Solutions for Developed Economies

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Debt limitation is necessary

Over the past decades, the government debt ratio of Organization for Economic Cooperation and Development (OECD) countries has registered a dramatic increase. Amounting to some 35 percent at the start of the 1970s, it has risen to the present figure of about 70 percent and by the turn of the century, according to an OECD scenario, is likely to level off at between 70 percent and 75 percent.[1]

The negative effects of a high level of government debt are now generally acknowledged. The extensive borrowing of past years has enlarged the share of interest payments in government spending, thus restricting the scope for future fiscal policy action. There is very little prospect of being able to initiate economic recovery by way of expansive fiscal policy. High deficits and rising debt ratios may trigger crowding out induced by interest rates or expectations with an adverse effect on private real capital formation, so that the future national product available for distribution could turn out to be smaller.[2]

The resulting burdens on future generations are seen as so disturbing mainly because the emerging demographic trends in conjunction with contribution-funded or tax-funded social security systems will lead in most industrial countries to the creation of a substantial "quasi-government debt" in the form of an invisible financial gap, if the claims now acquired on the basis of current arrangements are not covered by future receipts.[3] Consequently, either benefits will have to be cut or charges increased. These are measures similar to those used to reduce genuine government debt. Demonstrating the dimensions of the problem, a study carried out by Prognos AG in March 1995[4] estimates that social security contribution rates in Germany, currently 40 percent of the relevant part of income, would have to rise to about 50 percent by the year 2040.[5] What is more, in accordance with this scenario, the subsidies by central government to the pension insurance funds as provided for in the German system would increase from the current figure of DM 59 billion to about DM 440 billion in the year 2030.

In view of this, no additional burdens should be shifted to coming generations. This requirement alone prohibits any further increase in government debt as it now stands. The vicious circle of rising deficits, debts, and interest payments must be broken in order to regain scope for fiscal policy action. Reducing government debt means that capital can be released for private investment—the key factor behind sustained economic growth.

The prospects for a successful consolidation are now better than ever. The argument that consolidation leads to less growth and more unemployment has lost force in view of the situation described above. It is outweighed by the medium-term benefits of deficit reduction—stabilizing confidence in fiscal policy and creating room for interest rate cuts as well as a general improvement in aggregate overall economic conditions.

Of course, a policy of consolidation is, as remarked by Karl Schiller, a well-known former finance minister respected both inside and outside his own party, "a pretty fragile thing" in a democratic system. It can be successful only if it is pursued on a medium- to long-term basis and if the government demonstrates steadfastness, staying power, and the will to resist special interests. This requires political stability and persuasiveness in order to win support from the citizens. In Germany before the elections to the Federal

Parliament, we explained the need for budgetary consolidation to the voters, who are traditionally aware of the need for stability and allergic to high budget deficits. The 1995 draft federal budget and the financial plan through 1998 contained a clear consolidation objective. This course was confirmed by the reelection of the government.

The special case of Germany: the rise in debt since 1989

Germany's situation can supply valuable information for identifying ways of reducing deficits and debt.

Economically speaking, German unification may be termed an exogenous shock. It came at a time when the budget consolidation pursued during the 1980s was showing benefits.

From 1983 to 1989, the annual rise in spending in public authority budgets at 2.5 percent for central and 3.2 percent for general government was held well below the nominal GDP growth of 5.1 percent. In this way, the government spending ratio was brought down from roughly 50 percent to about 46 percent. The general government deficit of 3.3 percent of GDP was transformed into a surplus of 0.1 percent of GDP. The success of consolidation created scope for a three-stage tax reform that was initiated in 1986, and by 1990, had provided net tax relief of some DM 50 billion. As a result, the tax ratio declined to 23.6 percent in 1990—the lowest it had been for almost 30 years. Between 1982 and 1989, GDP increased by an average of 2.5 percent a year in real terms. Three million new jobs were created between 1983 and 1991.

Subsequently, German unification required a fiscal policy that led to substantial debts deriving from the inefficiency of the centrally planned GDR economy that can rightly be termed "inherited liabilities." These debts alone amount to some DM 350 billion and thus represent more than 10 percentage points of the German GDP.

Debts of some DM 66 billion that were budgeted in the public sector in the course of privatizing German railways in 1994 and the debts of the “German Unity Fund” (GUF) of some DM 95 billion are also to be regarded as special factors. The GUF was set up to ensure that the public authority budgets in the new Länder had adequate financial resources at their disposal in the period from 1990 to 1994, when the new Länder were not fully integrated in the federal financial equalization system that evens out differences in the financial strength of the Länder.

Additionally, public authority budgets made available a total of about 5 percent of west German GDP each year as transfer for the reconstruction of the east German economy. It is evident that such amounts cannot be financed solely by restructuring expenditure and raising taxes and that recourse to borrowing was also necessary. The federal government contributed more than DM 500 billion in expenditure over the five past years. Approximately a third of federal spending on unification was financed from revenue from the new Länder. A further 15 percent was met through tax measures. About three quarters of the federal government’s remaining net burden was financed by savings, cuts of subsidies, and reallocation of funds, the rest being covered by borrowing.

The enormous capital transfers are bearing fruit. Last year’s east German GDP was a good one-third higher than in 1991 when calculated in constant prices, and just under two-thirds higher when calculated in prevailing prices. (Due to the special price systems which were used in the planned economy of the former GDR, constant prices don’t completely reflect the development of value added.) This year, real GDP will again increase by about 9 percent. This puts the new Länder among the fastest-growing regions of Europe. If the present pace of investment can be maintained, they will succeed in bringing their capital stock up to western levels within ten years, according to a simulation calculation made by the OECD.

The transfer payments encouraged a unification-induced upsurge in demand in 1990 and 1991, which for some time enabled Germany to escape the recessive trends in the global economy. The turn of 1992 to 1993, however, finally brought a sharp drop in economic activity. The agreed response in Germany was to let the automatic stabilizers take effect and thus to accept a deficit increase of some DM 30 billion in 1993.

All in all, we have seen a marked increase in government debt since 1990 which is attributable primarily to German unification. Within a six-year period, Germany's government debt has more than doubled. While it was still well below DM 1 trillion in 1989, it may be expected to exceed DM 2 trillion by the end of 1995. The rise is, of course, less acute in relation to the GDP, but here too the trend is very clear. The general government debt ratio will increase to about 58 percent in the current year; in contrast, it stood at around 41.6 percent in 1989. This appreciably restricts the scope for fiscal policy action, particularly in the federal budget. In 1989, only 11 percent of central government spending was tied to interest payments, whereas this share will increase to just under 18.5 percent in the current year.[6] For general government (excluding social insurance funds), the share of interest payments in aggregate expenditure rose in the same period from 8.7 percent to 11.4 percent.

Implications for consolidation

Against this background, it is obvious that capital market developments are of major importance for public authority budgets. Given a debt stock of over DM 2 trillion, a permanent increase of only one percentage point in the interest level will restrict the scope for fiscal policy action by some DM 20 billion. In this context, growing significance attaches to the evident fact that the management of public authority budgets can itself influence borrowing terms.[7]

In view of this, it is especially gratifying to see that it was relatively easy to finance Germany's capital requirement over the past few years. Against a background of falling interest rates abroad, Germany's capital market rates declined as of late 1990 in a process lasting almost forty months to a historic low of 5.4 percent. They rose again in the wake of U.S. interest rate movements, but from January 1994 to April 1995 remained intermittently up to two-thirds of a percentage point below the U.S. level.[8]

Germany's net external assets showed a steady increase up to the end of the 1980s. This trend was interrupted by unification. Part of the enormous financing requirement for the reconstruction of eastern Germany was also met by drawing on savings abroad. This is a temporary situation which is now returning to normal. Germany has a high aggregate savings ratio of something like 20 percent of GDP and continues a net creditor nation: at about $200 billion in U.S. dollars, our net external assets are among the highest in the world.

This flow of capital came about because Germany obviously offered attractive investment opportunities. The past few years have seen a marked rise in demand for German government bonds on the part of foreign investors. The share of German government securities held by foreign investors rose accordingly from 22 percent in 1989 to 34 percent in 1993.[9]

This brings us to a decisive point in connection with government debt: investors have evidently recognized the special features of Germany's government debt increase and expect to see Germany make a successful return to the consolidation course adopted in the 1980s.

This confidence can be sustained in the long term only if a convincing and dependable consolidation strategy is proposed and maintained, above all in difficult periods. Otherwise, foreign investors could call for a risk premium for investment in Germany, thus pushing up interest rates and increasing the threat of interest-linked crowding out.

Expectation-linked crowding out is, in addition, a constant attendant of high government debt. We in Germany were also aware of this danger. In a poll conducted in the autumn of 1993 by the Association of German Chambers of Industry and Commerce (DIHT),[10] the enterprises designated as risk for their investment decisions for 1994 that consolidation was not making progress, that government debt was continuing to rise, and that plans for tax reduction had been deferred. In a situation such as this, it is highly probable that the rise in government debt is connected with expectation-linked crowding out in the private sector, which would render any anticyclical policy ineffective. This means that the deficits additionally incurred would not consolidate themselves by way of multiplier effects. We would then be left with more debt without having achieved the envisaged growth.

Against a background of high government debt, influencing expectations becomes exceptionally important. There is no alternative to a policy of consolidation with medium-term orientation. Consolidation should be geared to the structural deficit, which is progressively reduced. This implies on the one hand that cyclical additions to the deficit are accepted by allowing the automatic stabilizers to work; on the other hand, deficit reductions resulting from increased revenue when the economy is booming should not be permitted to lead to a slackening of consolidation efforts.

The following conclusions may be drawn from this.

> (1) Consolidation must remain at the forefront of attention even during recessions, if only because all experience shows that public spending cuts are very difficult to implement when economic recovery has generated a renewed upturn in revenue.[11]
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> (2) Consolidation must be geared to the medium or longer term so that fiscal policy remains dependable for those engaged in economic activity. We have seen that political decisionmakers can achieve significant structural improvements in fiscal policy in modern democracies, but also that it is difficult to preserve the benefits of consolidation for any length of time. As the positive outcome of consolidation becomes increasingly apparent, attention tends to focus once again on sociopolitical objectives and other accumulated needs.[12]

An OECD study[13] based on international comparisons regards the following elements as decisive for the credibility of consolidation strategies:

- Global targets for the reduction of deficit, debt, and expenditure ratios or for the rates at which nominal figures are to change. Incorporating targets in a statutory framework may help to ensure that they are achieved.
- Sustained political endorsement: multi-year financial plans may serve to anchor the strategy within the general policy concept.
- Cautious statements on the expected development of the economy.
- Selective expenditure cuts based on the evaluation of efficiency and effectiveness.
- Transparency both in the budget proper and in budgetary procedure.

The German approach to medium-term consolidation

On the basis of such considerations, Germany embarked in 1993 on a strategy of consolidation secured in the medium term by the Federal Consolidation Program (FCP) and the Savings, Consolidation, and Growth Program (SCGP).

Against widespread opposition, expenditure cuts were made under the FCP that affected central, regional, and local government and totaled over DM 10 billion. This involved, among others, measures to counter the misappropriation of unemployment and other wage-related benefits, staff cuts in the federal administration, savings on defense spending, and cuts in subsidies.

The FCP, intended first and foremost to deal with the settlement of inherited liabilities and to provide a permanent arrangement for the financial resources available to the new Länder, came up against a problem inherent in all federal systems. As the Länder were not prepared to finance these arrangements by making corresponding cuts in expenditure, the federal government was forced to assume the main burden. A central element is the solidarity surcharge of 7.5 percent on income and corporation taxes, payable as of 1995. This will generate revenue of some DM 26 billion in the current year. The federal government had originally made provision for a surcharge of only 3.5 percent, assuming that the Länder would be prepared to make an adequate contribution to the consolidation arrangements.

Attention was focused on the expenditure side in the SCGP, which was the largest consolidation package in the history of the Federal Republic of Germany. The bulk of savings related to spending in the labor market, achieved in particular by adjusting unemployment and other wage-related benefits and by measures to counter the misappropriation of benefits in general. Child benefits and upbringing allowances were tailored so as to go to those who really need them, while the rise in personnel spending was limited in particular by an increase in civil service pay that was only just above zero.

These measures have already afforded relief of some 1 percent of GDP on the expenditure side of the public authority budgets.

The continuation: a symmetrical fiscal policy

As already mentioned, the adopted course has strengthened confidence in Germany's fiscal policy in the international markets. Despite the extra burdens imposed by unification and the 1992-93 recession, Germany (beside Luxembourg) has met as early as 1994 the criteria laid down for budgetary discipline in the Maastricht Treaty, which in terms of fiscal policy confer the entitlement to entry into the European economic union.

But this notable achievement is not enough. As a result of the unprecedented national and international fiscal policy tasks, the government spending ratio, the tax ratio, and the ratio of taxes and social contributions have now reached a level that is unacceptable in the long term. We shall continue with our medium-term consolidation in the shape of a symmetrical fiscal policy, whose central element is the reduction of the government spending ratio and the tax and social security ratios.

The reduction of the government spending ratio from its present level of about 50.5 percent to the pre-unification figure of some 46 percent by the year 2000 is the central aim of the government's fiscal policy.

This is an ambitious but attainable goal. It means that we must hold resolutely and unreservedly to the adopted consolidation course at all levels of government. Any resulting scope for fiscal policy action must be used in both: to bring down deficits and to reduce the tax burden.

Scenario for the limitation and control of government spending

We have set up a medium-term scenario for attaining this objective. The envisaged reduction in the government spending ratio can be achieved if the rise in goverment spending can be held permanently well below the increase in the nominal GDP.

The GDP trend put forward here is based on the federal government's current forecast of aggregate economic development made in early May of this year, which extends to the year 1999. The projected nominal GDP trend of some 5.5 percent a year is rolled forward for the year 2000.

On this basis, it will be possible to reduce the government spending ratio to about 46 percent as early as 1999 and further to about 45.5 percent in 2000 if the average annual increase in government spending from 1996 to 2000 is held a good two percentage points below the average annual growth of nominal GDP. With nominal GDP projected to grow by some 5.5 percent a year, annual expenditure growth in the public sector will have to be limited to 3 percent to achieve this result.

Deviations from the assumed economic data are, of course, possible. The financial consequences are evident. Even the triggering of the automatic stabilizers in periods of flagging economic activity will lead to a perceptible rise in public spending. The 2 percent gap must be maintained on average over the period under review so as not to jeopardize the targeted government spending ratio.

If the 2 percent gap between GDP and spending growth were to be exceeded or undercut, the reduction of the government spending ratio would accordingly be achieved more quickly or more slowly. Even relatively small deviations from targeted spending or expected growth of GDP have a substantial effect on the development of the government spending ratio.

- If GDP growth is unchanged and the average annual growth rate of government spending from 1996 to 2000 is 2.5 percent instead of 3 percent, it will be possible to reduce the spending ratio to a good 44 percent by the year 2000.
- If GDP growth is unchanged and the average annual growth rate of government spending is 3.5 percent rather than 3 percent, the government spending ratio in 2000 will still amount to some 46.5 percent.
- If average GDP growth is only about one-half of a percentage point below the projected figure, given 3 percent expenditure growth, the result will be a government spending ratio of 46.5 percent in the year 2000.

The potential reduction of the government spending ratio by four to five percentage points by the year 2000 as set out in the model calculation would create substantial scope for fiscal policy action to cut taxes and effect a lasting reduction of the deficit. However, factors need to be taken into account that diminish this scope for action from the outset. For instance, tax cuts amounting to some DM 27 billion (including abolition of the coal subsidy added to electricity and gas prices) have already been agreed to take effect as of 1996, so that the share of tax revenue in GDP will decrease as early as in the following year. Taking account of developments such as this, the remaining scope for fiscal policy action may be put at roughly 3 percent of GDP.

In keeping with the symmetrical fiscal policy, we intend to use this scope in the coming years to achieve a progressive reduction both in the government deficit and in the tax ratio.

– Deficit ratio 2000: reduction by 1.5 percent to 1 percent of GDP

On the basis of current data, the government deficit in the national accounts definition which is put at some 2.5 percent of GDP for 1995 could decline to around 1 percent of GDP in the year 2000, provided that the economic situation remains in balance. This would provide an adequate safety margin to the deficit target laid down in the Maastricht Treaty (3 percent of GDP) while appreciably reducing the debt ratio. A government deficit of 1 percent would also be in line with the recommendations of the Economic Advisory Council at the Federal Ministry of Finance and the Council of Experts for the Assessment of Aggregate Economic Trends.

– Tax ratio 2000: reduction by 1.5 percent of GDP

The other half of the scope for action gained by limiting expenditure, also amounting to about one and one-half percentage points, is to be used to afford further tax relief in order to lend additional impetus to growth and employment. Priority tasks will be to dismantle the solidarity surcharge and reduce direct taxes on labor input and capital. In addition, we intend to continue with the provision of tax relief for families.

Common thrust of consolidation efforts at international level

The consolidation objectives outlined above are backed up by the Maastricht Treaty, which lays down a deficit ratio of 3 percent of GDP and a debt ratio of 60 percent as criteria for budgetary stability. These supranational targets exercise a disciplinary effect on European Union (EU) member states, some of which have also adopted additional objectives. In Denmark, for instance, the growth rate of government consumption is held below real GDP growth, while in the United Kingdom, as in the United States, budget balance has been set up as a target.

The principal instruments used to achieve consolidation at the international level are global expenditure ceilings, spending cuts, personnel reduction, privatization, contracting-out, and modern management techniques.

The way to consolidating government finance

How can Germany achieve in practice the benchmark figures given here? The only way is strict expenditure discipline at all levels of government. Clearly stated, this means that the restriction of expenditure growth to a yearly average of 3 percent as required by the scenario will imply in real terms a virtually constant level of government spending.

The federal government has already made allowance for its contribution to the concept in the 1996 draft budget and the planning extending beyond that year. The current financial plan to 1999 even makes provision for average medium-term expenditure growth of less than 1.5 percent.

The budget moratorium must be consistently adhered to if the expenditure growth rate is to be kept low. Unavoidable extra spending must be offset by savings elsewhere. All expenditure categories must in addition be reviewed in order to render the use of funds more efficient and to prevent “pulling effects.” Structural elements such as income ceilings for specific transfers that curb the tendency of spending to rise must be retained and extended. While subsidies in general are now on a declining trend, it is still important for them to be controlled and reduced. We must press ahead with our efforts to slim down the federal administration and pursue the privatization policy laid down by the federal government.

But in a federal system such as that in Germany, it is not enough for the central government to adopt the necessary measures. The other levels of government making decisions on public spending, principally the Länder and the communes, must follow the example set by the federal government and exercise the same degree of stringent expenditure discipline. Only then is the government spending target a feasible one. The Financial Planning Council, a body intended in Germany to coordinate the policies of central, regional, and local government, has agreed to a 3 percent limit on expenditure growth. This body, however, cannot make binding decisions. Länder and communes must continue with their own consolidation efforts and keep to the agreed 3 percent expenditure limit. To do so, they will have to make use of the full scope for potential savings. This comprises the following.

Staff cuts. Overstaffing is still widespread, particularly in the new Länder and their communes, and must be reduced without delay. The need to reduce personnel is also evident from the rise in pension payments that can be expected in the long term. This will impose a major burden in particular on the budgets of the Länder, in which personnel costs constitute a high proportion of spending. In this context there is also a need to take effective measures to counter the trend toward early retirement.

Privatization. This must continue at regional and communal levels as well. In view of the progress already made at the federal level, Länder and communes now have the greater privatization potential, which should now be exploited more intensively than hitherto. Even in those areas where tasks cannot be transferred completely to the private sector, appreciable savings can be made by contracting out, as the measures taken in Sweden, the United Kingdom, and the United States demonstrate.

Public facilities. There is further scope for savings in lowering standards in building and equipping public facilities such as schools, kindergartens, and roads. Compliance with standards laid down when funds were freely forthcoming is no longer warranted in view of the financial constraints to which many Länder and communes are now subjected.

The scenario is completed by including social insurance. The social insurance institutions are responsible in the projected scenario for holding contributions stable and, wherever possible, for reducing them.

The 1993 Health Structure Law and the 1992 Pension Reform Law were important steps on the road to improving the financial basis of the statutory pensions and health insurance funds without endangering the underlying system. We must continue on this course.

> Efforts must be made in the statutory pensions insurance to improve the ratio of pensioners to contributors. In this connection, measures are needed to counter the trend toward early retirement.
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> Priority must be given in the statutory health insurance to measures increasing general cost awareness. More competition and more market-oriented regulatory elements can help to make the health care system more efficient and more adaptable and thus reduce costs without detracting from the quality of medical care.

Outlook: the correct relationship between market and government

In the scenario that I have outlined here, we are endeavoring to proceed in accordance with the conclusion reached in the first part of this article: we need a dependable, medium-term consolidation perspective. But it is also evident that consolidation is a process that must be reviewed year for year and rolled forward without a break beyond the year 2000 if we are to identify an effective solution to the generation problems described at the outset.

Viewed in this light, consolidation is a task going beyond mere figures. We are called upon to find answers to the question of what tasks the state can and should assume in the future in a market-oriented system. According to Musgrave, points of departure for fiscal policy intervention are to be found in the areas of allocation, distribution, and stabilization. In view of the high level of government debt, one may safely say that the third area is unlikely to play a central part for some time to come. All the more attention should therefore be given to reviewing public sector activity in the areas of allocation and distribution.

There is, for example, much to be done in the field of subsidies. Here, subject to allocative considerations, the time-limited nature of subsidies must be stressed. Permanent subsidies heighten the risk of lasting structural problems. In this context, recourse to the area of distribution is indicated. Looking at the aims of distribution policy, it is evident that this area could have a great potential for savings, in that all measures ultimately serve personal redistribution, to which regional, sectoral, and functional redistribution are subordinated. In the selection of instruments, therefore, as in other respects, personal distribution should be at the center of all distributive policy. This implies converting to direct transfers all subsidies motivated by distribution policy considerations.

The compulsory membership in a social insurance system could also be reviewed. This requirement is, in part, underpinned by reference to merit goods: were there no compulsion, future needs would be systematically underestimated. This argument would appear to have little validity in Germany against a background of established prosperity and a growing preference for private insurance. What is more, the very existence of a “social security network” can lead to individuals failing to make any provision for the future. Even if one assumes that individuals act principally in their short-term interest, compulsion can also be exercised by ensuring that social insurance on a pay-as-you-go basis is at least supplemented by an obligation to take private action.

I hope that insights could be derived from these considerations that would be most helpful in bringing down government debt.

Endnotes

[1]See Leibfritz and others (1994).

[2]This would not be the case only if debt were used to finance public-sector investment with high productivity as compared with the crowded out private investment or if the private sector were to save more in expectation of subsequent tax rises, thus producing no change in the aggregate savings ratio. Neither is very likely in the current situation.

[3]See Leibfritz (1994), p. 525.

[4]Prognos AG (1995).

[5]Employers and employed each pay one-half of the contribution.

[6]This includes federal government interest relief to the special funds ("German Unity" Fund, Debt Processing Fund, Redemption Fund for Inherited Liabilities, Railway Fund) and to the east German housing enterprises in 1994 and 1995.

[7]According to an estimate made by the OECD, a deficit increase by one percentage point of the GDP can push up the long-term real interest rate by one-third of a percentage point if the deficit is financed entirely from abroad. See Orr and others (1995).

[8]German rates have again established their lead as of May 1995. The decisive fact, however, is that the lead which is basically a typical feature of German capital market rates intermittently showed a marked shift to a lead for U.S. rates.

[9]See EMI (1995).

[10]See Deutscher Industrie-und Handelstag (1993), p. 17.

[11]See U.S. General Accounting Office (1994).

[12]Ibid.

[13]See OECD (1995).

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