Economic Policy #04

Fiscal Policy II

(Public Debt and Rules and Institutions in Fiscal Policy)

Public debt

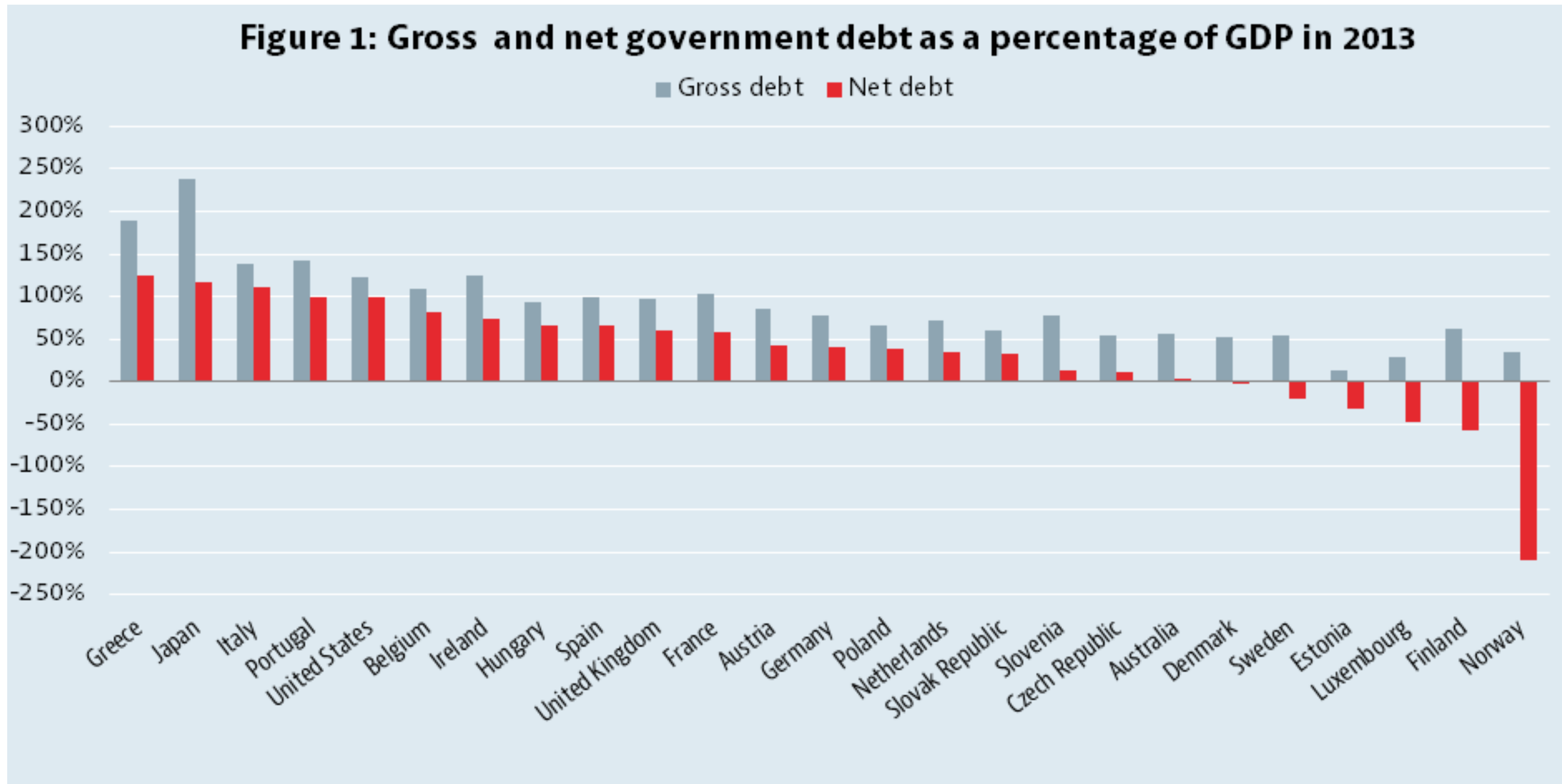
Public debt = the total of all bonds and other debt owed by a government. Usually cumulated deficits.

Debt at end of period (t) = Debt at end of period (t-1)
+ Financial deficit of period (t)

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

Debt at end of period (t) = Debt at end of period (t-1)
+ Interest payment on debt at end of period (t-1)
+ Primary deficit of period (t)

BOX. Gross vs. net debt



Source: OECD

Public debt dynamics

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

The two variables are crucial for the evolution of the debt-to-GDP ratio (debt ration): *real interest rate (r)* and *rate of GDP growth (g)*:

- when $g>r$, a stable debt ratio is compatible with a permanent primary deficit
- when $g<r$, there must be a primary surplus to stabilize the ratio of debt to GDP

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

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

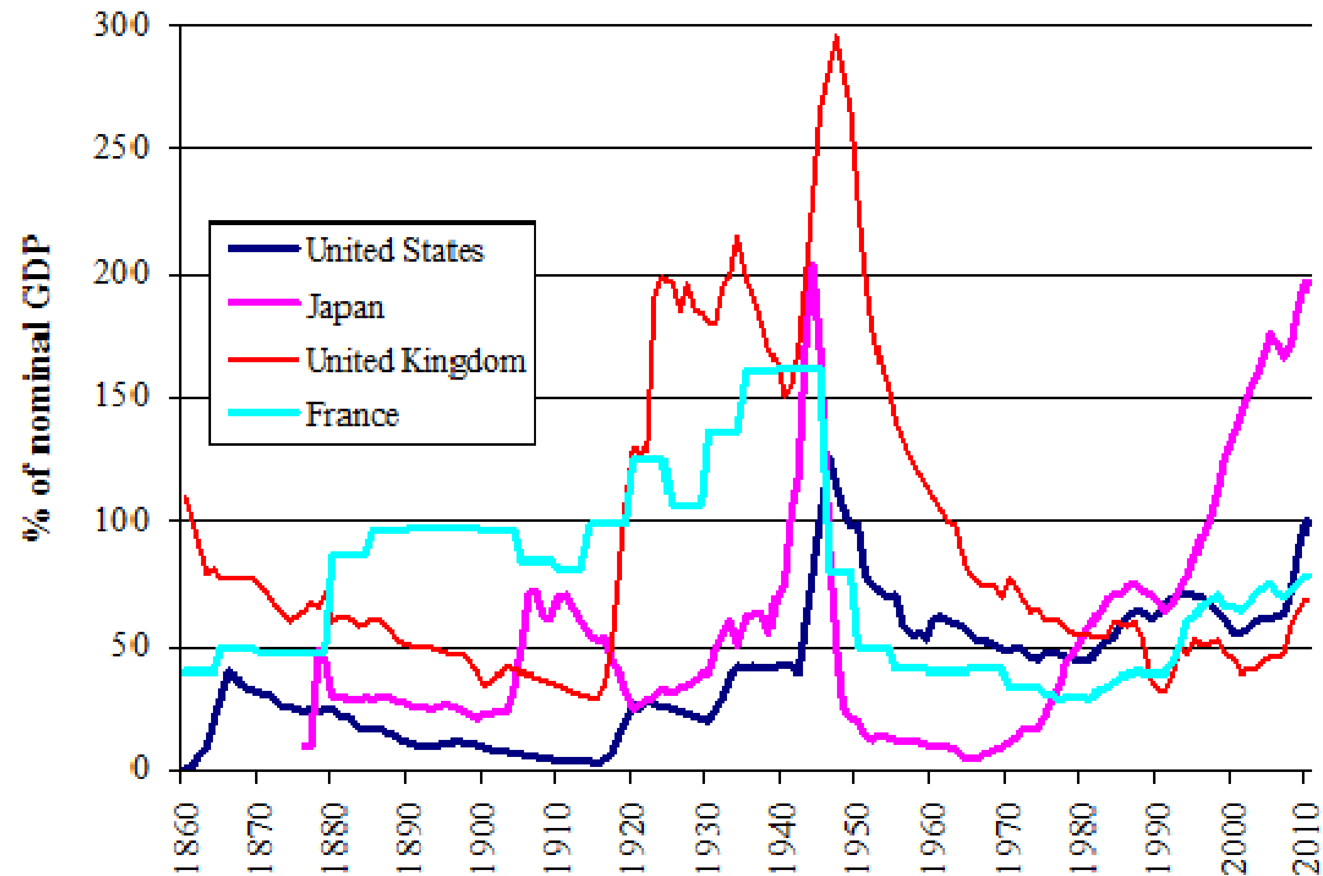
=> if *r* > *g*, debt stabilization requires a primary surplus

BOX. Net government indebtedness and primary budget balances, 2010 (% 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

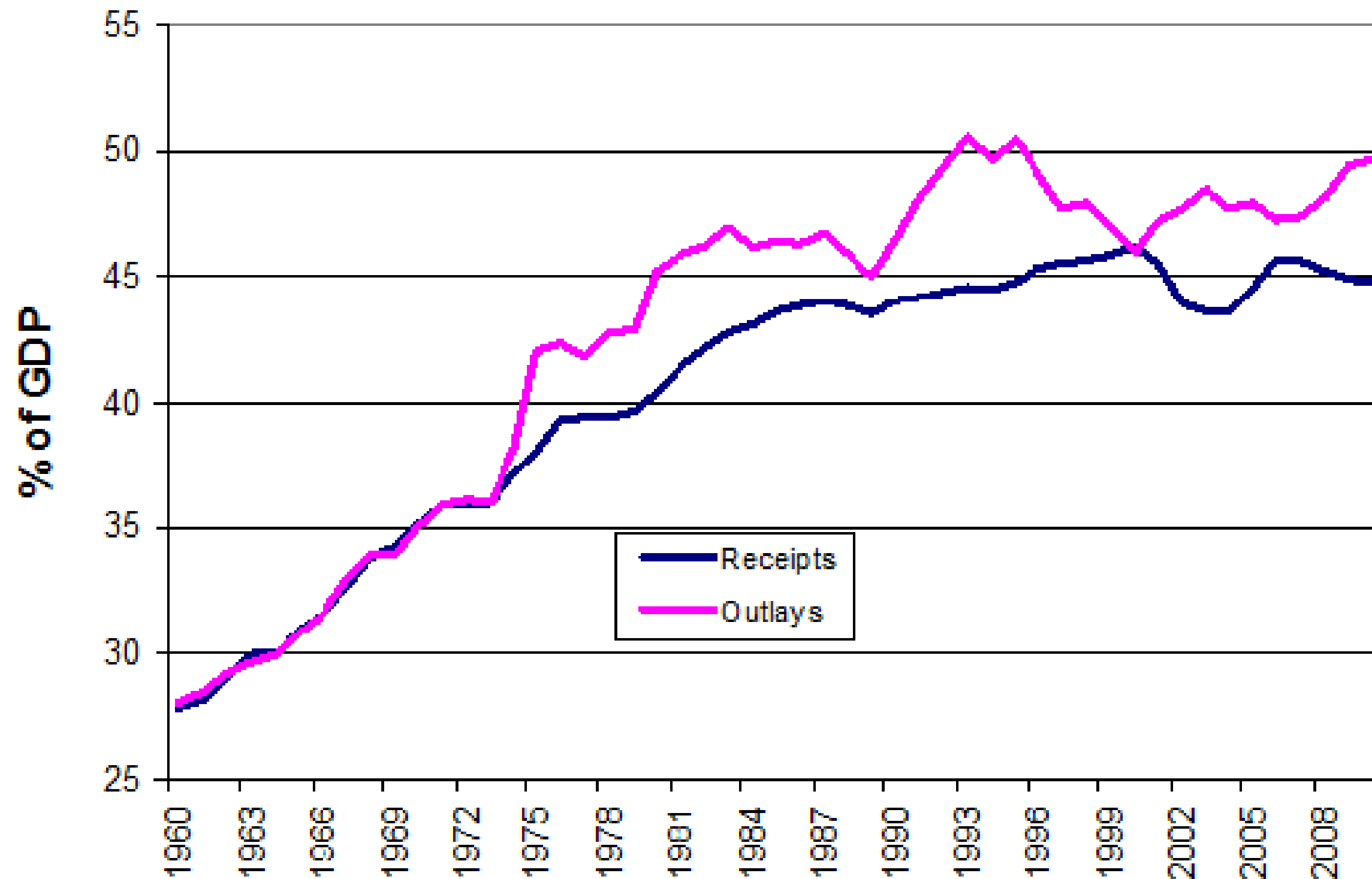
BOX. Development of gross debt (as % of GDP)



Source: Bénassy-Quéré (2012)

Public debt ratios have reached very high levels in the past.

BOX. Public expenditures and receipts in OECD countries



Source: Bénassy-Quéré (2012)

Advanced countries have been in deficit since 1970.

How to reduce the debt burden?

#1. ***Fiscal adjustment***: cut spending, raise taxes to generate primary surpluses

- the most virtuous but also most difficult way
- there is a limit to the tax burden beyond which the cost (especially the political cost) of collecting more taxes becomes too high.

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)***

- in result 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 20th century
- outright default destroys reputation of government
- implicit default includes restructuring: rescheduling, write-downs, haircuts, debt conversions interest reductions...

Political theory of debt

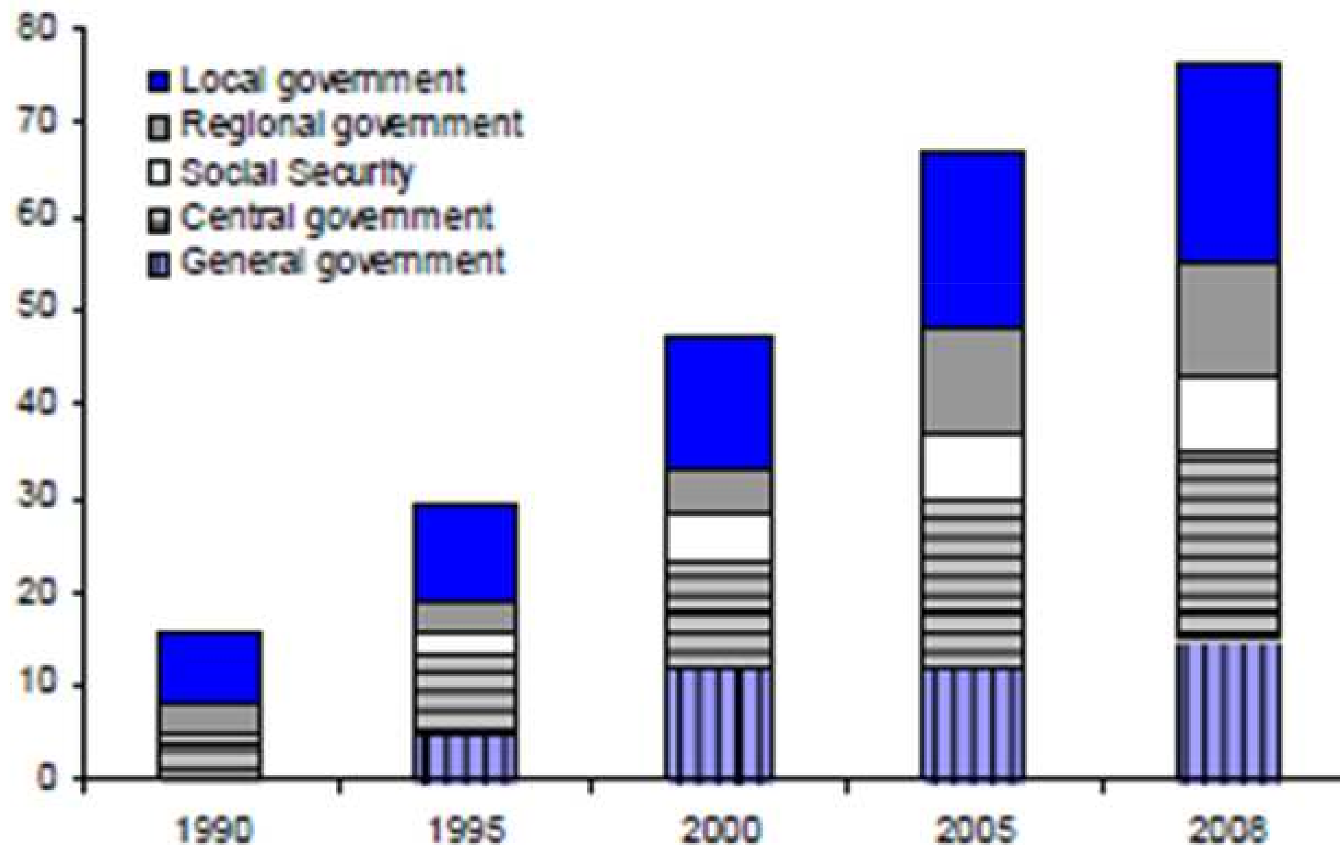
- The choice of who should pay for the reduction of a high debt is a problem of redistribution.
- Suppose that society can be divided into three groups: rentiers, entrepreneurs and workers.
- Each of these interest groups will seek to avoid the burden of adjustment and shift onto someone else.
  - rentiers 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 was traditionally discretionary and led to excessive debt burden.
- Now the scope for discretionary choices is limited by various form of rules and institutions.
- Increasing reliance on rules should to:
  - improve predictability
  - address political failures
  - improve credibility
  - enforce coordination

BOX. More and more rules..

Fiscal rules in EU member states, by sub-sector



Source: Bénassy-Quéré (2012)

Fiscal rules

- Fiscal rules are legal provisions that impose constraints on fiscal policy through numerical limits on budgetary aggregates.
  - They target the deficit, the debt, or public expenditures.
  - They can be expressed in nominal term, in real terms or in structural terms.
  - They can apply *ex ante* or *ex post*.
  - They can relate to the general government or to sub-entities.

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*

Alternative fiscal rules:

- ***Public debt ratio:***

+ direct link to sustainability
+ easy to communicate and monitor
- can be pro-cyclical
- debt-deficit relation can be affected by one-off developments

- ***Financial balance***

+ clear operational guidance
+ easy to communicate and monitor
- often pro-cyclical
- may lead governments to cut growth-enhancing investments

Alternative fiscal rules

- ***Structural balance***

+ clear operational guidance

+ good stabilization properties

- structural deficit is measured with uncertainty

- complex to communicate and monitor

- ***Current balance (golden rule)***

+ preserves incentives to invest

- no direct link to sustainability

- often pro-cyclical

- may favor brick-and-mortar spending

Alternative fiscal rules

- ***Primary balance***

+ easy to communicate and monitor
- partial link to sustainability
- often pro-cyclical

- ***Public expenditure (nominal or real)***

+ clear operational guidance
+ easy to communicate and monitor
+ good stabilization properties
- no direct link to sustainability
- interferes with allocation decisions

Source: Bénassy-Quéré et al. (2019)

BOX. Fiscal rules in practice. The UK

1998-2008

- *Golden rule* (no borrowing for current spending)
- *Sustainable investment rule* (debt ratio should not exceed 40% over the cycle)

Two problems:

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

2010

- *Fiscal mandate*: structural deficit < 2 % of GDP and put by 2020-21 the public debt ratio on a declining path
- *Office for budget responsibility:* independent fiscal council in charge of forecasts and assessment

BOX. Fiscal rules in practice. Germany

Since late 1960s

Golden rule of public finances 'except macroeconomic disturbance'

Two problems:

- extensive notion of 'macroeconomic disturbance'
- definition of public investment

2009 - (Debt brake)

- *Fiscal rule*: structural deficit < 0.35 % (Federal government) and < 0 % (Länder)
- *Current account*: deficit < 1 % at any time.
- *Exceptional circumstances*
  - natural disaster: more deficit allowed but amortization plan

Fiscal institutions

- All fiscal rules have shortcomings because they can lead to suboptimal policies when economic conditions change.

- Some economists suppose fiscal policy committee be in charge of fixing annual fiscal balance targets
  – problem: fiscal policy has much to do with redistribution
  – there are some examples of fiscal councils (Austria, Germany,..)

Reference textbook

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