Symposium Summary

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Chronic government budget deficits and escalating government debt have become major concerns in both developed and developing countries. Concern arises because fiscal imbalances siphon funds from private sector investment, retarding growth and ultimately reducing standards of living. Fiscal imbalances also create potentially large burdens on future generations, as workers may be forced to finance unfunded social programs for rapidly expanding elderly populations. And, fiscal imbalances can trigger disruptive movements in interest rates and exchange rates, as highly indebted countries become increasingly vulnerable to global market forces. Few economic issues have such far-ranging implications as excessive deficits and debt.

To gain a better understanding of the problem, and to consider potential solutions, the Federal Reserve Bank of Kansas City sponsored a symposium titled "Budget Deficits and Debt: Issues and Options" held at Jackson Hole, Wyoming, August 31 - September 2, 1995. The symposium brought together a distinguished group of central bankers, finance ministers, academics, and financial market representatives.

The discussions were marked by unusually strong agreement on several points. First, most participants agreed that government deficits and debt are already excessive and will become unsustainable as aging populations increasingly draw on unfunded pension and

health care programs. Second, large and growing fiscal imbalances harm economic performance, impose unacceptably large burdens on future generations, and raise the risk of major financial market disruptions. Third, solutions to the deficit and debt problems should stress spending reductions, not tax increases. And fourth, fiscal reforms will need to be decisive, transparent, and equitable if they are to receive public support.

This article summarizes the papers and commentary presented at the symposium. The first section lays out the dimensions of the buildup in government deficits and debt. The next two sections examine the economic consequences and monetary policy implications of the buildup. The fourth section considers potential solutions. The final section summarizes the remarks of an overview panel.

Dimensions of fiscal imbalance

Alan Greenspan opened the conference by observing that controlling government deficits and debt is a fundamental challenge for economies throughout the world. He noted that debt-to-GDP levels have risen steadily in most industrialized countries for over a decade, reducing economic output and placing countries at risk of financial breakdown. Moreover, the prospects of reversing these trends are not good. In the United States, for example, aging baby boomers will place mounting pressures on social programs. The solution, in Greenspan's view, is for policymakers to take strong action today and make a lasting commitment to sustain deficit and debt reduction in the future. "Today's actions," he cautioned, "are only the first step to fiscal reform. . . . Indeed, the will and means to follow through are at least as important."

Two papers, one presented by Paul Masson and Michael Mussa and another presented by Kumiharu Shigehara, underscored how serious deficit and debt problems have become in many countries.

Masson and Mussa noted that most industrialized countries have run persistent deficits since the mid-1970s, leading to rising debt-to-GDP levels. In the United States, gross government debt as a

percentage of GDP rose from 44 percent in 1980 to 69 percent in 1994. Over the same period, government debt rose from 32 to 50 percent in Germany, from 52 to 83 percent in Japan, and from 58 to 129 percent in Italy. To a large extent, this deterioration in fiscal balance sheets has been due to rapidly expanding expenditures on public pension and health care programs.

Why have governments let deficits and debt levels rise to such high levels? Masson and Mussa offered several possible explanations. First, public attitudes toward the role of the state have changed over the postwar era. As industrialized countries have become wealthier, the demand for government services to help the less fortunate has increased. Second, and related, beneficiaries of government services have increasingly come to view such payments as entitlements, making it politically difficult to reverse the trend. This is especially true of pension and health care programs. Third, miscalculations have caused deficit and debt levels to be higher than originally anticipated. These include rising health care costs, increases in structural unemployment, larger than expected increases in life span, and a general slowdown in productivity growth.

Developing countries also have encountered growing fiscal problems in recent years. While individual cases vary, Masson and Mussa noted that many developing and transition economies have begun to run persistent deficits. In contrast to industrialized countries, spending on social services in most developing nations has not yet surged, keeping levels of government spending relative to GDP relatively low. However, as developing and transition economies become wealthier and their populations age, they are likely to face the same set of fiscal challenges as developed economies.

Looking to the future, and in particular at prospects for industrialized countries, Masson and Mussa were not overly optimistic. Many industrialized countries have taken steps to reduce their deficits and debt-to-GDP ratios over the medium term. But over the longer term, success is uncertain. Fiscal problems run much deeper than current levels of government debt suggest. The growing liabilities of government commitments to provide social benefits, especially for the

elderly, are largely unfunded. Taking these liabilities into account makes tomorrow's fiscal imbalances truly daunting. Masson and Mussa urged policymakers to remain committed to reducing deficits, and to do so principally on the spending side. By acting soon to scale back social programs, Masson and Mussa argued, individuals would still have time to adjust to lower future benefits.

Shigehara concurred with Masson and Mussa's assessment of the deficit and debt problem. Focusing on industrialized countries, Shigehara presented estimates of future debt-to-GDP ratios based on current provisions in government pension and health care programs. The results were striking. In the United States, net public debt as a percent of GDP would more than triple from the year 2000 to 2030. In Germany, the ratio would double. In Japan, the rate would rise tenfold.

Equally striking were the implied tax burdens on future workers. Shigehara estimated that future U.S. generations would owe twice the amount of taxes owed by current taxpayers. Generational imbalances would also arise in the other countries for which the OECD has made calculations—Germany, Italy, Sweden, and Norway. Such figures led Shigehara to warn that current fiscal situations are unsustainable.

Shigehara's prescription, like that of Masson and Mussa, would be to cut growth in government spending. Given the already high tax rates in most industrialized countries—and the distortions such taxes impose—the only reasonable option is to adopt a comprehensive package of spending reforms. To garner political support, governments must make their current and future fiscal positions clear to the public. In particular, they must let taxpayers know how great the fiscal burden on future generations will be if the spending problems are not addressed soon.

Economic consequences

Laurence Ball and Gregory Mankiw then explored the economic consequences of rising deficits and debt. Their paper considered both real and financial market effects.

Ball and Mankiw began by noting that running government budget deficits typically reduces national savings. Lower national savings, in turn, lead to reduced investment and reduced net exports. Investment is curtailed because a drop in national savings restricts the supply of loanable funds, forcing interest rates higher. Net exports suffer because higher interest rates cause the domestic currency to appreciate. The resulting trade deficits are financed by a flow of assets overseas.

Over the long run, the decline in investment lowers the capital stock, reducing productive capacity and output. The crowding out of investment and capital also lowers productivity growth and hence real wages. Moreover, a continued flow of assets abroad leaves residents with less, and foreigners with more, of any interest, rents, and profits earned. Ball and Mankiw argued that this conventional view of deficits and debt aptly describes the recent experience in the United States. According to their calculations, output in the United States is 3 to 6 percent lower than it would otherwise be due to the fiscal imbalances of recent years.

Ball and Mankiw also looked at the possibility of what they called a "hard landing." In many countries, debt-to-income ratios are expected to move even higher in coming years. The conventional economic effects thus would be magnified—in the United States, for example, a doubling of the debt-to-GDP ratio from the current level would imply a 6 to 12 percent reduction in output. But more important, countries could face new, qualitatively different risks as debt levels continue to rise. In particular, a rising debt-to-income ratio could cause investor confidence in a country to fall. There may be limits to how many of a country's assets foreign investors are willing to hold. In addition, if the perceived risk of a government defaulting on its debt rose, investors would likely begin liquidating their holdings.

The effects of such a hard-landing scenario would be dramatic. Stock and bond prices would fall, and interest rates would rise. The rise in interest rates would depress investment, reducing output and real wage growth. Household spending might fall sharply. The

exchange rate would decline as investor demand for the country's currency fell, putting upward pressure on inflation. Inflationary pressures would also rise to the extent that the central bank came under increased pressure to be overly accommodative. Ultimately, a general financial crisis could erupt, causing widespread bankruptcies.

In sketching this scenario, Ball and Mankiw emphasized that such a fate is highly speculative—but still possible. Peacetime debt buildups like those now being experienced by most industrialized countries are unprecedented. No one really knows how the dynamics of a hard landing would play out. Consequently, the uncertain risk of a hard landing may be the most compelling reason for acting now to reduce deficits.

Robert Johnson, in discussing Ball and Mankiw's paper, questioned whether the output loss associated with the current U.S. debt level is as high as 3 to 6 percent of GDP. He was not convinced that the linkage between government debt and future productivity is that strong. Such a view rests on the assumption that rising interest rates stemming from rising deficits significantly discourage business fixed investment, which is an empirically questionable proposition. It is more likely, in Johnson's view, that part of the adjustment to fiscal imbalance takes place via increases in private saving, as interest-sensitive consumption and residential investment decline in the face of rising interest rates. Therefore, reducing deficits would not have as large a favorable crowding-in effect as Ball and Mankiw estimated. Moreover, Johnson argued, it would matter how the deficit was cut. The Ball and Mankiw estimates do not distinguish among alternative approaches. Raising taxes on capital or reducing government spending on research and development and education, for example, would presumably have a negative effect on potential output growth.

Johnson was sympathetic to Ball and Mankiw's hard-landing scenario. Today's investors, he agreed, are highly sensitive to fiscal policy imbalances and can shift funds quickly and efficiently. Johnson pointed out that the first type of potential asset crisis, the

portfolio-saturation scenario, is likely to be a problem only for the largest countries, whose assets make up a significant share of investors' portfolios. Of greater concern to most countries is the second scenario, where the ability or willingness to repay debt comes into question, driving borrowing costs higher. As Johnson noted, high-debt countries can be vulnerable to such disruptions even if they are addressing their fiscal problems. Sweden and Canada, for example, faced difficulties in the wake of the 1994-95 Mexican crisis.

To avoid such guilt by association, Johnson recommended that countries implement decisive reform measures. Global investors need positive proof that a country is serious about deficit and debt reduction. To gain investor confidence, governments need to sacrifice a "sacred cow." In that vein, investors are currently impressed by fiscal reform efforts in Sweden and Italy, for example, but are distrustful of efforts in France.

Allan Meltzer, in discussing the Ball and Mankiw paper, also stressed that it matters how a deficit is reduced—whether it is done through spending cuts or tax increases. Spending cuts have positive effects on resource use, while tax increases have negative effects on incentives. Indeed, according to Meltzer, the way a deficit is cut has more important effects than the actual deficit reduction itself.

Working from Ball and Mankiw's figures, Meltzer estimated that the output gain of eliminating the U.S. deficit—as opposed to Ball and Mankiw's experiment of eliminating the entire U.S. debt—would amount to less than 1 percent of GDP. However, if deficit reduction is achieved principally through spending cuts on entitlement programs, combined, perhaps, with tax reform, the ultimate impact could be greater.

Monetary policy implications

John Taylor presented a paper exploring the implications of deficits and debt for monetary policy. Taylor first examined the basic relationship between fiscal position and monetary policy. He noted that in large countries with access to credit markets, inflation is not

necessarily tied to deficits and debt. For these countries, changes in fiscal position can be brought about by changes in government bond issuance. That is, countries with access to credit markets need not rely on monetary expansions and contractions to adjust to government fiscal positions.

For many developing and transition economies, however, access to credit markets is limited. For these countries, budget cuts can have a large effect on money creation and hence a beneficial impact on inflation. Another channel through which lower deficits might help reduce inflation—for larger countries as well as for smaller ones—is credibility. Recent theoretical research suggests that lower deficits will reduce a government's temptation to inflate away its debt, that is, lessen the so-called time-inconsistency problem. In practice, governments and central banks have often been able to resist this temptation. In the United States, for example, inflation has trended downward since the early 1980s despite the large runup in public debt.

Taylor then addressed monetary policy issues that would arise during the transition from high to low deficits. He asked two key questions: Would it be advisable for the central bank to lower its short-term interest rate in response to deficit reduction? And, if so, how quickly should it be done?

To the first question, Taylor answered that the central bank should lower its interest rate by the amount the long-run real interest rate is expected to decline. By doing so, the central bank would prevent a shortfall in aggregate demand that would otherwise lead to an undershooting of its inflation target.

To the second question, Taylor answered that the central bank should lower its interest rate gradually, at the same pace that the budget deficit is actually reduced. He recommended against a more rapid reduction in interest rates on two grounds. First, rapid cuts would be unnecessary in that a credible deficit-reduction program would lead to an immediate decline in long-term interest rates. Second, the reduction might have to be reversed in the event that

deficit-reduction projections proved overly optimistic. On the assumption that eliminating the U.S. budget deficit over the next seven years would reduce the long-run real interest rate by one percentage point (an estimate recently offered by the Congressional Budget Office), Taylor's prescription for monetary policy would be to reduce short-term interest rates one-seventh of one percentage point, or about 15 basis points, each year.

Finally, Taylor observed that day-to-day operations of monetary policy might have to be altered somewhat in the aftermath of a transition to fiscal austerity. In particular, if austerity was brought about by balanced-budget rules that precluded cyclical deficits—and, hence, automatic stabilizers—monetary policymakers would likely have to become more responsive in adjusting interest rates to deviations in output.

Mervyn King, in discussing Taylor's paper, agreed that during a transition to lower deficits, a central bank should reduce its short-term interest rate only gradually. Indeed, if the central bank acted more aggressively, it might damage its own credibility. Doing so would cause long-term interest rates to rise, undoing the beneficial impact on long-term rates of fiscal reform.

King stressed that monetary policy has had important effects on fiscal policy in recent years. In particular, the move toward the pursuit of price stability in many industrialized countries in the 1980s and 1990s has exacerbated fiscal problems. Actual inflation has been lower than expected, raising the effective real interest rate on government debt. Hence, borrowing costs have increased, contributing to the rise in debt-to-GDP ratios. As the credibility of anti-inflation policies grows, however, inflation expectations will decline and borrowing costs will come down. The goal, King noted, is to have sound policies on two fronts: monetary policy must be dedicated to price stability, and fiscal policy must be dedicated to responsible debt management.

Helmut Schieber, in his comments, focused on European fiscal issues. He noted that countries will be permitted to join the planned

Economic and Monetary Union (EMU) only if their deficits do not exceed 3 percent of GDP and if their gross public debt does not exceed 60 percent of GDP. At present, only Germany and Luxembourg meet these criteria. Moreover, once countries are admitted to the EMU, they will be expected to continue to observe these ceilings. Schieber cautioned, however, that existing regulations may not be strong enough to prevent member countries from adopting overly expansive budget policies, and he suggested that separate treaties be signed to ensure that this does not occur. He emphasized that a future European Central Bank must have the will to counteract ill-advised fiscal expansions if monetary stability and low inflation are to be maintained. The German Bundesbank, for example, has had to adopt such an uncompromising position on two occasions in recent years—in 1981, following a runup of debt in the late 1970s, and in 1990-92, following reunification.

Solutions to fiscal imbalance

Conference participants then shifted their focus to finding solutions to the debt and deficit problem.

The Canadian experience

In the symposium's luncheon address, Paul Martin explained how Canada has addressed its fiscal problems. Like most other industrialized countries, Canada has run persistent deficits for years and has seen its debt rise steadily. Net federal debt as a percentage of GDP has increased in the last fifteen years from 30 percent to 73 percent. Interest charges alone account for almost 34 cents of every federal revenue dollar. Such a large stock of debt, combined with interest rates three to four percentage points higher than the country's growth rate, makes it very difficult to stabilize the debt ratio.

In response, the Canadian government has taken aggressive action over the last two years. The centerpiece of the program has been to commit to an interim deficit target of 3 percent of GDP in 1996-97 on the way to an eventual balanced budget. While the interim target is ambitious—the deficit was 6 percent of GDP in 1993-94—Martin

expressed confidence it will be achieved because of the strong measures contained in the two most recent federal budgets. The budgets provide for a 10 percent reduction in program spending by 1996-97, making Canada the only G-7 nation to budget an absolute decline in program outlays. According to current projections, by 1996-97 the 3 percent deficit target will be met, the government will be running a sizable operating surplus, and the debt-to-GDP ratio will begin to decline.

How has the Canadian government been able to bring about such sweeping fiscal reform? The most important factor, Martin stressed, has been public support. The public has come to understand the severity of the problem and regards the reform measures as balanced and fair. In addition, the reform process has been guided by three key principles: (1) to enhance accountability and credibility, the focus has been on short-term targets incorporating conservative economic assumptions, (2) to enhance efficiency, spending cuts have been allocated in a flexible, decentralized way among departments and agencies, and (3) to encourage dialogue and expand the range of options, extensive public consultations have been undertaken. Through these means, Martin explained, Canada has taken the crucial first steps in regaining its fiscal health. "What we have really launched is a fundamental reappraisal of the appropriate role of the national government. . . . Creating a public sector where it can truly be said that 'less is more' is the greatest challenge we face."

Solutions for developed economies

Four panelists then presented their views on solutions to the deficit and debt problem in developed countries.

Alan Auerbach's overriding theme was that fiscal problems in industrialized countries are generally far worse than deficit figures would suggest. In the United States, for example, balancing the budget in the short run will be insufficient—fiscal imbalances will worsen in the long run due to changing demographics. The same fate awaits other developed countries.

Auerbach used the generational accounting framework he helped pioneer to demonstrate the seriousness of the problem. Assuming no change in current policies, Auerbach estimated the lifetime tax rate on future U.S. generations would have to be 84 percent to achieve a sustainable fiscal position. Even assuming the budget becomes balanced in seven years—the goal currently being considered by Congress—the implied tax rate on future generations would have to be 72 percent, more than double the rate on today's taxpayers. The problem: the huge unfunded liabilities associated with Social Security and Medicare, liabilities that will come due as baby boomers begin to retire over the next twenty to thirty years. Such liabilities will impose an infeasible burden on future generations.

None of the potential solutions, Auerbach emphasized, will be painless. All will involve significant cuts in spending or increases in taxes. But delaying action today may force Draconian actions in the future. Auerbach was skeptical about some of the structural reforms that have been suggested. Budget rules, such as a balanced budget amendment, are suspect because the standard, annual deficit measures they rely on are poor indicators of a country's true fiscal position. Federalism—shifting more fiscal responsibilities to state and local governments—is unappealing because of its potentially undesirable effects on income distribution. One structural change that Auerbach would endorse is the adoption of improved government accounting procedures. In particular, he advocated procedures that would recognize long-term liabilities and estimate the generational consequences of policy actions.

Alberto Giovannini, in his remarks, emphasized the role played by financial markets in debt and deficit issues. In today's highly globalized markets, it is impossible for countries to inflate away their debt. Investors are quick to adjust their inflation expectations, precluding surprise inflations that lower ex post real interest rates. Today's free capital markets also impose a measure of discipline on fiscal policy. When a country's fiscal position begins to appear unsustainable, investors pare back their holdings of that country's debt, in effect evaluating government debt like corporate debt, including an assessment of default risk.

Like Auerbach, Giovannini stressed that there are no quick fixes to current deficit and debt problems, and that solutions will entail slow and gradual adjustments in public finances. On the subject of structural reform, Giovannini argued that reform options will vary by country. In Italy, for example, pension reform is likely to be limited by constitutional constraints. Stricter rules on local government spending, however, offer some promise.

Peter Peterson focused on the entitlements problem in the United States. He first documented the explosive growth of entitlements in recent years. Spending on non-means-tested entitlement programs such as social security, Medicare, federal pensions, and farm aid has grown about three and one-half times faster than the population and inflation over the last thirty years. Since the 1960s, benefits to the elderly have come to dominate the budget. Entitlement spending on the elderly now accounts for over one-third of the federal budget, doubling in the last thirty years.

Social security and Medicare have been two of the largest spending components and will become even larger as the population ages. These programs represent huge unfunded liabilities. Peterson estimated that if federal retirement programs were funded in the manner required of private pensions, some $800 billion a year would have to be added to the federal deficit. Such a figure shows that current programs are simply unsustainable.

Peterson then offered a specific social security reform plan that, if implemented soon, would bring about fundamental changes gradually. His program contains three elements. First, the eligibility age for full benefits would be raised over time to age 70. Second, an affluence test would be applied so that higher income individuals would receive fewer benefits. Third, more social security benefits would be made taxable. Peterson's projections indicated that these changes would keep the Social Security program viable well into the 21st century. Peterson stressed that such reforms will not be possible without popular support. The American public needs to understand the severity of the problem if it is to get behind the reform measures. Thus, an essential first step is to educate the public.

Jürgen Stark, in his remarks, explained Germany's efforts to improve its fiscal position. Germany made considerable progress in the second half of the 1980s, turning a government deficit of 3.3 percent of GDP into a 0.1 percent surplus by the end of the decade. But after reunification, Germany's fiscal position deteriorated as capital and transfer-payment expenditures in eastern Germany soared. During the six years since reunification, Germany's debt level has more than doubled.

German officials have responded by embarking on a medium-term program for fiscal consolidation. The central aim of the program is to reduce government spending as a percent of GDP from 50 percent currently to 46 percent by the year 2000. Two additional goals are to reduce the deficit to 1 percent of GDP and to reduce taxes as a share of GDP by one and one-half percentage points. Specific reform measures include reducing subsidies, cutting government staff, and adjusting unemployment and other wage-related benefits. Efforts also will be made to control government pension and statutory health outlays. More fundamentally, Stark emphasized that governments need to reassess what tasks they can and should assume, basing their decisions on issues of allocation and distribution.

Solutions for developing economies

The symposium then turned its attention to developing countries. What options are available to these countries as they attempt to address their debt and deficit problems?

Sebastian Edwards, in his paper, focused on Latin America. He noted that during the past few years, the majority of Latin American countries have undertaken major fiscal reforms to reduce inflation and achieve external stability. Such adjustments became necessary in the wake of the debt crisis of the early 1980s. In most cases, Edwards argued, the programs have been successful. The majority of countries have markedly reduced their public sector deficits relative to the mid-1980s.

The improvement in public sector accounts has been achieved through a combination of higher revenues and lower expenditures.

Higher revenues have been gained through tax reform and the privatization of state-owned enterprises. Lower expenditures have been brought about through reduced spending on both current and capital outlays. Data suggest that tax reforms—while contributing to efficiency and fairness—to date have had only a limited effect on total revenues. Tax revenues will grow only as tax administration and compliance improve, and this will take time. Expenditure reductions, on the other hand, have had a noticeable impact. Indeed, in virtually all Latin American countries, total public sector spending as a percentage of GDP has declined substantially.

Edwards looked at the reform programs in Chile, Mexico, and Argentina in detail. Chile is particularly interesting because of its pioneering role in privatizing social security. Chile has replaced its traditional pay-as-you-go public pension system with a system based on individual retirement accounts. The program has been a success, reducing demands on public finances as well as encouraging private saving and the development of the Chilean capital market.

Edwards stressed that, for all countries, a clear and modern regulatory framework must be in place. Otherwise, transferring basic infrastructure and other state enterprise activities to the private sector cannot be successful. Edwards also stressed that the challenge for Latin American countries, and for transition economies as well, is to increase domestic savings to boost potential growth.

José Pablo Arellano, in his comments, focused on recent developments in Chile, which has run a budget surplus since 1988. Several factors have contributed to Chile's improved fiscal position. On the revenue side, the country has been able to rely on a broad value-added tax and has put in place a tax structure that is protected from annual modifications. Chile also has created a stabilization fund that offsets the fiscal effects of variations in the price of copper, one of its key exports. On the expenditures side, Chile has transferred the provision of many social services to the private sector. While still funded by the state, such services now benefit from private-sector competition. In addition, Chile has gradually eliminated

direct lending by government agencies and has largely prohibited the earmarking of taxes for specific projects.

Arellano also discussed Chile's private pension system. The system now covers 90 percent of the country's employed workers and has accumulated a pension fund equal to 50 percent of GDP. In effect, Chile has replaced a pay-as-you-go system containing legally defined benefits with a privately funded system containing legally defined contributions. One important implication is that future government outlays will no longer depend on changes in life span.

John Flemming, in this comments, focused on recent developments in the transition economies of Central and Eastern Europe. Virtually all of these countries have experienced some output and employment loss in the transition to a market economy, but several have now resumed growth. Flemming noted that a resumption of growth has come only in countries that have been able to stabilize inflation and improve their fiscal position.

Flemming underscored the point made by Edwards that transferring infrastructure and functions to the private sector requires clear regulatory frameworks. He also noted that the financial sector can be a source of fiscal instability, and that the problem of bad debts and bankruptcy have not been fully resolved in some Eastern European economies. On a positive note, Flemming argued foreign investment will prove beneficial to the transition economies because of the transfer of associated technologies.

Overview panel

In the final session of the symposium, three overview panelists presented their thoughts on the debt and deficit issue.

Martin Feldstein argued that deficit reduction should be a critical goal of government policy, deserving the highest priority. Budget deficits are unambiguously harmful. Deficits undermine responsible government spending decisions by permitting politically popular programs to be established and expanded without having to be

financed through taxes. Deficits crowd out capital, which leads to lower productivity, lower real wages, and a lower standard of living. And, deficits generate an ever-growing national debt, whose interest payments keep tax rates restrictively high.

Feldstein calculated that if the U.S. government had run balanced budgets since 1980, today's national debt would be only 10 percent of GDP and current marginal tax rates could be 30 percent lower. The clear message is that budget deficits matter. They have had a profound effect on the U.S. economy in recent years.

Looking ahead, Feldstein was cautiously optimistic about the prospects for deficit reduction. The economics profession, policymakers, and the American public are all coming to recognize that the problem of deficits is severe. Reducing deficits and, in particular, coming to grips with entitlement programs, will not be easy. But the intellectual and political environment is now more conducive to fundamental change than at any time in the last fifteen years.

Goran Persson directed his remarks to Sweden's recent efforts to reduce its budget deficit. In 1994, Sweden had a budget deficit of 10 percent of GDP, the largest among OECD countries. Its public debt had doubled in three years. Such high debt levels were threatening Sweden's economic stability and making it increasingly vulnerable to disruptive global capital market flows. As Persson observed, "It is not an exaggeration to say that the rapid increase in the public debt challenged the whole idea of democracy."

Sweden had reached the point where something had to be done. The new government that took office in late 1994 put in place an aggressive fiscal consolidation program aimed at reducing the deficit to 3 percent of GDP by 1997 and balancing the budget by 1998. Strong measures have already been taken—the program is front-loaded—and two-thirds of the measures involve spending cuts. The program was passed with a 94 percent majority in the Swedish parliament.

Persson argued that three elements are required for a fiscal consolidation program to be successful. First, the program must be

designed so that the burdens are shared equitably. Otherwise, public support, which is absolutely essential, will be lacking. Second, and related, the consolidation program must be comprehensive, rather than a collection of ad hoc measures, making it clear to interest groups that everyone will be asked to make sacrifices. And third, the reform process and budgeting procedures should be as transparent as possible. Only in this way can credibility be established and maintained. Sweden has followed such an approach over the past year and, as a result, is facing a much brighter future.

James Wolfensohn, in his comments, focused on the developing countries outside of Latin America and Central and Eastern Europe. He stressed that the poorer countries of Asia, Africa, and the Middle East face a different set of economic problems than those faced by wealthier countries. Many poor nations are struggling to establish democracies in the post-Cold War era; most have limited economic resources at their disposal. While such countries are concerned about excessive debt and deficits, they often face the more fundamental problem of providing basic health and educational services. These new democracies are fragile, and continued economic support from the wealthier nations is essential. Wolfensohn called on the wealthier nations to remain outward-looking, and to integrate their deficit reduction programs with continued aid to the less advantaged nations.

The central theme running throughout the conference was that reducing government budget deficits and debt represents a major challenge to countries around the world. To meet this challenge, difficult decisions will need to be made. Public and political resolve will be tested. If successful, current and prospective fiscal reform measures will help unleash the world's economies to achieve their full potential.