Fiscal Sustainability – Selected Questions

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According to the latest Fiscal Monitor from the IMF[2], the fiscal situation in many countries represents a major challenge and a source of uncertainty for the near future worldwide. Despite making some progress in addressing sovereign debt problems in many countries, a key question remains how to sustain fiscal cuts without compromising or wiping out the so much needed economic growth. This article represents a synthesis of opinions and views on fiscal deficits and debt coming mainly from the IMF's Fiscal Monitor[3], and together with a description of fiscal sustainability and its selected challenges represents a reflection of the current global fiscal conundrum.

Introductory remarks

Fiscal deficit problems became one of the hottest topics in 2011 worldwide and it seems that it is going to stay this way for some (prolonged) time yet. Why are some nations desperately in debts and cannot find their way out and why are we amidst one of the biggest sovereign debt crises ever (in a sense that it is not a problem of only a few countries, but it seems to be prevalent among many developed countries)? The increasingly higher interdependency of countries is probably one of the main reasons. Fiscal problems in one country spill over to another almost seamless. Another nonnegligible reason could be that we experienced one of the worst credit crises just a few years ago. Simply said, banks made wrong decisions and instead of taking punishment in a form of huge losses and even bankruptcies, governments of many countries were willing to give them a big financial support. This financial bailout was defended as an inevitable step, as the sovereign governments tried to support the backbone of the whole capitalism – the banking system. But, that did not come for free. These governments had to take large debt in order to bail out the sick and bleeding banking system. Talking about not bailing banks out and basically letting the banking system fall apart would go beyond the concern of this article, but it would definitely be an interesting and challenging topic. There are, of course, other reasons, why some countries experience fiscal problems. Some countries are for example persistently collecting less revenue (taxes and other) than they are paying for their expenses. Why is this happening? Are these countries simply undisciplined or are there any external factors causing this situation? In some cases, governments are just undisciplined and unwilling to behave in a prudent way, because their main concern usually focuses on re-election. In other cases, external factors as wars, demographic structure of a population, natural disasters… etc. might cause an uneven (long term) balance of governments.

The budget deficit is a difference between the expenditures of government and revenues that government collects. When the expenditures do not contain interest paid on the previous debt, the difference between expenditures and revenues is called a primary deficit. Running country on a deficit is during difficult times unavoidable. There will always be two sides with disagreeing opinions about the role of a deficit. Is it OK to borrow every year a bit or should we stop indebting not only us, but also our children right away? An interesting quote from Benjamin Friedman appeared in the paper by Galbraith and Darity[4]. He expressed an opinion about America's unhealthy practices concerning too large indebtedness that could lead to serious imbalances and problems in the future. Interestingly, already in 1990s Friedman presented quite forward looking opinion. What does it mean to live on debt? When a country consistently produces deficits on a yearly basis, it cumulates to its national debt. This country needs to finance its debt, and the only way how to do it is to borrow from someone else. Usually, countries borrow from other countries, big banks or large institutional players by issuing bonds that these counterparties are willing to buy. This way they become effective lenders to a country that needs to finance its (accumulated) deficits and/or roll over its debt. The more credible and solvent the country appears, the better bond conditions it usually can negotiate (usually an interest rate paid to a lender or other bond characteristics).

Table 1 shows national debt levels of selected countries in 2010. As we can see, countries with the highest debt level are mainly the countries from the developed world, which is also documented in a world map of government debt on Wikipedia[5]. Interestingly, emerging countries that are expected to be the biggest contributors to the world's growth have generally low debt level ratios.

How can we fight deficits? The best, but not always easy way of fighting deficit is to "grow out of it". This means that the economic growth will boost a country's GDP much faster than its costs and debt. So, relatively speaking, the debt will

1 *The author of the article is a PhD candidate at the Faculty of Economics and Business of the Pan-European University in Bratislava.*

2 *IMF: Fiscal Monitor. Addressing fiscal challenges to reduce economic risks. September 2011.*

3 *IMF: Fiscal Monitor. Shifting gears (Tackling challenges on the road to fiscal adjustment). April 2011.*

4 *Galbraith, J.K., Darity, W. 1995. A guide to the deficit. In: Challenge, July – August 1995, p. 5 – 12. The quote by Benjamin Friedman in Galbraith and Darity (1995): "…course upon which the United States economic policy was launched in the 1980s violated the basic moral principle that had bound each generation of Americans to the next since the founding of the republic: that men and women should work and eat, earn and spend, both privately and collectively, so that their children and their children's children would inherit a better world. Since 1980 we have broken with that tradition by pursuing a policy that amounts to living not just in but for the present. We are living by running up our debts and selling off our assets. America has thrown itself a party and billed the tab to the future. The costs, which are only beginning to come due, will include a lower standard of living for individual Americans and reduced American influence and importance in world affairs."*

5 *http://en.wikipedia.org/wiki/Government_debt accessed on December 29th, 2011.*

Table 1 Debt of selected nations in 2010 (as % of GDP)

Country	(% of GDP)	Country	(% of GDP)	Country	(% of GDP)
Japan	220	Austria	72.15	Denmark	43.65
Greece	142.76	India	67.25	Turkey	42.15
Italy	119	Brazil	66.84	Slovakia	41.78
Belgium	96.67	Netherlands	63.68	Ukraine	40.06
Ireland	94.92	Spain	60.12	Sweden	39.7
USA	94.36	Norway	55.42	Czech Republic	38.54
Germany	83.96	Poland	54.98	Slovenia	37.26
France	82.39	Switzerland	54.52	China	33.83
Hungary	80.2	Argentina	49.10	Australia	20.5
UK	75.50	Finland	48.39	Russia	11.75

Source: IMF Fiscal Monitor (September 2011)[6].

decline. Another way how to get rid of huge debt is to allow hyperinflation and introduce so-called monetization of debt. This might, however, bring about some serious social problems and unrest, because besides eliminating country's debt, people's savings and welfare will be essentially eliminated, too. The third and the most drastic way is to allow a country go bankrupt, when it cannot meet its debt obligations anymore. It is a tough (market) solution, where many stakeholders would suffer huge losses – the country that borrowed finances has to undergo painful reforms and will face long term financial sanctions; the lenders that lent their finances in a hope that they would get it one day back, have to accept the fact that this investment might be gone forever…etc. Here the phenomenon of huge interdependency among many countries makes the third (and the most painful) solution hardly acceptable. The whole sovereign debt problem gets hence magnified several times into huge size. Sometimes this size can be so overwhelming that it is better (is it really?) to save the debtor at any cost than let him go bankrupt. The worries about financial destabilization are too big and there is too much in stake for many influential stakeholders.

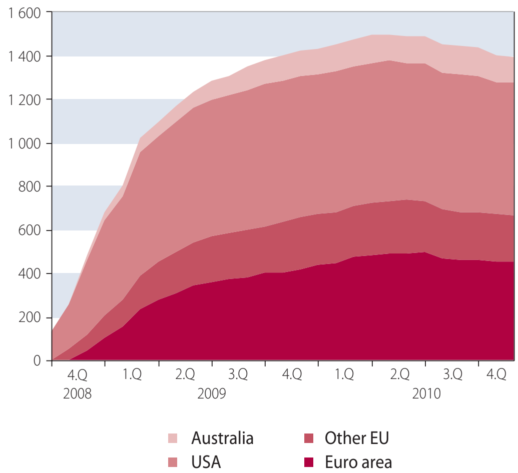
Still rising debt ratios, financing costs at historic highs and the fact that never since the World War II did it happen that the world's average government gross debt would exceed 100% of world's GDP already suggest in how serious situation we are. Generally, a speedy adoption of credible risk-reducing measures in developed countries in order to make significant fiscal adjustments is needed and in many countries was to some extent carried out. Some countries managed their situation successfully, some are still struggling with convincing investors about sustainability of their fiscal debt reducing plans and some countries buy time and do nothing. Japan for example had to defer its fiscal cuts due to the earthquake and nuclear disaster in 2011 and the US is the only developed country that has been so far only talking about government deficit cuts, but no real actions have been implemented yet (although they declared big government spending cuts, but these will become effective only in 2012 or later). When it comes to emerging economies, in their Fiscal Monitors, IMF generally recommends using good times wisely (e.g., in a form of building fiscal buffers). Therefore, the emerging economies should make use of prevailing favourable factors (e.g., large capital inflows, high commodity prices …) and prepare for headwinds that can occur anytime.

1. What could prevent us from getting fiscal deficits under control?

The IMF basic (forecast) scenario of future developments expects a slow and gradual interest rate increase from the current record lows. But what happens if a sudden increase in the interest rates occurs? Generally speaking, higher interest rates make it more difficult for a country to record a high GDP growth. And high economy growth is usually one of the best treatments for fiscal problems. Among developed economies, an effect of even a small (upside) interest rate change can be magnified by large debt ratios (e.g., Japan, as the most indebted nation, would get hurt most). A vital banking system is also necessary to proper functioning of governments' finance and dealing with fiscal problems. A country simply cannot afford to have a dysfunctional banking system. One striking thing that looks especially large by historical standards is an amount of bonds issued by financial institutions with a government guarantee. This is documented in Chart 1, where we can see that over USD 1.25 trillion US dollars have been issued in selected advanced economies at the end of 2010. This together represents roughly 6% of the combined GDP of the countries in that sample. Another big reason why governments cannot let banks fail… Last but not least, setting up a viable fiscal policy and its successful implementation represents another key factor in a successful fight against fiscal deficits. The reason is simple, if fiscal deficits are not managed properly, they automatically represent a ticking bomb. Fiscal transparency seems to be an issue

6 http://www.imf.org/external/pubs/ft/fm/2011/02/data/fmdata.xlsx accessed on 29.12.2011.

Chart 1 Outstanding government-guaranteed bonds (of financial institutions) in selected advanced economies (in USD billions)



Source: IMF, Fiscal Monitor (April 2011).

in some (not only) European countries, as some government officials intentionally hide truth, e.g. by reporting incomplete or fabricated financial statements. Other countries as Hungary or Argentina for example did not fear renationalizing their pension systems. All these things have a profound impact on a fiscal situation of a country. The more transparent and credible it is, the higher trust of foreign and domestic investors can a country earn.

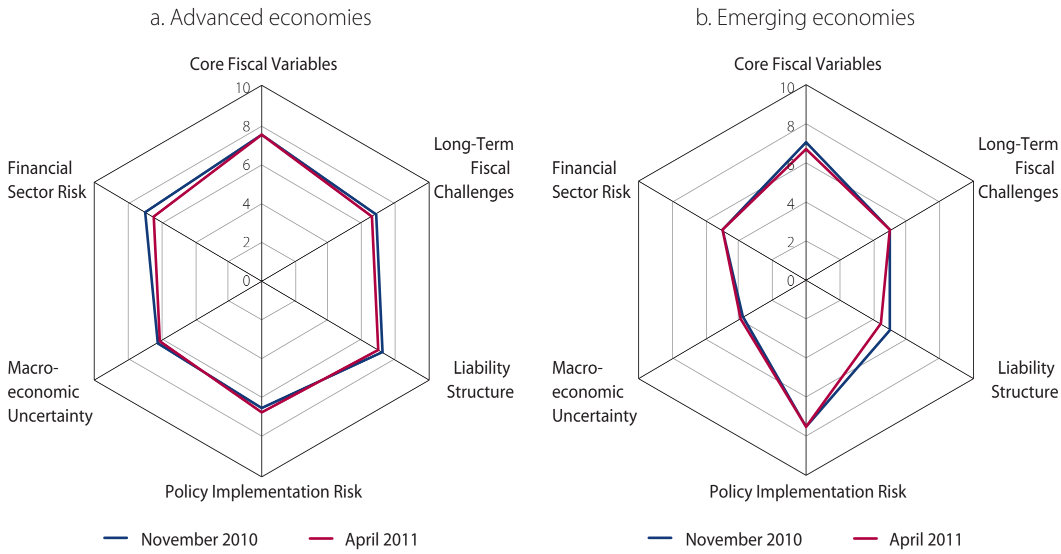
From this perspective, we have to admit that, although imperfectly, but still somehow political and economic leaders are trying to keep the interest rates down and the banking system alive. But the question remains, whether the measures and adjustments are credible and sustainable.

2. Fiscal sustainability

The idea of fiscal sustainability was already mentioned by Olivier Blanchard in the early 1980s. He advised that *"a budget deficit may be considered unsustainably large when the real burden of interest that must be paid on the existing debt is greater than the largest feasible primary surplus – or in other words, the surplus excluding interest payments."* (quoted in Galbraith and Darity, 1995). It is all right and even appropriate for a government to borrow, when the borrowed funds are used for stabilization and stimulation of economy, especially when there is less-than-full employment. Galbraith and Darity (1995) also claim that as long as the growth of national debt is rising slower than the nominal GDP, there is no reason to worry. In this sense, they criticize cutting debt level just for the sake of cutting.

In their Fiscal Monitor, IMF assessed risks of fiscal sustainability in advanced and emerging economies with respect to six critical factors. The key findings about these six factors are depicted in the fiscal sustainability risk map in Chart 2. Factors as *Core fiscal indicators* (primary balances, expected economic growth etc.), *Long-term fiscal challenges* (population growth, fertility rate, dependency ratio etc.), *Liability structure, Macroeconomic uncertainty, Financial sector risk* seem to be more favourable for the emerging economies. *Policy implementation* risk has increased in advanced economies as there is bigger uncertainty about stability of governments and their fiscal plans and has remained the highest risk in the emerging markets. Political instability and uncertainty about various political regimes make it more difficult to believe that fiscal plans will be fulfilled, or even worse, manipulated in a wrong direction. The overall comparison, however, favours emerging markets' fiscal sustainability that looks more feasible mainly thanks to lower debt levels and healthier economic prospects.

Chart 2 The fiscal sustainability risk map (a value of 5 should be interpreted as a broadly "neutral" outcome)



Source: IMF, Fiscal Monitor (April 2011).

3. Some other (hidden) challenges to fiscal sustainability

We already know that exceptionally high interest rate environment, troubled banking system or incompetent politicians and regulators are all lethal stabs to fiscal sustainability. In this section I will further elaborate on the ECB's Working Paper[7] about Fiscal sustainability and policy implications for the euro area. Here, not acting on health care reform globally is considered a major obstacle to medium to long term fiscal sustainability. Furthermore, IMF Fiscal Monitor (April 2011) warns against underestimating of fiscal transparency, because it, too, can have a profound impact on fiscal sustainability in the medium and long term.

As L. Kotlikoff[8] implies, the structural changes in the world's demographics pose *"enormous fiscal stresses because of the high and growing cost of meeting government pension and health-care commitments to elderly."* He continues that *"the costs associated with the coming generational storm will bankrupt the governments of most wealthy countries unless major and painful adjustments are made now."* The authors of the ECB's Working Paper tried to estimate the ageing-related spending for the euro area countries in the period from 2010 until 2050. They used two main assumptions – first, fertility rate in the forecasted period will increase (except France and Ireland), but will still be well below the replacement rate stabilizing population size. Second, life expectancy at birth is forecasted to rise further, though, at a slower pace. They continue that *"in this scenario population in the euro area will not be much smaller in 2050, but it will be significantly older: population of working age will decline by 16 percent."* Chart 3 shows a relationship between changes in dependency ratios and expenditure ratio. From the chart we can see that Italy and Austria have the lowest exposure to the ageing-related increase in expenditures (these two countries already introduced some structural reforms in the pension system). Spain, however, will face highest risk in terms of increased expenditures related to ageing population accompanied by increasing dependency ratio. All in all, the ECB analysis showed that the population ageing has clearly jeopardizing effects on fiscal sustainability in all EU countries with an exception of Finland. If other countries, Greece in particular, do not introduce some serious reforms of their pension systems, their demographics could pose a serious problem to their fiscal sustainability in the medium run. There is much uncertainty and too many questions about the future of our health care systems. Complex reforms seem unavoidable in the near future, but will these reforms bring the current system (where a state plays crucial role) to its end? Can these reforms have negative impact on health care affordability and accessibility? The first guess would be that, yes, more responsibility would be transferred to individuals (cost sharing) or private sector (private insurance) to help carry the debt burden. The second (and very naive) guess would be that governments will

Chart 3 Changes in dependency ratios and expenditure ratio (2010 – 2050)

Source: Balassone, J. et all. (2009).

learn how to be extremely effective and will be able to generate enough revenues to cover for increasing expenditures (that are also related to ageing population).

The second hidden challenge to fiscal sustainability is fiscal transparency. As IMF reminds in their Fiscal Monitor (April 2011), we have seen creative accounting practices in Greece, where they used currency swaps to reduce their national debt. The sale and lease-back of government property is another way of hiding debt. We saw this happening in the US, Italy, Portugal and other countries as well. Even Kotlikoff[9] thinks that *"use of the deficit not only tells us nothing about the stance of current policy, it also tells us nothing about policy changes. The reason is that no one can say whether changes in the deficit arise from true changes in fiscal policy or simply a change in labelling convention"*. To put it bluntly, not only you can use creative accounting techniques to hide a bad budgetary situation, but you also can change official practices and change labelling convention for example. Table 2 documents this fact very well. We can see that the US budget deficit was "only" little less

Table 2 Cash and accrual measures of the US Federal deficit (in USD billions)

	2008	2009	2010
Budget Surplus	-455	-1,417	-1,294
Veteran's Compensation	-339	149	-224
Military and Civilian Employee	-211	-114	-279
Troubled Asset Relief Program	0	110	-86
Government-Sponsored Entities	0	0	-268
Other	-5	18	71
Net Operating Surplus	-1,009	-1,254	-2,080

Source: IMF Fiscal Monitor (April 2011).

7 *Balassone, J. et all. 2009. Fiscal sustainability and policy implications for the euro area. In: European Central Bank, Working Paper Series No 994, January 2009.*

8 *L. J. Kotlikoff: Fiscal sustainability obtained from <http://www.econlib.org/library/Enc/FiscalSustainability.html>.*

9 *L. J. Kotlikoff: Fiscal sustainability obtained from <http://www.econlib.org/library/Enc/FiscalSustainability.html>.*

than USD 1.3 trillion in 2010, but the real deficit that the government produced in that year was over USD 2 trillion! So, how to improve quality of fiscal reporting? While introducing fiscal reforms several countries created an institute of an independent fiscal institution that would oversee government's spending. Increasing fiscal transparency is absolutely essential, but as we can see there are and will always be creative ways how to go around this problem. Publishing the entire public debt and not only the government's account could be another step towards improved transparency.

4. Previous attempts to tackle fiscal problems and conclusion

IMF in their Fiscal Monitor (2011) analyzed sixty six government plans of developed economies that wanted to improve the balance deficit by at least 1% of GDP. The reason why governments decided to improve their balances varied from too large deficits or rising public debt to even refinancing problems due to rising interest rate environment. We can see all sorts of reasons motivating governments to do something about their fiscal policies. What did they usually do? Most plans focused on government spending – only ten plans out of sixty six proposed increasing revenues as the main remedy for fiscal problems. Also, although governments intended to cut their deficits by 1.8% of GDP, they only managed to do so on average by 0.3%. This poor result was slightly offset by higher-than-expected revenues that governments were able to collect in a given year. This brings us to a naive suggestion that it is better to have bold plans to reduce deficit by a large number, because at the end of the day, the real decline could be only a fraction of it.

The sovereign debt crisis and fiscal sustainability represent the major source of risk and uncertainty in today's world economy. As the interdependency (also) in the sovereign debt market increases, it becomes more systemic and harder to deal with. When it comes to recommendations, how to deal with the debt crisis, probably the biggest one would be to account for shocks in fiscal (deficit reduction) plans, because so far most of the plans do not seem to be resilient to shocks (for example economic growth often derails fiscal plans). Also, I believe that a bigger emphasis should be put on (real) government expenditure reduction, ideally with a multi-year cost saving plan that would be strictly followed and enforced. Then, strict monitoring and accountability would be appropriate that would not give too much incentive to those in power to misuse public spending. Doing structural reforms is necessary, too, especially when it comes to those areas that are not sustainable forever (e.g., pension system due to demographics). Lastly, building public support by effective and honest communication and education plays crucial role in sustainability as well.

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