PREPARING FISCAL CONSOLIDATON

Economics Department
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Introduction

Governments and central banks have implemented comprehensive support packages in response to the global crisis that erupted in September 2008. Discretionary fiscal measures, coupled with cyclical revenue losses and expenditure hikes, have resulted in a sharp increase in budget deficits and a concomitant build-up of government indebtedness in many G20 countries. Although a fragile recovery warrants full implementation of the stimulus measures planned for 2010, many governments are already preparing exit strategies to ensure longer-term fiscal sustainability. OECD projections suggest that countries should be in a position to begin to withdraw fiscal support by 2011 at a pace that is contingent on the recovery and the state of public finances, as well as on the scope for monetary policy to provide support to the economy, if needed.

This note summarises the OECD assessment of fiscal policy developments after the crisis. The note draws heavily from the analysis reported in recent editions of the *OECD Economic Outlook* (June and December 2009) and highlights the need to prepare fiscal consolidation strategies for implementation from 2011.

Recent trends and projections[1]

Ongoing fiscal stimulus has underpinned the recovery. The size and composition of fiscal support packages have varied across countries, but has in general included *i*) hikes in government final consumption, *ii*) cuts in direct taxes, *iii*) new public infrastructure projects, and *iv*) measures that have helped to boost or bring forward private demand through car scrappage incentive schemes, direct lump-sum income payments to households and temporary reductions in indirect taxes and housing tax credits. At the same time, activity is also being supported by conventional and unconventional monetary ease and a gradual normalisation of financial conditions.

Consistent with ongoing fiscal support and the cyclical downturn, budget deficits are expected to reach historical highs in 2010 in several countries. Most of the deficit is estimated to be structural, notwithstanding a large margin of error in the computation of budgetary aggregates on a cyclically-adjusted basis in current circumstances (**Table 1**). Underlying balances are projected to improve slightly in 2011 but to remain in general high throughout the medium term. Projected improvements are predicated on the assumption that temporary parts of the fiscal stimulus programmes are being withdrawn depending on the specific national legislation. Underlying deficits will nevertheless remain at unprecedentedly high levels of 8% of GDP or more in Japan,[2] the United Kingdom and the United States.[3]

1. Recent trends and projections are based on OECD (2009a).

2. In the case of Japan, this reflects the incorporation in the projections of the new government's commitment to a variety of new spending programmes. The Japanese government has also announced that it would aim to finance part of such spending by reviewing and reshuffling existing budget allocations.

Table 1. **Fiscal positions: recent outcomes and projections**

In per cent of nominal/potential GDP

	2007	2008	2009	2010	2011
United States					
Actual balance	-2.8	-6.5	-11.2	-10.7	-9.4
Underlying balance[2]	-3.3	-6.0	-8.8	-8.8	-8.0
Underlying primary balance[2]	-1.4	-4.3	-7.3	-7.0	-5.7
Gross financial liabilities	61.8	70.0	83.9	92.4	99.5
Japan					
Actual balance	-2.5	-2.7	-7.4	-8.2	-9.4
Underlying balance[2]	-3.9	-4.7	-6.5	-7.0	-8.2
Underlying primary balance[2]	-3.3	-3.9	-5.6	-5.9	-6.8
Gross financial liabilities	167.1	172.1	189.3	197.2	204.3
Euro area					
Actual balance	-0.6	-2.0	-6.1	-6.7	-6.2
Underlying balance[2]	-1.5	-2.1	-3.7	-4.4	-4.3
Underlying primary balance[2]	1.1	0.5	-1.1	-1.7	-1.5
Gross financial liabilities	70.9	73.2	81.8	88.3	93.2
***Memorandum item*:**					
OECD[1]					
Actual balance	-1.3	-3.5	-8.2	-8.3	-7.6
Underlying balance[2]	-2.5	-4.0	-6.3	-6.6	-6.3
Underlying primary balance[2]	-0.6	-2.2	-4.6	-4.7	-4.1
Gross financial liabilities	73.1	78.4	90.0	97.4	103.5

Note: Actual balances and liabilities are in per cent of nominal GDP. Underlying balances are in per cent of potential GDP. The underlying primary balance excludes the impact of net debt interest payments.

1. Total OECD excludes Mexico and Turkey.

2. Fiscal balances adjusted for the business cycle and for one-offs.

Source: *OECD Economic Outlook* database.

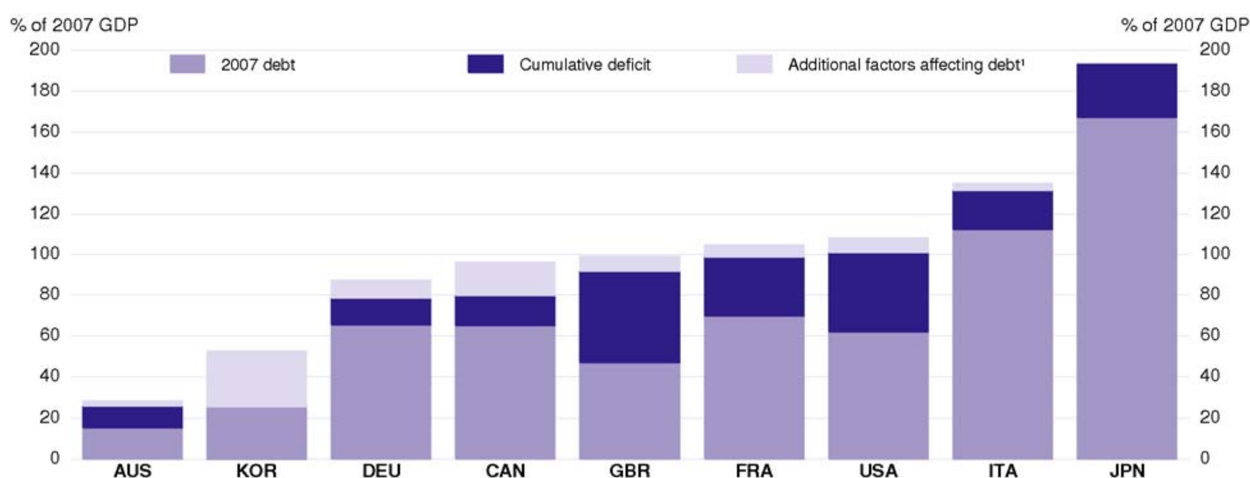
3. Underlying deficits are projected to exceed their pre-crisis level by almost 4% of GDP in the OECD area on average. In the euro area as a whole, hardly any improvement is likely on the basis of currently decided policies.

Post-crisis fiscal consolidation needs are unprecedented in several countries. In particular:

- **As a result of large budget deficits, government indebtedness is set to reach all-time highs in several countries in the near term**. In the case of Japan, the debt-to-GDP ratio is projected to exceed 200% in 2011 (**Figure 1**).[4]

Figure 1. **Government indebtedness**

Decomposition of the 2011 gross government debt



1. Refers to 2011 debt minus the sum of 2007 debt and the cumulative deficit for 2008-11 and includes debt-increasing equity participation in companies.

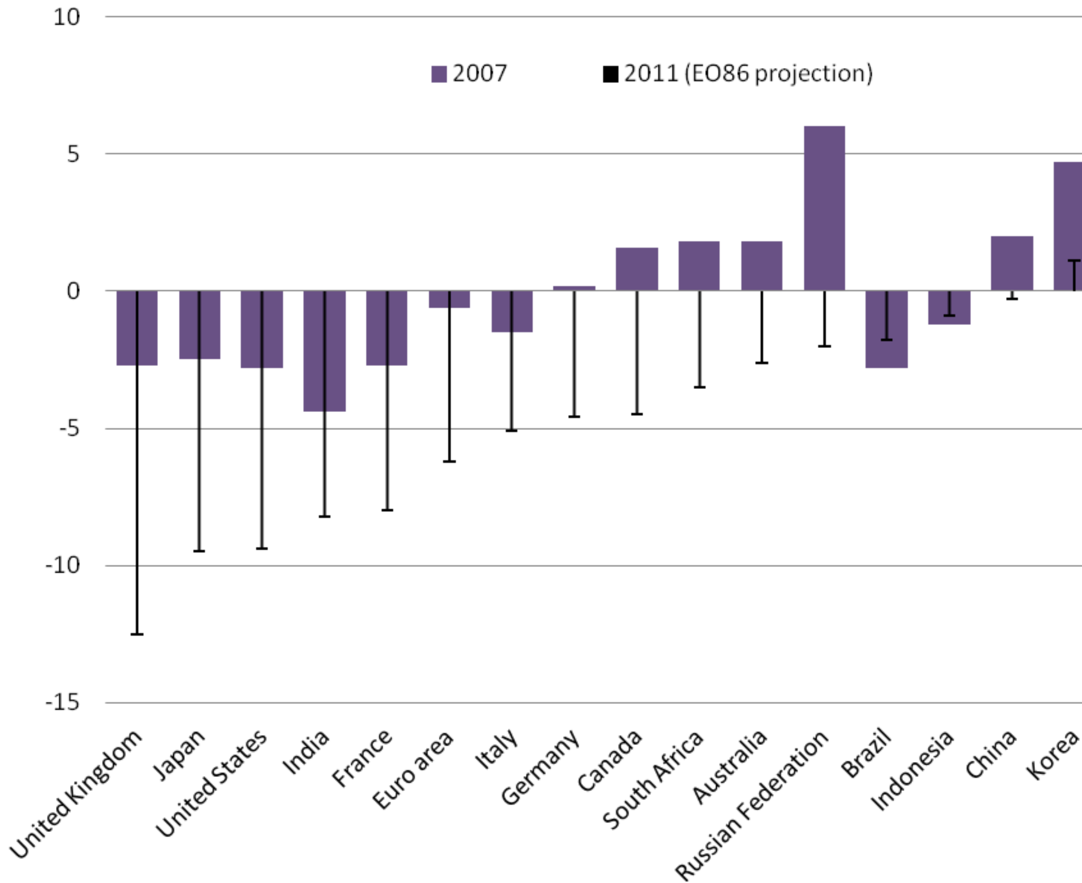
Source: *OECD Economic Outlook* database.

- **In some countries, low government indebtedness and healthy pre-crisis fiscal balances have created fiscal space for raising expenditure**. China had a large budget surplus and negative net indebtedness on the eve of the crisis and can therefore afford higher spending over the medium term (**Figure 2**). The counter-cyclical policy stance since the onset of the crisis in Brazil has been possible due to pre-crisis fiscal consolidation, which resulted in a reduction in public sector net indebtedness. The Russian Federation's long-term government debt dynamics will continue to be dependent on the price of oil and on the authorities' ability to save windfalls gains during cyclical upswings for stabilization purposes.

4. Gross government debt is projected to exceed 100% of GDP in the OECD area as a whole in 2011, about 30 percentage points higher than before the onset of the crisis.

Figure 2. **Pre- and post-crisis budget balances**

In per cent of GDP, a negative number denotes a deficit



Source: *OECD Economic Outlook* database.

- **Even under the assumption that consolidation is sufficient to bring budgets back to balance by 2017, debt-to-GDP ratios would still exceed pre-crisis levels in several countries**. Without significant action, debt levels would continue to rise in the medium term from already high levels in a number of countries, including Japan, United States and United Kingdom. Countries whose budget deficits are projected to exceed 6% of GDP in 2011, including United States, Japan, France and United Kingdom, would have to consolidate by 6% of GDP or more to deliver a balanced budget by 2017 (**Table 2**). By contrast, consolidation needed to reach a balanced budget in 2017 is relatively modest in Korea, whose budget deficit is projected at less than 2½ per cent of GDP in 2011.

Table 2. **Medium-term fiscal sustainability scenario**
In per cent of GDP

	Financial balances[1]			Net financial liabilities[2]			Gross financial liabilities[3]		
	2007	2011	2017	2007	2011	2017	2007	2011	2017
No consolidation (budget deficit of less than 2½ per cent of GDP in 2011)									
Korea	4.7	1.1	1.2	-36	-33	-28	26	41	44
Three years of consolidation (fiscal consolidation of 3 percentage point of GDP from 2012)									
Canada	1.6	-4.5	0.6	23	36	30	65	89	83
Germany	0.2	-4.6	0.1	43	58	52	65	85	80
Italy	-1.5	-5.1	0.5	87	103	88	112	130	114
Six years of consolidation (fiscal consolidation of 6 percentage point of GDP from 2012)									
France	-2.7	-8.0	-0.3	34	67	72	70	99	104
United States	-2.8	-9.4	-3.6	42	72	87	62	100	114
Japan	-2.5	-9.5	-3.4	80	113	131	167	205	223
United Kingdom	-2.7	-12.5	-5.3	29	70	95	47	94	120
Euro area	-0.6	-6.2	0.2	43	63	61	71	93	92
***Memorandum item*:**									
OECD	-1.3	-7.6	-1.9	39	64	73	73	104	113

Note: The scale of fiscal consolidation is assumed to be dependent on the initial financial balance. Those countries with a financial deficit of less than 2½ per cent of GDP in 2011 are assumed to have no additional fiscal consolidation. Those countries, with a financial deficit of more than 6% of GDP in 2011 are assumed to have a progressive additional fiscal consolidation of 1 percentage point of GDP (as reflected in an improvement in the underlying primary balance) each year from 2012, lasting six years to 2017. Finally, all other countries, namely those with a financial deficit of more than 2½ but less than 6% of GDP in 2011, are assumed to have a progressive additional fiscal consolidation of 1 percentage point of GDP each year from 2012, lasting three years. No attempt has been made to incorporate any official medium-term fiscal consolidation plans beyond 2011.

1. General government fiscal surplus (+) or deficit (-) as a percentage of GDP.
2. Includes all financial liabilities minus financial assets, as defined by the System of National Accounts (where data availability permits) and covers the general government sector, which is a consolidation of central government, state and local government and the social security sector.
3. Includes all financial liabilities, as defined by the System of National Accounts (where data availability permits) and covers the general government sector, which is a consolidation of central government, state and local government and the social security sector. The definition of gross debt differs from the Maastricht definition used to assess EU fiscal positions.

Source: *OECD Economic Outlook* database.

The need for post-crisis fiscal consolidation

Linkages with other policy domains

Fiscal consolidation plans will need to be formulated in conjunction with a broader exit strategy that will have to involve simultaneous actions across different policy domains. It is difficult to be sure about the ideal mix of exit measures, including the removal of conventional and unconventional monetary support and fiscal consolidation. The pace and timeframe for policy normalisation depends on country-specific conditions, the outlook for inflation and activity, and the state of public finances. A continued slow recovery would imply a need for exit plans to be progressive in nature. Premature withdrawal would undermine the recovery. A late exit may damage confidence in fiscal consolidation plans, which could elicit Ricardian responses by households. Moreover, the synchronicity of fiscal consolidation across countries calls for various degrees of coordination, ranging from *ex ante* information sharing to collective policy approaches, which could be addressed within the G20 *Framework for Growth*, to ensure more balanced growth.

Why to consolidate?

There is limited guidance from economic literature on optimal debt levels. But there are reasons for being ambitious in fiscal consolidation after the crisis. Pre-crisis debt levels were already exceedingly high in many countries (including Italy and Japan), and are likely to remain high over the medium term, notwithstanding the consolidation efforts subsumed in the calculations reported above. In particular:

- **Population ageing will impose transitory costs that need to be smoothed.** Many countries will be ill-prepared to do so unless fiscal consolidation can be delivered prior to the period when demographic transition will be most burdensome on the budget. Population ageing is also expected to create permanent costs that would need to be addressed through structural reforms, including a review of pension entitlements.

- **High public indebtedness curtails the scope for counter-cyclical fiscal action, when needed**. The effectiveness of fiscal action can be thwarted by sustainability considerations, which in turn could exacerbate market reactions to adverse shocks, deepening future cyclical downturns.

- **Excess supply of government bonds may put upward pressure on interest rates and therefore crowd out private investment and compromise long-term output**. So far, vast government bond issuances needed to finance exceptionally large budget deficits in the major countries have not unsettled financial markets, although these issuances may be crowding out budgetary financing for smaller countries. But appetite for government securities may change suddenly and sharply in the face of high deficit and debt levels. Another consideration is that the removal of unconventional monetary stimulus, which has kept longer-term bond yields low in some countries, will also likely exert some concomitant upward pressure on interest rates.

- **Ballooning outlays on debt service could crowd out government spending on growth-enhancing programmes**. A redistribution of expenditure away from programmes, such as R&D, human capital formation and infrastructure development, to meet the government's debt service obligations would take a toll on potential growth in indebted countries, which would in turn make consolidation more difficult.

How rapidly should consolidation be implemented?

Consolidation plans will need to be paced and contingent on the recovery. Less than half of OECD countries have announced detailed fiscal consolidation strategies with a clear description of the instruments to achieve the final target, which is a reason for concern. In particular:

- **The speed at which consolidation takes place should depend on the state of the economy, the ability of monetary policy to offset the related demand-constraining effects, if needed, and the size of the imbalance in public finances**. Countries with weak demand growth and policy interest rates at close to zero should consolidate at a slower pace, whereas countries with high growth and greater scope for further relaxation of monetary policy, if needed, should improve budgets more quickly. Likewise, countries with low budget deficits and public indebtedness can afford to consolidate more gradually than countries with high deficits and/or high debt, especially if financial markets are not confident about their authorities' commitment to consolidation.

- **Well articulated exit strategies need to be spelled out**. This is important for anchoring expectations, avoiding a back-up of bond yields and allowing flexibility in implementation, should economic conditions change in the course of consolidation.

- **Consolidation plans will need to take into account the synchronous nature of consolidation in different countries**. This synchronicity implies that activity will be affected not only by fiscal consolidation at home, but also abroad, via trade and financial linkages (**Table 3**). The G20 *Framework for Growth* would be an instrument for addressing this challenge by facilitating policy coordination across countries.

Table 3. **The effects of single-country and synchronized fiscal consolidation**

Fiscal consolidation equivalent to 1% of own-country GDP

	Impact of change on:[1]				
	United States	**Japan**	**Euro area**	**Total OECD**	**Of which "own country"**
Source of change:	GDP effects, per cent differences from baseline in first year				
United States	**-0.9**	-0.2	-0.1	-0.5	-0.3
Japan	0.0	**-0.8**	0.0	-0.2	-0.1
Euro area	-0.1	-0.1	**-0.8**	-0.3	-0.2
OECD	-1.2	-1.3	-1.1	**-1.1**	
Spillover as per cent of own-country effect	**26%**	**54%**	**32%**		

1. Figures on the diagonals provide an estimate of the "own country" effect of standardised fiscal consolidation, whereas off-diagonal figures provide an estimate of spillover effects based on simulations of the OECD's Global model. In the near term, spillover effects are between one-quarter and one-half of the size of own-country effects. These results do not allow for the possible effects of lower long-term interest rates from fiscal consolidation, which might be expected to offset some of the negative demand effects and have positive spillover effects as well.

Source: OECD Global model.

When should consolidation be planned?

Because there are lags in the budget process, **consolidation strategies and plans will need to be decided by mid-2010 if they are to be implemented in 2011 budgets**. If the start of consolidation is postponed, the required improvement in budget positions will increase, which may undermine confidence and endanger the recovery. In particular:

- **Steps should already be built into 2011 budgets, because consolidation strategies need to be embedded in the regular budget process**. Should economic conditions turn out weaker than projected, offsetting measures could be implemented in the course of the budget year.

- **Credible commitment to longer-term consolidation is essential for preserving household and financial market confidence**. A loss of confidence in the government's resolve and ability to reduce debt levels would put upward pressure on interest rates (through rising inflation and risk premia on bond yields) or prompt households to save through Ricardian mechanisms.

- **Governments could demonstrate their commitment to sustainable adjustment by undertaking entitlement reforms to pension and health care systems**. Many of these reforms will not have negative effects on growth in the near term and would be very beneficial in the long

term. In addition, because entitlement reforms are long overdue in many countries, early implementation could help to signal commitment to consolidation.[5]

What instruments should be used?

Fiscal consolidation should focus on instruments that minimise its adverse impact on trend growth. There are policy trade-offs that need to be taken into consideration in the choice of spending components and sources of taxation to achieve consolidation. Also, to the extent that the costs and benefits of different instruments differ across social groups, fiscal consolidation will have implications for income distribution and equity. In particular:

- **While expenditure cuts are needed, fiscal retrenchment should preserve pro-growth programmes**. This includes productive outlays, such as on education, R&D and infrastructure, which are expected to be growth-enhancing in the longer term. Education policies have a bearing on growth through productivity gains arising from human capital accumulation. Support for innovation, including through tax expenditures on R&D, has the scope for creating new sources of growth by enhancing labour and multifactor productivity. Initiatives to improve public infrastructure are pro-growth to the extent that they unleash opportunities for private investment.

- **As for tax hikes, they should rely on the least growth-distorting instruments**.[6] Taxes on immobile bases, such as property, and consumption are less distortive than those on factor income (such as personal and corporate income). Income tax hikes have a bearing on growth, because they influence labour utilisation (by affecting decisions on labour force participation and hours worked) and productivity (through incentives for human capital accumulation). Moreover, there could be greater recourse to green revenue in fiscal consolidation programmes, including receipts from green taxes and carbon trading, which would also be welfare-enhancing.

Can structural reform contribute to fiscal consolidation?

Structural policy actions contribute to longer-term fiscal consolidation. Evidence for OECD countries suggests that policy actions that lift the economy's growth potential by fostering productivity growth and/or reductions in NAIRU also tend to improve the budget balance in the long term.[7] For example:

- **Effort to improve public sector efficiency – producing the same output with fewer inputs – would contribute to fiscal consolidation**. The budgetary savings arising from policy action in this area may take time to materialize, but they should not be underestimated. In many OECD countries, an improvement in health spending efficiency could deliver current outcomes while reducing government expenditure. In some countries, there is also considerable room for efficiency enhancement in public education that would allow for sustaining current levels of educational attainment and student performance with lower spending. These reforms could yield a concomitant growth dividend to the extent that the ensuing budgetary savings are reallocated to growth-enhancing programmes.

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5. Empirical analysis for the OECD area suggests that consolidation driven by cuts in primary current expenditures, such as government consumption and social transfers, has been more successful in reducing deficits than consolidation based on tax increases.

6. See Johansson *et al.* (2008) for more information and empirical evidence.

7. See OECD (2009b) for a sensitivity analysis of medium-term projections, and OECD (2010) for more information on structural policy priorities in OECD countries and selected non-OECD G20 members.

- **Entitlement reforms in pensions and health care could also pay a double dividend**. While the budgetary impact of such structural reforms may be small in the short term, they are likely to be large over time. This is to the extent that these reforms remove incentives for early retirement, which helps to increase labour utilisation and therefore potential growth. Faster growth would in turn facilitate fiscal consolidation.

- **Additional structural reforms may contribute to fiscal consolidation**. For example, the elimination of agricultural and fuel subsidies could have a triple dividend of *i)* fostering productivity gains by ensuring greater efficiency in the allocation of economic resources, *ii*) creating savings in the budget that could be reallocated to the provision of pro-growth goods and services, and *iii*) contributing to environment protection.

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