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Fiscal consolidation in 1993
Issues for discussion

Introduction

There is a broad consensus that the persistence of a loose fiscal stance has detrimental effects on economic performance over the medium-term. The high interest rates brought about by excessive public sector borrowing requirements crowd out private investment and lead to an appreciation of the real exchange rate which in turn causes a reduction in net exports. The accumulation of public debt entails an increase in debt servicing, adding further to the budgetary deficit, with the risk of an explosive spiral of public debt accumulation. The decline in private investment and net exports, compounded by an unsound expansion of public consumption, will reduce growth potential.

The medium-run benefits of redressing fiscal imbalances provide the ultimate rationale for the adoption of measures to achieve fiscal consolidation in several EC countries. The convergence criteria contained in the Maastricht Treaty supply an important framework for the timing of the national processes of fiscal consolidation. Furthermore, they might become an additional incentive to take measures which are at any rate necessary but in many cases have long been postponed.

The need for fiscal consolidation, however, stands against difficult economic conditions: subdued economic activity and remaining uncertainties in the ERM. In this situation, policy dilemmas may arise. This note aims at providing some background for a discussion on the issues involved by the pursuit of fiscal consolidation in the present circumstances. Section I describes the main developments in public finances since 1989, while section II discusses the effects of fiscal consolidation, with a particular focus on the short-term effects on economic activity. Some issues for discussion conclude the note.

I. Recent developments in public finances

Budget deficits and public debt

After a period of fiscal restraint during most of the eighties, budget deficits in Community countries have increased considerably in recent years. As shown by Chart 1, public deficits, which on average had amounted to about 5% of GDP in the first half of the eighties, were brought down by consolidation efforts to 2.7% in 1989. Since then, however, the average fiscal deficit in the Community has nearly doubled and is expected to rise even further to almost 5.5% in 1993, the highest level recorded since the inception of the EC. As a consequence of these developments, the

ratio of gross public debt to GDP, which had stabilised at around 60% in the second half of the eighties, has started to rise again.[1]

Over the period 1981-1992, most Member countries were unable to bring down budget deficits in a permanent fashion. This resulted in a significant build-up of public debt levels and of debt-servicing obligations, which considerably narrowed the room for manoeuvre for national fiscal policies in the present economic slowdown. Roughly one-third of the increase in the overall budget deficit in the Community since 1989 can be attributed to higher interest payments, which, as a percentage of GDP, have reached new record levels last year and are expected to rise further. In the light of the fiscal consolidation efforts on the second half of the eighties, this fact indicates most obviously the difficulty of restoring control over financial balances once they are out of order. The accumulation of debt narrows the room for fiscal manoeuvre not only directly through the higher interest payments to service a mounting stock of debt, but also indirectly through the contribution of debt to higher real interest rates and lower growth.

Since 1989, the setback in the fiscal consolidation process experienced has been widespread throughout the Community. With the exceptions of Greece and the Netherlands, the overall budget deficit has increased in all countries, and most significantly in the UK and Germany (see Chart 2a). In addition, public debt ratios have risen in all Member countries with the exceptions of Ireland, Portugal and Luxembourg. (See Chart 2b.). In most countries, efforts to redress fiscal imbalances are presently facing severe difficulties. Indeed, in spite of the adoption of convergence programmes, present deficit forecasts for 1993 are already significantly higher than those originally envisaged, calling into question the success of the convergence process.

The structure of budget deficits

In addition to the developments in the size of budget deficits, it is also important to consider the evolution of the underlying components, with particular reference to the distinction between structural and cyclical elements; and between changes in expenditure and taxation:

- In principle, changes in budget deficits may be due to both discretionary decisions regarding spending and taxation (the so-called 'structural' component of the deficit) and to variations in the rhythm of economic activity (the so-called 'cyclical' component). Given that in recent years there has been a marked slowdown in growth, the cyclical component could be expected to be the major cause of the increase in budget deficits observed in the 1989-92 period. Although any attempt to separate the structural and cyclical components of deficit changes has to be taken with caution, estimates by the EC Commission tend to suggest exactly the opposite. Namely, for the Community as a whole, roughly two-thirds of the recent increase in budget deficits have been structural and only about one-third cyclical. As shown by Chart 3, the relative importance of the above two factors have, however, varied considerably across

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[1] All data in this note are taken from Commission sources.

countries, with Germany as the most notable outlier, given that the strong increase in the structural deficit was even mitigated by favourable cyclical developments.

- Another worrysome feature of the recent increase in budget deficits is that it has taken place in spite of a general expansion in tax revenues and it was thus the result of a faster growth in public spending (see Chart 4). In particular, in nearly all countries the ratio of total general government expenditure to GDP was higher in 1992 than in 1989, with the most marked increases taking place in the UK, Germany, Italy and Portugal. Both total spending and current receipts reached new record levels in the Community in 1992, exceeding 50% and 45% of GDP, respectively. Furthermore, increases in public spending generally were not devoted to capital formation in the form of public investment projects but rather to current spending, like transfer payments (including subsidies), government consumption and interest payments.

II. The short-run effects of fiscal consolidation

In many Community countries, current economic conditions are not very favourable for a reduction of fiscal deficits. Firstly, the combination of high real interest rates and high levels of public debt results in substantial interest payments which place considerable inertia in budget deficits. Secondly, the slowdown in economic growth, associated with high and rising unemployment, tends to increase budget deficits through the working of automatic stabilisers and to exacerbate any short-run cost associated with the redressing of fiscal imbalances. Therefore, notwithstanding the widespread consensus that fiscal consolidation will foster economic growth in the medium term, policy dilemmas may arise in the short run between the objective to take prompt action to reduce deficits and the desire to postpone adjustment costs until the end of the cyclical downturn.

The intensity of the policy dilemmas is naturally in relation to the size of the expected short-run costs of fiscal adjustment. These, however, are quite difficult to assess ex ante since the impact of a reduction of budget deficits on economic activity takes place through different channels and depends heavily on the reaction of private sector expectations to the implementation of measures of fiscal restraint.

Besides the contractionary effect on aggregate demand, reductions in budget deficits lead to lower interest rates which in turn stimulate economic activity. The size of the decrease in interest rates, however, is contingent on the credibility of the programme of fiscal adjustment. Although market expectations are always important for the impact of policy actions on interest rates, they become crucial in the case of fiscal adjustment in countries with a high level of public debt. In fact, when the stock of debt is high, a reduction in interest rates automatically brings about a significant decrease in the deficit which enhances the credibility of the fiscal consolidation. This process may initiate a virtuous circle which increases the effectiveness of improvements in the primary balance for the reduction in the total deficit, accelerate the decline in interest rates and thus puts forward the medium-term benefits of redressing fiscal imbalances.

Fiscal consolidation may also lead to a reduction on interest rates by helping to restore the credibility of the ERM. Fiscal imbalances have in many cases been a crucial factor underlying the

lack of economic convergence, which was at the root of the recent exchange rate crisis. Consequently, fiscal restraint, in particular in countries with high deficits and public debt, should help reduce exchange risk premia and thus narrow interest rate differentials vis-à-vis the Deutsche Mark without endangering exchange rate stability. At the same time, fiscal consolidation in Germany would increase the scope for a further decline in nominal interest rates throughout the Community and especially in countries with low rates of inflation and a relatively sound fiscal position.

The improvement in expectations of medium-term growth stemming from the adoption of measures of fiscal restraint may also have a direct impact on current spending decisions. In so far as the private sector expects faster growth and lower taxes to result from the present efforts towards redressing fiscal imbalances, current consumption and investment decisions may be favorably revised, thereby reducing the short-run costs of fiscal adjustment. This channel will be more relevant the larger are the medium-term benefits the private sector expects from fiscal consolidation. Therefore, not only the medium-term impact but also the short-term effects of a reduction in the budget deficit depends both on the size of the reduction and on the way the reduction is achieved:

- In general, the favourable effects on growth will be stronger if the measures are perceived to be permanent since the benefits of the fiscal consolidation measures would be enhanced. In this regard, the current situation compares favourably with previous experiences of fiscal consolidation in Community countries, since the framework set out in the Maastricht Treaty may contribute to strengthen the credibility of the measures. In fact, the excessive deficit procedure provided by the Treaty makes fiscal discipline not only a criteria in Stage Two and, in particular, for entry into Stage Three but also an essential feature once in full EMU.
- It also matters whether the reduction in the budget deficit is mainly achieved by increases in taxation or by decreases in expenditure. Reductions in government spending - especially if they take the form of cutting current consumption as opposed to investment or research programmes - might be expected to have a more favourable impact than increases in taxation. In fact, economic efficiency is reduced by the excessive expansion of the public sector and by the distortions associated with taxes.

In summary, although fiscal consolidation can be expected to have a short-run contractionary impact on economic activity, the size of this impact is not necessarily very large since measures of fiscal restraint may be accompanied by significant reductions in interest rates and by an increase in private demand in anticipation of higher growth in the medium term. Such favourable effects, however, hinge crucially on the responsiveness of private sector expectations to the implementation of fiscal consolidation programmes.

As a final point, it should be emphasised that the short-run impact of changes in aggregate demand on inflationary pressures, on the one side, and on real output and employment, on the other, is contingent on the presence of structural rigidities, especially in the labour market. The effective implementation of structural policies to increase the flexibility of the economy thus becomes even more important at the present juncture, as they might both reduce the short-term costs of fiscal consolidation in terms of output and job losses and improve the prospects for growth.

III. Issues for discussion

1) This note has argued that the short-run cost of fiscal adjustments can be significantly reduced if private sector expectations respond favourably to the implementation of measures of fiscal restraint and thus contribute to anticipate the medium-run benefits of redressing fiscal imbalances. In the Governors' opinion, what is the likely strength of such expectational effects relative to the contractionary impact directly stemming from the fall in demand which is associated with fiscal consolidation? In the light of the weak cyclical phase, what are the implications of this assessment on the current policy options? Which kind of policy measures could be adopted to enhance the favourable impact of fiscal restraint on the private sector expectations?

2) In the event that in some countries the current weakness of economic activity were to lead to a partial postponement of the implementation of fiscal consolidation programmes, which measures could be adopted to signal the continuing adherence to the objective of reducing fiscal imbalances? Could present legislative commitments to future tax increases, analogous to those recently introduced by the UK authorities, play a useful role?

3) By improving the prospects for economic convergence, fiscal consolidation could enhance the credibility of ERM commitments in many countries, thereby fostering exchange rate stability. On the other hand, it is sometimes argued that the short-tun effects of fiscal restraint may aggravate the economic slowdown and thus call for accompanying competitive devaluations which would lead to a conflict between the pursuit of fiscal consolidation and of exchange rate stability. How do Governors assess the risk that such a policy dilemma can arise?