FISCAL POLICY PROBLEMS IN FORMULATING A POLICY MIX

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The choice of a policy mix as the best combination of fiscal and monetary policies requires that structural features of both policies be taken account of. Moreover, it should be borne in mind that even the happiest choice does not necessarily have to produce the desired effect, since the power to shape the world in the case of both policies and the economic policy in general, is limited.

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Structural features of fiscal policy

When fiscal policy is discussed in macroeconomic literature, its structural features are usually ignored, which results in a distorted image of both its operational aspect and the capacity to influence economic processes. This applies in particular to authors describing fiscal policy in the context of monetary policy. They are accustomed to the instruments and decision-making procedures of the latter and tend to expect analogy in fiscal policy. Both policies, however, though they complement each other, differ radically, especially in their operational aspect.

In contrast to monetary policy, fundamental decisions in fiscal policy are not isolated; they constitute a complex of hundreds or even thousands of detailed, interwoven decisions. Arriving at such a set of decisions - the state budget, comprising hundreds of pages – is time-consuming and requires considerable administrative efforts. To ensure the document's necessary cohesion special procedures must be applied. It would not be practical to draft such an extensive and complex document often. Therefore is has been widely accepted that it should cover a period of one year (the rule of annual budgets). The consequence is, however, that fiscal policy becomes considerably more rigid, since crucial decisions can practically be taken only once a year. The possibility of adjusting fiscal policy during the period for which the budget has been approved is very limited not only by the content of the decision itself but also by the legal character of the budget as a law and the competences of the parliament.

Fundamental fiscal policy decisions are taken by two different bodies, which has many far-reaching consequences. The competences are divided between the government (if we take into account countries with a presidential system we should rather use a more precise term of "the executive"), who prepare a draft budget, and the parliament, who adopt it. It means, first of all, that decision-making, especially when it comes to adopting the budget, becomes a sort of a game played by the government and the parliament. Secondly, the system makes the decision-making a protracted, time-consuming process. Usually parliaments have 3 to 4 months to review and adopt the government's draft.

The executive and the parliament have been playing the "budget game" for many centuries. The struggle of representative bodies for the control over the public

finances fought in Europe since the Middle Ages has been the driving force behind the development of the parliamentary system and the gradual reduction of the powers of the executive. It is worth noting that up to the 19th century the parliaments were usually opposed to fiscal expansion and tried, more or less successfully, to curb expenditure ambitions of the executive. It was only in the 20th century that the roles were reversed. The executive and the legislative have always been suspicious of each other in budgetary matters; the suspicion lingers also today, even when the governments have a clear majority in the parliaments. The distrust is not totally unfounded, since both sides to the budget game – the governments and the parliaments – use various manipulation techniques.

No government would ever see its draft budget adopted by the parliament or preserve the fiscal policy of the budget bill "unspoiled" without some manipulation. Therefore governments are not willing to disclose all the aspects of their proposals, especially those, which could prove less popular. The members of parliament, for their part, always try to promote their own proposals and amendments, which further their particular interests and agendas or popular ideas. The MPs advocate them even when they do not stand a chance of success, just to win voters' approval. Limiting the powers of the parliament in budgetary matters is not a perfect solution to the problem, even though it is quite common today, since it only shifts the parliamentary pressure into backstage lobbying. The government is usually interested to see its draft budget adopted, therefore it must grant some concessions to the MPs. Eventually, a compromise is reached, but the parliamentarians get a certain "consolation prize", which means that some irrational elements are introduced into the draft budget, which for many reasons is not always fully rational and sound in the first place.

All this is time consuming and protracts the decision-making process. The parliamentary procedure is also necessary when the budget is changed during the budget year. The changes must be introduced as formal amendments to the budget law. Therefore fiscal policy can hardly be expected to be flexible and able to react quickly to crises.

Far-reaching legal regulations on public revenue and expenditure make fiscal policy even less flexible. While working on the budget, the government has little room for manoeuvre in decision-making; it has to comply with all relevant binding laws and

abide by the constitutional provisions. There is a legal act of some kind behind practically each budgetary proposal, concerning either revenues or expenditure. Without legal authorization the government are unable to introduce any provisions into the budget. Even if they did, it would not matter, since, according to a rule usually laid down by state constitutions, no revenue can be collected and no money can be spent without a proper legal basis. The situation differs in the case of public revenue and spending.

The budget law consists of practical decisions on the amount of spending, while the amounts concerning revenue are non-binging forecast. The amount of revenue depends on the tax law and other laws determining public levies (ex. social security premiums, etc.) and on economic events, with which the tax obligation is linked. The budget law assumes tax legislation as given. Naturally, tax laws can be amended in accordance with the fiscal policy assumptions. Apart from potential difficulties in getting the government proposals through the parliament, however, there are some important constraints concerning amendments:

1) changes in taxation rules cannot be introduced during the tax year (except for changes to the taxpayer's benefit),
2) all amendments must be introduced with respect for vacatio legis, which means in practice that changes, according to the Polish system, must be adopted at the end of November at the latest so that they can be published before the 1st of December, allowing time for the potential veto of the president,
3) any retroactive amendments are prohibited,
4) any changes, especially changes departing from accepted standards, can be challenged before the Constitutional Court as incompatible with the constitution.

Public expenditure – with one exception discussed later – must have a statutory basis. Laws authorize but also impose an obligation on the public funds – the state budget, local authorities budgets and appropriated allocations – to be spent on certain defined objectives. Statutory obligations in this respect can have a three-fold character:

1) the law can impose an obligation to finance certain tasks or organizational units, without specifying the amount to be spent; there is some discretion in

specifying the amounts to be spent on various activities in the budget law or the budget resolution of the local authorities. The discretionary powers are however limited: in the case of total withdrawal of funds or unacceptably low amounts of financing the parties concerned can file a lawsuit;

2) the law can leave the amount of spending unspecified, while defining in detail the rules for spending; a classic example are pensions granted according to rules strictly defined in a relevant law, while the total amount of spending is conditional on the number of people eligible. Therefore, the budget law has to provide for such an amount of spending for a given area as results from forecasts concerning the amount of legitimate claims likely to be received;

3) the law can earmark certain public revenue for specified expenditure; appropriated allocations both on the state and local authorities' level operate according to this principle.

Naturally, the laws specifying budgetary expenditures can be amended in accordance with the assumptions of fiscal policy. A serious limitation here, however, is the constitutional rule of protection of vested rights. It applies mainly, although not exclusively, to old age and disability pensions and other social security benefits. The case-law of the Constitutional Court in Poland shows that the Court is taking the protection of vested rights very seriously. Two cases, which were very painful for the state budget, evidence the seriousness of the Court's approach:

1) when the indexation rules for old age and disability pensions changed starting from January 1996 the government tried to use some unclear provisions of the old law on the deadline for periodic indexation to avoid the indexation for the IV quarter of 1995; the Court ruled for the indexation to be conducted, which cost the budget 1.3 billion zloty;

2) in 1991 in an extremely difficult situation for the budget, the government ceased quarterly indexation of the state sector wages required by the law, but omitted to amend the law accordingly. Therefore, till the end of the half-year 1992 the discontinuation of indexation was not yet legalized. The Court looked into the matter in 1996 and ruled that compensation be paid out to the injured parties (who by that time had largely forgotten about the case). Compensation payments started to be disbursed in 2000 and will continue for

5 years. The cost oscillates between 0.3 – 0.5% of GDP per annum. The Constitutional Court's decisions are, as we know, final and cannot be appealed against.

Budgetary policy is made even more rigid by the obligation to service the public debt, i.e. make interest payments. Debt service is the exception among public expenditures mentioned above in that it does not result directly from statutes (although the State Treasury usually contracts a debt on the basis of statutory authorization). Even so, debt service constitutes the element of public expenditure subjected to most rigorous rules, which result from the paramount importance of the governments' credibility as a debtor for financial markets. State budgets depend on financial markets not only because deficits are financed by loans coming from the market, but also because of the need to constantly and on a large scale roll over the existing debt. In Poland in 2001 the issue of treasury securities traded on the market totalled 83 billion zloty (11.5% of GDP), of which only 23 billion zloty (4.0% of GDP) were used to finance the deficit, while the rest – almost two thirds – served as repayment of the existing debt. Therefore interest payments must be treated as the most rigid item among expenditure in both the state budget and local authorities' budgets.

All the constraints in the area of expenditure render it very difficult to undertake actions to reduce the share of public spending in GDP. This is the case when the real GDP growth rate is low and, as a result, so is the real public revenue growth rate (*nota bene*: the revenue growth rate is usually slightly lower than the GDP growth rate). However, when the GDP and revenue growth rates are high, rigid rules can produce an opposite effect. Fixed expenditure increases according to its own formula, independent of the GDP growth rate, and its growth rate may prove slower than the GDP growth rate, which will automatically lower its share in GDP.

The problem with rigid expenditures is not limited to the need to differentiate in treatment between individual categories while working on the budget. When the budget is adopted all expenditures become rigid and funds have to be allocated in accordance with the legal provisions. Complications arise when the actual revenue is different than projected because of an unexpected slow-down in the dynamics of GDP or mistakes in the forecast often caused by excessive optimism or "wishful thinking". The more the real revenue deviates from the budget law forecast, the more difficult it becomes to

adjust the level of spending to the new situation and contain the deficit within the statutory limits. The easiest solution is to amend the budget act, especially since the parliament, faced with the choice: to reduce spending or to increase the deficit will usually opt for the latter. The price to pay is a blemish on the financial reputation of the country on international markets, although, as demonstrated by the Polish example in 2001, the markets are sometimes willing to show a lot of understanding, especially when the economy is on the brink of recession.

Policy mix criteria

Policy mix is a certain combination of fiscal and monetary policies deemed appropriate on the basis of an adopted criterion. The basic problem is the criterion applied to choose the right combination. If the basic and practically the sole objective of monetary policy is stability of prices, or to put it better, curbing inflation it is rather doubtful whether that same objective could be set in fiscal policy, except for extraordinary situations. It is worth stressing that we are not talking about formally formulated objectives, which are announced when draft budgets are submitted to parliaments, but about the actual objective function adopted while drafting the budgets as annual fiscal policy programmes.

The issue of the objective function applied in drawing up the budget is not unequivocal. Naturally, there may be many different situations and approaches; usually it seems, however, that the final version of the budget (or rather of the budget bill, since the “input” of the parliament is ignored here) is the resultant of several motives. Two of them seem most important to me: firstly the will to discharge constitutional and statutory obligations, which rest with the state authorities to finance certain areas of public service, and secondly the attempt to ensure middle-term stability of public finance. There are also other kinds of motivation behind the budget, like the ambition to influence domestic demand, yielding to the pressure of various interest groups (which boils down to the amount of earmarked funds) or the attempt at some income distribution, for example between different regions. The list of motives could be longer, but I will focus on the two major reasons.

It should be stressed at this point that the actual author of the budget in parliamentary cabinet system is the council of ministers – a collegial body composed mainly of ministers who are responsible for different areas of public service and therefore – quite naturally – who are also advocates of generous funding for their respective fields, and the minister of finance, who is – usually – concerned with public finance stability. A confrontation between these standpoints is therefore inevitable and the budget can emerge only as a result of a compromise, which is most often achieved after head of the government's arbitration – be it prime minister or chancellor.

With all this in mind it is possible to model the budget drafting exercise or, in other words, the process of formulating fiscal policy for annual periods[2], as a system, in which the objective function is to maximize public expenditures while the limiting conditions result from factors determining mid-term stability of finance. Quantification of these factors is rather complex and is not simply limited to identifying the acceptable deficit level in the government part of the public sector, whether understood in the traditional sense as part of expenditure, which is not covered by current revenue, or in the sense of net borrowing. The threat of undermining the stability of public finances is not posed by the deficit financed from the previous year's surplus, or from the revenue coming from privatisation of state enterprises, which not only did not generate any profits for the budget anyway, but required constant subsidies. The real threat comes from the deficit covered by gross debt growth, or, to be more precise, from the increase in debt service cost in future periods caused by the growing debt. When a certain level based on the projected public revenue growth is exceeded, the stability of public finances is at risk. Thus we have come to the point of identifying the budgetary constraint of public finance. In contrast to the most common approach accepted in literature, however, we assume the constraint is of a dynamic nature and takes account of the projected economic growth.

So far I have assumed that public revenue is not covered by the scope of the budgetary compromise, meaning that systemic solutions relating to revenue are stable and revenue growth results solely from economic growth. The reality, however, is different and the compromise between aspirations related to spending and the concern for public sector financial stability is achieved to some extent by increasing the tax

burden. In economic theory the practice of increasing tax burden is criticized. One can only agree with that, remembering, however, that practice often differs from theory.

If fiscal policy respects the conditions necessary to maintain the stability of public finance it should not be too difficult to reconcile it with monetary policy aiming at minimizing inflation. In other words, it would not pose too many difficulties to ensure a reasonable policy mix even though the objective functions in both policies are different. This kind of fiscal policy would always be rather tight, which would enable the monetary policy, which is much more flexible due to its operational capacity, to adapt more freely to changing situations.

To consider in greater detail what it means that fiscal policy aiming at ensuring the stability of public finances is contractionary it is necessary to analyse the very term of contractionary fiscal policy first.

Contractionary fiscal policy

Contractionary fiscal policy is commonly juxtaposed with the loose or expansionary policy kinds. It is not often remembered, however, that both tightness and expansiveness are quantifiable and that it is possible to have a policy which is neither tight nor loose, and which could be called neutral. The common criterion applied to determine whether fiscal policy is contractionary or expansionary is budget balance – its deficit or surplus. It is not correct for many reasons, including various methods of calculating the balance, which produce different results[3]. For the time being, however, I will adopt this point of view.

The tight or loose character of fiscal policy is assessed on the basis of the balance changes in relation to previous periods. Thus, when the deficit has been allowed to grow, the policy is expansionary and conversely, when the deficit has been reduced it means that fiscal policy is contractionary. The opinion that the sheer fact of the deficit being present makes for expansionary - or loose - character of fiscal policy cannot be supported. It would mean that an actual policy is compared with some ideal model,

[2] Although longer time horizons are usually applied when drawing up a budget - in Poland the Public Finance Act requires a three-year period - but only the decisions for the year to come remain binding.

while it is only the actual policy changes from period to period that are truly meaningful. Only such changes – and not comparisons with some ideal model – can exert influence on the course of economic processes. This influence is precisely what we are after when we discuss policy mix as a combination of fiscal and monetary policy variants.

If all fiscal policies allowing for deficit were deemed "loose" we would end up in a completely absurd situation of ignoring the efforts, which are sometimes quite extensive, to curb the deficit.

Looking at public sector deficit figures (or surplus, but – since it occurs much rarer, I will focus on the deficit) is not, however, a correct way of evaluating fiscal policy. When we are talking about the influence of fiscal policy on economic processes, we mean first of all the influence exerted on domestic demand. Deficit is by no means tantamount to the demand effect of fiscal policy[4].

First of all, not all fiscal operations influence the domestic demand. Some public spending is channelled to foreign entities and part of the revenue comes from abroad as well. Usually however, foreign spending is significantly larger then foreign revenue. It results therefore in a public sector foreign deficit. Foreign expenditures include first of all interest payments linked with foreign debt service, the cost of maintaining diplomatic, consular, cultural and scientific posts and army units abroad, membership fees charged by various international organizations, and last but not least import of goods and services for the public sector. Foreign revenue is made up of interest payments on loans extended from public funds to foreign parties, mainly governments, plus consular and visa fees, etc. which are levied on foreign entities. All in all, the receipts are rather negligible.

Both Polish and international statistics on public finances lack data on the foreign fiscal balance. In particular, the expenditure on goods and services is not broken down into domestic sources and imports. Nevertheless, we could attempt a rough

[3] In the case of Poland we can list three methods of calculating deficit: (1) national, (2) based on the GFS system, applied by the International Monetary Fund, and (3) the method used in the European Union, based on ESA 95. Interestingly, the deficit is highest when calculated using the national method.

[4] The need to differentiate between fiscal deficit and the demand effect was highlighted by professor Jan Lipinski in his study "On the potential influence of fiscal policy on the domestic demand," yet unpublished.

estimate of the foreign revenue and expenditure balance for Poland in the conditions of the current year. If we assume that 7% of the public spending on goods and services for both current use and investment purposes comes from import, then foreign expenditures of the public sector can be estimated at 7.5 billion zloty (including 4.4 billion in interest payments). Foreign budgetary revenue – since other segments of the public sector have no foreign revenue at all – are expected to reach 66 million zloty. It means that foreign deficit of the public sector would amount to over 7.4 million zloty, which translates into circa 1% of nominal GDP.

Secondly, domestic public spending as a whole does not influence solely domestic demand. In part it generates also private savings. In Poland among the most important are:

1) the state subsidy for the Social Security Fund which compensates the shortfall in social insurance premiums caused by their transfer to the open pension funds; the subsidy increases the level of private savings which will later be invested on the financial markets. In the current year the budget law provides for the subsidy of 11.7 billion zloty.
2) a significant part of domestic debt service interest payments is converted into savings; it concerns in particular the payments channelled to institutional investors, among them the open pension funds mentioned above, but also banks and households. The budget act for the current year provides for domestic debt service interest payments totalling 20.8 billion zloty. A cautious estimate would therefore be that at least half of this amount will increase domestic savings,
3) public funds transfers to households as net wages and social benefits (less income tax and obligatory social security and health insurance premiums) can be estimated at 150 – 155 billion zloty. If we assume that households will put aside 3% of the total as savings (which seems a very conservative estimate, since in the last years an average household saved circa 11% of its disposable income), than it will amount to 4.5 billion zloty.

All in all, it can be said that public expenditure will generate private savings in the amount of almost 27 billion zloty, which would translate into circa 3.6% of the projected GDP.

When we take together the foreign deficit of the public sector and the private savings generated as a result of public spending, the demand effect of the budgetary deficit amounting to 4.6% of GDP might actually be close to zero. This result should be borne in mind when fiscal policy is evaluated as either tight or expansionary, especially from the perspective of its coordination with monetary policy, in which the demand effect should come to the foreground.

The above argument is not intended to prove that fiscal deficit of 4.6% – at least in Poland in the current year – is correct or desirable. On the contrary, judged against the criterion of public sector stability such deficit would be far too big and could undermine its financial stability. The foreign balance and the expenditure, which generates private savings, do not produce the demand effect. As public spending components, however, they do contribute to the deficit, which has to be financed by increasing the debt. This is true, of course, only for those situations in which the revenue is unable to cover total expenditure.

Our reasoning so far leads to the following conclusions:

1) the demand effect and the deficit of the public sector should not be equated;
2) in the context of formulating a policy mix, which would be appropriate in the given circumstances, the character of fiscal policy should be evaluated against the demand effect it produces;
3) in numerical terms the demand effect is less than the deficit.

An important problem to be explained is defining the amount of allowable deficit, which would not threaten the stability of public finance.

Allowable deficit ceiling

Debt, which is financed by increasing the public debt, poses a threat of undermining the stability of public finances. It means that the part of the deficit, which can be financed by disposing of parts of the public sector assets, especially the State

Treasury's, remains outside the scope of the discussion on the allowable deficit ceilings. It does not mean that the disposal of assets to cover the deficit is unimportant. The process definitely merits some attention.

The possibility to finance the deficit by disposing of assets is always a transitional phenomenon. The assets owned by the public sector are rarely worth enough for the sale proceeds to ensure a systematic financing of deficits. Moreover, the disposal of a large part of the assets, for example the sale of the works of art from national collections, is for many reasons inadvisable. Generally speaking, there are four kinds of assets which can be disposed of to finance the deficit:

1) financial resources from the previous period exceeding the amount of financial reserves, which would be desirable in the context of liquidity management;
2) stocks and shares in enterprises sold during privatisation;
3) foreign loan receivables, related mainly to loans to the governments of other states (when a government is willing to repay its debt, which does not happen too often, we should probably talk of luck rather than asset disposal)
4) non-treasury securities – domestic or foreign, which came to be owned by public entities more or less accidentally.

As we can see, apart from privatisation proceeds, these are assets of a rather limited value, which appear accidentally. Privatisation proceeds can amount to quite a lot, but hey also have a transitory character, even if they are collected over several years. Balancing public spending against public revenue on the basis of the asset disposal revenue is therefore like setting a trap for oneself for the future: when this kind of revenue ends as end it must, there is a gap which can only be closed by curbing expenditure, increasing taxes or allowing an even greater deficit. An analogous situation appears when the budget is balanced on the basis of extraordinary revenue, which is either one-off or irregular.

In my opinion the most appropriate criterion for determining the allowable deficit amount is its influence on the costs of public debt service in the following period. A deficit in a particular year should not exceed a ceiling above which it could result in such an increase in the public debt in the consecutive year - at a given interest rate - that would lead to a higher ratio of total debt service costs to revenues in

comparison with the initial year. Seen in that way, the ceiling for allowable deficit depends on the economic growth projected for the following year, since it determines the public revenue growth rate, and on the interest rate charged on the loans used for financing in the given year.

Two issues merit special attention in the process of calculating the allowable deficit:

1) with unaltered systemic solutions, the public revenue growth rate is usually slightly lower than nominal GDP growth rate; it seems to be caused by developing skills of the taxpayers to lower the tax burden by legal and semi-legal methods, without actually breaking the law;
2) debt growth is always bigger than the total amount of the deficit, although the degree may vary; it depends on the debt instruments structure and the discount rate in particular.

According to simulations, with a projected revenue growth in the following year of circa 4.5% and the loan interest rate of 8% the allowable deficit would amount to 2% of GDP. With a faster revenue growth and lower interest rates the allowable deficit could be bigger, and conversely, with a slower growth rate and higher interest rate it would be lower. The allowable deficit at the level of 2% of GDP is not a universal rule, only a result of simulations conducted with certain parameters. In each case the allowable deficit level should be determined by a separate calculation.

A deficit at 2% of GDP would mean a negative demand effect. With the estimates presented above of the public expenditure components that do not influence the level of domestic demand, the negative demand effect could even amount to circa 2.6%. However, the estimate concerned a special case and should not be used as a basis for sweeping generalizations. Beyond doubt, however, the expenditures, which do not affect the demand, will be greater than 2% of GDP. Therefore a fiscal policy aiming at the deficit of 2% can rightly be considered as definitely tight.

A deficit of 2% would keep the share of public debt in GDP stable, or even lower it slightly. With the deficit of 3% the share will have an upward trend.

It is worthwhile to consider one more thing here. Fiscal policy codified as provisions of the budget law has an ex ante character in that it is a combination of intentions about the future and thus it is based on forecasts and assumptions. It has

therefore an inherent risk that the actual economic processes will turn out less favourably than assumed. Naturally the deviation from the forecast in the statute can also be positive. Usually, however, the forecast is optimistic rather than pessimistic (the statute assumes the upper, not the lower end of the bracket of the potential course of events) and negative deviation is more likely than positive. Therefore it would be advisable that some safety margin be introduced and the fiscal policy be based on the assumption that the deficit should amount to 1.5% and not 2%.

The theory on the allowable public sector deficit presented above is quite similar to the solutions proposed in the Stability and Growth pact adopted in 1997 by the member states of the European Union. There is, however, one major difference. The Stability and Growth Pact has a deficit ceiling of 3% of GDP (resulting from the Treaty of Maastricht from 1992) that cannot be exceeded. It recommends that member states should reach “a national medium-term budgetary target close to balance or in surplus” [5]. The solution is justified by the need to create “a safety margin to avoid excessive deficit.” The idea behind the safety margin is, as can be deduced from several commentaries, that it should not only compensate for the risk mentioned above (the risk that public revenue might drop unexpectedly in a situation where it would be extremely difficult to curb the spending planned for the fiscal year), but also enable a fiscal policy aimed at sustaining demand. And here is where doubts appear.

Fiscal policy can of course sustain falling demand, in particular by increasing spending, but it is questionable whether such measures are reasonable. First of all the cost of such actions (taking into consideration the consequences in the following years) is too high compared with rather modest results. Secondly, when spending is increased once it is difficult to take a step back when the economic situation improves. There is a danger that the practice of increasing the deficit, which was to be only temporary, will become an established rule. The situation is different when public revenue falls as a result of an economic slowdown. Radical reduction of spending would not be very constructive in such circumstances, since it would lead to worsening the economic situation even further and would deepen the recession trends. When no active measures

[5] Council Regulation no. 1466/91 of 7 July 1997, art. 3

to prevent economic slowdown are planned, the safety margin can be smaller. It does not have to be as big as 3% of GDP.

To avoid misunderstanding I should explain that in my opinion, when the economic situation is satisfactory and public revenue is lower than expected due to incorrect planning, there are absolutely no reasons why expenditure should not be radically curbed, without breaking the law, of course.

To conclude, I think it is reasonable to keep the deficit at the level of 1 – 1.5% of GDP. The local government part of the public sector should account for a significant part of the deficit, because local authorities, especially down on the level of communes (gminas) are practically doomed to deficit. Since their investments have to be indivisible, they cannot be financed from current tax revenue and have to resort to debt financing, which leads to a deficit. However, it is advisable that local governments should have limited access to the financial market to be able only to take out investment loans. This rule is applied in many countries, although not in Poland.

In the government part of the public sector, however, some deficit is even desirable, although only in the state budget. The social security system and other appropriated allocations, if they have been set aside, should be balanced, if necessary with budget subsidies. The deficit in the government part of the public sector should be concentrated in the state budget. In the appropriated funds only such deficits should be allowed as can be financed with the previous year's surplus.

The deficit in the government part of the public sector can be useful for two reasons. Firstly, a deficit, which does not threaten to undermine the stability of public finances, permits a slightly lower level of tax burden. Secondly, it ensures a fresh supply of government debt instruments on the financial market, which has a beneficial influence on the market, ensuring diversification of the available supply.

Ways of curbing the deficit

When the public sector deficit is too high compared to the allowable level, it is inevitable that it must be reduced, if the financial crisis is to be averted. The question arises, how it can be done.

Poland has now found itself in a situation when quick reduction of the deficit is absolutely necessary. The foreseen deficit of the Polish public sector in the current year has been estimated at 6.4% of GDP. The indicator has to be calculated on the basis of the national method. As it happens, the national method produces the highest result in numerical terms; calculated according to the ESA 95 method applied in the European Union, the indicator is lower (4.1% of GDP)[6]. The difference does not, however, alter the fact of the deficit itself. It has to be reduced quite quickly. Yet, when we look at the experience of other European countries, we will see that the degree by which the Polish deficit has to be reduced is not that great at all.

It was in Ireland where fiscal deficit was curbed in the most impressive way. In 1985 the country's deficit equalled 10.3% of GDP[7]. After 15 years Irish public finances had a surplus of 4.7% of GDP. In the meantime public spending went down from 50.5% of GDP to 30% of GDP and the tax burden (together with non-tax burden) sank from 40.2% of GDP to 34.7%. The secret behind the Irish success, however, was a very quick real GDP growth rate, with the annual average in the 90s of 6.9%. Such a high growth rate permitted a quick increase of public spending. Although its share in GDP fell by 20 percentage points in 2000, in real terms it was higher by more than 50% than in 1985.

It is very difficult to follow the Irish example, since it can hardly be expected that Poland can achieve this level of GDP growth. However, it is possible to significantly curb the deficit with a much lower GDP growth rate. In Spain the GDP growth rate was slower than in the years 1996 – 2000 with the average of 4.7%. Nevertheless, Spain managed to reduce the deficit from the level of 6% of GDP in the years 1993 – 1995 down to 0.3% in 2000. The reduction was possible due to the cuts in public spending from circa 45% of GDP to 38% in 2000. The share of tax and non-tax revenue in GDP remained unchanged (1994 – 39.0%, 1995 – 37.4%, 1999 – 38.2%, 2000 – 39.4%). The result might not be as spectacular as in Ireland, but it nevertheless merits attention. The reduction is likely to have been achieved with greater efforts than in the former case, since the increase of expenditure in real terms, if any at all, was barely noticeable.

[6] This indicator has been developed by the Ministry of Finance in close co-operation with Eurostat in order to ensure its methodological correctness. It has been published in the "Pre-accession economic programme 2002"

[7] Source of these and the following data: OECD, Economic Outlook

The Portuguese way was different. In mid-90s the deficit in Portugal was similar to that in Spain (in 1994 and 1995 the deficit was at 5.9% of GDP). The real GDP growth rate was comparable as well (4.9%). As a result of measures undertaken in the second half of the 90s the deficit was reduced to 2.0% of GDP in 1999 and further down to 1.4% in 2000, according to official data. When governments changed, the deficit estimate for 2001 was challenged; in this context it is possible that the previous data was not fully correct either, but in my argument I will ignore that possibility. On the basis of official data the share of public spending in GDP in Portugal was not reduced. It did fall from 42.6% in 1994 to 40.0% in 1996, but then rose again up to 41.6 % in 2000. The share of revenue in GDP was growing all the time: from 36.8% of GDP in 1995 to 40.2% in 2000. It means that Portugal reduced its deficit by increasing the tax burden.

Another country, which is worth looking at, is Italy. The country had a very low real GDP growth rate: in the 90s the average was 1.2%. The late 90s witnessed some improvement (for the period 1996 – 2000 the average was 1.9%). In the early 90s Italy was running record high deficits in Europe. In 1990 the deficit was at 11.0% of GDP, in 1991 – 10.0%. When the Treaty of Maastrich was signed it seemed impossible for Italy to reduce the deficit down to the maximum ceiling of 3% of GDP by 1999 and make it into the economic and monetary union, given the low growth rate. In 1998, however, according to the official data, the deficit went down to 2.8%, in 1999 – 1.8% and in 2000 – 0.3% of GDP, which enabled Italy to join the EMU. Today Italy complains about the difficulty in containing the deficit in the prescribed limits of 3% and is said to push for raising the ceiling of allowable deficit, but that is a completely different story.

The fiscal deficit in Italy was reduced primarily by cutting down public expenditure in the real terms. While in 1992 public spending accounted for 52.4% of GDP, in 1994 – for 52.8% (in 1993 for as much as 55.4%, but it can be considered “an accident”) in 1998 for only 47.3%, in 1999 for 46.7%, and in 2000 for 44.4 %. The increase in tax burden was rather limited; the share of public spending in GDP was at 42.1% and 42.9% in 1991 and 1992 respectively, in the years 1997 – 2000 it remained in the brackets of 44.1 – 44.9%.

The Irish way of curbing the deficit is rather difficult for Poland to follow, since in the coming years it can barely be expected that the GDP growth rate will be as fast as

in Ireland. However, it is worth pointing out that Ireland significantly reduced its spending as early as in the years 1987-1988, when the GDP growth rate did not exceed 5%. The tax burden was not limited in this period and the deficit went down from 10.2% of GDP in 1986 to 4.2% in 1988. Ireland at the end of the 80s rather than in the late 90s could therefore be after all a realistic example.

It seems that in Poland the reduction of the deficit calculated on the basis of the national method down to 2% of GDP (which in my opinion would be completely satisfactory) would have to entail some increase in the tax burden. However, following the Portuguese example, where curbing the deficit was done exclusively by raising the taxes, would be wrong and detrimental to the economic growth. At the end of the day it is the economic growth that will determine the reduction of the deficit down to the level, which would not threaten to undermine the financial stability of the public sector. Once Poland succeeds in achieving an adequate growth rate and once it reduces the share of public spending in GDP (today the ratio stands at almost 47% of GDP, calculated according to both the national and the ESA 95 methods) we can start reducing the tax burden.

Warsaw, 1st September 2002