The Evolution of Fiscal Responsibility

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With the rapid economic growth in the three decades following the Second World War, the industrialised countries in Europe and North America could afford the luxuries of generous social programmes. Even other types of government spending, such as the provision of public goods and industrial subsidies, were easily justifiable in that environment. It is no surprise this period witnessed a considerable expansion in the size of government.

The affordability of government programmes was not the only factor contributing to an increase in the size of government. Perhaps equally important was the reigning economic dogma of the time. As the Great Depression ended with increases in both military and social expenditures, the central ideas of John Maynard Keynes seemed to find confirming evidence. And in the years following the war, the Keynesian focus on short-run aggregate demand—and the inherent neglect of the long-run supply-side issues—came to dominate the thinking within finance ministries the world over.

In the context of quickly growing economies, such a short-run focus did little damage, and perhaps did some good. Long-run growth seemed to be taking care of itself; and the short-run demand-management policies may have had some success in dampening the swings of the business cycle. It was easy in that environment to have generous government spending and still have fiscal surpluses.

Troubles in the 1970s

With the actions of OPEC in the early 1970s, however, and with a corresponding slowdown in economic growth, the focus on the short run and on the demand side became a problem. Faced with the first OPEC-induced recession, many industrialised countries were flummoxed. They had never before witnessed inflation and recession simultaneously, and they were not quite sure what to do. But the instinctive Keynesian reaction was to not worry about the fiscal deficits that began appearing. After all, this year's deficit would be balanced by surpluses in better times ahead. Or would they?

With the slowdown in economic growth, it became harder to run fiscal surpluses to offset those early deficits. And with the unfortunate focus on the short run, policy-makers were not noticing—or at least were not worried about—the steady increase in the stock of public debt. Furthermore, the electorates had come to count on the generous level of government spending on social programmes, public goods, and industrial support. In the slow-growth environment of the 1970s and 1980s, it was politically easier for cash-strapped governments to borrow on the world's capital markets than it was to implement the necessary but painful reforms to expenditure or taxation.

As the stock of government debt accumulated through the 1970s and 1980s, however, governments found that more and more of their tax revenues were required simply to pay the interest on their debt. This was the beginning of the vicious debt spiral: as debt rises, debt-service payments must also rise, but without changes in other government spending, this increases the deficit, thus increasing the debt further.

Hitting the "Debt Wall"

Eventually, however, the level of government debt became high enough for governments to hit the "debt wall". Such a collision constrained governments in two ways. First, high levels of government debt led bondholders to worry about the possibility of the government using its monetary printing press to repay its debt, thus increasing inflation and reducing the real value of the bonds. This pushed up interest rates on government debt, exacerbating the fiscal problems by increasing the government's debt-service requirements. The second constraint—and there is some irony here—resulted in the inability of highly indebted governments to pursue short-run fiscal stabilisation policies without setting off concerns among creditors that even temporary increases in the deficit would put the stock of government debt on an unsustainable path.

By the early 1990s, many countries recognised the problems associated with high debt. And it is no surprise that fiscal responsibility and debt reduction has been pushed to the political centre-stage—by those same finance ministries that three decades ago were largely ignoring the problems of long-run debt accumulation. In Europe, governments of all political persuasions are trying to outdo one another in their attempts to pass the Maastricht debt and deficit guidelines. In America, a Democratic president flirted with a balanced-budget amendment and has now passed a plan that aims to eliminate the deficit by 2002.

The Anatomy of Fiscal Responsibility

The drive for fiscal responsibility has two components. The first, put simply, is to reduce annual budget deficits—in a sustainable manner—and thus to halt the further accumulation of government debt. This may be accomplished through tax increases or through expenditure reductions (or both), and different countries have taken different approaches. This is the part of fiscal responsibility that attracts the headlines, not least because it involves tough political choices and inflicts pain on citizens who have come to expect a particular level of government services. Despite the political fallout that typically accompanies these

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decisions, however, this is the reasonably straightforward part of achieving fiscal responsibility.

The more complex part of fiscal responsibility is the rethinking of government's role in the economy. Should government provide social programmes? If so, which type and how generously? Should government provide industrial subsidies and agricultural income-support programmes? What is the best way for governments to provide pensions to retired people? How best can government raise the revenue that it needs to finance these programmes? Rethinking the role of government is complex, because it involves articulating a view of what government should and should not do. This, in turn, requires clear thinking about what government is *able* to do, and what influences lie beyond its reach.

Only after the role of government has been re-evaluated in this way is it possible to arrive at a statement of the government programmes deemed worthwhile. And only then can the tax system be designed to raise the necessary funds. With a tax system crafted to finance the collection of government programmes, the problems of long-run debt accumulation will thereby be avoided. The fiscal authorities will then regain their ability to reap the benefits of short-run fiscal stabilisation.

A Unifying Theme

The theme of the evolution of fiscal responsibility is central to several articles in this issue of *World Economic Affairs*. In our feature interview, Paul Martin, Canada's Minister of Finance, reflects on these very issues. Canada was one of those countries about to hit the debt wall in the early 1990s. In 1993, Canada's debt-to-GDP ratio was hovering somewhere around 70%, the federal government's annual budget deficit was over 4% of GDP, and about one-quarter of government expenditure was devoted to servicing the public debt. Given the magnitude of the debt-service payments, combined with the size of spending programmes to which the government was committed, Canada in 1993 had little flexibility to conduct discretionary fiscal stabilisation.

The ability to design good programmes, and thus to provide good government, can only be acted upon after governments have freed themselves from the paralysing constraints of debt.

The Liberals came to office in the late autumn of 1993. Almost immediately, Paul Martin set the course for Canada's fiscal consolidation. For him, it was an issue of regaining some of the fiscal levers that had been lost through too many years of excessive deficits. In the subsequent four years, the fiscal turnaround has been remarkable. Though the debt-to-GDP ratio has declined only marginally since 1993, the annual budget deficit is now below 1% of GDP, and most observers expect a balanced budget to make its appearance sometime in the next year. Moreover, as the Canadian economy continues to grow at a healthy pace, a string of balanced budgets will generate a marked decline in the debt-to-GDP ratio. Canada has transformed itself from the fiscal profligate of the G7 a decade ago to a model of sustainable fiscal prudence. The Canadian electorate honoured this achievement by re-electing the Liberals in the late spring of 1997.

The theme of fiscal responsibility also permeates our *Dossier* on Switzerland, but here it is clear that Switzerland has yet to implement many of the broad fiscal changes already undertaken in Canada. In two articles within the *Dossier*, one by Helmut Schneider and the other by Oliver Landmann, it is clear just how serious the Swiss fiscal situation has become. Switzerland was not immune to the idea that generous social programmes could be afforded during the high-growth period in the years after the Second World War. Nor was it immune, however, to the slowdown in economic growth that other countries faced, particularly since the early 1990s. In a classic example of how expectations outstripped the available resources, Switzerland is now facing unprecedented deficits in most elements of its extensive system of social programmes. And the painful but necessary adjustment to those deficits, either an increase in taxes or a reduction in the generosity of social programmes, has yet to be finalised. But the writing is very clearly on the wall.

Finally, the same theme appears in an article examining the reforms to Hungary's public pension system. As is true in many countries with pay-as-you-go public pension systems, the ageing of the population means that there are fewer young workers around to finance the pensions of those who are retired. But the response to such demographic forces of simply raising the contributions of the currently employed workers may not be successful; if young workers perceive that the public pension system is no longer a good investment, then political pressure may force a more fundamental reform of the pension system.

In Hungary, the reforms have been quite substantial. Antal Deutsch, an advisor to the Hungarian government on its new pension system, knows the system from back to front. As Deutsch argues, there are two parts to the Hungarian pension reform. The first part is the redesign of the public system by reducing benefits and tightening eligibility conditions. This aspect of the reform reflects the simple fact, in Hungary and elsewhere, that overly generous social programmes can no longer be part of the fiscal landscape. The second part is the redirection of pension funds from the public system to the fully funded and privately owned and managed contribution accounts, as has already been developed in Chile. This second part of the Hungarian reform appears already to be a success; over the past three years there has been a substantial flow of funds into these private accounts, and all signs are that it will continue to increase in the near future.

Fiscal responsibility appears everywhere to be in fashion. Whether the location is Canada, Switzerland or Hungary, the same basic fact is at work. Governments must rethink what they ought to be doing, and strive to provide a better collection of programmes. But the ability to design good programmes, and thus to provide good government, can only be acted upon after governments have freed themselves from the paralysing constraints of debt. ◆