community and more broadly among the (largely wealthier, largely older) saving segments of the population. Western political systems indeed appear gridlocked over these issues, with little prospect of a clear progressive way forward.

In the longer run, conflicts of interest are also likely to pervade future plans. Inasmuch as fiscal stringency is likely to be the order of the day, we will have to make hard choices between the generosity of retirement, health care, and other social programmes, on the one hand, and public investment in human capital formation, infrastructure, and other productivity-enhancing activities. There are powerful supporters – and powerful arguments – for both sets of policies, and no easy decisions to be made.

**Avoiding another lost decade**

In this context, those who want to keep progressive ideals alive in these difficult times should focus on three important goals. First, in the short run, the primary imperative is to ensure a rekindling of economic growth. This requires maintaining stimulative fiscal and monetary measures as long as they are needed. A government that imposes austerity too soon will only prolong, and worsen, the agony – after all, the longer the downward portion of the economic cycle lasts, the harder it will be for the public and private sectors to service their debts.

Second, in the medium run, governments need to make reasoned decisions about their fiscal positions. Almost all Western governments face serious challenges as populations age, pension obligations come due, and health care becomes more expensive. Many of our tax systems are in need of reform to make the more effective and less prone to abuse by special interests. But it is almost certainly the case that adjusting to the new demographic and economic realities will require some increased taxation and some reduced expenditures. These tasks can be accomplished in a way that shares both the pain and the gain, or their cost can be shunted onto those least able to protect themselves. The job for progressives is to try to make sure that whatever fiscal adjustments need to be undertaken are both justified, and just.

Third, in the current environment in which all attention is focused on short- and medium-term issues – recovery and fiscal retrenchment – we need to assert the importance of ensuring the quality of the future. This means, first and foremost, safeguarding or upgrading our societies’ educational systems. The economic, intellectual, political, and social demands of modern society require an ever better educated populace. This is an expensive undertaking, but the return on this investment in human capital formation well justifies the expense. Many of our societies also need an extensive programme to renew the physical and economic infrastructure, from bridges and railways to telecommunications. Again, this will be expensive, but it is the only way to avoid a deterioration of the quality of modern life. One way or the other, industrial societies will have to address three sets of tasks – the recovery, fiscal adjustment, and socio-economic renewal. Our job is to make sure that these tasks are accomplished in a way that benefits all, rather than a select few.
Can the West avoid a second lost decade? It will be difficult – not for technical or purely economic reasons, but because the measures necessary to rekindle growth and make it sustainable will be resisted by powerful interests. In the short run, stagnant economies need stimulative fiscal and monetary policies; but these will be opposed by those less affected by the crisis, as well as by wealthier taxpayers, creditors, savers, and those on fixed incomes. In the longer run, our economies need substantial public investments to improve our human and physical capital stock; but these will be opposed by those who want less government and lighter taxation.

Nonetheless, our goals should be clear. If we are to stave off another lost decade, and to prepare for a better future, we need macroeconomic policies to restore acceptable levels of economic activity, and public investment to power sustained and productive growth. All dimensions require balance – balancing macroeconomic expansion with prudence, long-term growth with fiscal responsibility, and fiscal responsibility with social responsibility. The balancing act is not simple, and the opposition is powerful, but the stakes are very high.