Theoretical Considerations on the Fiscal Space

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Abstract. *This paper aims to capture the concept of fiscal space, which in principle denotes the amounts that governments can use to finance unforeseen or development expenditures without jeopardizing the country's fiscal sustainability, as well as the factors on which the size of available fiscal space depends. The importance of the fiscal space is highlighted again starting with 2020, with the covid-19 pandemic, when aid measures for some sectors of activity and the affected active population have requested additional amounts from governments, but the possibilities for intervention need to be calculated taking into account public debt, budget balance, tax collection performance and the ability to allocate resources efficiently.*

Keywords: **fiscal space, public debt, cost efficiency.**

JEL Classification: H12, E62, E60.

1. Introduction

The pandemic has created a global crisis, a shock that has deterred governments from meeting the proposed indicators, which has made it difficult to deliver on election promises - the new coronavirus has hampered the world economy. The pandemic has highlighted the importance of the fiscal space, of that margin that allows governments to create additional public debt without bringing the state to the brink of crisis. The fiscal space is the fiscal context in which public administration authorities can act without causing imbalances, depending on the level of existing public debt, the public deficit and the social challenges for which they are trying to design a response under the given conditions.

A wider fiscal space corresponds to sustainable public finances and enables governments to implement more emergency measures, ie to increase public spending in certain areas over certain periods without compromising sustainability. Sovereign debt is said to be a double-edged sword. Used properly, loans are geared towards investment and growth. An inappropriate level of public debt limits and eliminates fiscal space, slows economic growth and can lead to an uncontrolled increase in public debt.

2. Fiscal space: definitions, determinants, graphical representation

The concept of fiscal space is still evolving and there are many points of view on how it can be set up, when it is appropriate to use it and the mathematical ways in which it is quantified. Fiscal space refers to funding that becomes available to governments as a result of stimulating resource mobilization and reforms that ensure the economic and institutional environment so that fiscal policy actions are effective and achieve assumed development goals (Roy et al., 2007). Peter Heller (2005) describes the fiscal space as a financial context that allows the government to allocate resources to achieve desired goals, without compromising the financial position of the government.

Ensuring a large fiscal space must be a goal of public finances; its importance was proved by the pandemic, which forced governments to act immediately. The public authorities did not have any indications of such a challenge, so they did not have the time to develop strategies in advance or to prepare the necessary infrastructure for their implementation. Therefore, the fiscal space of countries with sustainable public finances gives them an advantage in the fight against unforeseen situations, and the (intervention) measures adopted in the short term by such states do not have negative long-term consequences. The existence of a wider fiscal space creates the premise that, in the event of objective and imminent challenges, they will be managed without burdening future generations.

The International Monetary Fund describes the fiscal space as the ability of a government to increase spending or reduce taxation without affecting market access and the sustainability of public debt. The Development Committee (2006) explains the fiscal space by accumulating additional resources for development. However, the formation and use of the fiscal space presents a different complexity, depending on the objectives of the fiscal policy. For developed countries, the fiscal space supports development by reducing the consequences of structural shocks, by measures to prevent poverty and increase the access of the less affluent population to services. In other words, the goals to be achieved are related to social and economic well-being. In the case of less developed countries, the challenges are more numerous, and fiscal policy will focus on investment that will lead to economic growth and on those basic needs that will enable the socio-economic development of the population.

Ostry et al. (2010) mathematically explains the fiscal space as the difference between a country's debt limit and its current debt, their work coming towards the end of the economic crisis that broke out in 2008, so at a time when states were still tense with the idea of this margin on which could use it usefully. The authors make recommendations for the preservation and increase of the fiscal space of all countries alike. Countries with a narrow fiscal space need to make fiscal adjustments that in a few years will improve the country's fiscal position, move it away from its historical fiscal "performance" (determination); Countries with sufficient fiscal space must also intervene, with medium-term adjustments capable of preventing potential fiscal challenges (aging population, commitments, contingencies).

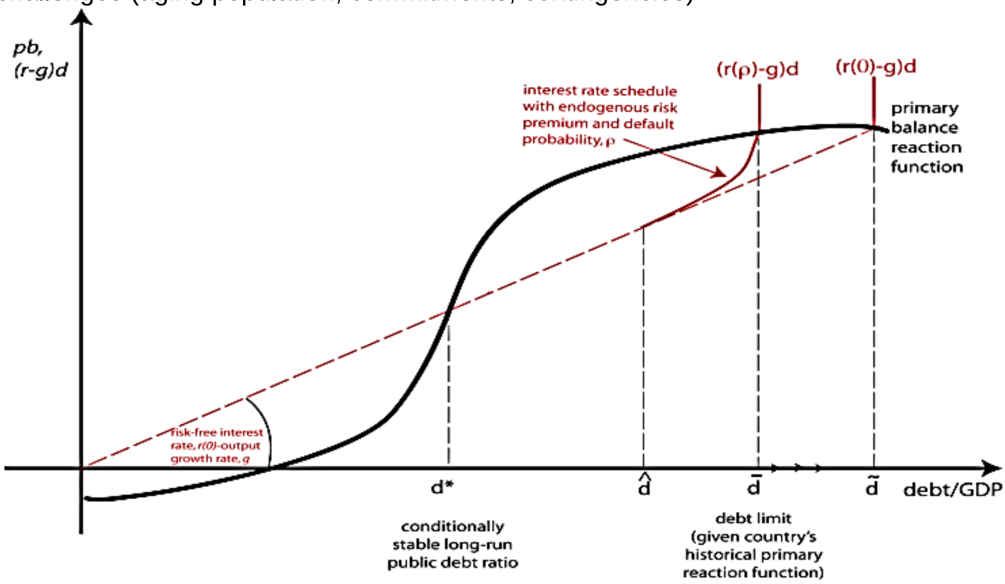

Figure 1 - Public debt evolution function

The previous graph (Ostry et al., 2010) explains how the limit public debt that does not affect fiscal sustainability can be determined. The graph shows the evolution of the primary balance as the level of government debt increases in GDP (*d*), taking into account the level of interest rate associated with government debt (*r*) and economic growth (*g*). Point *d** is the level of public debt that constantly maintains the level of public debt in GDP in the long run, if the public debt limit is not exceeded. It is noted that as the debt approaches its maximum level, the interest rate will also include a risk premium, which leads to higher interest rates and makes it more difficult to manage the level of debt.

The similarity of these definitions lies in the fact that the fiscal space is explained as availabilities that governments can use (coming from different sources), through which they can bring improvements to the economic situation, without affecting the sustainability of public debt. Therefore, the rationale for decisions to use the available fiscal space over a period of time must relate to the long-term impact of growth and the stock of public debt generated by the allocation of amounts.

The conclusions of a study on the optimal level of indebtedness carried out on 18 OECD countries are as follows: the maximum level of public debt up to which economic growth is not affected is 85% of GDP, and every 10 percentage points of additional debt leads to a downward trend by more than 1 percentage point of economic growth, according to the authors Cecchetti et al. (2010). The empirical results of Reinhart and Rogoff (2010) illustrate that at a level of public debt that exceeds 90% of GDP, both advanced and especially emerging economies have lower economic growth than would have been achieved in the case of in which it would have benefited from fiscal space - at a level of public debt that does not burden the economy. Kumar and Woo (2010) estimated that each time a developing country's public debt stock increases by 10 percentage points, real economic growth slows by 0.2 percentage points, with rich countries being even less affected. Even if the quantification of the impact on economic performance differs, we keep in mind the following certainty - the closer an economy is to the maximum debt threshold, the smaller its fiscal buffer.

Moreover, Cecchetti et al. (2010) warns of the aging of the population facing developed economies, which, if not prevented by measures to maintain the sustainability of public debt, will only lead to a growing public debt combined with a decrease economic. Reinhart and Rogoff (2010) also showed that at a high level of public debt, determined by the degree of economic development of each state, emerging economies register higher inflation. In contrast, for advanced economies, no causal relationship was identified between the high level of public debt and inflation.

There are numerous studies on the factors that increase debt and insufficient ones that assess the economic result of the increase in public debt, namely the evaluation of expenditures, due to the dogma of the permanent functioning of public finances on the basis of opportunity. It is necessary to use a performance indicator of the use of amounts, which indicates the projected savings / importance of the investment, based on the criteria of efficiency and effectiveness.

One of the reasons why fiscal policies do not turn out to be in line with a state's budgetary needs is that governments often act without taking into account the impact of long-term decisions and thereby diminish the fiscal space for future governments (Jankovics and Sherwood, 2017). The same authors point out that the fiscal illusion or lack of consistency over time in fiscal policies also hinders the achievement of fiscal objectives - and necessitate the intervention of independent institutions to ensure that slippage is avoided.

The amounts that practically supply the financial resources of the governments, the amounts for which no expenses have been committed are financial resources associated with the fiscal space. For example, they can come from reallocations, from additional tax revenues due to the increase in certain taxes, from loans that exceed the estimated expenses, from economic growth. According to Allen Schick, the volume of fiscal space at any given time depends on four factors, namely: ongoing government programs that require additional funding, the government's tendency to access credit, the government's propensity to tax, and the evolution of the economy. The same author distinguishes between the objective of the fiscal space according to the degree of economic development of the country. For developing countries, fiscal space shows the ability to stimulate the economy through loans, while for developed countries, fiscal space shows the opportunity to develop and refine programs that are already implemented.

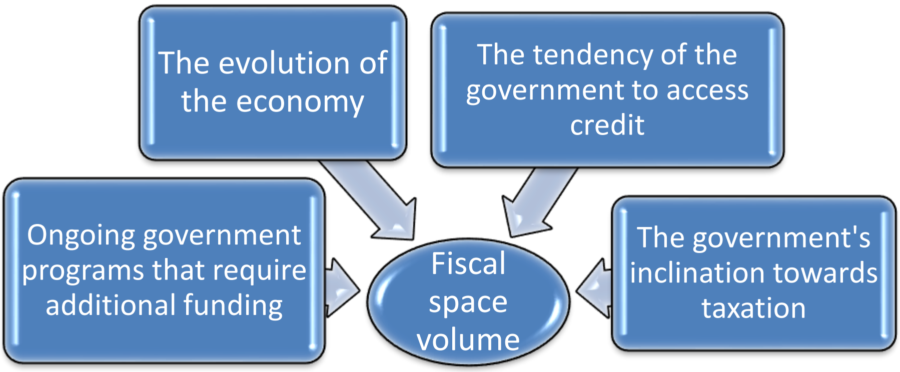

Figure 2 - Determinants of fiscal space volume

The management of the fiscal space is the responsibility of the government, which must make a fair assessment of the times or programs for which it is appropriate to use the available funds or, conversely, to expand the fiscal space.

The Development Committee represented for the first time graphically (2006) the concept of fiscal space in the form of a "diamond" based on 4 variables, and this illustration can determine the fiscal space at national level either in absolute value or as an evolution compared to previous periods. Therefore, the fiscal space shows how long-term development strategies can be financed considering the financial aids received in the form of grants, assistance or loans, mobilizing the income of the population by carrying out reforms in the administration / taxation policy, financing the public deficit through internal or external loans. and changes in public spending and allocation efficiency.

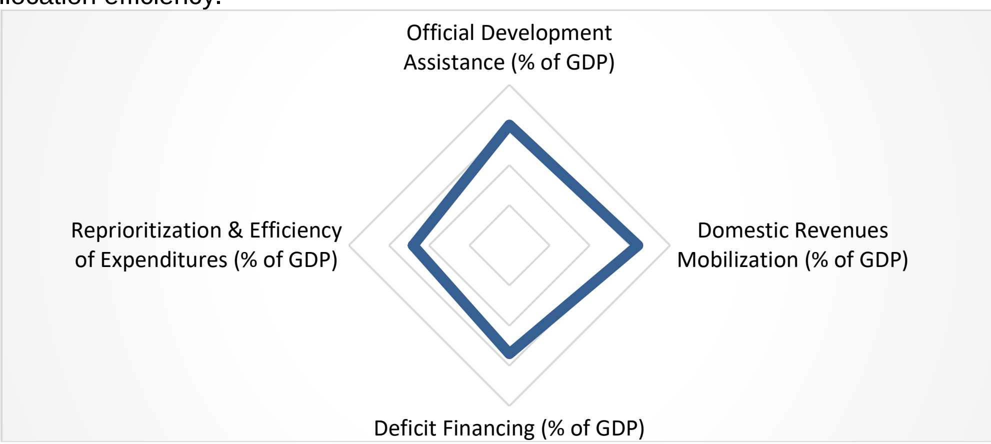

Figure 3 - Graphical representation of fiscal space

The Development Committee (2006) explains issues arising from the understanding of this representation, as follows:

- Regardless of the form in which a potential expansion of the fiscal space is obtained, it is necessary for the fiscal policy to remain focused on stabilization, economic growth.

- States differ, as does the share of taxes in the formation of revenues, as do public expenditures, depending on social requirements. The structure and amount of expenditure must be linked to the results and effects obtained.

- The efficiency of the use of resources, owned or acquired, also depends on the economic context, on the institutional capacity to allocate them. In order to ensure greater efficiency in spending, governments must first aim to reform the tax-collecting institutions and those that manage amounts from budgets.

3. Conclusions

The economic crisis triggered by the covid-19 pandemic has put state governments in difficulty as tax revenues have been reduced due to lockdowns and restrictions, and at the same time it has been necessary to supplement public spending on health and social assistance, and unemployment. In this context, the existence of a wider fiscal space has become relevant again, as the measures implemented by each state have depended on it. The fiscal space reveals the financial resources to intervene in unforeseen situations or for development, and which is determined by the level of deficit and public debt, by the management of tax expenditures and revenues. The quantification of the fiscal space is necessary to subsequently initiate opportunity analyses for the use of available amounts, depending on the projected growth and development rate and the present socio-economic constraints.

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