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FISCAL POLICY

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The term “fiscal policy” refers to all the measures that a government may take with respect to the level and composition of its revenues and expenditures or that have an impact in this regard.

Fiscal policy embraces both a government's spending and tax policies while also taking budget balances into account. Although in some contexts, “fiscal” is understood as referring specifically to taxes, as a rule, “fiscal policy” covers all government actions respecting revenues and spending as implemented through the budget.

The main fiscal policy tools are as follows:

- Public expenditures, which consist of operating expenditures (e.g., remuneration, rent, training, travel, etc.), transfer expenditures (e.g., financial assistance and grants to individuals, corporations and local governments), capital expenditures (e.g., equipment and infrastructure of all kinds) and debt service.
- Government revenues, which comprise all of the levies (income tax, sales tax, payroll taxes and other taxes) and non-recurring revenues (mining, oil and gas royalties, dividends, asset sales, etc.) that make up a government's resources.
- The budget balance, or the positive or negative variance (surplus or deficit) in revenues and expenditures. This variance may stem from a deliberate desire to increase spending, reduce levies, accumulate reserves or offset certain imbalances in the economy.

Function of fiscal policy

Through fiscal policy, governments use budgets to not only balance their accounts, but also to influence the macroeconomic situation. In fact, the primary goal of fiscal policy now appears to be to regulate the economy by curbing economic activity in the event of a foreign trade imbalance or inflation and stimulating it in the event of a recession or a major crisis. In other words, governments try to reduce the impact of a drop in consumer spending and private demand on aggregate demand by boosting public spending or cutting taxes and running deficits. When governments spend more than they bring in, economic activity is most certainly stimulated as a result.

Injecting additional funds into the economy has a cascading or multiplier effect. According to the multiplier theory, adding one unit of non-tax-funded public spending produces a more than proportional increase in gross domestic product (GDP). For example, a new public facility will

generate additional output and new revenues, of which the unsaved portion will in turn stimulate output in other sectors of the economy, generate new revenues, and so forth.

Automatic vs. discretionary policy

Economic ups and downs can be mitigated by public revenues and expenditures either mechanically or arbitrarily. Governments sometimes let public programs adjust to the economic cycle on their own, while at other times they intervene directly in an effort to head the economy in a different direction. In the first case, revenues and expenditures have an automatic stabilizing effect, while in the second case, specific measures are implemented.

A slowdown in the economy leads to an increase in public spending because certain expenditures (e.g., unemployment, social assistance, etc.) are directly linked to the overall economic situation while other expenditures cannot be easily reduced (e.g., remuneration, transfers, contractual commitments, etc.). At the same time, revenues decline, causing the budget balance to deteriorate. On the other hand, as economic growth has a positive effect on output, investment, revenues and employment, it generates additional capital inflows mechanically during a time when spending either decreases or remains stable. An automatic stabilization mechanism thus operates throughout government programs as a whole, making it possible to offset cyclical variations in economic activity insofar as households and businesses do not change their consumption behaviour and interest rates are not affected.

As opposed to automatic stabilizers, discretionary or activist fiscal policy involves making deliberate changes to spending, taxes and transfers rather than simply letting them fluctuate only in response to the dynamics of stabilization. The use of discretionary fiscal policy may be warranted at the national level, where the size of the public sector is limited in relation to the economy, or during major economic crises. Generally speaking, however, due to the problems inherent to predicting how the overall economic situation will evolve, the lengthy timelines involved in rolling out specific measures as well as fuzzily defined targets, discretionary intervention can produce uncertain outcomes and increases the risk of introducing distortions in the economy.

Limitations and constraints of fiscal policy

Budgets are not precision tools having the capacity to make the economy go in a specific direction. Indeed, fiscal stimulus has only a limited impact and is freighted with flaws. The main problems stem from external constraints, deficit financing and the weight of the public debt.

As economies become increasingly open, the multiplier effect of fiscal policy correspondingly decreases, since the injection of additional funds by the government does not affect domestic producers exclusively. Indeed, a portion of such moneys goes toward the purchase of goods and services abroad and, upon exiting domestic circuits of production and distribution, loses its ability to generate additional economic spinoffs at the local level. Furthermore, growth in imports can lead to a trade imbalance and unstable national currency, causing interest rates to rise and investment to fall. The risk is lower, however, when an economic crisis affects all countries at the same time and all of them adopt recovery measures.

Funding budget deficits is also problematic. On the one hand, printing more money can spark inflation, while on the other hand, contracting public borrowings can produce a crowding-out

effect. Competition for savings resources between the private and the public sector is usually at the expense of the former, with the reduction in available capital raising the cost of funding private investment projects and thus hampering growth. Once again, however, the negative impact of fiscal stimulus on private investment is significantly offset when credit tightening is widespread and interest rates are very low.

Repeated deficits over several years' time raise the public debt as well as the burden it will represent in the future. This situation is not without risks, for a large debt entails high interest payments and its weight in the budget increases the probability of new deficits, which can in turn lead to higher interest rates and so on. A vicious cycle of debt sets in, having a dynamic of its own. Ultimately, the burden of the debt can become unbearable, impeding a government's ability to not only stimulate the economy but to do what is expected of it in other areas.

Fiscal rules

Since the recession of the early 1990s, recurring budget shortfalls in OECD countries have become a major concern. Given that the much bandied intentions to regain control of public finances have not had a significant impact, certain countries have started to adopt more stringent formal rules. As of 2009, some 80 countries had introduced a fiscal policy framework on their own initiative or to honour international commitments.

A fiscal rule is a permanent restriction on fiscal policy that sets limits (ceilings) or numerical targets for the main public finance aggregates (i.e., revenues, expenditures, budget balance and debt). Such rules make it easier to maintain fiscal discipline and ensure that the fiscal consolidation efforts that flow from such discipline are more readily accepted – provided that the adoption of rules has flowed from a sociopolitical consensus.

Fiscal rules can vary in terms of their goals and thus their form. In general, however, they are aimed at ensuring the long-term sustainability of public finances. These rules may come in the form of:

- Budget balance rules, which specify a structural or cyclically adjusted global balance target for revenues and expenditures, with or without an explicit reference level for debt as a percentage of GDP;
- Debt rules, which set a precise limit or target for debt as a percentage of GDP but provide only limited guidance for fiscal policy when the debt is below this ceiling;
- Expenditure rules, which set permanent limits on public spending in absolute terms, growth rates or percentage of GDP and are not linked to debt since they do not constrain revenues;
- Revenue rules, which set ceilings or floors on revenues, making it possible to maximize revenue collection and prevent an excessive tax burden even though these rules, like those pertaining to expenditure, are not linked to debt.

As shown by the diversity of rules that may be implemented, choices have to be made. Targeting debt necessarily brings into play issues of long-term sustainability and intergenerational equity; however, defining what constitutes a desirable debt level entails a fair amount of subjectivity and is not readily grasped by the general public. Deficit rules, which are easy to comprehend during a period of fiscal consolidation, are less useful and less constraining during the up-phase of the economic cycle. Expenditure rules are straightforward and easy to account for, but they are hard to abide by and often circumvented. As for revenue rules, they are usually aimed at disgruntled taxpayers and offer no guarantee that public finances will be put back on a sound footing over the

medium or long term. Today, there is a growing tendency to bundle rules that link deficits to expenditures or debt, or revenues to expenditures, with greater sophistication and to adapt the rules to the situation in the country concerned.

The framework defined by fiscal rules is designed to combine discipline and flexibility – i.e., the key objectives of any successful rule. In short, this framework should make it possible to maintain fiscal discipline over the medium term but be flexible enough to mitigate fluctuations in the economic cycle over the short term. This dialectical relationship must achieve a balance that is tailored to the needs of each country. Rules that are applied too rigidly enjoy less credibility. They must set limits and involve penalties, while also making room for exceptions or compromises and offering a degree of flexibility. Latitude will be required in order to garner a firm commitment from governments and lasting support from the public.

Sustainability of public finances

Sustainability is generally defined as a government's ability to honour its long-term financial commitments. Some of the factors that currently call into question the sustainability of public finances are the substantial increase in government debt, the rigidity of certain public expenditures (e.g., entitlements), and population ageing. These factors give cause for concern since they raise the prospect that the programs and benefits now offered by governments will not be available forever.

This issue may be viewed from the perspective of intertemporal budget constraint or intergenerational equity. In the first case, the overriding concern is to ensure that surpluses can be generated in the future in order to pay down the debt. Indeed, the more the debt rises, the more it will be necessary to achieve positive budget balances so as to reduce or cap the debt, a process that requires major changes to the structure of spending. In the second case, the goal is to avoid transferring the burden of current spending to future generations by ensuring that an even-handed approach is taken toward the efforts to be made; the longer it takes to put public finances in order, the more costly adjustments will be, thus triggering an increase in fiscal pressure or cuts in services.

Sustainability is a central concern of today's governments and prompts reflection on public finances. It will no doubt continue to be a major focus of future discussions on fiscal policy directions.

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