

4th May 1993

TO THE MEMBERS OF THE COMMITTEE OF GOVERNORS

In preparation for the Committee's meeting on 11th May 1993 please find attached for your consideration a note for discussion, prepared by the Economic Unit, on issues relating to fiscal consolidation.

With kind regards,

A handwritten signature in black ink, appearing to read 'Gunter D. Baer', written in a cursive style.

Gunter D. Baer

Economic Unit

FISCAL CONSOLIDATION IN 1993

- A note for discussion -

I. SUMMARY AND ISSUES FOR DISCUSSION

While there is widespread agreement that the fiscal position in many Community countries needs to be consolidated, the present weakness of economic activity has, not surprisingly, given rise to the question of whether some fiscal expansion, or at least a temporary suspension of consolidation efforts, could contribute towards stimulating aggregate demand and growth. Against this background, this note addresses three issues: the experience with fiscal consolidation in the recent past; the factors affecting debt accumulation; and the short-term adjustment costs of fiscal retrenchment.

As it would go beyond the scope of this discussion note to examine the fiscal situation of individual countries, much of the empirical analysis is conducted for the Community countries as a group. Obviously, the experience of individual countries may be different from the "average" development and, consequently, the analysis does not lend itself to making specific policy recommendations to national authorities. Nonetheless, factors which have affected the overall fiscal position in the Community are in many instances relevant at the country level.

The main points which are developed in the following sections of the note are:

- past opportunities for fiscal consolidation have not been sufficiently exploited; while the aggregate public sector deficit as a percentage of Community GDP declined markedly between 1984 and 1989, these achievements have since then melted away; even more worrisome, the temporary improvement in the deficit/GDP ratio was almost entirely attributable to favourable cyclical influences, whereas the recent deterioration was predominantly of a structural nature, with rising interest payments also playing a significant role;
- the ratio of aggregate public sector debt to Community GDP practically stabilised between 1987 and 1991, but climbed again steeply in 1992 and is estimated to reach a record high in 1993; given the slowdown in growth and generally high real interest rates, the chances for stabilising, or even lowering, the debt/GDP ratio have substantially worsened;

- measures to reduce budget deficits are likely to have a negative short-term effect on aggregate demand, but determinate and credible consolidation programmes could help to limit the output costs of fiscal restraint.

Issues for discussion:

Firstly, even with due allowance for the different fiscal positions in individual Community countries (regarding both the magnitude of deficits and the level of public sector indebtedness), the experience over the past twelve years gives, in general, little cause for optimism. Which factors have, in particular, been responsible for this disappointing development and are they likely to constrain future consolidation efforts? What lessons can be drawn from those countries which were more successful in their fiscal retrenchment than the average of the Community?

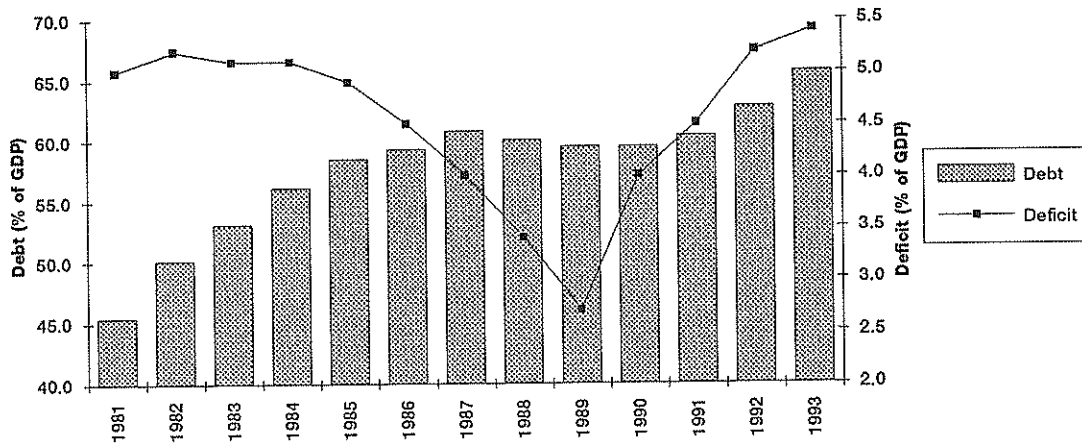
Secondly, the analysis of the factors underlying the accumulation of debt shows that fiscal consolidation is particularly challenging but all the more important in countries with high debt/GDP ratios and that stabilising or reducing this ratio becomes harder when growth is sluggish and high real interest rates persist. While the level of real interest rates is directly affected by the government's recourse to capital markets (i.e. fiscal restraint itself will make a significant contribution to lower real interest rates), what other policy measures could help to lower real interest rates? Is there a role for supportive monetary policy action (as advocated by the IMF in its most recent World Economic Outlook), taking into account, on the one hand, that real interest rates differ considerably across Community countries and, on the other, that the effects of changes in money market rates on real long-term interest rates are uncertain?

Thirdly, while cutbacks in deficits are likely to have adverse output effects in the short run, it could be argued that credible fiscal action could - through various channels - influence market expectations and thus speed up the decline in interest rates and the crowding-in of private spending. What is the practical experience of individual countries in this respect and which measures could be particularly effective in strengthening markets' confidence in fiscal consolidation programmes?

II. DEVELOPMENTS IN PUBLIC FINANCES OF THE COMMUNITY COUNTRIES AS A GROUP

Over the last decade, most Member countries have not succeeded in bringing down budget deficits permanently. As shown by Chart 1, recent developments in public financial balances can be broadly divided into two episodes: a period of falling deficits between 1984 and 1989, in which the rise in the debt/GDP ratio came to a temporary halt; and a subsequent period of renewed fiscal laxity, in which the average deficit in the Community has been approaching new record levels and the debt ratio has started to rise again. This section takes a closer look at the factors behind these developments in the two periods.

Chart 1. EEC: Gross Public Debt and Net Borrowing of the General Government



(a) 1984-1989

This period was marked by a steady improvement in the overall budget balance of Community countries. Public deficits, which on average had amounted to about 5% of GDP in the first half of the eighties, declined to 2.7% in 1989.¹ The correction in fiscal positions was widespread throughout the Community, with the strongest consolidation taking place in Portugal and Ireland (see Chart 3a). In these years, only Greece recorded a deterioration in public finances.

However, the reduction in budget deficits was, on average, mainly attributable to favourable cyclical conditions and not to retrenchment of structural balances. Although the attempt to separate cyclical and non-cyclical components has to be taken with caution, estimates by the EC Commission and the OECD tend to suggest that, for the Community as a whole, the structural component of the deficit remained roughly constant in the period 1984-89 (see Table 1). In that period, a significant decrease in the structural deficit was achieved only in Ireland, Portugal, Denmark, and, to a smaller extent, in Germany and Belgium (see Chart 4a).

The approximate stability of the average structural deficit is the result of parallel developments in both sides of the budget: on the one hand, consolidation efforts were made on the expenditure side, which added to the cyclical fall in total government expenditure. On the other hand, tax reductions to limit government involvement in the economy were implemented in many countries. As Chart 5a shows, total government receipts as a percentage of GDP fell slightly between 1984 and 1989, reflecting that, on average, the positive cyclical effect was more than offset by discretionary tax cuts.

¹ All data in this note are taken from internal Commission sources (Tables on Public Finance, January 1993), in which averages for the Community are calculated using 1989 exchange rates. These averages are slightly different from the latest figures published by the Commission (European Economy, Supplement A, January/February 1993) which are based on 1989 PPP exchange rates.

Table 1: Developments in EC General Government Financial Balances (1)

% of GDP

| Item | 1981-92 | 1981-84 | 1984-89 | 1989-92 |
|---|---------|---------|---------|---------|
| Change in Overall Balance | -0.2 | -0.1 | 2.4 | -2.5 |
| <u>1. of which attributable to:</u> | | | | |
| <i>Change in primary balance</i> | 1.5 | 0.9 | 2.4 | -1.8 |
| <i>Change in interest payments</i> | -1.8 | -1.1 | 0.0 | -0.7 |
| <u>2. of which attributable to:</u> | | | | |
| <i>Cyclical effects</i> | 0.9 | -0.7 | 2.2 | -0.8 |
| <i>Non-cyclical effects</i> | -1.1 | 0.6 | 0.1 | -1.8 |
| <u>Memo item:</u> | | | | |
| Change in Interest Payments | 1.8 | 1.1 | 0.0 | 0.7 |
| <u>of which attributable to:</u> | | | | |
| <i>Change in the stock of debt</i> | 1.5 | 0.9 | 0.5 | 0.1 |
| <i>Change in nominal interest rates</i> | 0.3 | 0.2 | -0.4 | 0.6 |

Source: EC Commission, January 1993.

Differences in the totals are due to rounding.

(1) Figures refer to the change between the first and the final year.

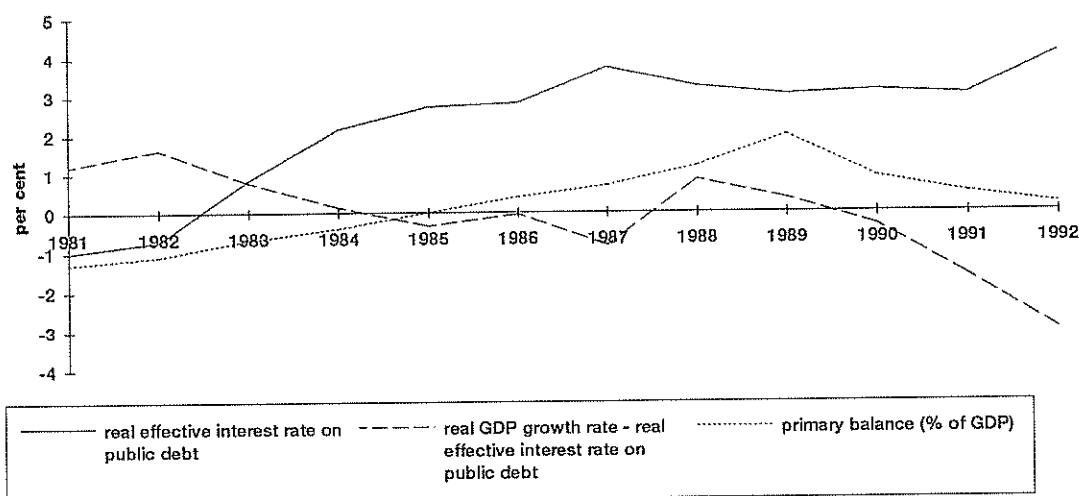
Interest rates form an important part of the structural deficit. In Table 1, the main factors underlying developments in interest payments are examined. Over a longer period (1981-92) interest payments increased, mainly as a result of the mounting stock of debt. However, between 1984 and 1989, interest payments remained constant, and this was the result of two factors working in opposite directions: the rise in the stock of public debt and the decline in nominal effective interest rates to serve the outstanding debt.

The debt/GDP ratio rose steadily until 1987, to fall only slightly thereafter (see Chart 1). As can be seen from Chart 2, the primary balance (i.e. the overall budget balance less interest payments) turned into surplus after 1985. Therefore, the continued increase in the debt ratio after 1985 was only due to interest payments. (The factors affecting changes in the debt/GDP ratio are discussed in the next section.)

(b) 1989-1992

In recent years, the fiscal position of Community countries as a group has deteriorated considerably, more than offsetting the earlier gains. Since 1989, the average fiscal deficit in the Community has nearly doubled and is expected to rise even further to around 5½ per cent of GDP in 1993, the highest level recorded since the EC was founded (deficits would be even higher if off-balance sheet items were considered). The slippage in fiscal positions 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, though in the latter cases from a position of surplus or balance on the governments' accounts (see Chart 3a). The increase of the deficit in these two countries accounts for nearly two-thirds of the overall deterioration at the Community level.

Chart 2: Factors behind debt dynamics



It seems particularly worrisome that, according to estimates by the Commission and the OECD, roughly two-third of the recent deterioration in fiscal balances has been structural and only about one-third cyclical. In eight out of twelve Member countries, structural deficits have risen significantly between 1989 and 1992, most notably in Germany, where the expansion of the structural deficit was even higher than the substantial increase in the overall deficit (see Chart 4b).

The rise in structural deficits reflects discretionary expansionary measures but also a significant increase in debt-servicing obligations. Nearly one-half of the increase in the structural component of the budget deficit in the Community since 1989 can be attributed to higher interest payments, which, as a percentage of GDP, reached new record levels last year and are expected to rise further. As can be seen in Table 1, a significant part of the rise in interest payments since 1989 can be attributed to higher nominal interest rates.

Another feature of the recent fiscal slippage is that the increase in budget deficits has been accompanied by an expansion in both public spending and tax revenues, generally reversing the trend of the previous period. Both total spending and current receipts reached new record levels in the Community in 1992, exceeding 50% and 45% of GDP, respectively. The most marked increases in the ratio of total general government expenditure to GDP took place in the UK, Germany, Italy and Portugal (see Chart 5b). The increases in public spending were not generally devoted to public capital formation but rather to current expenses, such as transfer payments (including subsidies), government consumption and, as already mentioned, interest payments.

The ratio of gross public debt to GDP, which on average had stabilised at around 60% in the second half of the eighties, has begun to rise again. Since 1989, public debt ratios have increased in all Member countries with the exceptions of Ireland, Portugal and Luxembourg (see Chart 3b.). As shown by

Chart 2, this movement is attributable to both a declining primary surplus and the emergence of a negative differential between the real growth rate and the real rate of interest.

III. EFFECTS OF FISCAL CONSOLIDATION ON THE DEBT RATIO

The experience in the second half of the 1980s - when the achievement of a primary surplus helped to pare the overall budget deficit but was insufficient to lower the debt/GDP ratio - demonstrates how difficult it is to bring about a sizeable, progressive decline in the debt ratio, i.e. to reverse the dynamics of the process of debt accumulation.²

To shed some light on the order of magnitude of the fiscal efforts needed, some simulations have been carried out to explore the effects of improvements in the primary balance on the debt ratio and on the overall deficit. Table 2 presents the results which were calculated on the basis of different assumptions about the initial level of debt and the other relevant conditions (real growth rate, real interest rate).

These illustrative calculations, based on hypothetical examples, suggest the following general conclusions:

- the higher the initial level of debt, the smaller the impact of a given primary surplus on the debt/GDP ratio; for instance, as shown in the example described in Table 2, an annual improvement in the primary surplus of 1% of GDP will, over a period of six years, bring down the initial debt/GDP ratio of 120% only to 109.4% but will lower a ratio of 80% to 65.8%;
- the evolution in the debt/GDP ratio is quite sensitive to the difference between the real rate of growth and the real rate of interest, especially if the initial debt/GDP ratio is high; for instance, Table 2 shows that a narrowing of the gap by 1 percentage point reduces, ceteris paribus and in comparison to the benchmark, the ratio in the "high debt/GDP ratio country" by 7 percentage points but only by 4.6 percentage points in the "lower debt/GDP ratio country";
- if the real rate of interest remains constant, a lower rate of inflation does not affect the level of debt but lowers the overall deficit, as it implies lower nominal interest rates and hence smaller interest payments;
- the mechanics of debt reduction indicate that achieving a marked decline in the debt/GDP ratio will require determined efforts for a prolonged period of time.

Of course, these are only illustrative calculations and assumptions about changes in the variables determining the process of debt accumulation do not take into account possible feedback effects

² Assuming no changes in the valuation of the stock of debt, it can be easily shown that the debt to GDP ratio rises if the difference between the real interest rate (i) and the real GDP growth rate (n) times the debt ratio (R) exceeds the surplus in the primary balance (S), i.e. if $R(i-n) > S$.

on economic activity, inflation and interest rates. Nonetheless, these stylised examples clearly point to the importance of the growth and interest rate conditions which would facilitate the achievement of a lower debt/GDP ratio. Given the present downswing and the high level of real interest rates prevailing in most Community countries, the prospect for a marked lowering of public sector debt in relation to GDP must be regarded as rather slim.

IV. THE SHORT-RUN EFFECTS OF FISCAL CONSOLIDATION ON ECONOMIC ACTIVITY

As noted above, in many Community countries the current economic conditions are not very favourable for a reduction of fiscal deficits. The slowdown in economic growth, associated with high and rising unemployment, tends to increase budget deficits through the effects of automatic stabilisers and to make the short-run costs associated with the redressing of fiscal imbalances more difficult to bear. Notwithstanding the widespread consensus that fiscal consolidation will foster economic growth in the medium term, there may thus be a desire to postpone fiscal consolidation until the end of the cyclical downturn.

However, the magnitude of short-run costs of fiscal adjustment is quite difficult to assess ex ante. A cut in budget deficits influences economic activity through different channels, with the impact depending crucially on the reaction of private sector expectations to the measures of fiscal restraint.

Reductions in budget deficits exert a direct contractionary effect on aggregate demand, dampening economic activity. The size of this effect can be expected to vary across countries, as economic structure and behaviour differ. However, most econometric models (both from national institutions and international organisations) suggest that the fiscal multiplier ranges between 1.1-1.6, under the assumption of constant interest rates and exchange rates. In contrast, if interest rates are allowed to decline, a fiscal contraction of 1% of GDP typically results in a reduction of real income of around 0.4-0.8%.

These estimates - which provide only a rough order of magnitude - do not make allowance for changes in private sector expectations which may take place in response to fiscal consolidation programmes. However, such changes in expectations, although very difficult to model, may be very important and substantially alter the estimates quoted above. On the one hand, if measures of fiscal restraint are adopted during a weak cyclical phase, business and consumer confidence may be depressed (further) leading to deferrals in spending decisions, thereby exacerbating and/or prolonging the contractionary impact of deficit reductions. On the other hand, a programme of fiscal adjustment may trigger favourable market expectations which would speed up the process of interest rate reduction and the increase in private sector spending, thereby helping to offset the contractionary demand effects from fiscal restraint.

A more rapid fall in interest rates triggered by a positive market response to a convincing consolidation programme would be particularly important in countries with high levels of public sector debt. Declining interest rates would have a direct impact on the governments' interest payments and thus contribute significantly to a visible reduction in the overall budget deficits. This may in fact set in motion a virtuous circle of improving budgetary performance and falling interest rates.

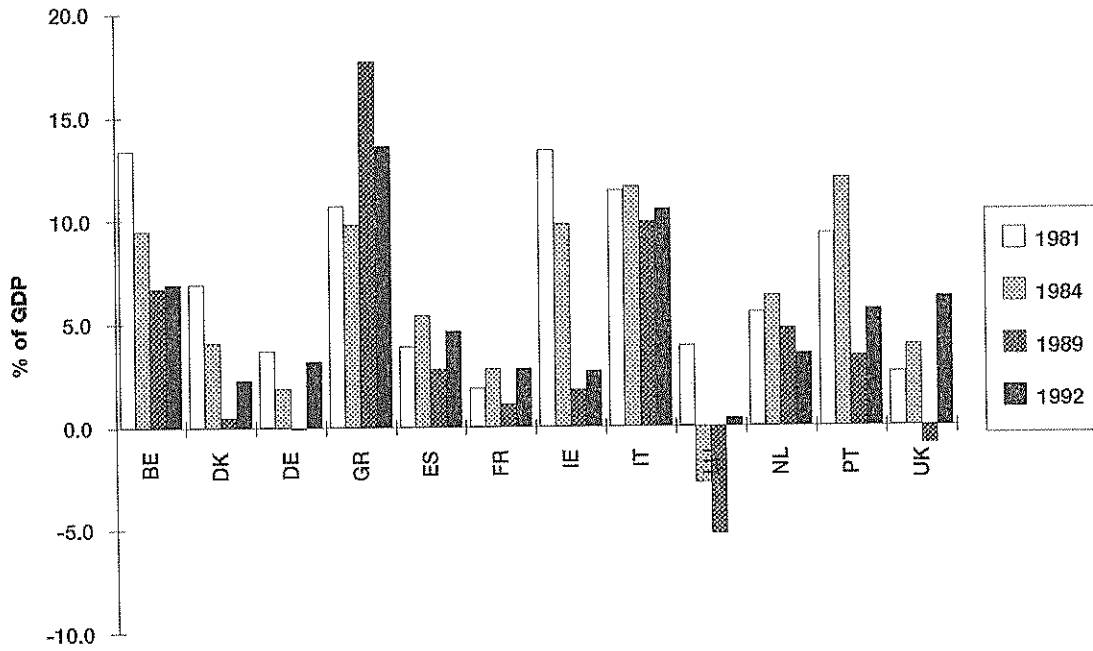
A credible programme to reduce fiscal imbalances would probably also be seen as a significant step towards strengthening economic convergence among Community countries. This, in turn, would help to restore the credibility in the ERM and give rise to smaller exchange risk premia and declining market interest rates.

Finally, if a fiscal consolidation programme is credible and succeeds in boosting market optimism, it may also have a direct beneficial impact on current private sector spending decisions. As the private sector expects growth to pick up, current consumption and, in particular, current investment expenditure may be increased, thereby reducing the short-run costs of fiscal adjustment.

The revision of spending decisions will also depend on the way the fiscal retrenchment is achieved. In general, the favourable effects on growth will be stronger if the fiscal measures are perceived to be permanent. In this regard, the objective of fulfilling the entry criteria into Stage Three of EMU, as laid down in the Maastricht Treaty, may strengthen the determination of the authorities to improve the fiscal positions fundamentally and may make the consolidation efforts more credible in the eyes of the market. In addition, reductions in government spending - especially if they take the form of cutting current consumption as opposed to investment, research and education programmes - are likely to have a more favourable impact than increases in taxation, as economic efficiency is reduced by an excessive expansion of the public sector and by the distortions associated with taxes.

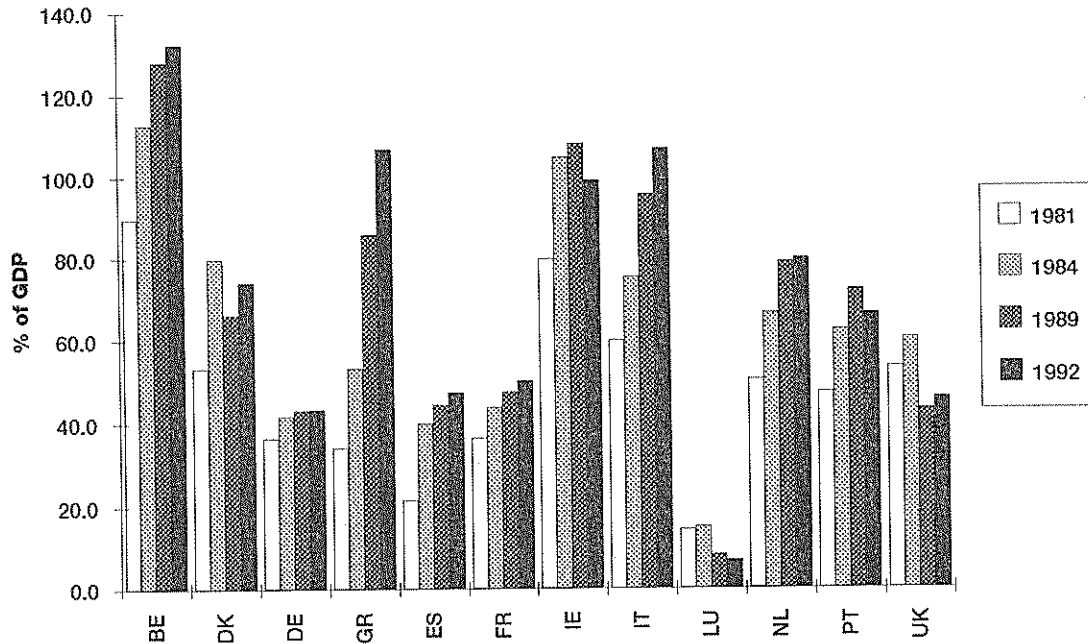
In summary, although fiscal retrenchment can be expected to have a short-run contractionary impact on economic activity, the size of this impact need not be large if measures of fiscal restraint lead to significant reductions in interest rates and to an increase in private demand in anticipation of higher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

Chart 3a. Net Borrowing of the General Government



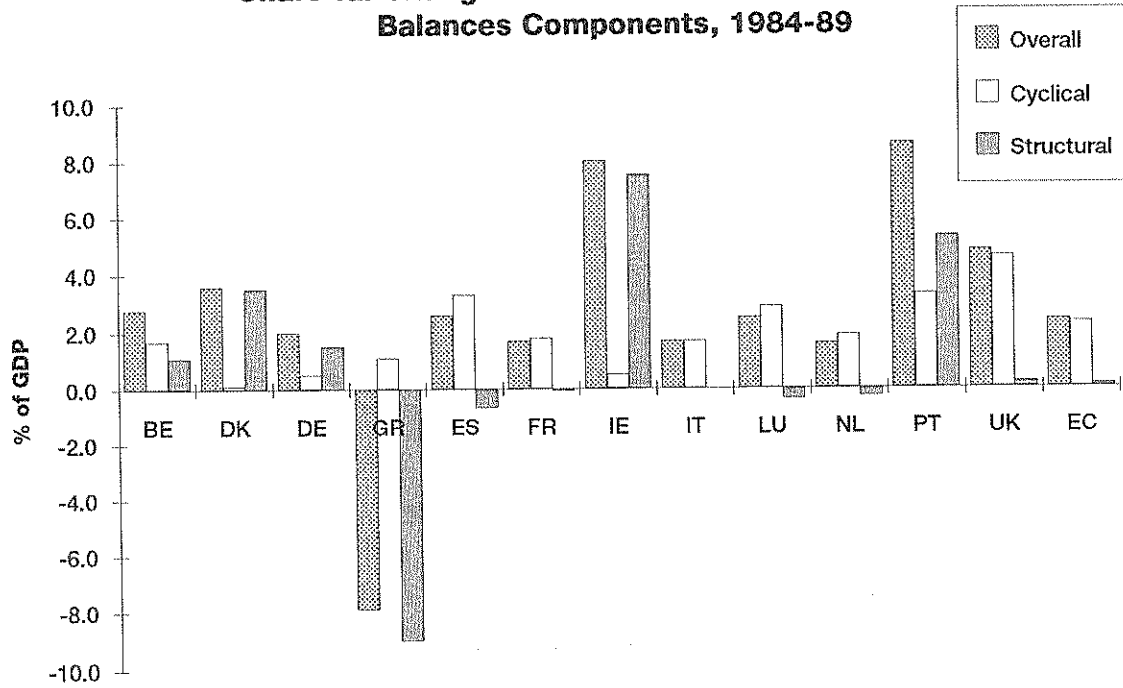
Source: EC-Commission, January 1993.

Chart 3b. Gross Public Debt of the General Government



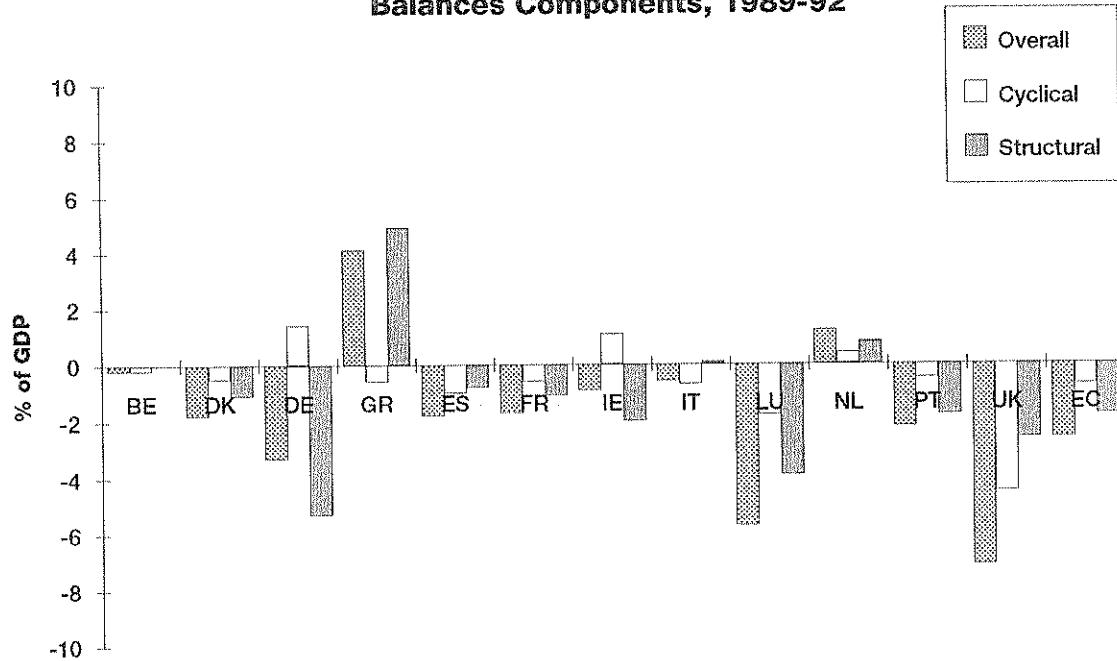
Source: EC-Commission, January 1993.

Chart 4a. Change in General Government Financial Balances Components, 1984-89



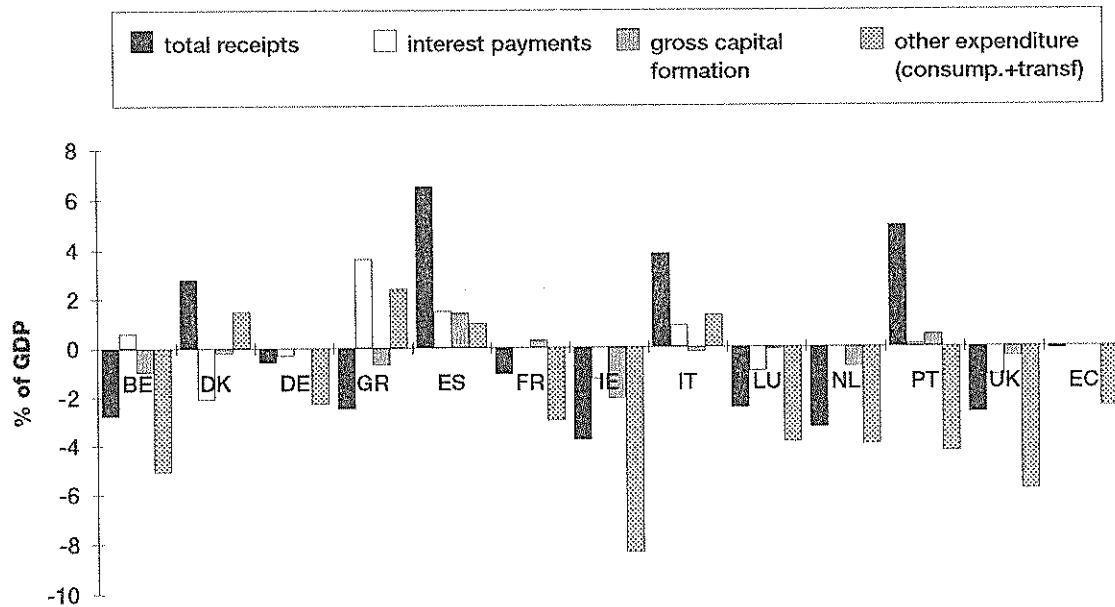
Source: EC-Commission, January 1993.

Chart 4b. Change in General Government Financial Balances Components, 1989-92



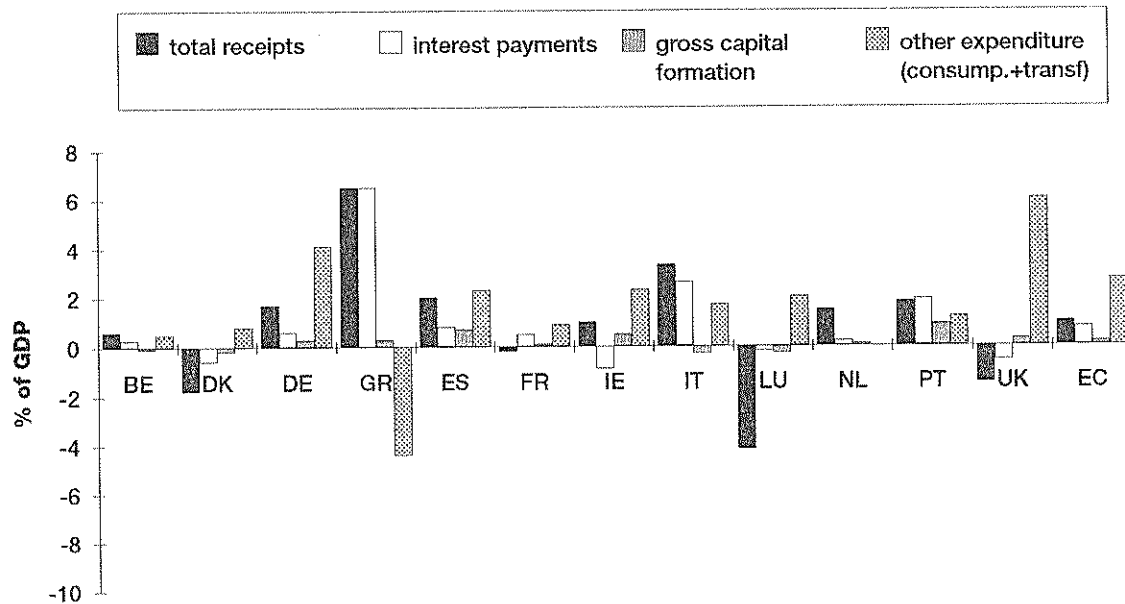
Source: EC-Commission, January 1993.

Chart 5a. Change in General Government Budget Items, 1984-89



Source: EC-Commission, January 1993.

Chart 5b. Change in General Government Budget Items, 1989-92



Source: EC-Commission, January 1993.

TABLE 2: Debt dynamics simulations

Starting conditions: 120% debt/GDP, balanced primary balance

| | Assumptions: | | | | Outcome after 6 years: | | |
|--------------------------------------|--------------|---------------|----------------|---------------------------|----------------------------|------------|-----------------|
| | Real growth | Real interest | Inflation rate | Change in primary balance | | Debt ratio | Overall deficit |
| | % | % | % | % of GDP | | % of GDP | % of GDP |
| Benchmark case: | 2.5 | 4 | 4 | 1 | (in all 6 periods) | 109.4 | 2.9 |
| Sensitivity to: | | | | | | | |
| a. Variation of consolidation amount | | | | 0 | (in all 6 periods) | 130.9 | 10.7 |
| | | | | 2 | (in all 6 periods) | 87.9 | -4.8 |
| b. Variation in growth rate | 1.5 | | | | | 117.0 | 3.5 |
| | 3.5 | | | | | 102.4 | 2.4 |
| c. Variation in interest rate | | 5 | | | | 116.8 | 4.7 |
| | | 3 | | | | 102.4 | 1.3 |
| d. Variation in inflation rate | | | 5 | | | 109.4 | 4.1 |
| | | | 3 | | | 109.4 | 1.8 |
| e. Variation of consolidation timing | | | | 6 | Once (in period 1) | 93.6 | 1.6 |
| | | | | 3 | Twice (in periods 1 and 4) | 103.1 | 2.4 |

Starting conditions: 80% debt/GDP, balanced primary balance

| | Assumptions: | | | | Outcome after 6 years: | | |
|--------------------------------------|--------------|---------------|----------------|---------------------------|----------------------------|------------|-----------------|
| | Real growth | Real interest | Inflation rate | Change in primary balance | | Debt ratio | Overall deficit |
| | % | % | % | % of GDP | | % of GDP | % of GDP |
| Benchmark case: | 2.5 | 4 | 4 | 1 | (in all 6 periods) | 65.8 | -0.6 |
| Sensitivity to: | | | | | | | |
| a. Variation of consolidation amount | | | | 0 | (in all 6 periods) | 87.3 | 7.1 |
| | | | | 2 | (in all 6 periods) | 44.2 | -8.4 |
| b. Variation in growth rate | 1.5 | | | | | 70.7 | -0.2 |
| | 3.5 | | | | | 61.2 | -1.0 |
| c. Variation in interest rate | | 5 | | | | 70.6 | 0.5 |
| | | 3 | | | | 61.2 | -1.6 |
| d. Variation in inflation rate | | | 5 | | | 65.8 | 0.1 |
| | | | 3 | | | 65.8 | -1.3 |
| e. Variation of consolidation timing | | | | 6 | Once (in period 1) | 49.9 | -1.9 |
| | | | | 3 | Twice (in periods 1 and 4) | 59.5 | -1.1 |

This table presents some calculations of the effects of improvements of the primary balance for a time horizon of six years. In all cases, the primary balance is assumed to be balanced in the starting period, with the initial level of debt being 120% in the upper part of the table and 80% in the lower part. The benchmark case assumes an annual improvement of the primary balance of 1% of GDP, implying a 6% primary surplus in the final period of the analysis. The real interest rate, the real growth rate and the inflation rates are assumed to remain constant over the period at levels of 4%, 2.5% and 4%, respectively. These assumptions imply in the starting period of the benchmark case an overall deficit of 9.6% of GDP in the upper part of the table and of 6.4% in the lower part. This benchmark case is contrasted with different assumptions regarding the size of the annual change in the primary balance, the real interest rate, real growth, and the inflation rate. In addition, the strategy of successive annual consolidation steps is compared with a one-step approach of an immediate improvement of the primary balance of 6% of GDP in the first period, and with a two-step strategy of two 3% of GDP improvements in periods 1 and 4.