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The Record and Characteristics of Fiscal Consolidation

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The Record and Characteristics of Fiscal Consolidation

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Douglas Sutherland is a senior economist in the OECD's economics department, responsible for the analysis of the United States and Iceland. Dr. Sutherland joined the economics department in 1998, initially working on bilateral economic surveillance and contributing to the publication of Economic Surveys of the Russian Federation. He then worked on a wide range of topics, often with a public finance focus, including examining the design sub-central government fiscal rules, sustainable development and public sector efficiency. More recently he has led projects on infrastructure investment, counter-cyclical economic policy, fiscal consolidation, and debt and macroeconomic stability. Prior to joining the OECD he worked as a research fellow at the University of Birmingham, from where he obtained his PhD.

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Table of Contents

The Record and Characteristics of Fiscal Consolidation

Douglas Sutherland

Abstract

Large fiscal challenges will confront OECD governments for some time to come. The economic crisis that began in 2008 caused deficits to surge, and fiscal imbalances were swollen further by stimulus measures and bank rescue operations. Together, these forces led to ballooning public indebtedness, the general government public debt-GDP ratio rising from under 80% of GDP in 2008 to almost 100% of GDP in 2010. In many countries, arresting the rise in debt and returning debt stocks to sustainable levels will require large and durable improvements in budget balances. With the economic recovery weak and hesitant, growing out of the fiscal problems is unlikely to be a durable solution, putting the onus in pursuing fiscal consolidation through spending cuts and revenue-raising measures. The size of the adjustment in many countries means that consolidation will continue to affect growth and also affect large spending areas, as revealed by fiscal consolidation intentions. However, there are a number of options that will have less detrimental impact, such as increasing spending efficiency and reforming unsustainable pension systems. Furthermore, reviews of tax and benefit systems could help identify how policy objectives could be achieved at lower cost and where support is less justified.

Key Words:

Economic Crisis, Fiscal Consolidation, Debt, Fiscal Imbalances, OECD

The Record and Characteristics of Fiscal Consolidation

Introduction

Large fiscal challenges will confront OECD governments for some time to come. The economic crisis that began in 2008 caused deficits to surge, and fiscal imbalances were swollen further by stimulus measures and bank rescue operations. Together, these forces led to ballooning public indebtedness, the general government public debt-GDP ratio rising from under 80% of GDP in 2008 to almost 100% of GDP in 2010. In many countries, arresting the rise in debt and returning debt stocks to sustainable levels will require large and durable improvements in budget balances. With the economic recovery weak and hesitant, growing out of the fiscal problems is unlikely to be a durable solution, putting the onus in pursuing fiscal consolidation through spending cuts and revenue-raising measures.

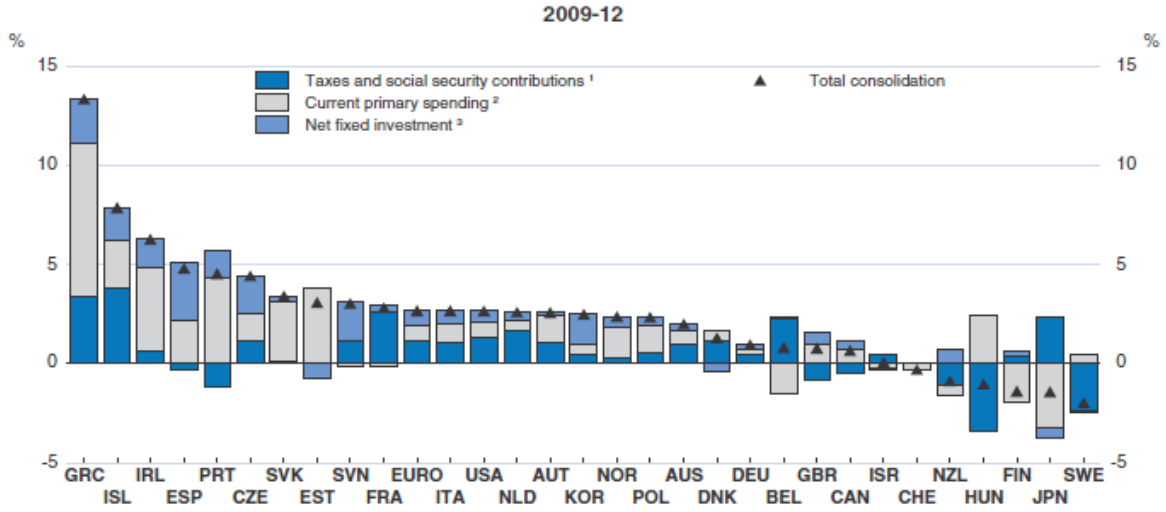
Pursuing sustained fiscal consolidation is not only needed to address the large fiscal deficits many countries have been running and meet the challenges posed by mounting pressures from ageing-related spending and providing health and long term care, but also to bring debt levels down to prudent levels. Many countries were insufficiently ambitious in bringing debt levels down after the relatively mild recession in the early 2000s. The impact of lower interest rates and debt servicing costs during the "great moderation" era and the apparent strength of revenues seduced some governments into cutting taxes and relaxing control over spending. As such, when fiscal positions appeared to improve before the financial crisis, they were often too flattering. And in retrospect, fiscal positions were insufficiently robust given the scale of the contingent liabilities that governments had to assume during the crisis.

The size and pace of consolidation

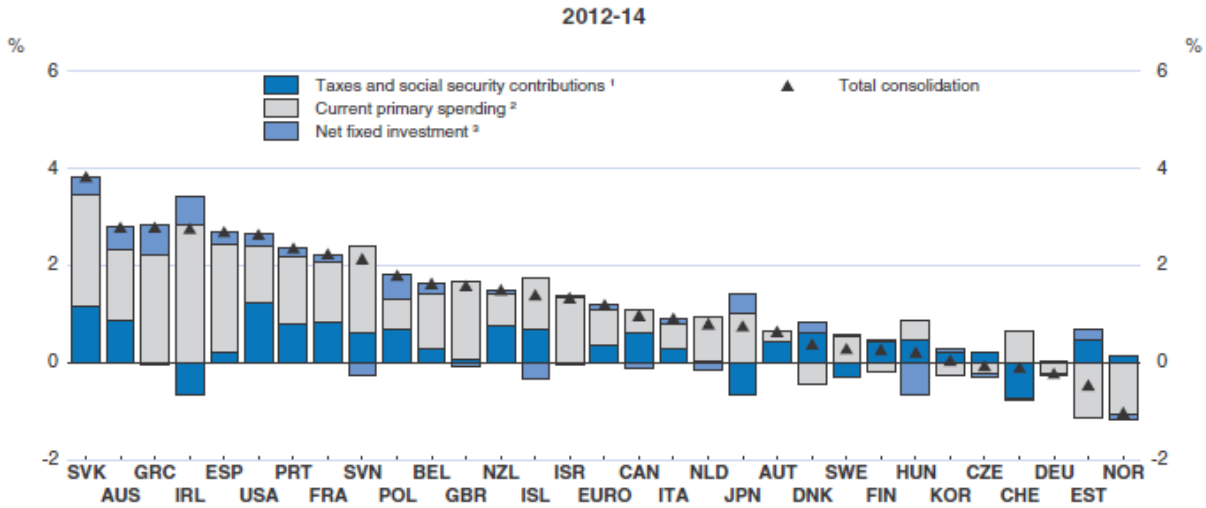
Facing large debt overhangs, many countries have already started fiscal consolidation, which has implications for economic growth in the short term. In some cases, notably for those countries most under pressure from the bond markets, the on-going and announced tightening is substantial, rapid and unusually correlated by historical comparison (Figure 1). Between the trough (measured by the underlying primary balance) following the onset of the crisis, which was 2009 for most countries, and the projected value for 2012, five countries are expected to tighten by more than 5% of GDP (Greece, Iceland, Ireland, Portugal and Spain). In 11 other countries, underlying primary balances are expected to have tightened by the end of 2014, by more than 2% of GDP.

Figure 1. Fiscal consolidation (as a % of GDP)

Panel A. Implemented



Panel B. Projected

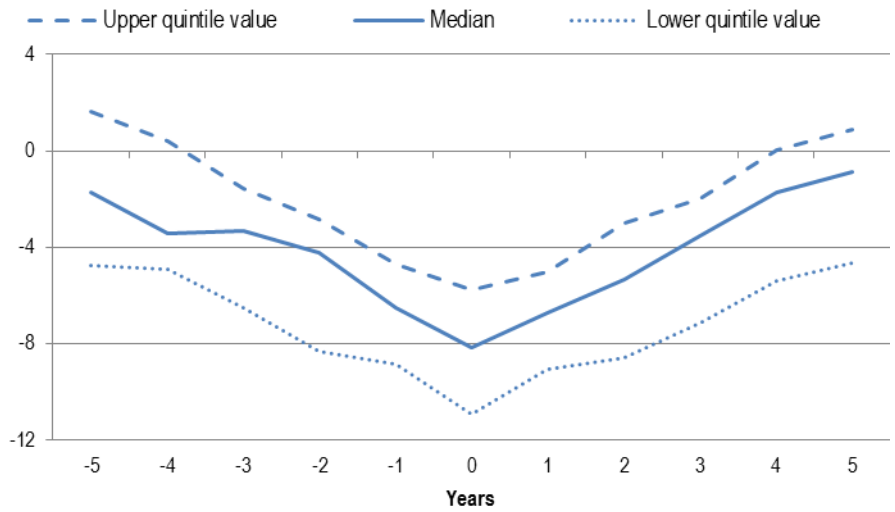


Source: Economic Outlook XXXX

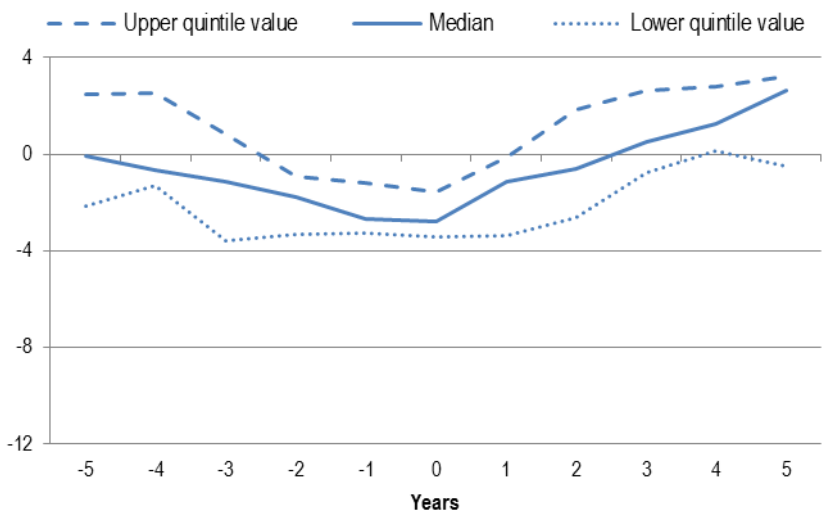
During previous large consolidations, fiscal tightening was generally implemented relatively gradually over a prolonged period (figure 2). Debt often began to stabilise a few years after the fiscal tightening began and often remained above the level that existed before the consolidation began. In most cases, improving primary balances contributed to bringing debt under control. The government spending-to-GDP share fell, particularly when spending was large relative to GDP. Furthermore, the spending composition tended to change with investment, one of the principal casualties. The share of revenues in GDP generally rose gradually prior to and during the consolidation episodes. During these consolidations, the macroeconomic environment often supported the consolidations and indeed had already turned favourable before consolidation started. Interest rate developments also often supported consolidation, particularly once it was underway. Long rates on government bonds tended to fall during a consolidation, but only once it was well underway.

Figure 2. Fiscal balances around previous large consolidations

Panel A: Government net lending



Panel B: Underlying primary balance



Source: Blöchliger *et al*, (2012).

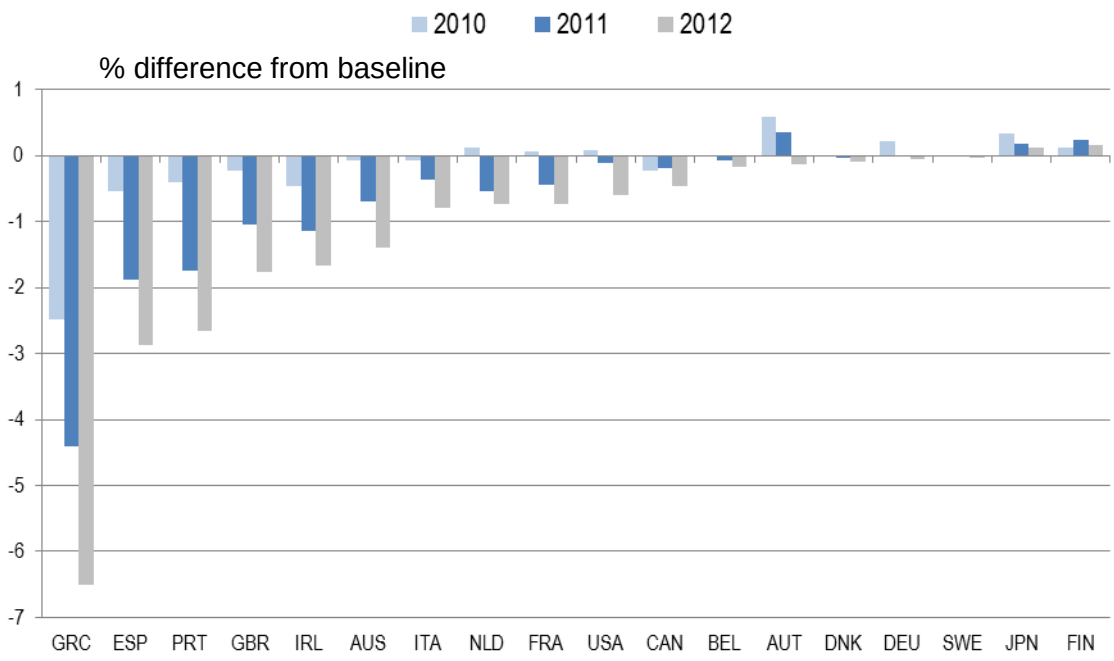
Adopting a gradual pace of consolidation was not an option for many countries during the current crisis. Given high government debt-to-GDP ratios, some countries ran the risk of unsustainable debt dynamics developing, especially with financing costs spiking dramatically. While interest rates on government debt remain relatively low in many countries, debt levels in the wake of the crisis are significantly higher, implying latent upward pressure on borrowing costs. When interest rates are linked to government debt levels, this can tilt the case towards earlier consolidation. Even moderate delays may incur high costs with the development of particularly adverse debt dynamics. Thus, in countries which are particularly exposed to a financial market reaction the extent of

consolidation may need to be larger and the pace faster than may be optimal if the sole concern was the strength of the recovery.

Barrell *et al* (2012) examined the impact on output of the consolidation programmes announced for the period 2010-12. The simulations assume financial markets are forward looking, consumers are myopic, all consolidation measures are permanent and monetary policy targets inflation and a nominal aggregate, the stock of money. In the first set of simulations, the model assumes unilateral action by governments. The results reveal that the expected impact on Greece is substantial, with a cumulative reduction in GDP of over 6% of GDP (Figure 3). Other substantial impacts on output are projected by the model in Ireland, Portugal, Spain and the United Kingdom. A further insight from the simulations arises when comparing different assumptions about expectations. When agents are forward-looking which is equivalent to assuming that policies are credible, the negative multiplier effects are smaller than when compared with scenarios when agents have myopic expectations.

An unusual aspect of current consolidation efforts is how widespread they are. Unlike past experience, fiscal consolidation is needed in almost all OECD countries simultaneously. In principle, simultaneous tightening intensifies the short-term contractionary impulse by reducing trade flows. In the simulations of Barrell *et al.* (2012), the impact of simultaneous consolidation across countries differs from unilateral action as the impact of trade spillovers from fiscal contractions, exchange rate effects and the downward pressure on interest rates can either magnify or reduce the contractionary impulse, but the overall negative impact of large consolidations remains.

Figure 3. The impact of announced fiscal consolidation on GDP



Note: Assumptions include financial markets are forward looking, consumers are myopic, all consolidation measures are permanent and monetary policy targets inflation and the stock of money.

Source: Barrell *et al.* (2012)

The longer-term challenge

Additional fiscal consolidation will be required beyond immediate consolidation needs. Recent OECD work has assessed these post-2012 needs, both in terms of stabilising debt over the medium term and also meeting prudent long-term debt targets, calculating so-called fiscal gaps (Merola and Sutherland, 2011). The long-term fiscal gaps make a stylised assumption that the tightening will be implemented immediately and sustained until 2050 to meet a specific debt target. The fiscal gaps should be seen as giving a common metric for assessing the need for fiscal consolidation rather than being normative about how such a consolidation should be implemented. When the fiscal gap is large, it would be difficult to implement such a large consolidation effort immediately. Furthermore, sustaining the fiscal policy tightening, even seemingly modest ones, over very long periods may also present a considerable challenge.

The simulation shown in figure 4 presents the immediate tightening of the underlying primary balance in 2013 needed to ensure that gross financial liabilities are 50% of GDP in 2050. The baseline assumes that pension, health and long-term care spending is constant as a share of GDP and, as such, the fiscal gaps present the minimum that is required. Fiscal gaps differ across countries mainly because of large differences in underlying deficits at the starting point and to some extent due to differences in the level of initial debt. Countries already undertaking large fiscal consolidations (Greece, Iceland, Portugal and Spain) generally face moderate fiscal gaps on the assumption that the present large improvements in underlying primary balances are maintained. Countries where underlying deficits are expected to remain substantial in 2012 face much larger fiscal gaps. For example, the fiscal gaps for Japan, the United States, the United Kingdom and New Zealand exceed 5% of GDP. On the other hand, a number of countries do not face any additional tightening requirements to meet the debt target. It may seem ironic that euro area countries with relatively modest fiscal gaps are the victims of a virulent debt crisis whereas other countries with much larger fiscal gaps enjoy very low bond yields at present. This partly reflects concerns about potential needs for intervention in euro area banking systems, but also that euro area debt essentially corresponds to foreign currency denominated debt for the individual country. In addition, the stylised assumptions used in the fiscal gap calculations assume interest rate developments are rather benign.

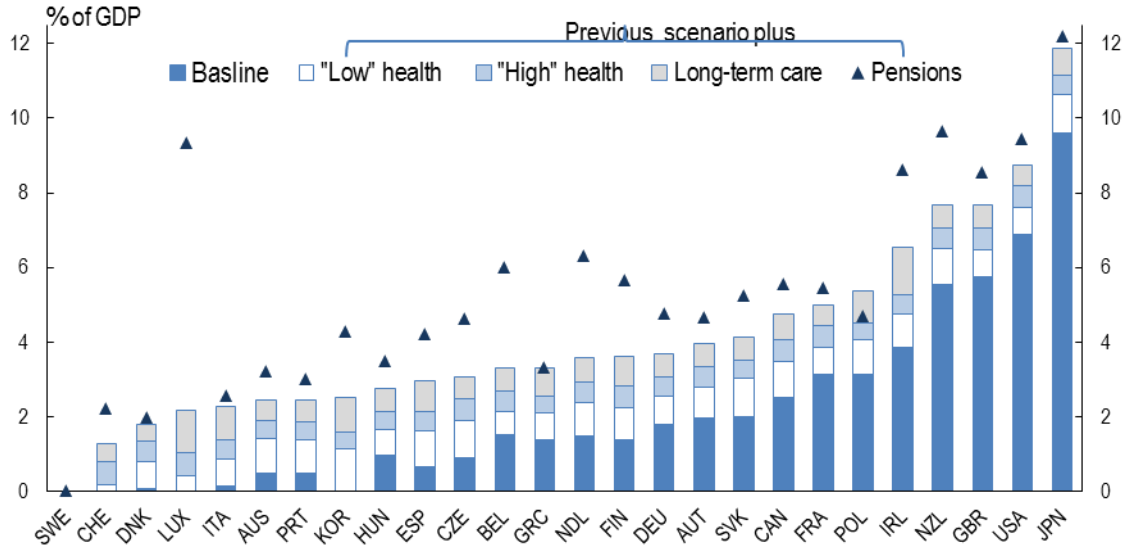
When spending pressures projected to arise from health and long-term care and pensions are included, all countries, with the exception of Sweden, will require significant additional fiscal consolidation. In the case of health care spending, higher levels of spending are not necessarily undesirable, but financing additional spending can create difficulties. Two different sets of health care spending projections are used (Oliveira-Martins and de la Maisonneuve, 2006). The average projected increases in health and long-term care spending by 2050 are 3½ per cent of GDP in a low spending scenario and around 6% of GDP in a high spending one. As the projected increases are relatively similar across countries, because health spending is not primarily driven by demographics but rather to a large extent by expected supply developments, the impact on the fiscal gaps does not vary much across countries. Nonetheless, the fiscal gaps rise over 1.5% of GDP in Canada, the Czech Republic, Japan, New Zealand and Switzerland when greater cost pressures affect health spending (Figure 4).

Including pension spending alters radically the fiscal gaps for many countries relative to the baseline scenario (Figure 4). The fiscal gaps of the countries facing the largest pension problems, such as Luxembourg, Belgium and the Netherlands underscore that meeting these challenges would be better addressed by reform rather than pre-saving.

In some cases, such as Greece and Spain, reforms to the pension systems in 2010, which are incorporated in the projections, have addressed significant pressures emanating from this source. In Sweden and Poland, the notionally-defined contribution pension system means that no additional or even less tightening is required to meet a gross financial liabilities debt target of 50% of GDP in 2050.

Figure 4. Fiscal gaps, baseline and with health & long-term care spending and pensions

Immediate rise in the underlying primary balance needed to bring gross financial liabilities to 50% of GDP in 2050



Note: "Low" health assumes policy action curbs health spending growth. "High" health is the additional cost pressure in the absence of these policy actions.

Source. Merola and Sutherland (2012).

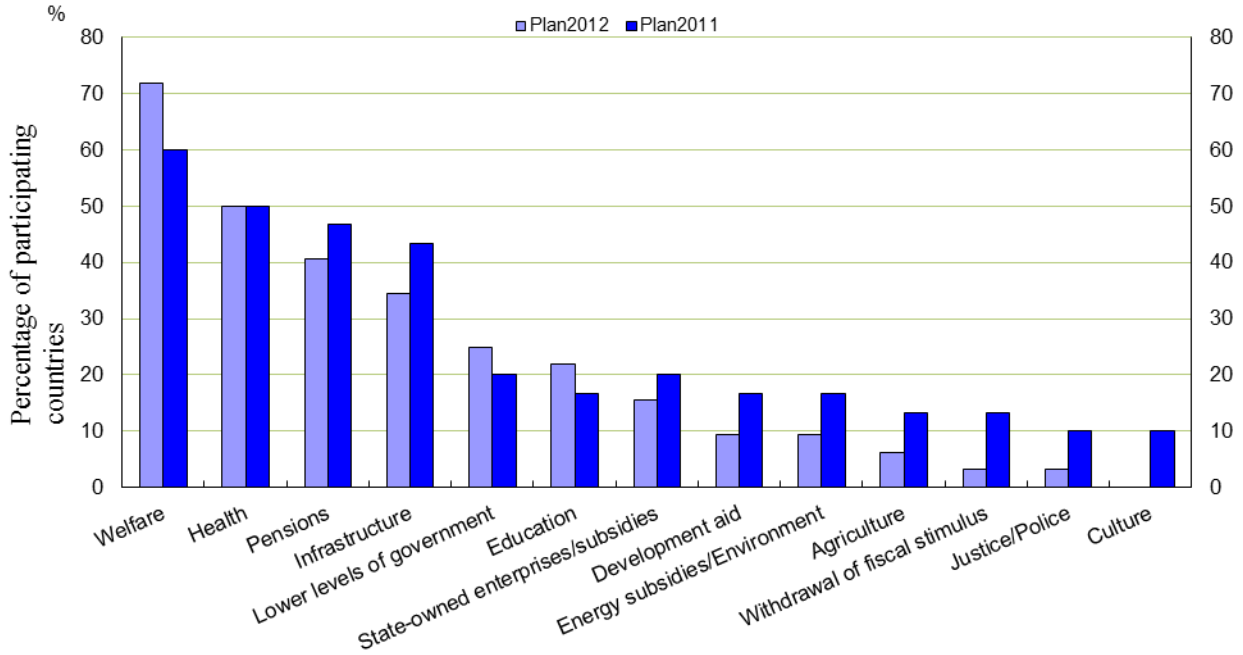
The composition of consolidation

Restoring fiscal sustainability and meeting the longer-term challenges ideally requires a coherent strategy. Successful fiscal consolidations in the past have been largely driven by spending cuts due to their positive impacts on efficiency and, when concentrated on transfers and other current spending, their perceived durability. However, past reforms have already reaped low-hanging fruit, making current consolidations arguably more difficult. Successful large consolidations in the past have also required action on the revenue side (Molnar, 2012). Relying on increasing revenues to meet the challenges is not an option for many countries. With revenues reaching around 35% of GDP on average across the OECD (and substantially more in some countries), many tax regimes unavoidably reduce GDP by blunting incentives to work, save and invest (Hagemann, 2012). Faced with spending pressures from population ageing, the most promising path to promote fiscal sustainability is through spending reforms that reduce outlays to improve allocative efficiency (*i.e.*, better overall use of resources) or productive efficiency (*i.e.*, lower resource cost per unit of service delivery). At the same time, the more vulnerable members of society need to be protected from cuts, including through targeted offsets if necessary.

Fiscal consolidation intentions give an indication of the nature of the tightening. Much of the fiscal consolidation appears to be on the expenditure side, though many governments are also addressing revenue (Figures 5 and 6). The planned consolidations

touch some of the most sensitive spending areas, such as health, welfare and pension spending, though capital spending is also a frequent target of the plans. Part of the reason for the targeting of the sensitive spending areas is that they now account for a very large share of government spending, making reforms in these areas unavoidable. However, in many cases scope exists for better targeting resources to the most vulnerable and correcting unsustainable spending commitments which are not fair from an inter-generational perspective.

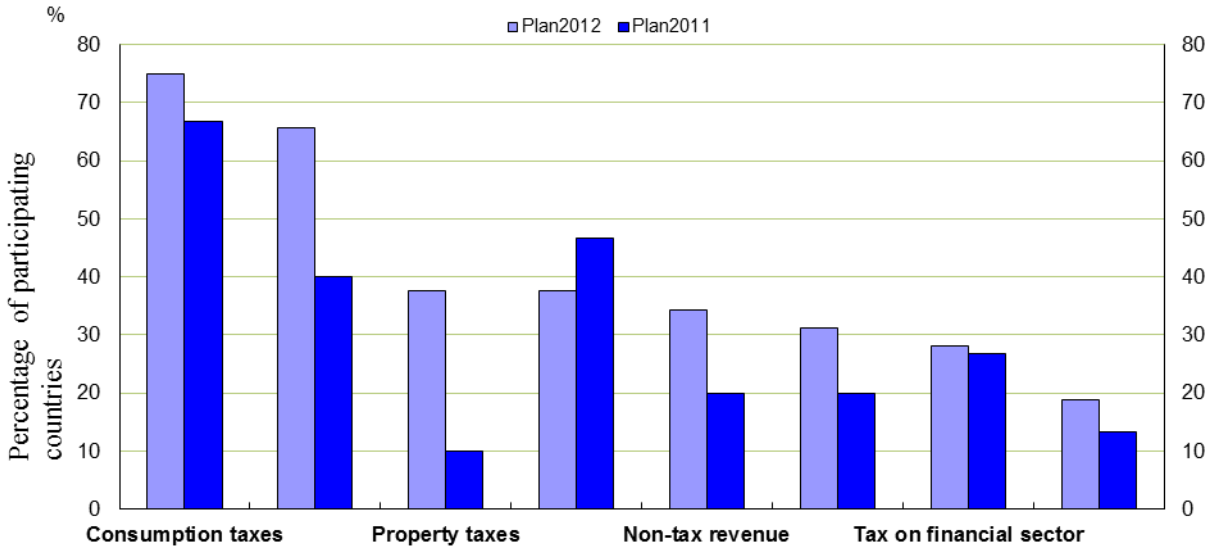
Figure 5 Spending programmes affected by consolidation



Source. OECD (2011)

On the revenue side many governments have planned changes to consumption and property taxes (Figure 6). Shifting taxation towards consumption and property taxes is less harmful to growth than increasing the burden on more elastic tax bases. Actions to address tax expenditures may also have relatively benign effects. To promote a range of objectives, all governments use tax expenditures in the form of exclusions from income, tax deductions and credits for selected spending items and, in the case of the value added tax (VAT), lower tax rates for some items or outright exemption. While some tax expenditures, such as earned income tax credits, raise employment and thereby economic activity, most are distorting, poorly targeted and reduce transparency. And by narrowing the tax base, they cause statutory rates to be higher than otherwise, further damaging overall efficiency.

Figure 6. Revenue sources affected by consolidation



Source. OECD (2011)

In a number of cases supporting reforms could assist fiscal consolidation. For example, aside from their direct budgetary impact, reforms to pension systems that delay retirement and increase labour force participation will boost revenues and thereby reduce long-run budget pressures. Reforms that link retirement age to gains in longevity would thus help cushioning budgets against future changes in longevity. More generally, growth-enhancing structural policy reform may support fiscal consolidation. This is most obvious when reforms lead to a higher sustainable employment level because such a change will have a permanent impact on the primary balance. The size of the effect will depend on the taxes levied on the additional income and consumption created as well as on whether the reform in question has any direct budgetary impact. The latter will be the case, for example, when additional spending on active labour market policy boosts aggregate spending or cutbacks on unemployment benefit duration reduces it. But many structural reforms have little direct impact on budgets while at the same time boosting employment levels, such as in the case of product market reforms that boost competition. Evidence of reform implementation during the Great Recessions suggests that those countries undertaking the largest fiscal consolidations are also generally the countries actively pursuing structural reforms (OECD, 2012).

Conclusion

Large fiscal challenges will confront OECD governments for some time to come. In the short-term, as on-going and announced tightening is substantial, rapid and unusually correlated by historical comparison, the contractionary impact is likely to be pronounced for most countries. In the longer term, additional fiscal consolidation will be required beyond immediate needs in order to address spending pressures arising from pensions, health and long-term care. The size of the adjustment in many countries means that consolidation will continue to affect growth and also affect large spending areas, as revealed by fiscal consolidation intentions. However, there are a number of options that will have less detrimental impact, such as increasing spending efficiency and reforming unsustainable pension systems. Furthermore, reviews of tax and benefit systems could help identify how policy objectives could be achieved at lower cost and where support is less justified.

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About the Crisis Observatory

In the context of the worst economic crisis in the history of post-war Greece and the wider European debt crisis, initiatives for the systematic and scientific documentation, study and analysis of the crisis in both Greece and Europe are sorely needed.

The Crisis Observatory aims to answer this call. The Crisis Observatory is an initiative of the Hellenic Foundation for European and Foreign Policy (ELIAMEP), with the support of the Stavros Niarchos Foundation.

Its primary objective is to become a central hub for information, research and dialogue for both the Greek and European crises. The Crisis Observatory's guiding principle is the presentation of new research, policy proposals and information, which are based on solid arguments and empirical evidence, with a view to improving the level of public discourse about the crisis. In order to achieve this objective, the Crisis Observatory's work is organized around three central pillars:

- The provision of educational material with a view to enhance the ability of the average citizen, who often does not have a good hold on economic issues, to understand basic parameters of the crisis.
- The provision of serious, evidence-based and representative, in terms of subject focus and theoretical/political approaches, information about the crisis.
- Intervention in the public discourse about the crisis, through the creation of a venue for the free expression of different views and policy proposals promulgation of new research about the crisis.

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