

COMMENTS ON SESSION 3: FISCAL SUSTAINABILITY

Jean-Luc Schneider^{*}

The papers in this session pointed towards two directions. Some of them focus on theoretical issues, such as the economic relevance of different fiscal sustainability concepts, others are more technically oriented, trying to define or refine adequate indicators of long term sustainability. Coming from a non-specialist, my comments will not try to challenge the theses developed in those papers, but rather to offer the view of an outsider about the characteristics that an indicator of fiscal sustainability must feature in order to make it useful for policy advising purposes. Some of these characteristics already exist in several of the indicators that have been presented, but other characteristics are still missing in most.

Fiscal sustainability issues have gathered a renewed interest in the recent period. This in turn provoked a flourishing of papers and indicators aimed at conveying adequate information in a synthetic way. But the adequacy of a given indicator can only be assessed against its intended use. Broadly speaking, fiscal sustainability concerns emerge in two different contexts.

First at national level, budget managers want to be warned well in advance about possible long term problems and the threat of crises. This requires two things from a good indicator: the focus should be put on the rather long term (such as in the indicators discussed in the paper by Gokhale and Smetters); and the focus should be on budgetary relevant accounting perimeters. The second point involves that the design of national institutions affects the definition of good indicators. To be useful, an indicator must be shaped according to the frontiers of the central government or of specific social programs or agencies.

But fiscal sustainability indicators are also used for a second purpose, namely multilateral surveillance, which involves rather different requisites. Here, the rationale is that fiscal position in the long term may exhibit negative externalities for other countries. In its benign form, this is going to happen through trade: necessary fiscal tightening will dampen demand addressed to other countries. But less benign spillovers may also materialize through default and a crisis spreading to financially integrated partners, or through monetization of public debt. Here what is expected from a good indicator is macroeconomic relevance and some comparability across countries. This means that good indicators are to be defined at the consolidated government level, and also that reasonable compromises and simplifications are needed to obtain common definitions and accurate multilateral surveillance.

^{*} Ministère de l'Economie, des Finances et de l'Industrie, France.

The views expressed in the paper are strictly personal and do not reflect those of the French Ministry of Finance.

Because of differences in their purposes, it is not surprising that different kinds of indicators emerge. However, beyond this cause, there are other more methodological reasons for an embarrassment of riches that is well described by the Belgian paper. There are various definitions of sustainability on the market, and many possible choices of indicators for each. The focus may be put on liabilities or on expenditures, on net or gross position, or on the financing gap, at different horizons. Even once the accounting unit has been set, the perimeter to be considered is a matter of appreciation. Should the liabilities be computed on an accrued or forthcoming basis, on open or close ended basis? Should implicit or contingent liabilities be included? How to choose the valuation method? and the discount rate?

All papers insist on how sensitive the results are to such assumptions. The contributions by the Banca d'Italia, the IMF and the ECB also emphasize the importance of the underlying macroeconomic scenarios. Economic growth and demographic changes are key determinants of the denominators in most indicators. But other macro variables, such as developments in relative prices and exchange rates, are probably of likewise importance, although much less discussed in the papers.

The abundance of indicators and their sensitivity to somewhat arbitrary assumptions make everyone well aware of their limitation and of the uncertainty attached to their use. But, because of the leeway in their construction, and in spite of their diversity, some common biases are to be expected from the available indicators. Because the concept of fiscal sustainability is seldom used without any strategic agenda, there may be a tendency to oversimplify and to get down to one single figure supposed to capture the harshness of the fiscal trends. Another bias, which ministries of finance or central banks may not be above of, is to favour dramatic presentations in order to catch the attention of the public or of policy-makers deemed too prone to spending. This is often done by focusing on long term debt ratios, more impressive than financing gaps.

But there is a drawback to using such dramatic indicators to catch a concept as soft as fiscal sustainability. The theoretical question the indicators are trying to answer is not necessarily the most relevant to policy-makers. This question is: can the current set of policies go on forever? And the answer is almost always: no, it cannot. And to prove that, some indicator is exhibited that is going to explode over the long time.

It is rather too easy for a minister to shrug off such presentation. First, policies change anyway, much more often than the horizon of any fiscal sustainability indicator. Second, beyond and sometimes unrelated to policies, crises happen and history teaches that crises are not much alike. Third, what matters in crises is how the markets react, and their reaction is certainly not proportional to any specific indicator or set thereof, as the ECB paper well demonstrates. That makes it too easy to discard indicators as mostly irrelevant to everyday policymaking, although their content in information is usually acknowledged.

How to reconcile this long-term information content with the need to convey some sense of urgency? Let me offer a personal tentative definition of sustainability.

A decision maker would recognize as unsustainable, and take actions to correct a situation that meets both of the following conditions:

- (i) its continuation would lead to some exploding imbalances;
- (ii) fixing it tomorrow would be significantly more costly than fixing it today.

Condition (i) is the usual one and whether it is met is well assessed by most available indicators. Let us call it the explosion condition. Condition (ii) means that decisions should not be delayed. Let us call it the urgency condition. To assess whether it is met, it is necessary to know what is meant by “significantly more costly”. The proper approach is to check whether the cost of fixing the situation, conditional to not having it fixed before, is increasing at a rate that is higher than the decision-maker’s discount rate. If so, the situation can rightly be called unsustainable, in the sense that the policy maker should prefer not to delay its resolution.

Most of this session has been devoted to refining assessments of whether the explosion condition is met. However, further works on it may soon enter a zone of decreasing returns. After all, it is difficult to imagine that a certain sustainability problem is worrying, but not captured by relatively basic indicators.

On the other hand, while such approach is mentioned in the CPB paper and in Prof Gokhale’s paper, very little has been done so far on the urgency condition, which is yet probably most important to convince that action has to be taken. Let me briefly suggest a possible way forward in two steps.

The first step would be to make the costs of reforms explicit. Adjusting for a situation that threatens to explode in the long term usually involves a mix of increased contributions and reduced expenditures. (Increasing economic growth may also be an option, but there is no need to expand on that, since it should be pursued for its own sake). Increasing taxes or reducing expenditures must not be seen as costly in itself, at least from a macroeconomic point of view. After all, it is equivalent to increasing the price and reducing the quantity of publicly provided services. The economic consequence of such a change is not necessarily more dramatic than, say, those of an increase in housing prices and a corresponding reduction in the size of homes afforded by the households.

The cost of reforming the public finance must be searched elsewhere. In my view, it is twofold. First, some costs are related to the ex-post inefficiency of decisions which were supposed to be optimal at their time, and turn out to be less so after the reform. Those sunk costs materialize at the time of the reform. It is not necessary to do long term projections to calculate them.

A second category of costs is related to the fact that reforming an unsustainable situation may involve a slowdown in the economy. Typically, increasing taxes will increase distortions and reduce potential output (at least if this is not simply viewed as a change in relative prices). This second kind of costs must

be assessed over the long term. Macroeconomic models provide reasonably reliable estimates of such costs.

So the first step of an urgency assessment would be to compute both kinds of costs associated with a given reform, and to add them up, that is to compute the total expected present value of the cost of reforming the system today.

The second step would be to do the same for a reform of the system that would be delayed till tomorrow, and to compare it with the cost of today's reform. More precisely, suppose we have agreed on a given relevant long term indicator of sustainability, S , which is going to explode if no reform is implemented, that is which is going to reach some non plausible level S^* at some date T .

Reforming today means to change the parameters of the economy, the tax ratio, the benefits level, etc, so that indicator S is no longer projected at S^* , but rather at a much lower and presumably sustainable level S° at date T . This reform would have a total cost C_0 (in present expected value computed today). Reforming tomorrow would mean not adjusting any parameter till date 1, and then adjusting the parameters of the economy so that indicator S reaches the same sustainable level S° at the same date T . This reform would have a total cost C_1 (in present expected value computed today).

It is then easy to compare the cost of reforming tomorrow with the cost of reforming today, both scenarios leading to the same adjusted level S° at the same date T . If C_1 is higher than C_0 , it means that, in today's present value, it is better to reform now. Note that the reverse may well happen too: for example, if growth is expected to strengthen in the short term, or if the discount rate between today and tomorrow is high, delaying the reform may be optimal.

A question that may be asked is whether the urgency indicator, $U = C_1 - C_0$, does or does not depend upon the choice of the long term sustainability indicator S . My guess would be that it does not depend much on S . It is not difficult to identify what is likely to play the central part in the urgency indicator. On the short term cost side, this is the interest accrual on the initial net liabilities, plus the new flow of net obligations between today and tomorrow. On the longer term, the spontaneous change in the marginal tax rates provides a proxy for the change in the marginal cost of raising taxes. And the full calculation of the cost indicators is not very difficult, probably no more than computing long term sustainability indicators.