COMMENTS ON SESSION 4: REFORMING PUBLIC EXPENDITURE PROGRAMMES

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I have been asked to comment on two papers that look at government expenditures. The first, by Zvi Hercowitz and Michel Strawczynski (HS), examines the large decline (as a share of GDP) in both total and program spending in OECD countries that began in the mid-Nineties and the subsequent rebound later in the decade. HS examine eighteen countries for the period 1981-2003 – twelve of which are members of the European Monetary Union (EMU) and fifteen of which are Maastricht Treaty signatories. HS take a positive rather than normative approach, developing a set of stylized facts, and also compute projected long-run values for the ratio of government spending (*G*) to GDP.

What are the stylized facts they observe?

- Contrary to what one might expect, both Maastricht and non-Maastricht countries display the same temporal pattern for the *G*/GDP ratio.
- Declines in interest payments are accompanied by increases in program spending.
- There is some evidence of ratcheting, *i.e.* asymmetric responses to expansions and recessions.
- Demographic variations (measured by the dependency ratio) are not associated with variations in the growth of government spending. Government spending, however, is positively related to population growth.
- Adjustment to long-run values of *G*/GDP is very gradual.

In computing long-run values of *G*/GDP, HS require an additional assumption – a value for the steady-state ratio of government debt (*D*) to GDP. They use the Maastricht criteria of 60 per cent. The long-run *G*/GDP values for a number of countries are close to the current values, but some (for example, Canada, Greece, Italy and Luxembourg) are substantially different than current levels.

The groundwork laid by HS provides fertile ground for further research. Four examples include: what theory would predict the same pattern for *G*/GDP in both Maastricht and non-Maastricht countries? Is there a common factor (or factors) at work? What theory of government spending would predict that program spending replaces interest payments as they fall? Is there some exogenous limit (or value) to *G*? Why don't demographic shifts seem to matter for the growth of government spending while simple populations levels do? Finally, suppose the calculations of long-run values of *G*/GDP are correct. Why is there such a large variation among countries? What are policy implications for countries like Canada and Italy that are

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currently far from their calculated long-run values? Hopefully, the provocative results of this paper will provide impetus to further work on these important issues.

The second paper I was asked to comment on is by Maura Francese, Daniele Franco and Pietro Tommasino (FFT). This paper provides the clearest, most concise expositions of the issues surrounding public pension reform issues I have read and thus does a great services to policy analysts.

The numbers involved in demographic change and the corresponding pension issues are staggering. For example, in the OECD the dependency ratio will rise from 24 to 50 per cent by 2050. In the European Union, the working-age population is projected to decline by 40 million. Age-related public spending in the OECD is projected to rise by 5.5 per cent of GDP (and this probably understates the true impact).

In addition to providing these critical facts, FFT focus on some key policy questions. They make clear that pension reform is not just about fiscal sustainability, but also about labour market reform and capital formation. Different approaches to pension reform will have different impacts on these three issues.

What are the critical ingredients to a successful pension reform and how do we measure success? Canada provides a useful case study. Canada is judged as a success story by the OECD, at least as measured by fiscal sustainability. In the late Nineties, Canada made parametric changes to ensure the sustainability of its public defined-benefit scheme. Contribution rates were raised from 5.4 to 9.9 per cent of insurable earnings. The expansion of benefits was slowed and asset returns were improved. Canada also improved the other two pillars of its pension system by increasing benefits for low-income seniors and increases the tax sheltering of private pension savings. The result of the reforms to the public pension scheme is that it is now judged to be actuarially sustainable for at least the next 75 years – the length of the current projection.

How did Canada achieve this success – especially since agreement of both the federal government and the provinces was required? The process began with broad public consultation where the public became convinced that the public pension plan was going broke and, without action, an unbearable burden would be placed on our children and grandchildren. Thus, the status quo was not an option.

Consultations also clarified public preferences on the direction of reform. A defined-benefit scheme was retained via increased contributions immediately to protect future generations. Investment policies were deregulated to permit higher returns to savings. Finally, increased contributions were phased in over several years.

Reforms had an important impact on labour market efficiency as well. For example, raising contributions rather than using debt finance improved generational equity and work incentives. Further measures will be required to remove biases against older workers remaining in the labour force. On the capital formation side, deregulation of public and private pension plan investment policy made more savings available for private investment.

A positive side effect of public pension reform in Canada was the building of a constituency for public debt consolidation. Canada's federal debt fell from almost 70 per cent of GDP at its peak to less than 40 per cent today, with a target of 25 per cent by 2015.

Can this approach to public pension reform be applied elsewhere – probably only in some cases. Ideology matters. Thus, the Canadian approach may be more applicable to Europe than the United States. Hopefully, the Canadian experience will be instructive, because, as the FFT analysis illustrates most clearly, coming to grips with this problem is a key factor in overall success of structural reform in Europe.