



MINISTRY OF FINANCE

Elements of fiscal sustainability

Helsinki, 28 November 2019

Martti Hetemäki

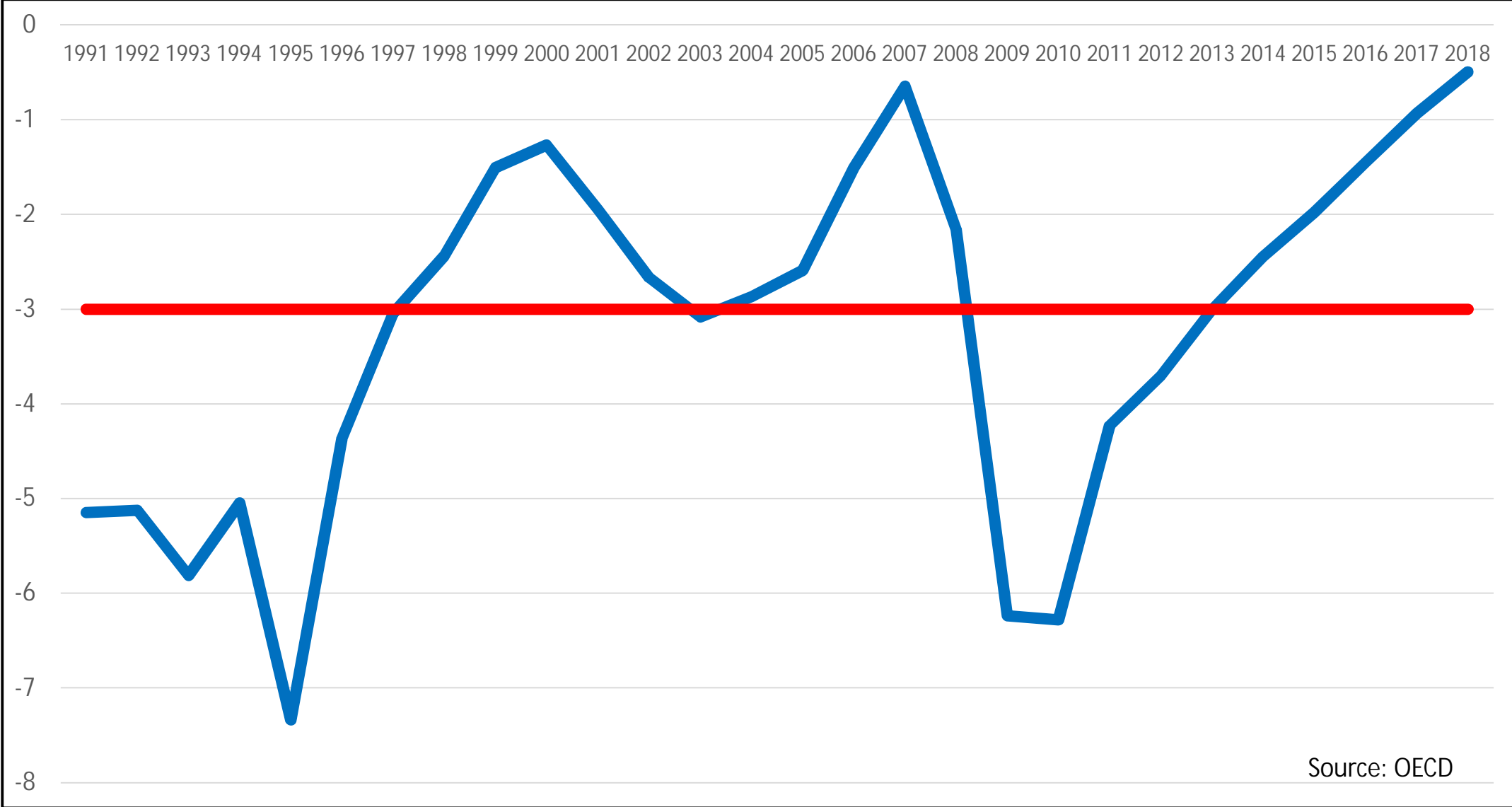


Do fiscal rules work?

Why has public debt/GDP increased?

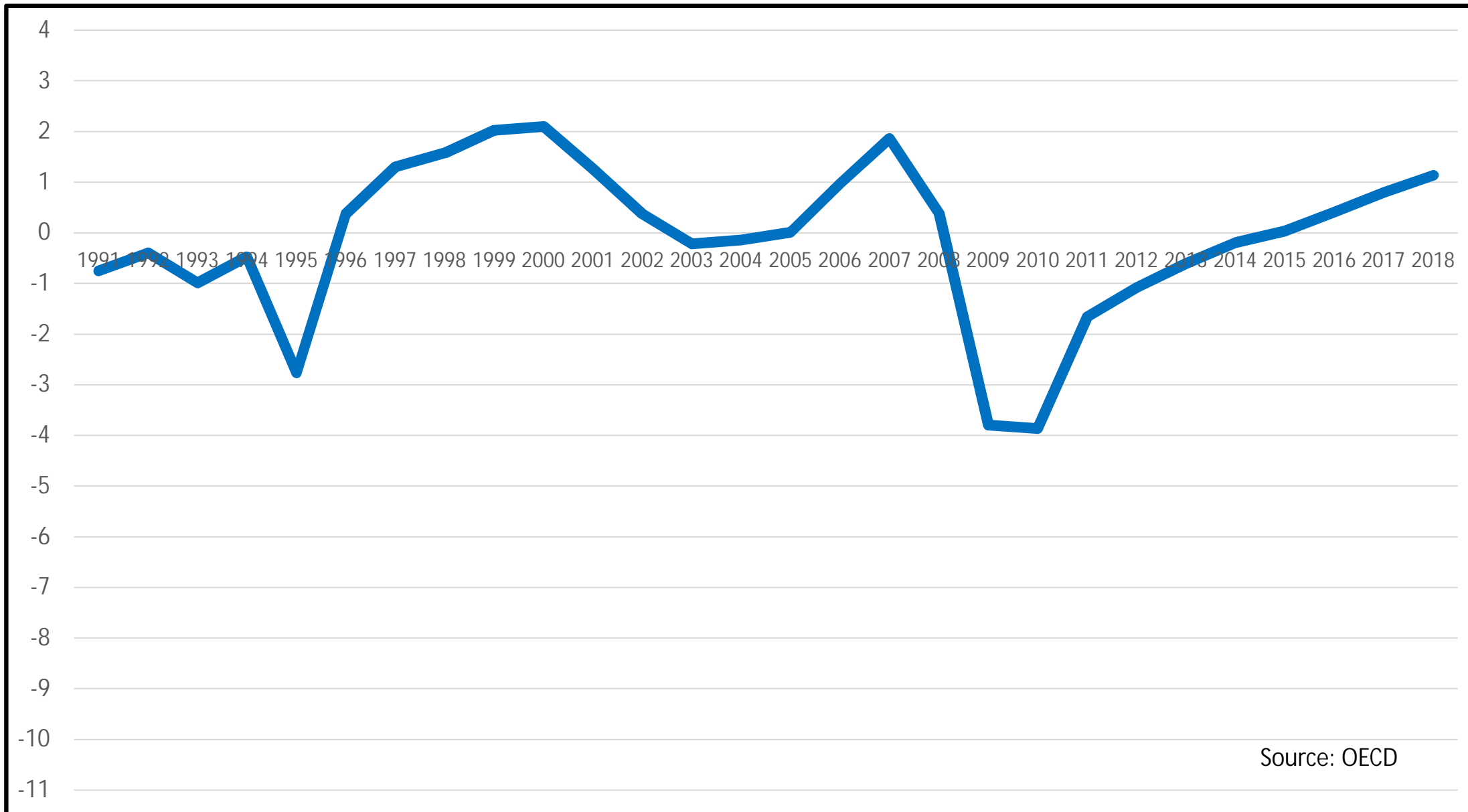
Three legs of fiscal sustainability

Euro area (17 countries) general government net lending/GDP 1991-2018, %



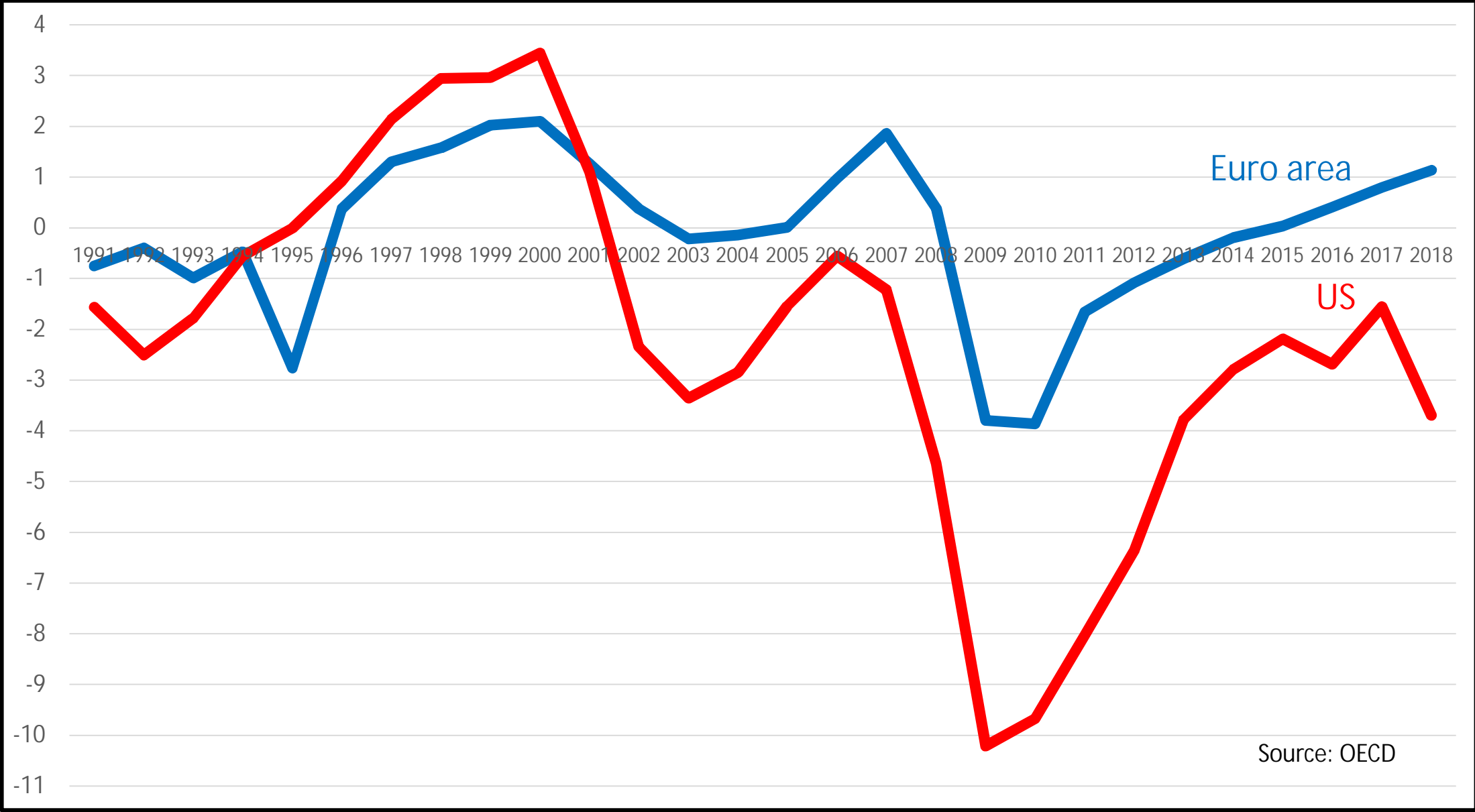
Source: OECD

Euro area (17 countries) general government primary balance/GDP 1991-2018, %



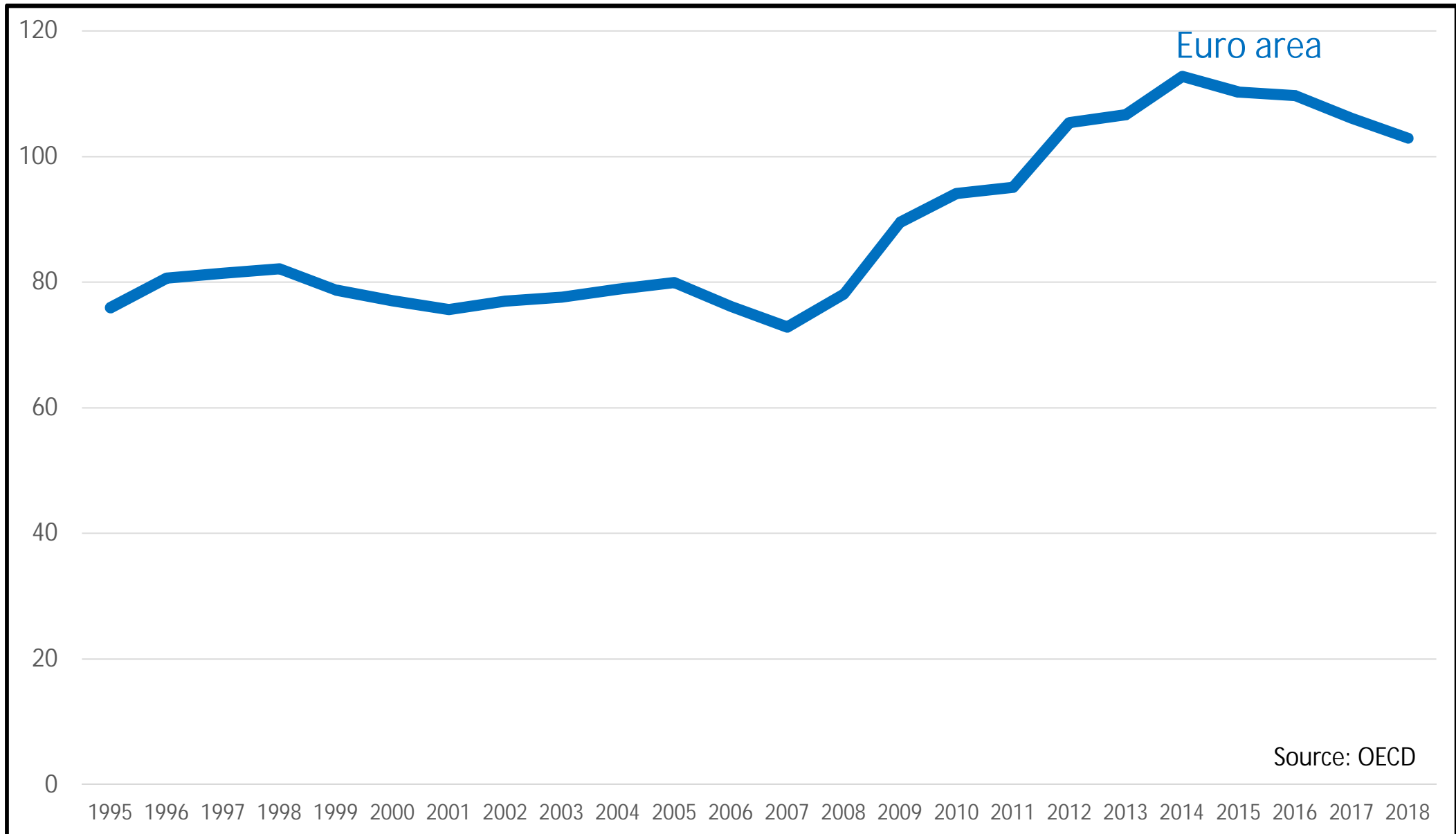
Source: OECD

Euro area and the US general government primary balance/GDP 1991-2018, %

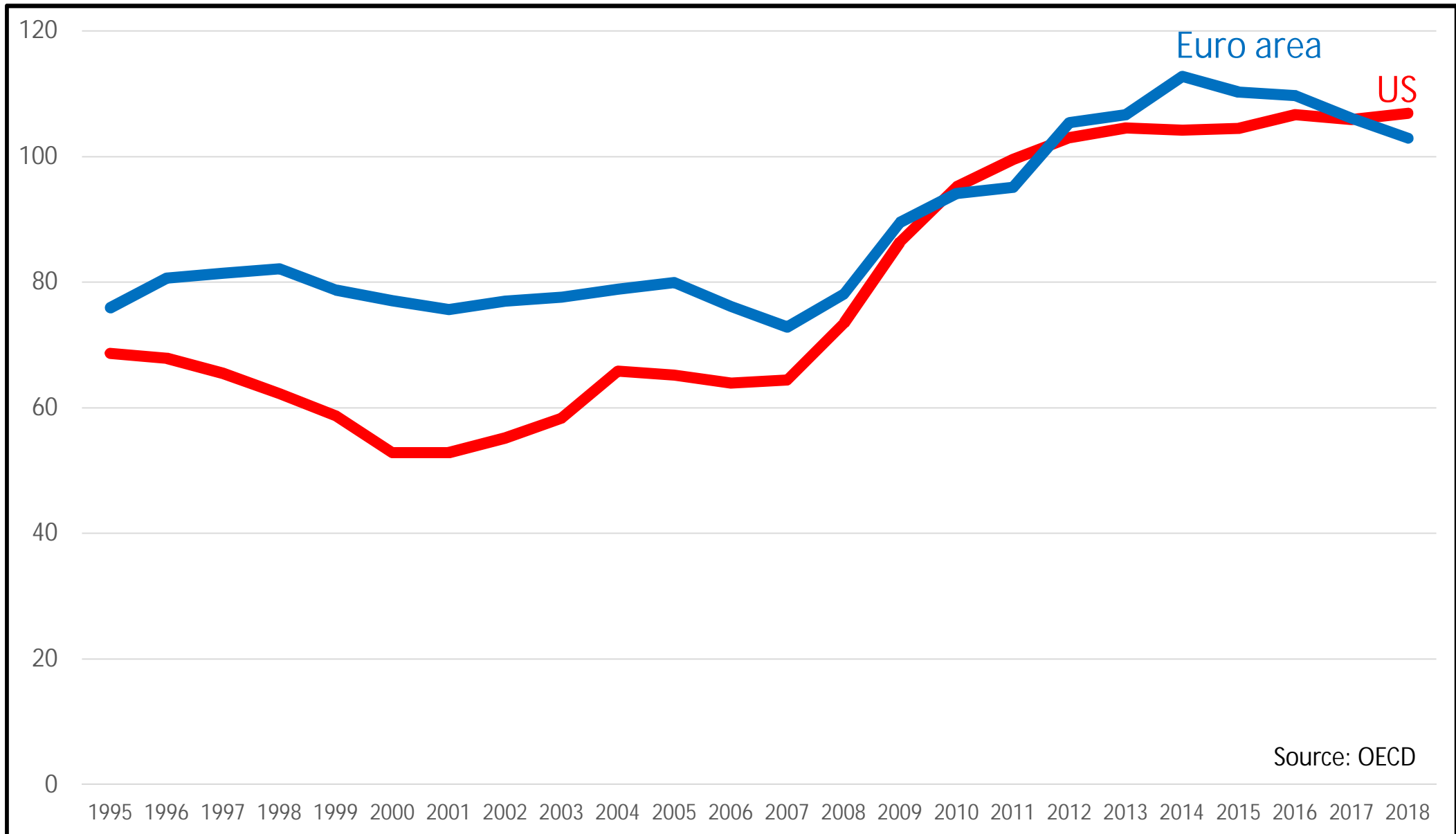


Source: OECD

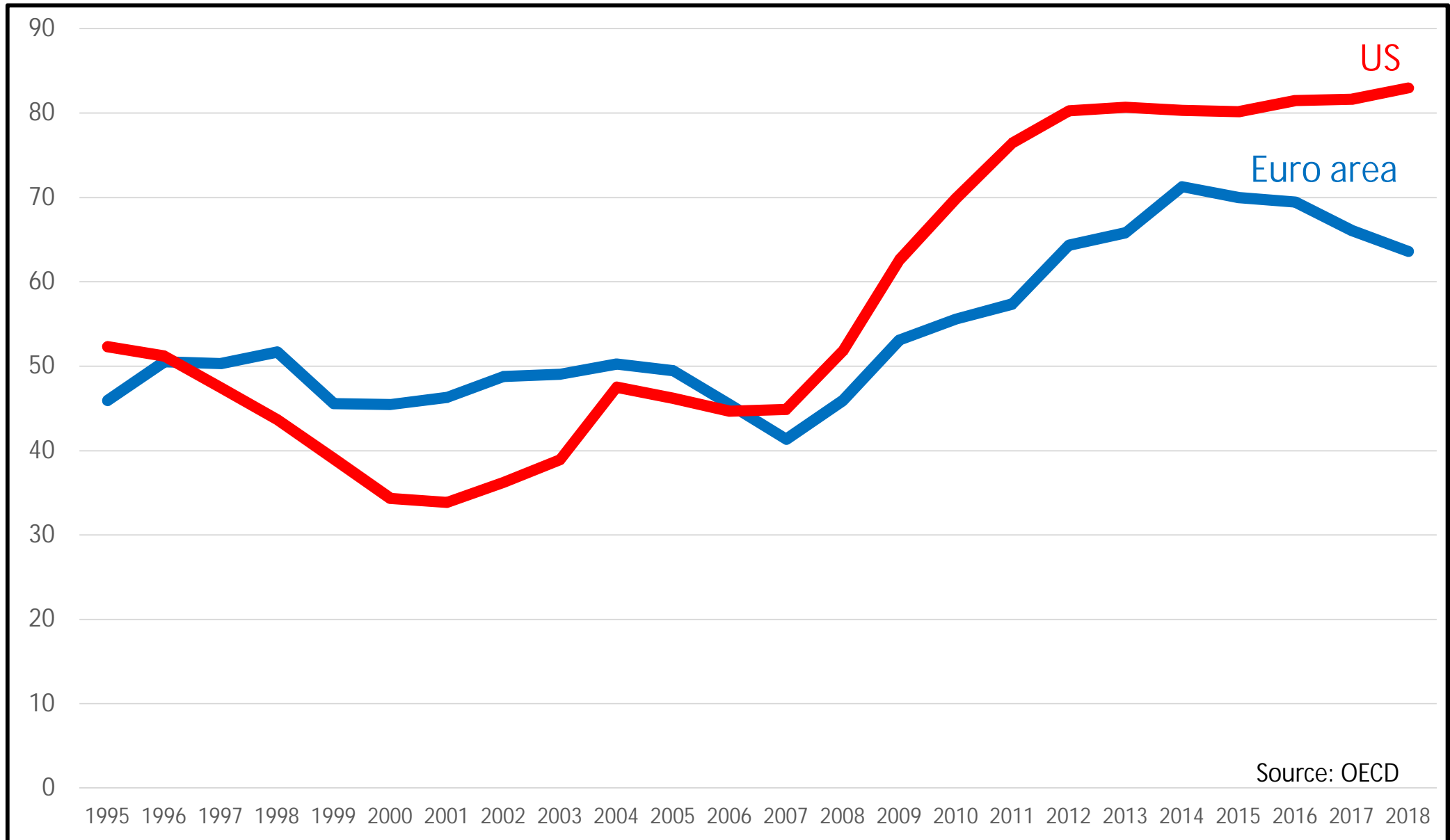
Euro area general government gross financial liabilities/GDP 1991-2018, %



Euro area and the US general government gross financial liabilities/GDP 1991-2018, %

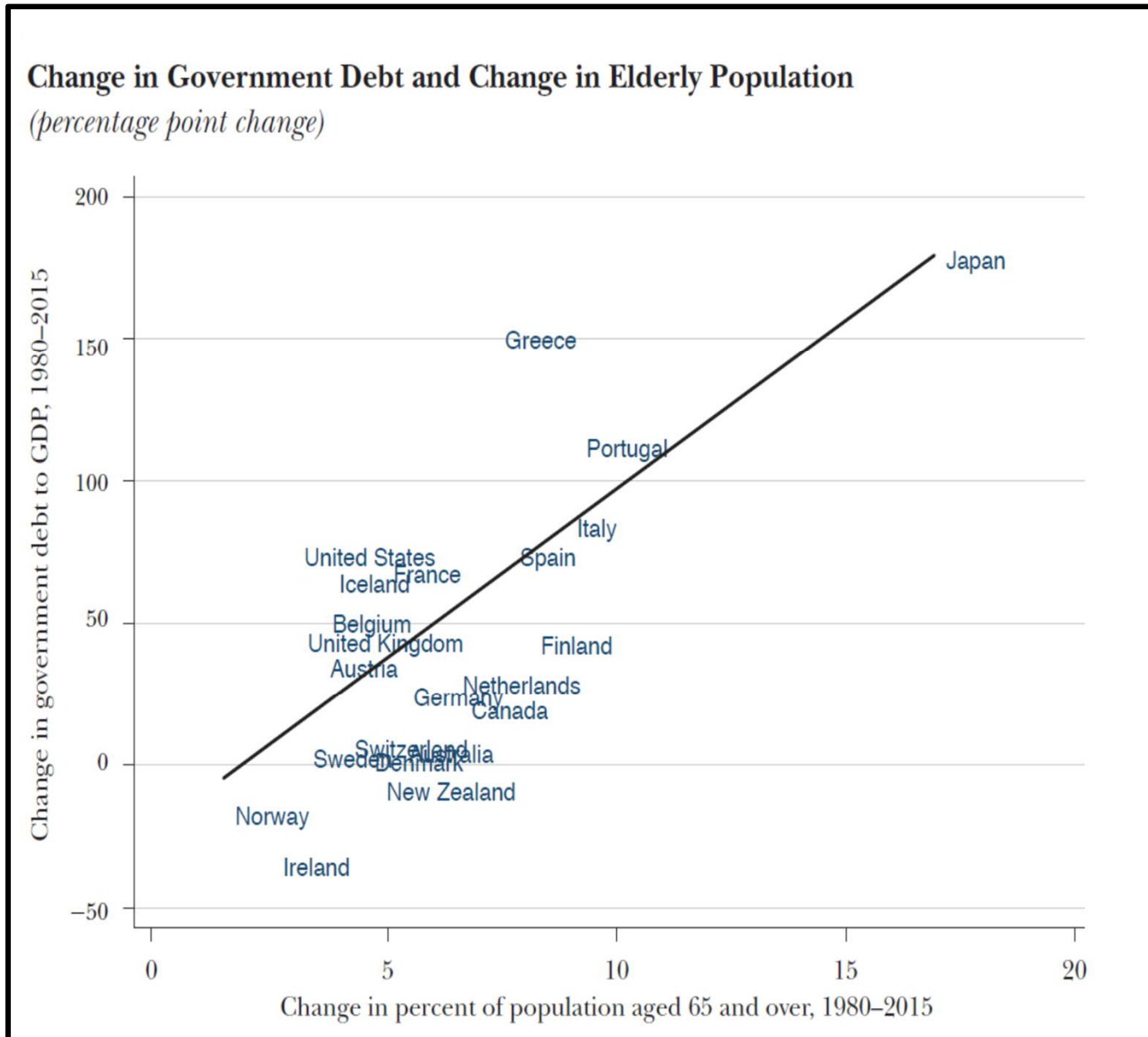


Euro area and the US general government net financial liabilities/GDP 1991-2018, %



Source: OECD

Why has public debt/GDP increased?



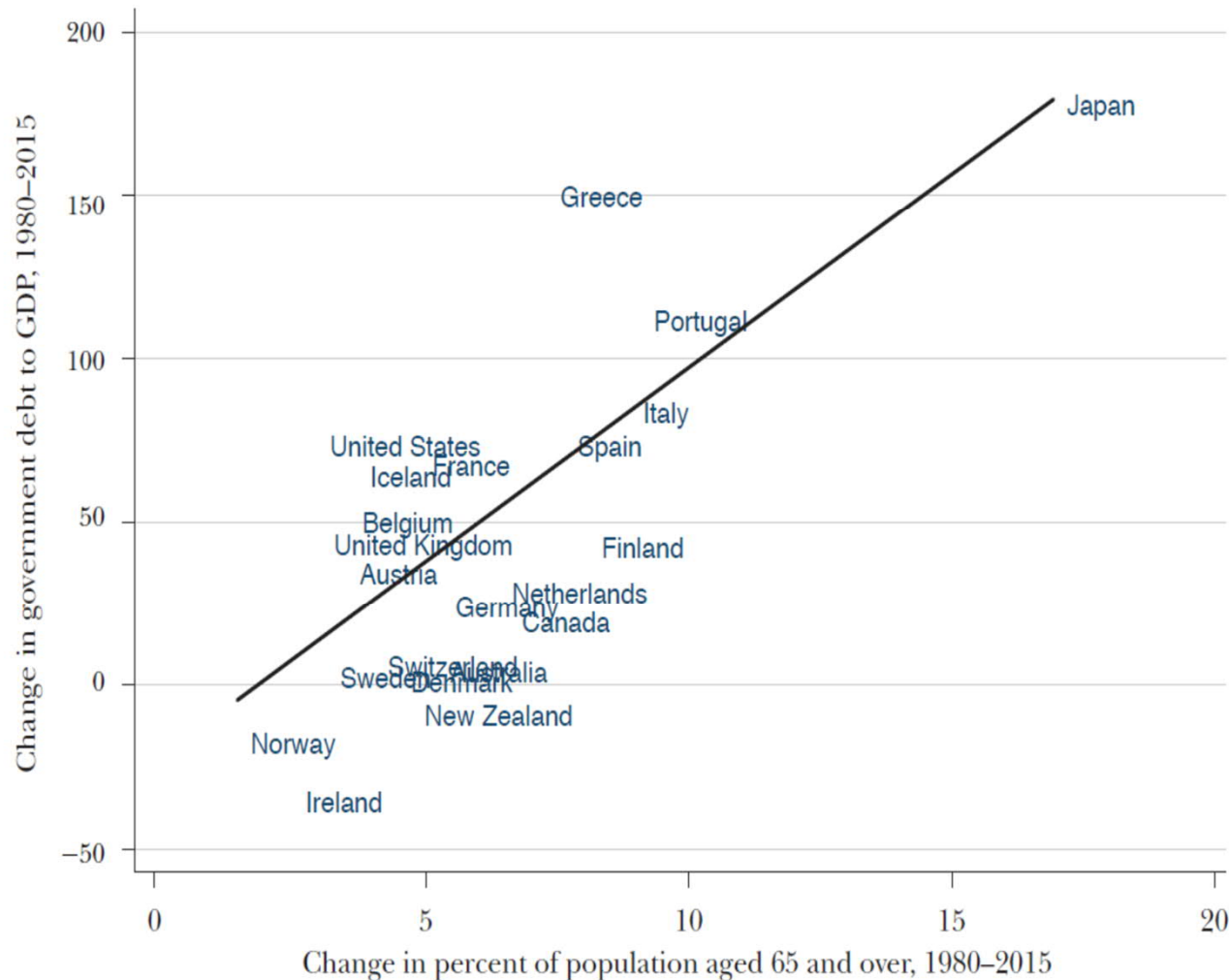
Source:

Yared, P. (2019), Rising Government Debt: Causes And Solutions for a Decades-Old Trend. *Journal of Economic Perspectives*, Vol. 33, 2019, 115–140.

<https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.33.2.115>

Change in Government Debt and Change in Elderly Population

(percentage point change)



Yared (2019):

“A plausible explanation is that increasingly competitive political parties both change the composition of government spending and increase government debt in their efforts to appeal to an aging constituency.”

Source:

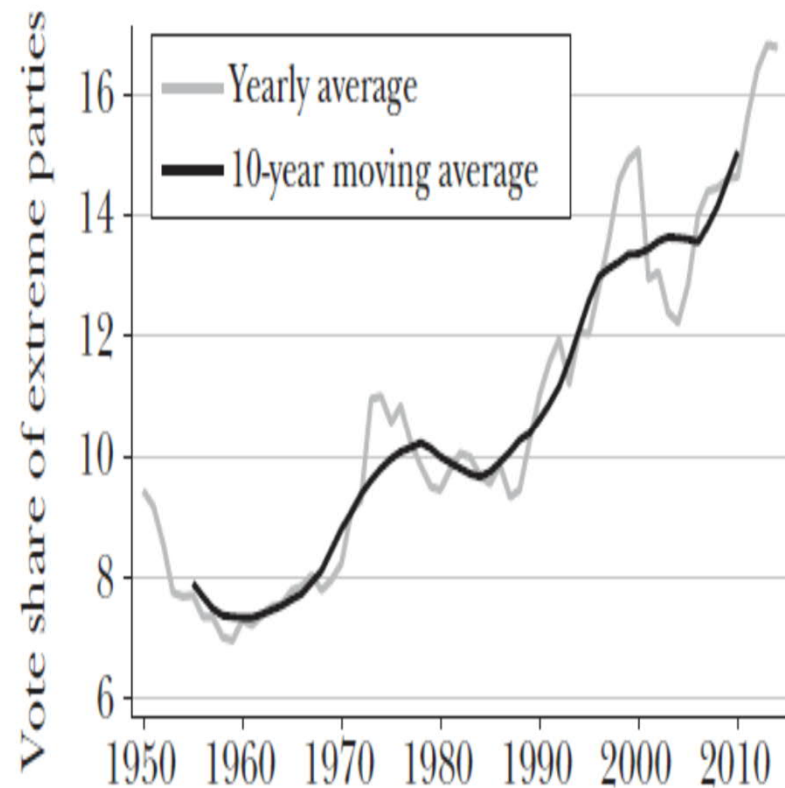
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Polarization and Fractionalization in the Legislature in Advanced Economies

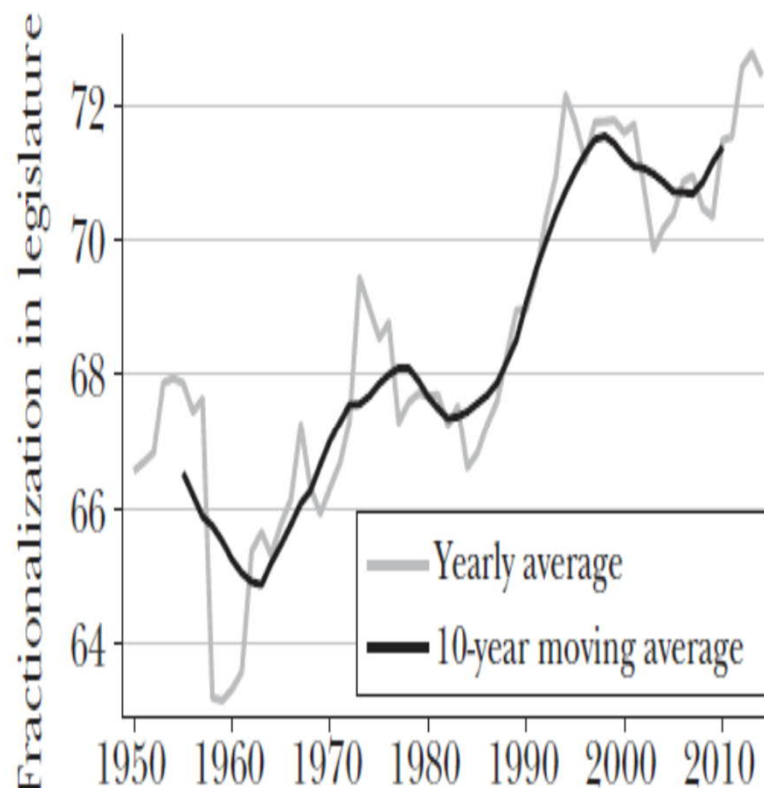
A: Rising Vote Share of Extreme Parties in the Legislature in Advanced Economies

(percent)



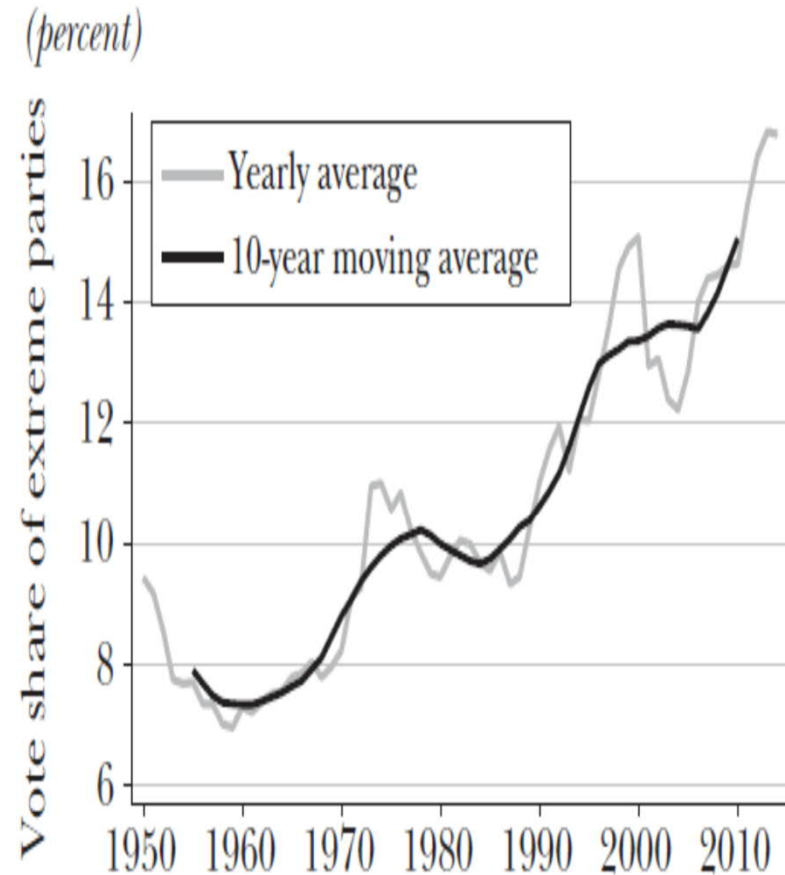
B: Rising Fractionalization in the Legislature in Advanced Economies

(percent)

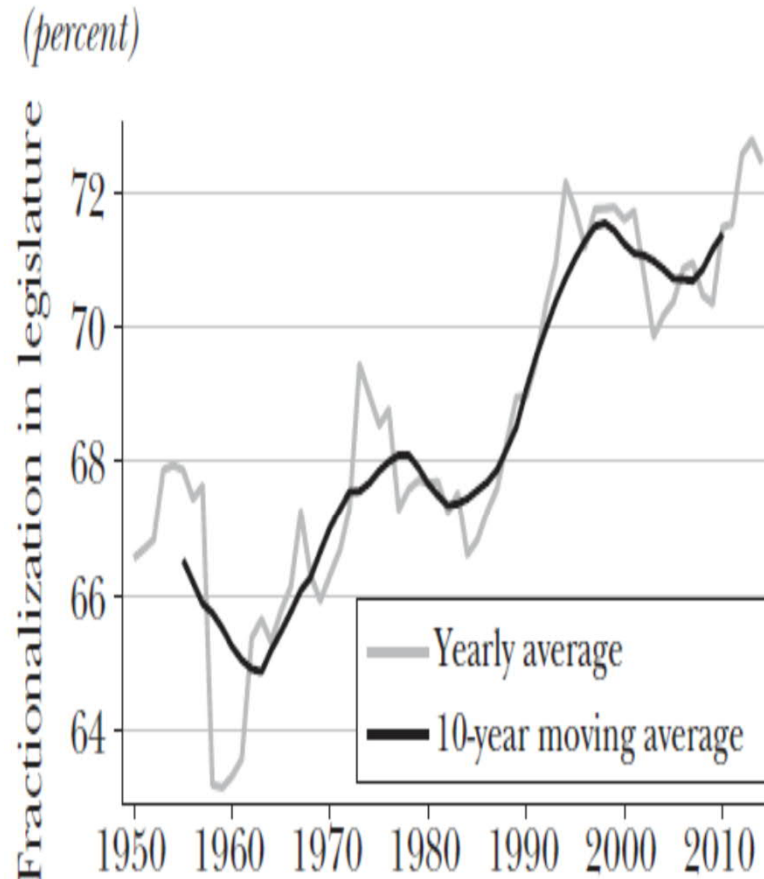


Polarization and Fractionalization in the Legislature in Advanced Economies

A: Rising Vote Share of Extreme Parties in the Legislature in Advanced Economies



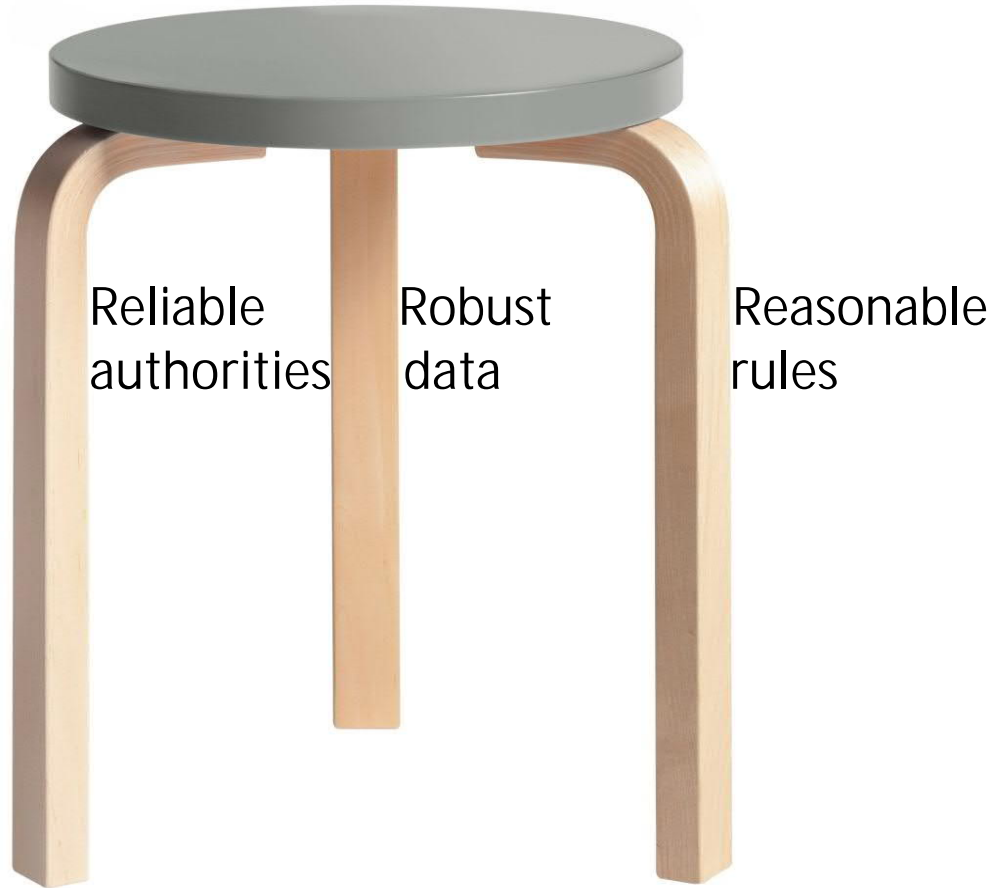
B: Rising Fractionalization in the Legislature in Advanced Economies



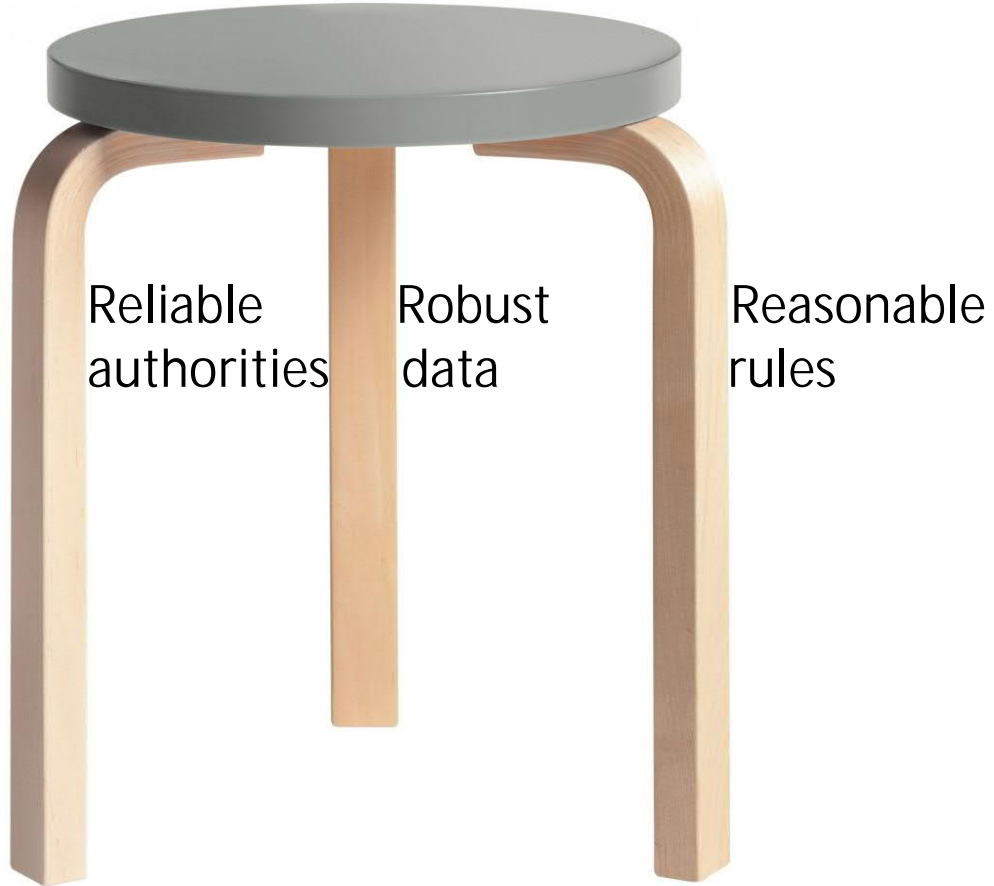
Yared (2019):

“Through the lens of this theory, the long-term trend in government debt in advanced economies is a result of the increase in political polarization and fragmentation across these economies.”

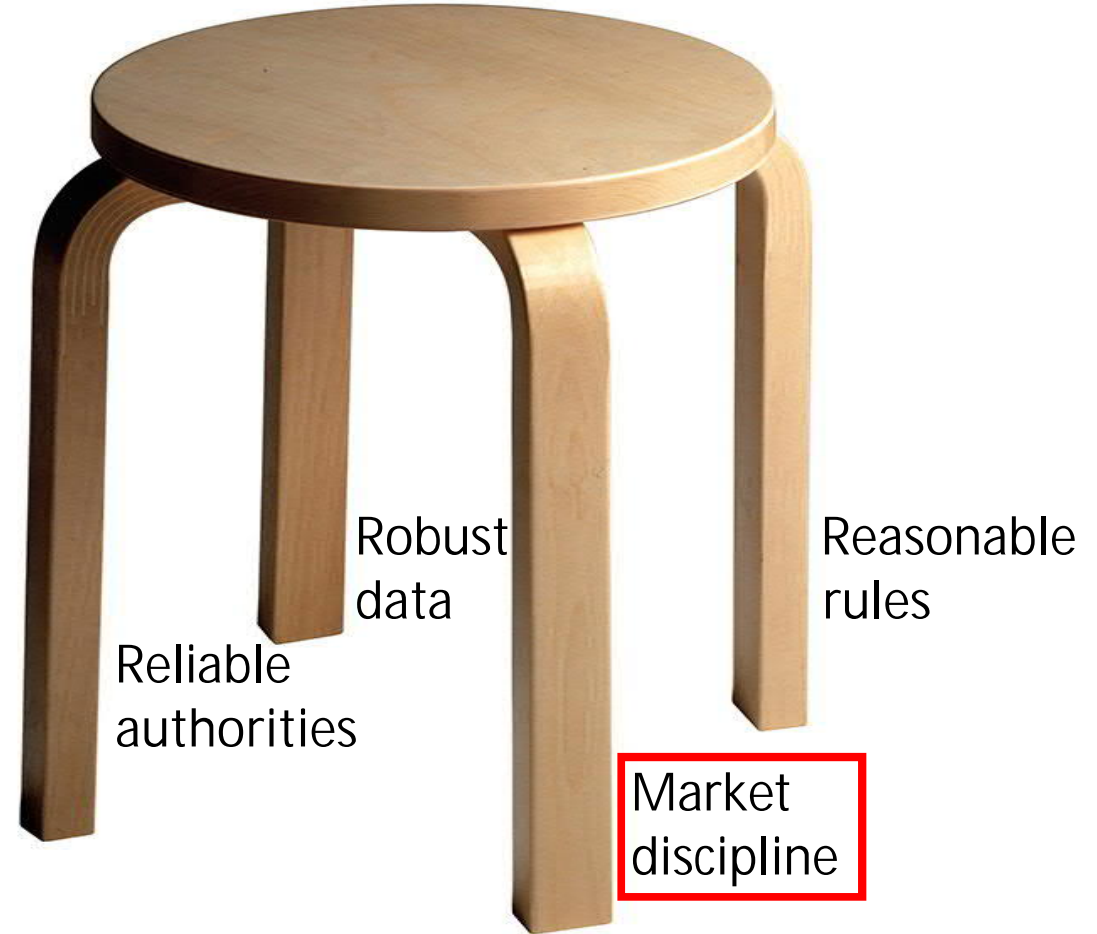
Three legs of fiscal sustainability



Three legs of fiscal sustainability



One more leg needed



Conclusions

Fiscal sustainability is hard to achieve

It is as solid as its weakest leg

Annex: Possible reasons for higher public debt/GDP

Yared (2019) notes: "A second theory of optimal government debt considers the role of public debt when the private sector cannot borrow or lend freely at the same terms as the government (for early examples, see Woodford 1990; Aiyagari and McGrattan 1998; Holmström and Tirole 1998; for recent examples, see Azzimonti and Yared forthcoming and the references cited therein). This theory builds on the fact that governments can borrow more cheaply than the private sector. As a result, when the government issues bonds, it slackens financial constraints on borrowers who now receive additional resources from the government (through tax cuts or government loans)." Yared (2019), however, concludes on these issues in the following way:

"Beyond this theoretical ambiguity, there are other reasons that the long-term trend in public debt across advanced economies does not appear to be an optimal policy response to globalization. First, government debt in advanced economies had been on an upward trajectory well before the onset of the global saving glut in the late 1990s, as shown earlier. Second, prior to the late 1990s, the degree of cross-border public debt holdings had been relatively stable, suggesting that the globalization of public debt markets was limited up until that point. For example, in the case of the United States, the fraction of government debt that was held by foreigners remained around 15 to 20 percent between 1980 and 1995 and increased significantly thereafter, reaching 46 percent in 2009 (Aizenman and Marion 2011, figure 7). Finally, the safe asset provision theory would predict that, all else fixed, smaller countries respond to globalization by increasing public debt proportionately more than larger countries, because globalization decreases the interest rate response to debt issuance by more for small countries."

Yared, P. (2019), Rising Government Debt: Causes And Solutions for a Decades-Old Trend. *Journal of Economic Perspectives*, Vol. 33, 2019, 115–140.
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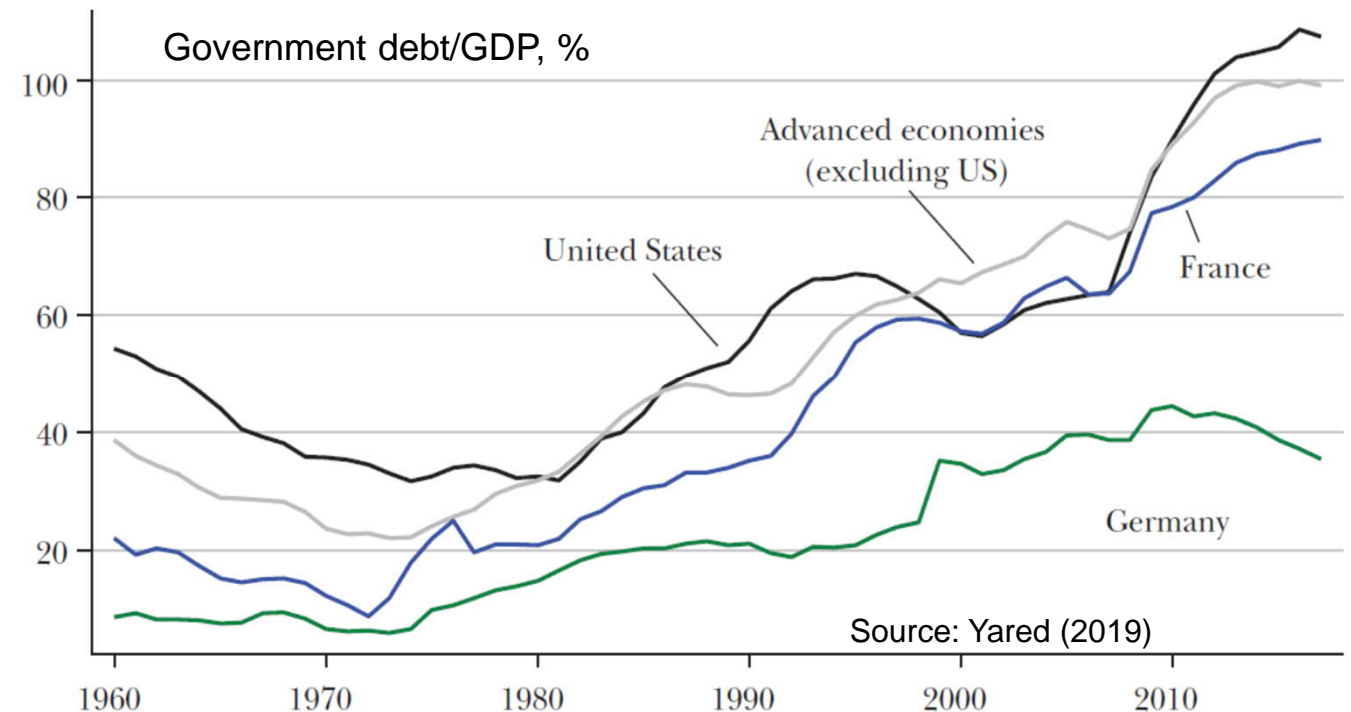
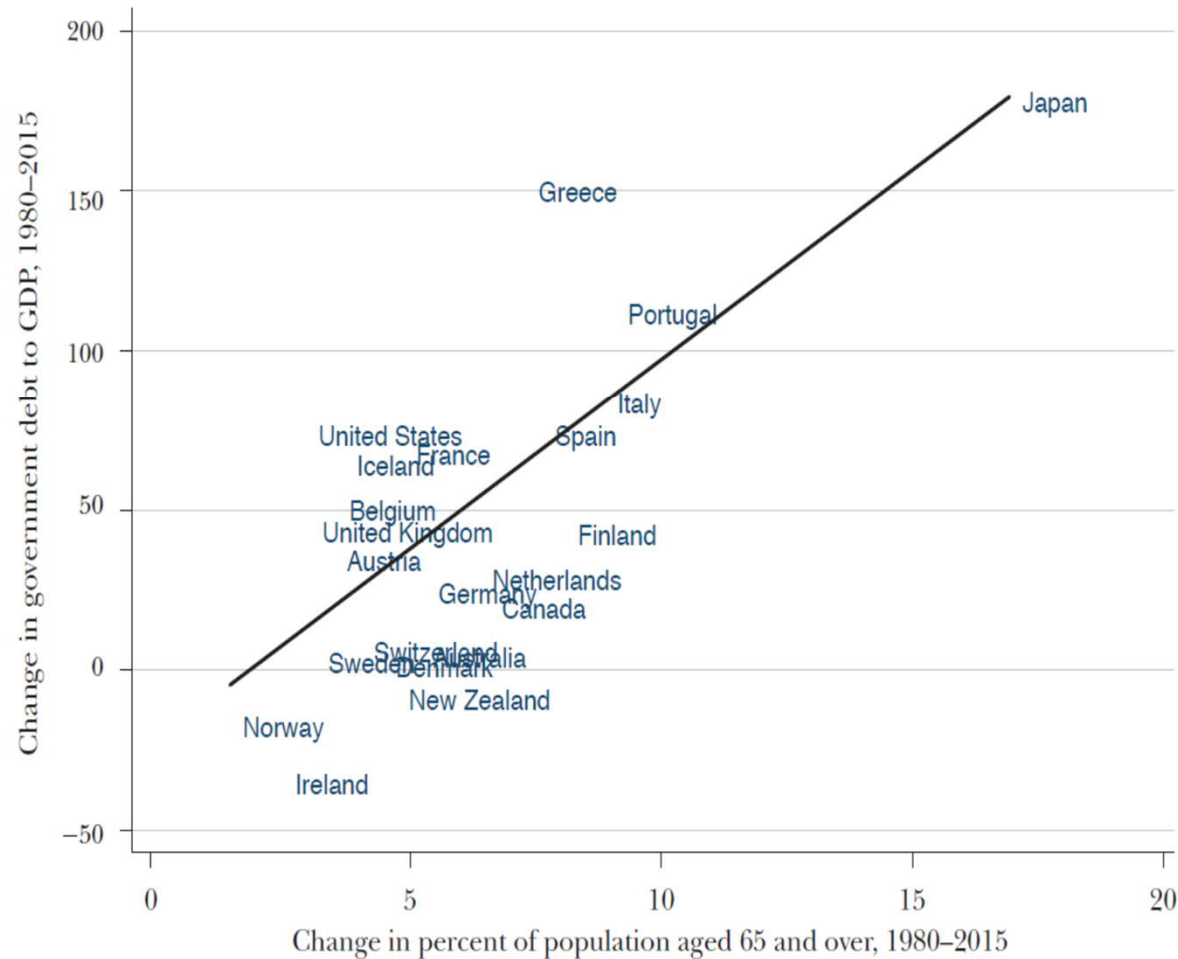


Figure 3

Change in Government Debt and Change in Elderly Population

(percentage point change)



Yared (2019): “In the face of these well-anticipated demographic changes, tax-smoothing theory would have prescribed a general decumulation—not accumulation—of government debt during the past several decades. Moreover, tax-smoothing theory would have predicted lower debt accumulation in countries anticipating greater strain due to an aging population. Nevertheless, the cross-sectional data illustrated in Figure 3 shows the opposite: countries experiencing a greater increase in population aging, such as Japan, have accumulated more debt as a percentage of GDP than those experiencing a lower demographic strain, such as Canada. In sum, the long-term secular trend in government debt accumulation in the United States and across advanced economies cannot reflect an optimal policy response to either unanticipated or anticipated fiscal needs.”

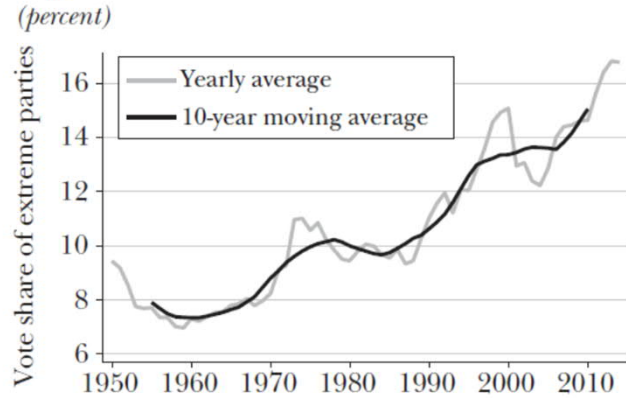
“...political economy theories do not explain why polarization and electoral uncertainty have increased in advanced economies, nor how this development may have been caused by certain economic trends or policies.”

“Finally, current political economy theories do not directly address the change in the composition of government spending, which has become increasingly concentrated in old-age government assistance programs. A plausible explanation is that increasingly competitive political parties both change the composition of government spending and increase government debt in their efforts to appeal to an aging constituency.”

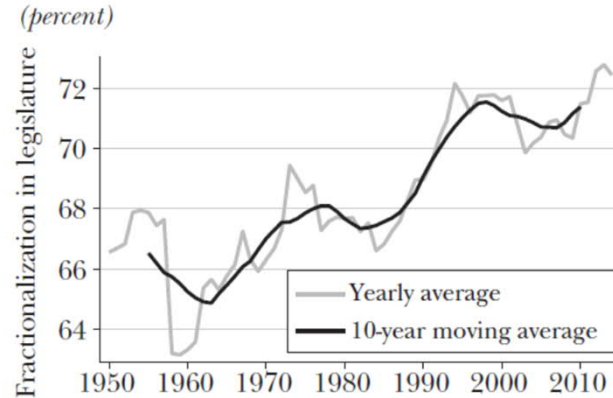
Source: Yared (2019)

Polarization and Fractionalization in the Legislature in Advanced Economies

A: Rising Vote Share of Extreme Parties in the Legislature in Advanced Economies



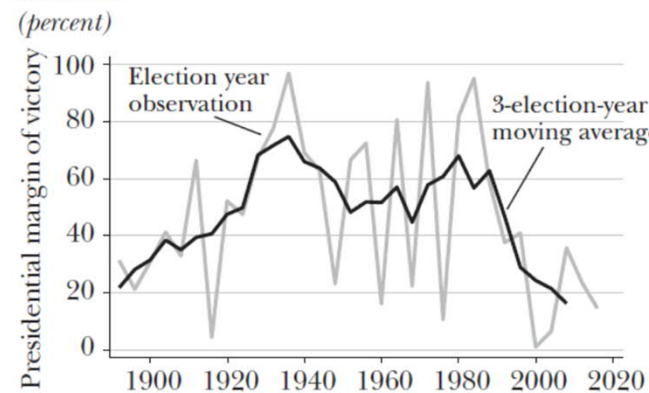
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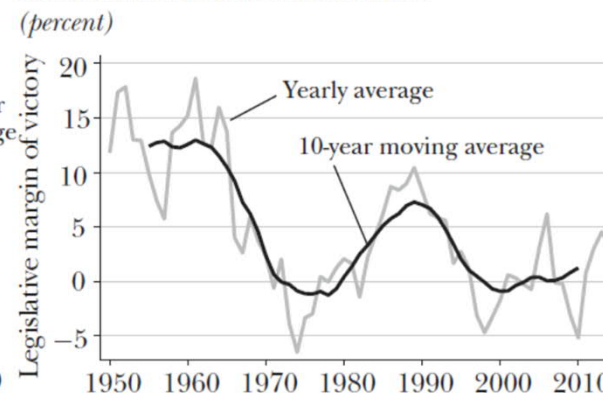
Yared (2019) notes: "Through the lens of this theory, the long-term trend in government debt in advanced economies is a result of the increase in political polarization and fragmentation across these economies. Evidence on this rise in polarization in the United States comes from many sources. The Partisan Conflict Index of Azzimonti (2018), which is based on the number of newspaper articles reporting political disagreement in a given month, shows an increase in partisan conflict in the United States since the late 1960s. This trend is consistent with evidence from other advanced economies, which have witnessed a declining influence of centrist political parties. Figure 4A shows that across advanced economies, the share of the legislative vote going to parties of the extreme left or extreme right has been on the rise since the 1960s. Figure 4B calculates the probability that any two members of the legislature are from different political parties, and by this measure finds a pattern of increasing political fractionalization in legislatures since the 1960s in advanced economies."

Declining Margin of Victory in Elections

A: Declining Margin of Victory in US Presidential Elections



B: Declining Margin of Victory in Legislative Elections in Advanced Economies



Yared (2019) notes: "This theory can explain the long-term trend in government debt in advanced economies as a result of rising political uncertainty for parties in power. The margin of victory in US presidential elections has been in decline since the mid-1980s, as shown in Figure 5A, suggesting that elections have become closer and less predictable. Similarly, analysis of US congressional elections has documented a declining incumbency advantage since the mid-1980s (for example, Jacobson 2015). This trend is consistent with the evidence from advanced economies in Figure 5B, which displays a decline in the average popular vote margin in legislative elections for the governing party or coalition."

"Political economy theories of government debt can qualitatively explain the long-term trend in government debt accumulation across advanced economies. Nevertheless, these theories leave several unanswered questions for future research."