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Comment on Anne Brunila, "Structural Reforms and Fiscal Sustainability"

1 Fiscal Sustainability Is not Just Related to Ageing

In practical politics of modern industrial societies, sustainability of public finance is associated with the pressing need to reform pension and health care systems, both related to the *ageing of populations*. As Anne Brunila has stated in her presentation, the prominence of the ageing debate derives from the dynamic development of pension expenditures as well as from the fact that the savings potential in other areas of public spending (such as education or unemployment benefits) is relatively small.

Beyond the narrow focus on ageing, fiscal sustainability and its relation to economic reform requires a much broader view. It is closely related to the virtues of "fiscal responsibility", the "quality" of public finance and eventually to the people's trust in government.

Of course, the issue of ageing itself is a broadly-based concept which in many countries constitutes an im-

portant element of ongoing reform efforts. The dynamics of ageing depend on a number of parameters (such as demographic developments, life expectancy and employment rates) which can, with reasonable degree of certainty, be projected far into the future (Economic Policy Committee, 2003). It is less obvious how the effects of, say, administrative reform or innovations in the health care system impact on long-term fiscal sustainability.

During this conference, we have had discussions on various aspects of structural reform, the umbrella covering all the topics being the *Lisbon strategy*. Disregarding the feasibility of the aspiration to develop the EU in time to the most dynamic and competitive region in the world, this goal is currently pursued by European governments, and it rests, among other factors, also on the sustainability of public finance.

The major focus of the current session is to search for the *optimal structural reform* package which helps achieve the given (intermediate) goal of fiscal sustainability. Since this requires a number of preparatory steps, such as a concrete definition of "sustainability" and a theory concerning the impact of structural reform on sustainability, practical politics is often just concerned with the *impact of a given reform agenda on sustainability*. In this more eclectic version, a number of policy measures are put in place and the effects are eagerly watched with the desire that at some time the one or the other instrument may hit the goal. The difference between the two approaches may not seem decisive, as in both cases the causality direction runs from structural reforms to sustainability. The outcome, however, can be quite different and need not be efficient in the latter case.

From Anne Brunila's presentation we know that it is not just structural deficiencies but a number of driving forces that could endanger fiscal sustainability, in particular:

(i) the underlying pressure to increase public expenditures which is not only due to population ageing and the related increase in the old-age dependency ratio, but generally to the daily demands from various interest groups,

(ii) a growing resistance of the population to further increases in the tax burden, and

(iii) the tendency towards lower potential GDP growth, partly induced by ageing which is seen to cause labour supply and productivity to decline.

Fiscal sustainability is not a terminal policy goal, but contributes to long-term economic growth. By losing fiscal sustainability, a country would be stripped of its credibility as a debtor, its citizens would revamp their expectations concerning the future tax burden, and economic policies would have to devote much effort to regain the previous growth potential. In this vein, Henriksson (2003) stated at last year's Conference that "sound public finances are a prerequisite for growth". It is thus not only the influence of structural reforms on fiscal sustainability that

is of interest, but also the reverse impact of sustainability on growth as well as the feedback from growth on the size of public expenditures and on the tax burden. These interdependencies are chiefly of the reinforcing type: Sustainability furthers growth which later on improves sustainability. Therefore, structural reforms that limit public expenditures and simultaneously foster growth would be most desirable.

2 "Fiscal" Sustainability Usually Means "Debt" Sustainability

Although "fiscal sustainability" has become a catchword in economic policy, it lacks a universally accepted definition. Anne Brunila uses an operational definition in the context of EU requirements: Sustainability prevails if the Maastricht reference value for the general government gross debt of 60% of GDP is maintained in the short and in the long run without raising the overall tax burden (i.e. the tax ratio as a percentage of GDP). Put in a broader international setting, sustainability could be understood to "maintain a constant ratio of public debt to GDP, in the context of low inflation and market-determined interest rates" (Offerdal, 1996).

Apart from the concrete definition, sustainability is a relative concept. As mentioned by Levy (2003), the US budget deficit is approaching 4% of GDP which is comparable to the budget deficits in a number of European countries (including France and Germany). However, US total federal spending amounts to less than 20% of GDP and total spending of federal, state and local governments is approximately 35% of GDP. In the average European nation, general government spending is as high as 47.5% of GDP. To broaden the coverage of the sustainability concept, the IMF and the World Bank, in their financial institutions approach, have suggested "Guidelines for Public Debt Management". It is argued that solvency *indicators* should be used to examine debt sustainability. Actual indicators used include tax revenue over debt service and interest payment over total revenue.

More general sustainability indicators are used in the Finnish Stability Programme 2002 which include expenditures over GDP, pension expenditures over GDP and the elderly dependency ratio (people over 65 relative to population of working age, i.e. 15 to 64 years). The EU's Economic Policy Committee (EPC) and its Working Group on Ageing (AWG) employ indicators that are even more general, including the budget balance and gross debt position, long-run risk factors to the government financial position, and other public policy concerns such as intergenerational fairness. To improve the assessment of sustainability, the AWG suggested (i) to improve transparency, (ii) to undertake sensitivity analyses, (iii) to improve the link between quantitative and qualitative indicators, and (iv) to improve the interpretation of results concerning high-debt countries.

Many definitions of "fiscal sustainability" are incarnations of the standard debt sustainability approach which means that the fiscal stance must permit repayment of the stock of debt. If this is not secured, policies must be designed to increase future primary surpluses of the general government budget (Perry, 1997).

3 The Growth-Enhancing Role of the Public Sector

Given the public's resistance in most countries to further increases in the tax burden, the possible remedies mentioned by Anne Brunila against the loss of sustainability are confined to two areas, first containing expenditure pressures (by implementing, e.g., general expenditure controls, pension reforms, or public sector reforms to improve efficiency), and

second furthering potential growth, in particular through structural reforms to increase labour supply and productivity. Structural reforms comprise the abolition of impediments to market behaviour, changes in the institutional framework to permit markets to work (deregulation), and re-regulation to reduce administrative and legal impediments.

Anne Brunila rightly cautioned on the effects of structural reforms on sustainability because of the uncertain magnitudes and the uncertain distribution of costs and benefits of reforms across the economy and over time. The empirical evidence on the effects of reforms which are designed to raise productivity and the long-run growth potential via more efficient allocation of resources, increased labour utilisation, and stronger incentives for innovation, is rather mixed.

Let us consider in somewhat more detail the role of the public sector concerning the growth and productivity potential of an industrial economy. There are three major channels for the public sector to influence the overall economy, and they are briefly considered one by one below:

(i) the constitutional environment of a society, including the law traditions, religions and institutions,
(ii) the size, structure and efficiency of the public sector, and
(iii) the impact of public sector activities on the private sector.

3.1 The Constitutional Environment Can Only Be Adjusted in the Long Run

The first channel is particularly relevant for inter-country comparisons in a world-wide context. A number of empirical studies come up with the result that "institutions" are relevant for development (e.g. Persson, 2004). La Porta et al. (1999) report from their regression analyses that governments tend to perform inferior in countries which are poor, close to the equator, ethnically and linguistically heterogeneous, use French law, and have a high proportion of Catholics or Muslims. A country's law tradition also seems important for the degree of government intervention. Civil law (as prevailing in many continental European countries) was used as a power instrument of the state, though to a lesser extent than under socialist (i.e. communist) law. English common law cares much more for the private rights of individuals (property rights) and attempts to restrain government. However, even if a given constitutional environment would be considered harmful to growth, major changes would most

likely meet with resistance and could therefore be implemented only in the long run.

3.2 Uncertain Effects of the Size of Government

As to the second channel, it is undisputed in the theoretical and empirical literature that an increasing efficiency of government exerts a positive impact on growth, directly by releasing resources for better uses elsewhere in the economy or indirectly by strengthening the trust in government.[1] This includes efforts to improve the effectiveness of public spending. Joumard et al. (2004) stress the importance of fiscal rules (tax, expenditure, budget balance or debt ceilings), extending the planning horizons, reducing budget fragmentation (into extra-budgetary funds and contingent liabilities) and focussing on public spending outcomes. Medium-term budget projections have already been introduced in many countries. In the EU, the "stability programmes" for members of the euro area and "convergence programmes" for other Member States serve that purpose.

Since a society's decision on the functions to be carried out by government not only bears on economic rationale, but also on political and historical grounds, the optimal size of government is not easy to determine by just relying on economic theory or empirical investigation. In economic terms, a larger size may be due to the larger scope of government duties or to inefficiencies which tend to hinder private activities and innovation. Empirical estimates concerning the relationship between government size and efficiency are conflicting. According to Afonso et al. (2003), countries with small public sectors report significantly higher government efficiency, indicating diminishing marginal returns on public spending. This is in contrast to the results reported by La Porta et al. (1999) who found that larger governments are able to provide more and better public services. It seems undisputed, however, that a larger size of government deters people from working hard: Because of a current or expected future high tax burden, people are driven off from work into leisure, and this has important negative implications for the financing of the government budget (Prescott, 2004).

3.3 Public Spending and Regulation Are Decisive for Economic Growth

The third channel is probably the most important one and covers the effects of public spending (in areas such as physical infrastructure, education, R&D, and health), of taxation and of regulation on private sector productivity. Because of the various sub-channels, the results of theoretical analyses of the effects of public sector activities remain ambiguous. Empirical investigations are also not conclusive, even not in

[1] *Afonso et al. (2003) employ a Free Disposable Hull analysis to measure the input and output efficiency of public spending or the relative "wastefulness" of government expenditures across countries. As a result, the USA, Japan and Luxembourg turn out to be the most efficient countries in the sample, followed by Australia, Ireland and Switzerland. Most of the EU countries lie well inside the production possibility frontier, implying that much less input would be necessary to achieve the same result as up to now.*

well-defined areas of public spending such as infrastructure, education and R&D. With regard to public infrastructure, there is evidence of positive effects, but also of decreasing marginal returns. The quantity and quality of education raises the productivity level in the long run, but there is no clear understanding of how public expenditures can improve productivity growth and, above all, there is little evidence for the presence of externalities in schooling (Hanushek, 2002). With regard to public sector expenditures on R&D, externalities seem to prevail, but it is by no means clear whether government assistance is complementary to private R&D or just substitutes for it (David et al., 2000).

With regard to *taxation*, most empirical studies support the notion that higher direct taxes, because of their distorting effects on the decisions of private agents, reduce growth more than higher indirect taxes (OECD, 2003).

Regulations are government-imposed limitations on the behaviour of individual firms. They range from the competition regime to setting standards and enacting social, health and environmental regulations, to mention just a few of them. Since the end of the 1970s there has been a tendency to cut back regulation in an attempt to revive market forces. However, it is also generally accepted that market processes to function properly need a certain level of regulation. With regard to the impact of regulations on private sector productivity, the most important areas are product market regulation (including the liberalisation of network industries), privatisation, environmental regulation and labour market regulation. Environmental regulations have gained in importance, while in other areas the degree of regulation has generally been reduced. Labour market regulations, which are regarded a pillar of the "European welfare state", have long been a battleground for the lobbying of interest groups.

The overall long-term impact of economic reforms on growth is mostly positive if reforms are comprehensive in scope and as long as they are carried out with the determination to be successful. Politics should engage in reform projects early on and not wait until internal or external crises trigger off reforms anyway.

4 Pension Reform in Finland and in Austria

Anne Brunila has covered the impact of structural reform on sustainability rather comprehensively in her statement, and she has added experience from the *Finnish pension reform* of 2002. It comprised a reduction in the annual indexation, an increase in the effective retirement age and adjustments of the benefits. As a result, the increase in public expenditures on pensions (currently at some 11½ percent of GDP) is seen to be limited to just above 14% by 2050 which is 2 percentage points less than in a baseline scenario without reform.

In *Austria*, public sector expenditures on pensions amount to 14½ percent of GDP in 2004, the largest share of all EU-25 countries. Pension reform has come in various stages; the last one, decided in mid-2003, comes into force during 2004 and will reach its full effect only after 25 years. It phases out early retirement schemes and includes a

stepwise increase in the statutory retirement age to 65 years. The accounting period for the pension basis will gradually be extended from currently 15 to 40 years by the year 2028. Still pending is the introduction of harmonised pension accounts for all citizens under 35 years, and the introduction of individual pension accounts which are supposed to provide additional financial incentives for postponing retiring.

However important these pension reforms are, in each of the two countries[2] they purchase less than a decade in terms of fiscal sustainability. Therefore, it can be guessed that further measures will be required soon.

5 Summary

The concept of fiscal sustainability usually encompasses debt sustainability which means that the fiscal stance must permit repayment of the stock of debt. One of the most important threats to sustainability is the ageing population in industrial countries and its effect on pension and health expenditures as well as on the tendency to reduce the growth potential. When remedies are discussed, these threats have to be addressed by containing expenditures and the tax burden, and by designing growth-enhancing structural reforms that take interdependencies into account. Structural reforms should address all aspects of public sector involvement, in particular the legal setting, the efficiency of government and the impact of government on private sector productivity. Given the uncertainties concerning the overall impact of public sector activities, reform strategies must be well-designed to secure their positive effects on fiscal sustainability and thereby on growth. Eclectic measures are likely to result in ambiguous, and therefore partly undesirable, effects. Pension reforms enable countries to "purchase time" without removing all threats to sustainability, and should therefore be complemented by growth-enhancing structural reforms. ❧

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[2] *Other countries have also embarked on pension reforms, among them Belgium (1996/97), France (2003), Germany (1997, 2003), Hungary (1998, 2001), Poland (1999), and Sweden (1993, 1999). For more details see, e.g., Disney (2003).*

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