Box 6

FISCAL CONSOLIDATIONS: PAST EXPERIENCE, COSTS AND BENEFITS

The financial crisis and the severe economic downturn have contributed to a strong deterioration in the budget balance and a substantial increase in the government debt-to-GDP ratio in many euro area countries. As this situation is creating serious risks for the longer-term sustainability of public finances, this box examines past experience with government debt reduction in the euro area countries and reviews the possible costs and benefits associated with fiscal consolidation.

Past experience with government debt reduction in euro area countries

Judging from past experience[1] in euro area countries, large reductions in government debt require a firm longer-term commitment to fiscal consolidation, a strong focus on spending reduction and parallel structural reforms to support potential growth. In particular, Belgium, Ireland, Spain, the Netherlands and Finland have in the past implemented substantial budgetary adjustments, often complemented by structural reforms, and successfully reduced their government debt-to-GDP ratios. Examples of sizeable reductions in the debt ratio (although generally not continuous) range from an overall decline of around 24 percentage points in Finland (1995 to 2008) to around 50 percentage points in Belgium (1994 to 2007), up to more than 69 percentage points in Ireland (1994 to 2006).

Significant primary surpluses contributed most to the successful debt reductions. The budgetary adjustment in the above-mentioned countries mainly occurred on the expenditure side. The periods of large debt reduction in Ireland, the Netherlands and Finland were accompanied by decreases in the respective government expenditure ratios of more than 10 percentage points. While part of this decline may be explained by the reduction in interest payments, primary expenditure ratios also fell markedly over these periods. These sharp declines even allowed countries to reduce their revenue ratios and still achieve budgetary improvements over the respective debt reduction periods. In Belgium and Spain, expenditure ratios also declined, but fiscal adjustment consisted of increases in revenue ratios too.

1 See the boxes entitled “Experience with government debt reduction in euro area countries” and “The Greek economic and financial adjustment programme” in the September 2009 and May 2010 issues of the Monthly Bulletin respectively.

Costs and benefits of fiscal consolidations

Fiscal consolidation may to some extent entail costs in terms of lower economic growth in the short run. Any such "Keynesian" short-term costs may, however, be rather limited under certain circumstances, as suggested by the literature. The circumstances which help to reduce the short-term costs include when: (i) the fiscal starting position is particularly precarious and thus confidence in the sustainability of public finances is rather low; (ii) fiscal consolidation is pursued in a credible and consistent manner, in particular as part of a comprehensive reform strategy; (iii) the composition of fiscal adjustment is of "high quality" (e.g. focused on reforms that improve the longer-term sustainability of public finances); (iv) economic adjustment is not impeded by nominal rigidities; (v) the share of consumers discounting the future effects of fiscal retrenchment (i.e. so called "Ricardian" consumers) is high; (vi) the openness of the economy is high; and (vii) the short-run impact of tighter fiscal policy is offset by a depreciation of the exchange rate and/or by a more expansionary monetary policy.

Expectation effects could also in theory more than offset the short-run contractionary impact on growth of fiscal consolidations (the so-called non-Keynesian fiscal effects). The hypothesis of expansionary fiscal contractions posits that consumers anticipate benefits arising from fiscal consolidations for their permanent income and consequently increase private consumption. However, if the reduction in government expenditure is small and temporary, or not credible, private consumption may not respond positively to the fiscal cutback.[2] Non-Keynesian effects may also be associated with tax increases at high levels of government indebtedness. This kind of argument is based on the "expectational view of fiscal policy". For instance, if the fiscal consolidation appears to the public as a credible attempt to reduce public sector borrowing requirements, there may be an induced positive wealth effect, leading to an increase in private consumption.[3] Furthermore, the reduction of government borrowing requirements diminishes the risk premium associated with government debt issuance, which reduces real interest rates and allows the "crowding-in" of private investment.

Moreover, if fiscal consolidation gives rise to some negative short-run effects on real GDP growth, unduly delaying fiscal consolidation will ultimately result in even greater adjustment costs as the government debt accumulated in the interim will necessitate an even more pronounced fiscal correction later on.

Overall, the longer-run benefits of fiscal consolidation are largely undisputed. They consist, notably, of a reduction in governments' financing needs leading both to lower long-term interest rates (owing to lower demand and declining risk premia) and the freeing up of revenues to finance more productive expenditure or growth-enhancing tax cuts. More leeway is then also created to allow the automatic fiscal stabilisers to operate when required.

2 See Giavazzi, F. and Pagano, M., "Can severe fiscal contractions be expansionary? Tales of two small European countries", in *NBER Macroeconomics Annual* 1990, Vol. 5, Blanchard, O. and Fischer, S. (eds.), MIT Press, 1990 and Alesina, A. and Ardagna, S., "Tales of fiscal contractions", in *Economic Policy*, 27, 1998, pp. 487-545.

3 See Blanchard, O., "Comment on Giavazzi and Pagano", in *NBER Macroeconomics Annual* 1990, Blanchard, O. and Fischer, S. (eds.), 1990, pp. 111-116 and Sutherland, A., "Fiscal Crises and Aggregate Demand: Can High Public Debt Reverse the Effects of Fiscal Policy?", in *Journal of Public Economics*, 65(2), August 1997, pp. 147-162.

Lessons from the past

Past experience suggests that creating significant primary surpluses through fiscal consolidation will be pivotal to reducing the very high debt ratios for many euro area countries and thereby limiting their dampening impact on output growth. Moreover, case studies conducted for Belgium, Ireland, Spain, the Netherlands and Finland found that fiscal consolidations based on expenditure reforms were the most likely to promote output growth, especially when combined with structural reforms.[4] Overall, it appears that expenditure-based fiscal consolidations are more successful and have more beneficial effects on long-run economic growth than revenue-based ones.[5] With tax burdens already high, the scope for revenue-based consolidation may be limited as many euro area countries may already be close to their revenue-maximising levels of taxation, i.e. the peaks of their Laffer curves.[6]

The empirical literature offers diverse results as to whether fiscal consolidations in the euro area have had expansionary effects on economic activity in the short run. With reference to the periods of sizeable government debt reductions mentioned above, expansionary fiscal consolidations are suggested in Ireland, the Netherlands and Finland.[7] Looking at a broader range of experiences, it is found that around half of the fiscal consolidations in the EU in the last 30 years have been followed by an improved output growth performance in the short term relative to the initial starting position.[8] Finally, it is also shown that fiscal consolidations have had negative but limited short-term implications for real output growth in a number of countries.[9]

Although fiscal consolidation may imply costs in terms of lower economic growth in the short run, the longer-run beneficial effects of fiscal consolidation are undisputed. Moreover, such short-term costs will tend to be rather limited for countries with precarious fiscal starting positions and must be weighed against the costs of greater adjustment efforts the longer the fiscal correction is postponed. By contrast, the early announcement and implementation of credible and ambitious consolidation plans, focusing on the expenditure side and combined with structural reforms, will strengthen public confidence in the sustainability of public finances, reduce risk premia in interest rates and thus support macroeconomic and financial stability. Given the substantial increases in government debt ratios, there is an urgent need to accelerate the correction of fiscal imbalances in many euro area countries to restore sound public finances, which are a necessary support for monetary policy in its task of maintaining price stability.

4 See Hauptmeier, S., Heipertz, M. and Schuknecht, L., "Expenditure Reform in Industrialised Countries: A Case-Study Approach", in *Fiscal Studies*, 28(3), 2007, pp. 293-342.
5 See Alesina, A., "Fiscal adjustments: lessons from recent history", mimeo, Harvard University, April 2010.
6 See Trabandt, M. and Uhlig, H., "How far are we from the slippery slope? The Laffer curve revisited", ECB Working Paper No 1174, April 2010.
7 See Alesina, A. and Ardagna, S., "Large changes in fiscal policy: taxes versus spending", NBER Working Paper No 15438, October 2009.
8 See Giudice, G., Turrini, A. and in't Veld, J., "Non-Keynesian Fiscal Adjustments? A Close Look at Expansionary Fiscal Consolidations in the EU", in *Open Economies Review*, Vol. 18(5), 2007, pp. 613-630.
9 See Afonso, A., "Expansionary fiscal consolidations in Europe: new evidence", in *Applied Economics Letters*, 17(2), 2010, pp. 105-109.