Session 4

FISCAL POLICY ISSUES IN ECONOMIC AREAS AND COUNTRIES

FISCAL POLICY IN A CURRENCY UNION – INSTRUMENTS AND IMPLEMENTATION

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If Sweden becomes member of the European currency union, the conditions for fiscal policy will change. The stabilization policy *objectives* will, however, hardly change with a membership. At the same time it is not clear if the *need* for stabilizing the Swedish economy will increase or decrease. National fiscal policy will, however, have to carry a bigger *burden* than before in stabilization policy as there no longer will exist national monetary and exchange rate policy. Fiscal policy will also be more *effective* in affecting real variables such as production and employment. Counteracting forces such as a flexible exchange rate and a domestic interest rate do not exist any longer. Fiscal policy will, at the same time, meet new and changed formal and economic *restrictions*. As member of the currency union we will face sanctions if our fiscal policy does not keep within the limits for the public sector's net lending and consolidated gross debt that apply within the EU. Increased mobility of tax bases and tax competition are examples of economic restrictions that may become stricter. The fiscal policy *instruments* and *institutions* will need to be reformed. Our conclusion is that fiscal policy will not be very much affected if Sweden becomes a member of the currency union. The pressure, to do what we anyway should do, will increase however. The paper finishes with a fiscal policy agenda with twelve items.

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The opinions expressed in this paper are our own and are not those of the authorities with which we are affiliated.

1. Introduction

We will discuss the conditions for fiscal policy if Sweden becomes a member of the third stage of the Economic and Monetary Union (EMU) in this paper. The third stage means that Sweden becomes a member of the currency union.[1] The alternative to this is a continued regime with a floating exchange rate. This would give room for a national monetary policy.[2]

An often-used motive for joining the currency union is that it will increase economic growth. Three reasons for this would be that transaction costs would decrease, that exchange rate risks would be reduced, and that comparing prices in different countries would become easier. Increased stability in the economic development is another argument for membership in the currency union. But what would really become more stable? Economic fluctuations may affect nominal variables such as prices and nominal wages, but it may also be real variables such as production and employment that are affected. Disturbances can be temporary or more permanent.

The argument about increased stability applies to the whole currency union. It is not certain that the economic development will become more stable in each of the currency union's member countries**,** especially not in smaller countries. The fluctuations may partly be common for all countries in a currency union, partly specific for the particular member country. It is an open question if the development will become more stable or not, but this notwithstanding there will probably remain some fluctuations. This is an argument for a need for stabilization policy on both union and national level both as regards real and nominal macroeconomic variables. The question is which role a national fiscal policy could have in this context.

An important starting point for the discussion in this paper is that Sweden would be a small member in a big currency union. There is a relatively extensive theoretical literature where the game between two countries in a currency union is studied. The results from these models are more relevant for big members in the currency union. The analogy to the

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1 Through out the paper the concept "membership in the monetary union" will be used as a synonym to "membership in the currency union". Even if this usage is somewhat incorrect formally, it is practical and is consistent with established convention.

2 The combination of free capital flows, national monetary policy and a fixed exchange rate is not a reasonable option; see, for example, Wyplosz (1997).

small open economy assumption in trade theory is closer for a country of Sweden's size.

The objective of the paper is to give an overview over and contribute some thoughts on fiscal policy. How shall one regard fiscal policy if one cannot pursue national monetary and exchange rate policies? In this context we will discuss the objectives of fiscal policy and also the need for stabilization policy.[3] A membership in the currency union may also affect the effects of fiscal policy. We will discuss the expected effects of fiscal policy on real economic activity in the short and the long run. Fiscal policy may also meet new and changed restrictions at the same time as the fiscal policy instruments and institutions may have to be changed. We will also discuss the available instruments and their precision. One important aspect of fiscal policy is the interaction between the central government and different local government bodies.

The most important issues regarding the stabilization of the Swedish economy are:

Do we want?
Do we have to?
Are we able to?
Are we allowed to?
Do we do it in the same way as before?
Are we capable?

There is a condensed answer to the question how the conditions for Swedish stabilization policy will change with a membership in the European currency union. The stabilization policy objectives will, however, hardly change with a membership. At the same time it is not clear if the need for stabilizing the Swedish economy will increase or decrease. National fiscal policy will, however, have to carry a bigger burden than before in stabilization policy as there no longer will exist national monetary and exchange rate policy. Fiscal policy will also be more effective in affecting real variables such as production and employment. Counteracting forces such as a flexible exchange rate and a domestic interest rate do not exist any longer. Fiscal policy will, at the same time, meet new and changed formal and economic restrictions. As member of the

[3] De Grauwe (2000), chapter 9, and Eiffinger and de Haan (2000), chapter 4, are two textbooks that, among other things, discuss national stabilization policy in a currency union. See also Eichengreen (1998).

currency union we will face sanctions if our fiscal policy does not keep within the limits for the public sector's net lending and consolidated gross debt that apply within the EU. Increased mobility of tax bases and tax competition are examples of economic restrictions that may become stricter. Members of the currency union cannot finance deficits by printing money. This is not important, however, in the sense that the Swedish Central Bank Law already today stops that this source of finance is used. The fiscal policy instruments and institutions will need to be reformed.

Our conclusion is that fiscal policy will not be very much affected if Sweden becomes a member of the currency union. The pressure, to do what we anyway should do, will increase however.

This paper has been written in close connection to our work related to the Swedish Official Government report *Stabilization policy in the monetary union*, SOU 2002:16. This official government commission (STEMU), appointed by the Swedish Minister of Finance, presented the report on March 12, 2002.[4] The present paper builds partly on Henry Ohlsson's background study to the report "Fiscal policy in a monetary union" (Ohlsson, 2002).[5] In addition it builds on two parts in the report – section 5.5 on labor market policy and section 5.6 on discretionary fiscal policy instruments. Yngve Lindh has written these sections in the capacity as expert of the commission while in the last part of the work taking part in the commission's secretariat. The text is highly influenced by the discussions in the commission, and follows closely these sections in the report.[6]

The paper is structured as follows: section 2 discusses the objectives of economic policy and if the objectives would change if Sweden became a member of the European currency union. We continue by discussing if the need of stabilization policy will change. We also in this section discuss of fiscal policy can contribute to stabilize the economic development and if the efficiency of fiscal policy in this respect changes with a membership in the currency union. The restrictions that fiscal policy meets now and with a possible membership are the topics of section 3. This concerns both formal

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4 A summary in English can be found at the web page http://finans.regeringen.se/propositionermm/sou/pdf/emu_summary.pdf.

5 The background study includes a section on the sensitivity of public finances to economic activity and the need of safety margins in public finances that is not included here.

6 The members of the STEMU commission were Bengt K.Å. Johansson (chair), Lars Calmfors, Ingemar Hansson, Nils Lundgren, Inga Persson, and Irma Rosenberg.

restrictions as well as economic. In section 4 we discuss automatic fiscal policy that, in our opinion, is an appropriate system of fiscal policy instruments for normal cyclical fluctuations. If shocks are large there may, in addition, be a need also for discretionary fiscal policy. This is the topic of section 5. Section 6 discusses fiscal policy institutions. The paper concludes in section 7 with a fiscal policy agenda with 12 items.

2. Objectives, need, and effects

Will the objectives of economic policy change if Sweden joined the currency union?

Will we *want* to stabilize the economic development to the same extent?

Will the need for stabilizing change if Sweden joined the currency union?

Will we *need* to stabilize the economic development to the same extent?

Will the effects of economic policy change if Sweden joined the currency union?

Will we *be able* to stabilize the economic development to the same extent?

It would be clear-cut to answer these questions if we always were in a situation where we want, need, and are able to stabilize the economic developments. Today stabilization is an objective of economic policy. There are also certainly cyclical variations in the economic development. The possible effects of economic policy have been more questioned. The question is how these possible effects may change with a membership in the currency union.

2.1 Objectives

Full employment and stable prices are the two traditional stabilization policy objectives. A stable increase in output can also contribute to reduce the variations in employment. Fast economic growth is also mentioned among the objectives for macroeconomic policy, but this

has more to do with the long-term development of welfare than the need to decrease economic fluctuations. In addition, it is usually a stabilization policy objective to minimize the GDP gap. The GDP gap is the difference between the actual GDP level and the potential level, that usually is defined as the average trend GDP level. At the same time it is possible to argue that a successful stabilization policy also can contribute to increase the potential GDP level in the longer run.

Traditionally, three roles of the public sector are discussed: stabilization, allocation, and distribution. The stabilization policy objectives cannot, however, be regarded in isolation from the other economic policy objectives. It is not possible to disregard that stabilization policy also may affect the extent to which other goals are fulfilled. If, for example, the tax system is changed for allocation reasons, this may also have consequences for stabilization.

- stabilization

  As mentioned before the most important objectives in this area are price stability and full employment. Why is low inflation with small variability desirable? The need for a credible monetary policy has been strongly stressed in recent years. Low inflation is important for prices to be good bearers of information and to avoid undesired redistribution between those who own real assets and those who hold assets yielding low nominal returns.
  Concerning the question why full employment is desirable it is important to stress that employment variations to a very little extent is borne by all via variations in hours worked. Instead the variation almost exclusively comes by variations in the number of employed. This way a few will have to carry the burden, while most are not directly affected. Employment variations are not distributed in an equal way.

- allocation

  In this case it is a question of pursuing policies so that the highest possible economic efficiency is reached. Policy measures used for stabilization reasons may also affect allocation. The design of the tax system is important for stabilization policy, but also for allocation. It may be that tax changes that are desirable from a stabilization policy view may affect allocation negatively because the excess burden of taxation increases.

- distribution

  One important motive for public expenditure as well as taxation is to make the distribution in society more equal. The welfare state with extensive public activity and a high tax pressure is an expression for extensive distribution ambitions.

Public activities can be performed on several levels. The question in the fiscal federalism literature is: Who shall do what? Shall all levels take care of all three roles of the public sector? The answer is that stabilization and distribution should be assigned to the central level. Regarding allocation it is a more open question. Many of the tasks can be done on local level. It is here important to remind that what is central level from one perspective (Sweden in a national perspective) can be local level from another (Sweden in a European perspective).

The assignment with stabilization and distribution on the central level and allocation shared by all levels is also in large the responsibility we have today in Sweden. Cangiano and Mottu (1998) notes that this also is the division of responsibility in most existing federations such as USA, Germany, Australia, and Canada. Within the EU it is different, however. The creation of a single market is an example of an allocation measure that is pursued on the highest union level. Harmonization of indirect taxes and corporations taxes is also discussed on union level. Distribution has, on the other hand, been left to the lower national level except structural funds and agricultural policy. Stabilization is assigned both to the union level, in the form of the common monetary policy, and to the national level by the national fiscal policy.

A membership in the currency union can be interpreted in fiscal federalism terms. If Sweden chooses to become a member of the currency union it implies that stabilization partly is moved to the union level. This is particularly true for the price stability objective.

This change raises the question if a policy objective continues to be as important if the main responsibility for achieving the objective and the most important policy tools for reaching it are lost. In other words, are the objectives affected by the possibilities of reaching them? Will price stability become less important on a national level if there no longer exists a national monetary policy to reach the objective?

However, membership in the currency union does not mean that the basic motives for price stability change. The problems that inflation creates

will not change. The problems that unemployment leads to will, in the same way, also stay the same. The objectives of stabilization policy should, therefore, not change.[7]

At the same time, economic policy is pursued in an environment that is far from perfect. It takes time to reach the policy objectives. Sometimes it is not possible to completely achieve what is desired. There are, therefore, clear tradeoffs. In such a situation it is not apparent if the economic policy will be balanced in the same way inside and outside the currency union. It is possible that the balance between different policy objectives should be different if the national fiscal policy follows a common monetary policy instead of if monetary policy and fiscal policy both are pursued on a national level. Inside the monetery union, while price stability is a primary objective at the union level it is possible that real objectives like production and employment will get higher priorities at the national level.

2.2 Need

There have always been disturbances in industrialized economies, this will continue. Economic fluctuations can show up in nominal variables such as prices and nominal wages, but it can also be real variables such as production and employment. Sweden, as other countries, is affected by some disturbances that tend to come in cyclical sequences, other disturbances are more unpredictable. Some disturbances are of demand character and have only temporary effects. Supply disturbances, on the other hand, have more permanent effects.

Price disturbances are stabilized by monetary policy with an inflation target of 2±1 percent in the present Swedish stabilization policy regime. The flexible exchange rate takes care of the external balance. The high tax and expenditure ratios work as automatic stabilizers.

Within the currency union, common price disturbances will be stabilized by a common monetary policy with an inflation target of 0-2 percent within the currency union. If anything this inflation target is

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[7] This is underlined by the government's choice of name of the official government committee, "The commission on stabilization policy", if Sweden becomes a member of the currency union.

stricter. It will, however, not stabilize any price disturbances that are specific for Sweden.

In addition, since Sweden only constitutes a small part of the union, there will no longer exist an exchange rate that can counteract export disturbances or wage cost disturbances. If the disturbances are common for all members in the currency union, the need for common stabilization will give rise to a common stabilization policy. The currency union in itself can contribute to more stability. This is one of the advantages with it. This should, among other things, come about by reduced transaction costs, no exchange rate risks in trade with other members in the currency union, and because it will be easier to compare prices in the different member countries (price transparency). The possibilities of a successful stabilization policy should be greater if the basic stability is bigger.

In this context it is an important question how much the Swedish development differs from the common development in the currency union. If the disturbances are specific for Sweden it is possible that there will be a bigger impact on domestic production and employment compared to a situation when the exchange rate is flexible.[8] Membership in the currency union would, in other words, imply that a variability that before appeared in nominal variables instead would appear in real variables. The need for stabilization of real variables would increase in a currency union, as the real activity would start to fluctuate more when there no longer is a national monetary policy and a flexible exchange rate available.

This increased variability can be counteracted by increased migration. Other ways to ensure that Sweden is internationally competitive is to influence the real wage cost development by, for example, more flexible wages, buffer funds, etc.[9] Still there will probably be a need for national stabilization policy. Without monetary and exchange rate policy, fiscal policy remains.

The question is if the flexible exchange rate is stabilizing or in reality destabilizing? Membership in a currency union will imply that disturbances caused by speculative behavior on currency markets can no longer arise. At the same time the type of uncertainty that characterizes fixed exchange rate regimes – the risk that the currency may be devaluated

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8 See Bergman (2001) which is an enclosure to the STEMU commission first report SOU2001:62.

9 This is the topic of Calmfors (2002), which is a background report to the commission final report.

will not exist. As a member of the currency union there is no longer any currency to devalue.

These questions are important, not to say decisive. There are no simple and clear-cut answers, the conclusions are not apparent.

There exists an extensive theoretical and empirical literature about the determinants of exchange rates. The interest rate parity condition says that we can expect that a change in the exchange rate if the domestic interest rate deviates from that abroad. But the relation between exchange rate and interest rates will no longer be relevant towards the countries in the currency union if Sweden becomes a member.

Purchasing power parity means that the exchange rate would change if there were differences between the domestic price development and the price development abroad. If this in reality would be a decisive determinant of the exchange rate it is apparent that the combination of a membership in the currency union and a faster domestic price increases would create serious problems for production and employment. It is a problem that national fiscal policy would have difficulties in dealing with.

The empirical literature on exchange rates is far from clear in its conclusions. If it were purchasing power parity that ruled we would expect that the real exchange rate would stay constant. Sweden, as most other countries, has, however, experienced large variations in the real exchange rate.

Taylor (1995) writes in a survey article that there are large and persistent movements in exchange rates that cannot be explained by macroeconomic variables such as interest rates and prices. There is a lot supporting the argument that there are speculative forces on the currency markets, forces not based on macroeconomic variables. There exists a discussion about so-called microstructures. Some agents on the currency market may have destabilizing expectations, and others may base their actions on technical analysis rather than macroeconomic variables.

Taylor's conclusion is, however, that macroeconomic variables are important for the determination of exchange rates in the short run, even if they are not the only determinants. At the same time there are studies that show that macroeconomic variables are more important in the medium run. In this context it is interesting to note that there exist studies that real exchange rates vary more when the nominal exchange rate is flexible than when it is fixed.

Thomas (1997) studies if the Swedish exchange rate is stabilizing. The conclusion is that the costs for Sweden from abandoning an own currency are not higher than for the countries already in the currency union, they may even be lower. This presupposes, however, that there is a national stabilization policy. The conclusions in Artis and Ehrmann (2000) are even more far-reaching. They write that the Swedish currency market rather seems to be a source of disturbances than an absorber of disturbances. It seems difficult to unambiguously draw the conclusion that the loss of national monetary policy will lead to more volatile production and employment.

2.3 Effects

The discussion about the roles of the public sector builds on the implicit assumption that economic policy affects the economy. The question if national fiscal policy has any effects is put in focus for members in a currency union when there is a need for national stabilization policy. This must be the case for there to be any point in further discussions. In a next step then the issues are which effects policy has and how big the effects are.

The question if fiscal policy has any stabilizing effect at all has received attention in the economics literature the last decades. An important theoretical result in the literature on ricardian equivalence is that the households' dynastic (altruistic) behavior implies that fiscal policy, in the form of the budget surplus, does not have any effect. The result is, however, built on a number of restrictive assumptions. One of these assumptions is that taxation does not give rise to any excess burdens.

There are several different approaches to empirically test if ricardian equivalence holds. One is to empirically try to show that fiscal policy has effect. This is usually done using macroeconometric methods, mostly with the aid of aggregated time series data. Another approach is to empirically study household behavior. Some studies focus on the question if household consumption behavior is consistent with ricardian equivalence while other papers study if the households behave in an altruistic way. This is usually done my microeconometric analysis of cross section or panel data.

There exists a fundamental problem connected with the identification of the relation between economic activity and fiscal policy. The economic activity affects fiscal policy at the same time as fiscal policy

also affects economic activity. The issue is, therefore, to isolate the possible effects of fiscal policy. A common way is to do this within the framework of vector autoregression models (VAR models). Blanchard and Perotti (1999) is a recent study based on this approach using U.S. data. They find that fiscal policy has effects. Swedish studies in this tradition are Hokkanen and Jansson (1994) and Becker and Paalzow (1996).

Another approach is to compare tax pressure and variations in economic activity across countries. Such studies suggest that high tax countries have smaller variations in the level of economic activity than low tax countries, see Galí (1994) and Fatás and Mihov (2001). Fiscal policy would, in other words, really have a stabilizing effect.

An important reason for why it would be in this way is the private consumption is liquidity constrained. This is the case if, at least, some household simply consume its total income because they cannot use the financial markets to consume other time periods than when they receive their income. Examples of studies in this tradition that use Swedish data are Campbell and Mankiw (1991) and Agell *et al.* (1995). The latter presents empirical results indicating that 10 to 25 percent of the Swedish consumers are liquidity constrained. This proportion may even be higher in recessions.

The empirical literature based on micro data also finds that, although the households seem to have altruistic motives for their actions, the quantitative effects are smaller than what the theoretical models predict. An early study in this tradition is Altonji *et al.* (1997) who use U.S. data. Laitner and Ohlsson (2001) find only weak evidence of altruistic behavior in Swedish data. Laitner (1997) discusses the hypothesis that there may exist big differences between households, some are altruistic while others are not. The empirical results do not support the hypothesis of ricardian equivalence and, therefore, indirectly support that fiscal policy really can affect the economy.

Three tentative conclusions can be drawn from the current international literature on the effects of fiscal policy. In the first place, directions of the effects are those expected, at least in situations when the credibility of the economic policy is high. Higher government consumption and investments as well as lower taxes and more transfers stimulate aggregated demand in the short run. A second conclusion is that variations in government consumption give stronger effects than changes in taxes and transfers. A third tendency is that the effects seem to be smaller compared

to what early Keynesian analysis indicated. Recent studies report multipliers of government consumption of approximately unity. The multipliers seem to be smaller than unity for taxes and transfers. Older studies showed multipliers substantially larger than one.[10]

In addition, for Sweden it is reasonable to believe that fiscal policy becomes more effective in affecting real variables such as production and employment for a member in the currency union.[11] Counteracting forces such as a flexible exchange rate and domestic interest rates do not exist anymore.

3. Conditions and restrictions

Will the restrictions on economic policy change if Sweden joined the currency union?

Will we *be allowed to* stabilize the economic development to the same extent?

In this section we start by discussing the formal restrictions that a membership in the currency union imply. We then continue by discussing the economic restrictions that will affect Sweden in the currency union.

3.1 Formal restrictions

There are three components that together form the formal restrictions. The first is the procedure when deficits are too large according to the Maastricht Treaty. The second element is the Stability and Growth Pact. Finally there are the general guidelines for economic policy.

The rules in the Stability and Growth Pact stipulate a medium run target for public finances to be in balance or show surplus. The rules apply for all EU countries, also those who are not members of the currency union.

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[10] See for instance Blanchard and Perotti (1999), Wren-Lewis (2000), and Virén (2001).

[11] Here we disregard the discussion whether fiscal policy may have non-keynesian effects that would imply that fiscal contraction in some situations could have an expansionary effect.

The Maastricht criteria concerning net lending and gross debt are now the same for Sweden as they would be in a currency union.[12] The most important difference is that countries outside the currency union cannot be subjected to the sanctions in the form of fines etc. that members may experience of the do not comply with the criteria. Countries outside the currency union can only be exposed to the other members peer pressure if they do not comply with the criteria.

The deficit in the public sector's net lending may not, except temporarily, be larger that 3 percent of GDP. The gross debt of the public sector shall be below 60 percent of GDP or by decreasing towards this value at a satisfactory pace. If GDP falls by more than 2 percent during a year net lending may show a bigger deficit than 3 percent. If the fall in GDP is in the interval 0.75-2 percent it is a question judgment if the deficit may be larger than 3 percent.

The most commonly mentioned motive for introducing these criteria has been that they protect from increased inflation risks. The reason is to avoid that the European Central Bank will have to bail out countries that have pursued an irresponsible fiscal policy. Such rescue actions risk to counteract the price stability objective. Another motive for the criteria is the fact that fiscal policy in one country may have external effects on other countries. Fairness is also often mentioned as a motive, the same rule shall apply for all countries regardless of they are big or small, and, therefore, does not have any considerable impact on other members in the currency union.

One might ask how binding these criteria would be in reality. There are rules when exceptions from the criteria allowing larger deficits at deep recessions. It remains to be seen if one really is prepared to use sanctions against a member of the currency union that is not able to fulfill the criteria, see Beetsma (2001). And if there are sanctions the question becomes how long it will take before the sanctions really are put into effect.

The critical fiscal policy variables in the Convergence Program concern the whole public sector and not the central government only. More specifically the program focuses on the public sector's net lending and

[12] We take the existence of the criteria as a starting point. A more normative discussion if the criteria are good or not and how the criteria should be designed are beyond the scope of this paper.

consolidated gross debt.[13] Net lending corresponds to the public sector's income minus expenditure on consumption, transfers, and real investment. The consolidated gross debt is the central and local governments outstanding debt in the form of bonds, certificates, loans, and deposits minus the central government's, the local governments', and the social security system's holdings of these financial instruments.

Figure 1 illustrates the convergence rules graphically. The rule that the public sector's net lending always shall be greater that 3 percent of GDP implies that the economy always must be to the right of the vertical line at –3. The rule that the public sector's consolidated gross debt never shall exceed 60 percent of GDP implies that the economy always shall be below the horizontal line at 60. In other words, the allowed area is in the lower right parts of the figure.

The thick solid line in the figure shows the convergence path of the Swedish economy since 1994. The first year the criteria were met literally was 2000, although it was by a thin margin for gross debt. The forecast for the coming years is that net lending will correspond to slightly more than 2 percent of GDP, considerably more than the net lending criterion, while gross debt will not decrease especially much under the 60 percent of GDP. The forecast is that gross debt will be approximately 48 percent of GDP 2004.[14] We will return to this below.

From the figure it is also clear that gross debt as a share of GDP in principle was constant during the second half of the 1990s and this even though net lending was negative. Shouldn't the relationship between net lending and gross debt by perfectly negative so that debt increases when net lending is negative and decreases when net lending is positive? It is possible to show that the change in gross debt as share of GDP can be written as the sum of three components:

- net lending

  Higher net lending will result in lower gross debt as share of GDP;

- nominal GDP growth

  Higher growth will result in lower gross debt as share of GDP;

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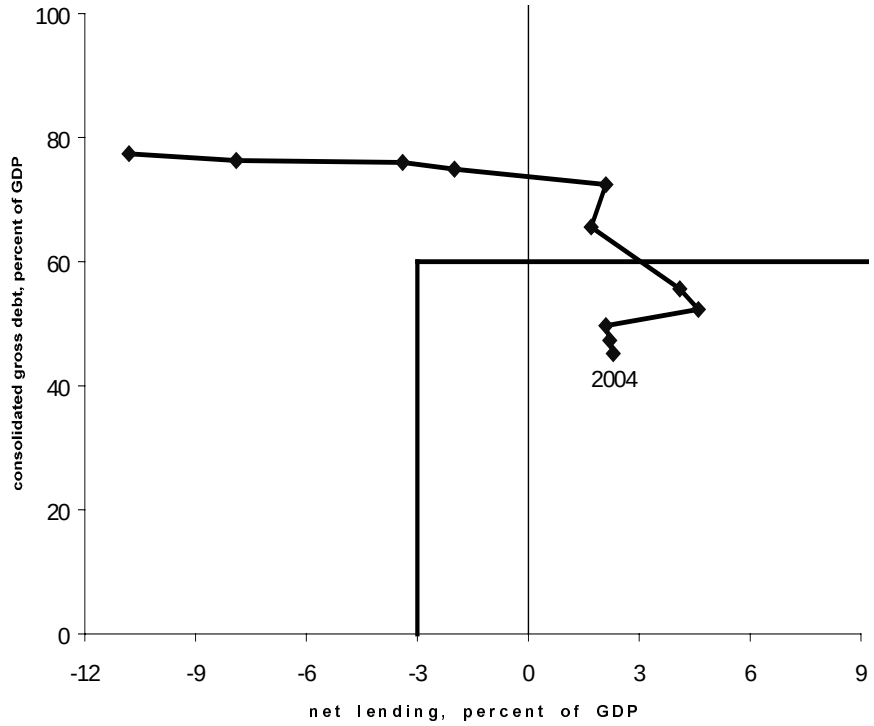
[13] European Commission (1996) reports the principles for how these variables should be computed.

[14] Spring Fiscal Policy Bill 2002.

Fig. 1

The convergence path for Sweden, 1994-2004



Data sources. Central government Bill 2000/2001:100, Ministry of Finance (2001).

- changes in holdings of public assets not included in net lending[15]

  Higher holdings of financial assets will result in higher gross debt.

It is only when nominal GDP does not grow and holdings of financial assets do not change that there is a perfect negative relationship between net lending and gross debt. At the same time it is possible to reduce gross debt even if net lending is negative. This can, for example,

[15] In European Commission (2000) this component is hidden behind the term "stock-flow adjustment".

happen when nominal GDP grows rapidly. This growth, in turn, can be because of high inflation, which is not desirable, or rapid growth in real GDP, which, of course, also has many more advantages than to reduce gross debt. Another way of reducing gross debt is to sell assets. Decreasing the amount of financial assets has no effect on net lending whereas decreasing real assets has.

It is important to stress that there is a close connection between public debt policy, budget policy, growth policy, and asset policy. The political choices not to sell 3G licenses and only partly privatize Telia, the Swedish public telecommunication company, have as important implications for meeting the convergence criteria as the budget policy. Selling Telia stock affected gross debt, but not net lending. It was viewed as a balance sheet operation, a financial reallocation that did not affect public sector net worth. The funds that a 3G-license auction would have raised would, on the other hand, have affected both net lending and gross debt. The license auction would have been regarded as a real transaction.

Table 1 reports the three components' importance for the gross debt's development 1996-2000. The first years net lending contributed to an increase in gross debt, the last years the effect was the opposite. The growth component has decreased gross debt by 2-4 percentage points each of the years. The contribution of the asset component (stock flow adjustments), finally, has varied a lot, from a debt increase of slightly more 2 percentage point 1998 to debt decrease of almost 3 percentage points 2000. The largest gross debt decrease during the five-year period was in 2000, when all three components gave considerable contributions to the gross debt decrease.

Are there big differences between the development for the central government and the development for the entire public sector? And which differences arise when net lending instead of budget balance is used? In national account sense there are obviously important conceptual differences between these variables. As is clear from Table 2, however, the development of the central government budget surplus most years corresponds relatively well with the development of net lending except a difference in levels. The same applies for public sector consolidated gross debt and central government debt that in principle have developed in a similar way most years. One reason to why the differences are not that big is that the local governments now have to meet a requirements to have balance in their economy.

Table 1

Change in gross debt (1996-2000)
(percent of GDP)

	1996	1997	1998	1999	2000
component:					
net lending	3.1	1.6	–2.1	–1.3	–3.7
economic growth	–1.9	–2.8	–3.2	–3.6	–2.9
asset change, excl. real investment	–1.4	–0.3	2.5	–2.0	–3.0
total	–0.2	–1.5	–2.7	–6.9	–9.6

Sources: European Commission (2000), The Swedish Ministry of Finance (2001).

Table 2

Fiscal policy convergence variables (1996-2000)
(percent of GDP)

	1996	1997	1998	1999	2000
public sector net lending	–3.1	–1.6	2.1	1.3	3.7
central government budget balance	–1.2	–0.3	0.5	4.1	4.9
public sector consolidated gross debt	76.0	74.5	71.8	64.9	56.3
central government debt	80.3	78.5	76.0	68.9	61.2

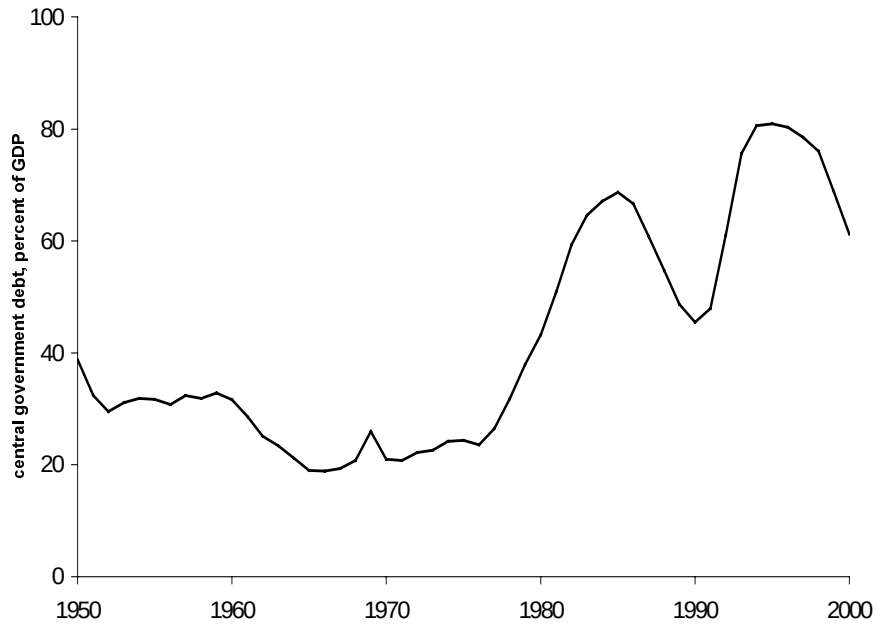
Sources: The Swedish National Debt Office, The Swedish National Financial Management Authority, Statistics Sweden.

But the effects of fiscal policy do not only concern the surplus. It is also a question of composition and design both concerning revenue and expenditure. In addition, asset changes may have stabilization policy effects, balance sheet changes may be important. The surplus is affected by cyclical effects, but the cyclical surplus or its change does not say how expansive the policy is either.

The cyclical variations also imply that there is a need for safety margins to the Maastricht criteria to be able to meet these criteria also during a recession. Otherwise one may be forced to a procyclical policy with tax increases and expenditure cuts during a recession. The higher tax pressure in a country, the larger will the magnitude of cyclical fluctuations in the surplus be. The safety margins will, therefore, have to be larger in high tax countries compared to low tax countries.

Fig. 2

Central government debt (1950-2000)
(percent of GDP)



Source: The Swedish National Debt Office.

There is also a need for a safety margin for the gross debt as it also shows cyclical fluctuations. Year 1977 central government debt equaled 26 percent of GDP. Six years later it had increased to 65 percent of GDP, an increase by 39 percentage points. This was repeated in the beginning of the 1990s. Year 1991 central government debt was 48 percent of GDP, three years later 81 percent or 33 percentage points higher. The forecasted margin to the gross debt criterion 2004 is not particularly big in view of this.

Figure 2 reveals that the debt ratio has shown an increasing trend the last decades. At the millenium change the debt ratio was three times higher than during the 1970s. But there has also been a high, and increasing, variability for the debt ratio.

In summary we can conclude that the Maastricht criteria are not neutral. They are not strict for countries with low taxes where public assets also are sold. At the same time it would be wrong to say that the criteria would be impossible to meet if one desires to keep a traditional welfare state.

3.2 Economic restrictions

Will the economic restrictions on economic policy change if Sweden joined the currency union?

The possibility to finance deficits by domestic money creation will disappear. This is not important, however, in the sense that the Swedish Central Bank Law already today does not allow for this source of finance to be used. At the same time, it is always possible to change national laws whereas a membership in a currency union has many consequences that are more or less irreversible.

Fiscal policy will, on the other hand, become more effective. Counteracting forces such as a flexible exchange rate and a domestic interest rate do not exist any longer. At the same time this is a truth that has to be qualified. If fiscal policy becomes too irresponsible to a risk premium may have to be added when financing public debt.

The tax bases have become more internationally mobile during the last years.[16] A membership in the currency union may make the speed of this development become faster. This concerns the basis for corporate taxation and personal capital income taxation in particular. One reason for this is that the exchange rate risk for financial investments abroad will decrease. Tax competition has also increased during recent years. Also within the area may a membership in the currency union speed up the process.

The experience from other federations and monetary unions such as the U.S., Canada, Australia, Germany, and Switzerland is, however, that there does not arise a complete equalization of taxes and public expenditure. In the U.S. there are big differences in tax pressure and public expenditure across states and cities.[17] This seems to be possible to sustain although there is a high degree of mobility in the U.S. economy.

Baldwin and Krugman (2000) point out that it is difficult to find that tax competition has driven down the tax pressure in Europe, on the contrary it seems likely that the tax pressure in European low tax countries is increasing and that the gaps to high tax countries has decreased somewhat. Generous welfare states with high taxes tend to have good infrastructure, well educated and experienced labor force, well organized markets, and are, therefore, attractive for investors. This gives room to have higher taxes to some extent. If taxes, on the other hand, become too high the flows out of human and financial capital of the country may become large and also irreversible. Another aspect of this reasoning is that an important condition for this argument to work is that taxation to a large extent must be based on the utility the tax payer has of the public activities (the benefit principle) rather than the tax payer's ability to pay taxes (the ability to pay principle). For some taxes, however, tax competition does not leave any room to diverge from other countries.

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[16] This is also the topic of an official government commission that currently is working, The commission on the internationalization's importance for Swedish tax bases and future tax structure. A number of papers, commissioned by this commission, were presented at a conference in November 2001. The papers will be published in a future issue of *Swedish Economic Policy Review*.

[17] In Ohlsson (1998) there is a short summary of data showing differences in taxes and expenditure in the U.S.

4. Automatic fiscal policy

Will the fiscal policy instruments have to change if Sweden joined the currency union?

Can we do it *in the same way* as before when stabilizing the economic development?

There are three main types of stabilization policy instruments within the national fiscal policy. First, there are the *automatic stabilizers*. The tax system can be stabilizing even at given tax rates as the tax payments increase during expansions while they decrease during recessions. The unemployment insurance system can, in a corresponding way, be an automatic stabilizer on the expenditure side.

Second, there are stabilization policy instruments that systematically have been used to affect economic activity. The active labor market policy can be seen as a comparatively stable reaction on the labor market situation. The volume of these instruments used is described by reaction functions. The difference compared to automatic stabilizers is that economic policy decisions about the volume of the measures are continuously made. Labor market policy to stabilize employment can be seen as a *semiautomatic stabilizer*. Finally, there are pure *discretionary* instruments that sometimes are used, other times not. For these instruments it is not possible to find a systematic and stable relation to the level of economic activity.

4.1 Automatic stabilizers

Many argue that one above all shall let automatic stabilizers operate. The advantage of this is, among other things, that lags regarding observing that there is a need for stabilization policy measures and lags in deciding about measures are avoided. A disadvantage is that this stabilization policy strategy may cause conflicts with the Maastricht criteria if there are not sufficient safety margins in the public finances. In addition, the business cycle is a multidimensional phenomenon. Automatic stabilizers usually only react in one dimension, for example, income or unemployment. There are, however, substantial phase lags between the activity on goods markets and that on the labor market. Automatics in itself is, furthermore, not sufficient. Stabilization policy must also have effect, but we have already discussed this in section 2.

Among the most important items in the central government's revenue side are the value added tax and payroll taxes. The personal income taxes is the main revenue source for the local governments.

The bases for these taxes are broad and reflect the development of economic activity well. The stabilizers could, however, be made more efficient. A faster tax collection is one way of reducing the time lags for these and other taxes. One way of doing this is to change the principles for how preliminary taxes are calculated. Another examples of changes would be that income and corporation taxes can be based on quarter or half year rather that the calendar year as time unit.[18] Realized capital gains could be taxed during the quarter when they arise. The principle of tax at source could be extended to more areas.

There is no direct possibility to affect the bases for these taxes. The tax rates, on the other hand, are direct fiscal policy instrument. There are, however, reasons to be careful in varying tax rates. The literature on tax smoothing argues against varying these over the business cycle. This is an allocation argument that clearly shows that stabilization may be in conflict with allocation. The equilibrium approach to fiscal policy (Barro, 1979) builds on that the agents in the economy optimize over time. Provided that the excess burdens that taxation creates are independent of the business cycle, the excess burdens are minimized if the tax rates are kept constant over time. Slightly simplified it is possible to say that the excess burden of a tax increases by the square of the tax rate. This means that an increase in a tax rate will give a considerably bigger increase in the excess burden than what a corresponding decrease in the tax rate will decrease the excess burden.

There is, however, a trade off between efficiency and stabilization. When disturbances are large there are good reasons to put more emphasis on stabilization.

Unemployment insurance and other passive labor market policy measures are maybe the most distinct automatic stabilizers on the expenditure side of the central government budget.[19] But the active labor

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[18] An example is The Swedish National Board of Student Aid which has half year as the time unit when computing the maximum income students may have without having their student aid reduced.

[19] Ohlsson (1991) study which parts of the central government budget has covaried with economic activity during the period 1970-1988. Labor market policy has been the most clear countercyclical part of the central government expenditure.

market policy has also been countercyclical. It has continuously been made decisions about the volume of the measures as a comparatively stable reaction on the labor market situation (see section 4.2 below).

There are also central government expenditure items with a procyclical development. The health insurance costs have recent years increased during good times. There is a conflict here. On the one hand there are reasons to decrease these variations. At the same time this will make the budget surplus more sensitive to the business cycle as the health insurance costs by being procyclical counteracts the countercyclical items of the central government expenditures. Another aspect on the health insurance is that it because the increased international mobility of tax bases may be necessary to remove the ceilings for the compensation. The same thing may also apply for the pension system and other parts of the social security system.

4.2 Labor market policy – a "semiautomatic" stabilizer"[20]

Labor market policy measures are intermediate policy measures between passive fiscal policy, using automatic stabilizers, and active discretionary fiscal policy. These measures could be viewed as semiautomatic stabilizers, i.e., as intermediate forms in the sense that they continuously demand discretionary decisions, but that these decisions are taken more or less rule based when unemployment varies. It could be described as the policy is implemented in a rather stabile and predictive way according to a reaction function.

Ohlsson (1993) examines the effect lags of job creation measures. The results show that an additional grant affected the number of people in job creation programs during 1½ year, with the strongest effects within one year. The maximum effect occurred after eight months. Ohlsson (1995) studies the effects of labor market policy measures over the business cycle. He finds that the job creation measures had desirable effects on unemployment during the 1970s and 1980s.

Calmfors *et al.* (2002) present results that also include the 1990s. They report results showing a slightly different picture of the effects of labor market policy. It seems difficult to find positive effects on regular

[20] This section draws heavily on section 5.5 in the STEMU report.

employment, not including people in labor market policy measures. On the other hand, *job creation measures* seem to have very large crowding-out effects on regular employment. This means that job creation measures have only limited effects on open unemployment. On the contrary, *labor market training* seems not to cause such crowding-out effects on regular employment. Consequently, variations in the volumes of labor market training have desirable effects on open unemployment. However, there are obvious limitations for the size of volumes of labor market training so that their efficiency would not be threatened. The substantial volumes put in place during the crisis in the the first part of the 1990s seem to have lead to that the average affects on incomes and employment for participants in the programs either have been insignificant or possible even negative.

A conclusion is that labor market policy, seen as a form of semi-automatic stabilizers, even in the future should be used as an active stabilization policy instrument also at smaller disturbances. The measures seem to have been implemented timely, although the volumes of the measures became too excessive during the deep crises in the 1990s. It is important that labor market policy measures is not used to such an extent that they become inefficient. Labor market policy measures directed toward stabilization should not be permanent and it must be possible to cut them in periods of economic recovery.

4.3 Local governments and automatic stabilizers

Central government grants to local governments is another large item on the expenditure side of the central government budget. Here it is important to note that the Maastricht criteria are for the whole public sector and not only for the central government. This means that the principles for economic interactions between the central government and the other parts of the public sector become central.[21] The question is how central government grants, tax equalization, and collection and payment of local governments' taxes shall be designed to contribute to, or at least not counteract, that the objectives of stabilization policy are fulfilled.[22] The

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[21] Balassone *et al.* (2002) discuss the interaction between the fiscal rules in the European Union and fiscal decentralization.

[22] There is a more formal discussion about local government economy in the Appendix.

design of the balance requirement for the local governments is also important for the behavior of local governments.[23]

When studying the stabilization policy effects of the present systems it is initially important to make a distinction between measures concerning the local governments economy that refer to periodized variables and those that do not. The local governments' costs and revenue are periodized and describe the local governments' economy in an accounting sense. The cash flows of local governments consist of unperiodized payments.

The balance requirement for local governments concerns the change in net worth. It is, in other words, an accounting measure on accrual basis and concerns revenue and costs rather than payments. Investments affect the balance requirement by the periodized annual capital costs. Net lending, which is the base for the Maastricht criterion, is, on the other hand, affected by the annual investment expenditure. The balance requirement affects the local government budget. The budgeted revenue must be greater or equal to the budgeted costs. This presupposes, however, that the outcome two years before was not a deficit, if it was the budget must show a surplus to compensate for the previous deficit.

For stabilization policy it is the local governments costs, rather than the revenue, that is the problem. The important thing is how the local governments' revenue and costs affect the behavior of households and firms. The local government income tax works as an automatic stabilizer in the same way as the central government income tax because the tax collection is joint. Crucial here is when the collection is made, when the disposable incomes of private agents decrease, not when the payment from the central governments to the local governments take place. The design of economic interactions between the central government and the local governments may, on the other hand, affects how local government costs evolve. This may be important for stabilization policy.

If the local governments' tax bases decrease temporarily during a year the balance requirement does not call for any immediate measures to be taken. The cost will, however, have to be reduced two years later. The alternative is to increase the local government tax rate two years later. Because of the design of the present central government grant and

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[23] The commission on local government economic management has recently in its final report SOU 2001:76 suggested a number of changes in the principles for how the local government economy shall be managed.

equalization system, the local government tax rate is the only tool for a local government to affect its own revenue. Regardless of which of the alternatives that is chosen, there will be a contractionary impact on economic activity.

This may not be desirable for several reasons. The fact that the balance requirement concerns costs and revenue on accrual basis makes it difficult for the local governments to reduce costs to any considerable extent by reducing local government investment as only the annual capital costs are included in the balance requirement. Or to put it differently local governments can do what the central government cannot periodize. At the same time this means that it is easier for the central government to use investments as a shock absorber. The probability is therefore high that it is the operating costs that the local governments will reduce.

In addition it may be that the recession that caused the local governments tax base to decrease has changed to an expansion two years later and that a conctractionary policy is desirable at this time. It is, however, dangerous to base stabilization policy on assumptions about stable business cycles both as regards magnitude and periodicity. One should not, in other words, "ride the lags".

Another objection is that it is the central government's, not the local governments', task to pursue stabilization policy. If the central government can contribute to a more stable development in one sector of the economy it should do it.

The tax base should, therefore, not only be equalized between local governments but also over time. Calculating the tax base as an average over the business cycle can do this. This way temporary variations in the tax base will be smoothed, while more permanent trend changes will affect the tax base.

5. Discretionary fiscal policy and large disturbances[24]

As was discussed above, if disturbances are normal, national stabilization policy should primarily be through automatic stabilizers and labor market policy, which could be viewed as a "semi-automatic"

[24] This section draws heavily on section 5.6 in the STEMU report.

stabilizer. Discretionary fiscal policy for stabilization purposes should only be used when there are major imbalances in the total capacity utilization, i.e., at large output gaps.[25] There is a trade off between stabilization and efficiency. Keeping tax rates constant can be desirable from efficiency point of view while stabilization may call for discretionary changes in tax rates. When disturbances are large there are good reasons to put more emphasis on stabilization.

5.1 Desirable characteristics

When choosing fiscal policy instruments for stabilization it is desirable to find instruments with as *general* effects as possible. By a general instrument we mean that the tax base or expenditure base is broad, so that the measure affects a large share of the economy. It is also important that the measure is *temporary,* i.e., that a parliament decision only concerns a limited time period, and *symmetric*, i.e., that tax cuts during bad times are counteracted by corresponding increases during good times.

Taxes and expenditures do not only have stabilization effects but also affect the distribution between different groups in society and the resource allocation. This is the reason why instruments should be general. However, it is desirable to, as far as possible, separate stabilization policy from distribution policies as well as from allocation policies. The more general fiscal policy instruments are, the smaller is the risk that there will be undesirable effects on distribution and economic efficiency.

Instruments with strong distribution effects are also often difficult to change back to previous levels after economic slowdowns and to use to counteract strong expansions. This is because tax increases or expenditure cuts are needed in both cases and could be difficult to get political support for. If fiscal policy instruments used for stabilization are general, and the distribution effects, therefore, are small, it becomes more likely that it will be possible to use the instruments in a symmetric way over the cycle. If the distribution impact of stabilization policy is small, the decision lags should also be small. In the same way, stabilization policy decisions are easier to make if the impact on economic efficiency is small.

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[25] The STEMU commission defines large output gaps as gaps at least of the size of 2 percent of GDP.

From a more general point of view, the use of general fiscal policy instruments seems natural. This is because fiscal policy in the monetary union should substitute for national monetary policy, which is general.

The experiences from the 1980s and the beginning of the 1990s illustrate what can happen if fiscal policy is not symmetric. Government debt increased strongly in many countries and in some countries this led to debt crises.[26] Stabilization policies were not implemented in a symmetric way over the cycle. Instead expansionary measures tended to be permanent, while contractionary measures were not implemented early enough or were not strong enough. The result was that the strengthening of fiscal policy in good times did not counter-balance the weakening of public finances during recessions. If the fiscal policy instruments instead had been used in a temporary and symmetric way, the average tax and expenditure levels over the cycle had not changed.

An additional motive for temporary use of stabilization policy instruments is that structural changes in tax and expenditure levels are avoided. Otherwise stabilization policy will cause permanent deviations from decisions the Parliament has taken based on distribution and economic efficiency aspects.

It is not only stabilization policy measures that could effect income distribution and economic efficiency. It could also be the other way around. An example is, for instance, when positive efficiency effects of a certain policy take a long time to materialize (long effect lags). Reforms that are motivated by efficiency effects improving productivity may initially lead to higher unemployment before demand increases and ”fills up” the new higher potential level of production.[27]

For this reason it is important to adjust the time of implementation for measures aimed for economic efficiency and distribution according to the expected level of economic activity. Structural reforms could in such a way be used for stabilization. However, such a policy would put great demands on knowledge about the structure and dynamics of the economy.

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[26] For the Swedish development see, for instance, Lindh and Ohlsson (2000).

[27] This mechanism seems relevant to explain why Margaret Thatcher’s reforms in the 1980s did not give positive effect until the 1990s, see Nickel and Van Ours (2000) and Calmfors (2002). It is also reasonable to believe that the positive efficiency effects of the Swedish tax reform in the first years of the 1990s came several years later.

Parallel to that, structurally motivated changes in instruments implemented at the wrong points in time from a stabilization policy perspective could aggravate macroeconomic shocks. A Swedish example is the time sequence of credit market deregulation (1985), deregulation of the foreign exchange market (1989), and the tax reform (1991). The time sequence between these reforms probably contributed to the overheating in the late 1980s and to the deep recession during the first years of the 1990s.

5.2 Fiscal policy instruments

We discuss different specific tax and expenditure instruments in this subsection. For each type of instrument, first, the channels through which *temporary* changes of the instrument affect the activity level in the economy are discussed. We then assess how suitable each instrument is as stabilization policy instrument. The discussed instruments are: personal income taxes and transfers, value added taxes, payroll taxes, internal exchange rate changes, public consumption, and public investment. Some special Swedish innovations will be briefly touched upon, for example the investment fund system. Taxes on capital incomes, real property, wealth, inheritance, gifts, corporation taxes, and taxes on specific goods seem for different reasons be less suitable to use to stabilize. Hence, they are not dealt with.

5.2.1 Personal income taxes and transfers

Changes in personal income taxes and transfers affect the households' disposable incomes. It is more difficult to assess how changes in disposable incomes in turn affect private consumption expenditures. One research result is that changes in disposable incomes in the short run do not fully lead to changes in consumption (compare the discussion in section 2.3). The households' possibilities to redistribute their consumption over time via the credit market are, among other things, of vital importance for the size of the effect. Empirical research for Sweden points to that 10-25 percent of the households, and possible somewhat more in recessions, are credit rationed.[28] That means that they have difficulties to get loans at the credit market against future incomes. For these households there are

[28] See Agell *et al.* (1995).

probably strong correlations between disposable income and consumption. For remaining households the correlation is probably weaker.

It is reasonable to assess that temporary changes in income taxes and transfers give weaker effects on aggregated demand then temporary changes of the same size of public consumption or public investments.[29]

Changes in income taxes and transfers can also affect labor supply. However, in a recession a tax cut will probably have only marginal effects, since in such situations employment is in the first place decided from the demand side.

Temporary changes in income taxes appear to be a possible stabilization policy instrument because a change in income taxes affects a large part of the economy. A possible method would be to impose an extra proportional tax,[30] a *stabilization tax* paid as a certain percent of the taxable income, equal for all, in strong overheated situations. In a corresponding way a special *stabilization tax reduction* could be given in recessions. Such changes would have relatively small distribution effects. Changes in income taxes that considerable change the progressivity should not be used for stabilization, because that would imply substantial redistribution effects, and could complicate the decision process.

A problem with variations of income taxes for the aim of stabilizing the cycle is that the effects on consumption via disposable incomes may be small when the tax change is temporary. Another problem is that increases in income taxes can, because of restrictions on retroactive taxation, only take place at turn of the year. This could contribute to long time lags.

Changes in transfers to households have similar economic effects as changes in income taxes. However, in general transfers should not to be used as stabilization instruments, because they usually concern specific groups in society and get proportionately large effects on the income distribution. This would probably make it especially difficult to decrease transfers when the cycle needs to be dampened.

However, it should be observed that also the value of transfers in the Swedish system is affected when general variations in the income taxes are

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[29] As a consequence a *balanced budget change* gives effects on aggregated demand. If for instance public consumption and taxes are increased to the same amount, so that the budget balance does not change, demand will be stimulated.

[30] Collected by the central government.

used as a stabilization instrument. The reason is that most transfers in Sweden are taxed in the same way as taxable incomes. Hence, changes in the income tax rate will in this way affect the size of transfers net of taxes.

5.2.2 Value added taxes

Variations in the value added tax, for instance a few percentage points around its normal value, can reallocate household consumption over time.[31] A temporary increase of the tax rate could reduce consumption temporary when there is a threat of economic overheating. Correspondingly, a temporary cut of the tax rate during a recession could give a temporary higher consumption. The effects on the income distribution of changes in the value-added tax would be rather small.

The tax base of the value added tax consists mainly of consumption expenditures. Temporary tax changes affect both goods and services gross as well as net prices. How much gross and net prices will change is dependent on how the burden of the tax is distributed between firms and consumers. How a general change in the value added tax would affect the aggregated price level, i.e., the size of the change in CPI, will also depend on the distribution of the tax burden.

The effect on consumption of a value added tax change originates partly through changes of relative prices between consumption in different periods and partly through the change in real disposable incomes when the aggregated price level is changed.

Variations in the value added tax is associated with certain problems. When households get to know about for instance a planned tax cut, they will decrease their consumption up to the time point the change will come into force. Further, households will advance consumption just before the tax cut come to an end, so that consumption decreases temporarily after the tax has been increased again. For the purpose to mitigate the first effect a temporary change in value added tax should be carried out rapidly after a decision.

Another problem connected to variations in the value added tax is that temporary large difference in tax rates compared to other countries could lead to trade over country boarders for the purpose to use the

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[31] In Sweden the normal tax rate is 25 percent of consumption expenditures.

possibilities of tax arbitrage. An administrative problem is the costs associated to changes of price tags.

There are reasons to believe that changes in the value added tax would get large effects on construction of dwellings. The reason is that this is regarded as similar to final consumption in Sweden. Hence, tax changes will fully affect costs.

Concerning value-added tax there exist certain EU-rules. However, these rules do not constitute obstacles for variations in the tax rate motivated by stabilization policy motives. The most important rule is that the normal tax rate must exceed 15 percent. Further, exceptions for certain types of goods are permitted. Member countries can chose maximum two reduced tax rates in between 5 and 15 percent. In the Swedish case there exists lower tax rates on books and foodstuffs, amounting to 6 and 12 percent, respectively. In the first place, variations in the normal tax rate would be recommended as a stabilization policy instrument.

5.2.3 Payroll taxes

Statutory payroll taxes paid by employers are charged on the wage sum and currently amounts to approximately 33 percent in Sweden. The immediate effect of a change of the tax rate is that firms' wage costs will be changed proportionally. Empirical studies show that the effect on wage costs still is substantial in between one to two years.[32] This depends on that nominal wages are rigid in the short term. Obviously, there exist possibilities during a couple of years to affect domestic production and employment by the means of temporary changes in payroll taxes.

A temporary increase in payroll taxes will increase firms' wage costs and will in an overheated situation contribute to moderate employment and production. In a recession a temporary cut of payroll taxes could in a corresponding way stimulate firms to sustain employment and counteract reductions in production.

The effects following temporary changes in payroll taxes resemble those of temporary exchange rate variations. At a payroll tax cut domestic firms' wage costs decreases relatively those abroad. Accordingly, domestic

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[32] An overview over the factors deciding wage costs, among them the effects of payroll taxes, is given in Calmfors and Uddén Sonnegård (2001).

production will turn more competitive and demand shifts from foreign to domestic production (an expenditure shift). In this way, variations in payroll taxes could to some extent substitute variations in the exchange rate no longer possible inside the currency union. Cuts in the payroll taxes should in the first place be used in situations when the position of the domestic cycle diverges substantially from that in the rest of the currency union. In such cases changes in Swedish payroll taxes should appear as acceptable from the point of view of other countries in the union.

Variations in payroll taxes also lead to changes in demand on the one hand by a change in the price level and on the other hand by effects on firms' profits.

5.2.4 Internal exchange rate variation[33]

Variations in payroll taxes can be combined with other tax and expenditure changes in such a way that the budget surplus does not change. In the literature this is called *internal exchange rate change.* Inasmuch as the discussion usually refers to a cut in payroll taxes it is most often named an *internal devaluation.* A compensating change can be carried out in personal income taxes, value-added taxes, employees' contributions to the social security system, or in transfers to households. The aim of an internal exchange rate change, in contrast to an unfinanced change in payroll taxes, is only a shift of demand between foreign and domestic production and that the effects on aggregated demand are small. Budget neutrality makes this instrument particularly attractive if the aim is to achieve a temporary cost cut in a situation when a weakening of the budget surplus is not desirable.

The parallel between internal and external exchange rate variations appears most clearly when a cut in payroll taxes is financed by an increase in value-added taxes. The direct effect on households will be price increases as in the case of a devaluation. For domestically produced goods and services decreased payroll taxes and higher value-added tax will counteract each other, but for imported goods the increase in payroll taxes will lead to higher prices.

However, it should be noticed that temporary value added taxes could lead to a redistribution of consumption in the way it was discussed

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[33] The discussion in this part draws strongly on Calmfors (1998).

above. Above that, problems with trade over the frontiers could constitute a problem. Financing decreased payroll taxes by employees' social security contributions or by income taxes are probably better alternatives.

5.2.5 Government consumption and government investments

Changes in public consumption and investment have direct and proportionately large effect on aggregated demand. Government demand constitutes a variety of activities of different character. A major part of public consumption is managed by local governments and consists for instance of primary and secondary education, health care and elderly care. Such activities are rather difficult to vary according to macroeconomic developments, but variations with a few percentage points could, at large shocks, be motivated from a socioeconomic point of view. A possible method is to generally increase and cut, respectively, the appropriations for central government consumption and investment as well as central government grants to local governments in around laid down normal levels. Central and local government authorities could with such a method be expected, at least, to partly use variations in appropriations to vary consumption and investment.

Government investments demand extended planning periods. Hence, they could be difficult to use for stabilization. However, the timing of already planned investments can to some extent be adjusted to the cycle. Examples are maintenance of infrastructure, repair works, and reconstructions. A precondition for these types of investments is a "planning reserve" of such projects.

5.2.6 Measures directed towards private investments

Another method to affect aggregated demand is to stimulate or dampen private investments. The aim would be to reallocate investments over time in a contracyclical way.

Investment funds were introduced in Sweden 1955 and came to an end 1991.The profound aim of these funds were to smooth the business cycle by stimulating firms to fund parts of their profits during good years

and use these funds for investment in slumps. Firms were given incentives to use the system by reductions in the corporate tax system.[34]

In the 1950s and 1960s the system seems to have functioned rather well. Results in Taylor (1982) indicate that the investment fond system contributed to smooth the cyclical fluctuations in Swedish investment during this period. Taylor draws the conclusion that a system of this type could play an important role, especially in situations when monetary policy primarily is not used for the aim to stabilize the cycle.

In the 1970s the authorities used the system to generally stimulate growth in the industry sector by permitting firms to more or less constantly use the funds. As a permanent measure, the investment funds loss their effect as a stabilization tool and they also had some adverse effects on economic efficiency, for instance by favoring already established firms. The experiences from this system illustrate the importance of a temporary use of stabilization policy measures. It seem not advisable to introduce investment funds of this type again.

5.2.7 Measures directed towards construction

Investments in construction varies to a large extend over time and are strongly tied to domestic activity. A possible stabilization instrument is to introduce an extra tax on new constructions and reconstructions in good times and corresponding subsidies in slumps. To get most possible coverage and to avoid distortions between sectors the tax and subsidy, respectively, should include all types of taxable real estates, i.e. different types of dwelling as well as industry buildings.

5.3 Summary

Discretionary fiscal policy instruments to be used to counteract large disturbances should, as far as possible, be general, temporary, and symmetric. For central government there are strong reasons to choose a few fiscal policy measures suitable for stabilization in advance. The aim is to shorten decision lags for discretionary actions. This is done by specifying in advance which instruments are believed to have stabilization

[34] For deeper discussions of the investment fund system and its effects, see Södersten (1989) and Agell *et al.* (1995).

effects, are not controversial from a distributive point of view, and do not have large effects on economic efficiency. The ex ante chosen instruments can be used separately or in combinations. The choice of instrument, or combination of instruments, should be dependent on the type of disturbance. The size of the contractionary or expansionary measure should be proportional to the size of the disturbance. Parliamentary decision about stabilization measures should concern a limited time period. If conditions change, the time period could, of course, be prolonged or shortened.

The following measures could be used in the first place:

1. A proportional *temporary change in income taxes*, equal for all, calculated as a certain share of taxable income. A variation of the tax rate by +/– 2 percentage points corresponds to an effect on general government net lending by SEK 25 billions (EUR 2.8 billions).[35]
2. Variations of *value-added taxes*, in the first place around the normal tax rate of 25 percent. If the tax rate is changed by +/– 2 percentage points it corresponds to an effect on net lending SEK 11 billions (EUR 1.2 billions). If all value-added tax rates are changed with the same amount the effect is approximately SEK 14 billions (EUR 1.6 billions).
3. Variations in *statutory pay-roll taxes paid by employers*. If the tax rate is changed +/– 2 percentage points it corresponds to an effect on net lending of approximately SEK 9 billions (EUR 1.0 billions).
4. Variations in *central government grants to local governments*. A change of +/– 2 percent of local governments expenditure corresponds to SEK 10 billions (EUR 1.1 billions).
5. Variations in the *appropriations to central government consumption and investment*. If the appropriation level is adjusted by +/– 2 percent it will correspond, at full effect on activities, to an effect on net lending by SEK 4 billions (EUR 0.4 billions).
6. Temporary *taxes/subsidies on new constructions and reconstruction of real estate.* A tax or subsidy rate 5 percent of the construction cost corresponds to an effect on net lending of SEK 7 billions (EUR 0.8 billions).

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[35] At the SEK/Euro rate prevailing in March 2002.

7. *Internal exchange rate change,* for the purpose to bring about a temporary cost change in situations when it is not possible or desirable to change general government net lending.

6. Fiscal policy institutions

Will the fiscal policy institutions have to change if Sweden joined the currency union?

Will we *be capable* to stabilize the economic development to the same extent?

Fiscal policy has the potential of contributing in stabilizing economic activity. But this also puts demands on the political system. It is not possible in the long run to have an expansionary policy during recessions without having a contractionary policy during good times.

This moves the issue of political institutions on the agenda. There are those who argue that the lack of policy institutions is not a serious problem. Wittman (1989), for example, claims that political markets are perfect, that politics work without problems. Others argue that there exist problems both in the short run, for example in the form of political business cycles, and the longer run. The question is if there is a need for policy institutions to contribute to strengthen policy.

Policy institutions, as the reformed budget process and the system with expenditure ceilings, have been important elements in the restoration of the public finances in Sweden. Both tax and expenditure ratios have decreased substantially during the last years and the ceilings have been respected without changes others than of technical reasons. At the same time there are signs that the efficiency of these measures could weaken in the future if the policy institutions not are further developed. An example is the budget margin under the expenditure ceilings, which was supposed to vary with the economic activity, but has been used almost completely for expenditure reforms recent years.[36] Other examples in the same spirit are the increased use of targeted tax decreases (tax expenditures) to circumvent the expenditure ceilings.

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[36] See Heeringa and Lindh (2001) for a discussion about expenditure ceilings in the Netherlands and Sweden, especially in a stabilisation policy context.

Expenditure ceilings and other elements in the budget process are self-imposed restrictions. For restrictions to be sustainable in the long run there must be a division between those who decide about the restrictions and those for whom the restrictions apply. There is indeed a certain kind of division today in the Swedish system, parliament decides about the expenditure ceilings that concern the governments use of funds, but this has not protected the budget margins from being used. There is also a division in the interaction between the central government and the local governments. There exists a constitutional independence for local governments in Sweden. But at the same the central government sets a number of restrictions on the actions of local governments.

A conclusion from the Swedish experience is that self-imposed restrictions as the budget margin risk to become less efficient over time.[37] Also the ceilings in themselves have problems. There is also a risk that the real effects decrease over time as the knowledge how to circumvent the restrictions has increased. We see this in the forms of more tax expenditures, more fixing, more inclusions and exclusions, new terms, postponements, and things brought forward. These phenomena taken together create the foundation for less efficiency.

Which types of new institutions could contribute to strengthen fiscal policy? Two alternatives have been discussed in the literature. One possibility is to create a fiscal policy board to which some stabilization policy decisions are delegated. The analogy to an independent central bank is close. An alternative is to create a fiscal policy council with advisory and supervising duties. Such a council can state both what is good accounting and what is good economics.

7. Concluding remarks

If Sweden becomes member of the European currency union, the conditions for fiscal policy will change. The general stabilization policy *objectives* regarding inflation, employment, and output will, however, hardly change with a membership. At the same time it is not clear if the *need* for stabilizing the Swedish economy will increase or decrease.

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[37] Restrictions may also have more direct economic consequences. Binding nominal expenditure ceilings makes the expenditure ratio to vary in a countercyclical way, and this even though the expenditure policy is not countercyclical in itself.

National fiscal policy will, however, have to carry a bigger *burden* than before in stabilization policy as there no longer will exist national monetary and exchange rate policy. Fiscal policy will also be more *effective* in affecting real variables such as production and employment. Counteracting forces such as a flexible exchange rate and a domestic interest rate do not exist any longer. Fiscal policy will, at the same time, meet new and changed formal and economic *restrictions*. As member of the currency union we will face sanctions if our fiscal policy does not keep within the limits for the public sector's net lending and consolidated gross debt that apply within the EU. Increased mobility of tax bases and tax competition are examples of economic restrictions that may become stricter. The fiscal policy *instruments* and *institutions* will need to be reformed.

Our conclusion is that fiscal policy will not be very much affected if Sweden becomes a member of the monetary union. The pressure, to do what we anyway should do, will increase however. The fiscal policy agenda can be summarized in twelve items.

1. The short run budget policy should be countercyclical in the sense that automatic stabilizers are allowed to operate. The automatic stabilizers can to some extent be complemented by discretionary measures if the disturbances are large. The policy must also be symmetric in the sense that surpluses during good times should be so large that they counteract deficits during bas times and contribute to keep the debt ratio on a sustainable path in the longer run.
2. The time lags of the different fiscal policy instruments should be decreased so that the automatic stabilizers will become more efficient. This way the stabilizing effect can be increased without increasing the sensitivity of the budget to economic activity. Tax collection can be made faster. One way of doing this is to change the principles for how preliminary taxes are calculated. Other examples of changes would, for example, that realized capital gains would be taxed during the quarter when they arise, that the principle of tax at source is extended to more areas, and that income and corporation taxes can be based on quarter or half year rather that the calendar year as time unit.
3. The time lags of the fiscal policy decisions should be shortened. The central government should be able to quickly increase expenditure in carefully defined situations, related to large output gaps or large deviations of actual unemployment from the equilibrium level, and

within carefully predetermined amounts (an amount decided by parliament that may not be exceeded). This applies in particular for labor market policy measures when unemployment increases rapidly.

4. The authorities should select a small number of appropriate fiscal policy measures in advance for use as economic stabilizers during major macroeconomic shocks. These tools should, as far as possible, be general and only have small effects on distribution and allocation. The objective is to shorten the decision lags. The measures should be adjusted to the type of shock and should be intended only for a limited time period fixed in advance. If Sweden becomes a member of the currency union, the choice of measures of this nature can be justified by the need to replace a national monetary policy that in itself constitutes a general instrument.
5. Fiscal policy should not be paralyzed by the criteria for public sector net lending. The levels and composition of revenue and expenditure are as important for the stabilizing effects of fiscal policy. The balanced budget multiplier is not dead. Internal exchange rate adjustments are examples of this.
6. The medium term budget policy should aim at net lending target to be reached over a business cycle. The target should give a safety margin big enough so that net lending always fulfills the Maastricht criterion. The size of the safety margin depends on how sensitive the budget is to economic activity. This sensitivity depends, in turn, on the design of the tax system and the level of taxes. It is difficult to imagine that it would be sustainable in the very long run to have positive medium run net lending targets. This sets limits for the design of the tax system and the level of taxes. The demographic changes that can be expected the coming decades, however, imply that a positive net lending target seems reasonable at least in the coming decade.
7. There is a great need for a clear policy regarding public sector assets, both financial assets and real assets – buildings and equipment. The optimal size of the public capital stock is an important question. Has public investment been large enough? The development of asset values must be seen in light of the Maastricht criterion for gross debt as the changes in assets is one of the factors behind the development of gross debt.

8. There is also a need for a safety margin for the consolidated gross debt. If net lending varies with activity it is also vary likely that gross debt also will fluctuate.

9. It is possible to have higher taxes than abroad without having tax bases to disappear provided that the services that the public sector provides, financed by the tax revenue, are considered as good value and of good quality. There is a need for quality control. Taxation will have to be based more on the benefit principle for taxation, less on the ability to pay principle.

10. Economic growth mitigates most restrictions that the economic policy meets. In particular this means that economic growth makes it easier for national fiscal policy in a currency union to meet the convergence criteria for net lending and gross debt. If people get more and better tools and better knowledge how to use these tools the economy will grow. Education and equipment investments are maybe not the most spectacular in the growth discussion both are still among the things that in the long run have proven to be among the variables that have the most positive effects on economic growth.

11. The Maastricht criteria concern the entire public sector and not only the central government. This means that the principles for economic interactions between the central government and other parts of the public sector become central. Collection and payment of local government taxes, central government grants, and the tax equalization system together with the balance requirement for local governments must be designed in a way that local government expenditure contributes to, or at least do not counteract, the stabilization policy. The tax base should therefore not only be equalized between local governments but also over time. Calculating the tax base as an average over the business cycle can do this.

12. The political systems ability to fiscal discipline has been questioned. Expenditure ceilings and other self-imposed restrictions in the budget process can be seen as attempts to give increased strength to fiscal policy. It is important to assure that the present restrictions can continue to contribute to fiscal discipline. If not, they will have to be adjusted and strengthened.

APPENDIX

LOCAL GOVERNMENT EXPENDITURE

The tax base of the local governments consists of earnings including taxable transfers. The actual tax income year t can on an accrual basis be written $\tau_t y_t$ where τ_t is the tax rate and y_t is the tax base. All amounts are in SEK per inhabitant. Tax income year t that is budgeted year $t–1$ can be written $\tau_t E_{t-1} y_t$. E_{t-1} denotes that the budget is a forecast made year $t–1$ and $E_{t-1} y_t$ is the tax base year t that is expected year $t–1$.

The central government collects the taxes for the local governments. In a cash flow sense the central government transfers collected taxes to the local governments according to a forecast of the tax base and a comparison between outcome and forecast two years before. We can write this as:

$$TP_t = \tau_t E_{t-1} y_t + \tau_{t-2}(y_{t-2} - E_{t-3} y_{t-2}). \quad (1)$$

The last two terms in (1) is the difference between actual and expected tax base two years before.

There exists an extensive central government grant and equalization system for the local governments. The most important parts of this system are income equalization, cost equalization, and general central government grants. The income equalization guarantees all local governments the same tax base regardless of the actual tax base of the local government. The local governments with a large tax base pay a fee, those with a low tax base receive a grant. Total fees correspond to total grants.[38]

The cost equalization shall equalize structural differences in needs and costs. Costs that depend of differences, fees, and efficiency shall, on the other hand, not be equalized. The general central government grant has two parts. In addition to a lump sum, identical for all inhabitants, the local government receives a grant based on how many inhabitants there are in the local government in five different age groups (7-15, 16-18, 65-74, 75-84, and 85 years and older).

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[38] The income equalization has two parts. In addition to the regular equalization, there is from 2001 adjusted income equalization for the local governments where the average tax rate in the county is more than 95 percent of the own tax rate.

The local governments are required not to report any economic deficits. The balance requirement is on accrual basis, not cash flow basis. It is, in other words, a question of periodized incomes and expenditures.[39] In addition the balance requirement is for the budget, the local governments may not budget a deficit. If the actual outcome has been a deficit, this must be counteracted by budgeting a surplus within two years. We can write the balance requirement as:

$$E_{t-1}R_t - E_{t-1}C_t \geq \max\{0, C_{t-2} - R_{t-2}\}, \tag{2}$$

where R_t is local government revenue year t and C_t is costs the same year. Equation (2) says that the local governments budgeted income must be at least as high as budgeted costs. The exception is if the actual outcome two years before has shown to be a deficit. In this case the budgeted income will have to exceed the budgeted costs with an amount corresponding to the deficit. Because of the design of the central government grants and equalization system, the tax rate is the only instrument available for the local government to affect income.

For the budgeted costs this implies that the following inequality must be fulfilled:

$$E_{t-1}C_t \leq \min\{E_{t-1}R_t, E_{t-1}R_t - (C_{t-2} - R_{t-2})\}. \tag{3}$$

In the normal case the balance requirement implies that budgeted costs shall be lower or equal to budgeted revenue. But if the local government has experienced a deficit two years before the budgeted costs, for given budgeted income, will have to be reduced. As we are dealing with costs on accrual basis, it is not possible to reduce costs to any large extent by reducing investments, as only the capital costs are included in the balance requirement.

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[39] We should, therefore, in fact use the terms costs and benefits.

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U.S. FISCAL POLICY
IN AN ERA OF FEDERAL BUDGET SURPLUSES

Jagadeesh Gokhale[*]

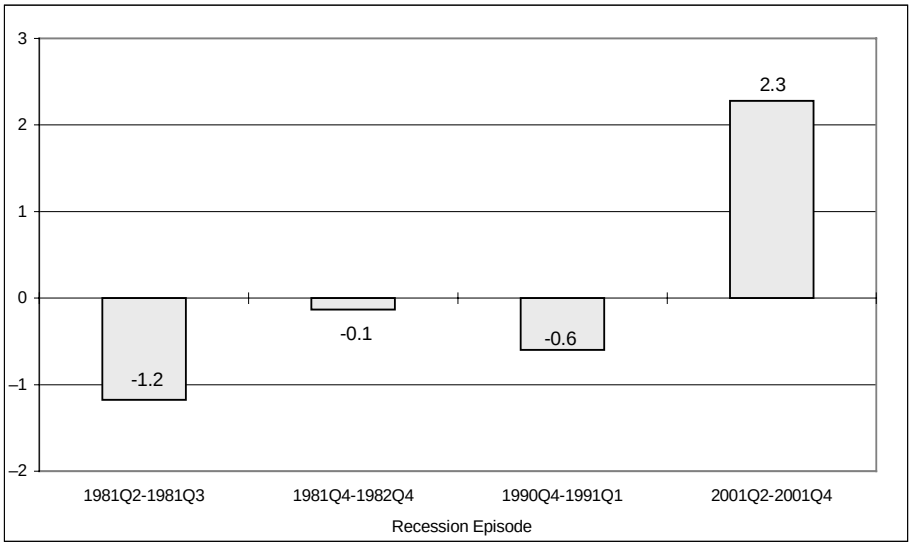
1. Federal Budget Developments in the United States

Except for a mild recession during 1991, the United States has enjoyed almost two decades of prosperity (see Figure 1). The growth phase that ended in March 2001 was the longest economic expansion recorded during the postwar period.

Some economists trace the origins of this remarkable two-decade-long performance to the fiscal-policy approach charted during the first

Fig. 1

Real Annual GDP Growth in the United States (1982-2001)
(percent)



Source: National Income and Product Accounts.

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[*] Federal Reserve Bank of Cleveland. This paper draws heavily on Gokhale (2001) and on the author's comments on Bohn (2002).

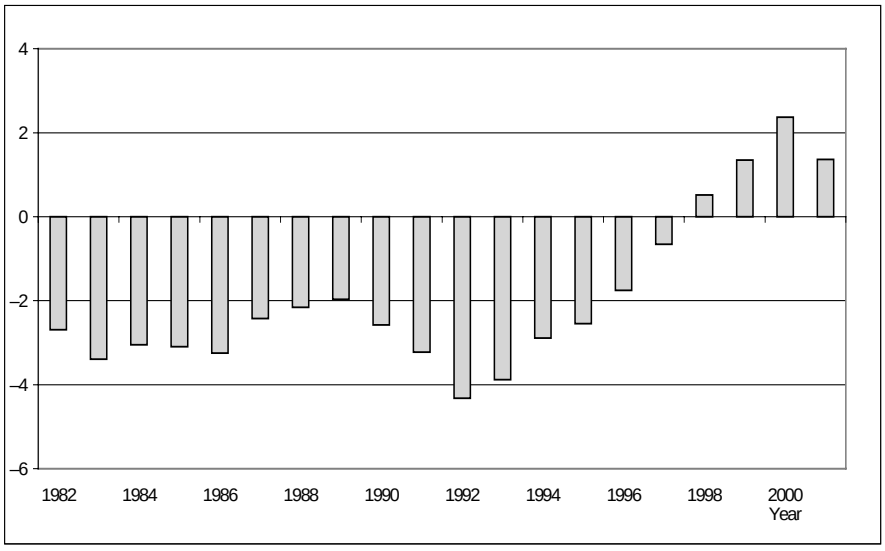
The opinions expressed herein are those of the author and not necessarily of the Federal Reserve Bank of Cleveland or of the Federal Reserve System.

Reagan Administration. The hallmark of this approach was to move away from using fiscal policy as a tool for aggregate demand management. Instead, fiscal policy was employed to construct the overall economic environment within which the private sector could thrive. This approach intended to boost economic growth by deregulating key sectors, providing tax incentives to households and businesses, reforming welfare programs, fostering competition through free trade, and keeping public expenditures and the size of government encroachment on the economy under check by constraining revenues.

The attempt to impose fiscal discipline by constraining federal revenues did not work as expected. The economic record of the 1980s and early 1990s was tarnished due to persistent and rising budget deficits and debt (see Figure 2). The record deficits prompted Congress to adopt budget procedures to curb federal outlays beginning with the Balanced Budget and Emergency Deficit Control Act of 1985 and the Budget Enforcement Act of 1990.

Fig. 2

U.S. Federal Surplus/Deficit (–)
(percent of GDP)



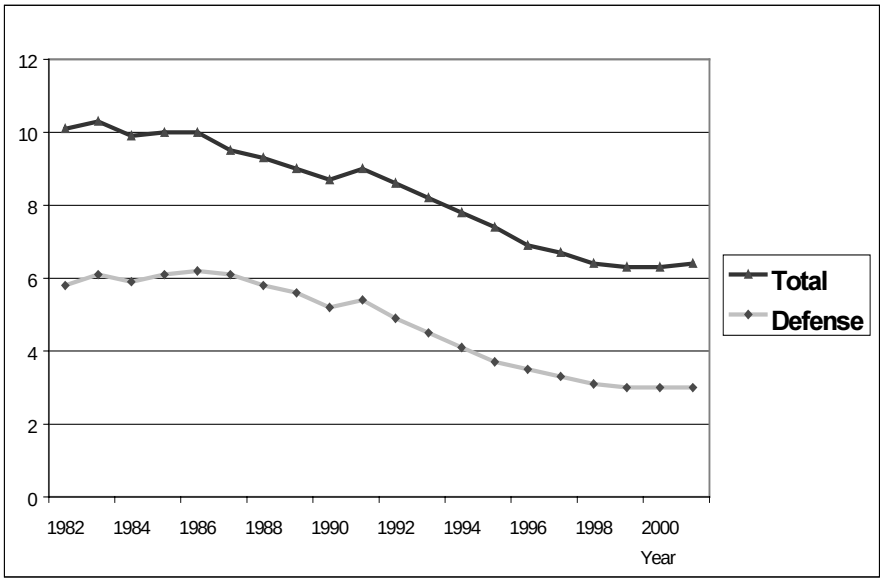
Source: National Income and Product Accounts.

In retrospect, the fiscal control mechanism introduced in 1985 successfully reduced nondefense spending as a share of GDP. The Budget Enforcement Act imposed stringent caps on discretionary spending and "pay-as-you-go" financing restrictions on entitlement outlays. However, the decline in federal defense spending after the collapse of the Soviet Union in 1990 provided a reprieve, rendering additional retrenchment in nondefense spending unnecessary for adhering to predetermined spending caps. Indeed, nondefense spending continued to grow with GDP during the 1990s (see Figure 3).

Spending controls imposed throughout the 1990s constituted one of the factors that transformed the federal budget from generating deficits to surpluses. The other was a "revenue surprise" experienced during the late 1990s (see Figure 4). Federal revenues trended upward after 1995 due to greater personal tax payments, which arose from larger capital gains realizations, rising taxable withdrawals from maturing IRA and 401(k) plans, and steep increases in the personal incomes of those subject to the

Fig. 3

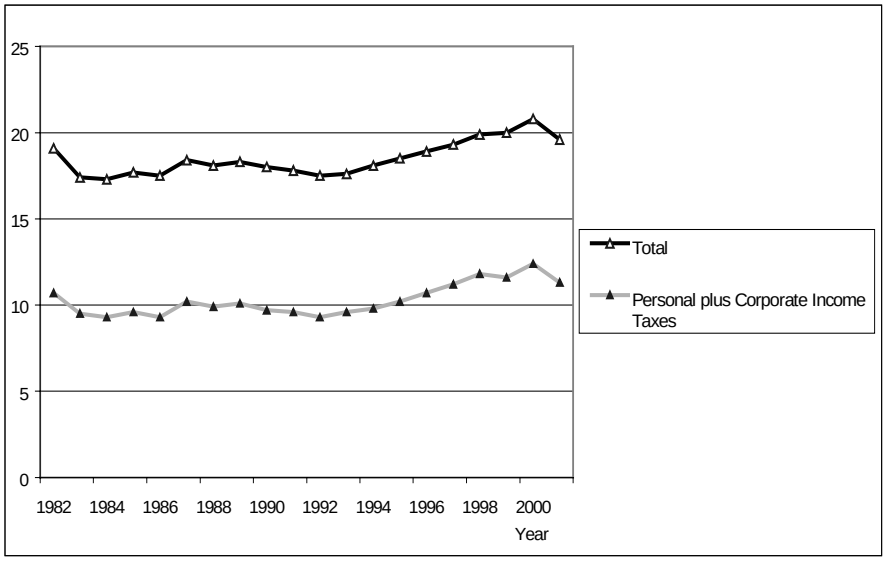
U.S. Federal Discretionary Outlays
(percent of GDP)



Source: Congressional Budget Office.

Fig. 4

U.S. Federal Revenues
(percent of GDP)



Source: Congressional Budget Office.

highest income tax brackets. As a result, worries about escalating deficits and debt have been supplanted by concerns over large accumulating surpluses.

2. Federal Budget Projections

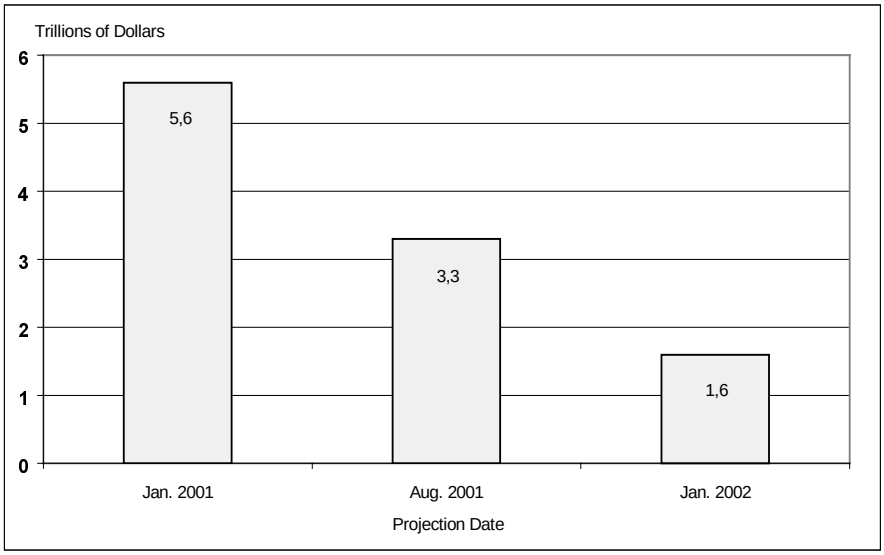
Official federal budget projections in January 2001 suggested that the 10-year (2002-2011) cumulative surplus would amass to $5.6 trillion.[1] A large portion of the total – $3.1 trillion – arose in the "on-budget" account and prompted the passage of a tax cut (Economic Growth and Tax Relief Reconciliation Act of 2001). The tax cut and spending legislation enacted in 2001 is expected to reduce the cumulative surplus by $2.4 trillion. The post-September 11 fight against terrorism, a reevaluation of

[1] Unless otherwise noted, budget projections cited are from the Congressional Budget Office of the United States.

health and domestic security needs and more recently, a stimulus package to assist the unemployed and provide corporate tax relief will further reduce the size of the cumulative surplus. Moreover, the recession of 2001 eliminated almost $1 trillion of the cumulative surplus via lower projected revenues, and unanticipated changes in the budget outlook have reduced the surplus by another $600 billion. As a result, the projected 10-year federal surplus has fallen to just $1.6 trillion (see Figure 5).[2]

Fig. 5

Cumulative 10-Year Projected U.S. Federal Surpluses



Source: Congressional Budget Office.

The outlook for federal debt has correspondingly worsened during the last year. In January 2001, official projections reported a balance of "uncommitted" funds with the Treasury of just over $3 trillion.[3] Today's

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2 See Congressional Budget Office (2002).

3 These refer to the surplus of revenues over outlays accumulating with the federal government after debt held by the public has been paid down as much as possible. The term "uncommitted funds" is used because no legislation has yet been enacted directing the disposition of a cash surplus with the Treasury.

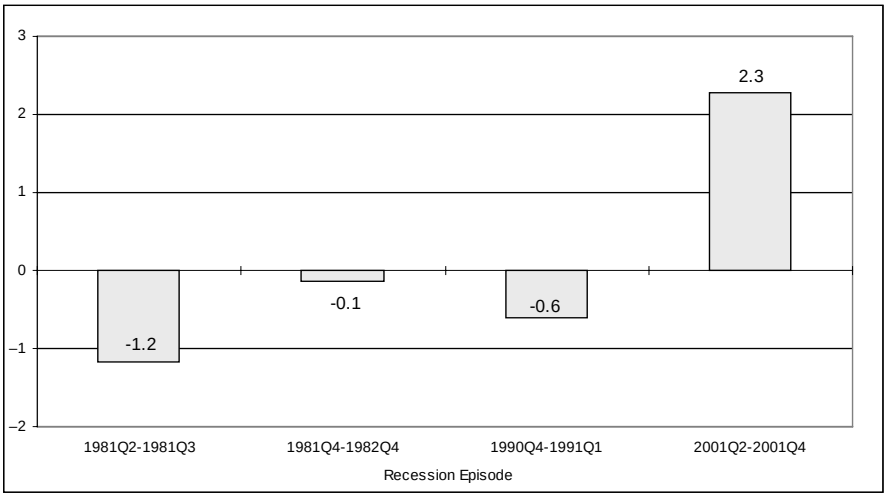
10-year projection places this number at zero. Instead, debt held by the public is now projected to remain above $1.2 trillion through 2012.

The current budget outlook probably postpones but does not entirely eliminate the need to think about how to deal with a potential cash accumulation with the federal government. First, budget projections are inherently uncertain. Recent data show that unlike earlier recessions, productivity remained high during the 2001 recession (see Figure 6). The U.S. economy has become more flexible in reacting to demand-driven recessionary episodes. The application of information technology has enabled businesses to forecast demand more accurately and to adjust production and inventory levels much quicker than earlier. If productivity-driven economic growth rebounds quickly and defense- and security-related outlays remain modest, we may yet see a rebound in projected surpluses and a reemergence of uncommitted funds accumulating with the Treasury.

Taking a longer-term view, however, irrespective of the size of short-term surpluses, population aging and pay-as-you-go Social Security and Medicare programs will combine to generate an inexorable force

Fig. 6

Annual Labor Productivity Growth During U.S. Recessions
(percent)



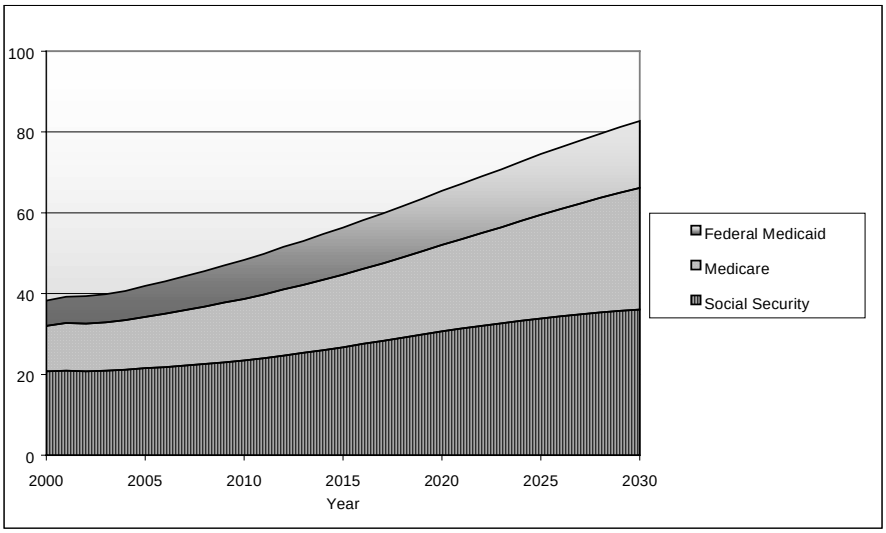
Source: Calculations based on Non-Farm Business Sector Output per Hour: Bureau of Labor Statistics.

pushing the U.S. federal government back into a severe budget crunch. As in Europe, long-term projections for the United States indicate that retirement and health outlays on the elderly will grow rapidly and remain high as the population grows older and a relative shortfall of working-aged people persists throughout this century. According to a recent estimate, if the share of government outlays in GDP remains the same as today, the fraction of outlays made up by Social Security, Medicare, and federal Medicaid will shoot up from 40 percent to 83 percent (see Figure 7).

If both tax hikes and Social Security benefit cuts are politically infeasible, growing entitlement outlays will squeeze spending on other programs unless the economy's income-generating capacity can be boosted sufficiently. The latter requires that both public and private sectors save and invest as much as possible today. Some recent studies indicate that given current levels of saving and wealth, a fiscal squeeze will become unavoidable even under the most optimistic assumptions about productivity growth.[4]

Fig. 7

Projected Shares of U.S. Social Security, Medicare, and Federal Medicaid in Total Federal Expenditures
(percent)



Source: Congressional Budget Office.

[4] See Kotlikoff, Smetters and Walliser (2001).

3. Fiscal Policy Objectives and Institutional Arrangements

3.1 The "Problem" of Large Surpluses

The prospect of large surpluses in the short term and deficits over the long haul poses a difficult dilemma for policymakers. Under the current institutional set-up, federal surpluses trigger debt pay-downs. If the surpluses turn out to be so large that debt is eliminated and a sizable cash reserve accumulates with the government, the funds will have to be invested in private assets.

The disposition of these funds presents several problems simultaneously and requires careful consideration. The objective is to avoid dissipating the surplus via tax cuts and spending increases to mitigate the long-term budget crunch. However, investing surplus assets in privately issued securities could impose large deadweight losses on the economy. In addition, if the assets accumulate with the Fed (as would happen under status quo policies) it may jeopardize the independence of the Fed and destroy the integrity of fiscal policymaking. In other words, we need a policy framework that will preserve the surpluses but avoid the undesirable consequences of large a accumulation with the federal government.

Current projections indicate that agency debt (debt owed by the Treasury to other federal agencies such as the Social Security Trust Fund [SSTF]) as a share of GDP will grow larger while debt held by the public (DHBP) as share of GDP will grow smaller over time (see Figure 8). As noted earlier, this process may accelerate if the U.S. economy recovers quickly and growth is stronger than anticipated. Debt reduction to the point where the Treasury market no longer remains liquid will force a change in monetary policy procedures.

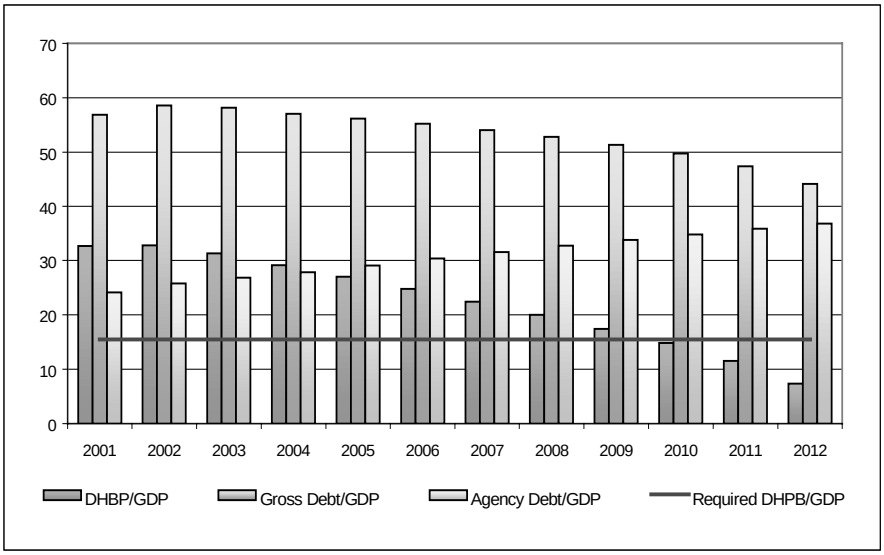
Fed holdings of Treasury securities amount to about 5.5 percent of GDP today, and Fed procedures call for limiting its portfolio of such securities to about a third of outstanding federal debt – to prevent the Fed's trades from unduly distorting Treasury securities' pricing in the market. This suggests that when debt held by the public approaches 16 percent of GDP, the Fed may have to conduct open market operations by with alternative, non-Treasury securities.

Some economists have argued that a dearth of treasury securities that forces the Fed to enter non-Treasury asset markets presents two

disadvantages. First, it compels the Fed into deciding which other sectors and markets should receive an infusion of public resources – a decision that properly belongs in the sphere of fiscal policy and over which Congress and the Administration should have full jurisdiction, responsibility, and accountability. Second, Fed trading in non-Treasury assets may

Fig. 8

Projected U.S. Federal Debt And Its Components
(percent of GDP)



Source: Congressional Budget Office.

compromise its political independence and destroy the integrity of monetary policy. Hence, these economists conclude that the Treasury should continue to issue Treasury securities despite the accrual of large federal surpluses in order to preserve current monetary policy procedures, protect the Fed's independence, and maintain the federal government's authority over fiscal policy.[5]

[5] See Broaddus and Goodfriend (2000).

3.2 Deadweight Losses

Maintaining, perhaps even increasing, the amount of debt issue at a time of accruing surpluses implies still larger cash accumulations with the Treasury. This cash will have to be invested in private assets to avoid draining the economy's money supply – and this raises the issue of deadweight losses.

Direct investment undertaken by the government in privately issued securities is generally economically inefficient because it is likely to be based on bureaucratic and political preferences rather than on market price signals. Moreover, the prospect of the government directly investing in private assets is likely to create incentives for private firms to lobby for federal investments. Such efforts will most likely be wasted because lobbying firms will mostly neutralize other firms' lobbying efforts, leaving the distribution of government investment little different than if no firm lobbied.

Some have argued that if such federal investments were restricted to safe private securities – fixed income corporate bonds, index mutual funds and so on – deadweight losses would be minimized. However, others suggest that such investment policies are unlikely to be adopted because the temptation for political intervention in the allocation of these funds would be irresistible.

3.3 Options Based on Social Security Reforms

3.3.1 Trust Fund Investments in Private Assets

Most of the projected surplus will accumulate on the so-called "off-budget" account (mainly Social Security). Given that Social Security is currently required to invest its surplus in Treasury securities, some economists propose that the Social Security Trust Fund (SSTF), rather than the Fed or the Treasury, be charged with investing the surpluses in private assets. Proponents of this view suggest that because it is an independent entity, the SSTF may be less susceptible to political and lobbying pressures when undertaking investments in private assets. Moreover, investments in private assets by the SSTF will help individuals (mainly poorer households) who predominantly depend on Social Security for retirement support and who do not benefit from stock ownership because of their low personal savings.

An additional argument in favor of the SSTF (rather than other federal agencies) investing federal net surpluses in private assets is that this will create a better system of sharing aggregate economic risks across generations – something that the current Social Security system achieves only imperfectly.[6] Under this system, if the SSTF's investments in private assets do well, retirement benefits can be maintained and the gains shared with young and future generations via lower payroll taxes. If the SSTF's private investments do badly and the SSTF is in danger of running out of funds, payroll taxes could be increased to maintain benefits, sharing the losses with younger and future generations. Investing the surpluses in private assets via the SSTF also solves the problem of Treasury market liquidity as Social Security surpluses will no longer be used to redeem federal debt held by the public.

3.3.2 Replacing Social Security IOUs with Marketable Bonds in Individual Accounts

An alternative to investing the surpluses via the SSTF is to issue marketable debt and use this to seed individual retirement accounts owned and controlled by workers. Indeed, the existing nonmarketable Treasury IOUs held in the SSTF (as well future issues of such IOUs) could also be included in such a conversion.[7] It is well known that the Treasury securities held in the Trust Fund are not really assets in the sense of income generating capital investments. They simply represent a claim on future workers' earnings. If and when they are to be redeemed (and, under current projections, they will have to be redeemed in another 10-15 years, when baby-boomers begin retiring in large numbers) taxes on future workers will have to be hiked or federal spending slashed to generate the cash to do so. Hence, these securities are best viewed as future liabilities of the federal government rather than assets of the SSTF. If they are converted to marketable securities and used to seed private Social Security accounts, those who receive them would be free to readjust their portfolios by trading the marketable Treasuries for private stocks and bonds. Workers would be able to diversify their retirement portfolios according to their own preferences toward market risks and returns.[8]

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6 See Bohn (2001).

7 See Feldstein (1996).

8 Implementing such a reform does not necessarily imply that the benefits of annuitizing retirement wealth – as under the current Social Security system – will necessarily be lost. The government (continues)

It should be noted that this solution completely bypasses the issue of deadweight losses. First, individual decisions about which assets to invest in will be based on private preferences given technology-driven risks and returns across different sectors and securities. Second, there will be little incentive for private firms to lobby for such investments (any more than they do now) because investment decisions will be made by millions of workers. In addition to avoiding deadweight losses, this approach preserves sufficient marketable Treasury debt circulating in the economy, thereby preserving the integrity of monetary and fiscal policymaking. Indeed, it may improve the operation and government accountability for fiscal policy by removing Social Security surpluses from the orbit of fiscal policymaking.

Finally, although it achieves the diversification of individual retirement portfolios across marketable assets, establishing individual Social Security accounts in this manner means that the surpluses cannot be used by the government to actively manage intergenerational risk sharing as described earlier. As discussed below, this may actually be a good thing.

4. Objectives and Policy Options: A Discussion of Tradeoffs[9]

The federal government must consider four (overall) objectives if surpluses prove large enough to require federal investments in private assets: (1) preserving sufficient Treasury market debt to ensure a liquid market and maintain the integrity of monetary policy, (2) minimizing deadweight losses from private sector lobbying and inefficient resource allocation by the government, (3) enabling a better diversification of retirement portfolios across marketable securities, and (4) improving intergenerational risk sharing. The discussion above suggests that four different regimes (institutional arrangements) that may be employed to invest the accumulating surpluses in privately issued securities: these are (1) the Federal Reserve, (2) the Treasury, (3) the SSTF, or (4) private individuals via an individual Social-Security accounts system. Table 1

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could easily mandate the annuitization of (a certain fraction of) savings. This is likely to spur the development of deeper annuity markets and products, reduce problems of adverse selection in such markets, and reduce further the already low and declining load charges for such products. See Brown, Mitchell, Poterba, and Warshawsky (2001).

[9] This discussion borrows heavily from Bohn's (2002) analysis of fiscal options in an era of disappearing federal debt. However, the conclusions and policy recommendations provided here are quite different.

Table 1

Fiscal Arrangements and Policy Goals

	Policy Goal → Policy Choice ↓	Liquid Treasury Market	Minimize Deadweight Loss	Diversify Retirement Portfolio	Inter-generational Risk Sharing
1	Assets with Federal Reserve (Status Quo)	X	X	X	X
2	Assets with U.S. Treasury	O	X	X	X
3	Assets with SSTF	O	X	o	O
4	Swap Marketable for Non-Marketable Bonds in SSTF*	O	O	O	X

SSTF = Social Security Trust Fund.
X=Goal not achieved; O=goal achieved; o=Goal partially achieved.
* = Treasuries accumulate outside of SS according to private preferences.

illustrates the trade-offs between the objectives achievable under different policies.

Bohn (2002) correctly points out that none of the arrangements achieves all of the objectives. In this discussion it is assumed that deadweight losses cannot be avoided if surplus federal assets are invested by any of the three government agencies because their investment decisions will not follow private preferences and market signals. Moreover, even though the two non-Treasury agencies may be initially inured from political influence, it remains unclear whether that situation will prevail indefinitely.

Since not all of the objectives can be achieved simultaneously, which of them should be sacrificed? The table indicates that the first two

choices are strictly worse than choices 3 and 4. Each of the latter two choices achieves three of the four objectives, but policy 3 achieves the objective of portfolio diversification only partially.[10] The choice, then, lies between sacrificing intergenerational risk sharing (by adopting policy 4) and accepting deadweight losses and only partial retirement portfolio diversification (by adopting policy 3).

In evaluating the choice between policies 3 and 4, one needs to consider the considerable difficulty attached to correctly formulating and implementing a state-contingent payroll tax policy (in the manner described earlier) to achieve a better intergenerational distribution of aggregate economic risks. Remember that payroll taxes must be adjusted in response to the performance of the SSFT invested in privately issued securities. That is, tax policy must react to asset valuation shocks. However, identifying such shocks from among the many different ones affecting the economy may prove too hard. For example, a negative asset-valuation shock may induce or reinforce declines in investment leading to lower labor productivity. Alternatively, if the multi-factor productivity (that affects the returns to both capital and labor) falls but is misidentified as an asset valuation shock, raising payroll taxes (to maintain Social Security benefits) when earnings are low is unlikely to be politically palatable.

Moreover, failure to correctly implement such a state-contingent payroll tax policy may make this policy itself a source of additional uncertainty rather than a means of countering fundamental aggregate economic risks. Another consideration is that moving to a new regime with state-contingent payroll taxation (if implemented correctly) will make current generations better off. If as a consequence these generations save less, capital formation may be reduced, impoverishing future generations. In other words, introducing intergenerational risk sharing via a state-contingent tax policy is unlikely to be a Pareto-superior policy.

A final consideration is that the government already employs general tax-transfer policies to spread risks across different generations by incurring budget deficits and surpluses. A special institutional arrangement

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[10] Investing surplus assets in private securities via the Social Security Trust Fund implies a partial diversification because it is accomplished centrally rather than separately according to each Social Security beneficiaries' preference. Moreover, beneficiaries do not necessarily receive the full benefits of such diversification because the Social Security benefit formula modifies the payoffs received upon retirement based on beneficiaries' demographic and economic characteristics.

via trust-fund-managed investments in private assets may not confer benefits that, at the margin, exceed the negative consequences of political influence on the trust fund's investments.

These arguments suggest that policy 4, which achieves all objectives except intergenerational risk sharing, may be preferable to policy 3. Disposing of the accumulating surpluses via an individual accounts type Social Security reform will also confer other advantages: Retirement assets will become bequeathable and prevent future generations from being disenfranchised of their inheritances. A recent study shows that this could improve wealth inequality among retirees and improve mobility across the wealth distribution. In addition, converting Social Security's implicit liabilities into explicit ones will lend greater visibility to future federal expenditure commitments, perhaps inducing greater fiscal discipline. Finally, today's workers may better appreciate the shortfalls in their retirement reserves and increase their personal saving.

5. Conclusion

The two-decade old consensus on achieving economic progress by limiting the scope and size of government has generated stellar results. High output growth during the late 1990s has placed U.S. federal finances on track to accumulating sizable budget surpluses. The prospect of accumulating large surpluses, although dimmed by the recession of 2001 and the terrorism-related surge in spending, may reemerge if rapid economic growth resumes and defense- and domestic-security-related outlays remain modest. In view of the steep projected increase in future entitlement spending, it is important to conserve and invest as much of the surpluses as possible. However, the disposition of surplus Treasury assets presents institutional and policy concerns, and the environment within which to accomplish this needs careful assessment.

An evaluation of the trade-off between alternative objectives and the costs of achieving them suggests that it may be best to use the surpluses to initiate an individual-accounts-type Social Security reform whereby workers own and control their retirement portfolios. This approach confers several benefits. It avoids deadweight losses from private lobbying, preserves a liquid Treasury market, avoids inefficient investment of federal surpluses, improves the diversification of retirement funds across marketable assets, and eliminates certain undesirable features of the current

Social Security system such as the inability to bequeath retirement assets. It also avoids the pitfalls inherent in trying to implement intergenerational risk via direct SSTF investments in private securities and manipulation of payroll tax rates in response to the fund's market performance.

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JAPAN'S EXPERIENCE WITH FISCAL POLICY IN THE 1990s IN THE AFTERMATH OF THE BUBBLE ECONOMY

Takehiko Nakao[*]

1. Introduction

The Japanese economy has been in a prolonged slump since the bubble burst at the beginning of the 1990s, although there was a short period of recovery in 1995-96 (Figure 1). Several years have passed since the new cliché "the lost decade of Japan" first appeared. More recently, many respected foreign magazines have reported Japan's situation from rather pessimistic viewpoints.[1]

The Japanese economy boasted higher growth rates than those of other major countries not only in the miraculous post-war period (average annual growth of 10% during 1956-73), but also after it transferred to a more stable growth stage triggered by the first oil crisis (average annual growth of 4% during 1974-89). It was not so long ago that Japan was much lauded, in the peak of the bubble economy, as the richest country in the world, the biggest donor country (it still is), and the world center of finance and industry.

Why has Japan continued to suffer from such a prolonged slump of over 10 years? What kind of policy measures has the Government taken? How effective were those measures? If the effects were less than expected, what were the reasons? In this paper, the author, from the standpoint of an administrator of the Ministry of Finance responsible for Japan's fiscal policies, will examine i) how economic policy, particularly fiscal policy, reacted in the 1990s (Chapter 4); ii) how the effects of the fiscal policy are evaluated (Chapter 5); and, iii) where the Japanese economy and its policy are going (Chapter 6). While this paper is not an academic paper based on empirical studies with quantitative models, the author tries to introduce

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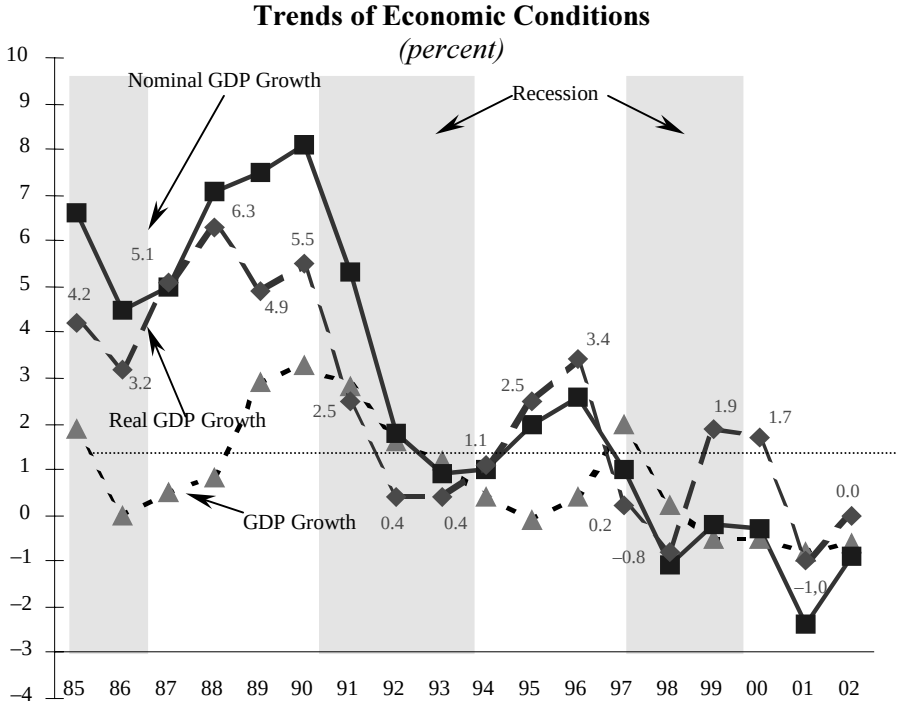
The opinions in this paper are those of the author and do not necessarily reflect the ideas of the Government of Japan or the Ministry of Finance.

The author owes a lot to Mr. Kaoru Saito and other staff of the Research Division of the Budget Bureau, who assisted with the preparation of the data, figures and tables in this paper.

[1] For example, a special report in the *Economist*, February 16-22, 2002 edition, titled "The Sadness of Japan".

Fig. 1



Real GDP and Nominal GDP: 93 SNA basis.
Real GDP, Nominal GDP, CPI: FY1985-2000: actual, FY2001: estimate, FY2002: forecast.

various issues taken up by domestic and overseas critics regarding the effects of fiscal policy and to make his own interpretation.

The conclusion of this paper is that the Japanese authorities have not been inactive. Rather, they have implemented a wide range of measures including consecutive and substantive fiscal packages. Those measures should have contributed to bolstering the economy and avoiding further decline. But they have not been successful in returning the economy to a robust growth path, and more recently, arguments have emerged concerning problems stemming from the build-up of outstanding Japanese Government bonds (JGBs), and the possibility of the decrease of multiplier effects. Japan has not lost its fundamental strengths, and structural reforms including deregulation are steadily taking place. If Japan continues to promote the necessary reforms with strong political commitment, and

implements appropriate fiscal consolidation without delay when the time comes, we should not be pessimistic about Japan's future.

Before moving to the main chapters, the author will discuss in some detail i) what was the bubble phenomenon in Japan in the late 1980s (Chapter 2); and ii) what are underlying reasons for such a prolonged slump after the burst of the bubble (Chapter 3). Without an understanding of this huge bubble which could have been rare in its size in the world economic history, and the very serious effects of its collapse, readers cannot correctly assess Japan's economic policy management in the 1990s.

2. What was the bubble?[2]

2.1 The bubble phenomenon

The Japanese economy in the late 1980s experienced a substantial increase in the asset values of stocks and land. The Nikkei 225 index doubled within 2 years from JY 13,113 at the end of 1985 to JY 26,000 in October 1987. Then, after Black Monday in this month, it rose further to the peak of JY 38,915 at the end of 1989. The TOPIX index, which reflects prices of all the listed stocks on the Tokyo Stock Exchange, tripled from the end of 1985 to the end of 1989 (Figure 2).

Land prices started to increase around 1983 in Tokyo; then the increase spilled over to the other two metropolitan areas (Osaka, Nagoya), and further to other cities and local areas. The land price index of the six largest cities more than tripled from the end of FY1985 [3] to that of FY1990 (Figure 2).

Why did such a sharp rise of asset prices occur? There were three major reasons; expansionary policy stance, in particular that of monetary policy; very vigorous activities by banks as well as corporations and individuals; and strong expectations for the bright future of the Japanese economy.

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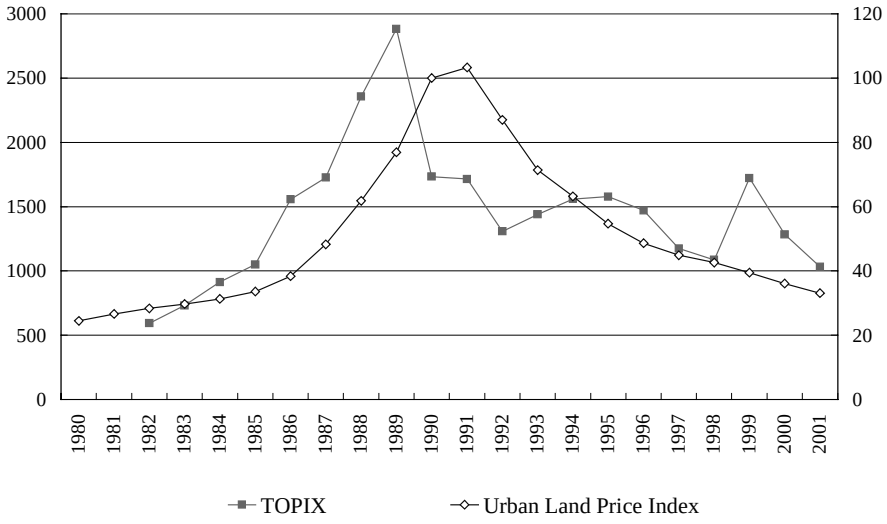
[2] This chapter (except Section 7) basically follows the analysis of the report issued in April 1993 by the Study Group on the Mechanism of Asset Price Variation and its Economic Impact chaired by Professor Ryuichiro Tachi and sponsored by the Research Institute of the Ministry of Finance.

[3] Japan's fiscal year starts on April 1 and ends on March 31 of the following year.

Fig. 2

Trends of the Tokyo Stock Price Index TOPIX
Urban Land Price Index of the 6 Largest City Areas



Sources: Tokyo Stock Price Index: TOPIX.
Urban Land Price Index of the 6 Large City Areas: Japan Real Estate Institute "Urban Land Price Indices".
TOPIX: Year End (CY), January 4th, 1968 = 100.
Urban Land Price Index: Year End (FY), March 31st, 1990 = 100.

2.2 Sustained expansionary monetary policy

First, expansionary monetary policy was maintained to promote domestic demand-led growth against the background of the very sharp appreciation of the yen after the Plaza Accord of September 1985.

The Japanese yen precipitously appreciated from JY 244 to the US dollar in September 1985 to JY 153 in August 1986. The average yen/US dollar rate in FY1986 appreciated 40% over the previous year (Figure 3). In the face of the deterioration of business sentiment due to this sharp yen rise, the Bank of Japan lowered its discount rate five times between January 1986 and February 1987 from 5% to 2.5%, and then maintained the historically lowest rate for 2 years and a quarter until May 1989 when it raised back the rate to 3.25% (Figure 4). In terms of liquidity also, loose

Fig. 3

Trends of External Current Balance (as percent of GDP), Exchange Rate and the Import Ratio of Manufactured Products

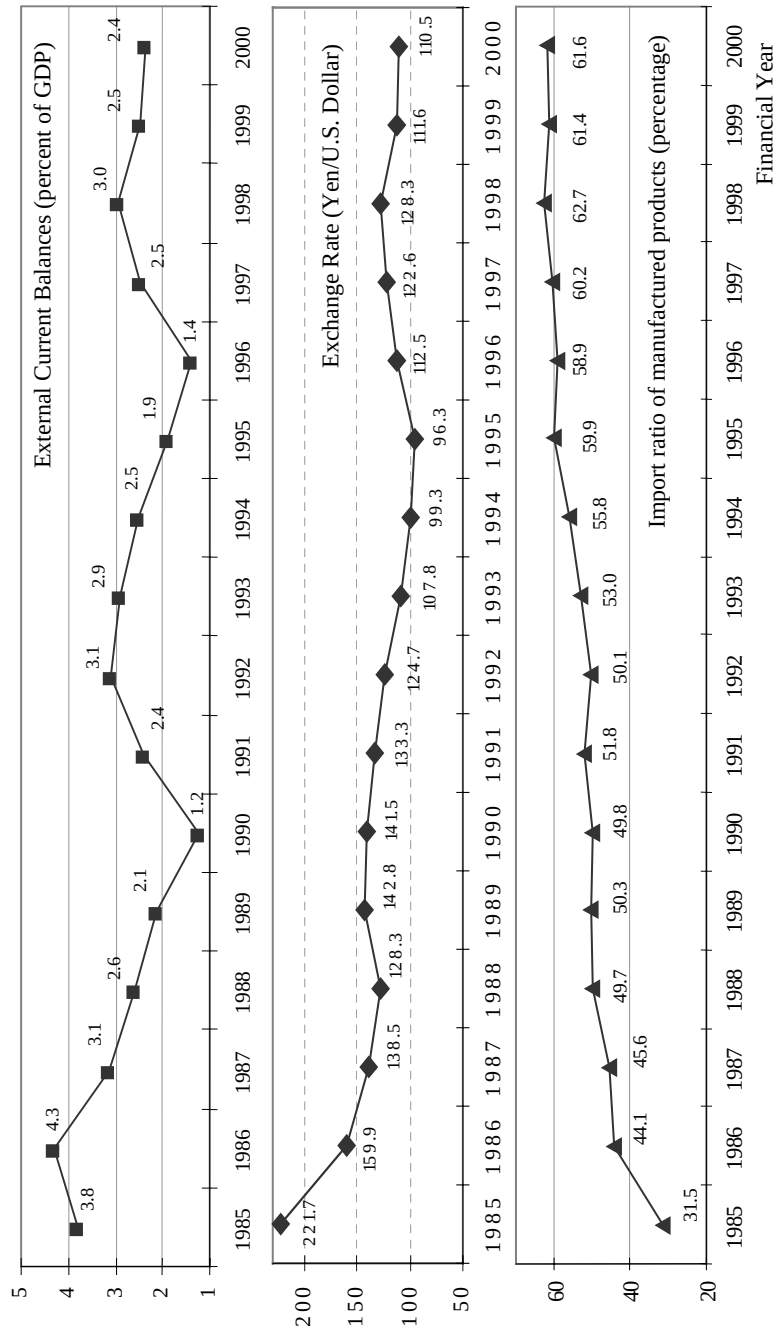
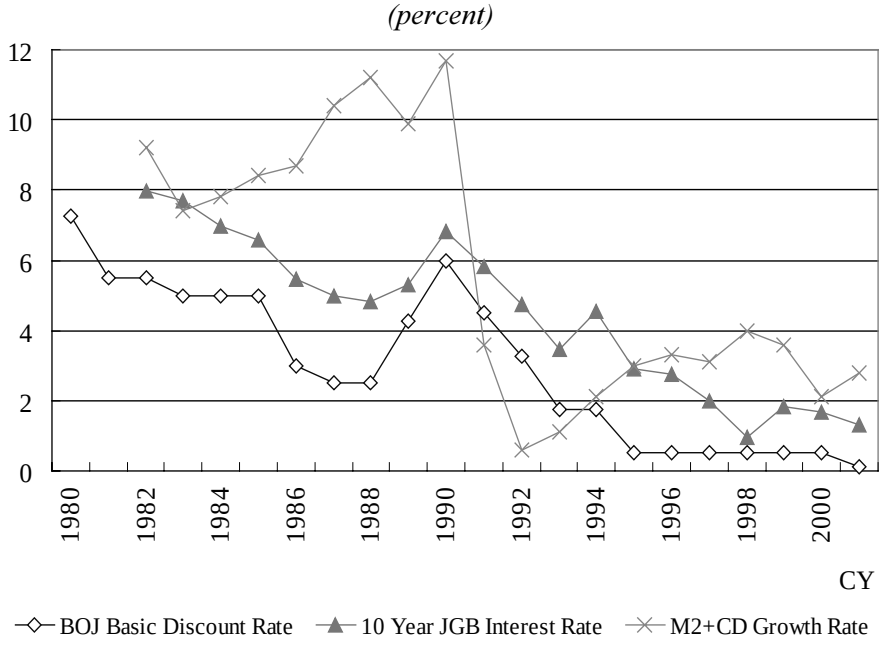


Fig. 4

Trends of BOJ Basic Discount Rate,
Long Term Interest Rate and Money Supply Growth Rate



Source: Bank of Japan.
BOJ Basic Discount Rate: Year End, 10 Year JGB Interest Rate: Average Rate, M2+CD Growth Rate: Average Outstanding Growth Rate.

monetary policy was sustained as exemplified by double-digit money supply growth from FY1987 to FY1990. In addition, two large fiscal packages were compiled in September 1985 and May 1987.

Why was this expansionary monetary policy sustained in spite of the very substantial increase in asset prices? The report referred to in this chapter mentioned five factors: i) it was almost an international commitment for Japan to maintain an expansionary policy since the Plaza Accord required Japan and Germany, with their current account surpluses, to aim at domestic demand-led growth, and the United States to reduce the fiscal deficit; ii) the Japanese authorities overestimated the negative impacts of the yen appreciation while the appreciation also should have had positive impacts including an increase in real-term income; iii) the CPI remained rather stable (Figure 1) despite asset price hikes, largely due to

the appreciation of the yen and its impact on import prices; iv) it is possible that monetary policy was required to remain expansionary while fiscal policy aimed to reduce the deficit; and v) Black Monday in October 1987 might have deprived the authorities of an opportunity to change their policy stance toward tightening.

2.3 Very vigorous financial activities

The second reason for the bubble was that financial institutions, non-financial corporations, and individuals became financially very active in the late 1980s. In these years, against the background of expansionary monetary policy and the progress of disintermediation, through which large corporations relied less on bank loans, financial deregulation proceeded without sufficient risk management and enforcement of the self-responsibility principle.

Manufacturing companies reduced borrowing from banks under the more streamlined management style prevalent after the slowdown of Japan's growth in the mid-1970s; their new investments had been increasingly financed by retained earnings. Deregulation of security issuance also invited less dependence on bank loans. In this environment, banks had to find new areas for their activities, and increased lending, directly or through their affiliated non-bank loans, to real estate-related businesses including construction and land development. For banks facing higher financing costs due to the liberalization of interest rates, lending to real estate-related businesses was also opportune because it was larger in volume per contract and more efficient, with a higher rate of return and longer maturity, and real estate could be used as collateral.

Institutional investors such as life insurance and investment trusts offered various new financial products reflecting deregulation, mobilized more funds, and invested actively in the stock market. Non-financial corporations also financed more funds in equity markets in the boom, including through issuing warrant and convertible bonds, and actively managed these funds in the stock market either directly or through institutional investors, which further raised stock prices. Some companies even became obsessed by financial management, paying less attention to their original business. In the bubble, individuals also became actively involved in investment in stocks, real estate, golf club membership, and fine art.

2.4 Strong expectations

The third reason was strong expectations for the future. The rise in asset prices seemed rationalized by the sustained expansion of the economy in the late 1980s, increase of real-term income reflecting the stronger yen, enhancement of the international status of Japan's economy, and larger role played by Japanese financial institutions in the international market. The land myth also played an important role in the bubble. Land prices in Japan had continued to rise in the post-war period, and the boom reinforced the belief that land would remain the most profitable asset and its price would further rise, inviting renewed speculation in land investment. In the midst of the bubble period, some analysts even predicted a shortage of office space in the center of Tokyo in the foreseeable future.

2.5 Impacts of the asset price rise on the real economy

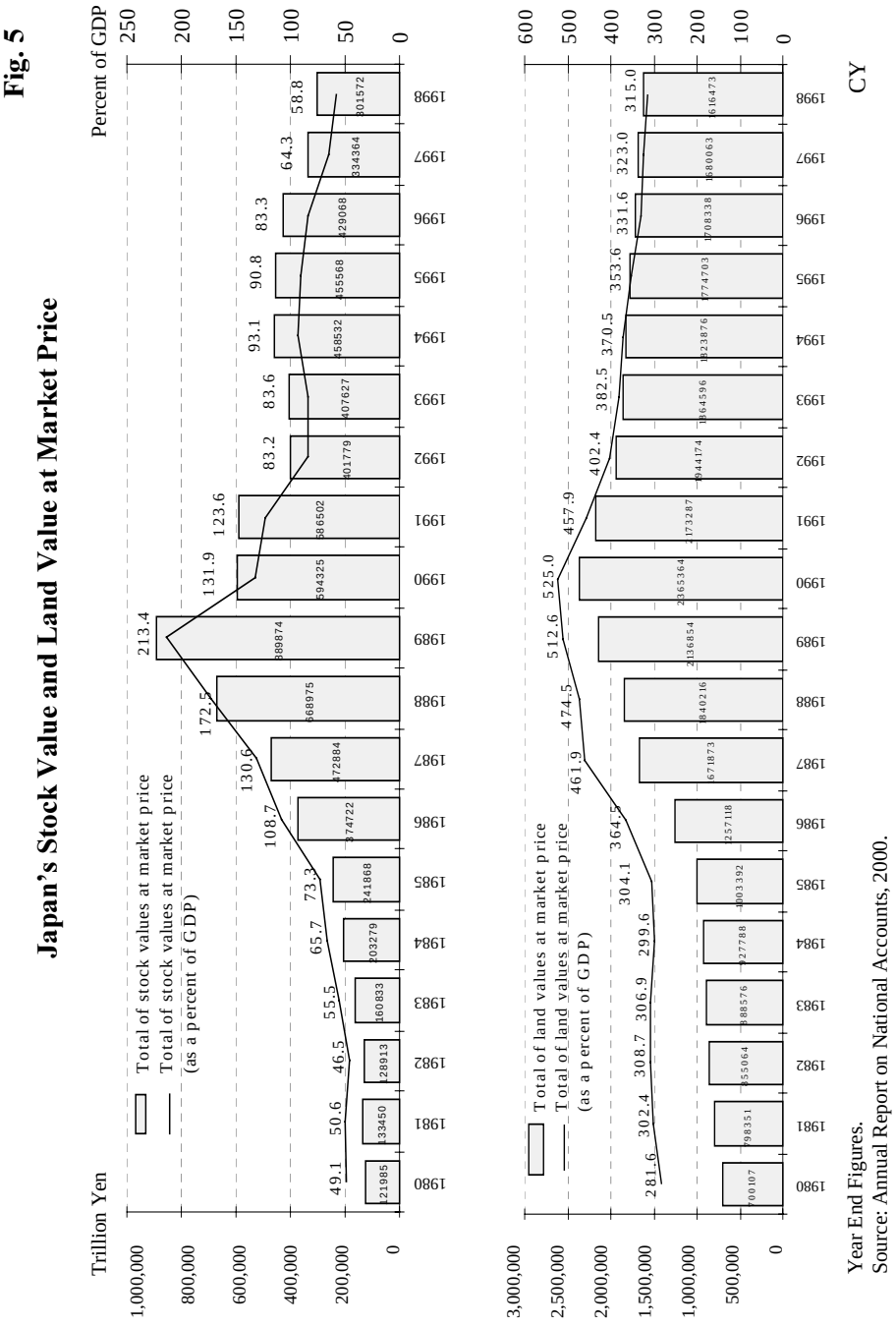
During the bubble, the rise in asset prices had a great impact on the real economy. Japan's economy grew 5.1% per annum from FY1987 through FY1990, of which investment in equipment and machinery and private consumption contributed 2.3% and 2.5%, respectively. The expansion of these expenditures was obviously influenced by the good performance of business earnings and household dispensable income, as well as the strong appetite toward investment for saving labor and utilizing information technology. In addition, however, the wealth effect from an increase of the total stock value by as much as 150% of GDP and of the total land value by as much as 200% of GDP between the end of 1985 and the end of 1990 should have substantially contributed to the growth of these expenditures (Figure 5). Incidentally, during this period, the external current account decreased sharply from 4.3% of GDP in FY1986 to 1.2% in FY1990 (Figure 3).

2.6 Bursting of the bubble

Like other bubbles in human history, the bubble in the late 1980s in Japan collapsed eventually, reflecting an alteration in the expectations of the people and the authorities' policy stance. The Bank of Japan tightened monetary policy in the face of some signs of inflation by raising its discount rate three times in 1989 from 2.5% to 4.25%, and twice in 1990 to 6.0%. In addition, in April 1990, a regulation concerning the volume of

Fig. 5

Japan's Stock Value and Land Value at Market Price



Year End Figures.
Source: Annual Report on National Accounts, 2000.

bank loans to real estate-related businesses was introduced, and in 1991 a comprehensive reform of taxation on land (including the introduction of a national-level land holding tax on the market value of land) was decided. Thus, stock price indexes started to drop from the beginning of 1990, and land prices started to decline during 1991, although the timing varied in different areas of Japan.

2.7 The bubble and monetary policy

Before concluding this chapter, the author would like to provide a few observations on the monetary policy in the lead-up to the bubble in the late 1980s. The World Economic Outlook of the IMF, April 2000 (referred to again in Section 3 of the next chapter) points out that monetary authorities should carefully monitor fluctuations in asset prices, and that they should take precautionary monetary policy in the face of sustained increase or rapid decrease in asset prices. On the other hand, it is often pointed out that Japan's authorities were probably late in taking precautionary tightening measures in the late 1980s. Among the reasons for sustaining the expansionary monetary policy during that period, which were discussed in Section 2 of this chapter, the author would like to emphasize the stable CPI due to the appreciation of the yen.

This is related to economic policy management under the floating exchange rate regime and the fixed exchange rate regime. Under the Bretton Woods-type regime with limited international capital movements and fixed exchange rates between major countries, when active growth and inflationary pressures occur in one country, the country is obliged to tighten its monetary policy due to balance of payments constraints. The trading partner's economy is influenced by the increase in exports and improvement in the current account balance as well as by automatic monetary expansion unless the authorities sterilize the increase in the base money caused by the increase in foreign reserves. Under this regime, therefore, economic situations between countries tend to converge.

On the other hand, under the floating exchange rate regime with huge capital movements between countries, when a country is in an economic boom, the real-term interest rates and asset prices rise, thereby inviting capital flows from abroad, and appreciation of its currency. This then leads to the reduction of import prices and the stability of the CPI. Although the external current account position may deteriorate, as long as

the deficit in the current account is financed by capital inflows, the ideal combination of high growth and low inflation can be maintained. In the condition of an external current account surplus like Japan in the late 1980s, it would be very difficult for the monetary authorities to alter the policy, solely based on the recognition of rapid and general rises in asset prices.

Incidentally, under such a regime, while the transmission channel through trade between countries works toward converging their economic conditions, the transmission channel through huge capital flows from the less active economy into the boom economy tends to diverge the economic conditions of countries because it further brings about expansionary effects in the boom economy and contractionary effects in the less active economy. It is possible that the divergence in economic performance between Japan and the USA in the late 1980s and in the late 1990s is related to this mechanism.

3. Why such a prolonged slump?

3.1 Prolonged slump

More than 10 years have passed since the collapse of the bubble. During this period, the annual growth of Japan's economy has been generally subdued, and the economy still has not returned to a robust growth path (Figure 1). The TOPIX stock index is now about one third of its peak level. The land price index of the six largest cities has continued to drop, and is now around one third of its peak, too (Figure 2). Due to the sustained decline of asset prices and bad performance of business earnings, balance sheets of banks and non-financial corporations are still in bad shape. The unemployment rate rose from 2.1% in 1990 to the highest ever level of 5.5% in December 2001.

The author was involved in the preparations for the G7 Finance Ministers and Central Bank Governors' Meetings in 1991 through 1993 as a staff member of the International Bureau of the Ministry of Finance. In those years, the Japanese authorities thought that although the Japan's economy was in the process of adjustment in the wake of the bubble, it would recover before long as monetary policy was loosened again in 1992 and the expansionary fiscal policy exemplified by the August 1992

package took effect. The author himself shared this view. Why has the slump continued for such a long time?

The author believes that the following three factors lie behind this prolonged slump, putting aside policy responses that will be discussed in the next chapter.

3.2 Negative wealth effect and stock adjustment

The first factor is simple. Within just a two-to-three year period closing at the end of the 1992, total stock value amounting to 130% of GDP and total land value amounting to 120% of GDP was lost (figure 5). As some economists argue, the wealth effect can work asymmetrically; its impact can be larger in the price decline phase. It is probable that household consumption and business investments were affected by a substantial negative wealth effect after the bursting of the bubble, together with the negative impact of peoples' altered expectations.

On top of the negative wealth effect, equipment and machinery investment of non-financial corporations dropped sharply due to the credit crunch (to be discussed later), decline of earnings, and stock adjustment after the excessive investment of the boom period.

3.3 Balance sheet problems and malfunctioning of financial intermediation

It is widely believed today that the balance sheet problems of financial institutions as well as non-financial corporations, and accompanying malfunctioning of financial intermediation have been the most important factors behind this prolonged slump of the economy. In this context, it seems quite useful to refer to the IMF World Economic Outlook of April 2000.[4] In this report, the IMF conducted an in-depth analysis of experiences in developed countries including Japan regarding asset price fluctuations and the business cycle.

The report emphasizes that large asset price swings could have disruptive impacts on balance sheets of financial institutions in addition to

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[4] Chapter III, "Asset Prices and the Business Cycle" of the WEO (IMF, April 2000).

well-known disturbances from positive or negative wealth effects. According to the IMF, a sharp downward swing of asset prices would have a major impact on balance sheets through channels of i) downward revaluations of non-loan assets; ii) the decrease in earning accruing from brokerage fees on the value of asset transactions; iii) the increase in the share of non-performing loans to the extent that falling asset prices affect the solvency of household and corporate borrowers; iv) the falling value of loan collaterals, and thereby undermining banks' capital position and lending capacity; v) the decline of asset prices due to sales of assets at fire sale prices; vi) the further decline of asset prices due to the credit crunch created by the deterioration of balance sheets; and vii) the combined, mutually reinforcing impacts of the above mentioned effects. The report says that this transmission channel has proven stronger in continental Europe and Japan where the financial system is bank-dominated, and especially in Japan where cross shareholding between the banking and corporate sectors is extensive.

This is exactly what has happened in Japan. According to the SNA statistics, the financial sector in Japan built up assets (excluding real assets) by 49% in four years, from JY1,091 trillion at the end of 1986 to JY1,623 trillion at the end of 1990. These assets in the balance sheets of financial institutions have deteriorated ever since due to non-performing loans and the revaluation of stocks. Behind this is the aggravation of balance sheets of borrowing corporations. The liabilities of the non-financial corporate sector increased by 46% in the same four years to JY855 trillion (195% of GDP in that year). Bad performance of earnings reflecting the economic slowdown and deflationary pressures have made it difficult for corporations to repay the debt and this debt overhang has kept many companies from making proactive investments.

On the other hand, the balance sheet of the household sector is in comparatively good shape. The household sector (including unincorporated enterprises) increased its gross financial assets by 49% during the bubble period to JY949 trillion at the end of 1990. The amount at the end of 1998 was JY1198 trillion. Out of this, JY722 trillion in deposits and JY289 trillion in life insurances (in sum, 85% of the total financial assets) were essentially covered by public insurances. The liabilities of the household sector at the time were limited to JY372 trillion and stock holding was as low as JY75 trillion at the market price. In a way, the burden of asset value reduction was concentrated in the balance sheets of the financial and non-financial corporate sectors.

3.4 Structural changes in the basis of the Japanese economy

The final factor behind the prolonged slump is represented by possible structural changes in the basis of the Japanese economy. Many preconditions of post-war growth should have been faced with major challenges from the late 1980s through the 1990s, but these were obscured by the bubble and only found belatedly.

The first of these underlying structural changes is the end of the catch-up process for Japan's economy in the post-war period. Japanese per capita GDP in US dollars became the largest among the major economies at the end of the 1980s. Being a front-runner meant that the economy could not take advantage of growing faster by importing technology from others. It also meant that demand growth would be restrained by the mature consumption pattern.

The second important change is the aging of society. In 1965, the proportion of people 65 years old or more in the Japan's total population was only 6.3%, which was much lower than that of other major countries. Fifteen years later, it remained at 9.1%, but by 1995 it had climbed to 14.5%. In the coming years, it is expected to rise very rapidly (Figure 6). The aging of the population would contribute to both lower potential growth and less exuberant demand. It also would have negative impacts on consumption due to anxiety over the increasing burden and/or the sustainability of the public pension and medical systems.

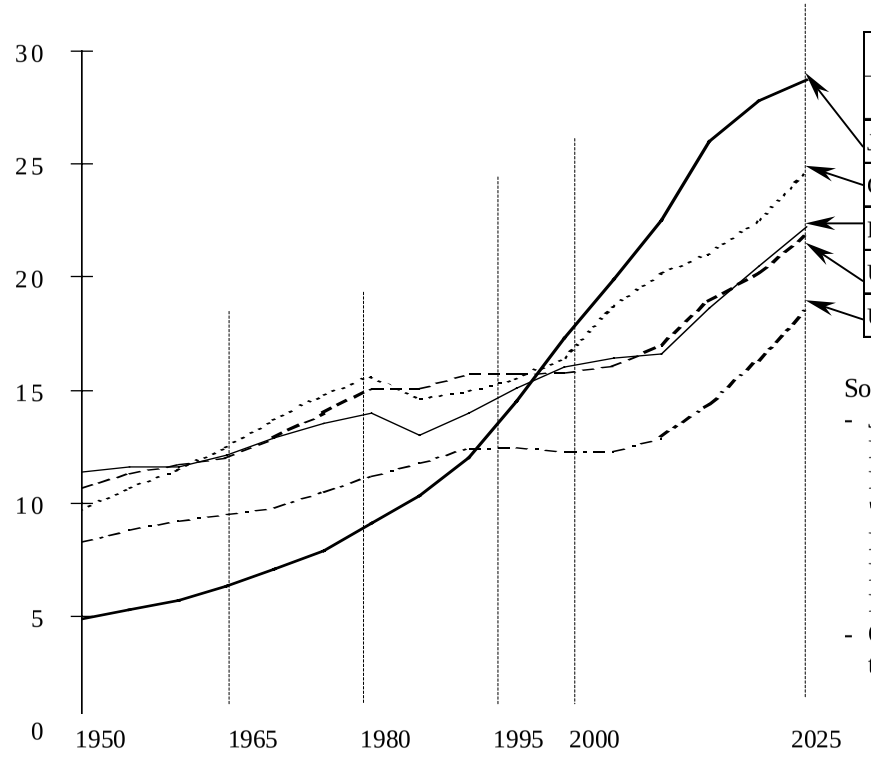
Third, Japan's economy has been more closely integrated with Asian countries through trade and investment. Accordingly, the ratio of Japan's imports of manufactured products to total imports increased from 31.5% in FY1985 to 61.6% in FY2000. In spite of the prolonged slump, total imports increased by 25% between FY1990 and FY2001 (against an increase of nominal GDP of 10%). Out of this, imports from China centered on clothes and electrical products increased fourfold and, *vis-à-vis* China, Japan now has the biggest trade deficit of JY3.2 trillion. It is probable that imports of Chinese products and the transfer of factories to China, which is becoming the manufacturing center of the world, have had substantial deflationary impacts on Japan's economy.

Fourth, the alteration from excess demand for land to its over-supply might have occurred between the pre- and post-bubble periods. Slower population growth, the aging of society, shift of the industrial structure

Fig. 6

Ratio of the Number of Aged People (65 years or more) to the Total Population

(percent)



	1965	1980	1995	2000	2025	1965-1995	1995-2025
Japan	6.3	9.1	14.5	17.3	28.7	8.2	14.2
Germany	12.5	15.6	15.5	16.4	24.6	3.0	9.1
France	12.1	14.0	15.1	16.0	22.2	3.0	7.1
U.K.	12.0	15.1	15.7	15.8	21.9	3.7	6.2
U.S.A.	9.5	11.2	12.5	12.3	18.5	3.0	6.0

Sources:
- Japan: "National Census" (Minisitry of Public Management, Home Affairs, Posts and Telecommunications) and "Japanese Future Demographic Projections" (National Institute of Population and Social Security Research, 2002)
- Other nations: United Nations projections.

toward more knowledge intensive industries, transfer of factories to Asian countries by manufacturers ("hollowing out"), decrease of migration to big cities, improvements of housing conditions which had been pursued throughout the post-war period, and saturating demand for houses by baby boomers who entered their mid-Forties in the 1990s, all contributed to the decrease of demand in land.

Fifth, more importantly, the post-war socioeconomic system of Japan failed to respond to the above mentioned major changes. To take a few important examples, what is regarded as the post-war Japanese system comprises: i) labor market with limited mobility as represented by lifetime employment by most large corporations; ii) a financial market heavily dependent on intermediation by banks; iii) cross-corporation relationships paying more attention to long-term reciprocity; iv) corporate governance with a higher priority on expansion of business than an maximization of return on capital; v) an education system with a high average level but which does not produce many genius and entrepreneurs; and vi) government policies emphasizing security and stability rather than promoting competitive environment. Obviously, these all contributed to high growth and the fair distribution of its fruits in the post-war era, but, by the beginning of the 1990s, they had made the Japanese economy less able to respond well to new challenges and to act speedily in the new environment of globalization and the IT revolution.

4. Fiscal policy in the 1990s

4.1 Overview

How did economic policy, fiscal policy in particular, react during the prolonged slump of the 1990s? Did the authorities take measures in a timely manner and on a sufficient scale? These are questions that have been asked by domestic and overseas critics. In short, the authorities have not been inactive. As discussed in detail later, consecutive and substantial fiscal packages have been implemented and contributed to the bolstering the economy and the avoidance of further plunging.

Touching upon other policy areas, monetary policy has been expansionary; since July 1991 the BOJ discount rate was lowered several times, reaching an historically low of 0.5% in September 1995, and then 0.1% in September 2001. Ample base money has been provided by the

BOJ through various channels although money supply (M2) has not increased as expected, possibly due to deterioration of financial intermediation (Figure 4). In the area of financial sector policy, all thinkable measures have been taken.[5] Banks, reflecting more rigid regulatory and inspection initiatives by the Financial Agency, have accelerated resolution of non-performing loans.

It is important that the Government, business, and the general public have been very keen on promoting wide-ranging structural policies, including i) deregulation in telecommunications, transportation, utilities, retail, medicine, and education; ii) reform of the labor market to improve mobility; iii) amendments of commercial and bankruptcy laws to encourage the restructuring of enterprises; and iv) reform of the public sector based on the concept of new public management. In essence, these policies are being pursued in view of the structural challenges that were discussed in Section 4 of Chapter 3.

4.2 Consecutive fiscal packages

Since the burst of the bubble, the Government has implemented 12 large fiscal packages, incorporating the Government's additional expenditures, in particular public works, through supplementary budgets (Table 1). The first package was compiled in August 1992 and, then, a new package was announced every year, except in 1996-97 reflecting a short recovery and a fiscal consolidation policy that was pursued but aborted shortly (footnote 16). The headline scales of 8 of the packages were over 2% of GDP, and the biggest one was over JY20 trillion or over 4.7% of GDP.

Public works were the biggest element in most of the packages. The amounts for the public works projects assumed funding contributions from local governments for joint projects with the central government as well as for independent local projects. It should also be noted that the amounts in

[5] Measures have been implemented since 1990 in order to i) regain and ensure the stability of the financial market (among others, public money injection to reinforce banks' capital, reform of the deposit insurance system); ii) promote efficiency and competition (various deregulations, cross-entry between banks, security firms, and insurance companies through affiliated companies and holding companies); iii) ensure fair and safe transactions (strengthening of accounting and disclosure practices, a new law to protect consumers in financial transactions); and iv) reform regulatory agencies (separation of the Financial Agency from the Ministry of Finance, the new BOJ law to enhance its autonomy from the Government).

Table 1

Economic Stimulus Packages after the Collapse of the Bubble Economy
(trillions of Yen)

	Aug. 92	Apr. 93	Sep. 93	Feb. 94	Apr. 95	Sep. 95	Apr. 98	Nov. 98	Nov. 99	Oct. 00	Oct. 01	Dec. 01
Public Investment	8.6	10.6	5.2	7.2		11.4	5.2	8.0	7.2	4.2		2.5
of Which: Lending by Housing Loan Corporation	0.8	1.8	2.9	1.2		0.5		1.2	2.0	1.0		
Measures for Small and Medium-Sized Enterprises and Credit Crunch	1.2	1.9	0.8	1.4	1.4	1.3	2.0	5.9	7.4	4.5	4.5	
Measures for Employment		0.0		0.0		0.0	0.1	1.0	1.0	0.1	1.0	
Measures for Disaster Relief					5.1	1.4	1.0	1.3	1.6	1.0		
Others	0.9	0.5		0.8	0.4	0.1	3.8	1.7	0.9	0.2	0.3	1.6
Tax Reductions		0.2		5.9			4.6	6.0				
Package Volume	10.7	13.2	approx. 6.0	15.3	approx. 7.0	14.2	over 16.0	over 20.0	approx. 18.0	approx. 11.0	approx. 5.9	approx. 4.1
Package Volume (percent of GDP)	2.2%	2.7%	1.2%	3.1%	1.4%	2.8%	3.2%	4.7%	3.5%	2.1%	1.2%	0.8%

Source: Ministry of Finance.

the packages included the expansion of lending from government financial institutions for housing and small- and medium-sized enterprises. Furthermore, the amounts included the effects of special and permanent tax reductions.[6]

Some critics have argued that these stimulus packages were not as effective as their scales implied. One of these arguments is that "real water" parts (those that involve an increase in real expenditures from the government or reduction of revenues, and that directly contribute to an increase in effective demand) were limited. While expansion of loans from government financial institutions typically involves increased capital contribution and subsidies from the government budget, the target of the loan was not always attained. Moreover, the expanded lending might only alter borrowing from private banks or be used to reinforce liquidity for daily business operations. Land purchases included in the amounts of the packages are recorded as transfers and do not appear as expanded expenditures in GDP statistics. According to an estimate in an IMF publication,[7] "real water" measures contributed 55% to 78% of the headline amounts of the packages except the one in September 1993, which involved a large expansion of loans from the Housing Loan Corporation. Thus, it is obvious that the amounts of "real water" parts alone were quite substantive.

Second, some have argued that although the packages with supplementary budgets were surely expansionary, every year's initial budget of the General Account Budget of the central government has been rather contractionary. Yes, the Ministry of Finance has tried to avoid loosening expenditures in every year's initial budget using the method of ceiling based on the previous year's initial budget for each ministry's budget request. However, the fact is that the total expenditures in the initial budget increased by 25% from JY66.2 trillion in FY1990 to JY82.7 trillion in FY2001 projection (Figure 7), partly due to the inevitable increase in social security-related expenditures. Excluding spending for interest and amortization of JGBs and for the Local Allocation Tax (statutory transfer to local governments based on a certain ratio of the national taxes on individuals, corporations, and consumption), the total expenditures of the

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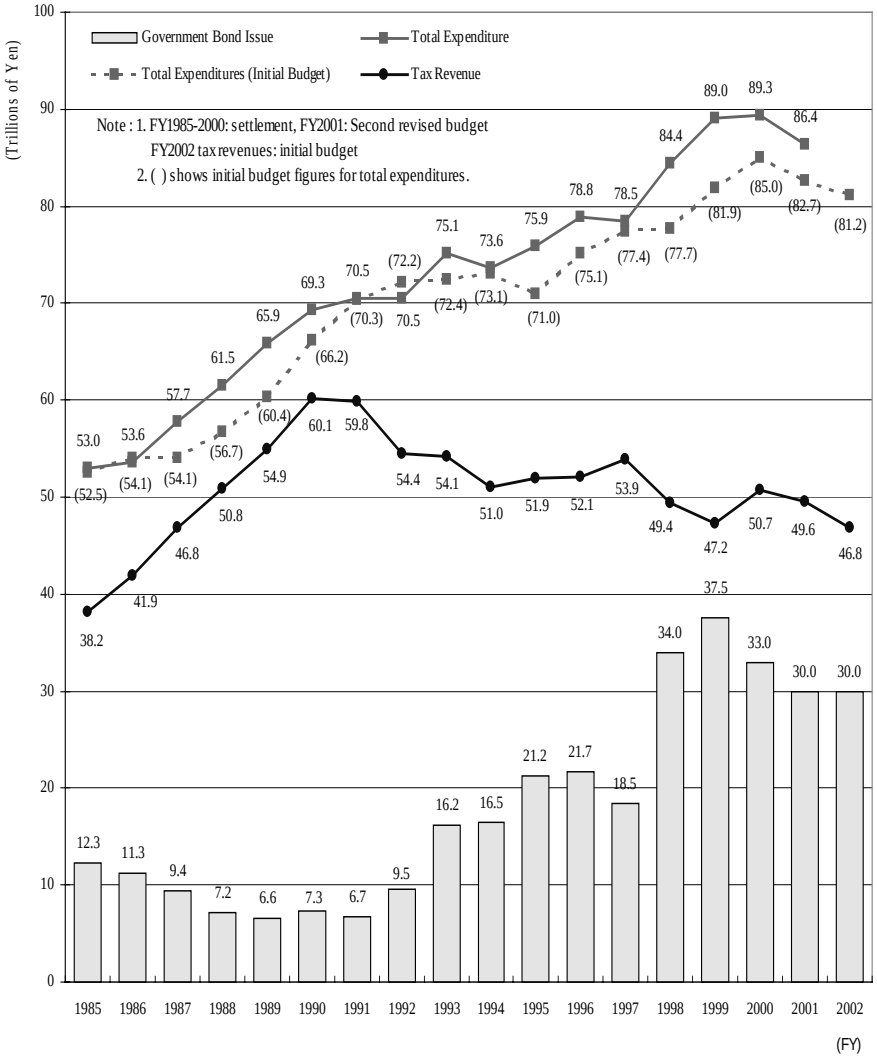
6 According to a Ministry of Finance estimate, the full effects on each year's revenues of the permanent tax reduction starting FY1999 [including a maximum individual income tax rate 65%→50% (sum of national and local), and an effective rate of corporate income tax 50%→41%] were JY 4.9 trillion (national) and over JY6.0 trillion (including local).

7 Chapter 6 of *Post-Bubble Blues* (IMF, 2000).

Fig. 7

Trends of General Account Tax Revenues, Total Expenditures, and Government Bond Issues



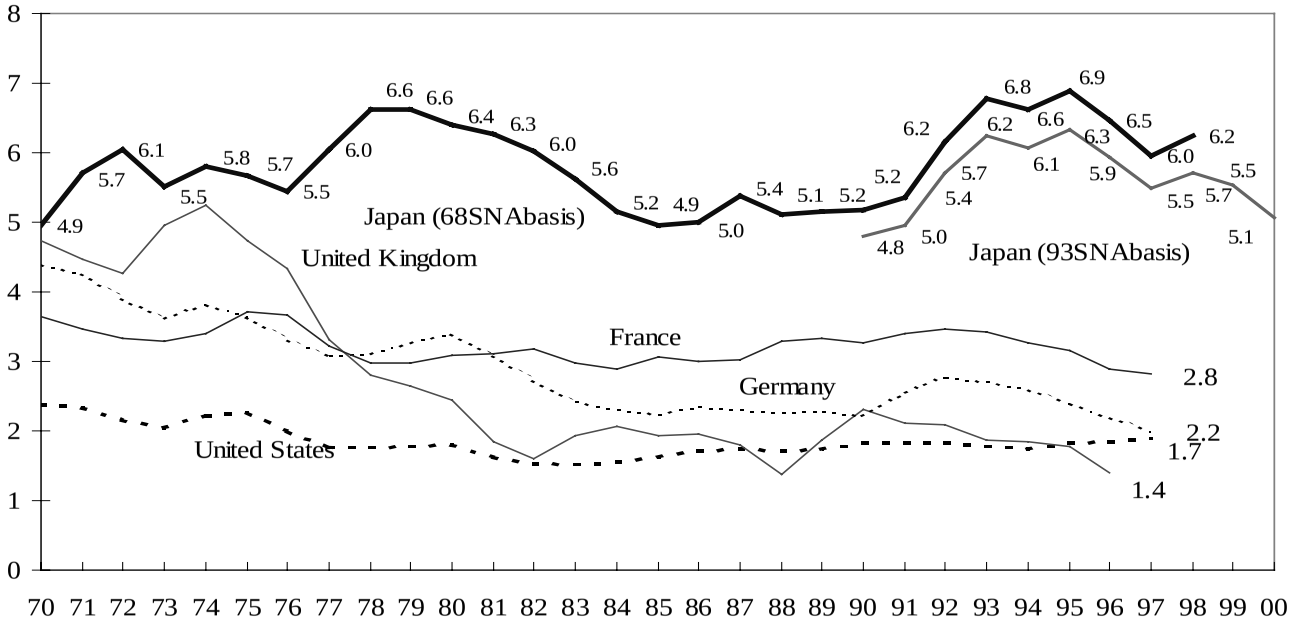
Nominal GDP (Trillions of Yen)	362.0	483.2	520.2 (FY2002 figures are estimates)	496.2

The permanent tax reductions (national and local), which substantially exceed 6 trillion Yen (full effect basis), are continuing since FY 1999.

Fig. 8

Trends in the Ratio of Government Investment to GDP on a General Government Basis

(percent)



Japan: Annual Report on National Accounts, etc. (FY basis).
Other countries: OECD National Accounts (CY basis). 68SNA basis.
Germany up to 1990: West Germany.

initial budget rose by 38% in the same period from JY35.4 trillion to JY48.7 trillion. Thus, it can hardly be said that the initial budget has been contractionary.

The third point regards the volume of government investment (Ig) on a general government basis (net sum of central and local governments as well as certain other public entities). The Ig rose by 47% from JY21.6 trillion in FY1990 to JY31.8 trillion in FY1995. During that period, the ratio of Ig to GDP increased from 4.8% to 6.3% (Figure 8), and contributed to supporting the economy. As some argue, however, after FY1995 the Ig leveled off, and its ratio to GDP declined as the deterioration of local governments' fiscal position restrained them from implementing the public works as vigorously as expected.[8]

4.3 Growing fiscal deficit

Japan's fiscal deficit grew throughout the 1990s after the burst of the bubble. The deterioration of the fiscal position in the General Account Budget of the central government is obvious (Figure 7). Due to the decline in tax revenues stemming from the economic slump as well as tax reductions, and the expansion of expenditures, the gap between tax revenues and expenditures is expected to widen to JY36.8 trillion yen in FY2001 (projection) and is being financed by the new issuance of JGBs worth JY30 trillion (supplemented by non-tax revenues for the remaining). It is quite abnormal that only 57% of the total expenditures is covered by tax revenues

Expansion of the fiscal deficit and reliance on JGB issuance naturally has brought about accumulation of outstanding JGBs (Figure 9). At the end of FY2001, outstanding JGBs totaled JY395 trillion or 79% of GDP.

Japan's serious fiscal position is also obvious in an international comparison using data on a general government basis (Table 2 and 3). In CY1990, Japan's position was in good shape and better than other major countries, but today, it is by far in the most serious condition.

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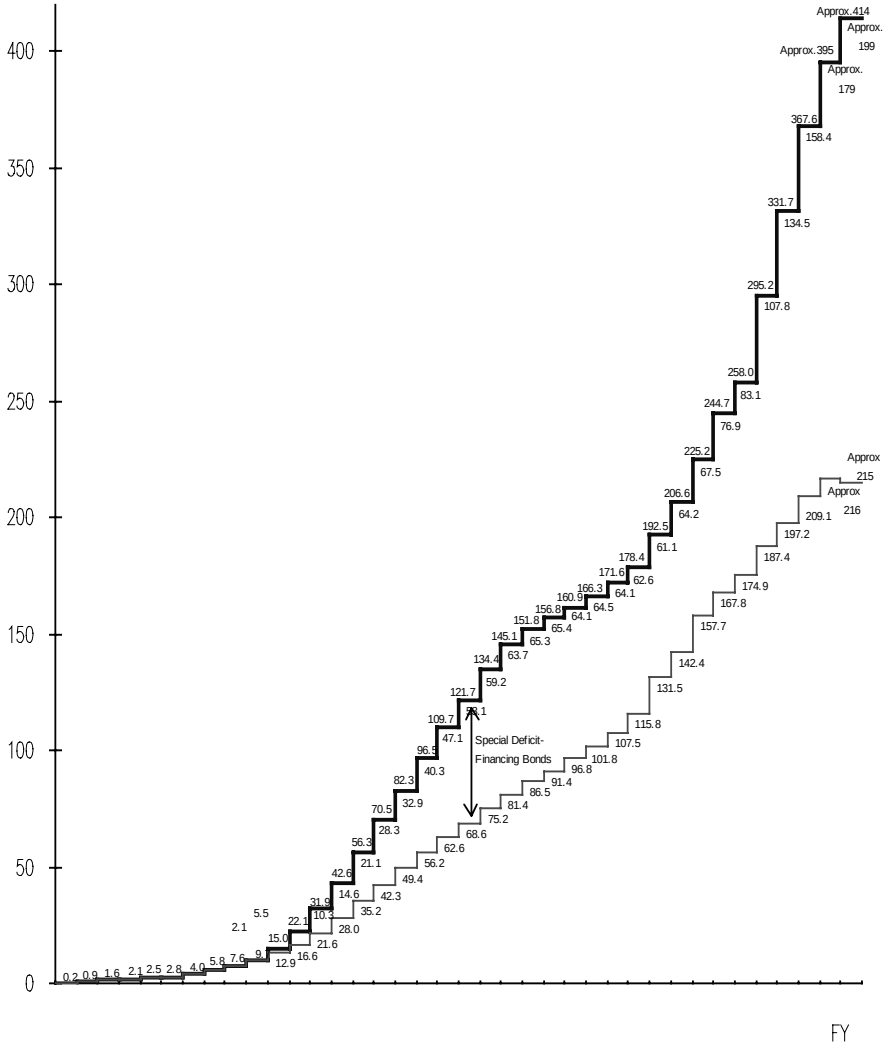
[8] Local governments' spending constitutes about 80% of the total Ig.

Fig. 9

Trends of Accumulated Government Bonds Outstanding (FY2002 Budget)



FY1965-2000: actual. FY2001, FY2002 are estimates. Figures for FY2001 include the scheduled issuance of FY2002 refunding bonds in FY2001 (approximately 7 trillion Yen).

The special deficit-financing bond amount includes refunding bonds for long term debts transferred from JNP Corp. settlement and National Forest Service, etc.

4.4 Structural or cyclical?

The increase in the fiscal deficit in the 1990s comprised both i) "structural deficit" stemming from discretionary stimulative expenditure policy and tax reductions, and from the inevitable increase in social security-related expenditures with the aging of the population, on the one hand; and ii) "cyclical deficit" caused by the gap between potential and actual GDP, stemming from the drop in revenues and the increase in unemployment benefits, etc., on the other.

According to an OECD estimate,[9] the fiscal deficit was 6.6% of GDP on a general government basis in CY2000, with structural deficit constituting 6.3% and cyclical deficit, 0.3%. This means that even if actual GDP increases to its potential, improvement of the fiscal position would be only 0.3%. However, it should be noted that, in general, estimates of potential GDP and, thus, the cyclical element in the fiscal deficit are based on various assumptions. The OECD estimate regarded the output gap to be 0.6% of actual GDP. It is possible that the gap and the cyclical deficit are much larger. If this is the case, when Japan recovers to its potential, the improvement in fiscal position could be more substantial than indicated in the OECD estimate.

In fact, according to an IMF estimate,[10] cyclical deficit in 2000 was 2.5% of GDP out of a total of 8.0% and, thus, the cyclical element is assumed to be much larger than that of the OECD estimate. Incidentally, the IMF publication[11] regards as structural the sharp drop in the tax revenue elasticity to GDP before and after the bubble (from 1.6 in 1986-90 to minus 0.5 in 1991-94), while regarding as cyclical the bad performance of revenues which reflect lower GDP growth by assuming the potential normal elasticity of 1.2 (observed in 1976-85). It is arguable whether such substantial alteration of the elasticity should be regarded as structural, as in the IMF paper, or as cyclical.

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9 *OECD Economic Survey, Japan 2000-2001* (December 2000).

10 The staff report of the IMF Article IV consultation with Japan that was published in August 2000. The gap between the IMF and OECD estimates of total fiscal deficit in 2000 may be due to the difference in the timing of the estimation.

11 Same publication as in footnote 10.

5. Views on the effects of the fiscal policy[12]

5.1 Effects of supporting the economy

Since the beginning of the 1990s, the Government has adopted an expansionary fiscal policy which brought about an increase in the fiscal deficit. Yet, the economy has not returned to a robust growth path. It seems that the impact from the collapse of the bubble has been much larger and prolonged than initially thought and that Japan's economy has undergone many structural challenges as discussed in Chapter 3. Against this background, various arguments have emerged concerning the effects of the fiscal policy.

First of all, the author would like to reiterate the generally-accepted view that the fiscal policy contributed to supporting the economy and preventing further decline. From FY1990 to FY2000, real GDP increased by 14.0%, out of which, contribution from public demand was 6.6% *vis-à-vis* 6.1% from domestic private demand.[13] Public sector expenditures have played a very important role in the economic slump, financing increasingly larger parts by the expansion of its liabilities, in spite of its small percentage of total GDP (23% in FY2000).

This role of fiscal policy is also clear from the investment-saving balance in the SNA statistics (Figure 10). Between FY1990 and FY2000, non-financial enterprises shifted from excess investment of 9% of GDP to excess saving of 3%. This huge swing resulted in major excess saving or shortage of investment in the whole domestic private sector. The public sector on a general government basis absorbed this excess saving by the private sector by shifting from excess saving (net lending) to excess investment (net borrowing). If the public sector had not made up for the excess saving by the private sector by increasing its expenditures and borrowing more, a macroeconomic balance would have been achieved through heavier reliance on net exports, and/or decrease in the private sector excess saving that, then, would have been achieved through the

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[12] The author's discussion in this chapter were inspired by the views of Professor Toshihiro Ihori (University of Tokyo) and Dr. Toshiki Tomita (Nomura Research Institute), both of whom are more concerned about the increasing fiscal deficit, and Professor Tatsuo Hatta (University of Tokyo), who is more supportive of the role of fiscal policy from the neo-classical standpoint. These views were expressed at conferences held within the Ministry of Finance and in their recently published books.

[13] Of 6.6%, public investment and public consumption contributed 1.6% and 5.0%, respectively. External net exports contributed 1.2%.

contraction of domestic production and, thereby, contraction of income and saving of the household and corporate sectors.

5.2 Why a Keynesian policy for Japan alone?

In the 1990s, other major countries pursued and achieved fiscal consolidation (Table 2). These countries did this despite occasional recessions and unemployment rates generally higher than the Japanese one. On the other hand, in Japan, except for the final stage of the bubble economy and the short period around 1997[14] [15] an expansionary Keynesian-type fiscal policy has been followed. In fact, the G7 Finance Ministers and Central Bank Governors' Meeting and the IMF continuously required Japan to take stimulative fiscal measures both before and after the bubble, while requiring the United States and European countries to adhere to fiscal consolidation. Why was there this contrast between Japan and other major economies?

The author supposes the reasons are the following: i) for Japan, reducing the external current account deficit has been always an objective; ii) the inflation rate has been generally low, and in recent years, signs of deflationary pressures have emerged; and iii) crowding-out of private investment was not an issue throughout the 1990s as evidenced by low long- and short-term interest rates, i.e., merits of lower interest rates and promotion of private investment have been lacking. In short, problems usually associated to the fiscal deficit have not been evident in Japan. In addition, in recent years, the scope of the monetary policy has been quite limited due to short-term interest rates of virtually zero, and a larger role has been expected of fiscal policy. Some economists argue that Japan's economy today is in a typical "liquidity trap" condition.

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[14] Following the economic recovery in 1995-96, Prime Minister Hashimoto's administration steered toward fiscal consolidation, raised the consumption tax (VAT) rate from 3% to 5% as scheduled in April 1997 to compensate for earlier income tax reductions, and enacted the Fiscal Structural Reform Act in November 1997. The Act incorporated the target of reducing the fiscal deficit (sum of the central and local governments) to 3% of GDP by FY2003, and supporting targets for major items of expenditures. Reflecting serious economic and financial conditions after the Asian currency crisis in 1997 and the bankruptcies of large financial institutions in Japan, the Act was suspended in 1998.

[15] Japan's strategies for controlling and reducing the fiscal deficit in the post-war era, as well as the budget system, are explained and analyzed in detail in *Making Fiscal Policy in Japan* by Professor Hiromitsu Ishi (Oxford University Press, 2000).

Table 2

General Government Financial Balances (National Accounts Basis)

CY	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
General Government Excluding Social Security																		
Japan	-3.1	-3.5	-2.5	-2.0	-1.4	-1.5	-0.7	-1.6	-4.5	-4.7	-6.0	-6.5	-5.3	-6.7	-7.8	-7.3	-7.0	-7.3
United States	-5.3	-5.4	-4.8	-4.4	-4.2	-5.4	-5.9	-6.7	-5.7	-4.5	-3.9	-3.1	-2.0	-0.9	-0.6	0.2	-1.0	-2.9
General Government																		
Japan	-0.6	-0.7	0.3	1.1	1.8	1.9	1.8	0.8	-2.4	-2.8	-4.2	-4.9	-3.7	-5.5	-7.0	-6.6	-6.4	-6.7
United States	-5.0	-5.3	-4.3	-3.6	-3.2	-4.3	-5.0	-5.9	-5.0	-3.6	-3.1	-2.2	-0.9	0.3	0.8	1.7	0.6	-1.1
United Kingdom	-2.9	-2.6	-1.8	0.5	0.8	-1.6	-3.1	-6.4	-7.9	-6.7	-5.8	-4.4	-2.2	0.4	1.1	1.9	1.1	0.0
Germany	-1.1	-1.3	-1.8	-2.1	0.1	-2.0	-3.0	-2.5	-3.1	-2.4	-3.3	-3.4	-2.7	-2.2	-1.6	1.2	-2.5	-2.5
France	-3.0	-3.2	-2.0	-2.5	-1.8	-2.1	-2.4	-4.2	-6.0	-5.5	-5.5	-4.1	-3.0	-2.7	-1.6	-1.4	-1.5	-1.8
Italy	-12.2	-11.4	-11.0	-10.7	-9.8	-11.8	-11.7	-10.7	-10.3	-9.3	-7.6	-7.1	-2.7	-2.8	-1.8	-0.3	-1.4	-1.1
Canada	-8.6	-7.1	-5.4	-4.3	-4.6	-5.8	-8.3	-9.1	-8.7	-6.7	-5.3	-2.8	0.2	0.5	1.6	3.2	2.8	2.1

Source: OECD Economic Outlook 70 (December 2001).

Table 3

General Government Gross Debt (National Accounts Basis)

CY	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Japan	67.7	71.2	71.6	69.6	66.7	64.6	61.1	63.5	69.0	73.9	80.4	86.5	92.0	103.0	115.3	123.2	132.0	141.5
United States	59.0	62.6	64.1	64.7	65.0	66.6	71.4	74.1	75.8	75.0	74.5	73.9	71.4	68.3	65.3	59.4	57.6	58.0
United Kingdom	59.2	58.4	56.1	49.7	43.0	44.4	44.3	49.2	58.1	55.8	60.6	60.1	60.5	61.4	56.4	53.8	52.2	50.9
Germany	41.6	41.5	42.2	42.2	39.9	42.0	38.8	41.8	47.4	47.9	57.1	60.3	61.8	63.2	60.9	60.8	60.9	62.5
France	38.0	38.8	40.1	40.0	39.9	39.5	40.3	44.7	51.6	55.3	59.3	62.3	64.7	65.0	64.6	64.1	64.9	65.4
Italy	81.9	86.2	90.4	92.5	95.3	103.7	107.4	116.1	117.9	124.0	123.1	121.8	119.6	117.2	115.7	110.8	107.7	105.2
Canada	84.0	88.7	89.1	88.6	89.8	92.8	101.8	109.7	116.2	116.6	119.8	120.0	116.4	114.4	109.6	103.2	98.3	95.1

Source: OECD Economic Outlook 70 (December 2001).
Japan and United States: General Government Financial Balance, excluding Social Security.

5.3 Fiscal sustainability

More recently, however, concerns related to the build-up of outstanding JGBs and the possible limited effects of the stimulative fiscal policy have attracted increasingly greater attention in Japan.

The first concern is related to fiscal sustainability. If the ratio of outstanding JGBs to GDP were expected to remain under a certain level in the future, fiscal sustainability could be regarded as being fulfilled. On the other hand, if this ratio were expected to continue to rise, people would start fearing eventual default or hyper-inflation, and that fear itself would immediately cause an increase in the risk premium of the JGB interest rates or the collapse of its prices. It would bring about the increase of interest payments by the Government, thereby making fiscal conditions even more serious.

In general, change (calculus) in the ratio of the public debt (B) to GDP (Y) is formulated as follows, assuming a constant nominal GDP growth rate (n), a nominal interest rate (r), the ratio (g) of expenditures (excluding interest payments on the debt) to GDP, and the ratio (t) of revenues (excluding proceeds from new debt issuance) to GDP.

$$d(B/Y) = (g - t) + (r - n)\, B/Y$$

This formula shows that change in the debt-to-GDP ratio (B/Y) depend on the primary balance deficit (g – t) and the difference between the interest rate and the growth rate (r – n). If the growth rate is higher than the interest rate, fiscal sustainability can be more easily fulfilled. If, however, the interest rate is higher than the growth rate, as is the case in Japan now, unless the primary balance is in surplus, the debt-to-GDP ratio will increase and blow up eventually.

In the case of Japan today, assuming the primary fiscal balance deficit on a general government basis is 5% of GDP,[16] the difference between the long-term interest rate and the growth rate is 2%, and the debt-to-GDP ratio is 130%, the ratio will increase by 7.6%. Thus, as far as the present situation of Japan is concerned, the debt-to-GDP ratio is rising and is expected to rise at a very high rate. Therefore, at this moment, the condition of fiscal sustainability, based on the simple application of the formula, is not fulfilled.

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[16] According to the OECD publication cited in footnote 12, the ratio in 2001 is expected to be 5.1%.

However, the fact is that the JGB market has been stable and interest rates have remained very low. This means that market participants expect that Japan's growth rate will increase in the future, but that interest rates will not rise as much, and the primary fiscal balance will move to a surplus in the coming years.

True, we cannot be overconfident. Some rating agencies have downgraded the JGB. When Japan's economy is restored to a stable, robust growth path and deflationary pressures disappear, the increase in the nominal growth rate itself and the expected improvement in the primary balance will have positive effects on the above-explained formula for fiscal sustainability. However, the expected rise in the nominal interest rate due to competition with expanded private needs in the financial market and due to the higher expectation of inflation will, in itself, contribute to an increase in the debt-to-GDP ratio. Another important point indicated by the formula is that, assuming the nominal interest rate is higher than the GDP growth rate, to the extent fiscal consolidation is delayed and, thereby, the debt-to-GDP ratio at that moment is larger, the primary balance surplus necessitated to reduce the debt-to-GDP ratio will be greater.

5.4 Decrease in the multiplier effect and expectation of future tax burden

Another concern is the weaker-than-expected impact of the series of large fiscal packages on the expansion of demand, or in more technical terms, the possible decrease in the multiplier effect of public works. The multiplier effect of public works, financed by government bonds, is influenced by i) the degree of people's expectation of a future tax increase to repay the bonds, and the degree to which people modify their consumption and saving patterns to prepare for the expected future tax increase, on the one hand; and ii) the effects expected from the increased public works on the productivity of the economy or on the welfare of people's life, i.e., efficiency of the public works, on the other.

Regarding the first point, under the assumption of a "super-rational expectation," people perfectly predict a tax increase over future generations (therefore "super rational") needed to repay the debt and consider the burden as their own at the present value. In this case, the Ricardian neutrality holds; people spend less and save more to prepare for the future tax increase. Thus, even if a government reduces tax by issuing bonds,

people act as if the same amount of tax, for repaying the debt in the future, is levied on them now, and no impact on effective demand can be expected. However, even in this Ricardian case, the increase in public works financed by bond issuance has an expansionary effect on demand. Such policy is equivalent to increasing public works by financing them through a tax increase, and this has the multiplier of one as indicated by the "balanced budget theorem," as the government absorbs, through taxation, people's income including the portion for saving, and spends that entire amount.[17] [18]

On the other hand, under the assumption of a simple Keynesian model, people do not expect a future tax increase to repay government debts and do not reduce their present consumption. Under this assumption, the increase in public works has a multiplier effect equivalent to the reverse of the marginal saving propensity; the increase in public works expands national demand by itself, and by the consumption by people who gain income from the public works, and then, in turn, by people who gain income from the increased consumption, and so forth.

The reality should be somewhere between the Ricardian model and the simple Keynesian model. As far as present-day Japan is concerned, however, it is probable that, increasingly in the recent years, people have become more aware of the future tax burden, which is needed to repay the cost of today's stimulus fiscal policy. Therefore, to the extent that Japanese people react to the expectation of a future tax burden by saving more today, the multiplier effect is decreased.

5.5 Decrease in the multiplier effect and the efficiency of public works

The discussion of the multiplier effect in the previous section disregarded the impact of public works on the supply side of the economy.

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[17] For the sake of simplification, the discussion in this section disregards the effects of an increase in GDP on the increase of imports and tax revenues. The multiplier of the public works decreases as imports and tax revenues absorb effective demand for domestic production.

[18] The balanced budget theorem is formulated as the following, in which dG (increase in public works) is financed by the equal amount of dT (tax increase), I (private investment) is constant, and c is marginal consumption propensity:

Y(GDP) = C (consumption) + I (private investment) + G (government spending)

$dY = dC + dG \rightarrow dY = c(dY - dT) + dG \rightarrow dY(1 - c) = dG - c\,dT = dG(1 - c)$

Thus, dY = dG

Public works are essentially investment for the future, and their efficiency should be taken into consideration. If public work projects contribute to an increase in the country's productivity (for example, highways to facilitate transportation by trucks) or to the welfare gain in the standard of living of people (construction of elevators to make subways barrier-free), returns or benefits from such investment should be offset against the burden of any future tax increase needed to repay the government bonds which are issued to finance today's public works.[19] On the other hand, if today's public works, financed by additional government bonds, crowd out private investment, and if the productivity gain from the private investment exceeds that of the public investment, extra burden in the form a decrease in the production level should be added to the burden of the future generation. In short, the multiplier effect of public works should take into account the degree of people's expectation of the future benefits or extra costs from the investment in public works, along with the future tax burden.

Regarding Japan, the increase in public works under the large fiscal packages since the burst of the bubble should have incurred little cost, if any, from crowding out private investment. However, many Japanese are becoming more skeptical about the efficiency of these additional public works themselves. Many believe that the efficiency or the productivity of additional public works has substantially decreased because the Government had focused on the construction of public infrastructure throughout the post-war era, and, despite this, additional projects were hastily initiated in order to provide fiscal stimulus in the prolonged economic slump. Critics often cite port renovation projects that are only used by local people as fishing sites, and highway projects in scarcely populated rural areas.

If this is the case, it is possible that the multiplier of public works has considerably dropped in Japan in recent years. Assuming that Japanese people more or less expect a future tax increase to repay the JGB debt, they

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[19] The Fiscal Law of Japan only allows the issuance of "construction bonds" to be used to finance certain public works, etc., which have benefits for the future generation. Alternatively, the law does not allow the issuance of "deficit-financing bonds" to finance current spending. Thus, when needed, a special law that allows deficit-financing bonds has been enacted each year. Although Japan maintained super-healthy fiscal policy until FY1965 (the year of recession after the Tokyo Olympics of 1964), construction bonds have been issued each year since then to promote construction of much-needed public infrastructure. Deficit financing bonds have been issued every year since FY1975 (the year of negative growth following the first oil crisis of 1973) except in FY1990-93 (Figure 9).

feel as if inefficient projects are being financed by today's tax increase. Thus, they save more[20] for the future tax increase and spend less today, and the multiplier effect of public works declines. Furthermore, if Japanese people expect that the Government will continue to implement inefficient public works which result in the building up of debt, they begin to feel their future real-term income is being substantially reduced. In extreme cases, the eventual multiplier effect of public works could even become negative if the decrease in consumption due to this negative income effect exceeds the increase in demand induced by the simple Keynesian multiplier of public works.

The decrease, rather than increase, in private demand induced by public works is called "non-Keynesian effects". To sum up the previous and present sections, it is likely that, in Japan now, "non-Keynesian effects" have become real, and, thereby, the multiplier effect has dropped considerably, partly due to people's increasing awareness of the future tax burden in the face of the building up of outstanding JGBs, and partly due to people's disappointment in the efficiency of public works.[21]

5.6 Rigidities in the budget and the economic structure

In addition to the above-mentioned concerns, the building up of outstanding JGBs has brought about rigidity in the budget. In the initial FY2002 General Account Budget of the central government, expenditures for interest and for reserves for future amortization (assuming maturity of 60 years) amount to 11.8% and 8.7% of total expenditures, respectively, and in sum 20.5%. This limits the scope of spending for other more constructive purposes.

Another issue is rigidity in Japan's economic structure. Critics argue that as the Government has sustained a high level of public works by issuing JGBs every year, resources (labor and capital), which should have

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[20] In Section 1 of this chapter, the economy-supporting effects were discussed from the viewpoint of the IS balances of the private and public sectors. However, excess saving is not independently determined from the fiscal position, and it is possible that the recent fiscal policy has induced the increase in the private saving.

[21] The presence of non-Keynesian effects (negative effects on private demand) does not necessarily mean that the multiplier is negative because the increase in public spending, by itself, constitutes an addition to demand or to GDP. However, if the public spending itself is not meaningful, as was the case for most of products in the Soviet Union days, such public spending should be regarded more like a transfer than spending.

been used by other leading private sectors, have been artificially fixed in the construction and civil engineering industries, thus inviting loss in the allocation of resources.

5.7 Neo-classical-type arguments for expansionary fiscal policy

Finally, in contrast to the critical arguments against Keynesian-type expansionary fiscal policy, more recently, some Japanese economists have argued for the same policy from a neo-classical viewpoint. They say that fiscal policy should be appropriately managed with a view to compensating loss from business cycles, no matter whether the fiscal policy has a multiplier effect or not.

According to such an idea, the unemployment produced in recessions is the loss of the efficient use of resources, and therefore, it is very meaningful for a government to utilize the surplus labor in public works, which are needed whether they are constructed today or in the future. Current criticism of the public works in Japan is because of the poor selection of projects. If properly chosen, there are still many infrastructure projects that would bring substantial gains in productivity or welfare. Another corollary of this school argues that public works should be rationalized as they mitigate the hardship of the unemployed. In any case, neo-classical economists support counter-cyclical fiscal policy based on the idea that, as a household is better off when it adjusts the ups and downs of its income by borrowing and repaying, the government should compensate for downturns in business cycles by issuing bonds.

In general, this argument is valid to rationalize a counter-cyclical fiscal policy. As far as Japan today is concerned, however, there are the following questions in addition to the problems that were discussed in the previous sections: i) Is there a legitimacy to forestall public works which should have been decided by the future generation, or, is it possible to reach a consensus to find really meaningful projects in this saturation of infrastructure projects? ii) Allocation of public goods is a political process based on democracy. Is it politically feasible to radically change their allocation even if we can theoretically find most productive projects? iii) If current unemployment is not caused by the cyclical downturn, but by the deep-rooted economic slump due to structural factors, is the government expected to keep absorbing surplus labor by implementing public works? Concerning the last question, the author believes that it is far beyond the

expected role of the government in a market economy to perform such a function. It would cause a huge loss of efficiency, which is the factor behind the collapse of the Soviet Union.

6. Where are the Japanese economy and its policy going?

Still, Japan's economy is in a difficult state, and the authorities are struggling to make every possible effort to restore the economy to a stable and robust growth path. Some critics argue that what is missing in Japan's economy is effective demand, that structural reforms will cause more difficulty, which will further dampen demand, and that the Government should even enlarge expansionary fiscal measures as long as deflationary pressures remain. However, the author strongly objects to this idea; we have done this too much for too long. The present view of the Government and the general consensus of the people is that, unless radical structural policies are taken, including those for the financial sector, people will not have positive expectations for the future, demand will not pick up vigorously, and the economy will not return to a growth path.

As far as fiscal policy is concerned, the present Government policy is to maintain, for the time being, a certain level of fiscal support, paying more attention to a wise spending and the rationalization of public expenditures. Then, as deflationary pressures disappear and as the basis for future growth is created by mobilizing the vitality of the private sector through structural reforms, decisive and substantial fiscal consolidation should be started. According to the "Medium-term Outlook for Structural Reforms, the Economy, and Fiscal Policy" published by the Government in January this year, important areas for the rationalization of public expenditures are i) public works, which should return to the level before the substantial increase; ii) social welfare, including ensuring efficiency in medical services and sustainability in public pension systems; and iii) transfer to local governments,[22] including reforms of the division of labor and of allocation of revenues between the central and local governments with a view to reinforcing incentives for saving on the part of local governments.

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[22] Transfer of Local Allocation Tax by the central government adjusts imbalances in the spending needs and revenues between different local governments. However, there is a criticism that this mechanism, which takes care of local expenditures for certain projects by transfers from the central government, induces moral hazard in spending by local governments.

The "Medium-term Outlook" assumes that the nominal growth rate will pick up from FY2004 to 2.5% or higher, and that the primary fiscal deficit of the central and local governments combined should become positive in the beginning of the 2010s. To achieve this goal, as the "Medium-term Outlook" emphasizes, efforts to improve the fiscal position is indispensable. When comparing Japan's fiscal structure of expenditures and revenues on a general government basis with other major countries (Figure 11), it is obvious that, while its ratio of total expenditures to GDP is comparable to that of the United Kingdom, the ratio of total revenues to GDP is even lower than that of the USA, and the gap is being financed by JGB issuance. Thus, there is some room for improving the fiscal position. But before utilizing that room by raising tax revenues, efforts should be made on the expenditure side. In particular, the reform of social welfare systems is inevitable. Due to the rapid aging of the population, total expenditures for social welfare – including benefits financed by contributions to pensions and public medical insurances – are expected to increase from JY78 trillion in FY2000 to JY127 trillion in FY2010, assuming continuation of the present system.

As discussed in the beginning of this paper, some critics have begun to present very pessimistic views on the future of Japan's economy. However, it should be noted that the authorities and the people are well aware of the problems and that they are preparing themselves to accept the burden of the needed reforms. Furthermore, the fundamental strengths of Japan such as wide-ranging and deep-rooted technologies, a well-educated and motivated workforce, and a high saving ratio have not been changed. Important challenges from fast-growing China can be overcome by making the relationship complementary rather than competitive, considering the wide gap in economic development between these two countries.

Japan is able to reform itself. When Japan embarked on its modernization in 1868 in the face of pressures from Western powers that were colonizing most non-Western countries, and when it recovered from the devastation of World War II, it mobilized the wisdom of its people and achieved the fundamental reform of outdated systems. If Japan promotes needed reforms today amassing the wisdom of the people and strong political resolution, the author believes that Japan has great potential for a bright future.

MEDIUM TERM FISCAL POLICY ISSUES AND CHALLENGES IN AUSTRALIA

Marc Robinson[*]

1. Introduction

This paper focuses on key issues pertaining to medium-term fiscal policy in Australia. It builds on the paper presented at last year's Banca d'Italia fiscal policy workshop (Robinson, 2001). That paper presented an outline and analysis of Australian national and state government fiscal rules, with particular emphasis upon the national level.

As articulated in the 2001-02 budget of the Australian Commonwealth (*i.e.* national) government, the primary fiscal rule is "maintaining budget balance, on average, over the course of the economic cycle". The "supplementary" fiscal policy objectives articulated in that budget (Treasury, 2001a: 1.8) are:

- "maintaining surpluses over the forward estimates period while economic growth prospects remain sound,
- "no increase in the overall tax burden from its 1996-97 levels; and
- "improving the Commonwealth net worth position over the medium to longer term."

The key issues and challenges which govern medium-term fiscal policy in Australia are the following:

- the implication of significant current account deficits and substantial external debt for fiscal policy,
- fiscal sustainability,
- the fiscal implications of public infrastructure requirements,
- intergenerational equity, and
- the fiscal implications of an ageing population.

With the exception of the first, all of these issues and challenges also face the great majority, if not all, of OECD countries. It is the primary

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purpose of this paper to review the specific nature of these challenges as they face Australia.

Before proceeding to the main point of this paper, there are two points worth mentioning.

Firstly, given the recent background of Australian medium-term fiscal policy, it might be thought remarkable that the fiscal policy rules and objectives stated above make no mention of targets or objectives pertaining to public debt. As outlined in last year's paper, Australian fiscal policy in Australia in the second half of the 1990s was very much preoccupied with the reduction of net debt. Indeed, for a brief period at the end of the 1990s, the government enthusiastically embraced the idea that, with the considerable assistance of privatisation receipts, it would be able to achieve *zero* net debt. At the present time, however, with the national government's general government net debt at less than 6 percent of GDP, and with a measure of fiscal loosening in the 2001-02 budget, further debt reduction appears no longer to be a policy objective.[1] Achievement of the primary objective of structural budget balance will, of course, result in stable nominal net debt[2] (cyclical fluctuations aside) and the Government appears now to be content with this debt outcome.

Secondly, although the primary fiscal rule (of balanced budgets over the business cycle) has been the cornerstone of medium-term fiscal policy since the present Commonwealth government came to office in 1996, the budget deficit concept in terms of which the rule has been articulated has changed over the years. Prior to 1999-2000, the rule referred to the cash accounting 'underlying budget balance'. In the 1999-2000 budget, the rule was reformulated, with considerable fanfare, to refer to a new fiscal concept, the 'fiscal balance', which represented the accrual accounting equivalent of the cash underlying budget balance. Issues related to this transition from a fiscal rule articulated in cash accounting terms to one specified in accrual terms were one of the primary focuses of the paper which I presented last year (see also Robinson 2002). It is rather striking that, having made so much of the transition to accrual accounting, the government has in 2001-02 reverted to a cash accounting concept of the budget balance. The reasons for this reversion to cash accounting concepts, and its implications, are discussed briefly towards the conclusion of this

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1 It is, nevertheless, perfectly possible that further privatisation will lower debt further in future.

2 And, of course, in the trend reduction of both real debt and the debt/GDP ratio.

paper. However, it needs to be borne in mind that the cash budget balance and the fiscal balance are quite similar concepts, and the essence of policy has not changed.

2. The Current Account Deficit and CAD

As noted in last year's paper, the most important driver of Australian fiscal policy from the second half of the 1980s till the present time has been the external current account deficit (CAD). In terms of decade averages, the CAD grew from 1.8 percent in the 1970s to 4.7 percent in the 1980s and 4.4 percent in the 1990s[3] (Edey and Gower, 2000: 286). Associated with this has been a growth in net foreign liabilities, from 21 percent of GDP as at 30 June 1980 to 45 percent (1990), 54 percent (1995) and then 58 percent (2000) (Treasury, 2001b: 108).

Policy makers reacted to these high current account deficits with alarm. The view which initially guided policy was that the high current account deficits were a concern quite independent of the source and composition of those deficits. It was expected that high CADs would inevitably erode international financial market confidence, imposing a growing risk premium on domestic interest rates and producing a growing vulnerability to far more damaging sudden shifts in market sentiment. (Consistent with this analysis, the official view was that by the early 1990s, Australia was in fact already paying a significant risk premium on its interest rates.) There was therefore in the 1980s and early 1990s a widespread view that high CADs imposed a 'speed limit' on the rate of growth of the domestic economy.

This view of the nature of the CAD problem clearly dominated fiscal policy up to the time of the Asian financial crisis (see Treasury, 1996: 1.9). Notwithstanding that the Australian CAD was primarily driven by the gap between *private* investment and savings, as opposed to public sector deficits, it was regarded as essential that fiscal policy play a key role in addressing the CAD "problem". The "twin deficits" theory was an important influence underpinning this policy perspective. Official thinking

[3] As Edey and Gower note, because Australia has significant external net debt, the implicit capital repayment element of the nominal interest rate (via the Fisher effect) will exaggerate the CAD. When adjusted for inflation, the CAD falls to 1.4 percent in the 1970s, 3.6 percent in the 1980s and 3.2 percent in the 1990s. These figures (and the increase implicit in them) clearly remain high.

at the time was that the appropriate response to high CADs was policies to substantially raise the rate of national savings, and that a key part of this was fiscal policy aimed avoiding public sector dissaving. Avoiding public sector dissaving was supposed to require the avoidance of (cash) budget deficits. Implicit in this was a mistaken view that the cash budget balance was a measure of government savings. This was erroneous, of course, because it failed to recognise that investment expenditure – irrespective of whether undertaken by government or the private sector – represents an *application* of, rather than a *subtraction* from, national savings. This error was pointed out by critics in the subsequent policy debate. It eventually came to be generally recognised that the cash budget balance[4] was a measure, not of public sector savings, but of public sector "net lending" to the private sector. This did not, however, alter the official fiscal policy view. The policy rationale was then reformulated into a proposition that medium term fiscal policy could make the most appropriate contribution to dealing with the CAD "problem" if the public sector refrained from drawing, other than temporarily during a recession, on private sector saving. The fundamental fiscal rule of "maintaining budget (or fiscal) balance, on average, over the course of the economic cycle" flowed directly from this reasoning.

The initial policy responses to the CAD 'problem' were not confined to medium-term fiscal policy. At the end of the 1980s, short-run demand management policies were brought to bear on the CAD, with a deliberate tightening of both fiscal and monetary policy (Hutson and Kearney, 1999: 75-76; Bewley and White, 1990). This policy tightening helped push the Australian economy into a severe recession in the late 1980s. There were also a number of policy initiatives designed to increase private saving (including the introduction of compulsory superannuation contributions for most Australian workers, as discussed below).

In the early 1990s, these policies became the subject of intense debate amongst Australian economists and policy-makers. The threshold issue was whether a high CAD was in fact a 'problem' which Governments needed to worry about. Australian economists like John Pitchford (eg 1989) and Max Corden (1991) argued forcefully that there should be no presumption that large CADs were in themselves a problem. In Australia's particular case, where the CAD was driven primarily by the gap between private sector investment and saving, there was, in the Pitchford-Corden

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4 Or, more precisely, the "fiscal balance" measure.

view, no problem at all. Large CADs could easily arise from private sector decision-making (capital flows to take advantage of sound investment opportunities, and inter-temporal consumption smoothing at the consumer level) which was both rational and sustainable. In any event, they argued, to the extent that there might be some irrational private sector decision-making contributing to the high CAD, the costs of that irrationality would generally be borne by direct parties to the relevant transaction (eg through bankruptcy or poor equity returns) without imposing substantial economy-wide costs. These economists suggested that international financial markets would take these considerations into account, rather than simply punishing any country because of the level of its CAD.

These views were, of course, hotly debated at that time. Many aspects of the issue were canvassed, including the presence and extent of external costs which might arise from poor private investment decision-making. It is not the purpose of this paper to review that debate.[5] The key point is that Australia's experience with continuing high CADs during the 1990s has lead to a major shift of opinion, including within official circles, towards the Pitchford-Corden position. As Gruen and Stevens (2000: 49) note, "few observers in 1980 would have considered it likely that a current account deficit of 4½ percent of GDP could be sustained for two decades. The fact that it has been…. has itself changed the nature of debate about the current account". Particularly significant was the fact that Australia's economy held up remarkably well during the Asian financial crisis at the end of the 1990s. Far from being punished at that time by the international financial markets for its high CADs, Australian interest rates benefited from the fact that Australia was seen as a safe havens for funds. Few Australian economists today take the view that Australia is being made to pay, or is likely under current policies to be made in future to pay, a significant risk premium on interest rates as a consequence of the CAD and the level of net foreign liabilities.[6]

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[5] Indeed, it might be argued there are good reasons to suppose that policy makers may now have become too relaxed about high current account deficits (see Cashin and McDermott, 1998).

[6] At the present time, there is no longer a consensus amongst official economists on the issue of whether in the early 1990s Australia was in fact paying a significant risk premium due to its high CAD. On the one hand, Treasury department analysis has estimated the risk premium on Australian interest rates in the early 1990s as 3½ percent (by contrast with ¾ percent in the early 1980s and also again at the end of the 1990s) (Treasury, 2001: 118). By contrast, the Head of the Reserve Bank of Australia's Economic Research Department has recently suggested that a more 'natural' explanation of Australia's relatively high interest rates in the early 1990s is 'that markets

(continues)

As a consequence of these experiences, in combination with broader currents of international economic opinion on the impact of current account deficits, Australian fiscal policy makers became in the second half of the 1990s increasingly relaxed about the CAD. The notion that macroeconomic demand-management should be used as a tool for restraining the CAD was completely discarded. The Commonwealth Treasury appears to have abandoned the notion that the sustainability of the CAD is a function of its magnitude, and to have moved a long way (perhaps too far) towards the Pitchfold-Corden view that high CADs driven by private sector investment and saving decisions are not a problem (Treasury, 1999: 1.17, 3.23). The view now appears to be that it is not so much the level, as the source and composition, of the CAD, which can be a problem. Notwithstanding this, at the end of the 1990s the Government's medium-term fiscal strategy continued to be rationalised publicly by reference to CAD concerns (e.g. Treasury, 1999: 1.14). The question is obvious: if the level of the CAD is not, per se, a concern, why should medium-term fiscal policy remain preoccupied with the CAD?

Essentially, the official view has been reformulated to one that focuses not upon the level of the CAD, but upon the potential threat of unsustainable fiscal policies to external balance and market confidence. As the 2001-02 Budget Papers put it:

> The fiscal strategy is not directed at particular current account outcomes, however, but at addressing one of the underlying contributions to unsustainable current account deficits: namely, unsustainable government borrowing. …. Sound fiscal policy can limit the risk premia attached to interest rates. Rising levels of government debt and uncertainty regarding future policy can weigh on investors' confidence, such that they require higher interest rates to induce them to finance Australian debt, both for government and private issuers….. The medium-term strategy assures investors that the CAD over time will largely be based on private sector decisions subject to market disciplines (*Treasury, 2001: 1.25-1.26*).

This policy shift is extremely significant. Essentially, it means that the CAD is no longer seen as a key fiscal policy concern *distinct from* the fiscal sustainability issue. An implication of this new view is that the only way in which the imperative of sustaining international financial market

took a long time to be convinced that the step-down in inflation at the beginning of the decade would be sustained' (Gruen and Stevens, 2000: 61).

confidence would alter the preferred fiscal policy of the Australian government would be if the view taken by international financial markets of what constitutes a 'sustainable' fiscal policy differed from that which might be taken by domestic financial markets or from the policies which government might pursue if, hypothetically, it were not operating in the context of a globalised financial market.

3. Fiscal sustainability and the public sector capital stock

The revised view of the implications of external balance for fiscal policy being taken with official circles essentially means that the undisputed dominant policy criteria for medium-term fiscal policy Australia at the present time is fiscal sustainability.[7]

As outlined in last year's paper, there has been an enduring tendency for Commonwealth Government fiscal policy to be guided by the notion that (general government) public debt is both a threat to fiscal sustainability and inconsistent with intergenerational equity. No distinction is made in this context between borrowing for capital purposes and borrowing for current purposes. Nor is it recognised that increases in debt do not necessarily threaten fiscal sustainability if the ratio of debt to the tax base remains moderate. Nothing has changed in this respect in recent Commonwealth fiscal policy developments, notwithstanding the opportunity presented by the move to accrual accounting to adopt a more discriminating view of the implications of the fiscal sustainability requirement.

The central problem with a medium-term fiscal policy of this type is, as noted in last year's paper, its inherent anti-capital expenditure bias. Not only is the budget outcome targeted by this policy "improved" by squeezing general government capital expenditure, but – worse still – it improves even more if general government assets are sold. It is true that the Australian "underlying" cash budget balance measure was redefined in the early and mid-1990s so as to prevent the general government budget outcome being artificially boosted by the sale of public enterprise assets.

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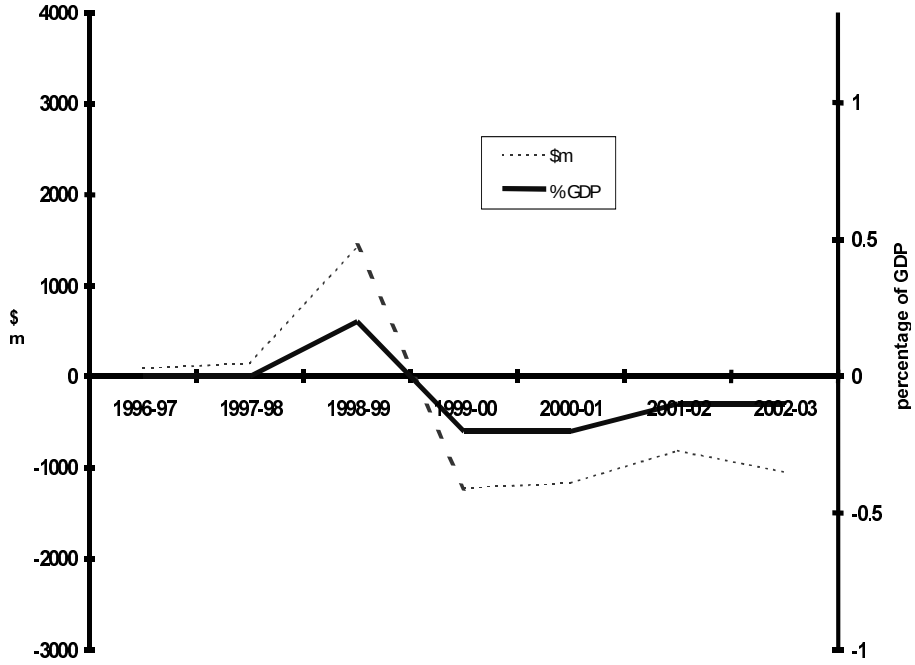
[7] At the risk of stating the obvious, fiscal sustainability may be defined as the avoidance of fiscal policy settings which, if maintained over time, would ultimately result in the burden of financial obligations rising to levels which would lead government to default, and which at some point prior to that would lead to a loss of confidence on the part of potential lenders.

Fig. 1

Commonwealth General Government Net Capital Investment



Source: Commonwealth Budget Papers, 2001-2002.

However, it is not widely understood in Australia that this did not affect the treatment of receipts from the sale of *general government* assets, which continued to be treated in effect as ordinary revenue in the calculation of the underlying budget balance. Nor did this practice change with the introduction of the new quasi-accrual "fiscal balance" measure. It is significant in this context that the magnitude of Commonwealth general government asset sales over recent years has been so great that general government net capital investment has generally been negative, as indicated in the following chart.

This points to one of the central issues of Australian medium-term fiscal policy. The result of fiscal policies at the Commonwealth and State level which have focused upon a measure of the budget balance which fails

to distinguish between capital and current spending has been a long-term capital expenditure drought. In this respect, of course, Australia's experience has been little different from that of a number of other OECD countries. The implications of this capital spending drought have become quite serious in a number of areas. The very poor state of Australian railway system infrastructure – particularly in respect to long-distance freight services – is a particularly serious case in point.

The infrastructure funding problems posed by this type of fiscal policy are even more serious for Australian State governments than they are for the Commonwealth Government. This is because, firstly, the States have always played the dominant role in public sector infrastructure and, secondly, because some of the areas of public infrastructure for which the Commonwealth was traditionally responsible have moved out of the public sector as a result of privatisation. It is therefore hardly surprising that two of the States have in recent years moved away from the traditional focus upon the cash budget balance to a "golden rule" fiscal policy. One of these is Queensland, which had for years prided itself on a fiscal policy based on a 'no debt' policy, and which as a consequence of this policy and rapid population growth experienced a serious erosion of public infrastructure (Robinson, 1996). In 1999, Queensland shifted to a golden rule policy and has over recent years undertaken a significant program of reconstruction of public infrastructure, while at the same time firmly maintaining a sustainable and responsible fiscal position.

The anti-capital spending bias of a fiscal policy targeting the cash budget balance (or the "fiscal balance") have, as in a number of other countries, had significant microeconomic consequences. In particular, this fiscal policy has undoubtedly been a key factor in the wave of popularity amongst Australian States for PFI/PPP-type policies under which the private sector directly funds general government capital expenditure projects. The concern here, of course, is not with the "privatisation" of such capital expenditure per se. Privatisation does, of course, offer efficiency gains in many areas, and where this is the case it should be prosecuted vigorously. The concern, rather, is with PFI/PPP projects which are driven not by efficiency gains, but by a desire to effectively move public debt off balance sheet. It is worth noting in this context that private sector participation in public capital projects in Australia has for many decades been very extensive in precisely the areas in which the greatest efficiency gains can generally be expected. In particular, Australian

governments have for a long time generally contracted out the construction phase of nearly all public infrastructure projects.

4. Intergenerational equity and ageing population

Although the primary rationale for current medium-term Australian fiscal policy is fiscal sustainability, the claim is also made that the policy also meets the intergenerational equity criteria (eg Treasury, 2001a: 1.8). However, official policy-makers do not appear to have seriously examined the issue of intergenerational equity. The alternative, golden rule approach to fiscal policy is, of course, one which explicitly argues on intergenerational equity grounds for the spreading the costs of capital expenditure over time through the use of debt. Given this, the assertion the current Australia fiscal policy is consistent with intergenerational equity clearly requires some detailed theoretical substantiation. Such substantiation has, however, been absent. When the current Government put legislation through Parliament to implement a "Charter of Budget Honesty", the legislation contained a provision apparently requiring the provision at five year intervals of an "intergenerational report" on fiscal policy. That report is apparently due this year, and will be of some interest when and if it is produced.

As generational accounting so effectively reminds us, the issue of intergenerational equity is not only one which relates to capital expenditure. Life cycle tax/benefit transfers are also extremely significant. One generational accounting studies of Australian fiscal policy suggested that, when the total picture is taken into account, it cannot be argued that fiscal policy is imposing a net burden on future generations (Ablett, 1998).[8]

An alternative way of getting some perspective on these issues is, of course, to consider the fiscal effects of demographic change. The most recent, and most pessimistic, projection of the fiscal impact of population ageing in Australia is a study by Guest and McDonald (2000). In their 'base' case projection, Guest and McDonald project that social expenditure, defined as the sum of social security, health and education expenditure, will rise from 20.6 percent of GDP in 2001 to 28.0 percent in 2051. Most of this increase will take place in the period after 2011, with

[8] This study was undertaken some years ago. The nature of fiscal policy changes since that time would suggest, prima facie, that the conclusion would hold even more strongly at present.

the main driver being social security expenditure, reflecting increased aged pension expenditure. Earlier estimates of ageing-related expenditure pressures, although somewhat lower, nevertheless also indicate a significant growth of expenditure (eg EPAC, 1994; Alvarado and Creedy, 1996).

These expenditure trends need to be put into context. The fiscal pressures for Australia arising from an ageing population, although significant, are not as severe as those of other developed economies. The OECD's 1996 study, for example, projected that the demographically-driven increase in social expenditure (which they defined as social security plus health) would be less in Australia than in any other OECD country (OECD, 1996). A central reason for this is a projected elderly dependency ratio which is the lowest of all OECD countries,[9] which in turn reflects immigration and fertility rates which are relatively high by OECD standards. Another key factor is the nature of Australia's retirement incomes system. Australia is the only OECD country to have developed a three-pillar retirement income model along the lines recommended by the World Bank (1994). The feature of this system which is of the greatest fiscal relevance is that publicly-funded pensions provide and income floor only, and are unrelated to the individual recipient's pre-retirement income (Khan, 1999). Supplementation of the public pension is provided by contributory superannuation. An important development occurred in the 1980s and early 1990s, when a framework of compulsory minimum superannuation contributions covering almost all Australian workers was introduced, under which contributions which reach the equivalent of 9 percent of wages by 2002/03 (Edey and Gower, 2000). It is also relevant that publicly-funded aged pensions are means-tested in Australia.

5. Fiscal balance vs cash balance

As indicated in my paper to last year's Workshop, one notable recent feature of Australian medium-term fiscal policy was its reformulation in accrual accounting terms in 1999. In the 1999-2000 budget, it was announced that the primary fiscal rule would henceforth be expressed as a

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[9] In their base case projection, Guest and McDonald (2000: 50) estimate the aged dependency ratio for Australia in 2030 as 33.0 percent, far below the two countries with the biggest problem: Germany (49.2 percent) and Italy (48.3 percent).

requirement "to achieve fiscal balance, on average, over the course of the economic cycle" (Treasury, 1999: 1.14). In this reformulation, the accrual concept of *fiscal balance* replaced the former cash accounting concept of the *underlying budget balance*. As previously explained, whereas the flow counterpart of the cash budget balance is net debt, the flow counterpart of the fiscal balance is net financial liabilities. Net financial liabilities is essentially a *broad debt* measure which includes, together with conventional debt, other financial assets and liabilities such as the superannuation (pension) 'debt' to government employees and the value of government equity in public enterprises. As noted in last year's paper, the fiscal balance measure is a conceptually more precise measure of the extent to which the (general government) public sector is drawing upon private sector saving to finance itself, and it is for this reason that the fiscal balance is known in the Australian Bureau of Statistics' framework as 'net lending'. Given the present national government fiscal policy objective of leaving private sector saving for the use of the private sector alone, the reformulation of the primary fiscal rule in terms of the fiscal balance made excellent sense. It was also noted that, as an indicator of fiscal sustainability, net financial liabilities is certainly a better measure that the traditional narrow net debt measure.

As noted at the outset of this paper, in the 2001-02 national government budget, the rule has been reworded again so that it now reads "maintaining *budget balance*, on average, over the course of the economic cycle". The words 'budget balance' have replaced the words 'fiscal balance', and refer to the cash accounting underlying budget balance measure. The obvious question is: if, for all the reasons clearly articulated by Treasury, the fiscal balance concept permitted a more precise formulation of the thrust of current medium-term fiscal policy, why has the government reverted so very quickly to a focus upon the cash budget balance?

The answer is a simple one: in 2001-02, the budget went into deficit on the fiscal balance measure, while remaining in surplus as measured by the underlying cash budget balance. As projected in the official October 2001 Mid-Year Economic and Financial Outlook statement, the 2001-02 fiscal balance is expected to show a deficit of $3.1 billion (0.4 percent of GDP). In part, the divergence between the fiscal deficit and the underlying cash balance arises from a revenue timing anomaly arising from a change in the company tax regime, which can be regarded as temporarily distorting

the accrual revenue figures (Treasury, 2001a: 2.4). However, even if were to adjust for this disturbance, there would probably remain a small deficit.

The Australian economy has not been in recession in 2001, unlike some other countries. Thus, in terms of the fiscal balance measure, the 2001-02 budget does not comply with the supplementary fiscal policy objective of "maintaining surpluses over the forward estimates period while economic growth prospects remain sound". As noted earlier, there is debate about the appropriate stance of short-run fiscal policy stance amongst Australian economists. There is one school of thought which suggests that, given the lags of fiscal policy and the likelihood of an eventual Australian economic downturn arising from the world recession, a deliberate fiscal deficit in 2001-02 would have been perfectly appropriate. But this has not been the position of the Government. Hence the need to shift emphasis back to the cash budget balance in order to maintain the appearance of continued respect for stated fiscal policy principles. This is regrettable.

6. Short-run fiscal policy

Although the focus of this paper is not upon short-run fiscal policy issues, a brief word on these is useful. A key point is that the present government has no fiscal rules which impose ceilings upon short-run deficits, in the manner of the Masstericht stabilisation pact principles. The present official view in Australia is that, faced with a recession, it is appropriate not only to permit the automatic stabilisers to operate unhindered, but also to make 'cautious' use of discretionary fiscal demand stimulus policies (Treasury, 2001a: 1.9, 1.26). There has, as one would expect, been considerable debate amongst Australian economists as to whether short-run fiscal policy should at the present time, in the face of world recession and uncertain recovery prospects, be more or less stimulatory than it actually is. Whether it is in response to a more challenging global economic environment, or simply as a political response to the political imperative posed by a national election in late 2001, the Commonwealth government did loosen the purse strings in the 2001-02 budget. Indeed, on one measure of the budget balance, the budget went into deficit. However, it is probably true to say that there is at the present time a much broader consensus than previously existed amongst Australian economists (official, academic and private sector) as to the appropriate principles governing short-run fiscal policy.

7. Conclusion

This paper has presented an overview of key medium-term fiscal policy rationales and challenges in Australia. The most notable recent shift in Australian medium-term fiscal policy thinking has been a revised view of the role of the CAD 'problem' in fiscal policy. In the past it was seen as vital that fiscal policy be pressed into duty in the cause of lowering the high CAD. By contrast, the present view is that fiscal sustainability is the key concern.

Although Australia to some extent faces similar fiscal challenges to other OECD countries (such as the fiscal pressures of an ageing population), its fiscal position is generally a favourable one. There is certainly no fiscal sustainability problem. One central fiscal problem facing the country, however, concerns the state of public infrastructure. This problem arises in large measure from the continued pursuit of a fiscal policy which fails to distinguish between capital and current expenditure.

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ITALY: FISCAL CONSOLIDATION AND ITS LEGACY

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Sandro Momigliano[*] *and Daniela Monacelli*[*]

1. Introduction

For about 25 years, from the mid-Sixties to the early Nineties, Italy ran unsustainable fiscal policies. High deficits, stemming from persistent primary imbalances, fuelled public debt accumulation. In 1994 the debt reached 124 per cent of GDP. Over the same period, future pension liabilities gradually increased to about 400 per cent of GDP. Fiscal policy and rapid population ageing set public finances on an unsustainable path, with large generational imbalances and perspective deficits.

In this context, from the mid-1980s debt stabilisation became the main target of Italian fiscal policy. Initially, in spite of the favourable macroeconomic conditions, results were limited. Progress on the primary balance was offset by increasing interest expenditure. Fiscal consolidation gained momentum in the early 1990s, when primary deficits were replaced by sizeable primary surpluses. The overall deficit declined from double digit levels to well below the 3 percent limit established in the Maastricht Treaty. The debt to GDP ratio shifted to a downward path. Pension liabilities were substantially cut.

The consolidation process was characterised by a large resort to corrective measures with only temporary effects, which made it necessary to adopt sizeable budgetary manoeuvres repeatedly. The focus was on deficit reduction and left little space to issues related to stabilisation policies. Allocative and distributive targets were also frequently forfeited. The adjustment relied on significant increases in tax revenues and a sharp reduction in capital expenditure. The ratio of primary current outlays to GDP did not change significantly. The increasing expenditure trend of the previous decade was halted thanks to reforms of the pension system and to reductions in the resources transferred to local governments. The decline in the cost of servicing the debt, stemming from the increasing confidence in the success of the consolidation effort and from the reduction of the

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The views expressed in the paper are those of the authors and do not commit the Banca d'Italia.

inflation rate, significantly contributed to the outcome. The participation of Italy to EMU consolidated these results by further reducing the risk premium on Italian bonds.

Notwithstanding the success of the adjustment, its characteristics may have been unapt to minimise its costs. The heavy reliance on tax increases and capital spending reduction may have hampered the growth performance of the economy. The recurrent corrective measures may have negatively affected expectations of households and companies. Emergency action frequently prevailed over long-term solutions. This particularly applied to the pension system, where reforms were incremental, and to local government finance, where the rationing of transfers was preferred to the design of permanent budgetary rules. In the tax domain, the pressure to sustain revenue levels conflicted with the need to reconsider allocative targets in a context of increasing economic integration. In recent years structural reforms were finally set up; however, their design did not follow a linear path and subsequent modifications have at times pulled the system in opposite directions. These factors may explain why, in spite of the large reduction in interest rate, the success of the consolidation effort has not lead to a significant acceleration in growth.

In the present context of rapid institutional change (both at the international level, with EMU and globalisation, and at the national level, with a drive towards a federalist reform) these elements leave the country with a problematic legacy.

Sustaining a high tax burden may become more difficult as the integration of the Single European Market is strengthened and the process of globalisation accelerates: the competitiveness of the Italian productive system may suffer excessively. The lack of infrastructures negatively affects several sectors and regions. The quality of public services limits the competitiveness of the Italian economy. Moreover, some public services become increasingly exposed to international competition.

There is a need to make close-to-balance budgets a permanent feature of Italian fiscal policy and shift the focus of budgetary policy from short-term deficit control to the traditional functions of stabilisation, allocation and distribution. The new more decentralised features of the country should obviously be taken into consideration. This may require changes in budgetary procedures and institutions.

Reducing the tax burden while complying with EMU fiscal rules calls for tight expenditure control, a task made more difficult by the upward pressure on outlays exerted by the ageing process. Pension reform was a central tenet of the fiscal policy debate over the 1990s. Further changes, although necessary, may prove politically difficult. Ageing will also put budgetary pressures on health and long-term care.

Consistency between fiscal decentralisation and EMU fiscal rules may require significant institutional engineering. There is a need to replace the quantitative limits on transfers to local governments with other budgetary arrangements more suitable to a federal system based on financial autonomy of local administrations.

Distributional targets may also have to be reconsidered. In spite of several reform projects, the social protection system still concentrates its resources on pensions, while limited resources are devoted to family support, unemployment benefits and welfare services.

Finally, in the context of EMU, fiscal stabilisation has regained importance. Budgetary targets should allow sufficient room for manoeuvre. The size and quality of stabilisers should be reconsidered.

In the late 1990s, the policy debate to some extent re-focused on these issues. Reforms were introduced to simplify the tax system, reduce distortions in productive and financial decisions and gradually reduce the tax burden. A restructuring of social programmes was widely debated, with spending to be shifted from pensions to unemployment and welfare benefits. The issue of fiscal rules for local governments came to the fore. But, little progress was achieved.

This paper examines the consolidation process and the new challenges faced by Italian fiscal policy. In particular, it focuses on what may be seen as a gradual shift of attention from the arithmetic to the microeconomics of fiscal sustainability .

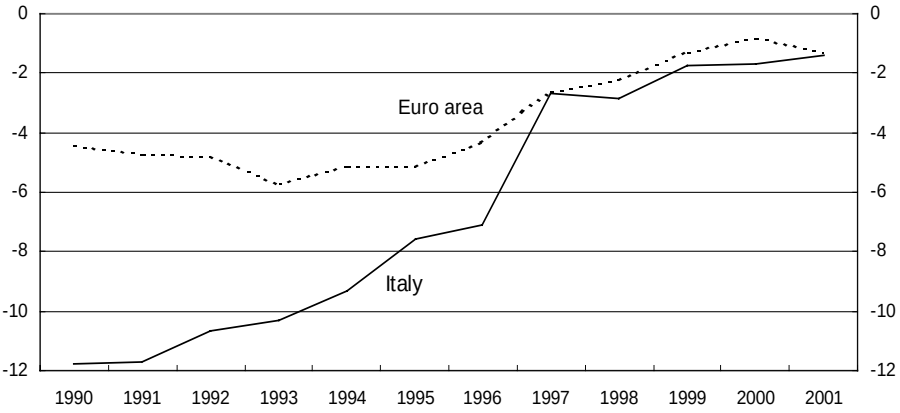
Section 2 provides a broad overview of the fiscal policies implemented in the 1990s. Section 3 examines the pension reform process. Section 4 considers the changes introduced in the tax system. Section 5 discusses the most prominent issues to be dealt with in the coming years.

2. The consolidation process

At the start of the 1990s, public finances showed severe imbalances. Net borrowing in 1990 was equal to 11.8 per cent of GDP, more than 7 percentage points above the average for the other countries of the euro area. Public debt was growing rapidly (23 percentage points between 1989 and 1993). In 1997, the deficit gap with the other countries of the area was closed: the deficit was below the 3 per cent Maastricht threshold (Chart 1) and the debt was on a downward path. There was also a drastic improvement of the inter-generational imbalances.[1] These remarkable and generally unexpected results[2] were obtained in a relatively unfavourable macroeconomic context.[3]

Chart 1

General Government Net borrowing in Italy and in the Euro Area
(percent of GDP)



[1] On the basis of 1990 public accounts, the gap between the net taxes paid by the last new-born generation (on the basis of current policies) and those paid by future generations (taking into account policy actions to restore government solvency) was extremely wide and comparatively larger than in the other western countries (Franco *et al*., 1992). In the following years the gap substantially closed and was in line with the other countries (Leibfritz, 2000, and Cardarelli and Sartor, 2000).

[2] "Still in the middle of 1996 the prevailing opinion was that the participation of Italy to the Monetary Union was impossible, given the existing distance from respecting, in 1997, the condition set in the Maastricht Treaty" (Spaventa and Chiorazzo, 2000, page 9).

[3] The macroeconomic context was not particularly favourable even when account is taken of the impact of consolidation on growth (see Section 2.4).

The budgetary problems of the early Nineties were the result of two decades, from the mid-Sixties to the mid-Eighties, when the sustainability of public finances was an issue largely neglected by Italian policy makers. These decades, together with the unsuccessful consolidation policies of the late Eighties, are briefly recalled in paragraph 2.1. Paragraphs from 2.2 to 2.5 focus on the fiscal consolidation in the 1990s. After a short chronicle of the run-up to EMU and the following years, three important aspects of the adjustment are examined: the rise and fall of the debt and its determinants; the bi-directional relation between the budget and the economy; the composition of the fiscal consolidation.

2.1 The Prologue

The roots of Italian budgetary troubles can be traced back to the mid-Sixties, when sizeable primary deficits started being recorded. Between 1964 and 1979 government expenditure increased from 30 to 42 per cent of GDP, a pace similar to that recorded in other European countries.[4] Expenditure growth was not matched by revenue growth: over the same period the ratio of revenues to GDP increased only from 29 to 32 per cent (Chart 2). As a result, the primary deficit progressively increased, reached a peak at 8 per cent of GDP in 1975, and fluctuated around 4 per cent of GDP in the late Seventies and early Eighties. However, up to the early 1980s, the increase in the debt to GDP ratio was moderated by high inflation and negative real interest rates.

Revenues substantially increased in the first half of the 1980s (to 39 per cent of GDP in 1985), but further expenditure growth (to 51 per cent of GDP in 1985) precluded the reduction of the deficit. The Italian expenditure to GDP ratio, which had long been below the EU average, moved above it in 1983. While fiscal consolidation prevailed elsewhere in Europe, Italian imbalances increased even further.

In the 1980s, with the shift in monetary policy, the opening of financial markets and the worldwide rise in real interest rates, the cost of public borrowing rose sharply; debt accumulation became rapid. In those years the unsustainable state of public finances began to be widely

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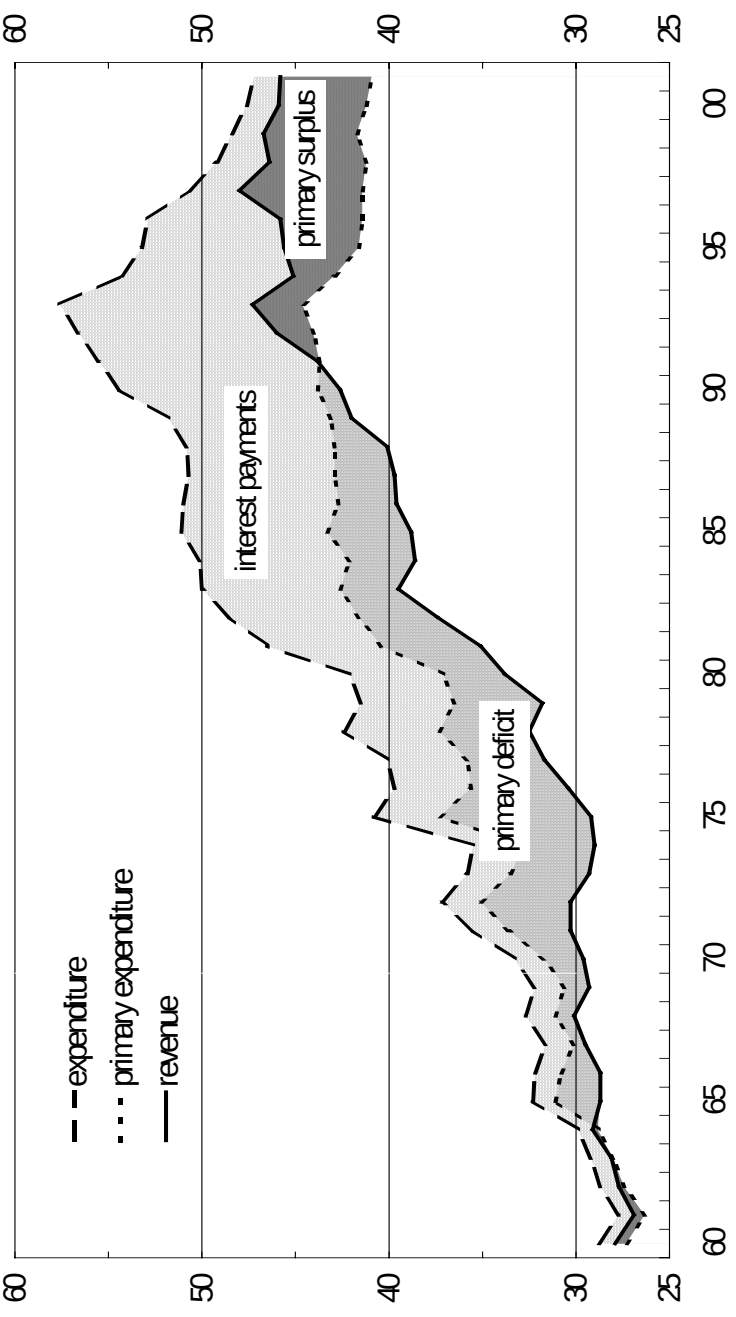
[4] See Franco (1993).

Chart 2

General Government Revenue, Expenditure and Primary Surplus

(percent of GDP)



recognized and fiscal consolidation became the main objective of budgetary policies.[5]

However, consolidation policies in the second half of the 1980s lacked determination and had limited success. Italy lost the last chance for implementing a gradual fiscal adjustment. It also missed the opportunity for stabilising the debt to GDP ratio without necessarily creating high primary surpluses.[6]

Notwithstanding the reverse oil shock, which allowed governments to increase tax rates without increasing inflation, in 1990 the primary deficit was only 2.1 points below the 1984 level, with about ¾ of the decline determined by the change in cyclical conditions.[7] There was no improvement in the overall balance, as the reduction of the primary deficit was entirely offset by the increase in interest payments. The debt ratio climbed to 100 per cent of GDP, 23 points higher than in 1984.

In the late 1980s there was also a large recourse to budgetary measures of a temporary nature (anticipating revenues, deferring expenditures, increasing the stock of tax credits), which left a difficult legacy to the policy makers of the early 1990s.[8]

2.2 A chronicle

In the early 1990s, the consolidation process accelerated considerably under the pressure of external constraints.[9] In 1991 the primary balance returned to surplus for the first time since the mid-Sixties. In the second half of 1992, the adjustment process speeded up, spurred by the exchange rate crisis which forced the lira to quit the EMS.

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5 The Italian budgetary policy in the 1970s and 1980s is examined in Amato (1990), Baldassarri and Briotti (1990), Bosi, Golinelli and Stagni (1990), Giavazzi and Spaventa (1989) and Morcaldo (1993).

6 See Sartor (1998).

7 European Commission (2001).

8 The stock of tax credits in 1990 has been estimated at 4 per cent of GDP.

9 Different authors place at diferrent times the the take off of Italy's consolidation process. The analyses by Alesina and Perotti (1997) and Zaghini (2001) begin, respectively, in 1989 ad in 1991. Spaventa and Chiorazzo (2000), while noting the efforts made in the late 1980s, put the start of the adjustment in 1990-91. Degni *et al.* (2001), taking into account the effects of the cycle on the budget, attribute a crucial importance to the measures taken in the second half of 1992.

The looming financial crisis forced the government to take unprecedented corrective actions, which for 1992 included one-off levies on bank and post office deposits and on real estate. The 1993 budget represented a turning point in Italian fiscal policy. In order to curb the deficit expected for 1993, expenditure cuts and revenue increases amounting to nearly 6 per cent of GDP were implemented.[10] Structural measures were also adopted to attenuate the expansionary trends in the major expenditure items.

The pension system was eventually reformed after the long inconclusive debate of the 1980s (see Section 3). The organisation and the financial structure of the National Health Service was reshaped with a view to decentralise decisions and responsibilities. Local authorities powers of taxation were broadened. Rules governing public employment were also reformed and an independent body was set up to conduct bargaining.

Moreover, adjustment of pensions to inflation was temporarily stopped and constraints on the hiring of public sector employees were strengthened. Legislation enacted in previous years had not been able to stop the increase in public employment, but the trend was reversed in 1993. The steady decline of public employment in the following years lead to a cumulated 5 per cent reduction in the number of public employees at the end of the decade.[11]

Notwithstanding the large fiscal effort, the initial budgetary outcomes were relatively unsatisfactory, influenced by the worst recession since 1975, the growth in interest payments and the expansionary tendency of the deficit on a current-program basis.

After the start of the second stage of EMU in 1994, compliance with the deficit requirement set in the Maastricht Treaty was the external constraint of greatest importance for Italian budgetary targets. The reference balance for budgetary policy was changed from the state sector borrowing requirement to general government net borrowing, the yardstick for the 3 per cent limit established by the Maastricht Treaty.

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[10] Banca d'Italia (1992) presented in May the results of an econometric exercise envisaging corrective measures similar to those introduced in the following months. The exercise envisaged for 1993 a correction of the budget balance of 6 percentage points of GDP. As a result, over the period 1991-96, the ratio of primary expenditure to GDP would have declined by 4 points, while the revenue ratio would have increased by 2 points. The interest burden was projected to decline by 1.5 points. Structural reforms in several areas were considered necessary to achieve these results.

[11] Banca d'Italia (2000).

Progress towards the 3 per cent threshold was not linear. Budgetary policy for 1994 aimed at avoiding hampering the macroeconomic recovery and at consolidating the results of 1993. Within the unfavourable context of world-wide increasing interest rates, this pause fuelled concerns over the credibility of the fiscal consolidation process in Italy, widening again the spread between Italian public bonds and other comparable financial instruments (Chart 3). The difference in interest rates peaked in the first quarter of 1995, when the lira depreciated very much. This was the last occasion in which the success of the consolidation efforts was called in question. In the following months the situation gradually improved. Overall, fiscal adjustment continued in 1995 and in 1996, in spite of the slowdown in economic activity.

The consolidation process was given a final boost in 1997, with the aim of ensuring Italy's participation in the Monetary Union from the outset.[12] A two-step budget adjustment amounting to about 3 per cent of GDP was implemented, mainly in the form of revenue increases. Substantial use was made of temporary measures, which amounted to more than 1.5 per cent of GDP and mainly concerned one-off taxes.[13] These included the so called "euro-tax", which was a progressive surcharge on the personal income tax. The deficit reduction was accelerated by the sizeable decline in interest rates (the ratio of interest expenditure to GDP declined by 2.1 percentage points).

Over the 1990s, corrective measures accounted for about 22 points of GDP. This reflected both the need to offset the sharply rising trend of expenditure and the extensive recourse to temporary measures. In several years supplementary budgets were introduced.[14] Economic agents' expectations were influenced with adverse repercussions on demand and interest rates. The latter only fell to the levels prevailing in the rest of Europe towards the end of 1997.

The successful conclusion of the drive to qualify for adoption of the single currency brought to an end the long period in which Italian budgetary policy primarily aimed at correcting imbalances. The focus of budgetary policy shifted towards strengthening social policies and fostering

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12 Ministero del Tesoro (1998).

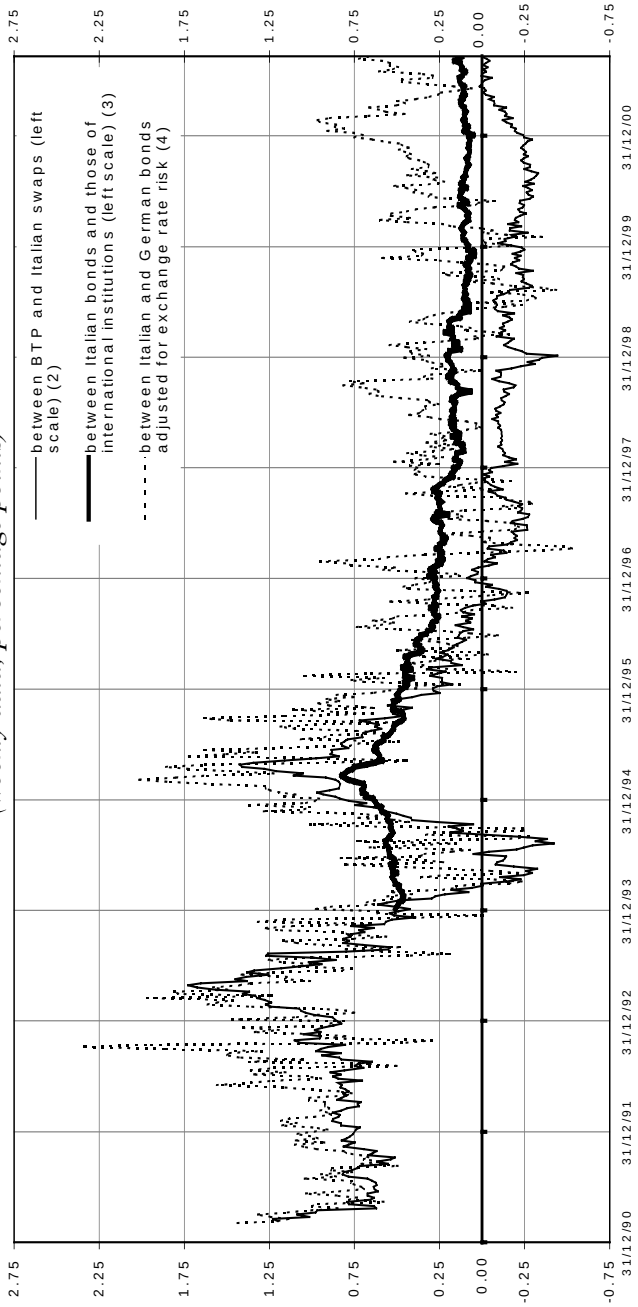
13 Ministero del Tesoro (1998).

14 The corrective measures are examined in the Annual Reports and the Economic Bulletins of Banca d'Italia and in Degni *et al.* (2002).

Chart 3

Italian Bond Spreads (1)

(weekly data; percentage points)



(1) Source: BIS and Bank of Italy.
(2) Differentials between 10-year BTP and 10-year Italian swaps.
(3) Simple average of yield differentials between Republic of Italy issues and IBRD bond with similar caracteristics.
(4) Differentials between 10-year BTPs and Bunds adjusted for swap rates differential.

economic growth. An extensive reform of the tax system was introduced. It aimed at simplifying the tax structure and increasing its neutrality, while gradually reducing the tax burden.

In the years 1998-2001, the stance of fiscal policy relaxed: the primary surplus, which had peaked at 6.7 per cent of GDP in 1997, went down to 5.2 in 1998 and remained approximately constant in the following three years. The overall balance remained nevertheless on a declining trend, as a result of the steady fall in interest payments.

The dynamics of interest payments was extremely important, both in determining the changes in the overall deficit and in influencing the orientation of fiscal policy. Between 1980 and 1990 the interest burden as a share of GDP rose by 5.4 percentage points, to 10.5 per cent. This increase largely outsized the improvement in the primary surplus recorded in that period (2 percentage points). Interest payments rose further by 2.5 per cent of GDP in the following three years, almost entirely offsetting the large fiscal corrections in those years. From 1994 the cost of the debt started to fall, reflecting the subdued inflation, the decline of the debt ratio and the gathering confidence on the success of the consolidation process. In the period 1994-97 interest payments contributed to about half of the 7.6 points reduction in the overall deficit.

The gains from low interest rates remained significant after 1997. In the years 1998-2001 interest expenditures fell further by 3.1 points, to 6.3 per cent of GDP, enabling fiscal policy to change its orientation and focus. Assuming unchanged interest rates, a further decline of about 1 point can be expected over the 2002-04 period.

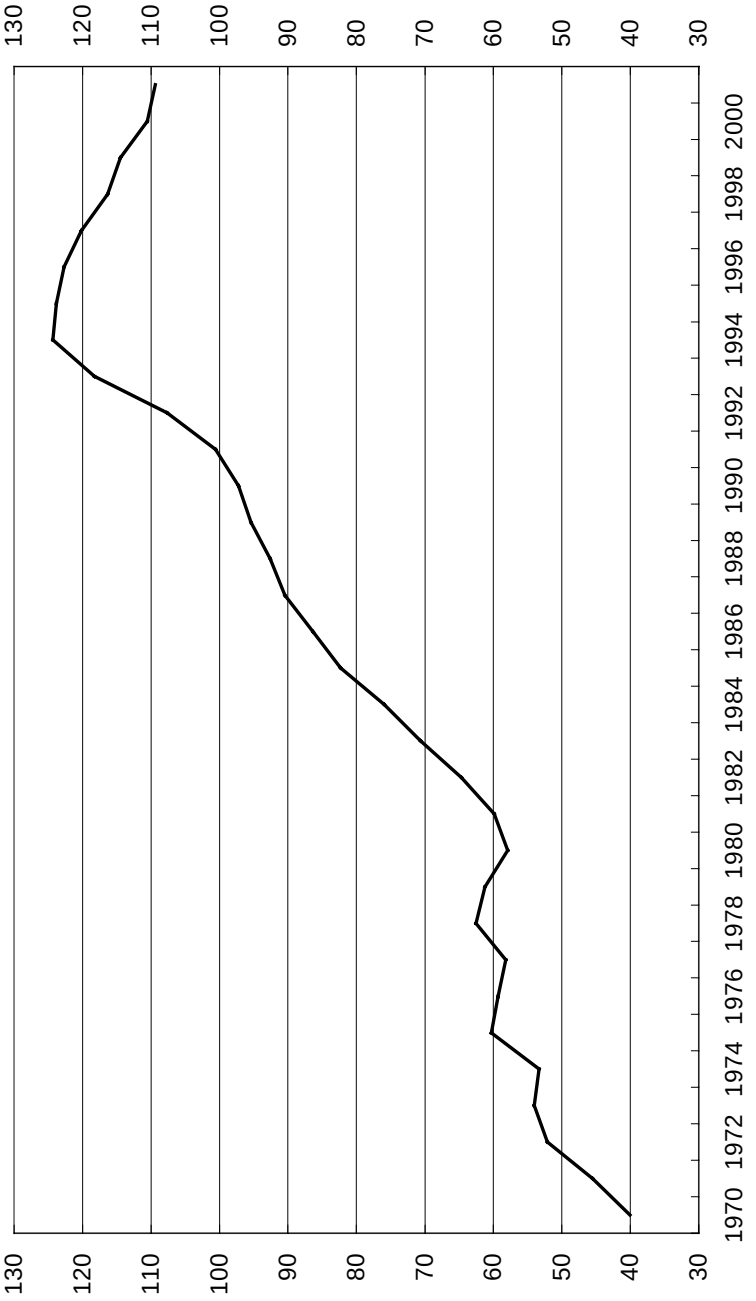
2.3 The dynamics of the debt

The debt to GDP ratio grew almost continuously from a level of 35 per cent of GDP in mid-Sixties to a peak value of 124.3 per cent in 1994 (Chart 4). Thereafter it has declined, reaching a low of 109.4 per cent in 2001.

The bulk of the debt accumulation occurred in the 1980s and the early 1990s. In the 1980s, the increase in the debt-to-GDP-ratio was boosted by large primary deficits and stock-flow adjustments. Initially, the impact of these factors was partly offset by the negative differential

Chart 4

Debt to GDP ratio: 1970-2001
(percent of GDP)



between the average cost of the debt and GDP growth, which had kept the dynamics of the debt-to-GDP ratio nearly constant in the late 1970s. The differential progressively waned and was approximately nil over the second half of the decade (Chart 5).

In the early 1990s, the differential between the average cost of the debt and GDP growth rate turned positive and was the main determinant of the large increases of the debt ratio, largely offsetting the effects of the primary surplus, achieved since 1991. In 1993, also as a consequence of the negative GDP growth, the differential reached a peak of 9.5 points.[15] The differential more than halved in the following two years and fluctuated around a declining trend afterwards. In the years 1992-93, the debt ratio was also driven up by unfavourable stock-flow adjustments.[16]

Since 1995 the debt ratio has fallen, owing to the large primary surpluses (about 5 per cent of GDP per year) and the reduction in the differential between the average cost of the debt and GDP growth. The impact of stock-flow adjustments was kept broadly neutral by a large privatization programme (in the 1990s its proceeds amounted to 4.9 per cent of GDP, almost entirely accrued in the second half of the decade).

2.4 The budget and the economy in the 1990s

In the 1990s, the Italian economy grew at the yearly rate of 1.5 per cent, half the average growth of the period 1971-1989. The slowdown in growth characterised most industrialised countries, but its extent was generally more limited (1 per cent in the OECD countries). It is likely that fiscal consolidation contributed to the slowdown in Italy, as well as in other European countries, but other factors also played an important role.[17]

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[15] This gap had an impact on the debt dynamics of about 10 points.

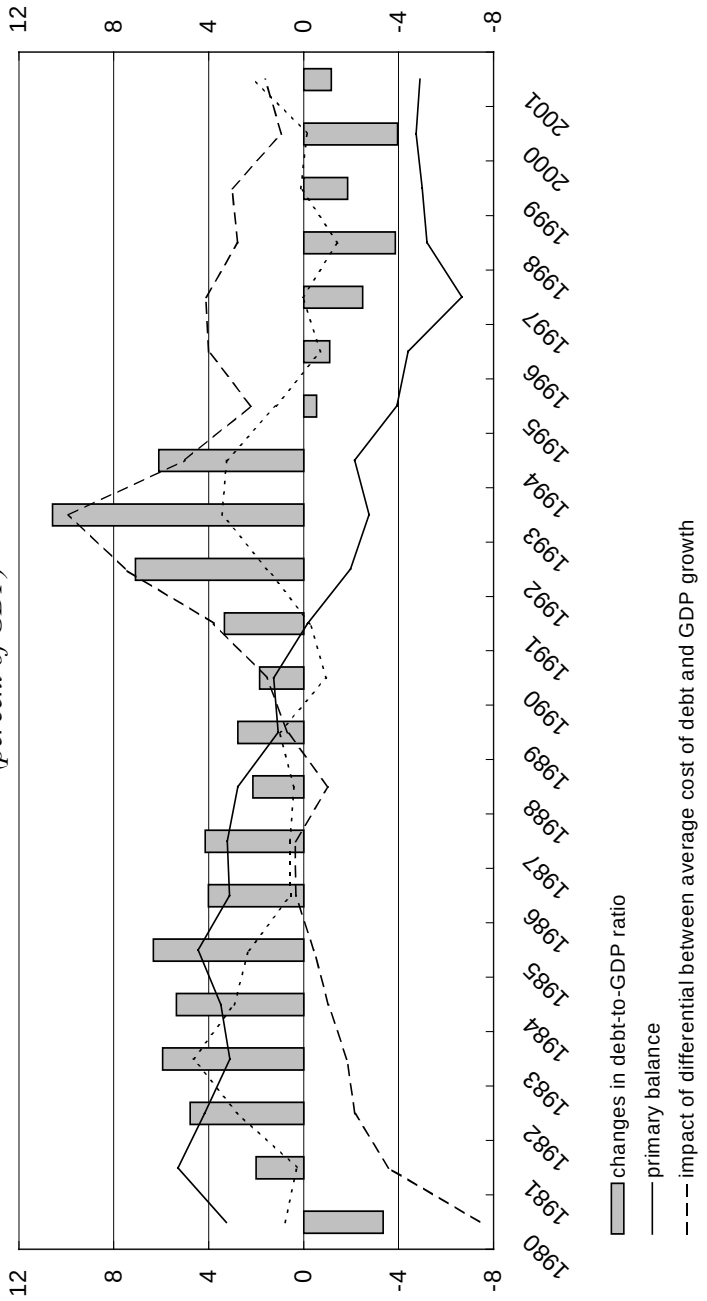
[16] These were related to the devaluation of the lira (which caused the lira value of foreign currency debt to rise in relation to GDP by about 1.5 percentage points), to the issue of securities to provide resources for the Treasury payment account at the Bank of Italy (amounting to nearly 2 per cent of GDP), to the assumption by the state of debts of the former autonomous government agencies (amounting to about 1 per cent of GDP), and to settlements of general government past debts.

[17] See Buti *et al.* (1999). The quality of public expenditure in some key sectors (e.g. education, infrastructures) and a relatively costly public regulation are also likely to have contributed to the poor performance of the Italian economy in the period. See Ferro, Momigliano and Salvemini (1999).

Chart 5

Change in debt-to-GDP ratio and its determinants

(percent of GDP)



Source: Banca d'Italia and Istat.

In the period 1991-97, when most of the adjustment was achieved, the economy grew at a yearly rate of 1.3 per cent, 1.7 points below the average of the previous two decades. On the basis of a preliminary assessment,[18] which takes into account the short-term impact of the budget on growth, fiscal policy accounts for about a third of the growth differential over the consolidation period. In 1998, 1999, and very likely in 1990, the impact was instead positive. The restrictive impulse from fiscal policy was amplified by the composition of the adjustment, which heavily relied on cuts of purchases of goods and services and investments. The labour market was also unfavourably affected by the freeze on the hiring of public employees. Moreover, tax increases and cuts in capital spending may have reduced growth via supply effects.[19]

While restrictive on average, fiscal policy was significantly anti-cyclical over the period, in the relatively narrow sense that deviations from the decade's average growth were generally accompanied by counteracting deviations from average of the impact on growth of the budget (Chart 6). The only exceptions are in the year 2000, when the relaxation of fiscal policy added to the relatively high growth, and in 1993, when fiscal policy was largely dictated by financial emergency. In each of the other seven years examined, the deviations from the averages of the impact of fiscal policy and of the growth of the economy show opposite signs.

To fully appreciate the fiscal efforts made over the period, it is important to take into account also the impact of the cyclical conditions on the budget balance. The estimates of this impact for Italy unambiguously indicate that macroeconomic conditions significantly hampered fiscal consolidation in the run-up to EMU (Chart 7).[20]

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[18] See Momigliano and Siviero (2002).

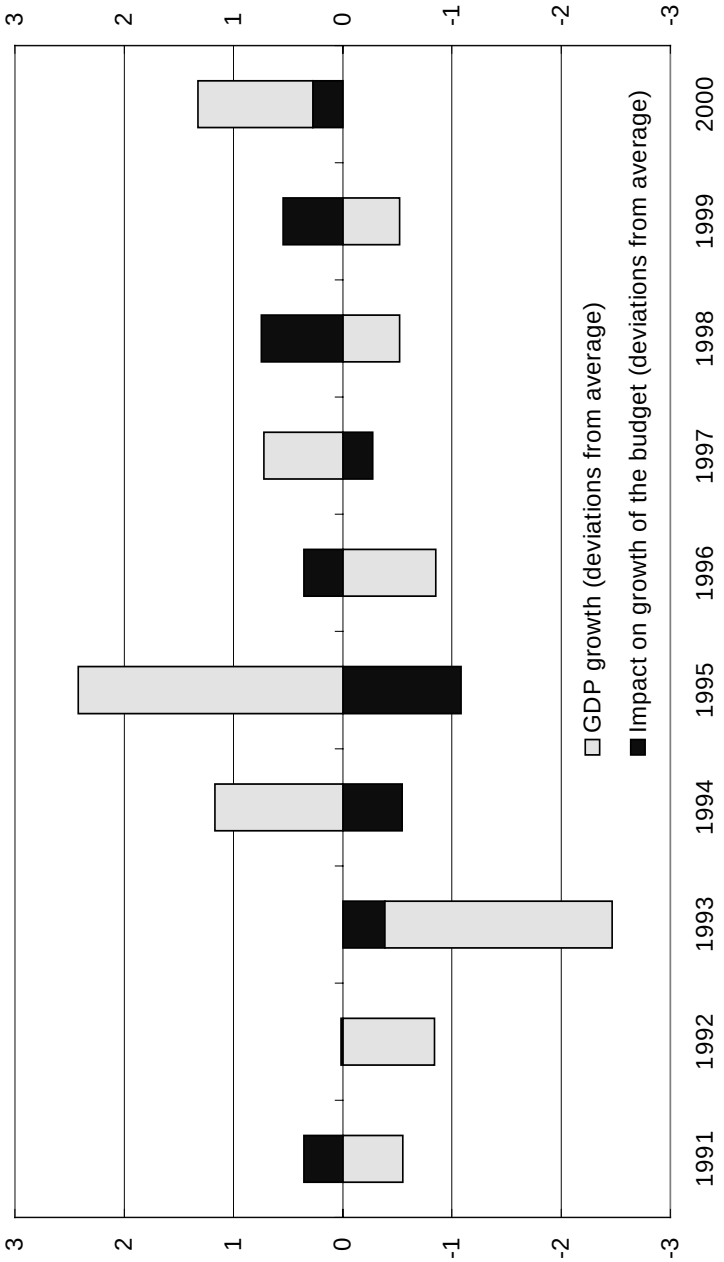
[19] Spaventa and Chiorazzo (2000) compare primary balance changes and GDP growth in EU countries over the period 1991-1998 and notice that the costs of Italian fiscal consolidation had been significant, but – taking into account the size of the adjustment – had been in line with those of the other countries.

[20] The relevance of underlying macroeconomic conditions to the success of fiscal consolidation is stressed in Von Hagen and Strauch (2001).

Chart 6

GDP growth and budget impact on economic activity, deviations from period averages (1991-2000)

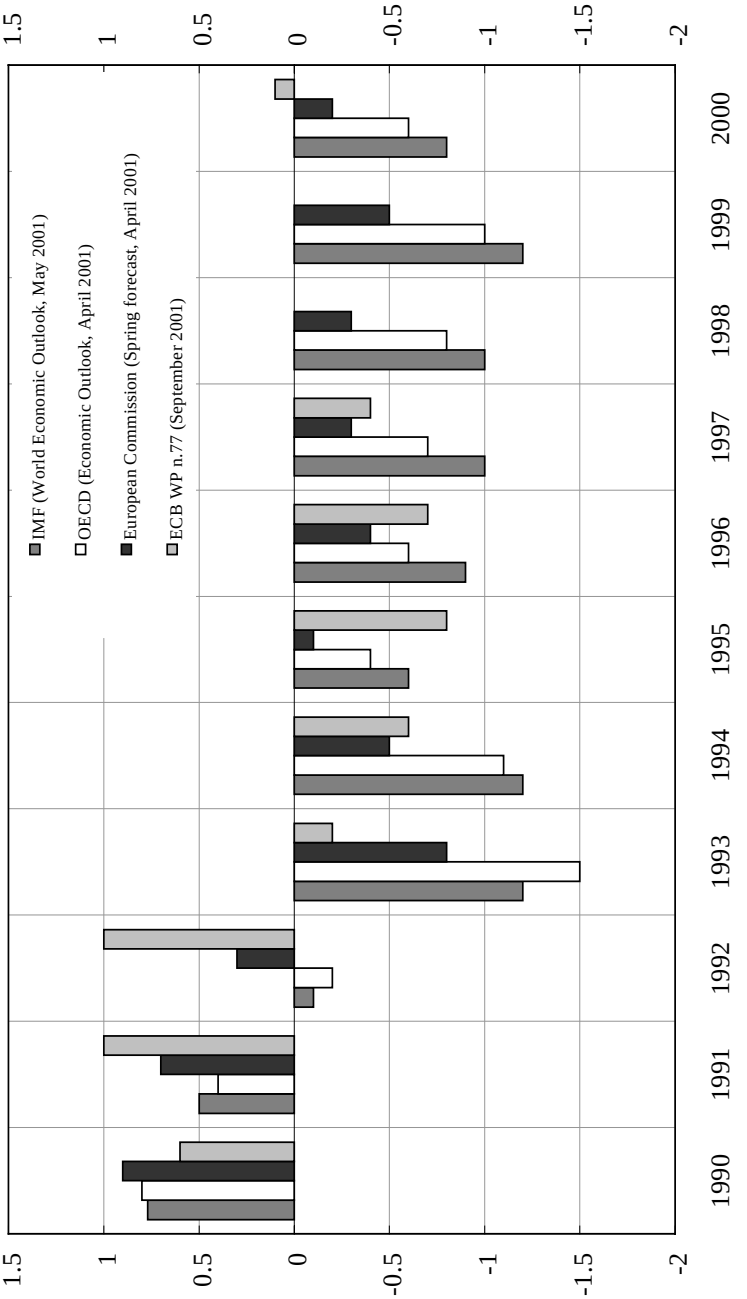
(percent of GDP)



Source: Momigliano and Siviero (2002).

Chart 7

The cyclical component of the Italian General Government balance (1990-2000)
(percent of GDP)



Focusing on the estimates based on the method developed within the European System of Central Banks,[21] the initial three years of the decade were relatively favourable, with the cyclical component averaging 0.9 per cent of GDP. The cyclical component of the budget became negative already in 1993 and declined further until 1996; in 1997 it improved slightly. Overall, in the period 1991-97, the cycle worsened the balance by 1.4 percentage points (the cyclical component declined from 1.0 to –0.4 per cent of GDP). In the following years the cyclical component went gradually to zero.

2.5 The composition of the adjustment

In the 1990s, the ratio over GDP of primary expenditure in the EU countries initially rose fast. From 1992 it declined, reaching the level of the late 1980s at the end of the decade. The revenue to GDP ratio followed a similar pattern, but with more limited changes (Chart. 8).

In Italy, the dynamics of revenue and primary expenditure over the 1990s followed a more complex pattern. Until 1993, continuing the trend which had characterised the 1980s, both sides of the primary budget grew rapidly, with the increase in revenue being by far faster. Afterwards, primary expenditure decreased, while the revenue ratio initially declined, then rose again to an historical peak in 1997 (at 48 per cent of GDP). Since 1998, the primary current expenditure ratio stabilised just below the level of 38 per cent of GDP and the revenue ratio declined to about 46 per cent.

Overall, the reduction in the Italian budget deficit in the 1990s was largely due to revenue increases. In terms of GDP, the latter increased by 4.7 percentage points between 1989 and 1999. Most of this increase occured before 1992, the two peaks of 1993 and 1997 being mainly the result of one-off measures. The contribution of capital expenditure to fiscal adjustment, 1.1 points, was also significant, as a proportion of its share of the budget. Primary current expenditure, growing rapidly until 1993, were subsequently reduced and eventually returned to the level prevailing at the start of the decade.

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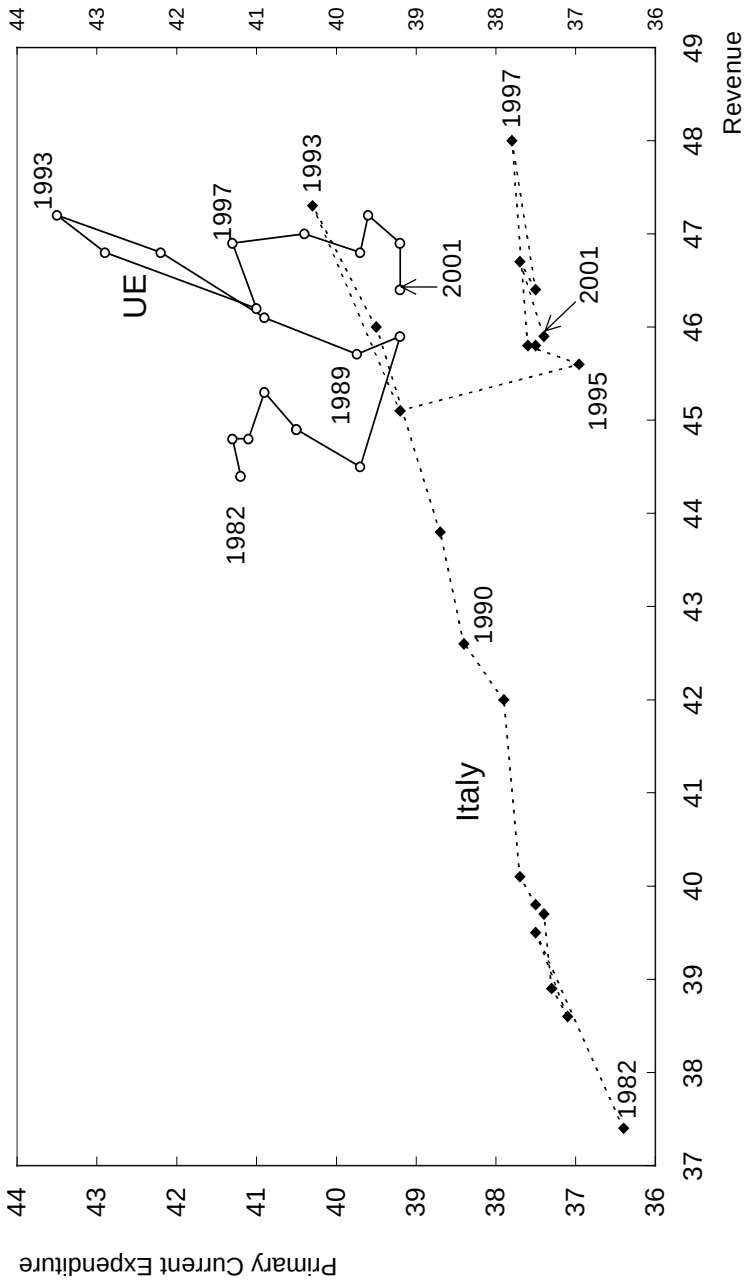
[21] The ESCB method (Bouthevillain *et al.*, 2001) is more disaggregated then those used by the OECD, the IMF and the European Commission, and thus allows to take account of the effects of changes in the composition of income and aggregate demand. These effects were particularly large in the early 1990s (Momigliano, 2001).

Chart 8

Primary Current Expenditure and Total Revenue in 1982-2001

(percent of GDP)



Focusing on the years 1991-97, when the primary balance improved by 7.9 per cent of GDP, the relative contribution of revenue and expenditure is slightly more balanced, but revenue still accounts for over two thirds of the adjustment (Chart 9).[22] Social security monetary benefits, mainly pensions, continued to increase as a ratio to GDP, notwithstanding the reforms (see Section 3). The effects of the corrective measures showed up more evidently on the dynamics of the other components of current expenditure (in particular, the wage bill), and of capital expenditure: both declined by about 2 percentage points of GDP over the period. In particular, the ratio to GDP of public investments was cut by a third, from 3.3 to 2.2 per cent.[23] Expenditure cuts were mainly carried out at local level, under the pressure of falling state transfers, not entirely offset by a greater tax autonomy (Chart 11 and Section 4). The large revenue increase was distributed among the three main components: direct taxes, indirect taxes and social security contributions.

Over the years 1998-2001, the primary surplus diminished by 1.8 per cent of GDP. Primary expenditure continued to decline, by 0.5 points, mainly due to the dynamics of expenditure on social security monetary benefits. Revenue fell by 2.2 per cent of GDP from its 1997 peak (Chart 10). The composition of revenue changed significantly, with a reallocation from social security contributions to indirect taxes, mainly determined by the introduction of IRAP (see Section 4).

These data seem to indicate that the Italian consolidation process has been eminently revenue based. As the recent strand of literature on the composition of adjustment has shown, this feature is often correlated with the absence of positive macroeconomic effects coming from the improvement of expectations and lack of success of the consolidation effort.[24] The Italian case seems to confirm only the first of the two

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[22] 1993 is not suitable as a reference point in order to assess the composition of the adjustment in terms of GDP ratios because of the sharp slowdown in growth recorded that year.

[23] The fall in investment expenditure was due in part to the discovery of widespread irregularities in tenders for public works. The need to ensure the efficient use of the resources allocated to investment led in 1993-94 to the start of a reform process, which is still under way, aimed at reducing the scope for irregular behaviour on the part of public officials and firms, guaranteeing more competition in tenders and increasing the project planning and evaluation capabilities of central and local government.

[24] See Giavazzi and Pagano (1996), Alesina and Perotti (1997) and Zaghini (2001). On the relationship between fiscal policy composition and the level of economic activity, see also Ardagna (2001).

Chart 9

Changes in the composition of the budget in the years (1991-97)

(percent of GDP)

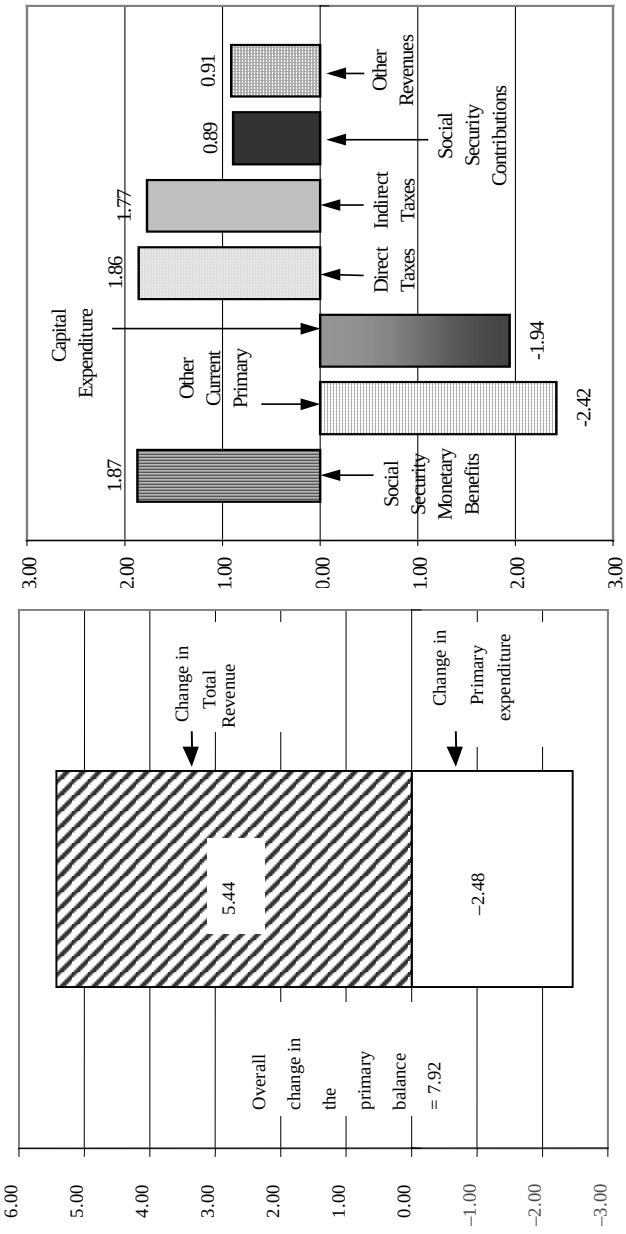

Chart 10

Changes in the composition of the budget in the years (1998-2001)

(percent of GDP)

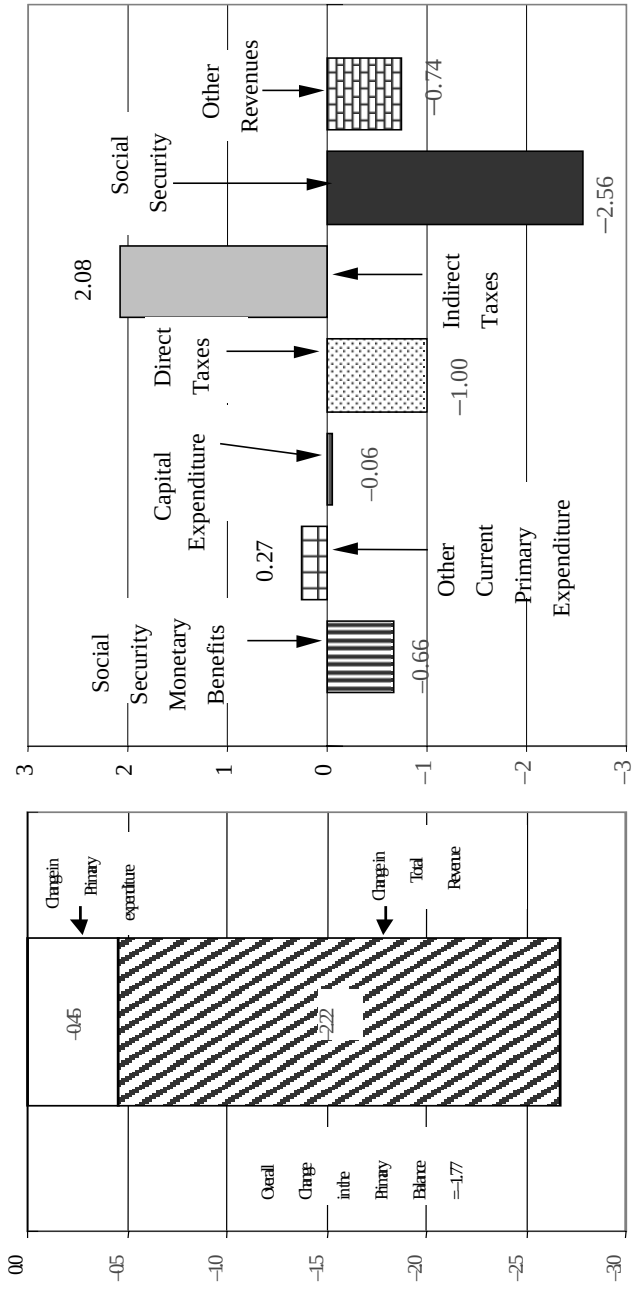

Chart 11

Local Government transfers and expenditure (1980-2001)

(percent of GDP)

predictions, as internal demand did not accelerate towards the end of the consolidation. However, a partly different view on the composition of the adjustment can be reached when account is taken of the impact of corrective measures on the tendency of expenditure to expand inherent in programs that were in place at the outset of the decade. The policies implemented in the 1970s and 1980s had created large future commitments, implying a significant increase in the expenditure to GDP levels also in the 1990s, especially in the social protection domain. In terms of correction of budgetary trends, the consolidation of the 1990s was probably almost evenly split between revenue and expenditures.[25]

It should also be pointed out that the political burden for reversing these trends was enormous, especially for coalition governments with limited political legitimisation.[26] The policy makers were also facing a credibility problem, partly stemming from the failure to consolidate public finances in the second half of the 1980s, when the macroeconomic context was favourable.

Most of these caveats do not apply to recent years, making particularly worrisome the seeming incapacity to gradually reduce primary current expenditure as a ratio to GDP. Lacking the pressure for consolidation previously exerted by large fiscal imbalances, governments seem now unable to achieve further reductions in order to alleviate the tax burden. Progress in restructuring public expenditure also seems limited. In particular, the calls for moving resources from pensions to welfare and unemployment benefits have been basically unanswered.[27]

3. The search for a sustainable pension system

The reform of the pension system has long been at the core of the effort to ensure fiscal consolidation and long-term sustainability in Italy. The ratio of pension expenditure to GDP is one of the highest in industrial countries, while Italy's fertility rate is among the lowest (1.2 children per woman of childbearing age). Moreover, the ratio of the elderly to the

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[25] In a similar vein Spaventa and Chiorazzo (2001) stress the change occurred in the trend ratio of public expenditure to GDP.

[26] Bernardi (2000a).

[27] See Commissione per l'analisi delle compatibilità macroeconomiche della spesa sociale (1997). The issue is also examined in Franco (1996) and Monacelli (1998).

working age population is expected to increase from 21 per cent in 1990 to about 30 per cent in 2010 and 48 per cent in 2030; it will be among the highest in the world.

In the 1980s it was gradually apparent that the system governing pension benefits and demographics were mutually incompatible: the pension formula, the eligibility conditions and the indexation rules granted rates of return which were considerably higher than the rate of growth of the social security tax base. Pension expenditure increased from 5.0 per cent of GDP in 1960 to 10.2 in 1980 and 14.9 in 1992, far outstripping the growth of the other items of social spending which only increased from 5.1 to respectively 6.7 and 7.3 per cent of GDP. Later projections estimated that pension expenditure would have reached 25 per cent of GDP by 2030.[28] In spite of frequent calls for a general reform of the pension system, no large-scale change was introduced. Still in 1990 prospective expenditure was further increased by the decision to raise the benefits for the self-employed.

Pension reform has also been recognised as an important component of any policy aimed at improving the functioning of the labour market, namely at increasing labour mobility and the low participation rate.[29] Given the relevance of pension spending, pension reform is also a key element in any strategy aiming to reduce the tax burden while keeping a broadly balanced budget. Finally, since the incidence of pensions on total social spending is very high (70 per cent), pension reform is also a precondition for implementing policies which may increase public support for the non-elderly groups of citizens and finance additional spending on long-term care.

3.1 The 1992 and 1995 reforms

The situation radically changed in 1992. Under the pressure of the exchange rate crisis and the urgent need to curb the deficit, the pension formula and the eligibility conditions were extensively modified. The reform implemented in 1992 cancelled about a quarter of net pension

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[28] See Ministero del Tesoro (1994).

[29] See Franco and Frasca (1992).

liabilities (Chart 12).[30] Most of the savings were obtained by the switch from earnings to prices as the basis for revaluations and the determination of new pensions on the basis of workers' entire working lives.

The reform also started a gradual harmonisation of pension rules and, by relating the pension levels of younger workers to lifetime contributions, strengthened the link between contributions and benefits. However, it did not tackle the issue of seniority pensions, which allowed retirement at any age provided certain contributory requirements were satisfied. This substantially reduced the impact on the effective retirement age of the increase in the age-limit for old-age pensions. Moreover, the exclusion of individuals with at least 15 years of contributions from changes in the pension formula implied a long transition period and an uneven distribution of the reform burden.

Expenditure prospects remained rather worrying. However, by breaking the deadlock of Italian pension policy and immediately restraining expenditure increases, the 1992 reform set the conditions for better planned and more systematic changes.

A new major reform was introduced in 1995.[31] While the 1992 reform changed the parameters of the system and primarily aimed at cutting pension expenditure, the new reform changed the basic design and had a wider range of objectives. It aimed at stabilising the incidence of pension expenditure on GDP, at reducing distortions in the labour market and at making the system more fair.[32] A tighter link of pensions to individual contributions was instrumental in achieving the latter objectives.

It was expected that contributions would have been more clearly perceived as deferred earnings, thereby reducing the distortionary effect of labour income taxation. The reform, which was probably inspired by the one undertaken in Sweden in 1994, envisaged the shift from a defined benefit to a defined contribution system. Under the new system, each individual holds a notional social security account. Contributions are transformed into an annuity at retirement on the basis of actuarially determined coefficients linked to retirement age. The 1995 reform aimed at

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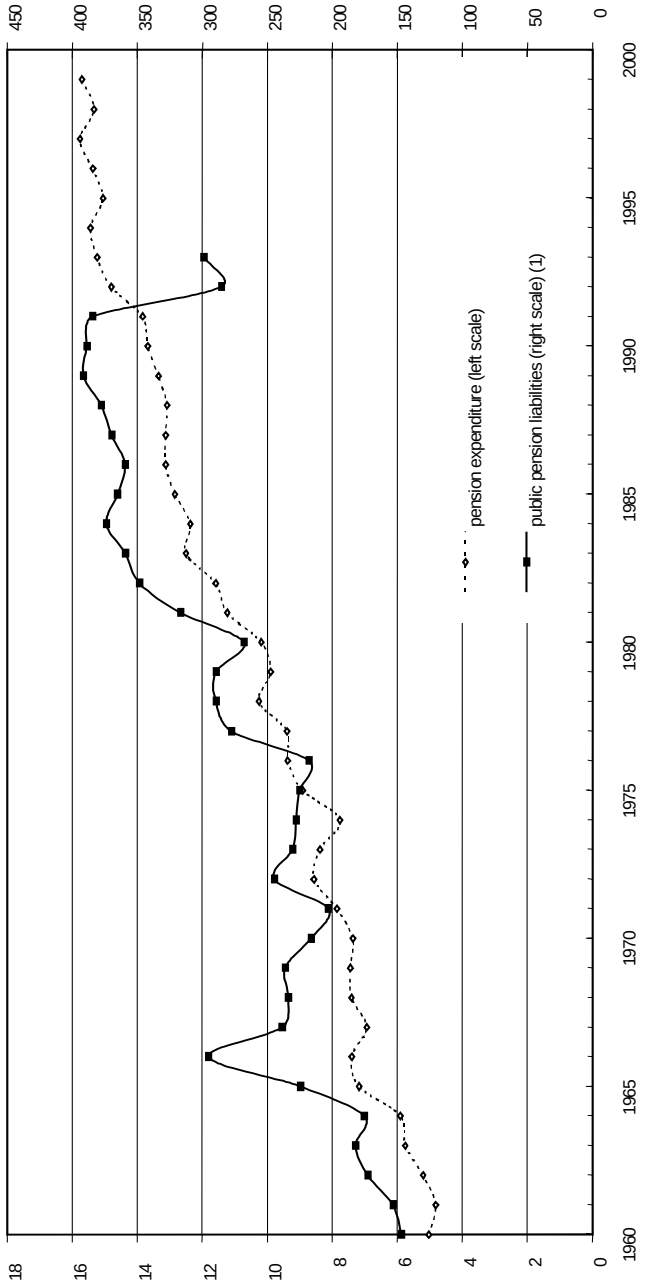
[30] See also Beltrametti (1994) and Rostagno (1996). These estimates refer to the present value of pensions to be paid in the future on the basis of accrued rights to pensioners and existing workers, net of the contributions that the latter will pay under current rules.

[31] See Aprile *et al.* (1996); Banca d'Italia (1995); Castellino (1995); Peracchi and Rossi (1998).

[32] See Rostagno (1996).

Chart 12

Pension expenditure and public pension liabilities
(percent of GDP)



(1) Source: Beltrametti (1996).

equalising the yields of the contributions paid by all workers of the same sex and the same pension cohort. It removed the favourable treatment previously granted to workers with dynamic careers.[33]

Legislation supporting the development of pension funds was also introduced in 1995, supplementing earlier steps. The consensus view reached over the 1990s was that the growth of such funds is a means to adjust retirement provisions to the different needs of the citizens, to allow workers to offset the reduction in replacement rates resulting from reforms of PAYG schemes and also to strengthen the role of institutional investors in the capital market.

3.2 Critical aspects

Overall, during the 1990s Italian governments radically redressed the prospects of the PAYG pension schemes, introduced an innovative solution to make these schemes more incentive compatible,[34] successfully harmonised the rules applying to the different schemes (thereby facilitating further reforms) and aimed at gradually developing a two pillar system more diversified and resilient to shocks.

However, some aspects still remain problematic.

The 1995 reform did not significantly affect long-term expenditure trends.[35] In the 1990s, in spite of the reforms, the ratio of the average pension to average earnings rose by around 15 per cent; the number of pensions increased by around 10 per cent. In the year 2000, pension expenditure represented 15 per cent of GDP. Further increases in the expenditure to GDP ratio are expected over the next decades. While these increases are less dramatic than in most other EU countries,[36] the present size of pension expenditure makes them hardly sustainable. Moreover, the implementation of the reform is extremely gradual. The length of the

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[33] Under the new rules, which apply to all categories of workers, the level of the pension wealth of each individual would not be affected by the age of retirement.

[34] The actuarial approach underlying the reform represents a structural break in Italian pension policy-making, since in previous decades actuarial considerations did not have any significant role. See Castellino (1996).

[35] Rostagno (1996).

[36] Economic Policy Committee (2000).

transition phase and other aspects of the reform may significantly reduce its expected microeconomic benefits.[37]

The 1995 reform avoided showing cuts on replacement rates at the cost of increasing pressures from pensioners in the future.[38] Most expenditure cuts came from changes in the indexation mechanisms, which are perhaps more acceptable to public opinion since they are less visible and more gradual, but may prove politically unsustainable in the long run if associated with lengthy retirement periods.[39] More generally, the reliance on the reduction in the transfer ratio, rather than on increases in retirement age, may create political pressure for discretionary increases of pension in real terms.[40]

An actuarially based pension system, such as that introduced in Italy in 1995, can deliver the expected labour market benefits only if the link between contributions and benefits is transparent, easy to grasp and perceived as stable by citizens. This may not be the case in Italy, where a large number of workers are not affected by the new pension regime, no major effort has been conducted to inform citizens, and further reforms are expected by public opinion which thereby perceive the return to the contributions as uncertain.[41]

There is now considerable consensus among pension experts, if not among politicians, that a comprehensive package including a faster implementation of the 1995 reform, some parametric changes in the pension regime established by that reform, and an acceleration of the development of funded schemes would avoid the expected rise of the pension expenditure to GDP ratio and reduce the negative effects of the systems on the labour market and employment. The acceleration of the implementation of the 1995 reform would provide some budgetary margins for a gradual reduction of the contributions to the PAYG system, which could be implemented in parallel with the development of funded schemes.

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37 Further changes were introduced in legislation in the following years. See Onofri (1998).

38 Pizzuti (1998) remarks that this decision, which relies on the short-sightedness of individuals, is in stark contrast with one of the main roles of public action in retirement provision, that is that of compensating for this short-sightedness.

39 Moreover, revisions of conversion coefficients at ten-year intervals may produce large differences in the treatment of contiguous generations of pensioners. This also may also be politically problematic.

40 See Gronchi and Aprile (1998), Peracchi and Rossi (1998).

41 See Franco (2002).

The optimal mix of PAYG pensions and funded pensions remains open to discussion. However, high contribution rates and budgetary constraints limit the speed of the transition to funding. It is likely that the Italian pension system will remain for a long time predominantly based on PAYG criteria. If funding were to assume a greater role than PAYG, the optimality of coupling a funded defined contribution system and a PAYG defined contribution system (rather than a defined benefit system) should also be discussed.

3.3 The design of pension policies

The policy-making process also proved problematic.

The delay in introducing a reform imposed high costs on Italian present and perspective pensioners in terms of unexpected reductions in purchasing power (e.g., those produced by the partial suspension of price indexation in 1993) and sudden changes in expectations (e.g., those related to the fast increase in the standard retirement age). Policy-making was affected by short-term considerations. Changes were frequently introduced under external pressure. The effort to minimise the reactions of the more vocal groups led to solutions which may result unsustainable in the long run.[42]

Reforms were introduced without adequate preliminary work. The need to make use of political windows of opportunity to introduce reforms prevented adequate reflections on their design and implications. This deficiency was understandable in the emergency situation of 1992; it was less so in later years, when the focus shifted from expenditure control to a wider range of objectives.[43] No government document was presented in the 1990s to illustrate the case for reform, the alternative changes taken into consideration, the objectives and the expected outcomes. In particular, it is

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[42] The distribution of the burden of reform between generations and group of workers was uneven. The cut in the pension wealth of pensioners and elderly workers is very limited with respect to that imposed on younger workers. Generational disparities replaced industry-based disparities. While workers with long-contributory records retained their seniority pensions, those with shorter periods faced a sudden increase in the age-limit for obtaining an old-age pension.

[43] Gronchi and Aprile (1998) link some deficiencies of the 1995 reform to the speed with which it was introduced, that in effect gave little time to understand its implications. See also Aprile *et al.* (1996).

remarkable that the 1995 pension formula was never officially published.[44] This creates some ambiguity for future revisions of conversion coefficients.

Being lengthy and largely incremental, the reform process introduced additional burdens. The widespread perception that more adjustments are required maintains uncertainty and induces elderly workers to retire at the earliest possible date. This increases public expenditure and negatively affect the labour market. The employment rates of Italian males in the 50 to 64 age-brackets significantly declined over the 1990s in spite of the increase in the age limit for old-age pensions. Moreover, while most experts consider that further changes are required, public opinion is experiencing 'adjustment fatigue'.

4. Tax system between revenue maximisation and efficiency targets

Over the 1990s, the ratio of total government revenues to GDP increased by about 4.7 percentage points, to 46.7 points. This increase does not fully convey the strains imposed by fiscal consolidation on the Italian taxpayers. Tax legislation was frequently modified. The revenue ratio was raised to 47 per cent of GDP in 1993 and 48 in 1997. Moreover, between 1975 and 1990 the ratio had already been increased from 29 to 42 percentage points (Chart 13). This is one of the fastest and largest increases experimented by European countries.[45]

At the beginning of the 1990s, there was clearly a need for consolidating the revenue increase on the basis of allocative and distributive considerations and for tackling some critical aspects of the revenue structure. Revenue growth in the previous 15 years had been the result of a major tax reform in 1973, which had significantly enlarged the number of taxpayers, of the effects of high inflation on nominal tax bases and of several measures taken since the mid 1980s to curb the increasing deficits.

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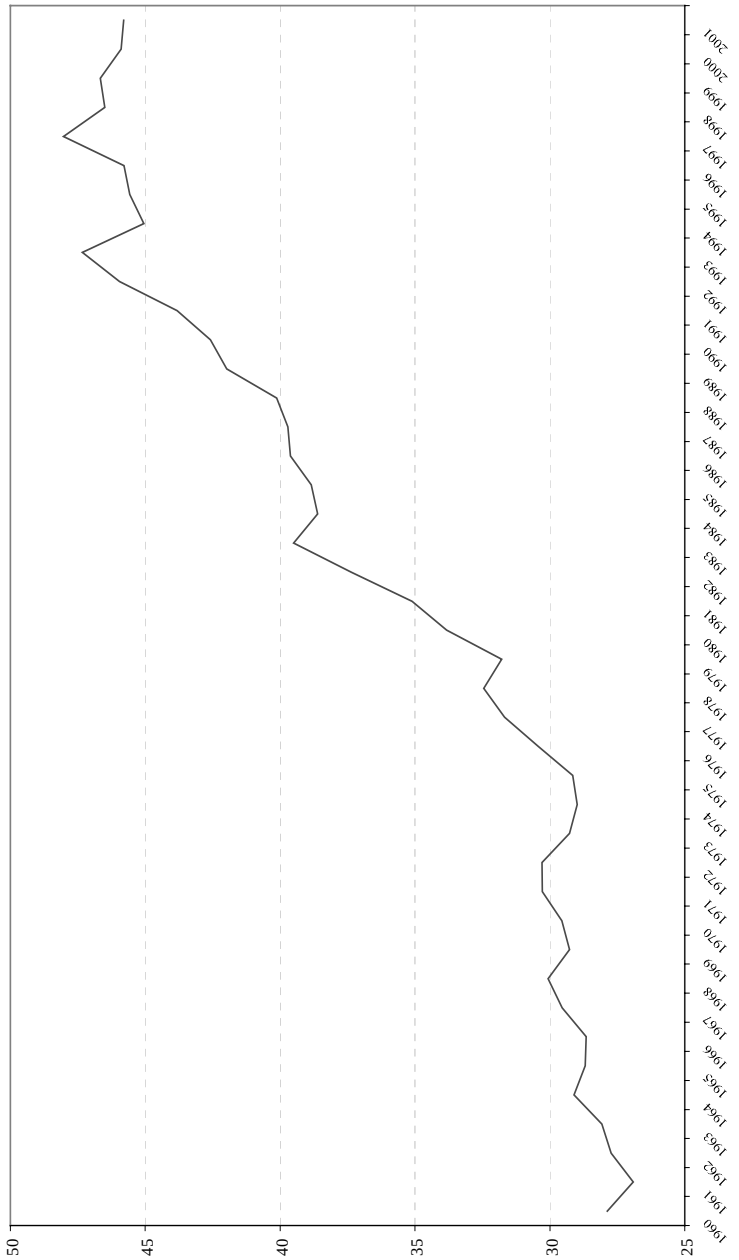
[44] Gronchi (1997).

[45] A review of the evolution of the Italian tax system in an international comparison perspective is in Tanzi (1996). For General Government statistics, see Banca d'Italia, "Public Finance Statistics in the European Union", *Supplements to the Statistical Bulletin – Monetary and Financial Indicators*, various issues.

Chart 13

General Government Revenue
(percent of GDP)



However, over most of the 1990s tax policy remained subordinated to expenditure decisions and overall budgetary constraints. Fiscal packages were introduced, even two or three times a year, to achieve deficit targets.

Only in recent years, has the design of the tax system *per se* again come to the fore. The decline of the tax burden has become a primary policy target. The policy debate has also increasingly shifted to the issue of the structure of public revenues and their effects on the economy.

4.1 The legacy of the 1980s

At the beginning of the 1990s, some problematic aspects of the Italian tax system were quite evident. While the tax burden in GDP terms was not high by European standards, the statutory tax rates were relatively so. Because of tax erosion, avoidance and evasion, the tax burden was concentrated on some groups of taxpayers. This situation largely depended on the structure of the Italian economy, characterised by the small size of enterprises and a vast presence of self-employed workers, and on the inadequacy of the tax-administration to cope with the problems such a structure implied for tax assessment.

A particularly critical point was that of the personal income tax (Irpef).[46] Most of the revenue growth in the late-Seventies and the Eighties came from this tax. Irpef had progressively lost its generality, being unable to assess and tax the overall income of each taxpayer due to increasing erosion, avoidance and evasion. By the beginning of the 1990s, it had already become a tax mostly on dependent labour income. It had needed assiduous amendments to hinder the effects of high inflation via fiscal drag. Heavy reliance on this revenue meant concentration of the tax burden on a specific category of taxpayers.

Another critical area was that of regional and local government finance. The increasing decentralisation of expenditure contrasted with the centralised financing framework. At the end of the 1980s, some limited steps had been taken to increase the municipalities' and provinces' tax autonomy. Regions did not have significant power yet.

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[46] See Gerelli and Valiani (1984).

4.2 Tax policy up to 1997

Up to the late 1990s, the primary concern of tax policy was to increase revenue. Whenever revenue goals were in contrast with allocative or distributive targets, the latter were forfeited.

Between 1990 and 1997, direct taxes grew by 1.8 percentage points of GDP, indirect taxes by 1.7 points and social security contribution by 0.9 points. Capital account taxes, including revenues from one-off measures and tax amnesties, increased by 0.6 points (from 0.1 to 0.7 per cent of GDP); in 1992, they reached 2.0 percentage points.

For personal income tax, the main challenge was to maintain the "social sustainability" of the tax system by limiting the inequity induced by the concentration of the burden on some groups of taxpayers. One way to compensate for the different degrees of evasion possible to the different categories of taxpayers, was by replacing deductions with a very articulate system of tax credits, linked to the different sources of income, the family composition, and other personal characteristics. Equity pursuit shifted from vertical to horizontal.

The priority given to sustaining revenue levels from the personal income tax is also apparent in the choice to suspend in the early 1990s the automatic mechanism for the repayment of nominal fiscal drag introduced at the end of the 1980s.[47]

Measures to limit tax erosion, avoidance and evasion were also implemented. In the late 1980s, an attempt to introduce a minimum tax on autonomous labour and individual firm incomes had failed due to the opposition of the interested categories. In the following years, some procedures to evaluate the adequacy of reported incomes based on predetermined coefficients were introduced with greater success.[48] Such procedures were forerunners of the most recent Sector Studies (Studi di settore), which provided a more sophisticated and articulate set of parameters to estimate ordinary incomes in several economic activities.

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[47] However, it must be acknowledged that the decline of inflation reduced impact of the fiscal drag in terms of equity.

[48] The so-called *coefficienti presuntivi e di congruità*.

Studies to identify sources of erosion in enterprise income were envisaged during the 1990s, as pre-requisites for future reform.[49] Major changes were enacted, however, only in the late 1990s. Meanwhile, revenue needs induced increases in the corporate tax, in contrast with the reductions already taking place in other countries. In 1988, depreciation allowances had already become less generous. In 1991, the local income tax became non-deductible for the purposes of determining taxable corporate income. In 1994, the corporate statutory tax rate was increased. Overall, the statutory tax rate on corporate retained profits was raised from 46.4 per cent to 53.2. In 1992, a special levy on firms' net assets was also introduced (at the rate of 7.5 per thousand). It was meant to be temporary, but was applied until 1997.

Over the same period, transitory incentives were introduced in order to foster investment. In 1991-93, a tax credit on innovative investment was designed for small enterprises. In 1994-95, 50 per cent of the investment spending exceeding the previous 5 years average spending was made deductible from the corporate tax bases.

As to VAT, the harmonisation process in the EU limited the room for manoeuvre at the national level. Only some reallocation of products within the categories taxed at reduced or ordinary rates was possible.[50]

Transitory levies played a relevant role. In 1992, receipts for 1.8 per cent of GDP came from one-off levies on real estate and bank and postal deposits and from a revaluation of companies' assets. Some of these measures were replaced by permanent sources of revenue, like the extraordinary real estate tax that was replaced by a permanent tax on real estate income (ICI) the year after. In 1997 a special "Europe" tax was raised on households and firms. Transitory receipts were also cashed by anticipating revenue from future years.[51]

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[49] Such reform should have aimed at restoring some degree of neutrality in the tax system. Erosion turned out to be mainly ascribable to a very articulate set of incentives, due to a progressive stratification of tax measures over time, the overall effects of which were not always obvious.

[50] The recent acceleration in revenue from VAT mainly reflects the impact of tax incentives granted in determining direct taxes in case of documented building re-structuring. Such incentives favoured the emerging of otherwise evaded transactions on which VAT is paid.

[51] The rules regarding the pre-payment of self-assessed taxes were frequently exploited. Any increase in the tax liability, indeed, gives rise in the second year to an increase of roughly twice the level it would have produced when fully phased in. In the same line, the withholding tax on incomes from financial assets gave a major contribution to the consolidation process, for example, thanks to the high pre-payments on interests from bank deposits imposed since 1995 to the intermediaries acting

(continues)

4.3 Tax policy after 1997

Policy orientations changed in the late 1990s, when the budgetary conditions became less critical. In the period 1998-2001, the revenue to GDP ratio was reduced. With respect to the 1997 peak, direct taxes declined by 1 percentage point of GDP. Capital taxes decreased by 0.6 points, re-gaining their physiological level. Social security contributions declined even more (–2.6 per cent of GDP), as contributions to the National Health Service were replaced, along with other taxes, by a new regional indirect tax (IRAP). Indirect taxes increased by 2.1 percentage points of GDP.

An important reform of the tax system was introduced in 1998.[52] Another major reform is now under way.

The 1998 reform aimed at making the tax system more efficient and neutral. It aimed at reducing tax-induced distortions in capital markets and business activity, lowering statutory rates, increasing fiscal responsibility of local government, particularly regions, and simplifying the tax system. The reform did not envisage immediate effects on the budget balance. The two more relevant features of the reform were the introduction of a dual income tax system (DIT)[53] and IRAP.

DIT envisaged a reduction of the average tax rate on corporate income subject to financing by equity capital. It significantly lowered the fiscal advantage for debt financing.[54] In the years 1999-2000, new

as tax authority substitutes. These high pre-payments generated high tax credits *vis-à-vis* the bank system. Banks were obliged to anticipate revenue based on previous year's levies, even when the tax base was declining due to decreasing interest rates.

[52] The guidelines were approved by Parliament in 1996. Proposals for a possible reform had already been presented in 1994 in Ministero delle Finanze (1994) by the Centre-Right Government taking office that year, but they could not be implemented as the Government fell a few months later. The same indications are now inspiring the incoming tax reform. In 1996, a new proposal was put forward by the "Commissione Gallo" under the following Government, focusing on the fiscal federalism issues. By that time a new regional tax was envisaged, which was re-considered some years later, in 1998, when finally a tax reform was passed by the Centre-Left coalition. On the 1998 tax reform see Guerra (1998), Pedone (1999), Bernardi (2000b), Giannini and Guerra (2000).

[53] See, among others, Giannini (1998).

[54] A reduced tax rate (19 per cent) was applied to the imputed returns to the increase in equity capital. The residual taxable profit was subject to the ordinary rate (37 per cent). Revenue needs suggested that the *Italian DIT*, contrary to the *Scandinavian DIT*, should have limited the reduced tax rate only to the "new equity capital" (invested in the company through new capital subscriptions and retained earnings since 1996). For the same reason, a minimum ceiling to the average rate was set (27 per cent). Such constraints were gradually softened. In 2000, the new equity capital to be taken

(continues)

temporary incentives for investment were also introduced, conditional on equity financing.

IRAP replaced several taxes, such as the local income tax, the net worth tax and the contributions levied on labour income for financing health care. Its tax base includes profits, rents, interest payments and labour costs.

Overall, the introduction of DIT and IRAP increased neutrality in the tax treatment of finance sources. DIT reduced the tax penalisation for new equity against debt financing. IRAP is neutral with respect to different finance solutions, as it applies an identical rate (4.25 per cent) both on profits and on interest payments. The abrogation of health contributions and their substitution with IRAP reduced labour costs. The reform lowered marginal tax rates on labour and capital, although capital was relatively more de-taxed.

Since the contributions were deductible against the personal income tax base, contrary to IRAP, and since self-employed labour incomes were now subject to the new tax, a revision of IRPEF was needed as well.[55]

The 1998 tax reform also revised the taxation of income from financial assets. It confirmed the exclusion of most of saving incomes from the personal income tax base and their taxation via a withholding tax on a proportional rate. The primary aim of the changes was neutrality, which was pursued by broadening the tax base to include capital gains from all financial assets. Intentions to move towards a single rate system (somewhere between the two applying, 12.5 and 27 per cent) were announced, but the actual unification of rates was postponed to avoid revenue losses. Taxation of capital gains was extended to all financial instruments and was based on the maturation criterion. These changes, while increasing revenue levels in a long run perspective, also increase the instability of revenue, in relation to the volatility of the stock market performance.[56]

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as basis for the DIT calculation was increased, by applying a multiplier (1.2 for 2000, 1.4 for 2001). In 2001 the average rate ceiling was removed.

[55] To compensate for the effects of the new tax arrangement, *Irpef* tax brackets were re-designed and tax rates reviewed. Tax credits were even more linked to income levels and family status. Further reductions were enacted only starting in 2000.

[56] A new system of taxation for managed portfolios through approved intermediaries was introduced, which was compulsory for investment funds. A 12.5 tax rate is levied on the total net return from managed portfolios (defined as the difference between the market value at the end and at the

(continues)

In 2001, the new government submitted to Parliament a proposal for a new tax reform.

The proposal envisages a radical change of the structure of Irpef. The tax structure is changed, by applying a basic proportional rate (23 per cent) to the portion of incomes below 100 thousand euros and a second rate (33 per cent) above. More than 95 per cent of the taxpayers would end up inside the first bracket. Progressivity is ensured by deductions. All tax credits are replaced by income deductions, the nature of which has not been specified yet.

As to profit taxation, the proposal envisages a return to the pre-1998 situation by the abolition of DIT and IRAP and the enforcement of a uniform corporate tax rate (33 per cent). The incentives in favour of debt finance are restored. Tax levies are redistributed in directions that are opposite to those induced three years ago.

Taxation of savings is affected by milder changes. The issue of a uniform rate is re-affirmed, levelling it out at the lower end between the two rates applying today (12.5 per cent). The choice of a very low rate obviously reduces the redistributive capacity of the tax system. Finally, the new reform would recede from the application of taxation on matured capital gains to go back to the realisation criterion.

4.4 Local government revenue

Local government revenue accounted for less than 8 per cent of general government revenue until 1990. The introduction in 1993 of a municipal tax on real estate incomes (ICI) increased this share to more than 12 per cent in 1997 and the introduction of IRAP in 1998 made it rise above 19 per cent (Chart 14). While since the mid 1990s central government revenue stabilised, local government revenue kept growing.

Fiscal consolidation years were initially characterised by attempts, although limited in scope, to increase the tax autonomy of the lower levels of government. Emphasis was on obligations to fully cover the costs of services supplied. Some increase in local taxes took place, by transferring

beginning of the period). By doing so, all capital incomes and net gains accruing to the portfolio are included in the tax base and capital gains are taxed according to the maturation rather than realisation criterion. To ensure the same treatment for savings outside investment funds, actually taxed only at the realisation, an equalising system was provided.

minor levies to municipalities and provinces. These measures, however, seemed to contribute to the consolidation process more as a means to justify cuts in the central government transfers to local administrations than to increase tax autonomy per se. In the early 1990s, a substantial revision of the transfer system was enacted. The criteria underlying equalisation moved from expenditure needs to differential endowments in taxable bases. The most important step towards tax autonomy was the above mentioned introduction of ICI in 1993.

At the peak of the fiscal consolidation process, in 1997, the initial push toward an increase in local financial autonomy was somewhat slowed down by the introduction of administrative constraints on local government cash flows. Specific ceilings were set on withdrawals by local administrations from their Treasury accounts.[57] Additional limits were provided for the amounts to be credited on such accounts by central government.[58]

Controls over the Treasury accounts cash flows represented a successful tool to ensure short-term reductions of local public expenditure. Under a longer-run perspective, however, they are inconsistent with tax autonomy and can have adverse effects on efficiency objectives: while financial constraints rely on the scarcity of resources to gain efficiency, financial responsibility implies the possibility to increase available resources through local levies. The ambiguity of the resort to both mechanisms during the fiscal consolidation was not completely overcome in the following years.

The greater boost to local tax autonomy came from the 1998 reform, by the introduction of IRAP. In its early years of implementation, IRAP is earmarked to financing of health expenditure. In perspective, it is going to lose its destination constraint and be available for financing any other category of expenditure.

IRAP is levied and administered at the national level, together with personal income and corporate taxes. Revenue is then attributed to regions. To a certain extent, the attribution takes place according to ad hoc parameters rather than to the revenue actually raised in the region's

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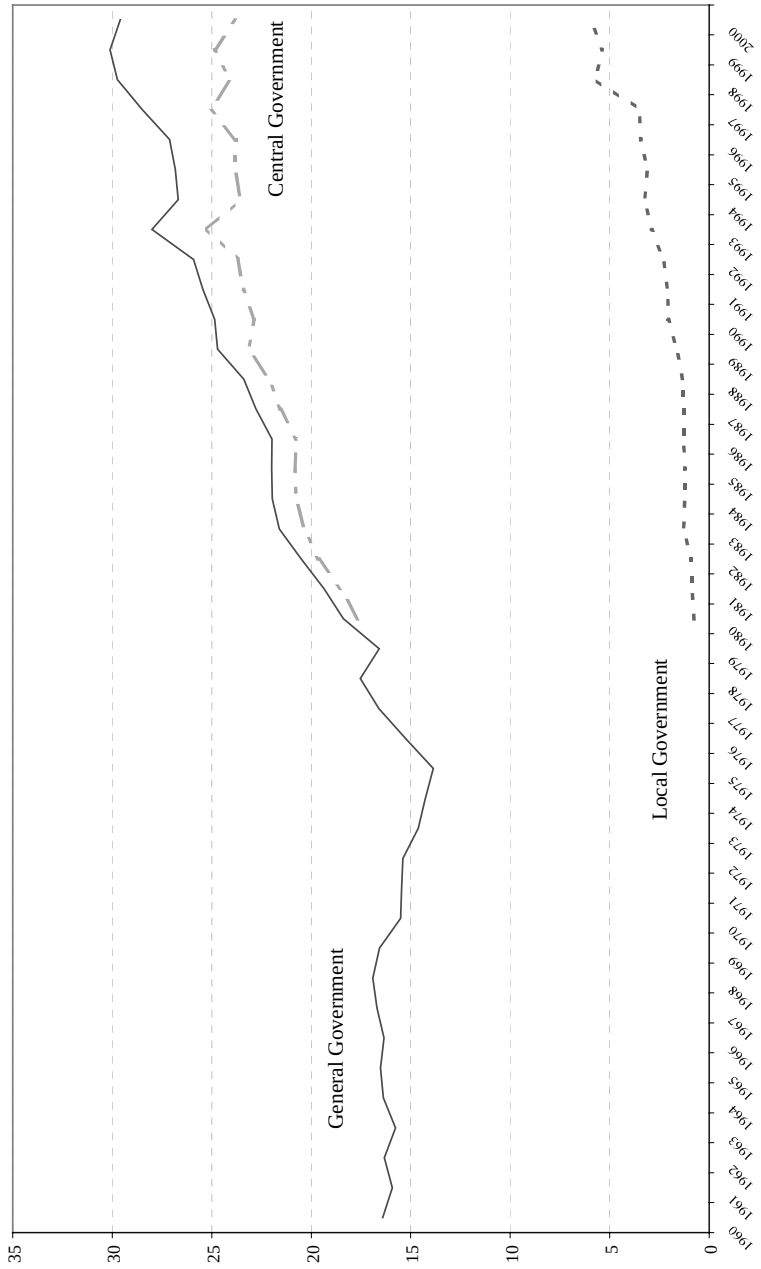
[57] Within 90 per cent of the amount withdrawn in the same period of the previous year.

[58] No credits were allowed as soon as the cash in hand did not exceed 20 per cent of the amount in stock at the beginning of the year.

Chart 14

General, Central and Local Government tax Revenue

(percent of GDP)



territory. IRAP raises problems of equalisation, since business activity is less equalised across regions than, for example, consumption. To tackle this problem, an equalising fund based on VAT-sharing was introduced.[59]

On the other hand, IRAP has the advantage of a broad tax base, allowing high revenues to be raised (above 20 million euro in 2001). Nevertheless, it is very likely that its revenue will be insufficient to finance health spending in the long run, due to a significantly slower dynamics of its tax basis with respect to health expenditure.

4.5 The tax system in perspective

In the 1980s and 1990s, the Italian tax system largely contributed to fiscal consolidation. The dominance of revenue targets forced tax authorities to postpone important reforms that had already proved necessary by the late 1980s.[60]

In the meantime, the increased openness and integration of the European economies, the liberalisation of commodities and capital movements, the resulting increase in tax competition, shifted the attention of policy makers towards efficiency goals, putting equity in second position. The higher elasticity of economic agents' decisions to tax differences made neutrality, i.e. a reduction in tax distortions, a primary goal. Taxation of capital, more mobile than labour, was attracting most of the attention of policy makers.

This process was common to all the industrialised countries.[61] Many countries revised their tax systems, towards more neutrality, lower tax rates, broader bases. Some countries considered models of dual income tax with increasing interest. By such models, income from capital is excluded from the personal income tax basis and taxed proportionally at the first bracket tax rate. Progressivity is confined to labour income, reducing the redistributive scope of taxation. Significantly, the first countries to introduce these schemes were the Scandinavian ones, where equity reasons had justified high progressivity of personal income taxes for a long time.

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[59] On the calibration of the new system of equalising transfers, see Zanardi (1999).

[60] For the debate about problems and perspectives of Italian tax system at the end of the 1980s, see, among others, Gerelli (1986) Pedone (1989), Ceriani, Frasca and Monacelli (1992).

[61] For an overview of problems and perspectives of the tax systems in the industrialised countries see Sartor (1999), Bernardi (2000a), Tanzi (2000).

Justifications for the choice to tax incomes from capital at a lower rate rely on the need to avoid its migration[62] and gain competitiveness.

Corporate taxation was subject to revisions, with the aim of reducing tax disincentives on investment decisions. Tax treatment of non-resident incomes, subject to withholding levies according to international bilateral treaties, was already a major factor in the tax competition. Most industrialised countries ended up by completely de-taxing such revenues.

In Italy, only at the end of the 1990s the tax authorities started to lessen the tax burden (at first on capital income), introduce more neutrality in firms' finance decisions, revise the personal income tax (reducing the number of brackets and the top marginal tax rate) and decentralise revenue. A delayed timing characterised also the de-taxing of non-residents incomes.

Italy has now to catch up with the other countries. Four main issues are to be tackled.

First, the equity issue is still open and possibly worsening. The personal income tax has failed in redistributing resources across citizens. This failure can be exacerbated, in perspective, by the need to further reduce the taxation of capital incomes due to tax competition. Dual income tax systems put a relatively higher burden on income from labour and raise the problem of redesigning public policy in order to compensate for the tax penalisation of labour *vis-à-vis* capital. Unless vertical redistribution is abandoned or severely curtailed, or it is pursued via public spending, it is difficult to envisage ways to design adequately a new personal income tax.

Changes along the lines followed in the last decades do not seem sufficient. Recent policies linked more strictly tax credits to income levels. By doing so, they met again the problems of unrepresentative tax bases. The recent proposals, on the other hand, seem to put less emphasis on redistribution and more on the reduction of the tax burden. The proposals rely on a substantial tax cut, which can make the new regime socially and politically acceptable in the short run. It is less evident whether such acceptance can be maintained in a longer-run perspective, where one-off reductions gained by all taxpayers will presumably be perceived as less relevant than the relative dimensions of tax burdens.

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[62] On the issue of tax competition, see for all OECD (1998).

Second, international economic competition and efficiency reasons suggest the need for a significant reduction in the overall tax burden. This will only be attainable if primary expenditure significantly declines in GDP terms. This result may be rather problematic, especially in view of the possible need to replace some of the redistribution carried out by taxation with redistribution through social expenditure.

Third, the decentralisation of the country raises several critical features. A genuine decisional autonomy requires that a substantial autonomy be granted on the revenue side. Co-ordination between higher financial autonomy and the possible need for budgetary constraints from central government, working through very different incentives, must be though of carefully. The increase in tax autonomy of local administrations can hinder the reduction of tax revenue for the public sector as a whole. Moreover, the dimension and the characteristics of the tax bases to be decentralised are crucial and hard to define. In this framework, the envisaged abolition of IRAP could be very problematic.

Finally, there is a need to limit the resort to frequent tax reforms. Radical fiscal reforms are necessarily costly in terms of adjustment costs and loss of certainty in perspective decisions, like those concerning investment and production. As a rule, global reforms should not be undertaken too often and should give economic agents time to adapt to major changes in the incentives structure underlying the tax regime. On the contrary, in recent years, the Italian tax system has been subject to contrasting, radical changes, mainly reflecting different political views about the role of the public sector.

5. The legacy

Starting with persistently high deficits and growing debt, the consolidation process left Italy with a relatively low imbalance and a debt to GDP ratio set on a downward path. In 1997, the decline of the deficit below the 3 per cent threshold set in the Maastricht Treaty allowed Italy to join Monetary Union. Interest rate spreads clearly signal that the possibility of public debt default is no longer an issue.

However, some aspects of Italian fiscal policy remain problematic. This partly depends on the characteristics of the consolidation process.

The first issue is one of sustainability. There is a need to consolidate the budgetary results of recent years and to offset the effects of ageing on public expenditure and the implications of economic integration on revenues. At the same time, fiscal policy must become more growth compatible. Concern over the effects on growth of a significant reliance on tax increases and capital expenditure cuts has already been voiced, but the issue is more general, being relevant for other budget categories (e.g. expenditure on education and research) and public activities (e.g. regulation in the labour and product markets).

Second, the role of stabilisation policy needs to be reconsidered. In the effort to ensure deficit reduction, little space was left to issues related to fiscal stabilisation. In the context of EMU, these issues have regained relevance. The reforms of the tax and social protection systems currently debated will have an impact in this domain.

Third, consistency between fiscal decentralisation and EMU fiscal rules may require significant institutional engineering. During the adjustment, local governments' outlays were kept under control by introducing quantitative limits to transfers from central governments. The present drive towards federalism makes these instruments no longer viable. The issue of fiscal rules for local governments has come to the fore. More generally, there may be a need for a revision of present budgetary institutions and procedures with a view to improving the quality of policy-making.

5.1 Fiscal sustainability

Fiscal sustainability is a central tenet of EMU: it is a precondition for financial and monetary stability. EMU fiscal rules have been designed with the goal of ensuring that national policies maintain a sound fiscal stance.[63] While the rules have so far proved effective in constraining deficit and debt levels, it is too early to draw definitive conclusions as to their effectiveness in shaping fiscal policy over a long time range. Compliance with EMU rules today says nothing about the possibility of compliance tomorrow. Fiscal discipline can be endangered both by policy changes and by exogenous factors, such as the sizeable demographic changes expected in all Western countries. Continuous policy action may therefore be

[63] Balassone and Franco (2001b).

necessary. The time horizon of politicians may not be long enough to ensure that such action is taken.

The arithmetic of sustainability hinges on four factors: the structural primary budget balance (net of cyclical and temporary components), the cost of public debt, stock-flow adjustments and growth.

The reduction of the debt-to-GDP ratio after 1994 relied on high primary surpluses, a declining interest rate bill and a large privatisation programme that kept the stock flow adjustment broadly neutral. It was hampered by the relatively low growth performance.

Net of cyclical and temporary components the primary surplus in 2001 was in the 4-4.5 per cent range. Challenges to the stability of this level and to the achievement of the balanced budget objective set in the Stability and Growth Pact come from two sources. On the one hand, the ageing process is putting an upward pressure on public sector expenditure such as pensions and health care. On the other hand, the ongoing integration of the Single European Market and the process of globalisation exert a downward pressure on tax rates. It should be noted that, ceteris paribus, a primary surplus lower than the one recorded in 2001 by 1 percentage point of GDP would have halted the decline of the debt to GDP ratio.

Given current interest rates, by the year 2003 the interest bill will have almost completed its declining path: the gap between the average cost of public debt, that is affected by past issues of high yield bonds, and cost of newly issued bonds, that reflect EMU-rates, will have largely been closed. In the future, interest expenditure reductions will mostly come from the reduction in the size of the debt.

Stock-flow adjustments should remain broadly neutral: on the one hand the proceedings of privatisation may be lower than in the past decade; on the other hand hidden liabilities have already been sizeably reduced. However, the difference between cash-based and accrual-based measures of the general government fiscal position increased to unprecedented levels in 2002 and widened further in 2001;[64] should the gap persist in the coming years, it may hamper the reduction of the debt to GDP ratio.

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[64] See Fazio (2001a).

After a decade of unsatisfactory growth performance, concern over the relatively high tax rates and the relatively low level of capital outlays prevailing in Italy has gained a centre stage position in the public debate. The focus is gradually shifting from the arithmetic of sustainability to its microeconomic underpinnings.

5.1.1 The primary balance: the perspectives

The major source of perspective budgetary imbalances is represented by the ageing process. Raising dependency ratios is likely to increase expenditure on pensions, health care and long-term care and thereby gradually worsen the primary balance. Over the last two decades several studies have provided estimates of pension expenditure trends,[65] while only a few studies have taken a broader view of the implications of ageing.[66]

The Treasury[67] projects the spending of the main pension schemes to rise from 14.2 per cent of GDP in 1998 to 15.4 per cent in 2015 and 15.9 per cent in 2030 (Chart 15). As noted in Section 3, these increase are less dramatic than in most other EU countries, but the present size of pension expenditure makes them hardly sustainable.

The ratio of pensions to active workers is projected to rise from 90 per cent in 1998 to 94 per cent in 2015 and 112 per cent in 2031. The ratio of average pension to average earnings is expected to increase from 15.5 per cent in 1998 to 16.3 per cent in 2015 and to decline thereafter to 14.0 per cent. The decline in the replacement ratio may imply pressure for discretionary increases of pension levels. If pensions were to be fully adjusted to real wage dynamics, the expenditure ratio would increase by about 5 points.

The level of social security spending in GDP terms heavily depends on the evolution of the labour market. The key factors are the participation rates of older workers and of women. Official forecasts[68] also consider a forecasting scenario based on favourable employment trends (the so-called

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65 For a survey, see Franco and Marino (2001).

66 Ministero del Tesoro (1997) and Franco and Munzi (1997).

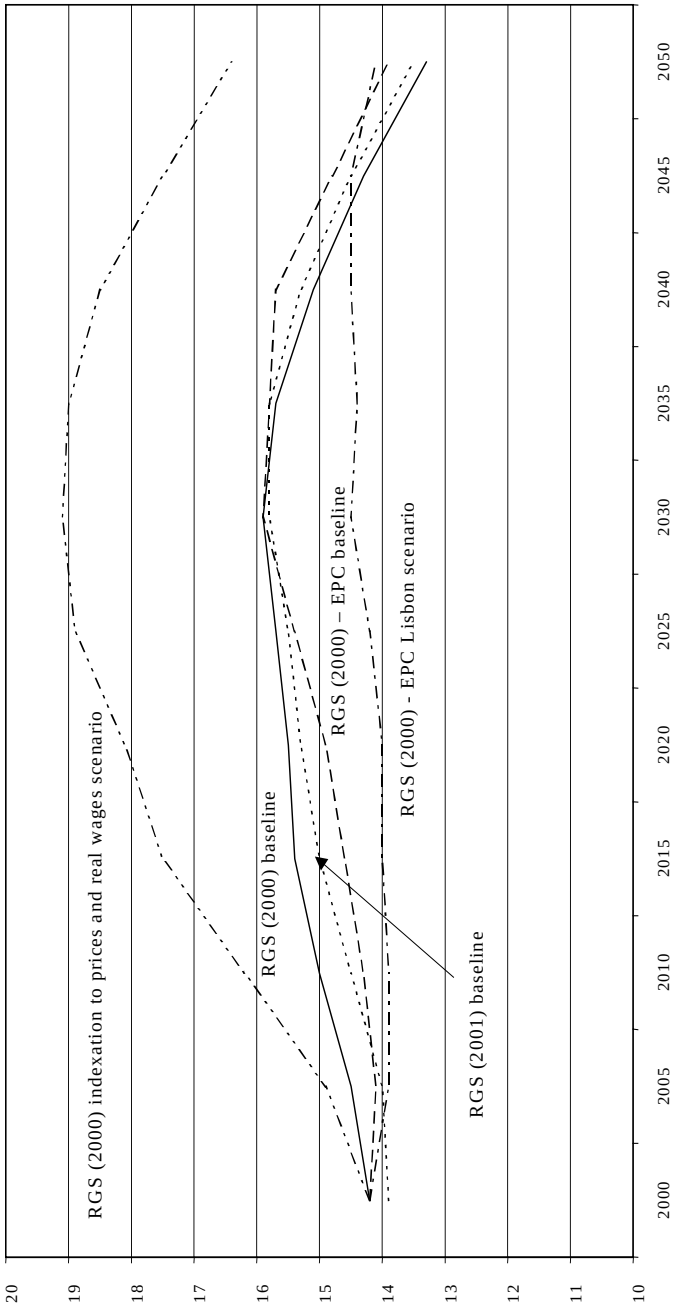
67 Ministero del Tesoro (2000).

68 Ministero del Tesoro (2000).

Chart 15

Forecasts of expenditure by the main pension schemes conducted by the State Accounting Office in 2000 and 2001: alternative scenarios

(percent of GDP)



Lisbon Scenario). In this scenario the ratio of pension expenditure to GDP only marginally increases over the next 30 years.

Relevant expenditure pressures are likely to stem also from other areas. On the basis of mechanical projections of current per capita expenditure levels, increases of health spending and non-pension social benefits of about 2 percentage points of GDP by the year 2030 can be expected.[69] Combining these results with the baseline scenario for official pension expenditure projections,[70] the mechanical effects of demographic changes can be estimated in about 3 per cent of GDP.

This implies that, on the basis of current legislation, the primary surplus is set to decline gradually, but that the pressure of ageing is gradual and apparently manageable. The decline in the debt ratio ensuing from the commitment to balance the budget would provide budgetary room for greater age-related expenditure. Lower interest spending will largely offset greater spending on pensions and health and long-term care.

The two alternative pension expenditure scenarios mentioned above point to the uncertainty concerning long-term expenditure trends, to the risks related to the characteristics of expenditure control and to the opportunity offered by the current low activity rates.

On the revenue side, increased openness and integration of the European economies have increased the risk of tax competition leading to revenue losses.

5.1.2 Fiscal policy and growth: the feasibility of tax cuts

According to part of the economic profession and to most policy makers, international economic competition and efficiency reasons suggest the need for a significant reduction in the overall tax burden. However, significant and durable tax cuts will only be attainable if primary expenditure decreases.

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[69] See Franco and Munzi (1997), who also estimated the possible expenditure savings in the educational sector. OECD (2001) offers projections that indicate a rise in the ratio of health spending to GDP in Europe of around 3 percentage points. For Italy, see the projections in Ministero del Tesoro (1996a, 1996b and 1997).

[70] See Ministero del Tesoro (2000).

The narrowness of the path facing Italian fiscal policy can be appreciated by way of reference to the strategy described in *the Economic and Financial Planning Document* (EFPD) for the years 2002-06 and in the *Update of the Stability Programme* presented in 2001 by the Italian government, where the reduction of the tax burden plays a central role.

According to both documents, Italy would achieve a balanced budget by 2003 and keep it thereafter. Over the planning horizon the tax to GDP ratio would decrease by 4 points. The two targets imply a reduction of the expenditure to GDP ratio by about 5.5 points (the deficit amounted to 1.4 per cent of GDP in 2001). Assuming unchanged interest rates, a contribution of about 1.5 per cent may come from interest outlays (Table 1).

Primary outlays amounted to about 41 per cent of GDP in 2001. Pensions account for about 15 points, health care for about 6 points and capital outlays for about 4. Since the government plans not to reduce any of these outlays, other expenditures, currently amounting to about 16 per cent to GDP would have to be cut by 4 points in order to attain the targets set for the deficit and the tax burden. These outlays mainly concern compensation of employees and acquisition of goods and services; assuming a 3 per cent GDP growth rate in real terms – as set in the EFPD, a reduction by four points in terms of GDP would imply and annual cut by about 3 per cent in real terms.

These figures highlight the crucial role that expenditure control is going to play in the next few years. They also suggest that unless action is taken concerning all expenditure items, the task of reducing the ratio of outlays to GDP may prove problematic.

5.2 Stabilisation policies

The need to allow sufficient margins for budgetary flexibility in bad times is another prominent feature of EMU fiscal framework. It is needed for stabilisation policy, which has become more important in EMU as member states can no longer rely either on a monetary policy tailored to national needs or on exchange rate adjustments.

During the 1980s and the 1990s the countries now members of EMU did not use fiscal policy as a stabilising tool. Indeed, according to the European Commission, fiscal policy often assumed a pro-cyclical stance.

Table 1

Italy's general government budget – A medium-term simulation
(percent of GDP)

	deficit	total revenue	total outlays	interest	primary outlays				
					total	pension	health	capital	other
2001	-1.4	45.8	47.2	6.3	40.9	15	6	4	15.9
2002	-0.5	45.5	46	5.5	40.5	15	6	4	15.5
2003	0	45	45	5	40	15	6	4	15
2004	0	43.4	43.4	4.9	38.5	15	6	4	13.5
2005	0	42.4	42.4	4.9	37.5	15	6	4	12.5
2006	0	41.8	41.8	4.9	36.9	15	6	4	11.9
change over the period:	-1.4	-4.0	-5.4	-1.4	-4.0	-	-	-	-4.0

Table 2

Cyclical sensitivity of EMU member states budgets and its composition

	Bel	Ger	Gre	Spa	Fra	Irl	**Ita**	Lux.	NL	Aus	Por	Fin	Euro	DK	Swe	UK	EU 15
Total	0.56	0.45	0.38	0.40	0.53	0.42	**0.48**	0.33	0.69	0.47	0.50	0.55	0.49	0.67	0.75	0.65	0.53
Revenue	0.49	0.40	0.38	0.35	0.48	0.33	**0.47**	0.30	0.45	0.50	0.42	0.48	0.43	0.56	0.61	0.43	0.44
Expenditure	-0.07	-0.05	0.00	-0.05	-0.05	-0.09	**-0.01**	-0.03	-0.24	0.03	-0.08	-0.07	-0.05	-0.11	-0.14	-0.22	-0.09

Deficits did not fall in periods of high growth, because governments offset the effects of the automatic stabilisers via discretionary tax cuts or expenditure increases. Fiscal relaxation in good times made it necessary to take pro-cyclical action in downturns.[71]

The pro-cyclicality of fiscal policies in EMU member states may to some extent depend on how the fiscal stance is assessed. In the case of Italy, for example, while retaining its basically restrictive impact throughout the decade, the effect of the budget on economic activity was mildly counter-cyclical.[72] Indeed, the largest negative effects were recorded in 1994 and 1995, when GDP growth was relatively high.

However, the issue remains of whether such mild counter-cyclical character would be sufficient in the future, given the new context.

EMU fiscal rules, by demanding that a cyclically adjusted balanced budget is maintained over the cycle, should reduce the pro-cyclical bias that seems to have affected European fiscal policy in the past decades. But EMU rules have not yet been tested in the context of severe recessions or large scale asymmetric shocks and, in any case, it is not clear that the envisaged "automatic pilot" version of fiscal policy – in which stabilisers work freely and a cyclically-adjusted balanced budget is maintained – would provide a sufficient degree of cyclical smoothing, in view of the larger requirements of fiscal stabilisation in EMU.[73]

The issue is whether the size and quality of the automatic stabilisers currently embedded in the budget of the general government is adequate to the new framework.

Italy's budget displays a relatively low sensitivity to the cycle. Recent estimates by the ESCB, which refer to the structure of the budget in 1999, suggest a value close to 0.5, in line with the Euro area average, but significantly below the values prevailing in northern European countries (Table 2).[74]

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71 European Commission (2001), p. 63.

72 Momigliano and Siviero (2002), who confirm the results of earlier studies for the 1970s and 1980s.

73 Brunila, Buti and Franco (2001).

74 See Bouthevillain *et al.* (2001). The relatively low cyclical sensitivity of the Italian budget also shows in the European Commission estimates of the maximum level that the deficit adjusted for the cycle could take without risking to breach the three per cent threshold should a recession take place: the estimate for Italy (1.4 per cent of GDP) is among the highest.

Italy's budget differs from those of other EMU members also with respect to the source of its stabilising capacity: in the case of Italy unemployment related expenditure represents a minor share of the budget (0.4 per cent of GDP) as against an average of 1.3 for the Euro Area and of 1.4 for the EU.

Almost all of the cyclical sensitivity of the budget comes from revenues (99 per cent) as against 88 per cent for the Euro area and 83 for the EU.

Current plans for tax reform should also be assessed also against this background. Making the personal income tax essentially proportional would imply a further reduction of automatic stabilisers. While assessing the appropriate size of automatic stabilisers is not easy, in the case of Italy it would be difficult to argue that the present level is too high.

The composition of Italian stabilisers also highlights the need for improving their quality. It has long been recognised that the composition of social benefits needs to be reassessed. Italy's social expenditure to GDP ratio is not higher than that prevailing in major EMU member states; however, the share of pensions is much higher. A White Book recently released by the Minister for Welfare acknowledges the need for reform.[75]

Given present budgetary constraints, however, the reduction of pension outlays appears to be a pre-requisite for any reform of unemployment related expenditure.

A revision of the scope and structure of unemployment benefits would also have beneficial effects in terms of labour market efficiency as it would be the counterpart to the necessary increase in flexibility.

However, as Italy's economy is markedly dual and suffers from the presence of a large black sector, this strategy is not without risks. On the one hand, benefits may concentrate in the South and be ineffective if the local economy does not pick up; on the other hand, benefits may in fact subsidise the black economy (Table 3).

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[75] See Ministero del Lavoro e delle Politiche Sociali (2001).

Table 3

Italy's main economic indicators – Regional breakdown

	Per capita GDP (1)		Unemploy Rate		Black Economy (2)	
	1995	1999	1995	2000	1995	1999
North	123.82	122.59	6.6	4.7	39.99	37.74
Center	107.95	108.26	10.1	8.3	20.02	20.63
South and Islands	66.42	67.50	20.4	21.0	39.99	41.63
Italy	100.00	100.00	11.6	10.6	100.00	100.00
					14.48 (3)	15.09 (3)

(1) As a percentage of Italy's average.
(2) Irregular labour units.
(3) Irregular labour units as a share of total labour units.

5.3 EMU fiscal rules and fiscal federalism

Although the 1948 Republican Constitution placed great emphasis on the role of the Regions, five of which were granted a high degree of autonomy under special statutes, the 15 ordinary statute regions were actually established only during the 1970s. Up to the 1980s the responsibilities attributed to regions have been relatively limited.

The contribution of local governments to the fiscal adjustment of the 1990s was governed by instruments typical of a centralised institutional set-up. Mandatory limits for transfers from the State to local authorities were introduced in 1996 and 1997. Overall expenditure ceilings for health expenditure – the major item in regional budgets – were fixed annually.

During the same years, however, the decentralisation process gained momentum and culminated in the constitutional reform of 2001 which has substantially extended regional powers.[76]

In this context administrative instruments are no longer viable. The difficulties met by the Italian legislator in finding new means of control and co-ordination are evident in the layout of the 1999 Domestic Stability Pact.[77]

Its name notwithstanding, the Domestic Pact is a law of central government and does not mimic the European Pact. It is essentially a rule setting maximum ceilings to local governments' deficit growth. Moreover, its features hardly make it a binding rule. First, the deficit referred to in the Domestic Pact is not a comprehensive measure as it is computed excluding health, capital and interest outlays. Second, overruns with respect to the ceiling can be compensated in subsequent years; in this respect, it is important to note that amendments to the original law introducing the Domestic Pact have retroactively redefined the budgetary ceilings, allowing higher deficits than would have been possible otherwise.

De facto, the Domestic Pact is gradually moving towards a cooperation based mechanism, centred around institutional *fora* where fiscal targets are discussed and agreed upon. One category of such agreements between the State and the regions concern health outlays: their effectiveness seem to suffer of a lack of incentives on the part of the regions.

Overall the Pact's features seem to be of little help in disciplining local governments.[78]

This issue, while relevant *per* se, assumes new importance because of its interaction with EMU fiscal rules. While compliance with these rules depends on the behaviour of all levels of government, it is the central government that is held accountable at the EU level. This asymmetry

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[76] On fiscal relationships between different government levels in Italy, see Arachi and Zanardi (2000), Buglione (1998), Fausto and Pica (2000) and Messina (2001). On the recent constitutional reform see Balassone, Degni and Salvemini (2001) and Fazio (2001b).

[77] For an analysis of the solutions adopted in other EMU countries, see Balassone, Franco and Zotteri (2002) and the references therein.

[78] For an analysis of the Italian Pact, see Balassone and Franco (2001a); the results obtained are analysed in Balassone, Franco and Zotteri (2001) and in Balassone and Zotteri (2001); for a more optimistic view, see Giarda and Goretti (2001).

increases the need for rules applying to lower government tiers, not only to ensure fiscal discipline, but also to avoid the allocative efficiency losses which would result if central government ends up systematically compensating for the slippages of other government levels.

There is a need for rules or procedures combining decentralisation of fiscal responsibilities with the respect of EMU rules, while avoiding pro-cyclical policies and cuts in capital spending at the local level.

The problem is not restricted to Italy. The solution currently adopted by most EMU member states rely on the strengthening of consensus-based institutions and procedures, with little recourse to formal rules.[79] However, since European rules call for clear accountability and rapid adjustment, in theory the introduction of explicit domestic rules, mimicking the European ones, has marked advantages over purely cooperative mechanisms. The introduction of predefined rules and sanctions may redress the incentive structure facing politicians and induce faster adjustments.[80] It may also increase transparency and allow better control of policy implementation on the part of both the electorate and the market.

Moreover, while cooperation has in most cases proved effective in terms of general government deficit reduction, it may not withstand stress-testing in terms of both economic and institutional developments. For example, cooperative approaches may require protracted negotiations and prevent rapid adjustment of revenue and expenditure to new circumstances. This may especially apply when a large number of governments is involved, to the detriment of the effectiveness of economic policy.

One should consider whether the existing arrangements are adequate to deal with relevant shocks, such as a deep recession. Cooperative approaches similar to those adopted by Italy for the health sector may require protracted negotiations and prevent rapid adjustment of revenue and expenditure to new circumstances, to the detriment of the effectiveness of economic policy. One should also take into account that the process of decentralisation is still on course. If a larger degree of autonomy is introduced in the future, expenditure control may become unfeasible, while it may be advisable to strengthen the role of rules referring to the budget balance.

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[79] Balassone, Franco and Zotteri (2002).

[80] Kopits and Symansky (1998).

Many EMU countries are taking steps towards supplementing cooperation with some rules. Rules can be especially useful in Italy where decentralisation is relatively young and where the number of governments involved is large.[81]

The feasibility of a rules-based approach depends on the adoption of a common accounting and statistical standard. At the European level this was achieved by reference to ESA95. This was also a key element of the cooperatively-defined rules adopted in Austria. Unfortunately, this principle seems to meet greater difficulties in Italy where it is sometimes claimed that the Constitution gives Regions autonomy also with respect to accounting practices. More generally, there is an issue concerning the quality, homogeneity and timeliness of Italian local governments accounting which has so far made it especially difficult to monitor local developments and enforce budgetary discipline.[82]

6. Conclusions

The consolidation of Italian public finances in the 1990s has been highly successful in putting an end to endemic high deficits and preventing the country from sliding into debt default.

The consolidation process, which was started in the mid-Eighties, involved large and continuous fiscal efforts over a long period of time. It required in many occasions the recourse to supplementary budgeting and forced to tackle structural reforms which had been repeatedly postponed. These features reflect the nature of the Italian fiscal imbalance. The large deficits in the middle of the 1980s were not the outcome of an exogenous shock or a temporary fiscal slippage but the result of two decades in which interest expenditure as well as part of primary expenditure were financed by additional borrowing. The very concept of meeting expenditure needs with revenues was lost.[83] Budgetary targets were systematically missed. Rules for local government finance were frequently breached. There was a

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[81] In a longer term perspective, direct democratic procedures at the local level (like a compulsory referendum on the level of deficit allowed) may be an efficient instrument in reducing the issuance of debt. The Swiss and US experiences seem to provide evidence in this respect (Feld and Kirchgassner, 2001; Kiewet and Szakaly, 1996).

[82] For example, the budget deficit referred to for the Domestic Pact is computed according to cash accounting rather than according to accruals accounting as the ESA95 requires.

[83] See Steve (1978), Romani (1980) and Salvati (1984).

persistent incapacity to modify the pension system, which promised unsustainable benefits and gradually crowded out other social benefits. As late as 1990, legislation was introduced to further increase pension expenditure. Overall, the Italian deficit in the middle of the 1980s appears to have been more entrenched than in most European countries.[84]

The need for fiscal consolidation was acknowledged well before the European fiscal rules were set in the Maastricht Treaty. However, the efforts put in place during the second half of the 1980s lacked determination and had limited effects. The consolidation process accelerated in 1992 for domestic reasons, when the debt was increasing fast and there was a clear risk of losing control of public finances. The exchange rate crisis triggered policy actions which were already widely considered necessary. There was a broad consensus on the need to avoid the economic, social and political costs of debt default.

After 1992, EMU fiscal rules and the prospects of joining monetary union played a major role in the consolidation process. They provided an incentive to accelerate the adjustment. They guided the choice of the targets and gave a reward in terms of fast interest rate reduction. Credibility effects were very important. Fiscal consolidation without EMU would have been much more costly. Italy would have needed to attain higher primary surpluses and maintain them constant for a longer period.

While fiscal consolidation has avoided major economic and social shocks, it has not been a panacea for Italian fiscal problems. In some areas of public spending it has reduced waste, but it has also induced governments to neglect allocative, distributive and stabilisation issues.

There is now a need to reconsider the targets, procedures and instruments of fiscal policy.

The EMU framework can provide a safe anchor for Italian fiscal policy also in the coming years. It keeps the debt on a declining trend and allows public finance to meet the ageing of the baby boom generation on sounder positions. It may force the introduction of clear budgetary rules for regional and local governments. The credibility effect stemming from

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[84] The fragmentation of Italian governments may have had a bearing on the outcomes. For a review of the literature on the politico-institutional determinants of budget deficits, see Alesina and Perotti (1995). Balassone and Giordano (2001) and Padovano and Venturi (2001) model the effects of government fragmentation on deficits and find evidence that this played a role in determining Italy's fiscal policy the 1970s and 1980s.

adherence to the EMU fiscal rules and procedures will continue to bring benefits to Italian public finances, in terms of lower and more stable interest rates on government securities.

To fully exploit the benefits of this framework, fiscal soundness, as demanded by EMU fiscal rules, should now be reconciled with policies focusing on the issues of allocation, distribution and stabilisation.

Economic integration requires an efficient use of resources in the public sector, in order to limit the tax burden. It also requires policy action supporting the competitiveness of the economic system, such as greater funding for human and physical capital accumulation. The design of the tax system should also be examined, in order to reduce distortions on the allocation of resources and disincentives to invest and work.

In the distribution domain, traditional solidarity and social protection objectives are to be reconciled with population ageing, expenditure containment and competitiveness objectives. Moreover, new needs, such as those of elderly citizens in long-term care and lone-parent families, are to be faced. Labour market policies, while going in the direction of achieving a comprehensive system of unemployment support, should be designed to increase labour supply, by assisting job search, supporting retraining and delivering strong incentives to work.

As to stabilisation, monetary union may require a larger role for automatic stabilisers in case of asymmetric shocks. A shift of social spending from pension to welfare and unemployment benefits may compensate for the reduction in the size of automatic stabilisers determined by a less progressive structure of the personal income tax.

There is also a need to improve the statistical information available during the year at all levels of governments. This would make decentralisation compatible with national fiscal targeting and increase transparency in budgetary procedures. There may also be a need to reconsider the timing and features of budgetary policy in a context in which targets are increasingly set in the framework of European fiscal rules.

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COMMENTS ON SECTION IV: FISCAL POLICY ISSUES IN ECONOMIC AREAS AND COUNTRIES

Riccardo Faini[*]

The extremely insightful papers included in this session span a broad set of highly topical issues. For the sake of both concision and effectiveness, this discussion will be organized around a limited number of selected themes.

1. The role of fiscal rules

The issue is addressed in both the Robinson and the Lindh and Ohlsson papers. While many of the related issues had already been dealt with in the previous Bank of Italy conference, there some new aspects to the discussion.

The choice between a golden rule versus a balanced budget rule

Robinson's paper makes a strong plea in favour of the former, on the ground mainly of intergenerational equity and of the embedded bias against public investment in the budgetary process, particularly during a period of fiscal stringency. This may well be true, but a number of additional factors should be considered:

1. The definition of public investment is still largely arbitrary. Hence, excluding such item from the budgetary target would greatly increase the temptation to resort to creative public sector finance.
2. It cannot be excluded that the shift to a golden rule set-up may, somewhat perversely, induce an increase in current rather in capital spending. This may sound paradoxical, but is not so, when we recall that capital spending is difficult to expand, particularly in the short to medium run, and that most countries in Europe run a surplus on their current budget. With the golden rule set-up, however, the current

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budget would only need to balance. The new budgetary framework therefore would either lead to a boost in current spending or, at best, to a cut in taxes with little visible impact on public investment.

3. Last but not least, there is little evidence that those countries that have resorted to a golden rule framework for fiscal policy have been better able to protect public investment against unwarranted cuts. In the UK, for instance, public investment still accounts for one of the lowest, if not the lowest, proportion of GDP among OECD countries.

On balance, therefore, I remain quite sceptical about the wisdom of shifting from a balanced budget to the so-called golden rule. At the very least, the golden rule should be combined with a debt sustainability rule – as it is indeed done in the UK – to ensure that low productivity deficit financed public investment does not lead to an unsustainable debt accumulation. Equally crucially, the shift toward the golden rule should only be implemented if rigorous and transparent public investment evaluation procedures are in place.

The role of fiscal rules in a currency union

1. Fiscal rules in a currency union are typically designed with a view to preventing opportunistic behaviour by high debt countries who otherwise may impose negative externalities on other members. In particular, the pursuit of unsustainable fiscal policies by high debt countries may force more virtuous members to bear the cost of a fiscal bail out.
2. However, suppose bails out are ruled out. There is indeed no evidence, on current policies, of unsustainable debt dynamics in any EU country. Then, opposite to the existing wisdom, high debt countries would benefit relatively more from broad based fiscal discipline across the union as a whole, to the extent that fiscal rectitude is associated with lower interest rates. This key factor was explicitly acknowledged in Italy's 2001 Stability Program.

The inherent weaknesses in fiscal rules

First, fiscal rules can always be changed, albeit at some credibility costs. Second, and perhaps more crucially, existing fiscal rules are typically unsuited to prevent a long run deterioration in the fiscal position

of the public sector due a significant change in long run entitlements. For instance, for an assessment of a pension reform to be sufficiently reliable, projections would need to be made over a at least a 50 year horizon. Unfortunately, this is rarely required by existing budgetary procedures. In Italy, for instance, pension reforms must be assessed over a 10 year period, a clearly inadequately short period to evaluate the impact of this kind of reforms.

2. Measuring fiscal adjustment

Balassone, Franco, Momigliano and Monacelli provide an insightful account of Italy's fiscal consolidation during the Nineties. The authors acknowledge that the size of the fiscal adjustment was indeed remarkable, with the general government net borrowing falling from around 12 percent of GDP in 1990 to close to 1.5 per cent in 2000. However, their argument goes, this "adjustment relied on significant tax increases, capital spending reductions and the rationing of transfers to local governments". Reductions in current spending were conspicuously absent. According to this view, the Italian economy still suffers from this biased pattern of adjustment, stifled by high taxes and inadequate public infrastructures. This interpretation is not without merits, but should be complemented by at least two observations:

1) First, the choice of the relevant period matters. It is true that from 1989 to 2001 current primary spending in Italy declined from 37.9 per cent to 37.6 per cent of GDP, a somewhat less than remarkable achievement. However, if we take 1993 as the starting point of our analysis (a well advised choice, I believe, given that 1993 marks the first determined attempt to address Italy's fiscal imbalances) we find that current primary spending fell substantially from 40.3 per cent to 37.6 percent of GDP, thereby providing a significant contribution to the fiscal consolidation effort. Moreover, much of the decline in current primary spending came from the downsizing of the public employment wage bill. Alesina and Perotti would certainly include such a pattern among the episodes of virtuous fiscal retrenchment.
2) Second, the counterfactual also matters. A simple comparison of say fiscal spending after and before the adjustment can be highly misleading. Suppose for instance that public spending is on an unsustainable trend, because of large and rapidly rising pension entitlements. Suppose now that the government takes effective

measures to stop first and then modestly reverse such trend. The data would only show a limited fall in the level of pension spending. Should we then conclude that restrictions in current spending did not play a role in the process of fiscal consolidation? The answer should obviously be no. In the case of Italy, in particular, the dramatic fall in pension wealth attendant on the 1993 reform was instrumental in prompting an unprecedented decline in consumers spending. Interestingly enough, the next consolidation episode four years later in 1997 had a significantly more muted effect on household behaviour, presumably because it was interpreted as signalling the end of increasing fiscal austerity once Italy had joined the European monetary union. To conclude, it cannot be overlooked that in the absence of the two pension reforms in 1992 and in 1997, pension spending would be substantially higher today, by more than 5 percentage points of GDP.

To sum up, it is difficult to accept the view that Italy's fiscal consolidation during the Nineties was achieved by a combination of rising taxes and falling interest payments, with primary spending contributing modestly to fiscal adjustment. This view neglects the fact that substantive measures were designed to curb an otherwise explosive path of public spending. While such measures do not show up in a standard before-after comparison they did however have a profound impact on the economy and should be included in any reliable measures of the fiscal effort.

3. The tools of stabilization policy

The Lindh and Ohlsson paper focuses on the key question of how the framework for fiscal policy should be adapted following the participation into a currency union. The paper covers a lot of ground. In trying to be selective, two questions spring to mind. First, is it true that a strengthening of fiscal stabilizers is called for after a country has lost its ability to run an independent monetary policy? At first blush, the answer may seem yes, until however we recall that such a strengthening of fiscal stabilizers would require an increase in the progressivity of the tax system and an expansion in the generosity of unemployment benefits. It is doubtful whether there is much appetite in Sweden and elsewhere for such kind of reforms, despite their well intentioned objective of enhancing the counter cyclical role of fiscal policy. Second, should the role of discretionary fiscal policy be strengthened? Again, there are many reasons for scepticism. First, payroll and income taxes are not particularly effective as an

anti-cyclical tool. Second, while temporary changes in consumption and/or corporate taxes are potentially more effective, they face a number of severe hurdles, namely the need to predict with sufficient accuracy the turning points of the cycle. Mistakes here can be very costly as highlighted by the premature withdrawal of the fiscal stimulus in Japan in 1997.

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COMMENTS ON SESSION IV: FISCAL POLICY ISSUES IN ECONOMIC AREAS AND COUNTRIES

Ulrik Nodgaard [*]

1. Introduction

The interesting papers presented in this session all discuss important aspects of fiscal policy based on specific country experiences. In my view the papers raises three main themes: Fiscal policy and stabilisation policy, fiscal sustainability and the structural aspects of fiscal policy.

2. Fiscal policy and stabilisation

As expressed by Nakao the experience of the Japanese economy suggests that the ability of fiscal policy to affect economic activity even in the short term is not as strong as the textbook IS-LM model would suggests. The Danish experience also suggests that fiscal policy might not always work as keynesian theory tells us. From 1982-1986 a massive fiscal tightening took place in Denmark. However, the tightening led to a significant boom in private consumption and investment.

The Japanese and Danish experience is clear evidence that when fiscal contractions/expansions affects the overall credibility of fiscal policy, non-Keynesian effects can be quite strong.

Lindh and Ohlsson raise the important question of how national fiscal policy should be conducted in an currency union. The authors suggest that one should choose in advance an instrument that (i) has minimal distributional effects and (ii) does not have large effects on economic efficiency. Based on the Danish experience the second point is a bit surprising. Indeed, some of the most significant structural reforms has been passed through parliament as measures that should reduce aggregate demand and hence reduce the risk of overheating (and not as structural measures). The deductibility of the interest expenses has been reduced

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dramatically, green taxes have been introduced and compulsory savings schemes, that raises national savings, has been enacted.

3. Fiscal sustainability

The public debt has increased and is still increasing dramatically in Japan. Hence, fiscal policy in Japan is not sustainable measured by conventional measures. However, Nakao argues that the low interest rates suggest that the market expect that the Japanese economy will return to a more sustainable path soon. However, it should be stressed that a low interest only indicates the absence of any significant default risk and does not necessarily imply that fiscal policy is expected to become sustainable soon.

In sharp contrast to the Japanese experience, the public debt in the US and Australia has been reduced dramatically. In Australia this has according to Robinson meant that further debt reduction no longer appears a policy objective.

However, as pointed out by Gokhdale, a complete elimination of public debt can give rise to some problems related to the functioning of the capital markets. These problems can potentially be alleviated by allowing public agencies to hold private financial assets. Gokdale is skeptical of such an arrangement as there can be a potential deadweight loss from having public agencies having large holdings of private assets. *In principle*, there is clearly a danger of such losses. However, I doubt whether *in practice* these deadweight losses constitute an important problem. At least the experience of Nordic countries such as Norway, Sweden and Finland suggests that it is possible to have large public funds that perform quite well. In Denmark we have the supplementary, public pensions scheme ATP, that was started back in 1964. The fund currently has assets amounting to 25 percent of GDP and hence owns a significant share of many large Danish firms. The board consists of persons from trade unions and employers organisations together with independent experts and government officials. In order to avoid deadweight losses the board is obliged by law to seek the highest possible return (taking into account risk, of course). The fund has performed very well in terms of return on the portfolio. According to Herbertsson, Orszag and Orszag (2000) “there has been little evidence of political interference with asset management decisions”. Furthermore, the administrative costs are very small and far smaller than in private pension schemes. Indeed, the ATP is so efficient that it provides adminstrative services to private occupational schemes.

4. Structural aspects of the fiscal policy

As expressed nicely by Balassone *et al.* it is important after decade of fiscal consolidation to shift focus towards the microeconomics of fiscal sustainability.

Robinson argues that there is a conflict between fiscal consolidation and raising the productive capacity of the economy. In Australia and other countries, politicians, eager to improve public finances, has cut back on public investment that is crucial to long-run growth. This is surprising, given that economic theory tells us that public investments does not affect long-run sustainability provided that the return on the investment is equal the market return.

There clearly is a danger of public investments is being squeezed too much. However, a significant share of public investments cannot pass a cost-benefit analysis. For instance, in Denmark many investments in infrastructure projects are a result of intensive regional lobbying and do not reflect cost-benefits considerations. Hence, we should be cautious about saying that public investment does not affect fiscal sustainability.

One way of raising the growth potential without affecting fiscal sustainability is to do revenue-neutral tax-reforms. Balassone *et al.* give a very informative description of the reforms of the Italian tax system in recent years. Their analysis suggests that the reforms have so far not reduced the distortionary effects significantly. The Danish experience suggests a more mixed conclusion. Several reforms have been enacted in the last 15 years. The reforms have been very successful in making the taxation of capital income far less distortionary. However, in terms of reducing the marginal tax rates on labour income the reforms has been far less successful, see Ministry of Economic Affairs (2002). This is partly due to the rise in local income taxes. However, it also reflects that the base-broadening reforms have meant that many persons have shifted to higher tax-brackets.

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