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Editorial

Towards Fiscal Sustainability

The financial crisis that started in 2008 has radically redefined the short and medium term priorities for fiscal policy in countries around the world. Triggered by the rapid deterioration of budgetary positions, long-term fiscal sustainability has become a paramount issue. Especially in the US and Europe, fears have been raised that debt rollovers would require an increasingly large amounts to service, adding to the already accelerating costs caused by higher health care and pensions expenditure. Concerns about a government's long-term fiscal position could have destabilising macroeconomic effects and offer only second-best solutions of fiscal policy responses to economic events. Both budget deficits and public sector debt levels in a number of developed economies have been rising to alarming levels not seen since the aftermath of World War II. Budget deficits rose in 2010, as a percentage of GDP, to -8.9% in the US, -10.1% in the UK, -6.2% in Euro area and -7.5% in Japan. And projections of public sector debt levels are equally frightening. Baseline scenarios for 2020 public debt projection, as a percentage of GDP, are 133% for the US, 124% for the UK, 120% for the Euro area and 246% for Japan. Failing to address the unsustainable fiscal positions would expose those countries which decide not to take action to a heightened risk and an increasing economic risk.

The recent crisis has split governments around the world in their decision regarding the use of fiscal policy. The choice between pursuing fiscal austerity or economic policies *that stimulate growth, implicitly assuming a loose fiscal policy, continues to remain a hard one. While the US, favored by the global status of its currency could afford to use monetary and fiscal policy for spurring economic growth, for small open economies which need access to external finance fiscal stringency might be the only one viable in the short and medium term. Moreover, the requirements of the Growth and Stability Pact in Europe together with Germany's tough stance on fiscal austerity suggest that, for the EU as a whole, fiscal austerity policies would take precedence over the activist approach in which fiscal policy is employed to stimulate economic growth.*

Given these circumstances, what are the possible action plans fiscal policy could pursue in order to minimise the risks associated to these unsustainable fiscal positions?

First, it is clear that fiscal policy would need to be country specific and thus tailored to the existing individual macroeconomic circumstances. Long-term fiscal strategies have to be developed and these will have to ensure that the pursued social objectives are met without recourse to persistent budget deficits that could, eventually, endanger macroeconomic stability.

Second, fiscal policy objectives would need to be careful assessed over short, medium and long term in order to balance risks. During the recent crisis fiscal policy has been used extensively by governments to soften the economic effects of the crisis and prop up large sectors of the economy such as banking, real estate or auto industry. Government-led bailouts have converted private losses into public debt and thus pushed up government debt levels, in effect transferring the bailout costs to the future generation of taxpayers. The risk is that, in the short run, the uncertainty about exploding future deficits could affect households and businesses decisions by making them more cautious *about spending, capital investment, and hiring. In the long term, a high level of government debt relative to national output is likely to put upward pressure on interest rates and thus discourage capital formation, productivity, and economic growth. One way to reduce uncertainty over the course of fiscal policy and increase transparency would be the adoption and enforcement of fiscal rules. These should help mitigating to some extent the risks mentioned above.*

Third, fiscal policies would need, ultimately, to be devised in such a way as to spur economic growth. Traditionally, the distinction has been between the activist and the incentivist approach. The former favors increases in government spending while the latter argues that tax cuts would provide incentives for an increased work effort, in the case of individuals, or an increase in capital investment, in the firms'case. Unless government spending is not bond-financed the activist approach necessarily requires that taxes be raised in the future in order to pay for the extra government spending today. The incentivist approach seems to have provided better results in practice, leading to a higher path of economic growth by boosting savings, and thus investment. Implementing such policies, however, would require cuts in government spending, such as welfare benefits, for instance, which are politically sensitive. The activist approach has been used temporarily by various governments during the current crisis but in the medium and long term the scope for such a strategy would be limited. Downsizing government, externalising various government expenditure and involving voluntary groups and private sector in activities previously performed by local or central authorities may well be strategies that would be necessary to be implemented in the future. For instance, 'Big Society' is a concept devised by the current UK government along these lines. It envisages wresting power from local authorities and giving it to *community groups. Such ideas, if implemented, would have profound changes at all levels of the economy.*

Last, fiscal policy would play a crucial role in shaping economic growth models in a post-crisis world. For small developing countries access to finance would be a defining factor in this respect. Increasing domestic saving for financing growth could prove to be a superior strategy to relying on external financing, especially given global uncertainties, which are likely to persist for a while. Thus, devising fiscal policies, notably a taxation system, that would encourage domestic saving would be essential. In practice, taxes are inevitably distortionary and the nature of these distortions is quite complex. But the economic implications of these distortions depend on the response of economic agents and the effects of taxation on economic growth and employment should take into account changes in product and factor markets. For instance, an income tax change would lead to a substitution effect between labour and capital while a corporate tax change would affect the way firms finance their investment.

Meeting the challenges fiscal policy faces would not be an easy task. And it would require decision makers to make difficult decisions in order to ensure that fiscal sustainability would be achieved.

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