DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/85/70

CONTAINS CONFIDENTIAL INFORMATION

March 11, 1985

To: Members of the Executive Board

From: The Secretary

Subject: World Economic Outlook: Supplementary Note 1 - Fiscal Policy in the Major Industrial Countries

The attached note on fiscal policy in the major industrial countries provides background material for the Executive Board discussion on Monday and Wednesday, April 1 and 3, 1985 of the World Economic Outlook.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Blackwell (ext. 8980).

Att: (1)

Other Distribution:
Department Heads

CONTAINS CONFIDENTIAL INFORMATION

INTERNATIONAL MONETARY FUND

World Economic Outlook: Supplementary Note 1

Fiscal Policy in the Major Industrial Countries

Prepared by the Research and Fiscal Affairs Departments

(In consultation with the Asian, European, and Western Hemisphere Departments)

Approved by Wm. C. Hood and Vito Tanzi

March 11, 1985

Since the late 1970s, a central objective of governments in industrial countries has been the reduction of fiscal deficits. A major goal in most cases has been to release a greater share of available saving for use in investment by the private sector. Another goal for some countries has been to arrest the long-term deterioration in fiscal flexibility. Despite these aims, however, the combined deficit of the seven major industrial countries taken as a group was considerably higher in 1983-84 than it had been five years earlier, whether the comparison is made for the central government, or for a broader measure of the public sector (Tables 1 and 2). There are two main reasons for this result, apart from slippages in the implementation of intended policies. First, the 1980-82 recession weakened revenue growth and raised transfer payments, a development which the subsequent recovery, at least in some European countries, was not able to reverse. Second, the rapid growth in government indebtedness and high real rates of interest have led to a sharp rise in the relative magnitude of government interest payments.

This supplementary note provides a discussion of three interrelated aspects of fiscal policies and developments in the seven largest industrial countries. Section 1 analyzes the implications of recent and prospective shifts in fiscal balances in terms of their restrictive or stimulative effects on the course of economic activity in the relatively short run. Section 2 examines the important relationship of fiscal imbalances and the resultant government borrowing requirements to private saving and to alternative uses of such saving. The third section provides a brief note on the current status of certain major long-term shifts in the composition of government expenditures. Finally, Section 4 gives a technical description of the concepts and methodology underlying the "fiscal impulse" statistics discussed in the first section.

I. Fiscal Balance and Impulses

1. Background

The data on fiscal balances presented in the upper halves of Tables 1 and 2 show a considerable widening of the combined deficit of the seven major industrial countries between 1979 and 1983. In relation to GNP, the combined deficit increased during that period by about 2 1/2 percentage points whether the comparison is made for the central government or at the broader "general government" level (which includes also regional and local government units).

This deterioration in the fiscal position is greatly influenced by the effect of cyclical developments on government revenue and expenditure. In analyzing fiscal developments, it is therefore useful to employ a concept that abstracts from these cyclical influences and measures the direction and strength of year-to-year changes in the underlying fiscal stance. The concept utilized here is that of the "fiscal impulse" whose measurement is described in more detail in Section 4, below. Unlike the figures for the unadjusted fiscal balance, the fiscal impulse data in the lower half of each table suggest a moderate tightening of the collective fiscal policy stance until 1983, which tended to mitigate the cyclical effects on the budgetary position. 1/

The data on fiscal impulses also bring out the contrast since 1979 between the expansionary thrust of U.S. fiscal policy and the generally restrictive thrust in Japan and most of the major European countries. In the United States, the federal budget (on a "unified budget" basis) imparted an expansionary impulse equivalent to 2 1/2 percent of GNP between 1979 and 1983. In contrast, in the other six countries as a group, the fiscal operations of central government resulted in a composite withdrawal of stimulus of about 1 percent of GNP. This difference in fiscal policy thrust stems largely from divergent trends on the revenue side of budgets, with the personal and corporate tax reductions introduced in the 1981 Economic Recovery Tax Act in the United States having a marked effect

---

1/ In 1983, when aggregate output expanded in line with the composite potential growth rate, fiscal policy of general governments was broadly neutral in the sense that it imparted no composite thrust in either direction, compared to an expansionary impulse equivalent to 1 percent of GNP at the central government level. Apart from the different sectoral coverage, such differences in policy thrust can arise from the exclusion of central government net lending in the general government data, which are on a national income accounts basis, as well as from timing differences between cash transactions in the central government budgets and the corresponding accruals data in the national income accounts.

Table 1. Selected Industrial Countries: Central Government Fiscal Balances and Impulses, 1977-86 1/

(In percent of GDP/GNP)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Fiscal balance (+ surplus, - deficit)										
Canada 2/	-3.5	-4.6	-3.5	-3.5	-2.2	-5.3	-6.2	-6.4	-5.5	-4.4
United States	-2.7	-2.0	-1.2	-2.4	-2.5	-4.3	-5.8	-5.0	-5.7	-5.3
Japan 3/	-5.1	-5.3	-6.2	-6.3	-6.0	-6.0	-5.8	-5.6	-5.1	-4.8
France 4/	-1.0	-1.6	-1.5	-1.1	-2.6	-2.8	-3.3	-3.4	-3.4	-3.4
Germany, Federal Republic of	-2.2	-2.1	-1.8	-1.7	-2.2	-1.9	-2.0	-1.6	-1.2	-1.0
Italy 5/	-9.0	-13.1	-10.8	-10.8	-12.8	-15.1	-16.5	-15.7	-14.1	-13.3
United Kingdom	-3.0	-5.0	-5.3	-4.7	-4.1	-2.8	-4.8	-3.3	-3.2	-2.7
All countries above	-3.2	-3.4	-3.0	-3.5	-3.8	-4.7	-5.7	-5.1	-5.2	-4.9
All countries above except the United States	-3.7	-4.6	-4.5	-4.4	-4.7	-5.0	-5.6	-5.2	-4.8	-4.5
Fiscal impulse (+ expansionary, - contractionary)										
Canada 2/	1.5	1.2	-0.5	-0.1	-1.1	0.8	0.7	0.8	-0.8	-1.0
United States	0.2	--	-0.8	0.4	0.1	0.4	1.7	0.5	0.8	-0.3
Japan 3/	0.2	0.2	1.0	0.2	-0.3	-0.2	-0.5	0.2	-0.5	-0.6
France 4/	-0.3	0.9	0.1	-0.7	1.0	--	0.1	-0.2	-0.1	-0.1
Germany, Federal Republic of	-0.4	0.1	0.1	-0.4	-0.8	-1.8	-0.3	-0.2	-0.3	--
Italy 5/	-0.8	3.8	-1.7	0.1	0.6	0.6	-0.5	-0.7	-1.8	-1.2
United Kingdom	-2.0	2.8	0.9	-2.6	-2.4	-1.4	2.2	-1.6	0.3	-0.2
All countries above	-0.1	0.6	-0.2	-0.1	-0.2	-0.1	0.9	0.1	0.2	-0.4
All countries above except the United States	-0.3	1.1	0.3	-0.4	-0.4	-0.5	0.2	-0.2	-0.4	-0.5

1/ Composites for the country groups are weighted averages of the individual national ratios for each year, with weights proportionate to the U.S. dollar value of the respective GNPs in the previous three years.

2/ Data for Canada are on a national income accounts basis.

3/ Data for Japan cover the consolidated operations of the general account, certain special accounts, social security transactions, and disbursements of the fiscal investment and loan program (FILP) except those to financial insitutions. Japanese data other than FILP transactions are based on national income accounts.

4/ Data for France are on an administrative basis and do not include social security transactions.

5/ Data for Italy refer to the state sector and cover the transactions of the state budget as well as those of several autonomous entities operating at the state level, but do not include the gross transactions (revenue and expenditure) of social security institutions, only their deficits.

Table 2. Selected Industrial Countries: General Government Fiscal Balances and Impulses, 1977-86 1/

(In percent of GDP/GNP)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Fiscal balance (+ surplus, - deficit)										
Canada	-2.4	-3.1	-1.8	-2.7	-1.6	-5.0	-6.2	-5.8	-5.0	-4.1
United States	-0.9	--	0.6	-1.2	-0.9	-3.8	-4.1	-3.4	-4.4	-4.1
Japan	-3.8	-5.5	-4.8	-4.2	-3.6	-3.4	-3.3	-2.4	-1.7	-1.0
France	-0.8	-1.9	-0.7	0.3	-1.8	-2.6	-3.3	-3.3	-3.3	-3.3
Germany, Federal Republic of	-2.4	-2.5	-2.8	-3.1	-3.9	-3.4	-2.7	-2.3	-1.7	-1.3
Italy	-8.1	-9.7	-9.5	-8.0	-11.9	-12.7	-11.8	-13.5	-12.2	-11.5
United Kingdom 1/	-3.3	-4.2	-3.3	-3.7	-3.1	-2.4	-3.5	-3.4	-2.8	-2.4
All countries above 2/	-2.1	-2.3	-1.7	-2.5	-2.7	-4.0	-4.2	-3.8	-3.9	-3.5
All countries above except the United States 2/	-3.2	-4.2	-3.6	-3.5	-4.0	-4.2	-4.3	-4.1	-3.5	-2.9
Fiscal impulse (+ expansionary, - contractionary)										
Canada	0.4	1.1	-0.6	0.5	-0.8	-0.4	1.2	0.6	-0.4	-0.8
United States	-0.2	-0.1	-0.5	0.6	-0.3	1.0	0.7	0.9	1.3	-0.2
Japan	0.3	1.7	-0.6	-0.2	-0.9	-0.4	-0.4	-0.4	-0.8	-1.0
France	--	1.4	-1.0	-1.7	0.5	0.1	-0.1	-0.9	-0.4	-0.2
Germany, Federal Republic of	-0.8	0.4	0.9	--	-1.1	-2.6	-1.2	-0.3	-0.5	-0.1
Italy	-2.2	1.2	0.4	-1.3	2.1	-1.0	-3.1	1.6	-1.6	-1.0
United Kingdom 1/	-1.3	1.9	-0.2	-1.8	-2.6	-0.8	1.4	-0.1	-0.1	-0.2
All countries above 2/	-0.3	0.6	-0.3	-0.1	-0.5	-0.1	0.1	0.4	0.3	-0.4
All countries above except the United States 2/	-0.5	1.3	-0.2	-0.7	-0.6	-0.8	-0.4	-0.1	-0.6	-0.6

1/ Data are on a national income accounts basis except for the United Kingdom. Data for the United Kingdom are on a cash basis and exclude net lending.

2/ A weighted average of the individual national ratios for each year, with weights proportionate to the U.S. dollar values of the respective GNPs in the previous three years.

in slowing the growth in fiscal revenues. The ratio of federal revenue to GNP in the United States declined by more than 1 percentage point between 1979 and 1983, whereas in all the other major countries government revenue increased substantially faster than GNP, reflecting both increases in statutory rates and the effects of fiscal drag.

2. Fiscal developments in 1984

A notable feature of the fiscal position of the seven major industrial countries in 1984 was the fact that their combined fiscal deficit (whether measured at the central government or the general government level) declined for the first time since 1979. This development, however, is wholly accounted for by improvements in the level of economic activity: abstracting from cyclical factors, the underlying budgetary position would have either stayed about the same (central government level) or moved into larger deficit (general government level).

Differences in fiscal tendencies between the United States and most of the other major industrial countries continued in 1984. The fiscal impulse in the United States remained expansionary, especially for the broader measure of the government sector, while in the other six countries taken together, budgetary changes were in the direction of restraint (for central government) or neutral (general government).

In the United States, where output growth was particularly strong, the federal deficit (on a "unified budget" basis) declined by 3/4 of 1 percentage point in relation to GNP, despite a further moderate addition of stimulus. In contrast to most recent years, the expansionary thrust derived wholly from the expenditure side, since the effects of the income tax reduction program on the fiscal impulse were tailing off, and 1984 saw some revenue raising adjustments to social security tax. Particularly significant expenditure increases occurred for defense, where spending authorizations approved in earlier years began to be reflected in actual outlays to a substantial extent. Interest payments also rose strongly, reflecting continued rapid growth in the federal debt and a somewhat higher average interest rate.

For the broader, general government sector of the U.S. economy the decline in the recorded deficit was slightly smaller than for the federal government (on a "unified budget" basis) and the estimated expansionary impulse was therefore larger. The difference in policy thrust, equivalent to almost 1/2 percent of GNP, is attributable partly to the more expansionary stance of state and local government budgets 1/ and partly to

---

1/ State and local governments remained in surplus to approximately the same extent as in 1983, but the failure of these surpluses to increase during strong economic expansion implies that the underlying trend was towards a lower surplus (i.e., an expansionary impulse).

differences in the way central government transactions are accounted for in the respective (central and general governments) sets of accounts. 1/

For the other six countries as a group, the composite fiscal impulse in 1984 was slightly contractionary at the central government level and approximately neutral in the general government accounts. In Japan and the Federal Republic of Germany, where budgets have been framed in accordance with medium-term consolidation plans for several years, further progress was made toward reduced fiscal deficits. The Japanese general government deficit declined by more than 1/2 of 1 percentage point in relation to GNP, reflecting both the positive influences of above-trend growth and continued withdrawal of stimulus. In the Federal Republic of Germany, where output grew in line with its potential rate, the decline in the general government deficit (equivalent to 1/2 percent of GNP) reflected increases in social security contributions, postponement of wage increases for civil servants, and curtailment of selected entitlement programs.

Fiscal developments in France were influenced in 1984 by the slow pace of economic recovery. However, the negative effects of below-trend growth on the general government accounts were offset by a tightening of the fiscal stance. The withdrawal of stimulus, equivalent to about 1 percent of GNP, stemmed from the revenue side and reflected in part an increase in the rates of social security taxes. The contractionary impulse at the central government level was much less marked, and the official objective of containing the deficit at 3 percent of GDP could not be met.

In the United Kingdom and Italy, the fiscal thrust in 1984 is more difficult to characterize, as trends in the general government deficit in both countries were rather different from those in the central government deficit. In the United Kingdom the general government deficit in relation to GNP remained virtually unchanged, with higher-than-expected oil revenues (in sterling terms) partially offsetting the costs of the coal miners' strike and other expenditure overruns at both the central and the local levels. In contrast, the central government deficit declined by 1 1/2 percentage points (of GDP), mainly because of large sales of government assets. In Italy, the general government deficit widened considerably, reflecting an expansionary thrust equivalent to 1 1/2 percent of GDP, whereas the central government deficit declined.

1/ While the general government accounts are prepared on a national accounts basis, in which most transactions are recorded when liabilities accrue and government lending is classified with financing, the "unified budget" accounts are generally on a cash basis and classify government lending with expenditure.

This latter result stemmed from a reduction in government lending and transfers to local governments that was more than sufficient to offset increases in other expenditures.

In Canada, where output growth exceeded the potential rate by a significant margin, the general government deficit declined somewhat, despite a further move toward expansion. The addition of stimulus, equivalent to 1/2 of 1 percent of GNP, derived from the expenditure side of the accounts and reflected to a large extent a sharp rise in debt interest payments.

3. Outlook for 1985 and 1986

The projections for 1985 presented in Tables 1 and 2 are generally based on proposed and, in some cases, adopted budgets and medium-term fiscal plans. For the seven countries as a group, they indicate a slightly expansionary composite fiscal thrust at the central government level, and a similar positive impulse, equivalent to less than 1/2 percent of GNP, at the general government level.

For the United States, the projections are based on the authorities' "current services" estimates, 1/ with an adjustment made to allow for the difference between the staff's projections of economic growth, employment, and interest rates and those of the authorities. The federal deficit (on a "unified budget" basis) is projected to increase by 3/4 of 1 percentage point in 1985, and to reach 5 1/2 percent of GNP. With little change in cyclical position, the expansionary impulse would be of similar magnitude. A major source of the impulse is again defense spending. Revenue is projected to increase at a faster rate than GNP, and thus to impart a significant contractionary impulse. This reflects essentially the elasticity of the tax system and prearranged increases in social security contributions, rather than new discretionary measures. The projections for the general government indicate a more expansionary thrust than those for the "unified budget," equivalent to 1 1/4 percent of GNP. While state and local governments are expected to step up their spending, most of the difference between the two "impulse" estimates reflects the accounting differences mentioned in footnote 1, page 5.

In Japan, the budget proposal for 1985/86 provides for continued efforts to reduce the deficit. Primary emphasis is again placed on the containment of expenditure growth, with cuts being proposed for certain categories of discretionary outlays, including public works spending. Social security transfers, on the other hand, are expected to rise quite rapidly, reflecting for the most part demographic factors and an increasing proportion of the elderly with eligibility for pensions. Relative to

---

1/ That is, estimates based on existing programs and tax rates.

GNP, restraint in discretionary expenditures will more than offset the further growth in entitlement spending, while revenues will rise. Mainly because of this last factor, the projections for 1985 indicate a contractionary fiscal impulse equivalent to about 1/2 of 1 percent of GNP at either level of government. With growth projected at about its trend rate, this would imply a corresponding decline in the government deficit.

In the Federal Republic of Germany, the authorities' commitment to fiscal consolidation has been reaffirmed in the 1985 federal budget. In keeping with the objective of reducing the size of the public sector, the strengthening of the central government's financial position will be effected mainly by restricting the growth in federal expenditure. (Tax reduction plans have been announced for 1986 and 1988, but no change in tax rates is envisaged in 1985.) As state and local governments are also expected to curb expenditure growth, the general government deficit is projected to decline by 1/2 of 1 percent of GDP, with most of this decline reflecting a restrictive shift in fiscal policy stance.

A principal objective of fiscal policy in France remains the containment of the central government budget deficit to no more than 3 percent of GDP. With the additional goal of reducing the share of government spending in total output, the 1985 budget proposal implies reductions in the real growth rates of most expenditure categories (other than interest payments). On the revenue side, reductions in direct personal taxes and the business tax would be only partially offset by an increase in gasoline taxes. On balance, a marginal withdrawal of stimulus is indicated by the staff estimates for both levels of government, but it is rather less than would be needed to bring the recorded deficit back to 3 percent of GNP, given the slow output growth projected by the staff.

In the United Kingdom, revised fiscal estimates for 1985/86 were announced in November 1984. Overall public sector expenditure is expected to be held approximately constant in real terms, but the contractionary effect of this restraint would be partly offset by some stimulus from tax reductions. On the basis of these assumptions, the general government deficit, relative to GDP, would decline by 1/2 of 1 percentage point in 1985, with most of the fall reflecting the effects of above-trend economic growth. The deficit of the central government would change only marginally, since asset sales, which had benefited the cental government position to a considerable extent in 1984, will probably be less important in 1985.

The projections for Italy are based on the budget proposal for 1985, which targets a further reduction in the central government deficit in relation to GDP. If the budget were implemented without change, there would be a contractionary thrust equivalent to about 1 3/4 percent of GDP at either level of government. This withdrawal of stimulus would reflect measures on both the expenditure and revenue sides of the budget. Expenditures other than interest payments are budgeted to remain constant in real terms, with cutbacks for education and health offsetting increases in some other items. On the revenue side, the withdrawal of stimulus will come from a variety of measures, including increases in indirect taxes and a one-time rise in receipts associated with a tax amnesty on illegal construction. Although there are possibilities of slippage in the implementation of the Italian budget, which would reduce its contractionary impulse, all present indications point to the maintenance of a relatively restrictive overall stance of fiscal policy in 1985.

In Canada, the new government issued an Economic and Financial Statement in November 1984, updating budgetary projections and introducing a package of deficit-reducing measures for immediate implementation. On the basis of these projections, the federal deficit in relation to GNP would decline by about 1 percentage point in 1985, reflecting above-trend economic growth, as well as the effects of the fiscal measures.

Highly tentative staff projections of central government fiscal balances for 1986 indicate a contractionary composite fiscal thrust equivalent to 1/2 of 1 percent of GNP, with significant moves toward restraint in Japan, Italy, and Canada, along with moderate or marginal withdrawals of stimulus in the other four countries. The projection for the United States is based on the working assumption that a significant part of the expenditure reduction package proposed to the Congress by the Administration will be implemented. If no such measures were implemented, the fiscal impulse in the United States would be slightly expansionary, and the combined contractionary impulse for the seven countries taken together would be small. The projected 1986 impulse of fiscal policy at the general government level broadly parallels the projection for central government in all seven countries.

II. Fiscal Deficits in Relation to Private Saving

World Economic Outlook reports of the past two years have laid considerable emphasis on the historically unusual proportions of private saving being absorbed by the financing of government deficits in a number of industrial countries. These large government demands for credit are generally regarded as a major factor underlying the high real interest rates of the past several years, and there is widespread concern about the possibility that large fiscal deficits might continue into the later stages of the current economic recovery. Such a continuation would pose the threat of either squeezing out some private borrowing for productive investment or reviving inflationary demand pressures, depending on the accompanying monetary policies and public expectations.

Despite the progress made by several major industrial countries during the past few years toward restoration of better balance in their fiscal positions, this threat has by no means been removed. Particularly in the United States, Canada, and Italy, the general government deficits projected for 1985 will still be impinging on private saving to a vastly greater degree than during periods of cyclical recovery prior to the mid-1970s. The contrast with earlier experience is only moderately less striking for France; and none of the major industrial countries has yet restored the kind of relatively neutral fiscal balance that characterized the pattern of uses of private saving prior to 1974. Even in the countries that have moved farthest in that direction--Japan and the Federal Republic of Germany--roughly one tenth of gross private saving was still used over the past two calendar years to finance the respective general government deficits. Although these shares are expected to drop further in 1985, into the 5-7 percent range, they will remain in sharp contrast with the small or moderate surpluses characteristic of the general government fiscal balances of these two countries in comparable periods prior to the mid-1970s.

The dimensions of current and immediately prospective fiscal imbalances in the seven major industrial countries are depicted, in relation to other closely relevant macroeconomic variables, in Charts 1-7. These charts focus on the relationship between gross private savings and the uses which absorb such saving: private domestic investment, the general government deficit, and the net foreign balance. The charts are based on the national income accounting identity which (apart from statistical imperfections in the available estimates) equates a country's aggregate private and public saving with its total domestic investment plus the change in its net international claims. In the variant of this identity plotted in Charts 1-7, general government expenditures for fixed capital assets and stocks are included in the calculation of a broadly defined fiscal balance, rather than combined with private investment in a national aggregate of capital formation. Such a fiscal balance reflects comprehensively the financing requirements of the general government sector. 1/

Consistently with this concept of the government fiscal position, the saving aggregate stressed in the chart is gross private saving, rather than total national saving. The other variables shown in the charts, including private domestic capital formation and net investment

---

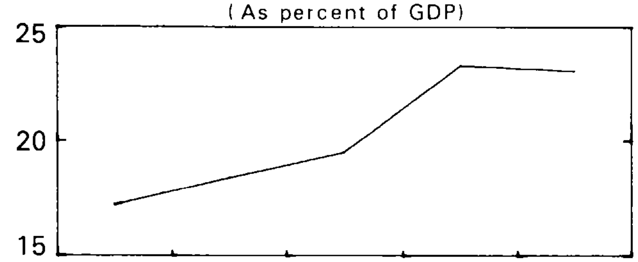
1/ This fiscal balance is the one presented in Table 2 and discussed in Section 1, above, insofar as that discussion relates to the general government sector.

CHART 1

CANADA

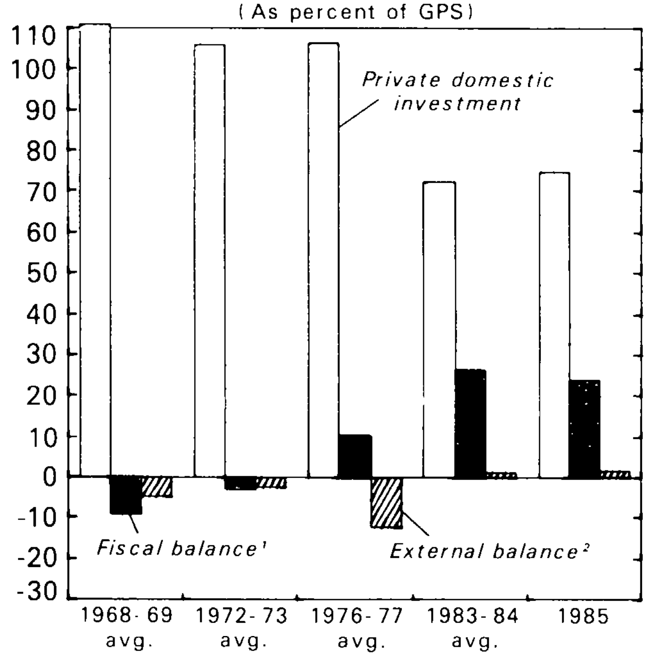
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



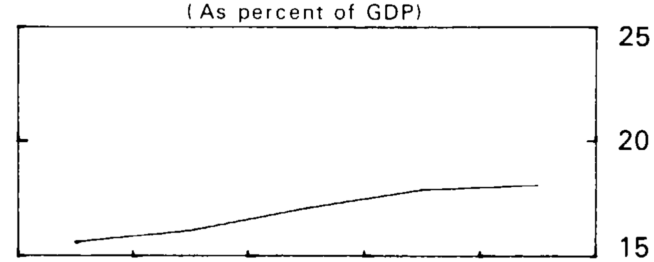
[1]General government deficit or surplus( )
[2]Net investment or disinvestment( ) abroad

CHART 2

UNITED STATES

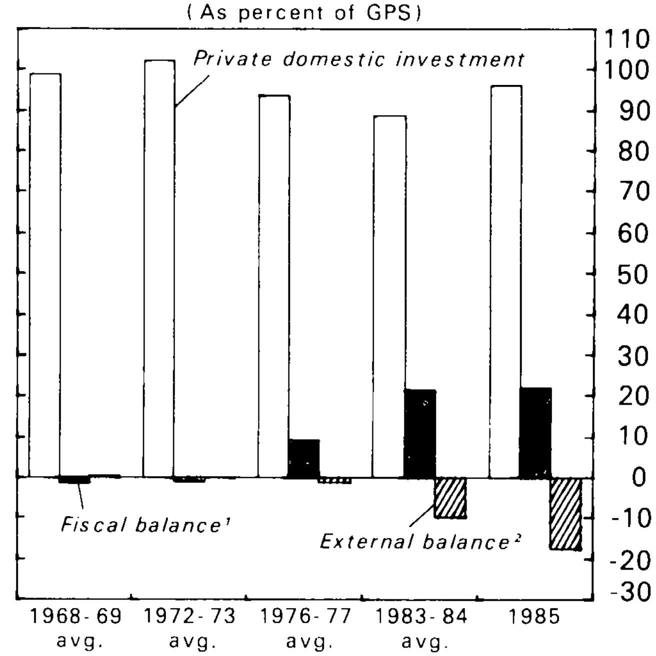
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



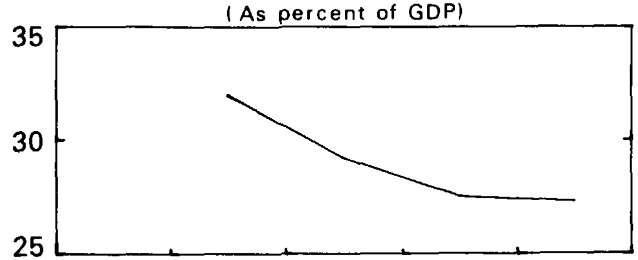
[1]General government deficit or surplus( )
[2]Net investment or disinvestment(-) abroad

CHART 3

JAPAN

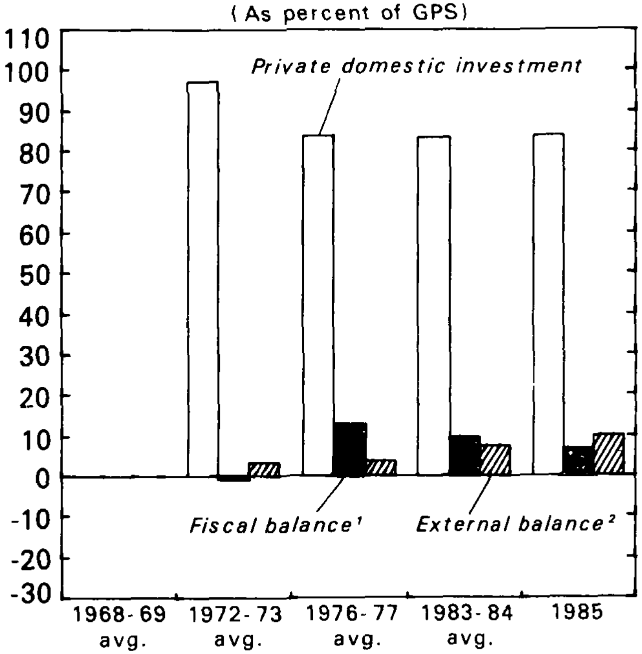
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



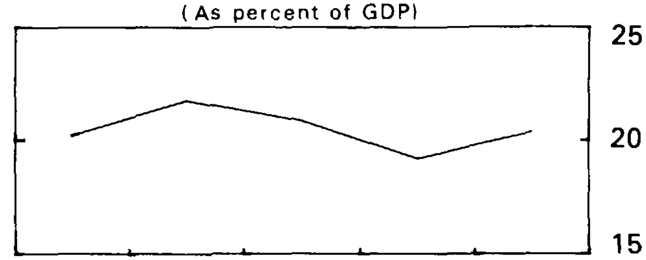
[1]General government deficit or surplus(-).
[2]Net investment or disinvestment(-) abroad.

CHART 4

FRANCE

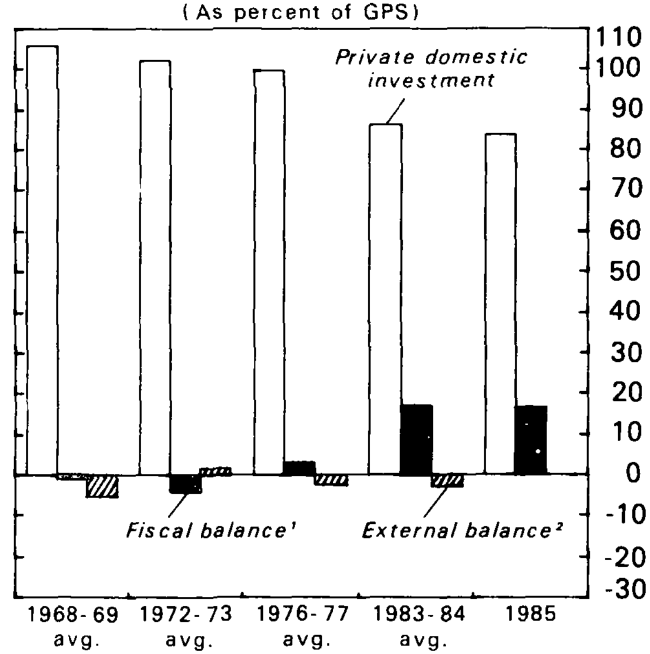
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



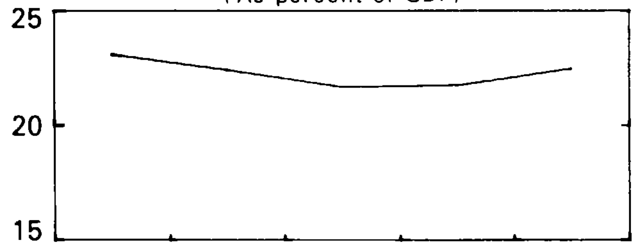
[1]General government deficit or surplus(-).
[2]Net investment or disinvestment(-) abroad

CHART 5

GERMANY

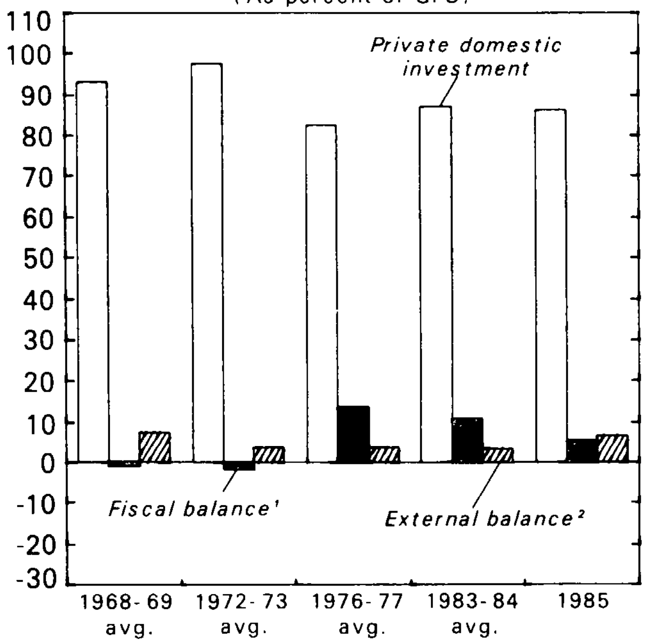
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



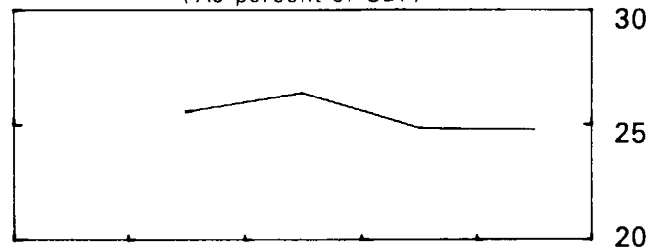
[1]General government deficit or surplus(-).
[2]Net investment or disinvestment( ) abroad

CHART 6

ITALY

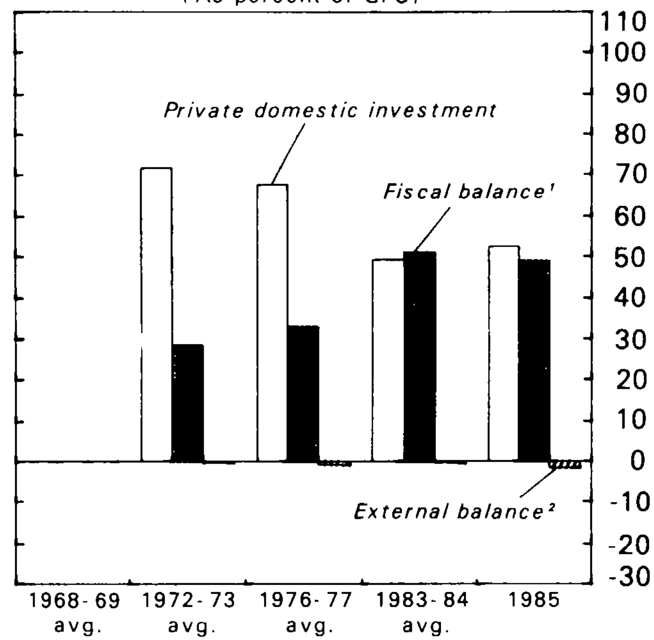
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



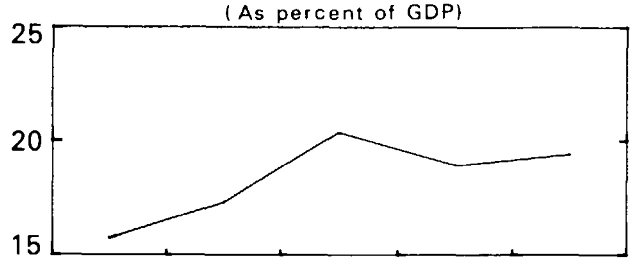
[1]General government deficit or surplus( ).
[2]Net investment or disinvestment(-) abroad.

CHART 7

UNITED KINGDOM

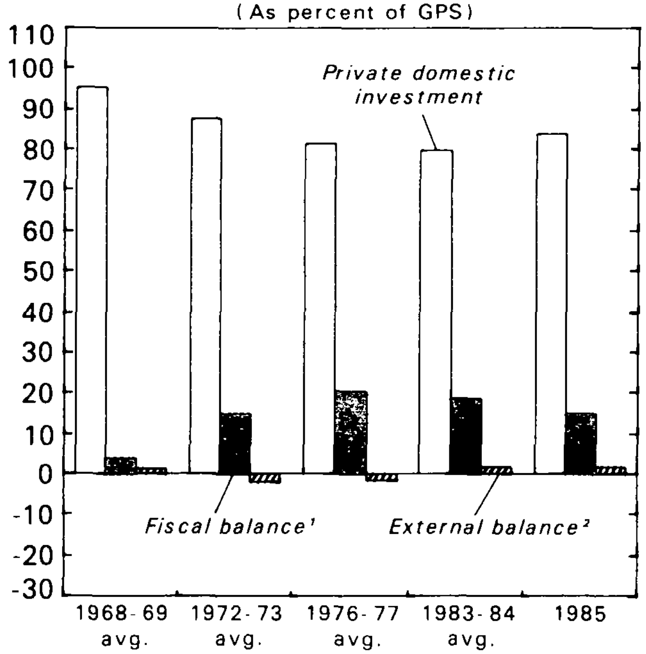
GROSS PRIVATE SAVING . . .

(As percent of GDP)



. . . AND ITS DISPOSITION

(As percent of GPS)



[1] General government deficit or surplus(-)
[2] Net investment or disinvestment(-) abroad

(or disinvestment) abroad, as well as the government deficit, must account (in principle) for the entire disposition of a country's gross private saving. 1/

Both the saving series and the domestic investment series are here measured on a gross basis, without deduction of allowances for the consumption of fixed capital. Uncertainties and ambiguities involved in the calculation of appropriate capital consumption allowances are thus avoided, leaving both the saving and the investment aggregates representative of actual receipts and payments, rather than partly reflections of bookkeeping allowances. (This choice is made, of course, without prejudice to the merits of net saving and net investment estimates in other contexts, such as efforts to measure real wealth or real changes in the stock of productive capital assets.)

The time periods for which data are plotted in Charts 1-7 have been chosen with a view to minimizing cyclical distortions in comparisons of recent figures with those for earlier years. Apart from the 1985 projections, each plot represents an average for the first two calendar years of a cyclical recovery following the calendar year of a recession trough. If all four of the recessions covered had been of equal depth and duration, differences among the time periods shown could be regarded as approximations of underlying, or "structural" changes in the level and distribution of gross private saving. In fact, of course, the recessions of the mid-1970s and the early 1980s were substantially deeper than the two earlier recessions, so that substantial cyclical influences, as well as structural changes, remain implicit in these comparisons. Nevertheless, a number of the sharp changes depicted in the chart can be interpreted as reflective of important underlying shifts in the disposition of private saving, rather than as primarily cyclical phenomena. The key questions of current relevance are implications of these shifts in savings patterns for the future use of resources and for international financial relationships.

1. The relative stability of private saving

Among the long-term changes in levels and uses of saving flows that are shown in Charts 1-7, several broad features deserve attention. One of these is the relatively limited range of fluctuation in the ratio of gross private saving to GDP in each of the major industrial countries. In five of these seven countries, the average ratio during the 1983-84 recovery period was within 1 1/2 percentage points of the corresponding

1/ The "private" sector as defined in the standard national accounts includes (while the general government sector excludes) public enterprises engaged in industrial or commercial activities.

average for the earlier recovery periods shown in the charts. For France, the Federal Republic of Germany, and Italy, these recent private saving ratios--all in the range of 20-25 percent of GDP--were slightly lower than in previous cyclical recoveries; for the United States and the United Kingdom, on the other hand, the 1983-84 deviation from earlier experience was moderately upward. In the two latter countries, where the proportion of income saved has long been appreciably lower than in the major continental European countries, Japan, or Canada, the share of gross national income saved privately nevertheless remained well under 20 percent.

The two countries where recent private saving ratios have differed more widely from historical averages are Japan and Canada. Japan's gross private saving, although about 3 percentage points lower in relation to GDP during the 1983-84 recovery period than during the two previous recoveries, remained by a considerable margin the highest (27 1/2 percent of GDP) among the large industrial countries. Canada's deviation from prior experience has run in the opposite direction, with a saving ratio for recent years nearly 5 percentage points above its historical average. Among the major industrial countries, this is the only case of a really substantial upward deviation in the past few years.

2. Contrasting shifts in the disposition of saving

Against the general background of relative constancy in ratios of gross private saving to GDP, variations in the disposition of savings have been much wider--and in some cases dramatically so. These variations are readily evident in the respective lower panels of Charts 1-7, where the main uses of gross private saving are traced for the last four cyclical recovery periods (and for 1985 as projected by the staff). In every case, a salient feature of the panel on the disposition of gross private saving is the significantly lower proportion absorbed by gross private domestic investment during the past two years than during earlier recoveries. The main counterpart of this decline over the whole period covered by the chart was the sharp increase in the proportion absorbed by the financing of greatly enlarged government deficits. However, both the magnitude and the time path of these major shifts differed appreciably from country to country. In addition, changes in external balances--i.e., in net investment or disinvestment abroad--also played important roles in the shifting patterns of disposition of saving for several of the countries. In some instances, the viability of prevailing and immediately prospective external balances remains a major question for consideration elsewhere in the World Economic Outlook report.

In three of the seven major industrial countries, it may be seen that fiscal deficits in relation to total savings were highest in 1976-77, in the wake of the 1975 recession. In these countries, (the Federal Republic of Germany, Japan, and the United Kingdom) general government deficits were subject after 1979 to determined and persistent restraint on the part of the respective authorities. In these three countries, accordingly, the proportions of private saving absorbed by the financing of general government deficits were appreciably lower in the 1983-84 recovery period than in the previous one, despite the severity of the intervening recession (Charts 3, 5, and 7). Significant further declines in all three of these government deficits are projected for 1985, as noted above in Section 1.

In the Federal Republic of Germany, the counterpart of the downward shift in the proportion of saving absorbed by the fiscal deficit was a rise in the share used for private domestic investment. This share was about 87 percent during 1983-84, compared with 82 1/2 percent during the 1976-77 recovery (Chart 5). For both Japan and the United Kingdom, on the other hand, the counterpart was a shift in the external balance. Japan's net investment abroad increased by an amount very similar to the decline in government credit requirements, while private domestic investment was virtually the same proportion of gross private saving (some 83-84 percent) during the past two years as during the 1976-77 recovery (Chart 3). Similarly, a shift by the United Kingdom from moderate net disinvestment abroad to moderate net investment in other countries was more than sufficient to absorb the proportion of gross private saving released by the relative decline in government borrowing (Chart 7). Gross private domestic investment in the United Kingdom was equivalent to slightly less than 80 percent of gross private saving in the 1983-84 period, compared with 81 1/2 percent in 1976-77. Although the staff projections for 1985 indicate a fairly substantial rise in the share of private saving used for private domestic investment in the United Kingdom, they suggest only a slight increase in Japan, where a further rise in net investment abroad is also expected to absorb part of the savings made available to the private sector by reduced government demands for credit.

In the other four major industrial countries, concerted efforts to contain government deficits were launched considerably later than in the three countries discussed above. Consequently, in Canada, the United States, France, and Italy, the absorption of private saving by government deficits was considerably larger during the 1983-84 recovery period than during 1976-77 (Charts 1, 2, 4, and 6). In all four of these countries, such absorption is expected to remain quite high in 1985, even by the standards of the 1970s. The four differ considerably among themselves, however, as to the ways in which their economies have accommodated to extraordinary increases in government borrowing.

In Italy, the only country in this group characterized by very sizable and persistent government deficits even before the mid-1970s, the further enlargement of deficits in recent years had as its counterpart a broadly commensurate drop in the share of gross private saving directed to private investment (Chart 6). This share dropped from some 68 percent in 1976-77 to only about 50 percent in 1983-84. It is not expected to be much more than 50 percent in 1985, although some increase should be facilitated by the projected decline in the relative size of the general government deficit.

In France, too, the main counterpart of the negative shift in the government fiscal position was a decline in the proportion of private saving going to private domestic investment. That proportion averaged 86 percent during the past two calendar years, compared with almost 100 percent in 1976-77 and with well over 100 percent in earlier recovery periods (Chart 4). However, the French fiscal shift began from a nearly balanced position throughout the latter half of the 1970s, and even at their peak in 1983 the credit requirements of the general government sector absorbed less than one sixth of gross private saving. France's reliance on net inflows of foreign savings was quite moderate in both of the last two recovery periods, despite a bulge during the early 1980s.

It is in the two North American industrial countries that recent fiscal imbalances have exhibited the sharpest contrast with prior experience. The general government accounts of Canada and the United States had shown small or moderate surpluses during recovery periods prior to the mid-1970s, thus helping to supply funds to support a level of private domestic investment that was high in relation to private saving. By the middle of the decade, however, government demands for credit had become quite substantial in both countries, absorbing about one tenth of gross private saving during the 1976-77 recovery period. By 1983-84, partly because of the intervening recession and partly because of fiscal policy changes discussed elsewhere in this note, the corresponding absorption had reached 26 percent in Canada and well over 20 percent in the United States, with no prospect of any very substantial reversal as early as 1985.

In Canada, private domestic investment had been high (in relation to private saving) during the 1976-77 recovery period, when it was partly financed by a large net inflow of foreign capital. During the 1983-84 recovery, the impact on domestic investment of the sharp further rise in government use of credit was accompanied by an absence of net external financing. Reflecting this shift as well as the growing fiscal deficit, the share of saving going to private investment dropped precipitately, from 106 percent in the 1976-77 period to some 72 percent in 1983-84 (Chart 1). However, the impact of this shift in shares of the saving flow on the level of domestic investment was softened considerably by the concurrent rise--unique among the major industrial countries--in Canada's gross private saving as a percentage of the gross national income.

During the past two years, the proportion of gross private saving flowing into private domestic investment has been higher in the United States (89 percent) than in any other major industrial country, and the margin of difference is expected to widen in 1985. In the face of the dramatic increase in the deficit of the general government sector, private domestic investment has only been able to absorb such a high proportion of gross private saving through a massive increase in the net inflow of foreign savings. Net disinvestment abroad by the United States, which was relatively slight during the 1976-77 recovery period, increased to the equivalent of 6 percent of gross private saving in 1983 and 14 percent in 1984. As indicated in Chart 2, it is projected to increase substantially further in 1985, to some 18 percent of gross private saving. It is the unprecedented magnitude of these inflows of foreign savings that has permitted the United States to divert such large shares of private domestic saving into financing of the government deficit without more serious inroads on the economy's ability to finance private domestic capital formation.

3. The need for reduction of government borrowing

For the countries where large shares of private saving are still being absorbed by government borrowing, and especially for the United States, it seems highly probable that one element in any full recovery from the recession of the early 1980s will have to be a substantial reduction of government financing requirements. In the absence of such a reduction it would be very difficult to visualize the attainment and maintenance of gross private domestic investment at levels consistent with satisfactory gains in productivity and real income. Theoretically, the higher levels of investment might be reconciled with fiscal deficits outside the range of previous peacetime experience either by substantial increases in the ratio of private saving to GNP or by a continuing massive drain on the savings of other countries. Neither of those alternatives, however, seems feasible for any extended period.

Total gross private saving in the United States has already risen to a level, in relation to GNP, that has only rarely been reached in the past--and never, during the quarter-century since 1960, at a time of high capacity utilization. At such times, indeed, private saving has characteristically been supplemented by general government surpluses as a source of funds for high rates of investment. The present high level of aggregate private saving in relation to GDP is partly a result of relatively recent income tax changes favorable to the gross operating surpluses of corporate enterprises, and there is no prospect of further similar easing of corporate profits tax burdens. In fact, various current proposals for "loophole closing" and other types of tax reform in the United States would tend, if enacted, to have the opposite effect, at least in the short or medium term. All in all, the ratio of U.S. gross private saving to GNP seems unlikely to rise during the next few years.

The current high level of capital inflows accruing to the United States reflects not only the various attractions of the U.S. market, including those exerted by strongly favorable long-term interest rates, but also a relative dearth of attractive investment opportunities elsewhere. When and if the European economic recovery gains more satisfactory momentum, there will be greater need for European savings to finance private domestic capital formation, and thus some curtailment of the availability of funds for investment in the United States. Similarly, revival of growth in the developing world, in combination with the desired progress in dealing with current international debt problems, would imply stronger competing demand from developing countries for global supplies of savings. All of these major influences would tend to limit or even reverse the growth of capital flows to the United States. Such a development would leave reduction of the fiscal deficit as the only means of expanding the proportion of private saving available for domestic investment. On the other hand, maintenance or expansion of U.S. domestic investment through continued drains on foreign saving would tend to generate renewed upward pressure on interest rates in both the U.S. market and international markets, with adverse consequences for investment outside the United States and ultimately for U.S. investment as well.

Italy, France, and Canada all face broadly similar needs to divert private saving flows from the financing of government deficits to the support of private domestic investment. Unlike the United States, none of these other countries with relatively high fiscal deficits is currently confronted with a significant external imbalance. All of them, however, would be vulnerable to the emergence of such imbalance if a marked rise in domestic investment were to occur in the absence of fiscal restraint.

Among the countries that have already achieved a considerable degree of fiscal restraint during the early 1980s, a somewhat worrisome aspect of the pattern of adjustment to date is the degree to which saving diverted from the financing of fiscal imbalances has gone (in proportionate terms) into net foreign investment, rather than into private domestic investment. The Federal Republic of Germany is the only one of these three countries where domestic investment absorbed an appreciably larger share of private saving in 1983-84 than in the previous recovery period. Even for Germany, however, the staff projections for 1985 suggest that the additional saving rechanneled away from government obligations in that year will go mainly into investment abroad, rather than into further relative growth of domestic capital formation. Although the opposite is true of the 1985 projections for the United Kingdom, the shift in that country's use of private saving from the 1976-77 recovery period to 1983-84 had been toward net investment abroad rather than at home. The latter pattern is also evident for Japan, both in the actual shift from 1976-77 to 1983-84 and in the further shift projected by the staff for 1985.

Of course, shifts of this type toward greater investment abroad contribute toward containment of upward pressures on interest rates in international financial markets. In that respect, they are clearly helpful, under prevailing circumstances, to borrowing countries. Moreover especially for Japan, but also to some extent for the Federal Republic of Germany, the current account surpluses associated with the net capital outflows have provided important support for aggregate demand and the growth of output. Nevertheless, consideration must be given to the possibility that future productivity gains and long-term growth in these countries might be better served by redirection of part of the saving flow from foreign to domestic investment. Such a shift would be facilitated, of course, by some significant easing of U.S. demands on international credit markets.

III. Shifts in the Structure of Fiscal Balances

Long-term changes in the structure of general government fiscal balances in the seven major industrial countries were reviewed in the 1984 World Economic Outlook. 1/ Broad developments emphasized in that review included the marked rise in the scale of government transactions--both receipts and expenditures--in relation to overall economic activity; the general tendency of growth in expenditures to outpace that in revenues; and the concentration of increases in spending predominantly on transfers and subsidies (and in recent years on payments of public-debt interest), rather than on government purchases of goods and services. Currently, all of these broad tendencies appear to be tapering off or even undergoing some reversal in most of the large industrial countries.

As a percentage of GDP, general government expenditure was lower in 1984 than in 1983 by amounts in the range of 1/4 to 1 percentage point in the Federal Republic of Germany, Japan, and the United States; and the increases in the other four countries were equivalent in every case to well under 1 percentage point. Revenues of the general government sectors rose less rapidly than the value of total output in Italy and the United States while increasing only a little faster elsewhere. Moreover, some of the 1984 increases in ratios of government receipts to GDP are expected to be reversed in 1985. On the whole, then, it appears that the long-standing tendency toward continual expansion of the role of government in the major industrial economies is finally being arrested by the general pursuit of fiscal policy restraint.

1/ World Economic Outlook: A Survey by the Staff of the International Monetary Fund, Occasional Paper No. 27 (Washington, April 1984), Supplementary Note 1, pp. 102-106.

In most instances, the stabilization of government spending in relation to GDP seems to be proceeding fairly evenly as between outright purchases of goods and services, on the one hand, and transfers and subsidies, on the other. The staff projections for 1985 indicate ratios to GDP for both categories that, with few exceptions, are close to those recorded in 1983 (Table 3). One exception is the United States, where the expansion of expenditures for national defense is expected to give an upward tilt to government purchases of goods and services--which, however, should be more than offset by the declining relative magnitude of transfers and subsidies and of government interest payments. The other principal exception is Japan, where government purchases are being rolled back somewhat (as a percentage of GDP), but transfers and subsidies are projected to continue edging upward.

A notable feature of the 1984 estimates and 1985 projections shown in Table 3 is the tapering off, except in Italy and Canada, of the steep rise during the early 1980s in the relative magnitude of government interest payments. Among the other five major industrial countries, the lowering of interest rates since 1982, together with the reduction in rates of growth of government debt in most of these five countries is providing a somewhat tenuous stabilization of the respective national ratios of government interest payments to GDP. However, this ratio would tend to rise again, especially for the countries whose current fiscal deficits remain relatively large, with either a renewed upturn in interest rates or an unexpected faltering of growth in GDP.

In Italy and Canada, the present relative magnitudes of general government interest payments are so high (on the order of 8-10 percent of GDP) that they present a formidable hazard to the containment of further expansion of government debt, with its impetus, in turn, to still more growth of interest payments. This hazard is less serious for the United States, the United Kingdom, and Japan, where general government interest payments are all expected to be about 4 1/2 percent of GDP in 1985. The corresponding ratios are still lower--only 3 percent--in the Federal Republic of Germany and in France. These last two ratios are comparatively low, however, for different reasons: relatively low interest rates in the case of Germany and a below-average ratio of general government debt to GDP in the case of France.

IV. Calculation of Fiscal Impulse and Fiscal Data Base

This section provides a brief description of how the "fiscal impulse" measure is derived from the "cyclically neutral budget" model, and of the fiscal data used in the analysis undertaken in the section on Fiscal balances and impulses above. The "cyclically neutral budget" technique involves a distinction, with respect to government revenues and expenditures,

Table 3. Major Industrial Countries: Selected Components of General Government Expenditures in Relation to GDP 1/

(In percent of nominal GDP/GNP)

	1970	1975	1979	1983	1984 Estimated	1985 Projected
Canada						
Interest payments 2/	3.8	4.0	5.2	7.2	7.7	8.6
Transfers and subsidies	9.5	13.3	12.4	16.4	16.5	16.3
Purchases of goods and services 3/	23.1	24.0	22.6	24.4	24.3	24.1
United States						
Interest payments 2/	2.2	2.5	2.9	4.6	4.9	4.4
Transfers and subsidies	8.4	11.6	10.5	12.3	11.4	11.1
Purchases of goods and services 3/	22.2	21.9	19.6	20.7	20.4	21.2
Japan						
Interest payments 2/	0.6	1.2	2.7	4.2	4.3	4.4
Transfers and subsidies	5.7	9.3	11.3	12.9	13.0	13.2
Purchases of goods and services 3/	11.9	15.4	16.2	15.8	15.3	15.0
France						
Interest payments 2/	1.1	1.3	1.5	2.6	3.0	2.9
Transfers and subsidies	19.8	23.2	26.3	30.0	30.4	30.2
Purchases of goods and services 3/	17.3	18.0	17.6	19.1	19.0	18.7
Germany, Fed. Rep. of						
Interest payments 2/	1.0	1.4	1.7	3.0	3.0	3.1
Transfers and subsidies	17.9	23.9	23.3	23.3	23.1	22.5
Purchases of goods and services 3/	20.2	24.2	23.0	22.6	22.4	22.2
Italy						
Interest payments 2/	1.8	4.0	5.8	9.1	9.5	9.8
Transfers and subsidies	13.7	17.7	17.4	21.4	21.1	20.7
Purchases of goods and services 3/	17.0	19.3	19.7	23.8	24.0	24.0
United Kingdom						
Interest payments 2/	4.0	4.0	4.5	4.9	4.8	4.6
Transfers and subsidies	10.1	14.7	14.8	17.0	16.9	16.8
Purchases of goods and services 3/	22.5	25.8	22.2	23.7	24.3	23.2

1/ The fiscal data used in computing the ratios shown in this table are on a national income accounts basis.
2/ Gross interest payments.
3/ General government consumption plus general government investment.

between changes considered to be associated with cyclical fluctuations in the output of an economy and other changes, which may be viewed as imparting expansionary or contractionary impulses to the economy independently of the more or less automatic responsiveness of government transactions to cyclical developments. Revenue is regarded as cyclically neutral when it grows in proportion to actual GNP at current prices, and is contractionary (expansionary) when it increases faster (more slowly) than actual GNP. Expenditure other than unemployment insurance benefits is regarded as cyclically neutral if it parallels the movement of potential GNP at current prices, and is expansionary (contractionary) when it increases faster (more slowly) than potential GNP. Year-to-year variations in unemployment insurance benefits are viewed as cyclically neutral--that is, merely reflecting cyclical developments in the economy. 1/

The net "impulse" from changes in revenue and expenditure (i.e., that part of any net change in the fiscal balance that cannot be attributed to "cyclically neutral" changes in revenue or expenditure) may be interpreted as a cyclically adjusted indicator (according to the criteria just specified) of stimulative or restrictive shifts in government fiscal operations. 2/ Such changes may be viewed as policy determined either (1) by the introduction of new measures or (2) by the operation of previously existing measures that automatically result in revenue (expenditure) changing disproportionately to the change in GNP (potential GNP) by which "neutrality" is judged.

The fiscal impulse measure, as defined above, differs from the measure of "discretionary changes" in budget items employed by the Organization for Economic Cooperation and Development in its OECD Economic Outlook reports. The latter measure is calculated by deducting from the change in the fiscal balance the estimated effect on the budget of the operation of automatic stabilizers. The deduction is based on structural estimates of the automatic responsiveness of revenue and expenditure to cyclical fluctuations in real output, rather than on equiproportionate revenue and expenditure rules.

1/ This view, although somewhat simplistic (in that it ignores changes in the scale of benefits or in eligibility requirements), is adopted on grounds of expediency; data for a more refined treatment of unemployment insurance benefits are not readily available for all of the major industrial countries.

2/ The net fiscal impulse (FI) may be expressed in terms of the change in revenue (T), expenditure other than unemployment insurance benefits (G), actual GNP (Y), and potential GNP (YP), as follows:

$$FI = -(\Delta T - t_0 \Delta Y) + (\Delta G - g_0 \Delta YP)$$

where t_0 and g_0 are the base year ratios of revenue to actual GNP and of expenditure other than unemployment insurance benefits to potential GNP, respectively.

The fiscal impulse measure also does not taken account of the potentially different aggregate demand effects associated with increases in noninterest expenditure or decreases in revenue as opposed to increases in expenditure due to the effects of inflation on interest payments. In a situation of increasing inflation, nominal interest rates may rise sharply, leading to a significant increase in interest payments and a deterioration in the fiscal position. It has been argued that the implicit amortization component of these interest payments (reflecting the erosion of outstanding debt, in real terms, through inflation) has a much weaker impact on aggregate demand than other types of expenditure or revenue measures. The appropriate adjustment of the fiscal balance for the effects of inflation is itself a matter of controversy, but the effects of such adjustments on the measure of fiscal impulse are likely to be important only in periods when the inflation rate accelerates or decelerates rather sharply. If movements in the expected inflation rate could be assumed to closely parallel movements in the actual inflation rate, then adjustment of the fiscal impulse measure for the effects of inflation would impute a more expansionary (contractionary) character to fiscal policy in a period of declining (increasing) inflation than would be implied by the unadjusted fiscal impulse measure.

The data on central government fiscal balances shown in Table 1 generally conform to the standards used in the Fund's Government Finance Statistics Yearbook, which call for the recording of government transactions on a cash basis and the classification of net government lending (loan disbursements less repayments) with expenditures rather than with financing. For Canada, however, and for Japan (in large part), the data are on a national income accounts basis; for France, the data are on an administrative basis and do not incorporate social security transactions; and for Italy, the data cover the transactions of the state budget as well as those of several government-owned enterprises but, instead of including the gross revenue and expenditure transactions of social security institutions, include only net transfers from the central government to these institutions. The data on general governments in Table 2 cover the consolidated balances of central, regional, and local government units engaged in performing governmental functions but exclude government-owned industrial and commercial enterprises. These data are on a national income accounts basis, except for the United Kindgom, and thus exclude net government lending from expenditure. The data in Tables 1 and 2 are derived from national sources and staff estimates. The base year for the calculation of the fiscal impulse in 1978. Several of the fiscal data series for both central and general government and some of the GNP series have been revised since publication of the April 1984 World Economic Outlook.