TOPIC OF THE DAY

FISCAL POLICY

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According to an orthodox approach, fiscal policy together with monetary policy forms the main sub-branch of the economic policy, which allows managing aggregate demand on macroeconomic level[1]. Historically, the role of the fiscal policy in managing demand gained significance in the years preceding World War II when *General Theory of Employment, Interest and Money* by Keynes started to spread. According to the theory, the level of the aggregate demand will determine the level of aggregate economic output and the government has a significant role in managing it through fiscal policy.

In the decades following World War II, the role of the fiscal policy in managing demand in several countries was interpreted as an opportunity to achieve a constantly high economic growth. While initially relatively rapid growth in productivity allowed financing expansive fiscal policy, the growth slowdown in the 1970s involved constant budget deficit and soaring government debt in many states. In 1970–1990, the average annual government budget deficit in the US reached 3.8% of GDP.

While in late-1980s and early-1990s it turned out that continuous expansive fiscal policy was not able to affect long-term growth potential in the intended direction, the concept of balanced budget, which had been prevailing during the times of gold standard, regained its importance. Nowadays, however, the position is that fiscal policy can be used only provisionally to influence aggregate demand. This means that appropriate fiscal policy will help to smooth cyclical fluctuations of the economy but it cannot change long-term economic growth potential.

Over the last decade, population aging in most of the developed industrial countries has increasingly brought into the focus long-term budget balance. The share of taxpayers to dependants will decline in the decades to come; and, therefore, it will be necessary to revise the current principles of funding public services. This applies most to the PAYG pension systems. The impact of various pension systems and reforms to the budget balance is addressed in more detail in the article *Population Aging – Factor Affecting Budget Balance for Decades to Come*.

Fiscal Policy in EMU and Fixed Exchange Rate Countries

A monetary policy framework without instruments to pursue active monetary policy is characteristic of the EMU Member States and fixed exchange rate systems. In other

[1] A more recent approach frequently analyses also possibilities to influence with budgetary policy the supply side of the economy.

words, in these countries it is not possible to affect domestic demand with an independent monetary policy. Therefore, fiscal policy is the primary instrument to regulate demand and balance cyclical fluctuations of the economy in the EMU countries and Estonia. Moreover, the fixed exchange rate system, the balance-oriented and conservative fiscal policy is one of the essential prerequisites for efficient performance of economy.

Since 1992, Estonia's monetary policy system has been based on the fixed exchange rate and currency board framework, which is why fiscal policy has been central in balancing domestic demand and ensuring efficient performance. In 1993–2002, average government deficit reached 0.5% of GDP a year and government debt ratio has remained below 10% of GDP throughout the years of independence. Kalle Kukk provides a more detailed overview of the development of Estonia's fiscal policy over the last decade in his article *Fiscal Policy in Independent Estonia*.

Vis-à-vis the upcoming accession to the European Union and joining of the European Economic and Monetary Union in two-three years, Estonia will have to meet provisions of the Stability and Growth Pact. They provide that Estonia's budget should be balanced or have a surplus in the medium term and budget deficit cannot in any one year exceed 3% of GDP. Although, in principle, the currency board arrangement has set similar requirements to Estonia's fiscal policy throughout the previous decade, the accession to the European Union and joining of EMU will make the framework more pronounced. The ability of Estonia's fiscal policy to meet the requirements of the Stability and Growth Pact and the role of fiscal policy in stabilising cyclical fluctuations are analysed in the article *The Role of Automatic Fiscal Stabilisers in Estonia and the European Union* by Martti Randveer and Rasmus Kattai.