Economic Policy #04

Fiscal Policy 2

Public debt

Public debt = the total of all bonds and other debt owed by a government. Usually cumulated deficits.

Debt-to-GDP ratio => ability to repay the debt. But the public debt needs not be repaid.

Net public debt = gross public debt – value of public assets

Problem of *off-balance-sheet liabilities* (ageing, too-big-to fail banks)

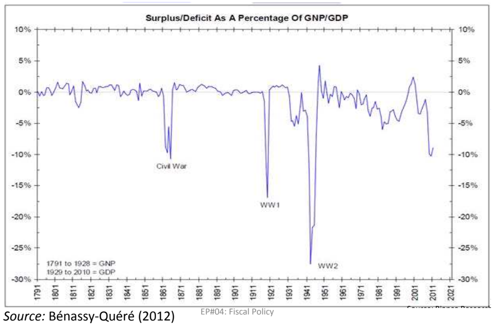
Gross vs. net debt

Gross and net public debt ratios in selected OECD countries in 2010 (% of GDP)

En pourcentage du PIB			
	Bruts	Nets	Écart
Norvège	49,7	– 165,9	215,6
Finlande	57,6	– 64,5	122,1
Japon	200,0	116,0	84,0
Suède	49,1	– 26,1	75,1
Corée	34,6	– 37,4	72,0
Danemark	55,6	– 1,3	56,9
Canada	85,1	30,4	54,6
Estonie	12,5	– 36,5	49,0
Slovénie	48,4	0,8	47,6
Suisse	42,6	1,3	41,4
France	95,2	58,9	36,3
Pays-Bas	70,6	34,4	36,2
Allemagne	87,1	52,2	34,9
Autriche	78,2	44,0	34,2
Pologne	62,4	28,7	33,7
Royaume-Uni	82,2	53,9	28,3
Italie	126,1	98,6	27,5
Espagne	67,1	40,3	26,8
États-Unis	94,2	68,4	25,8
Australie	23,6	1,8	21,9
Belgique	100,2	80,3	19,9
Zone euro	92,9	58,5	34,5
Total OCDE	97,9	58,1	39,8

Source: Bénassy-Quéré (2012)

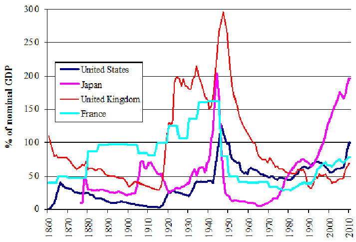
Large deficits were mostly the results of wars (e.g. USA)



Source: Bénassy-Quéré (2012)

Public debt ratios have reached very high levels in the past

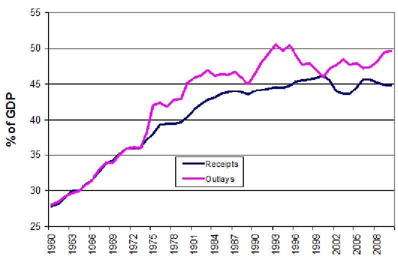
Fig. Gross debt (as % of GDP)



Source: Bénassy-Quéré (2012)

Advanced countries have been in deficit since 1970

Fig. Public expenditure and receipts in OECD countries



Source: Bénassy-Quéré (2012)

Debt sustainability

- ***Solvency***: borrower's ability to face its commitments
- ***Sustainability***: policy course compatible with solvency at all times in the future
- Sustainability is forward-looking by nature and relies on assumptions on future policy and on the ability of the government to collect/increase taxes.

Debt and deficit dynamics

- Stock-flow equation: *B = (1+i) B-1 + D* where *D* is the primary deficit, *B* is the public debt and *i* is the nominal interest rate.
- In percentage of nominal GDP:

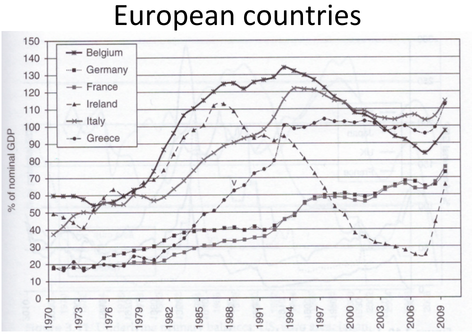
$$\frac{B}{GDP} = (1+i)\frac{B_{-1}}{GDP_{-1}} \times \frac{GDP_{-1}}{GDP} + \frac{D}{GDP}$$

- Denoting by *n* nominal GDP growth, *g* real GDP growth and *r* the real interest rate:

$$b = \frac{(1+i)}{(1+n)} b_{-1} + d \cong (1+i-n) b_{-1} + d \cong (1+r-g) b_{-1} + d$$

=> if *r* > *g*, debt stabilization requires a primary surplus

Public debt developments in selected European countries



Net government indebtedness and primary budget balances, 2010 (% of GDP)

	Net debt in 2010	Primary budget surplus in 2010	Required primary surplus	
			to stabilize the absolute debt stock	to stabilize the debt/GDP ratio
Belgium	80.8	-0.9	4.0	2.0
Germany	50.1	-1.3	2.5	1.3
Ireland	59.9	-30.0	3.0	1.5
Italy	99.1	-0.3	5.0	2.5
Netherlands	34.6	-4.1	1.7	0.9

Source: Burda&Wyplosz, 2013

How to reduce the debt burden?

#1. ***Fiscal adjustment***: cut spending, raise taxes

– the most virtuous but also most difficult way

	1981-85	1986-90	1991-95	1996-2000	2001-05	2006-10
Greece	0.2	1.3	1.3	3.5	4.0	0.8
Italy	1.7	3.1	1.3	1.9	0.9	-0.3
Portugal	1.5	6.2	1.9	4.2	0.8	0.5
Spain	1.3	4.7	1.7	4.1	3.3	0.9
Euro Area	n.a.	n.a.	1.4	2.7	1.5	0.8
EU	1.5	3.1	1.5	2.9	2.0	1.0

Source: Burda&Wyplosz (2013)

As difficult as it is, deficit reduction had been successfully implemented in many European countries.

How to reduce the debt burden?

#2. ***Raising economic growth***

– is possible in medium to long run

– factors determining the attainable rate of growth will be spelled out later (Growth policy)

How to reduce the debt burden?

#3 ***Monetization (inflation tax)***

- reducing the value of the money base (the central bank's liability) and of the public debt (the Treasury's liability) => tax on money and bondholders.
- inflation must rise unexpectedly and quickly enough
- temporary solution: lenders will demand higher interest rates and will be less willing to agree to long-term loans
- risk of hyperinflation if the government will be forced to create more money to pay back maturing debt

How to reduce the debt burden?

#4. ***Default***

- not rare in Europe before 20^{th} century
- restructuring: rescheduling, write-downs, haircuts, debt conversions (Brady plan, 1989), interest reductions...
- voluntary/compulsory
- coordination: Paris club (public creditors); London club (private creditors); IMF, World Bank.

Political theory of debt

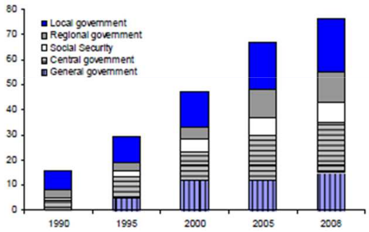
- The choice of who should pay for the reduction of a high debt is a problem of redistribution.
- Suppose that society can be divided into three groups: rentiers, entrepreneurs and workers.
- Each of these interest groups will seek to avoid the burden of adjustment and shift onto someone else.
  - rentiers are opposed to default and inflation tax
  - entrepreneurs are opposed to taxes on capital
  - workers prefer taxes on wealth and capital and the repudation of debt

Rules and principles

- Fiscal policy is traditionally discretionary
- However increasing reliance on rules to:
  - improve predictability
  - address political failures
  - improve credibility
  - enforce coordination
- European Stability and Growth Pact (1997)
- Current discussions in Europe:
  - strengthening fiscal discipline
  - national fiscal rules and institutions

More and more rules

Fig. Fiscal rules in EU member states, by sub-sector



Source: Bénassy-Quéré (2012)

What is a good rule?

The 'good rule' according to Kopits and Symansky (1998):

- *clear definition,*
- *transparent public accounts,*
- *simplicity,*
- *flexibility – in particular regarding the capacity to react to exogenous shocks,*
- *policy relevance in view of the objectives pursued,*
- *capacity of implementation with possibility of sanctioning non-observance,*
- *consistency with the other objectives and rules of public policies,*
- *accompanied by other effective policies*

Many rules in practice

- Headline deficit rules (SGP)
- Structural deficit rules (Germany after reform
- Golden rule (Germany before reform, UK 1998)
- Debt rules (UK under Blair/Brown)
- Spending /receipts rules

=> ***Enforcement is very uneven and difficult to check***

Example #1. The UK

1998-2008

- *Golden rule* (no borrowing for current spending)
- *Sustainable investment rule* (debt ratio 40% over the cycle)

Two problems:

- Who determines what is the cycle?
- How to take contingent liabilities into account?

Example #1. The UK (cont.)

2010

- *Fiscal mandate*: structural deficit < 1 % of GDP over 5 years
- *Office for budget responsibility:* independent fiscal council in charge of forecasts and assessment

Example #2. Germany

Since late 1960s

- ***Golden rule*** of public finances 'except macroeconomic disturbance'

Two problems:

- extensive notion of 'macroeconomic disturbance'
- no correction mechanism
- inconsistency with SGP (that does not distinguish between current and investment spending)

Example #2. Germany (cont.)

2009 - (Debt brake)

- *Fiscal rule*: structural deficit < 0.35 % (Federal government) and < 0 % (länder)
- *Control account*: deficit < 1 % at any time.
- *Exceptional circumstances*
  - natural disaster: more deficit allowed but amortization plan
- *Progressive phase-in* (2016)

The Stability and Growth Pact #1

- Two planks
  - Preventive arm
    - Medium term objective (MTO)
    - 'Stability' (Eurozone) and 'convergence' (non-Eurozone) programs
  - Dissuasive arm ('Excessive Deficit Procedure' – EDP) allows for:
    - Advance warning
    - Recommendation to correct excessive deficit within given timeframe
    - Eventual sanctions

The Stability and Growth Pact #2

- Recent reforms (six-pack, fiscal compact)
  - Earlier sanctions
  - Reverse-majority voting
  - Debt rule
  - Broadened surveillance (scoreboard)
  - National rules

Reference textbook

Bénassy-Quéré, A. et al. *Economic Policy : Theory and practise*. Oxford University Press, 2010. ***Chap. 3***