

FISCAL SUSTAINABILITY AND THE WELFARE STATE IN EUROPE

Zsófia Barta¹

¹University at Albany, SUNY

***Abstract:** The issue of fiscal sustainability has gained increasing attention in the past decades as many prosperous developed countries grapple with growing levels of explicit debt and implicit liabilities. However, there is a considerable gap between the theoretical concept of fiscal sustainability and the metrics that policy-analysts use in practice to gauge looming fiscal problems. The discrepancy has considerable impact on the policy recommendations that follow from different assessments of fiscal sustainability. This chapter contrasts the theoretical literature on fiscal sustainability with the practical applications of the concept by organizations like the IMF, the OECD and the European Commission to explore the implications of different assessments for policy. It shows that tests of fiscal sustainability applied by these three entities rest on partial equilibrium models that support a very conservative interpretation of fiscal sustainability, which is not inherent in the theoretical concept. Recommendations for austerity logically follow from this particular interpretation. The chapter also presents an alternative conception of sustainability, which seeks to combine fiscal, economic and social sustainability through appropriate social spending. It notes that the IMF, the OECD and the European Commission had embraced this alternative notion before, but it seems to be completely abandoned in the wake of the Global Financial and Economic Crisis.*

***Suggested Citation:** ACRN Oxford Journal of Finance and Risk Perspectives, 4(3). July 2015, from <http://www.acrn-journals.eu/jofrp/jofrp0403.html>*

Introduction

Are European countries headed for bankruptcy? Many analysts seem to think so. Sovereign debt crises and elevated debt levels left in the wake of the Global Financial and Economic Crisis called heightened attention to the issue of fiscal sustainability in Europe. In recent years, expert observers in the ranks of the European Commission, the IMF and the OECD have warned that the overwhelming majority of European countries – even the ones not currently at risk of a debt crisis – cannot afford to continue their present policies indefinitely into the future without risking explosive debt growth and, ultimately, default. They urge governments to correct their budgetary balance and bring public debt down to more manageable levels. Citing already high levels of taxation, they advocate structural reforms to public spending (OECD 2010, IMF 2013).

As logical as it seems to call for budgetary corrections in the face of unsustainable budgetary imbalances, such policies might be counterproductive not only in the short run, but also in the longer term. Embracing austerity arises from a particular – and partial – interpretation of fiscal sustainability, which takes crucial parameters of sustainability as externally given. However, since economic growth is one of the main determinants of fiscal

sustainability, it is imperative to factor in the second-round effects of reforms of public spending on growth. This chapter argues that a more comprehensive understanding of fiscal sustainability can lead to radically different policy recommendations that emphasise the productive role of social spending. However, in the present economic and political climate, the austerity paradigm is almost sure to dominate.

The next section examines the theoretical foundations of the concept of fiscal sustainability. The second section shows that the current discourse on fiscal sustainability rests on partial equilibrium models of sustainability that are bound to support the austerity paradigm. The third section elaborates on the alternative approach that sees social spending as a productive force and explains that – despite earlier efforts to incorporate the alternative approach into European policy-making – the austerity paradigm is likely to carry the day in Europe in the foreseeable future. The last section concludes by contemplating the role of the crisis in the dominance of the austerity paradigm.

What is fiscal sustainability?

A key thing to note when pinning down the meaning fiscal sustainability is that the definition rooted in pure economic theory and actual indicators used for policy analysis are not fully aligned (Balassone and Franco 2000, Chalk and Hemming 2000). Since the theoretically grounded definition of fiscal sustainability does not lend itself easily to practical application, practical indicators impose criteria and benchmarks that are not inherent in the theoretical concept of fiscal sustainability and therefore introduce a considerable degree of arbitrariness into the assessment of the sustainability of existing policies. This section explains both the theory of fiscal sustainability and practical approaches to gauging sustainability to demonstrate the gap between the two. It argues that the benchmarks that currently used sustainability indicators rest on bias assessments to create an exaggerated urgency of budgetary adjustment and divert attention from alternative policy options of dealing with existing budgetary problems, which would emphasize sustained growth.

From a purely theoretical perspective, fiscal policy is sustainable as long as it does not endanger a sovereign's solvency now or any time in the future. This requires that public debt never exceed the present value of future primary surpluses either in the present or the future. This condition is commonly referred to as the no-Ponzi game condition (Chalk and Hemming 2000, Buiters 2004, Ostry et al 2010). Therefore, in the long run, the rate of debt accumulation should be smaller than the interest rate (Spaventa 1987). Notably, this condition does not necessarily rule out large deficits or high and growing debt. Debt is allowed to accumulate as long as it is viable to run large enough primary surpluses in the future to counterbalance the accumulation (Chalk and Hemming 2000). The key question is of course what the limits to viable future primary surpluses are. Since the size of future primary surpluses is constrained by the size of the economy – because governments cannot raise more revenue than the income the economy generates – the debt-to-GDP ratio has to be bounded (ibid). Therefore, sustainability requires that at some point in time high enough primary surpluses need to be generated so that the debt ratio stabilizes (Blanchard et al. 1990).

However, applying these theoretical considerations to provide policy recommendations in terms of limits for admissible levels of debt, deadlines for stabilization or the size of adjustment necessary is wrought with practical difficulties, because the calculation involves input parameters that are impossible to forecast. On the one hand, the calculation crucially depends on assumptions about the maximum level of primary surpluses that can be achieved at some point and maintained indefinitely into the future in order to stabilize the debt-to-GDP ratio. The absolute theoretical limit is of course a hundred percent of the GDP, but that is

clearly impossible in practice. Most analysts of fiscal sustainability agree that political and economic factors place very tight limits on primary surpluses, but operationalizing that limit is by no means straightforward (Spaventa 1987, Blanchard et al. 1990, Roubini 2001, Ostry et al. 2010). On the other hand, interest and growth rates – further crucial input parameters of the calculation – can change abruptly due to exogenous shocks, so a debt level that appears sustainable under one set of assumptions might lead to instantaneous insolvency if interest rates surge or the growth rate plunges. Therefore, it is impossible to estimate the maximum level of sustainable debt, provide a firm deadline for stabilizing a growing debt ratio or otherwise definitively show when policies are close to violating the long-term solvency constraint.

Empirical-practical assessments of fiscal sustainability have sought to escape these difficulties in three different ways. *Sustainability tests* use advanced statistical models to retrospectively gauge whether fiscal policy has followed a sustainable path up to the present¹. This approach deals both with the difficulty in forecasting interest and growth rates and with the indeterminacy of the maximum level of primary surpluses, because it uses past observed values for all of these variables. However, the usefulness of this approach for policy analysis is rather limited. First, there is considerable disagreement among scholars about the statistical test that best captures the concept of sustainability, and studies using different statistical methods and different data sources have drawn contradictory conclusions about fiscal policy in the same country in the same period (Chalk and Hemming 2000, Croce and Juan-Ramon 2003). Second, the backward-looking assessment says nothing about how well policy might adapt to challenges of the future. Third, the statistical tests applied are quite arcane and they fail to provide a clear, easily interpretable policy metric of the urgency or the size of a necessary adjustment. They show whether the hypothesis of retrospective sustainability can or cannot be rejected. However, the only conclusion that can be drawn from this is whether policy can go on unadjusted forever, but no indication is given to what extent or how urgently it needs to change.

In contrast, the main advantage of the second approach is its ability to generate a metric to demonstrate the magnitude and the urgency of the necessary correction. *Primary gap indicators* measure the adjustment to the primary balance that would need to be carried out today if the debt-to-GDP ratio was to be stabilized immediately (Buiter 1985, Blanchard 1990). As an alternative to the ‘primary gap’, Blanchard also calculates the ‘tax gap’, which is the change in the tax ratio that would be necessary to stabilize the current debt-to-GDP ratio (Blanchard 1990). In other words, this approach works with the arbitrary assumption that the debt target is the current level of debt and stabilization is to happen in the present, in order to sidestep both the ambiguities concerning the maximum admissible level of debt and the problems involved in estimating future interest and growth rates. Primary gap indicators provide a diagnosis that is easy to interpret because they show how painful the adjustment would need to be to stabilize the debt today. Although a positive fiscal gap means neither that the country's solvency is in immediate jeopardy, nor that adjustment is instantaneously needed, the size of the gap gives an indirect indication of how long the adjustment can be put off without risking that tax increases and/or spending cuts needed to secure continued solvency would be unrealistically large. Keeping in mind that – unless 'exogenous' conditions like interest and growth rates change – the sustainability gap keeps widening as long as adjustment is delayed and debt is allowed to grow, users of the primary gap indicator can decide for

¹ For a detailed technical presentation of these, see Chalk and Hemming (2000, pp 65-66)

themselves how close the present need for adjustment is to the limit of what is politically and economically feasible.

The two main limitations of this approach both arise from its avoidance of the thorny issue of estimating maximum sustainable debt limits and maximum viable primary surpluses. From a theoretical perspective, the first limitation is more serious. By pinning the issue down in the present – both in terms of the debt target and in terms of the timing of adjustment – the primary gap indicators impose a condition that is neither necessary nor sufficient for the sustainability of fiscal policies (Spaventa 1987). Present debt levels that can be stabilized by immediately closing the primary gap given current interest and growth rates might still threaten solvency if interest rates rise and/or growth rates drop. Conversely, they might also be low enough to allow further debt accumulation under more favourable combinations of interests and growth. The second limitation is more practical. In the absence of a concrete estimate for limits on viable future primary surpluses (and, by the same token, for the limits on viable adjustments), the assessment of the gravity of the sustainability problem on the basis of the fiscal gap indicator becomes a highly subjective exercise.

The recently developed third approach seeks to address the shortcomings of all of its predecessors. The *fiscal space indicator* builds on the statistical testing approach insofar as it uses historical data and it is rooted in the same intuition that drives the most recent generation of statistical tests of sustainability. Instead of focusing on the adjustment needed to restore the stability of the debt-to-GDP ratio in any given moment (like primary gap indicators), it defines sustainability as a fiscal path along which the primary surplus reacts sufficiently to increases in debt to ensure that the debt-to-GDP ratio is bounded in the long run. The intuition is that fiscal policy is sustainable as long as the primary surplus reacts sufficiently strongly to changes in debt to make sure that debt growth is bounded in the long run (Bohn 1998, 2008). At the same time, it also provides a tangible, policy-relevant indicator similar to the primary gap indicators, which helps to assess the sustainability of a country's fiscal position at one given point in time. Using a country's historical track record of adjusting primary surpluses to debt levels, the fiscal space approach models the evolution of primary surpluses as a function of the debt-to-GDP ratio. The path along which primary surpluses grow as debt grows is country-specific: it is determined by a large number of political, social, institutional, economic and fiscal factors (Abiad and Ostry 2005, Ostry et al 2010, Eichengreen and Panizza 2014). The model shows that the reaction of the primary surplus to debt growth declines as debt levels get higher, so the primary surplus levels off at a given debt-to-GDP ratio. Identifying this level as the maximum of viable primary surpluses, the model provides an upper limit on the debt-to-GDP ratio, which is still consistent with solvency based on the historical evolution of the primary surplus. Fiscal space is difference between current debt-to-GDP ratio and the upper debt limit. Therefore, it is an indicator of the amount of debt the country can accumulate on top of its existing debt stock without risking insolvency (Ostry et al 2010, Ghosh et al 2013).

However, the improvements of the fiscal space model on alternative approaches come at a price. Compared to primary gap indicators, the fiscal space indicator provides much less concrete policy recommendation. Although the size (and especially the shrinking) of fiscal space is a good way to drive home the gravity of a fiscal situation, this indicator does not give an indication of the size of adjustment that needs to be carried out. Compared to statistical tests, the main drawback is the need for estimates and forecasts of future interest and growth rates as well as future primary surpluses. Just like in the case of primary gap indicators, the validity of the assessments of sustainability through the fiscal space model are very sensitive to assumptions about those parameters (Balassone and Franco 2000).

In this context, it is important to note that both the fiscal space model and primary gap indicators rest on a *partial equilibrium* analysis that considers interest and growth rates to be

exogenously given. In the calculation of the original primary gap indicators, present interest and growth rates are used, because the indicator assumes immediate stabilization. If stabilization is assumed to take place in the future, interests and growth have to be forecasted. The fiscal space model predicts future long-term interest and growth rates on the basis of historical data, whereas primary surpluses are partly endogenous (changing as a function of debt growth subject to country-specific political, social and economic factors). Admittedly, the fiscal space model incorporates some endogeneity in the determination of interest rates insofar as escalating risk premia are assumed to apply to countries that are approaching their maximum debt level. However, no attempt is made to incorporate effects of debt on growth.

Because they rely on partial equilibrium analysis, none of the tangible, policy-relevant indicators take into consideration the second round effects of adjustment or the lack of adjustment on interests and growth (Balassone and Franco 2000). Although it is understandable given the intensity of disagreement about both the short-term and the long-term effect of debt and austerity on growth and interest rates², this omission is important for two reasons. On the one hand, forecasts used to calculate those indicators are *bound to be incorrect*. Growth and interest rates can be expected to change due to a complex set of reactions by private actors, both if adjustment is made and the structure of fiscal policies changes and if sustained policies lead to a persistent accumulation of debt. This means that any assessment of fiscal sustainability using current estimates for interest and growth rates is insufficiently reflexive of future changes in those parameters.

On the other hand – and more importantly – the assumption of exogenously given interest and growth rates in the partial equilibrium analysis *favours austerity over other forms of adjustment that target growth or interests*. Both types of sustainability indicators are inherently biased towards budgetary adjustment because of the way they are defined. Primary gap indicators as well as the fiscal space indicator focus on the link between budgetary change and sustainability only, even though it is clear from the theoretical definition that sustainability is jointly determined by primary surpluses, growth and interest rates. The assumption that growth and interests are exogenously determined is part and parcel of the focus on primary balances. While this definition conveniently simplifies the indicator to be easily applicable in policy analysis, failure to model the effects of changing growth and interest rates on sustainability can easily lead to the conclusion that budgetary adjustment is the only game in town. The only way to mitigate this bias is to always complement sustainability indicators with explicit sensitivity analyses of the results to changing interest and growth rates in order to demonstrate the effects of policies aimed at changing those parameters.

In sum, while the theoretical concept of sustainability is fairly straightforward, its practical application is wrought with insurmountable difficulties that require trading off clarity, intuitiveness and policy relevance against theoretical precision. On the one hand, sustainability tests seek to remain closely aligned with theory at the expense of using arcane statistical methods that do not easily translate to policy-relevant conclusions. On the other hand, sustainability indicators – both the fiscal space indicator and primary gap indicators – impose arbitrary simplifying assumptions for the sake of producing intuitively appealing,

² For the controversy about the long-term effects of debt on growth see Pattillo, Poirson, and Ricci 2002, Reinhart and Rogoff 2010, Kumar and Woo 2010, Irons et al. 2010, Herndon et al 2013, Panizza and Presbitero 2013. On the short-term effects of fiscal consolidation on growth see Domar 1944, Giavazzi and Pagano 1990, Alesina and Perotti 1996, Alesina et al 1998, Mulas-Granados 2003, Alesina and Ardagna 2009, Eggertsson and Krugman 2012.

policy-relevant metrics. Due to these simplifying assumptions, the indicators are not fully aligned with the theoretical definition of sustainability – and impose conditions on policy that are neither necessary, nor sufficient for sustainability – while at the same time lead to policy recommendations that are biased towards budgetary adjustment and disregard the options of targeting growth or interest rates. The next section shows that primary gap indicators dominate assessments of fiscal sustainability in Europe and argues that this leads to an exaggerated emphasis on the need for austerity, which overshadows alternative conceptions of economic and fiscal consolidation.

Fiscal sustainability in current policy analysis

Motivated by concerns about high debt stocks, the costs of population ageing and worrisome growth prospects, supranational entities – the European Commission, the IMF and the OECD – have paid intense attention in the past few years to the issue of fiscal sustainability in advanced economies in general and European countries in particular. The opinions of these organizations matter greatly for policy making in Europe both because they set the tone of the discourse on policy options due to their prestige and immense research capacities and because they can bring pressure to bear on governments in various pecuniary ways. At first sight, the three entities approach the issue quite differently, but beyond apparent divergences in style, the pronouncements of these three entities are remarkably aligned. They use similar definitions of sustainability, apply very similar (arbitrary) benchmarks for admissible levels of debt, set similar deadlines for consolidation, and recommend immediate budgetary correction across the board without entertaining alternative policy options to influence growth or other structural determinants of the budgetary balance in the medium- or long-term.

In Europe, sustainability analysis is carried out by the Directorate General of Economic and Financial Affairs of the European Commission based on a mandate provided by the Treaty of the European Union as well as the Stability and Growth Pact. Initially, it was included in the assessment of stability programmes, but since 2006, Fiscal Sustainability Reports are issued every three years, which provide a comprehensive overview of sustainability challenges across all member states. The analysis presented in these reports place very strong emphasis on the quantitative-technical aspects of sustainability assessments: they make the calculation of the size of sustainability challenges fully transparent and mostly refrain from making specific policy recommendations (with the exception of advocating pension reform).

Recent OECD publications, on the other hand, forego explicit presentation of the quantitative assessment of sustainability and instead concentrate on providing unequivocal policy advice on how to best carry out the budgetary adjustments they deem necessary. Since the start of the Global Economic and Financial Crisis, the OECD has published two documents on the sustainability challenges that OECD member states face. One opens with a quick case for immediate stabilization and then summarizes the past experience of OECD member states with fiscal consolidation to provide lessons on how to best carry out the necessary adjustment (OECD 2010). The second document analyses the size of necessary adjustment and reviews adjustment measures already announced by individual countries (OECD 2011).

IMF publications take the middle ground by advocating budgetary adjustments – based on background calculations of sustainability measures – without making specific policy recommendations on where and how to tighten the budget. The IMF has recently revised its methodology of assessing fiscal sustainability (IMF 2011 and 2013) and comments regularly on sustainability issues and commendable adjustment measures in its yearly Fiscal Monitors.

The documents issued by the three organizations – explicitly or implicitly – define sustainability as the ability to continue current policies indefinitely into the future without foreseeable need for future adjustment. According to the European Commission’s Fiscal Sustainability Report, “[s]ustainability of fiscal policies is the ability to continue now and in the future, current policies without change regarding public services and taxation, without causing the debt to rise continuously as a share to GDP” (EC 2012, p17). For the IMF, “[t]he fiscal policy stance can be regarded as unsustainable if, in the absence of adjustment, sooner or later the government would not be able to service its debt.” (IMF 2011, p5). Recent OECD publications refer to sustainability without providing an explicit definition of the term. These definitions impose stronger constraints on policy than the theoretical concept of sustainability. The theoretical interpretation implies that policy is sustainable as long as it is feasible to halt debt growth some time in the future. The definition used by the EU, the IMF and the OECD, on the other hand, requires that current policies ensure non-growing debt levels for the foreseeable future *without change*. Naturally, it does not rule out future adjustment to unforeseeable shocks, but it does demand that present policies keep debt from growing even once predictable future changes in underlying conditions – most importantly, population ageing – kick in and exert pressure on the budget.

Given their focus on stable debt levels, all of the documents work with primary gap indicators that show the size of the adjustment that would need to be carried out to stabilize the debt-to-GDP ratio. At the same time, all entities impose stronger requirements than the original primary gap indicators, because they call for the debt-to-GDP ratio to converge to a level considered to be sufficiently safe, rather than requiring it to stabilize at its current level. Remarkably, all three entities choose 60 percent to be the appropriate target for the debt-to-GDP ratio. In the case of the European Commission, the use of the 60 percent benchmark is unsurprising, given that it was chosen as a benchmark in the original Maastricht criteria and is now used as an upper limit for debt in the Treaty on the Functioning of the European Union. Although the economic rationale for this upper limit was debated at the time of its adoption (Buiters 1993), the Commission is bound to work with it. What is more intriguing is that the other two entities unbound by EU regulation also stick to the same targets. The IMF justifies the 60 percent upper limit with reference to empirical studies on prudent debt levels (IMF 2011, p13). OECD publications use primary debt indicators with a debt target of 60 percent without any reflection on the appropriateness of this choice. All three entities require that the target be reached within the next ten to fifteen years. The 2012 Fiscal Sustainability Report of the Commission explains that 2030 was chosen as the deadline for reaching the debt target “to be [far] enough to allow the impact of ageing to be analysed in a meaningful way, while still remaining within the sights of current taxpayers and policy makers” (EC 2012, p4). The choice of the target date is not discussed in either the IMF or the OECD publications (they use 2030 and 2025, respectively).

In order to test whether current policies are sustainable even in light of population aging, the documents factor the costs of ageing that arise until the target date into projection of revenue and expenditure trends. As a supplement, the 2012 Fiscal Sustainability Report also calculates the conventional primary gap indicator (with an infinite horizon and no particular debt target) to demonstrate the effect of budgetary pressures from ageing beyond the target date of 2030. The Report also meticulously documents the different components of the two sustainability indicators: the adjustment needed to reach the debt-stabilizing primary balance, the added adjustment necessary to reach the debt target and the adjustment needed to counterbalance the costs of ageing.

These choices made in selecting and computing the key indicators impact the assessment of fiscal sustainability dramatically. First, by quantifying the necessary change in the primary

balance, the primary gap indicator focuses attention unduly strongly on explicit spending cuts or tax increases, because growth and interest rates as well as underlying structural conditions influencing the evolution of spending and revenues are all assumed to be exogenously given. This diverts attention away from ways to deal with fiscal challenges through measures aimed at influencing the real economy and underplays the risks of unfavourable economic changes in the wake of major retrenchments of public services and social safety nets. Second, this bias towards fiscal adjustment is aggravated by an exaggerated sense of urgency of fiscal challenges. Urgency matters, because the less time there is to act, the more constrained a government is to use policy options that can be imposed by fiat – like a spending cut or a tax increase – and the less possibility to experiment with options that might exercise their effect indirectly in the long run as some growth-enhancing or employment boosting measures might do.

This exaggeration of the acuteness of fiscal problems arises from the requirement to bring debt-to-GDP ratios under the (arbitrary) limit of 60 percent and the incorporation of ageing costs into current policy analysis, because they inflate the sustainability gaps. Based on the numerical results, all three entities draw the conclusion that the majority of European countries face a serious problem that needs to be addressed through resolute and prompt budgetary adjustment (EU 2012, p1; IMF 2013, p vii, OECD 2011, p16). The Commission and the IMF underline that the fiscal effort to be made is unprecedented (EU 2012, p5; IMF 2013, p18). However, the unprecedentedly high values of required adjustment arise from the additional prudential requirements. The IMF's Fiscal Monitor and the OECD's Restoring Fiscal Sustainability explicitly admit that current structural primary balances in most countries are sufficient to stabilize debt-to-GDP ratios at their present levels (IMF 2013, p vii; OECD 2011, p14). The same also becomes obvious from the tables presented in the European Commission's Fiscal Sustainability Report, which show that the sustainability gap – i.e. the adjustment needed to stem the growth of the debt-to-GDP ratio – is close to zero in most European countries with some notable exceptions (EU 2012, tables 3.3 and 3.5). While the prudential considerations motivating the demand for moderate debt levels and for timely responses to future challenges are not to be dismissed offhand, treating them as necessary conditions for sustainability creates a unsubstantiated sense of emergency about the present situation.

These biases towards budgetary solutions are well reflected in the policy recommendations of the Commission, the IMF and the OECD alike. Albeit they differ in the specificity of advice they provide, all three entities strongly concur that adjustment needs to take place through (prompt) fiscal tightening. The 2012 Fiscal Sustainability Report refrains from giving specific advice on the desirable composition of adjustment. However, it does recommend that countries prepare a “credible strategy of entitlements reforms (pensions, health care, long-term care), to address the expected growth in age-related spending (EU 2012, p1). The IMF's 2013 Fiscal Monitor also remains at the level of generalities when calling for fiscal tightening and fails to comment on ways to deal with the consequences of aging. The two recent OECD publications, on the other hand, explicitly advocate stabilization programmes which are heavy on spending cuts and light on tax increases and which prioritise cuts in welfare spending and public employments (OECD 2010, p9 and 14, OECD 2011, p47).

None of the reports entertains the alternative that medium and longer-term policies targeting growth or other structural features of the economy underlying future budgetary developments could be a major avenue for restoring sustainability. They all note the role of growth and interest rates in determining sustainability, but only as parameters of fiscal policy making, rather than policy variables in and of themselves. They warn about downside risks if growth fails to pick up or interest rates rise and argue that fiscal tightening itself could effect favourable changes in these parameters, if increased fiscal stability triggers virtuous circles of

dropping interest rates and increased growth, further bolstering sustainability (EC 2012 p4, IMF 2013 p18 and 33, OECD 2011 p14). At the same time, they caution against possible adverse effects of tax increases on growth (EC 2012 p12, OECD 2011 p9). It is also notable that the European Commission's 2012 Fiscal Sustainability Report – which expends great effort at specifying projections about future employment and participation rates underlying the costs of population ageing – fails to discuss policies other than pension retrenchment that could improve those underlying conditions to mitigate the budgetary pressures arising from demographic shifts.

In sum, policy conclusions emerging from the sustainability assessment of the European Commission, the IMF and the OECD converge on a set of neoliberal recommendations that advocate drastic fiscal austerity with a (more or less explicit) preference for expenditure cuts over tax increases. Although this consensus follows logically from the choices of indicators and prudential requirements that the three entities use in their quantitative assessments, it is considerably at odds with alternative solutions that the three entities have advocated in the past decades as ways to deal with demographic and economic problems closely related to the issue of fiscal sustainability. The next section shows that these three influential supranational organizations have not so long ago espoused alternative interpretations of sustainability that take into consideration economic, demographic, social and political aspects of the sustainability of public finances and recommended policies targeting growth and employment which are difficult to reconcile with the demand for unprecedented fiscal tightening.

Alternative interpretations of sustainability and the welfare state

Although the past years of economic and financial crisis have clearly taken their toll on public finances across the developed world, the most important long-term challenges to fiscal sustainability – slow growth, the secular increase of debt-to-GDP ratios and the prospect of population ageing – have been well-known for several decades. In these decades, austerity has not been the only panacea proposed. Admittedly, neoliberal solutions have been hugely influential since the late 1970s. Balancing of budgets through trimming welfare spending and shrinking public employment were the order of the day through the late 1990s, as were calls for stimulating growth through labour and product market liberalization. From the second half of the 1990s, however, an alternative view also gained ground and came to be embraced by the European Commission and the OECD. This alternative approach seeks to make “social policy a [...] productive factor” and, thus, to reconcile adequate social protection with economic efficiency and fiscal balance. It promises to create the foundations for strong growth and to improve employment and productivity through social investment in human capital, in order to make the welfare state more affordable and the present contours of public finances more sustainable (Giddens 1998). Given its strong emphasis on adequate spending on education, enabling social services, activation and generous protection, this approach is difficult to reconcile with calls for large budget cuts. Austerity and the social investment paradigm are thus at odds with each other (Hemerijck 2013, p147).

The social investment paradigm is not aimed at solving the issue of fiscal sustainability *per se*. Instead, it seeks to simultaneously address the interconnected problems of slow growth, high unemployment and fiscal imbalances that many European welfare states face. Its more comprehensive interpretation of sustainability encompasses economic, political, social and fiscal sustainability at once. Therefore, it rejects policy options that address one of these issues at the expense of unacceptable outcomes in other areas. Consequently, it disagrees with neoliberal policy recommendations that would restore budgetary balance through cuts in

welfare transfers and public services at the expense increasing inequality and poverty, which threaten social and political stability and might even undermine economic efficiency (and thus be counterproductive to the goal of fiscal sustainability).

At the same time, the social investment paradigm does not question the need to reform the welfare state. However, instead of rolling it back for the sake of fiscal savings, it advocates refocusing welfare efforts on areas that improve employment and productivity to create a deeper pool of resources for preserving the social achievements of the welfare state. It emphasizes investment in human capital – through early childhood education, family support, vocational training and continuous learning – as well as the provision of public services that facilitate employment, such as child- and elderly care services, retraining and various active labour market policies. These measures promise to address the issues of growth, unemployment and to some extent even adverse demographic changes by boosting the employability and productivity of the population, increasing the ability of women and elderly people to stay in the labour market and reconciling female labour market participation with child rearing, which is an important factor in mitigating further ageing of the population. In order to finance such investment and services, the social investment paradigm recommends that social spending be reallocated from pensions to these areas. This provides added incentives for the elderly to remain in the labour market. At the same time, this approach also insists that passive transfers are kept in order to preserve a tight safety net (Esping-Andersen et al. 2002, Hemerijck 2013).

In other words, the social investment paradigm offers to restore fiscal sustainability by targeting the structural economic, demographic and social issues behind fiscal problems. By improving growth, employment and fertility, it seeks to increase the size of the pie rather than limit the slice that the government can avail of. Better productivity and a larger labour pool help to produce more income, which yields higher tax revenues and make the outstanding debt more affordable. At the same time, lower unemployment and pension reform leads to a smaller cohort of inactive people, which decreases spending without having to accept increasing inequality, poverty, weakening social cohesion and political stability. Thus, the gist of the social investment paradigm is that there need not be a trade-off between equity and social protection on the one side and economic efficiency and fiscal rectitude on the other. If a government spends money in order to ensure the availability of sufficient resources in the future, it does not violate fiscal discipline. In fact, proponents of this approach call for a change in public accounting that reflects that spending on education, family services and the like constitute public investment – rather than consumption – expenses (Hemerijck 2013, p147).

As different as the social investment paradigm is from the neoliberal policy attitude reflected in the above-presented fiscal sustainability assessments of the European Commission, the IMF and the OECD, it was mostly developed under the umbrella of these same institutions. From the mid-1990s through the present, the OECD has published a series of documents and reports advocating (and elaborating on various aspects of) the paradigm, while European authorities worked closely with senior welfare scholars in producing concrete policy recommendations based on it (Hemerijck 2013, p133). In 2000, the European Council adopted the Lisbon Strategy that set out to make Europe the “most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater cohesion” by “investing in people and developing an active and dynamic welfare state” (quoted in Hemerijck 2013, p134). The commitment to this goal was reinforced in the Europe 2020 Strategy, which set out new targets for improving educational attainment, increasing employment levels and improving social cohesion.

The social investment paradigm was understandably a very attractive option for squaring the circle of welfare reform and restoring fiscal sustainability with minimum social strife and

upheaval. Its advocates could draw confidence from extensive empirical research that substantiates the claim that there needs to be no trade-off between efficiency, equity and fiscal rectitude as well as from studies that evidence the effect of investment in human capital on GDP growth (Kenworthy 2004, Lindert 2004, Sapir 2006, Ostry et al 2014). Furthermore, the experience of Nordic welfare states further corroborates this model by having displayed healthy growth, relatively low unemployment and sound fiscal policies despite having the highest government spending and the most extensive welfare states in international comparison. Sweden, Norway and Denmark also boast the highest levels of female participation in the labour market and decent fertility rates. Thus, they are under relatively little pressure from population aging. These countries were, in effect, to serve as blueprints for reforms in the “less efficient” Continental and Mediterranean welfare states (Sapir 2006, Van Kersbergen and Vis 2013).

Regrettably, however, the social investment paradigm has little to show for the decade and half of *quasi*-official policy status in Europe. Despite its attractiveness, official espousal by European authorities, strong endorsement by the OECD and ample empirical evidence for its viability, it failed to make a tangible mark on policy making since the turn of the millennium. The reasons have to do with the policy making dynamics in Europe. The European Union has few powers in the areas that affect social investment and thus it was left to the discretion of the member states whether they want to put into place the “official policy”. In the field of fiscal policy, however the Stability and Growth Pact grants extensive rights for the Commission to interfere in member states’ policy making. Unable to meaningfully impact fiscal sustainability through the delicate long-term policies that the social investment paradigm requires, the Commission applied pressure where it had more tangible influence, namely on budgetary policies. By doing so, it effectively starved its own policy agenda of funds. Given this bias towards fiscal adjustment, it is unsurprising that the Lisbon Agenda was an unmitigated failure. None of its targets was met and no country developed a comprehensive set of policies to apply the social investment paradigm in practice other than the Nordic welfare states (Hemerijck 2013, p147).

In light of its track record and given the present atmosphere of fiscal and economic emergency, the social investment paradigm is very unlikely to carry the day in policy making in the wake of the financial and economic crisis. Although the Lisbon Agenda was formally taken further when the Europe 2020 Strategy was adopted, expert observers consider it nothing more than window dressing (Pochet 2010). The European Commission, having always been of two minds on the choice between austerity and the social investment paradigm, has now clearly taken a stance by the former, which is evident even in the Europe 2020 Strategy, the document that purports to address the issue of economic, fiscal and social sustainability in a more complex fashion (Pochet 2010).

Conclusion: The crisis as the crucible?

It might seem that it is the financial and economic crisis that seals the fate of the social investment paradigm and consolidates the dominance of the neoliberal approach. However, it is important to emphasize that – just as before – the assessment of the situation and the choice of a solution is dependent on the scholarly lens through which experts view present conditions, and there is little that objectively determines the superiority of fit of one approach over the other. The crisis seems like a crucial turning point because it magnified long-standing fiscal problems to daunting proportions. This gives advocates of austerity a reason to argue that there is no more time to waste in forestalling a fiscal disaster. After all, public finances in

affluent countries – and in European countries in particular – are in worse shape than ever before. However, proponents of the social investment paradigm can make an equally strong case for the urgency of embracing the idea that human capital is the key to long term economic and fiscal sustainability and call for emergency measures to avert grave losses of human capital in the present employment crisis³. The crisis affected sustainability in more dimensions than one. Problems abound in the economic, fiscal, social and political spheres alike. Singling out one aspect to focus on – as the fiscal sustainability analyses of the European Commission, the OECD and the IMF do – is a question of scholarly convictions rather than an objective necessity.

References

- Abiad, A. and J. D. Ostry. 2005. "Primary Surpluses and Sustainable Debt Levels in Emerging Market Countries". *IMF Policy Discussion Paper* PDP/05/6
- Afonso, A. and C. Rault. 2007. "What do we really know about fiscal sustainability in the EU? A panel data diagnostic." *William Davidson Institute Working Paper* 893.
- Afonso, A. and J. Tovar Jalles. 2012. "Revisiting Fiscal Sustainability – Panel Cointegration and Structural Breaks in OECD Countries". *ECB Working Paper Series*. NO 1465
- Alesina, A., R. Perotti, et al. 1998. "The political economy of fiscal adjustments." *Brookings Papers on Economic Activity* 1: 197.
- Alesina, A. and Ardagna, S. 1998. "Tales of Fiscal Contractions: Fiscal Adjustments. Why They Can be Expansionary" . *Economic Policy*, 27, 489-543.
- Balassone, F. and D. Franco. 2000. "Assessing fiscal sustainability: A review of methods with a view to EMU" *Servizio Studi*, Banca d'Italia
- Blanchard, O., J.C. Chouraqui, R.P. Hagemann and N. Sartor. 1990. "The sustainability of Fiscal Policy: New Answers to an Old question", *OECD Economic Studies*, No. 15, pp. 7-36.
- Buiter, W. 1985. "A Guide to Public Sector Debt and Deficits", *Economic Policy* No. 1, pp. 612-35
- Buiter, W. 2003. "Fiscal sustainability" Paper presented at the Egyptian Center for Economic Studies in Cairo on 19 October 2003
- Chalk, N. and R. Hemming. 2000. "Assessing fiscal sustainability in theory and practice", *IMF Working Paper*, WP/00/81
- Croce, E. and V. H. Juan-Ramon. 2003. "Assessing Fiscal Sustainability: A Cross- Country Comparison". *IMF Working Paper*. WP/03/145
- Domar, E.D. 1944. "The burden of the debt and the national income". *American Economic Review* pp. 798-827.
- Eggertsson and P. Krugman. 2012. "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach". *Quarterly Journal of Economics* 127(3)
- Eichengreen, B. and U. Panizza. 2014. "A Surplus of Ambition: Can Europe Rely on Large Primary Surpluses to Solve Its Debt Problem?" *CEPR Discussion Paper* 10069.
- Esping-Andersen, G., D. Gallie, A. Hemerijck and J. Myles. 2002. *Why We Need a New Welfare State*. Oxford University Press
- European Commission. 2006. "The long-term sustainability of public finances in the European Union." *European Economy* 2006/4.
- European Commission. 2012. "Fiscal Sustainability Report 2012" *European Economy* 8/2012
- Ghosh, A. R., J. I. Kim, E. G. Mendoza, J. D. Ostry and M. S. Qureshi. 2013. "Fiscal Fatigue, Fiscal Space and Debt Sustainability in Advanced Economies". *The Economic Journal*, 123 (February), F4–F30
- Giavazzi F. and M. Pagano. 1990. "Can Severe Fiscal Contractions be Expansionary? Tales of Two Small European Countries" NBER Working Paper No. 3372
- Giddens, A. 1998. *The Third Way: The Renewal of Social Democracy*. Cambridge: Polity
- Hemerijck, A. 2013. *Changing Welfare States* Oxford University Press
- Herndon, T., M. Ash, and R. Pollin. 2013. "Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff", *Political Economy Research Institute Working Paper*. No. 322.

³ For a compellingly made case, see Theodoropoulou 2010.

- Irons, J. and J. Bivens. 2010. "Government Debt and Economic Growth -Overreaching Claims of Debt 'Threshold' Suffer from Theoretical and Empirical Flaws" *Economic Policy Institute Briefing Paper*. No.271
- IMF. 2002. *Assessing Sustainability*
- IMF. 2010. *Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis*
- IMF. 2011. *Staff Guidance Note for Public Debt Sustainability Analysis in Market Access Countries*
- IMF. 2013. *Fiscal Monitor*
- Irons, John and J. Bivens. 2010. "Government Debt and Economic Growth – Overreaching Claims of Debt 'Threshold' Suffer from Theoretical and Empirical Flaws". *Economic Policy Institute Briefing Paper*. No.271
- Kenworthy, L. 2004. *Egalitarian Capitalism: Jobs, Incomes and Growth in Affluent Countries*. Russel Sage Foundation
- Kumar, Manmohan and J. Woo. 2010. "Public Debt and Growth". *IMF Working Paper* WP/10/174
- Lindert, P.H. 2004. *Growing Public: Social Spending and Economic Growth since the Eighteenth Century*. Cambridge University Press
- Mulas-Granados, C. 2003. "The Trade-Off between Growth & Equality and the Economic Impact of Alternative Fiscal Adjustment Strategies in the EU" *Groupo de Economia Europea Working Paper*. no. 20/2003
- OECD. 2010 *Restoring Fiscal Sustainability : Lessons for the Public Sector*
- OECD. 2011. *Restoring Public Finances*
- Ostry, Jonathan, A.R. Gosh, J.I. Kim, M.S. Qureshi. 2010. "Fiscal space", *IMF Staff Position Note* SPN/10/11
- Ostry, Jonathan, A. Berg, C. G. Tsangar. 2014. "Redistribution, Inequality, and Growth". *IMF Staff Discussion Note* SDN/14/02
- Panizza, U., and Presbitero, A. 2013. "Public debt and economic growth in advanced economies: A survey". *Swiss Journal of Economics and Statistics* 149(II): 175-204.
- Pescatori, A., D. Sandri and J. Simon. 2013. "Debt and Growth: Is There a Magic Threshold?" *IMF Working Paper* WP/14/34
- Pochet, P. 2010. "What's wrong with EU2020?" *ETUI Policy Brief European Social Policy Issue* 2/2010
- Reinhart, Carmen, K.S. Rogoff and Savastano. 2003. "Debt Intolerance" *Brookings Papers on Economic Activity*. Vol. 2003, No. 1, pp. 1-62
- Reinhart, Carmen M and K. S. Rogoff. 2010. "Growth in a Time of Debt." prepared for the American Economic Review Papers and Proceedings
- Roubini, N. 2001. "Debt Sustainability: How to Assess Whether a Country is Insolvent" (mimeo Stern School of Business New York University December 20, 2001)
- Sapir, A. 2006. "Globalization and the Reform of the European Social Models" *Journal of Common Market Studies*. 44(2)
- Schelkle, W. and D. Mabbett. 2007. "Social policy as a productive factor: Can we make political and economic sense of this paradigm?" (mimeo RECWOWE State of the Art Conference: Warsaw, 12-16 June, 2007)
- Spaventa. L. 1987. "The Growth of Public Debt". *IMF Staff Papers*, 34:2
- Theodoropoulou, S. 2010. "Addressing Europe's employment crisis: what policies for recovery and reform?" *EPC Policy Brief*
- Van Kersbergen, K. and B. Vis. 2013. *Comparative Welfare State Politics*. Cambridge University Press