FISCAL POLICY, FISCAL SPACE
A FEW IDEAS TO MOVE FORWARD

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OECD
BETTER POLICIES FOR BETTER LIVES

Roadmap

- A new approach to fiscal policy

- How can we measure fiscal space?

- An agenda for future work

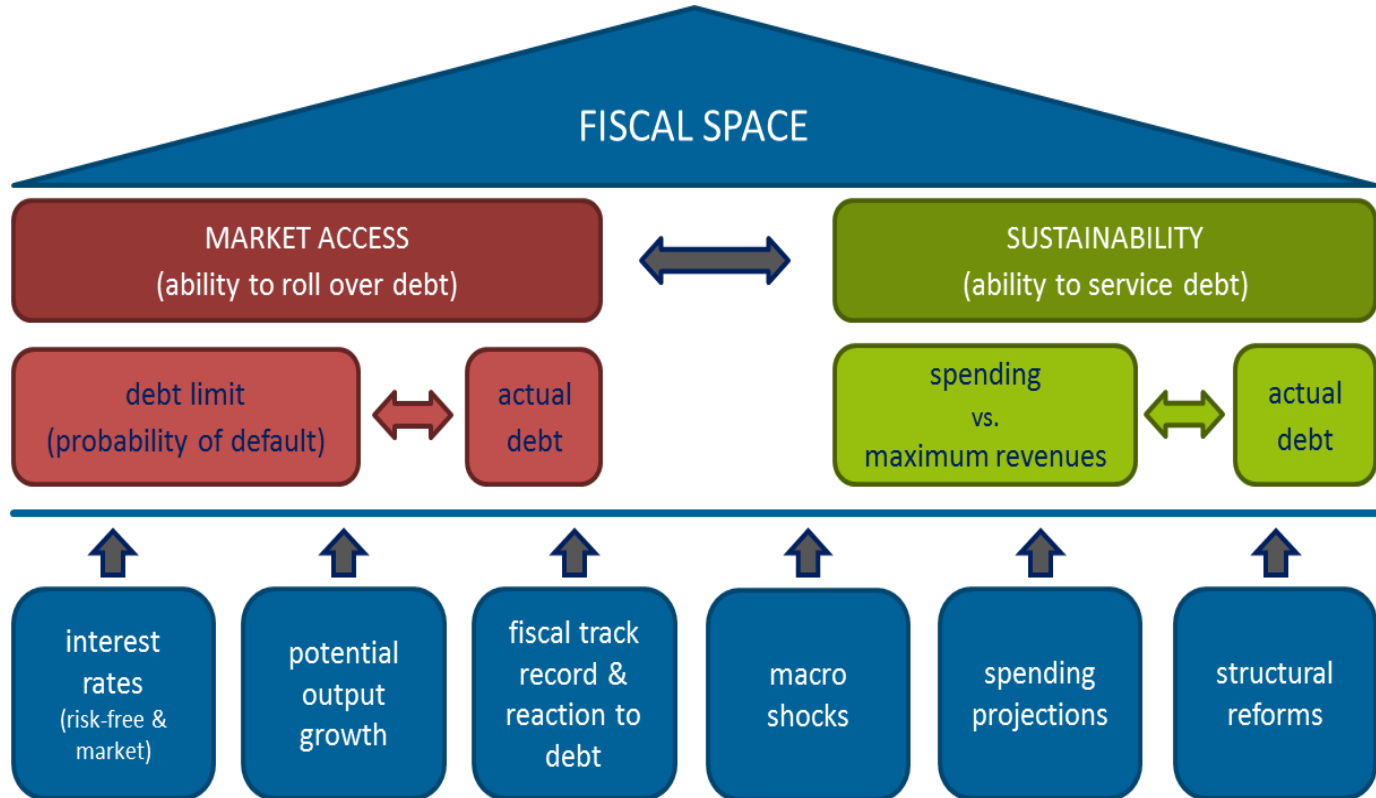# A new approach to fiscal policy

New approach

- The economic environment has changed.

- The crisis has underlined the role of hysteresis.

  →**This blurs the traditional trade-off between stabilising the economy and ensuring long-term debt sustainability**
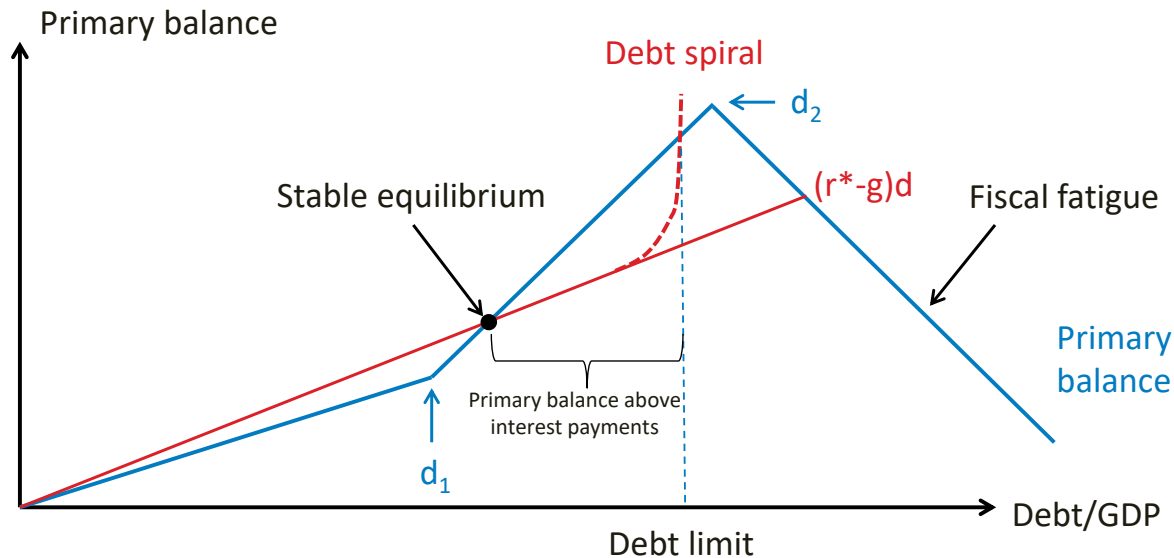
Fiscal space is a multidimensional concept

Measures of fiscal space

What is the debt limit?

Primary balance

Debt spiral

d_2

Stable equilibrium

$(r*-g)d$

Fiscal fatigue

Primary balance

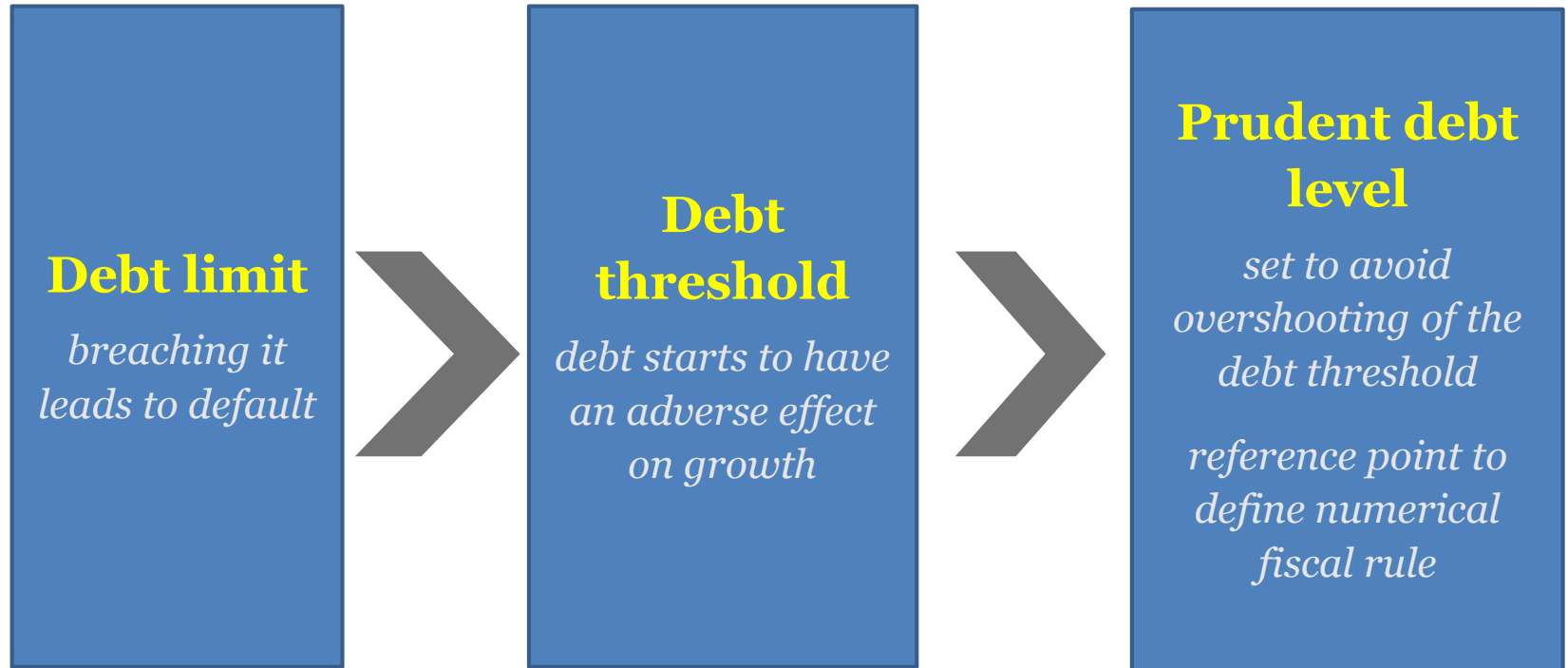Primary balance above interest payments

d_1

Debt/GDP

Debt limit

Note: g is the growth rate, r* is the risk-free interest rate, d is the debt-to-GDP ratio, d_1 and d_2 are two estimated thresholds signalling changes in the reaction function to increasing debt.

Source: Fournier, J.M. and F. Fall (2015), "Limits to Government Debt Sustainability", OECD Economics Department Working Papers, No. 1229, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/5jrxv0fctk7j-en**.**

Debt limits, debt thresholds and targets

Measures of fiscal space

Debt limit

breaching it leads to default

Debt threshold

debt starts to have an adverse effect on growth

Prudent debt level

set to avoid overshooting of the debt threshold

reference point to define numerical fiscal rule

Source: Fall and Fournier (2015).

Measures of fiscal space

Contributions to changes in fiscal space between 2014 and 2016

% of GDP

Legend:
- Contribution of potential growth
- Contribution of real interest rate
- Contribution of gross debt
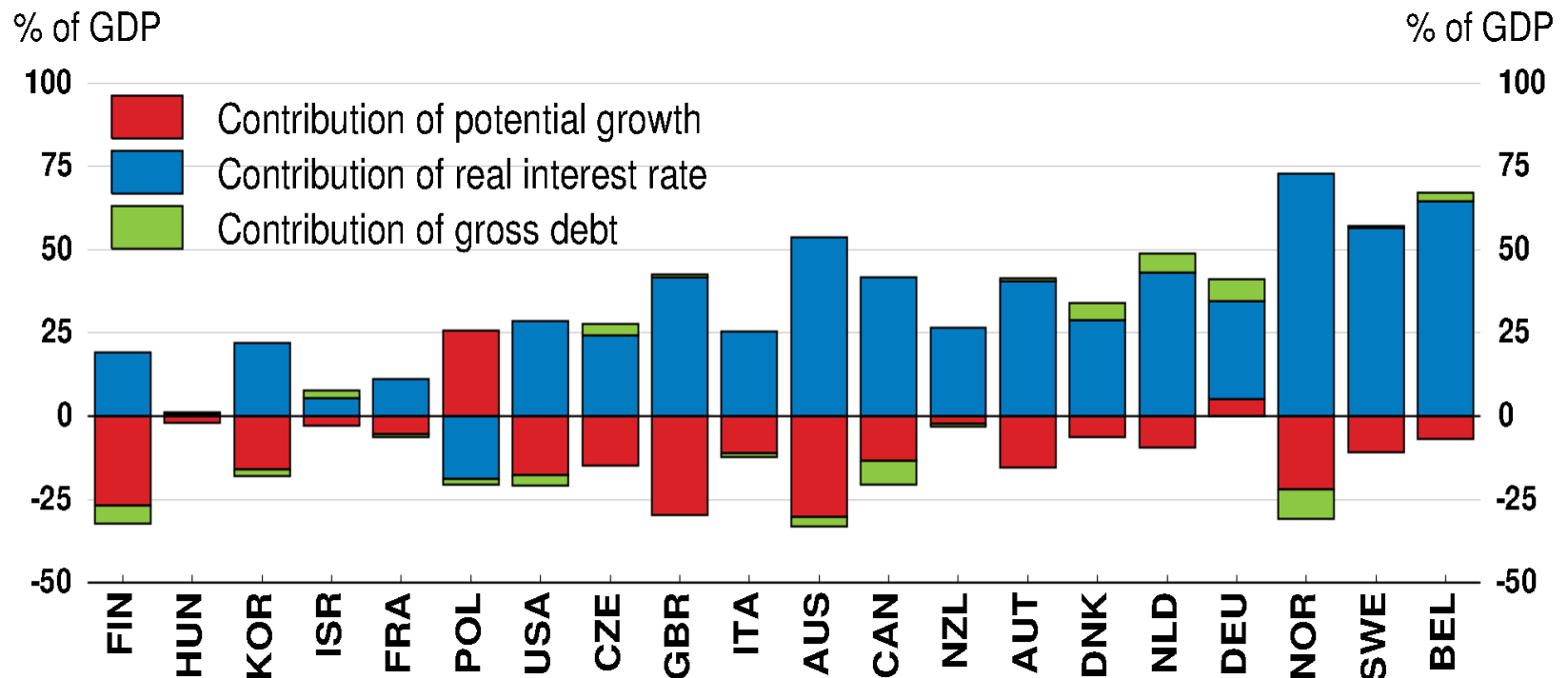
Source: OECD calculations based on Fournier and Fall (2015) and OECD Economic Outlook database.

Bi's debt limits methodology

- Based on Bi (2011), Bi and Leeper (2013)

- Derived from a DSGE framework

- **Debt limit:**

  = maximum sustainable debt at time t+k

  = expected present value of all future maximum primary surpluses,

  i.e. given spending projections and with taxes at their revenue maximising level (at the peak of the Laffer curve), accounting for macroeconomic shocks
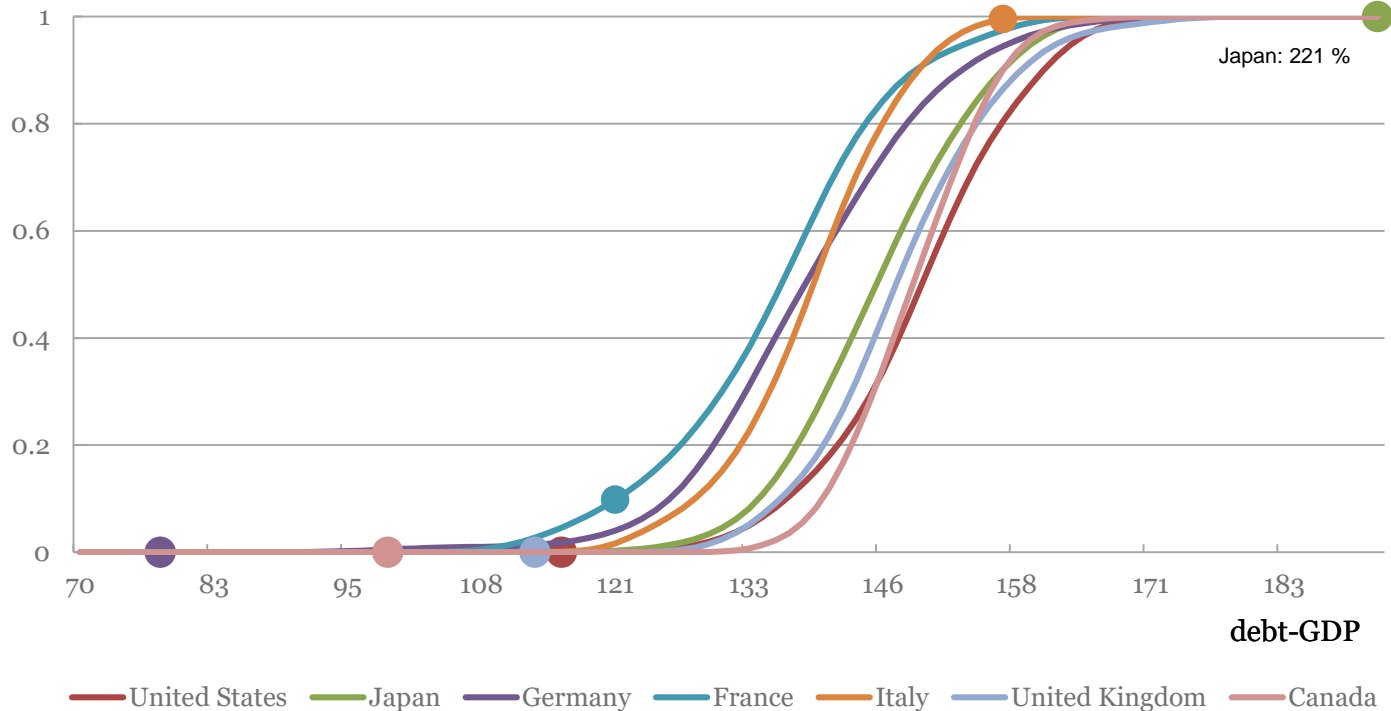
  $\rightarrow$ debt limit **probability distribution**

Tax revenues, spending

Maximum primary surplus

Projected spending

Laffer curve

t*   Tax rates
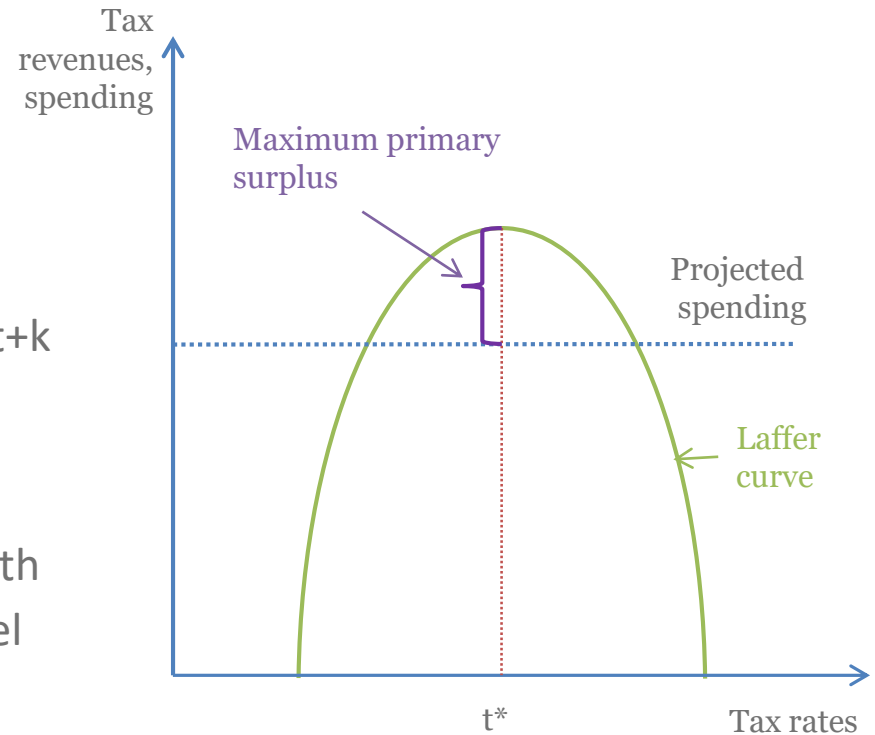
Fiscal space in G7 countries according to Bi

Fiscal limits of G7 countries
cumulative distribution function

Note: For each country the curve depicts the probability of default at each given public debt-to GDP ratios. For instance, the probability of default is zero is in all G7 countries when the actual debt-to-GDP ratio is below 113%. Circles correspond to the 2017 level of the debt-to-GDP ratio. Public debt refers to general government gross financial liabilities according to the SNA definition.

Source: OECD calculations using Bi (2011) and Bi and Leeper (2013).

What's next?

- Filling the information gaps:
  - Need to refine model parameters
  - Little information on tax multipliers or green investment multipliers

- Missing dimensions
  - Redistribution
  - Political dimension

THANK YOU

MERCI

Key documents

- OECD (2016), "Using the fiscal levers to escape the low-growth trap", in OECD Economic Outlook, Volume 2016 Issue 2, OECD Publishing, Paris.

- Mourougane, A., et al. (2016), "Can an Increase in Public Investment Sustainably Lift Economic Growth?", OECD Economics Department Working Papers, No. 1351, OECD Publishing, Paris.

- Botev, J., J. Fournier and A. Mourougane (2016), "A Re-assessment of Fiscal Space in OECD Countries", OECD Economics Department Working Papers, No. 1352, OECD Publishing, Paris.

- Fournier, J. and F. Fall (2015), "Limits to government debt sustainability", *OECD Economics Department Working Papers*, No. 1229, OECD Publishing, Paris.

- Fall, F. and J. Fournier (2015), "Macroeconomic uncertainties, prudent debt targets and fiscal rules", *OECD Economics Department Working Papers*, No. 1230, OECD Publishing, Paris.