International examples of spending consolidations

[redacted]

17 September 2009

Contents

Introduction: Context of expenditure consolidations

A historical perspective on expenditure trends:

- Over the past 25 years, there has been a continuous and sustained rise in budget deficits[1] and government debt[2] in many OECD countries.
- This is mainly owing to slower growth following the post-war Golden Age of economic activity, ending around 1973 at the time of the global oil crisis.

Expenditure consolidations:

- Since the 1980s many countries have made efforts to contain deficits.
- These have mainly concentrated on **public expenditure cuts** rather than tax increases[3].
- There is broad agreement in the literature that **spending restraint is more likely to generate lasting fiscal consolidation and better economic performance** than tax increases [4].

1 the yearly excess of government expenditures over revenues
2 the deficits accumulated over the years
3 OECD, 2006
4 Alesina and Perotti, 1995

Introduction: Scope of this paper

This slide pack will examine ambitious expenditure consolidation episodes in industrialised countries over the last 25 years. It will analyse in detail the experiences of a range of international case studies.
This pack does not examine unsuccessful fiscal consolidations, such as experienced by Japan in the 1990s and further work may be required in this area

Selection of case studies:

• The analysis will focus on ambitious, large scale expenditure consolidations (see Annex A for the identification of large consolidation episodes)
• Case studies will be limited to OECD countries over the last 25 years as there is reliable data and literature available and they are most comparable to the UK.
•The following case studies will be examined: Finland (1993-2000), Sweden (1993-2000), Ireland (1982-1989), Belgium (1983-1990), Canada (1992-1999), Netherlands (1993-2000), Spain (1993-2000), New Zealand (1993-2000) and Iceland (1989-1996).

Areas to be examined:

1. Background of the expenditure consolidation: the main contextual facts with respect to the macroeconomic environment
2. Scope and composition of the expenditure consolidation: including important institutional components of the reform and complementary measures.
3. Outcomes of the expenditure consolidations: effects on public finances, public services and the wider economy.
4. Lessons learnt

Introduction: Defining 'successful' consolidations

Academics have established the criteria for 'success' of consolidation programmes:

• IMF identify that of **74 fiscal consolidation periods** identified across 20 countries during 1974 - 1995, **only 14 could be counted as 'successful'*.** While the UK undertook fiscal consolidations across 78 – 82 and 93 – 95, neither are judged ***successful*** under this criteria (McDermott and Westcott 1996)**.

• Similarly, Alesina and Perotti (1995) find that of **52 consolidations** which took place during 1965 - 1990, 14 could be judged successful while **38 could be judged as unsuccessful** against their criteria***. They also find that the characteristics of unsuccessful consolidations largely mirror the characteristics of successful consolidations.

•Most often, successful and unsuccessful attempts are distinguished by the scale of debt reduction. Scale of reduction is an important factor in success (McDermott and Westcott 1996). However, snapshot analyses can ignore whether consolidations were sustained or were quickly followed by rapid increases in expenditure necessitating a further period of consolidation.

In this paper, we judge successful consolidations according to the criteria cited in academic literature, discussed above.

*McDermott and Westcott define a successful consolidation as a reduction of at least 3 percentage points in the ratio of gross public debt to GDP by the second year after the end of the two-year fiscal tightening;
** Between 1992 – 1999, however, the UK reduced its primary expenditure by 7.2% of GDP
**According to Alessina and Perotti, a *successful* adjustment in year t is defined as a 'very tight' fiscal stance in year *t* such that the gross debt / GDP ratio in year *t*+3 is at least 5 percentage points of GDP lower than in year *t*.

Contents

Finland, 1993-2000 (i)

BACKGROUND

- Following the burst of the 1980s bubble-economy and the disruption of trade with the Soviet Union, Finland experienced a severe economic slump from 1990 to 1993.
- Rising welfare spending, the need for public bank support and falling revenue undermined public finances and the budget deficit reached 7% of GDP in 1993[1]
- GDP contracted for 3 consecutive years from 1991 to 1993 inclusive
- Big increases in debt repayment costs due to increasing borrowing but also sharply higher yields to remove debt was a major factor behind the need to consolidate

SCOPE & COMPOSITION OF PROGAMME

Finland undertook an ambitious expenditure reform programme in 1993 aimed at fiscal consolidation and the fulfilment of the EMU convergence criteria:

- **Between 1993 and 2000, primary expenditure was reduced by 14% of GDP**. This was mainly based on:
  - Cuts in government employment, including major savings through moderate wage agreements
  - Reductions in central government transfers to municipalities, including to social care, health care, education and public pensions[2]. Cuts were made in health and social services as they were large programmes and offered the possibility of reducing spending rapidly.
  - Cuts to other 'easy wins', including subsidies to agriculture, business, investment and foreign aid

▪**Changes in fiscal institutions** were also made, including the introduction of expenditure ceilings, which were crucial to the attainment of expenditure cuts[3]

▪**The fiscal adjustment was accompanied by significant complementary reform measures.** These included pension, labour market and banking sector reforms.

▪**R&D spend** was deliberately protected (~1%GDP) during consolidation.

1 Huaptmeier, 2006, 2 Timonen, 2001, 3 Corsetti and Roubini, 1996

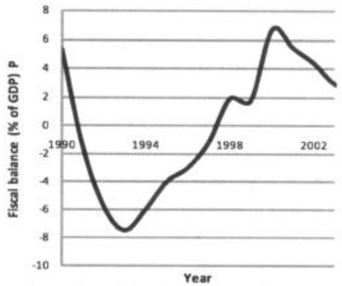


Fig1: Fiscal balance (% of GDP)

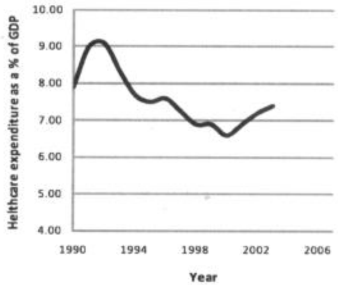


Fig 2: Health expenditure (% of GDP)

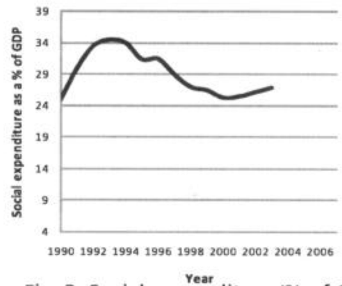


Fig 3: Social expenditure (% of GDP)

Source: SKATE and Worldbank data

Finland, 1993-2000 (ii)

OUTCOMES

Effect on public finances

- Between 1992 and 2000, the fiscal balance improved by 14.4% to a surplus of 7%. Public debt also started declining rapidly towards the end of the 1990s[1].
- This was helped by a period of economic recovery between 1994-2000, where growth and employment picked up strongly.
- Depreciation of the Marrka during this period also helped economic recovery.

Effect on public services:[2]

- There were large cuts in public sector staff. Between 1990 and 1993 the number of people employed by the public health and social services declined by around 8%
- Productivity in Finnish health centres between 1988 and 1995 was found to have increased[3]
- Institutional care was often replaced by outpatient care (which is usually more expensive for the patient) and there was an increase in the number of private services and service providers
- The standard of service provision declined for some groups such as the elderly and people with mental health problems. However, there was an increase in the service quality in many areas and the overall quality of services remains world class.

KEY LESSONS

Large cuts in public expenditure led to a dramatic and sustained improvement in the fiscal position and service quality declined in some areas.

However, evidence suggests that reductions in transfers to municipalities resulted in local tax increases, which may have offset budget cuts and maintained expenditure for local services. Clear accountability for local government and autonomy to react by allocating budgets/raising taxes, allowed national government to cut local spending quite substantially during the period, without major impact on local services.

1 Huaptmeier, 2006
2 Timonen, 2001 and Ministry of Social Affairs and Health, Finland, 1997
3 Hemmings et al (2003)

Sweden, 1993-2000 (i)

BACKGROUND

•In the early 1990s, Sweden was confronted by a sharp recession coupled with a banking crisis, following the burst of the bubble-economy of the 1980s. This led to a significant decline in the employment ratio, fiscal imbalances and strong inflationary pressures

•By 1993 the budget deficit reached 12.9% of GDP, one of the highest in the OECD and public debt reached almost 80% of GDP[1]. There was acknowledgement in Government and amongst the electorate that Sweden had to dramatically reduce its budget deficit.

•Big increases in debt repayment costs due to increasing borrowing but also sharply higher yields to remove debt was a major factor behind the need to consolidate

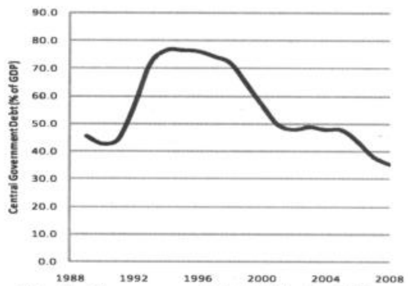


Fig 1: Government Debt (% of GDP)
Source: Swedish National Debt Office

SCOPE & COMPOSITION OF PROGRAMME

In 1994, the Government reacted by undertaking a large consolidation drive, with most measures being implemented by 1995. This was split (roughly 50/50) between tax increases and substantial reductions in public expenditure, backed up by reforms to fiscal procedures and institutions.

•**Public expenditure was cut by almost 16 percentage points over 7 years**[2]. The main expenditure categories being reduced were:

- o Transfers and subsidies (which fell from 27% of GDP in 1993 to 19% in 2000): Permanent reductions were made in unemployment, sickness and parental benefits (through the freezing of nominal benefits). Eligibility for benefits was also tightened, for example, the length of time a person could draw unemployment benefit was decreased.
- o Government consumption: Reductions in public sector employment and across-the-board cuts to the operational budgets of central and local authorities between 1995 and 1998 of 11%.

•**Institutionally,** there was fundamental change in the budget process. 3-year expenditure ceilings were introduced on public expenditure for all government departments. After spending cuts were complete, an annual productivity target based on public sector levels was built into expenditure plans.

•**Complementary policy measures** included a privatisation programme and measures to encourage a higher degree of labour market liberalisation. In addition, policies were introduced to upgrade labour force skills by giving people with basic schooling the chance to complete secondary school and qualify for higher education[3].

1 McKinsey Quarterly , June 2009
2 Huaptmeier, 2006
3 The 'Knowledge Lift' programme was taken up by 10% of the workforce.

Sweden, 1993-2000 (ii)

OUTCOMES

Effect on public finances

•There was a rapid improvement in the fiscal position, reflecting a combination of dramatically improved economic circumstances and the major consolidation effort[1]. By 1997 the government had balanced its budget and by 2006 public debt had almost halved to just above 40% of GDP[2].

Effect on public services[3]:

•Cuts in medical funding angered the public and led to a subsequent rise in waiting times

•Cuts in government consumption and efficiency targets encouraged cross agency collaboration, which led to better service delivery.

Wider economic effects

•The consolidation program was also accompanied by a strong and rapid rebound in trend economic growth (however, there is work ongoing in MFP to better understand impacts, for example on domestic demand, which may have been negative.

KEY LESSONS

•Sweden is an example of a successful expenditure based fiscal consolidation, backed up by vast institutional reform and streamlined fiscal procedures.

•The Finance Minister at the time, Goran Persson, gave the following reasons for the programmes success[4]:

- **~~The programme was designed as a comprehensive package~~**
- **It was a front loaded programme, starting with the most difficult measures to demonstrate the Government's resolve to tackling the deficit.**
- **Transparency of the programme.**

1 Roseveare, 2002
2 Hauptmeier, 2006
3 Mckinsey Quarterly, 2009
4 McKinsey Quarterly, 2009

Ireland, 1982-1989

BACKGROUND

- Major expenditure consolidation was initiated in the early 1980s after Ireland had been suffering persistently low GDP growth, accompanied by rising unemployment and widening fiscal deficits.
- By 1982, public spending reached 56% of GDP, the budget deficit exceeded 15% of GDP and the public debt-to-GDP ratio had increased to nearly 85%[1].

SCOPE AND COMPOSITION OF PROGRAMME

- Attempts at fiscal stabilisation between 1982-1987 were focused on revenue increases.
- **The 'programme for National Recovery' launched in 1987 rested essentially on deep-rooted expenditure reform.** These included:
  - Social spending - specifically health and pension expenditure - was reduced considerably.
  - Subsidies were cut by almost two-thirds in 1988.
  - Eligibility for social security benefits was tightened and targeting was improved, while the real value of benefits was frozen.
  - User fees for universities and hospitals were established.
  - Wage restraint and a 7% fall in public employment between 1987-1989
  - Major projects in the energy and telecommunications sector were cut
- **Complementary measures** to the expenditure reform included public sector wage moderation and the transformation of centralised wage bargaining as well as reforms to the tax system.

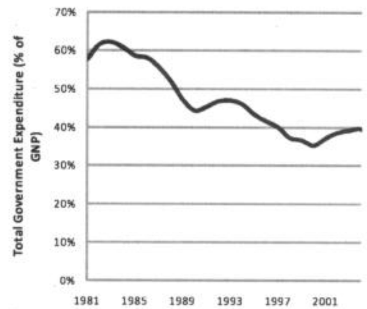


Fig 1: Total Government Expenditure (% GNP)

Fig 2: Social expenditure (% of GDP)

Source: OECD & Ireland Dept of Finance

OUTCOMES

- Between 1985 and 1989 there was an 8.2% fall in spending as a percentage of GDP and a 6.6% increase in the primary balance
- Fiscal consolidation is thought to have contributed significantly to Ireland's economic recovery in the 1990s[2].

KEY LESSONS

Example of how expenditure consolidation can coincide with a swift and sustained economic recovery. This experience sparked the debate on possible expansionary effects of fiscal policy.

1 Hauptmeier et al 2006
2 De la Fuente, A. and Vives, X. (1997)

Belgium 1983-1990

BACKGROUND

Following the second oil crisis of the late 1970s, the Belgian economy deteriorated markedly. By 1983, public spending stood at 63.8% of GDP, the budget deficit was nearly 15% of GDP and the debt level exceeded 100% of GDP[1]. Belgium seemed trapped in a vicious cycle of low competitiveness, rising unemployment and widening public sector deficits.

SCOPE AND COMPOSITION OF PROGRAMME

In 1982, the government entered a period of fiscal consolidation. This included measures to increase government revenue but was mainly focused on expenditure based measures.

- **Primary expenditure was cut by 12.3%** of GDP. Most of the adjustment in primary spending came from:
  - Drastic reductions in transfers and subsidies: a considerable redrafting of the benefit system enabled sustained spending reduction and improved incentive effects of these schemes.
  - Public wage restraint
  - Cuts in public investment (from 3.9% of GDP in 1983 to 1.7% in 1990).
- **Complementary structural reforms** were also undertaken. Including, a more active labour market policy to complement the reform of the benefit system.

OUTCOMES

- Between 1983 and 1990, the fiscal balance improved by 8% of GDP. However, significant deficits still remained and public debt was on the rise.
- A second phase of fiscal consolidation occurred between 1992 and 1998 in the context of Maastricht convergence, which eliminated fiscal deficits and brought public debt onto a clear downward path[2].

KEY LESSONS

The large adjustment was not sufficient to stabilise the public debt ratio and a second phase of reform was needed in the 1990s

1 Hauptmeier et al 2006
2 Mainly revenue raising measures through restructuring the tax system

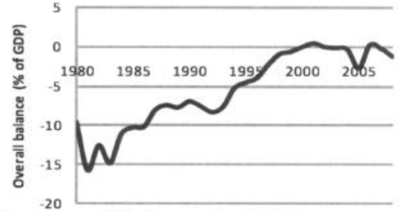


Fig 1: Overall balance (% of GDP)

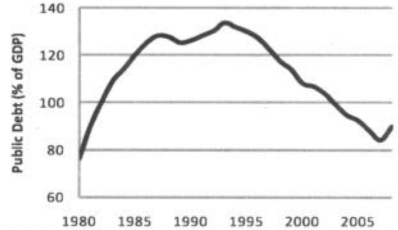


Fig 2: Public debt (% of GDP)

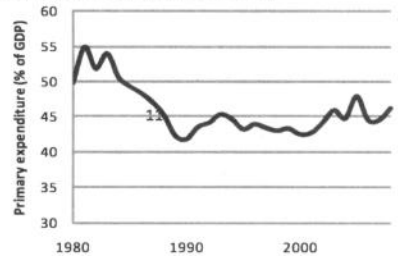


Fig 3: Primary expenditure (% GDP)

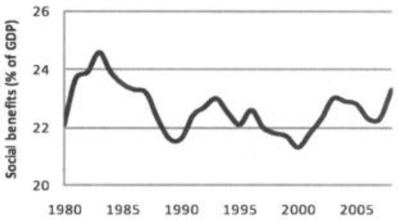


Fig 4: Social benefits expenditure (% GDP)
Source: National Bank of Belgium

Canada, 1992-1999 (i)

BACKGROUND

The Canadian economy entered a severe downturn in 1990, followed by a historically slow recovery. In 1992, fiscal deficits reached 9% of GDP and public debt grew sharply to well above 100% of GDP[1].

- Between 1984-1993, the government launched a number of initiatives to control or reduce expenditure. These included privatisation programmes, across-the-board cuts and public sector salary freezes. However, these were unsuccessful at balancing the budget, and there was a recognition that a new approach was needed.
- Big increases in debt repayment costs due to increasing borrowing but also sharply higher yields to remove debt was a major factor behind the need to consolidate

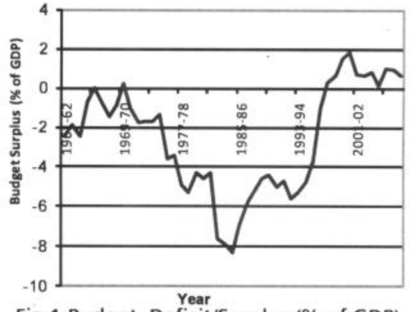


Fig 1:Budget Deficit/Surplus (% of GDP)

SCOPE & COMPOSITION OF PROGRAMME

- In 1993, the federal government started an ambitious programme of fiscal tightening, which unlike previous attempts at fiscal adjustment was largely expenditure based[2]
- In 1994-95 and 1995-06, the Government conducted 2 formal rounds of **Program Review**, a comprehensive review of all departmental programs. This consisted of the scrutiny and review of programme spending and a fundamental reassessment of the governments role and priorities going forward. Departments were asked to submit programmes to a test of six primary tests to select authorised public spending (see Annex B). Central ministerial committees were then tasked with reviewing plans prepared by individual Ministers and officials.
- **There were significant expenditure cuts**, each department was given an expenditure reduction target ranging from 5-60% to be implemented between 1994-95 and 1997-98. Overall, central government departments budgets were reduced by 20% from 1994 levels within four years[3].
- **There was a 23% fall in public service employment**
- The success of Canada's fiscal consolidation in the 1990s was also based on a **wide range of complementary reforms**. Including, measures to increase labour market flexibility and the skill level of the work force. Major reforms were also made to the system to transfers to the provinces with the aim of making them more cost effective and flexible.

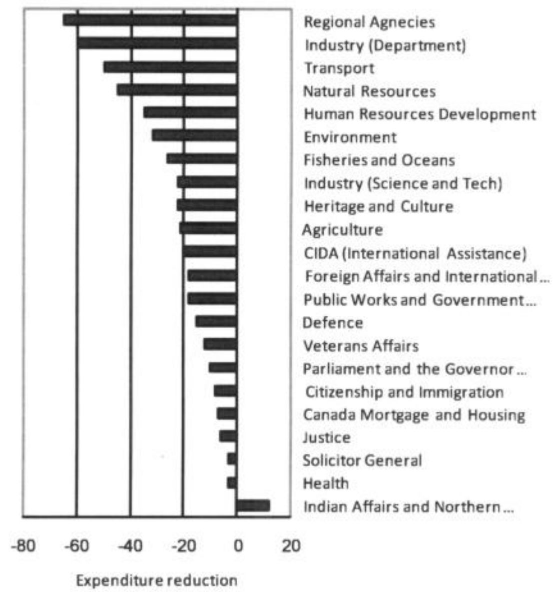


Fig 2:Expenditure reduction by Department 1994-95 to 1997-98

Source: Institute fro Government

1 Hauptmeier et al 2006
2 Kneebone and McKenzie, 1999
3 Bouthevillian, 2006

Canada, 1992-1999 (ii)

OUTCOMES

Effect on public finances:

- Spending fell by more than 11% of GDP between 1992 and 1999. The budget was balanced in 1997, and in 1999 the fiscal deficit had been improved by more than 10% of GDP compared to 1992[1].

Effect on public services:

- A number of sources cite efficiency gains and improvements in the quality of programme and service delivery[2]. For example,
  - Cuts led to an increase in innovative thinking to avoid waste and duplication
  - There was an increase in integrated services amongst departments and agencies.

Wider effects:

- Trend growth as well as employment picked up significantly and notably early on in the course of the process.
- There were no significant strikes or civil unrest and the government was re-elected.

LESSONS LEARNT

- **Canada is often cited as the best example of a successful fiscal adjustment, achieved by combing a complete overhaul of public spending, a profound reform of fiscal institutions plus other structural reforms.**
- **The following elements of the process of the programme were identified as being crucial to its success[3]:**
  - **One team: There was buy-in from across government, who all spoke with one voice**
  - **No target: There were no departmental targets given until later in the process**
  - **Common guidelines: All programs were subject to the 6 interconnected tests outlined above**
  - **A free hand: Each department was given responsibility and flexibility to develop proposals, this helped achieve departmental buy-in.**
  - **Strong support for the strategy among private agents: There was the public perception that the deficit was unsustainable and needed to be eliminated[4]. The government also went to great lengths to publicise its actions to generate further public understanding of the actions required.**

1 Hauptmeier, 2006
2 OECD, 1999 and Treasury Board of Canada, 1997
3 Institute for Government presentation, May 2009 and Bouthevillian, 2006
4 As evidenced by a number of public opinion polls (OECD, 2001)

Netherlands 1993 –2000

BACKGROUND

- The Netherlands experienced a period of successive budget deficits in the 1980s and early 1990s.
- Despite a period of expenditure retrenchment between 1983 and 1990, public debt continued to rise, reaching 77% of GDP in 1993. Maastricht convergence (see Annex C) also provided a source of impetus for further consolidation

SCOPE AND COMPOSITION OF PROGRAMME

- A second phase of expenditure consolidation was initiated in the early 1990s. **Primary expenditure fell by over 7 percentage points between 1993 and 2000**. Measures included:
  - Lower social security outlays were the main contribution to spending cuts. For example, sickness insurance was privatised and in the disability scheme a major tightening combined with the introduction of competition occurred. This was complemented by tightening of the eligibility criteria for social benefits.
  - Subsidies for housing transfers and public transport were reduced
  - Defence expenditure was reduced markedly
  - Public wage restraint

- As well as the expenditure consolidation, the government implemented a number of **structural reforms and improvements to fiscal institutions and rules.**

OUTCOMES

- Reforms dramatically improved public finances; the fiscal position improved by 4 percentage points between 1993 and 2000 and government debt fell from 77.2% to 54% of GDP over the same period.

KEY LESSONS

Cuts in public expenditures can be reconciled with strong growth performance.

1 Hauptmeier et al 2006

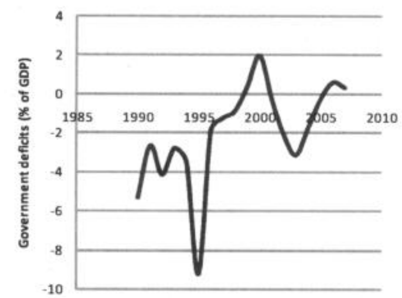


Fig 1:Budget Deficit/Surplus (% of GDP)

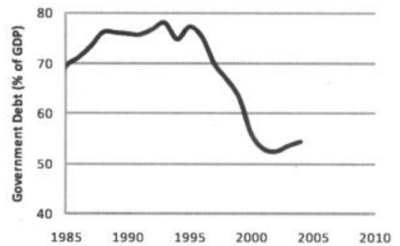


Fig 2:Government debt (% of GDP)

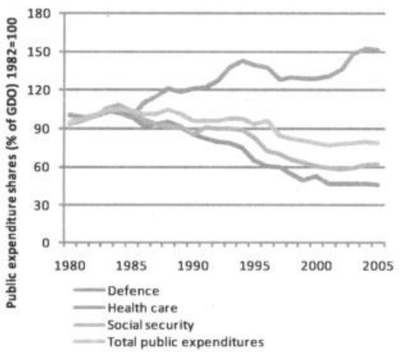


Fig 3:Public expenditure shares (% of GDP)
Source: OECD and De Mooij (2003)

Spain 1993-2000

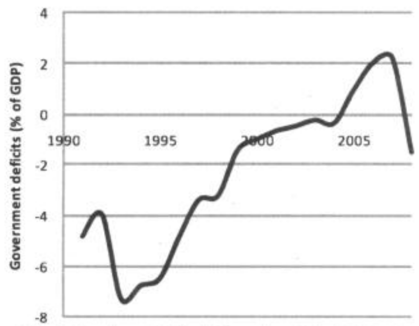
BACKGROUND

Following the deep recession of the early 1990s, Spain was confronted with an unsustainable deterioration in its public finances. The deficit rose to 6.7% of GDP and public debt rose to almost 60% of GDP in 1993.

SCOPE AND COMPOSITION OF PROGRAMME

Under the Maastricht convergence process (see Annex C), the government embarked on a large-scale expenditure based consolidation effort between 1994 and 1997.

- **primary expenditure was reduced by 6.4% of GDP between 1993 and 2000**:
  - Most of the expenditure consolidation fell on cuts in social transfers (4% of GDP). These included, reductions in the generosity and tightened eligibility of unemployment, pensions and disability benefits. This was in the context of wider reform of the benefit system, which reduced fraud and abuse. For example, the coverage of the unemployment scheme was reduced from 83% of registered unemployed to 69%.
  - Public sector wage restraint and some reductions in public employment
  - Public investment was protected
- **These measures were supplemented with revenue raising measures, budgetary reform and structural initiatives**. Including:
  - Reforms to company tax (1995) and individual income tax (1998) as well as labour and financial market reforms
  - Privatisation of state owned firms



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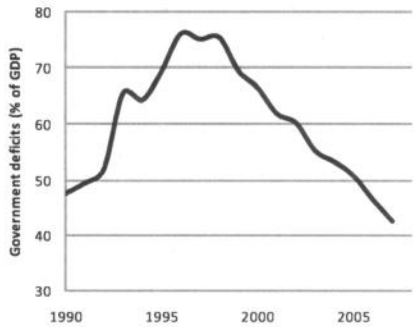


Fig 2:Government debt (% of GDP)

Source: OECD

OUTCOMES

The fiscal balance increased by 5.8 percentage points. The state of public finances was helped by robust economic growth and a decline in the nominal interest rates.

KEY LESSONS

Comprehensive and coordinated package of reforms signalled a credible commitment to reducing the deficit and was successful in doing so[2].

1 Hauptmeier et al 2006
2 Rato (2004)

New Zealand 1993-2000

BACKGROUND

Tax receipts lagged behind spending growth in the 1980s. Net debt reached 52% of GDP in 1992 and was expected to grow by 20% by the mid-1990s[1]

SCOPE AND COMPOSITION OF PROGRAMME

- **Expenditure consolidation programme** included:
  - Welfare benefits cut by around 9% in 1991. Including, increasing age of eligibility for state pensions
  - Cuts in central government operating expenses.
  - Generalised subsidies in healthcare and education were removed in favour of targeted subsidies, saving 0.5% of GDP and encouraging compliance.
- **The Fiscal Responsibility Act (FRA)** in 1994 set out a series of management, targeting/objectives, and reporting principles for responsible fiscal management.
- NZ$19.2bn raised from sale of government assets and businesses between 1987 and 1999

OUTCOMES

Effect on public finances

- New Zealand's reform efforts have improved its fiscal position dramatically; it shifted from a deficit of 5% of GDP in 1992 to a surplus of 3% of GDP in 1995. The ratio of public debt to GDP fell from 58% to 38%.

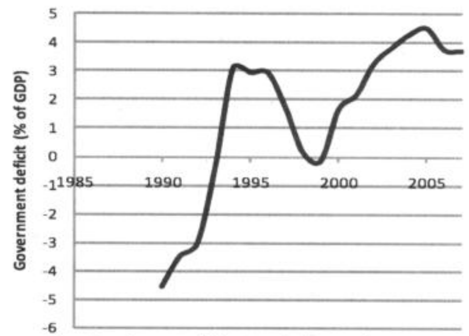
Effect on public services:

- More private led investment in healthcare and social housing

KEY LESSONS

Dramatic improvement in fiscal position through a comprehensive package of expenditure reform.

1 New Zealand Treasury



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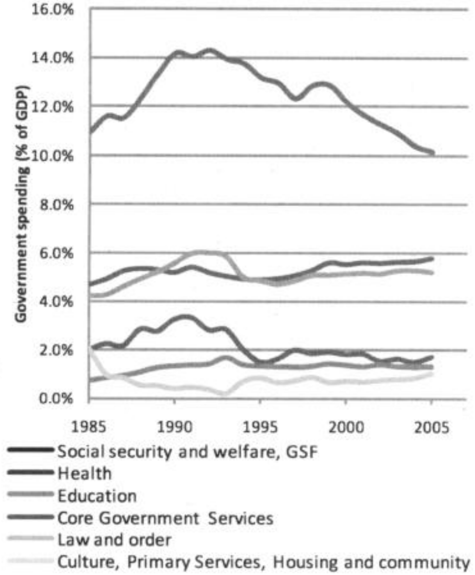


Fig 2: Government spending by category (% of GDP)

Source: OECD and New Zealand Treasury

Iceland 1989-1996

BACKGROUND

Major fiscal imbalances emerged in the late 1980s, to some extent reflecting weak economic activity; the expenditure ratio reached 42% of GDP and the budget moved into substantial deficit[1]

SCOPE AND COMPOSITION OF PROGRAMME

- Budget consolidation efforts in the 1990s concentrated on social security benefits and subsidies, while government spending on goods and services were less effected.
- Changes were also made to the budget process to enhance the control and effectiveness of public spending. Expenditure ceilings for each ministry introduced in 1992 are thought to have contributed to the improvement in the fiscal situation.
- Privatisation programmes also helped reduce gross debt.

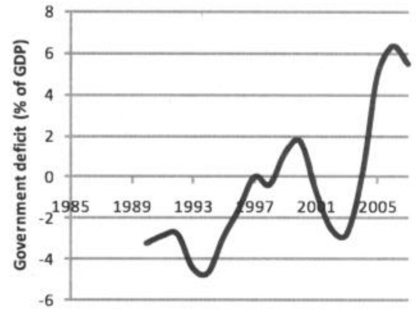
OUTCOMES

- Budget consolidation efforts and public sector reforms temporarily reversed the upward trend in public expenditure in the mid 1990, with the deficit eliminated by 1997. However, it began to increase again in the late 1990s, mostly due to discretionary action.

KEY LESSONS

Measures were insufficient to sustainably reduce the deficit. There is a need for further reform to enhance public spending control[3]

1 Suppanz, 2003
2 Ibid.
3 OECD (2003)



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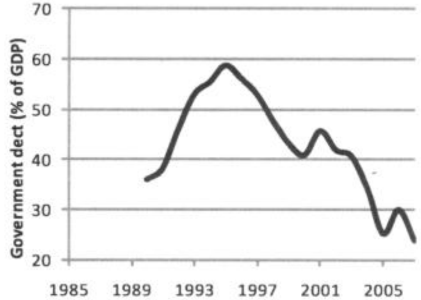

Fig 2:Government debt (% of GDP)

Fig 3: Subsidies (% of GDP)

Source: OECD and Suppanz, 2003

International examples: Summary table

Case Study		Reduction in primary expenditure (% of GDP)[1]	Main areas of cuts	Other complementary measures	
Country	Period of fiscal consolidation			Institutional reform	Structural reform
Finland	1993-2000	14%	Public employment, transfers and subsidies, health, education	✓	▪Labour market incentives ▪Taxation ▪Privatisation
Sweden	1993-2000	14%	Public employment, central government operations, transfers and subsidies	✓	▪Labour market incentives ▪Taxation ▪Privatisation
Ireland	1982-1989	12.4%	Public employment, transfers, health.	✓	▪Labour market incentives ▪Taxation ▪Privatisation
Belgium	1983-1990	12.3%	Public employment, transfers and subsidies, public investment		▪Labour market incentives
Canada	1992-1999	9.5%	Public employment, transfers and subsidies, education, health	✓	▪Labour market incentives ▪Taxation ▪Privatisation
Netherlands 1990s	1993-2000	7.5%	Public employment, transfers and subsidies, defence	✓	▪Labour market incentives ▪Taxation ▪Privatisation
Spain	1993-2000	6.4%	Transfers, public sector employment	✓	▪Labour market incentives ▪Taxation ▪Privatisation
New Zealand	1993-2000	3.8%	Transfer, subsidies, central government operations, health	✓	▪Privatisation
Iceland	1989-1996	3%	Benefits and subsidies	✓	▪Privatisation

1 Data from Hauptmeier et al, 2006 and OECD

Contents

Emerging Themes

Each expenditure consolidation experience is unique:

- Every expenditure consolidation is unique and heavily dependent on the political and economic context. Therefore the composition and effects of consolidation programmes differ from country to country and over time.
- However, there are some common themes which emerge from these examples and the literature.

The following slides summarise the emerging themes and key findings including:

1. The context of large spending consolidations
2. The composition of spending consolidations
3. The outcomes of consolidation on public finances, the economy and public services
4. Factors important for the success of spending consolidations

Emerging Themes:
(1) The context of large spending consolidations

a) Crisis situations:

- It appears that ambitious consolidation programmes have been mainly implemented in the context of recession or economic crisis where there was extra ordinary fiscal stress[1].
- Fiscal crises present strong opportunities to undertake lasting reform with positive impacts on long-term fiscal sustainability (e.g. addressing pension reform, demographic changes, etc).

b) Maastricht convergence process

- A number of consolidation programmes also took place in the context of the Maastricht convergence process (see Annex C).

1 This is supported by the literature (e.g. Wagschal and Wenzelburger, 2008)

Emerging Themes:
(2.a) The composition of spending consolidations

a) Areas often cut:

- Efforts are often focused on[1] :
  - The reduction of public sector employment (e.g. wage restraint and workforce cuts)
  - Social transfers (e.g. through tighter benefit entitlement criteria and reduced benefit levels)
  - Subsidies
  - Defence [2]
- In some cases, large programmes (e.g. healthcare) are often targeted as this is where the largest cuts can be made[3]
- It is interesting to note that preventative spend is often cut (e.g. social services), which can have long term effects.

b) Areas protected:

- Education spending and public investment tends to be protected in the consolidation process. Health expenditures often continue to rise (e.g. Netherlands).

c) Expenditure reform was always part of a broader reform agenda:

- These often include revenue raising measures, labour market reforms, tax reform and privatisation.
- Many feature a significant strengthening of national and sub-national budgetary procedures and institutions. Including, expenditure ceilings and the introduction of multi-year budget planning
- The literature suggests that the beneficial effects of expenditure reform can be reinforced if they are conducted as part of a comprehensive reform programme where macroeconomic or structural bottlenecks elsewhere in the economy are eliminated at the same time.[4]

1 *This is supported by the literature (Hauptmeier et al, 2006 , Bouthevillian, 2006 and Schuknecht & Tanzi, 2005)*
2 *This fall in defence spending up to the late 1990s can mainly be attributed to the 'peace dividend'*
3 *Timonen, 2001*
4 *Hauptmeier et al 2006, Tanzi and Schuknecht 2000 and 2003.*

Emerging Themes:
(2.b) Dividing lines between successful and unsuccessful consolidations

- Some of the literature suggests that in successful consolidations, almost all of the reduction (around 80%) comes from expenditure cuts. In unsuccessful consolidations expenditure reduction accounts for 22%;
- In unsuccessful consolidations the ratio of tax increases to expenditure cuts is greater than 3:1. In successful consolidations, tax revenue accounts for 16% of the reduction.

Composition of Expenditure Reductions (% of GDP) in successful and unsuccessful consolidations

	Exp. Reduction	Public Investment	Transfers	Non-Wage Gov Consumption	Gov Wages	Subsidies
Successful consolidations	-2.193	-0.41	-0.54	-0.38	-0.58	-0.29
Unsuccessful consolidations	-0.49	-0.26	-0.02	-0.09	-0.07	-0.08

Composition of revenues (% of GDP) in successful and unsuccessful consolidations

	Revenue Increase	Direct taxes (household)	Direct Taxes (business)	Indirect taxes	Soc Sec Taxes
Successful consolidations	0.44	-0.14	0.53	0.17	-0.14
Unsuccessful consolidations	1.28	0.44	0.20	0.43	0.17

Cuts in government wages and employment have previously been important components of serious fiscal consolidations

Source: Alessina and Perotti (1995)

Emerging Themes:
(3) Outcomes of spending consolidations (i)

a) **Large expenditure consolidations led to dramatic improvements in fiscal positions:**

- Each case study observed a large improvement in the fiscal balance and a reduction in the level of public debt
- Smaller and less comprehensive spending packages (e.g. Iceland, Netherlands 1983-1990 and Belgium) often were insufficient to put public finances on a sustainable path and further consolidation was required.

b) **Public expenditure can be consolidated without adversely impacting the economy:**

- A number of the case studies demonstrate that expenditure consolidations do not need to be contractionary (for example, Ireland[1] and Canada). Most of the countries experienced strengthening economic growth during and following the consolidation phase.
- These 'non keynesian' effects of consolidation are discussed widely in the literature[2]. It is explained that increased fiscal credibility can counterbalance fiscal drag, therefore credible and decisive fiscal consolidations can have limited contractionary effects, or even none at all.

c) **Transparency is a key driver of success:**

- Evidence shows that raised public awareness of budgetary challenges can reduce resistance to change. For example, the Canadian government provided strong leadership and took considerable steps to publicise its actions to generate public understanding throughout the process.

d) **Ambition and sustained impact are key drivers of success:**

- Whilst there is a tautology in identifying these as drivers of success when they are so closely related to the criteria for success, fiscal consolidation was more successful at reducing the budget deficit in countries with ambitious and comprehensive packages of reform. Expenditure reforms showed quick results in improving deficit figures, with greater scope to reverse adverse debt dynamics and significantly reduce public debt ratios. Large scale reforms tend to be introduced in a single stroke to demonstrate the consistency of the overall project, build credibility and may encourage private agents to prepare for a future decline in the tax burden (for example Sweden, Finland).

1 *The fiscal consolidation experience of Ireland in the mid-80s caused acceleration of growth just after the government put in place measures that drastically reduced budget deficits*
2 *For example, Alensa et all (1998, 1999), Giavazzi, F and M, Pagano (1990), Briotti, (2005)*

Emerging Themes:
(3) Outcomes of spending consolidations (ii)

d) **Effects on public services:**

- Spending consolidations are often noted as being reflected more in efficiency gains than in significant cuts to the quality or quantity of services[1]. For example, an increase in integrated services and collaboration across departments and agencies was observed in the cases of Sweden and Canada.
- There is a lot of evidence in the literature that ambitious expenditure reform as part of a comprehensive package coincides with little cost, if any, to social indicators[2].
- Afonso (2002) presents an index of overall public sector performance in 1990 and 2000. Of the case studies analysed which experienced dramatic expenditure consolidation in the 1990s, a mixed picture emerges of the change in public sector performance; Finland, Sweden and Iceland saw a decrease in overall public sector performance whilst, Canada, Netherlands, New Zealand and Spain saw it increase.
- However, **it is difficult to disaggregate overall improvements in long-term outcomes for public services (for example mortality/cancer rates) from changes to expenditure/investment levels.** Factors such as new technologies and improved performance management also impact outcomes. In some areas outputs such as user satisfaction declined (healthcare in Sweden) and further work is required to assess the overall impact of consolidation on public service outcomes, which may be highly context specific.

1 *This is supported by the literature. For example, Hemmings et al, 2003*
2 *Hauptmeier et al 2006, Tanzi and Schuknecht 2000 and 2003, Afonso et al., 2005*

Emerging Themes:
(4) Factors important for successful spending consolidation

[redacted]

Contents

Scope for further work

Evidential difficulties:

- Data of spending on different public services is limited. This data would have allowed further quantitative analysis.
- Analysis of the effects of spending consolidations on public services was constrained as:
  - There is very little literature or data available on public service outcomes. Most measures of public service outcomes (e.g. WHO, OECD PISA indicators, Unensco) begin in the 1990s. Therefore it is impossible to observe any changes in trend outcomes resulting from spending consolidations in the 1980s and 1990s.
  - Even where data is available, it is difficult to disentangle the complex factors leading to public service outcomes and to isolate the effects of the spending cuts. In addition, public service provision and quality has many dimensions and it is hard to find an accurate measure of outcomes.

Scope for further work:

- Examining further examples of spending consolidations.
- Looking at current and planned spending consolidations efforts around the globe (e.g. Latvia, France, US)
- Interviews could be conducted with international experts on public services and spending consolidations. For example, with officials at the relevant Finance Ministries or the OECD (GEP have already conducted interviews with Swedish and Finnish officials).
- Strengthen the performance management framework to better demonstrate the link between expenditure, inputs, outputs and outcomes and provide a stronger basis for VfM calculations in public services (PMDU are currently scoping up some work along these lines).

Next steps

[redacted]

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Annex A: Expenditure consolidation episodes in OECD Countries from 1980

Country	Period of expednditure consolidation[1]	Primary expenditure reduction (% of GDP)[2]
Finland	1993-2000	14
Sweden	1993-2000	14
Ireland	1982-1989	12.4
Belgium	1983-1990	12.3
Canada	1992-1999	9.5
United Kingdom	1981-1988	8.2
Netherlands	1993-2000	7.5
United Kingdom	1992-1999	7.2
Spian	1993-2000	6.4
Ireland	1992-1999	6.2
Luxenberg	1981-1988	5.7
Netherlands	1983-1990	5.1
Austria	1993-2000	4.3
Denmark	1993-2000	3.9
New Zealand	1985-1992	3.8
United States	1992-1999	3.4
Iceland	1989-1996	3
Italy	1993-2000	3
Japan	1998-2005	2.7
Belgium	1993-2000	2.1
Germany	1996-2003	0.6
France	1996-2003	0.5
Switzerland	1998-2005	0.3

Source: Hauptmeier et al., 2006 and OECD Data

Ambitious reform (primary expenditure reduction of >5% of GDP within 7 years of maximum

Timid reform (primary expenditure reduction of between 3% and 5% of GDP within 7 years of maximum

1 Seven year period from total expenditure peak of each country. Seven years is chosen as it is broadly the duration of observed reform 'waves' and adjustment fades out around this date. It also roughly corresponds to the length of many business cycles. (so that cyclical adjustments of expenditure developments become less important).

2 Total expenditure net of debt servicing costs

Annex B: Canadian Program Review Tests:

1. **Public interest test:** Does the program of activity continue to serve public interest?
2. **Role of government test:** Is there a legitimate and necessary role for the government in this programme?
3. **Federalism test:** Is the current role of the federal government in the programme a candidate for realignment with the provinces.
4. **Partnership test:** What activities or programmes should or could be transferred in whole or in part to the private or voluntary sectors
5. **Efficiency test:** If the programme or activity continues how could its efficiency be improved?
6. **Affordability test:** Is the resultant package of programmes and activities affordable within fiscal restraint and, if not what programmes of activities should be abandoned?

Annex C: Conditions for accession to the EMU in 1990s

Background to fiscal consolidation
All EU member states had to conform to the terms set out in Treaty of Maastricht in order to join the EMU. According to the Treaty, member states (amongst other criteria) must have a government deficit not exceeding 3% of GDP and public debt must be below 60% GDP by 1999.

Fiscal consolidation programmes

- At the beginning of the 1990s, most EU countries had sizeable imbalances in their public finances. From 1991 to 1997 extensive consolidations were required by many states to comply with Maastricht criteria.
- For most member state, the general government deficit was pushed down by increasing revenues. This was primarily achieved by active job creation and promotion policies. These polices had two effects: rising employment caused welfare payments to decrease, and led to an increase in income tax receipts.
- Revenue created through privatisation and the sale of government assets was used to reduce general government debt, thus reducing interest payments. This had a significant impact on the most indebted countries. Reducing interest payments also meant government deficits could be greatly reduced without cutting costs elsewhere.
- A number of countries (e.g. Finland, Sweden, Denmark and Ireland) dramatically reduced social transfers. It should be noted that the reduction of social transfers did not result in a reduction in consumption – in most member states consumption increased following a period of consolidation
- Government administration was also streamlined in most countries. Often the rate of growth of government expenditure was reduced rather than expenditure itself.

Annex D: Definitions

Public finances:	
Budget Deficit/Fiscal balance	The yearly excess of government expenditures over revenues
Primary balance	Fiscal balance net of debt servicing costs. This is a good indicator of discretionary fiscal policy
Cyclically adjustment balance	Fiscal balance adjusted for short term fluctuations of actual GDP around the productive potential of the economy. The estimate provides a picture of the underlying trend fiscal position and an indication of the effects of policy decisions.
Public/government debt	Deficits accumulated over the years
Government spending:	
Total expenditure	= Transfers +Government consumptions + Public Investment + Subsides + debt servicing
Primary expenditure	Total expenditure net of debt servicing costs
Social spending	Transfers linked to healthcare, pensions and low income support
Government current expenditure	Public sector employment, wages
Government consumption	Government spending on goods and services
Government Transfers	Benefits in kind and subsidies to people. Includes social security benefits, social assistance grants, unfounded employee pension and welfare benefits, transfers to the rest of the world and non-profit institutions
Government subsidies	Subsidies to private industries and public corporations
Public Investment	Government gross fixed capital formation