The Costs of the Financial Crisis 2008/09: Governments are Paying the Tab

by Sebastian Dullien

One could almost get the impression that the storyline of the global economic and financial crisis of 2008/9 is forgotten. Questions of bank regulation and financial sector oversight are hardly discussed in public anymore and legislative efforts to rein in speculative and highly risky activities seem to have petered out. Instead, the public debt crisis has taken center-stage. Around the world, discussion focuses on cutting public deficits, with a strong focus on cutting public expenditure and a secondary focus on raising general direct and indirect taxes. The debate has turned from one about obvious market failures, especially in financial markets, to one about alleged government failure. That is, governments spending much more than they take in as revenue and hence piling up increasingly unsustainable public debts.

However, if one looks into the details of the development of the public debt in many of today’s crisis countries, it becomes clear that it is precisely the economic and financial crisis of 2008/9 which has put the debt levels onto an unsustainable path. Prior to the crisis, countries such as Spain or Ireland and probably even the United States were on a path of (or at least close to) fiscal sustainability. After the crisis, markets now question public finance sustainability even in countries such as France.

In a study commissioned by the Friedrich-Ebert-Foundation, we calculated the costs of the global financial and economic crisis for Germany, a country which is not a core crisis country, but is often revered for its resilience in the crisis and its rapid recovery afterwards. In this study, we tried to pin down the costs of the crisis for the economy as a whole as well as for different groups in the country such as wealth owners, wage earners and the government. Germany is an important case study here as it did not experience a real estate bubble prior to the crisis. One can thus argue that the crisis costs can be seen as being completely exogenous to the crisis.

Computing the costs of the crisis is not as simple as one might think. It starts with the government sector. One cannot simply use the headline figures presented in the mainstream media on bank rescue packages and stimulus packages and add them up. Firstly large parts of the bank rescue packages have not been real costs to the governments. If a government gives a guarantee to a bank and the bank continues business without the government ever having to pitch in, this is not a real cost in the end. If a government injects capital in private banks and later sells off the shares again, only the net loss can be counted as a cost. If the government sells the shares for more than it has injected earlier (as has been the case for the Swiss measures to support the country’s large banks), there are no costs, but even profits. Only if the government has to inject money into the financial system in a way that it cannot recoup later, the injection has to be counted as a cost. Similarly, if a publicly owned financial institution has inferred losses, these are clearly net losses for the government. For these costs stemming either from direct losses of public banks or non-recoverable injections of public funds, we use the term direct costs of the crisis.

Secondly, stimulus packages cannot completely be seen as net costs. If a government builds new highways or repairs public buildings in the crisis as a stimulus measure, it incurs expenditure, but at the same time the value of the public’s assets increases. Again, as long as the government does not overpay and does not build useless gimmicks such as pyramids, this spending is not a net cost.

In contrast, tax cuts used to stimulate private spending might at least be net costs to the government; yet, if we are interested in the macroeconomic costs, we need to keep in mind that these tax cuts increase the disposable income of the private sector and hence are not net costs to the economy as a whole.

Be that as it may, looking only at expenditure for stimulus packages and bank rescue packages misses an important part of the costs: The automatic fall in tax revenues caused by the recession and the automatic increases in expenditure stemming from such a crisis, that is, for unemployment compensation. We have called costs of lost government revenue or higher transfers of lost output indirect costs.

Similarly, computing the costs for the private sector is not completely straightforward. If someone defaults on her mortgage and the value of mortgage backed securities falls, this is not necessarily a net cost to the economy. While the bank loses, the person defaulting on the mortgage might increase her net wealth. As long as both the debtor and the creditor are domestic, this does not change the net wealth of the economy. Only if the debtor is foreign, a default changes the net wealth of the country in question. However, just looking at losses in the financial markets again neglects important elements of the crisis costs: The loss of output and consequently wage and profit income of the private sector through the crisis. In parallel to the terms used for the public sector,
the private sector has borne both direct and indirect costs of the crisis: Direct costs are those caused by a fall in the net value of assets. Indirect costs are income flows foregone due to the crisis.

We calculated three scenarios: an optimistic rapid return to the old growth path; a slower return to the old growth path and a pessimistic scenario in which output never recovers to the pre-crisis growth path, but remains significantly below this path.

By now, at least until the summer of 2011, the German economy has developed roughly in line with our most optimistic scenario. The scenario assumes a GDP growth rate of 3.5 percent in 2010 and 2.8 percent in 2011. However, at the time of writing, there are some signs that the recovery is seriously slowing down and a risk of a new recession is emerging. Thus, it is unlikely that the most optimistic recovery scenario continues. One can probably say that the most likely real-world development will be between our most optimistic and the medium scenario.

Table 1 below presents the results of our computation. The first very interesting result is that indirect costs of the crisis dwarf direct costs. Total costs even in the most optimistic scenario are around €700bn, of which only a little less than €100bn are direct costs. In the less optimistic scenario, the ratio becomes €2154bn to €100bn. The second central result is that the government bears most of the crisis costs. Government revenue even in the most optimistic scenario (which now can be seen as the lower limit) has been hit by a total of €270bn or more than 10 percent of GDP. In the less optimistic scenario (which now can be seen as the upper limit), costs to the government even add up to about €800bn or more than 30 percent of current GDP. The third interesting element is that wage and transfer earners in Germany might not be quite as hard hit as sometimes feared. In the more optimistic scenario, their incomes are only reduced by €177bn, yet in the less optimistic scenario by €755bn. The low value for the optimistic scenario is probably a special feature only to be found in Germany and might be explained by the labour market policies during the crisis when the German government paid firms to keep workers on reduced hours instead of firing them (“Kurzarbeit”) which in turn led to a very low increase in unemployment in Germany during the crisis.

In international comparisons, the costs in Germany can probably be seen as rather modest. Germany has experienced one of the most vigorous recoveries after the crisis. Yet, already in Germany, the crisis can be seen to have been responsible for a significant deterioration of public finances. Wealth owners, who can be seen of the main beneficiaries of a deregulated financial sector which has finally wreaked havoc with the economies of most advanced countries, in contrast, have only borne a comparatively modest part of the crisis costs.

Table 1: Crisis costs for wage and transfer recipients, wealth owners and government in Germany

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Wage earners, transfer recipients</th>
<th>Wealth owners</th>
<th>Government</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Optimistic</strong></td>
<td>0</td>
<td>73</td>
<td>22</td>
<td>95</td>
</tr>
<tr>
<td>Direct costs</td>
<td>177</td>
<td>188</td>
<td>248</td>
<td>613</td>
</tr>
<tr>
<td>Indirect costs</td>
<td>0</td>
<td>73</td>
<td>22</td>
<td>95</td>
</tr>
<tr>
<td><strong>Less Optimistic</strong></td>
<td>755</td>
<td>527</td>
<td>777</td>
<td>2059</td>
</tr>
<tr>
<td>Direct costs</td>
<td>0</td>
<td>73</td>
<td>22</td>
<td>95</td>
</tr>
<tr>
<td>Indirect costs</td>
<td>755</td>
<td>600</td>
<td>799</td>
<td>2154</td>
</tr>
</tbody>
</table>

This imbalance in bearing the crisis burden should be kept in mind when measures to rebalance the public accounts in the OECD countries are discussed. Wealth owners here should at least pay a fair share of the burden. Specifically, this means that the balance between spending cuts and tax increases and the specific changes to the tax codes which have been part of many austerity packages need to be rethought. The first point here is that budgets should rather be balanced by tax increases than cuts in social security spending.

Second, when taxes are increased, a focus should be on those types of taxes which are borne by people who have in the decades before benefited the most from deregulated financial markets: This would mean a focus on increasing taxes on interest and dividend income, capital gains and wealth. In addition, one should also increase the income tax rates in the top tax brackets as these individuals disproportionately benefit from the investment opportunities in deregulated financial markets. Last but not least, these numbers support a financial transaction tax as well as a financial activities tax: Both make financial transactions and financial intermediation slightly more expensive and will secure that society at least gets a small share back of the costs that irresponsible financial markets and financial institutions have incurred.

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