COMMITTEE FOR A RESPONSIBLE FEDERAL BUDGET Fiscal Roadmap Project

Deficit Reduction: Lessons From Around the World
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"[E]ven as important steps have been taken to address the recession and the intense threats to financial stability, maintaining the confidence of the public and financial markets requires that policymakers begin planning now for the restoration of fiscal balance. Prompt attention to questions of fiscal sustainability is particularly critical because of the coming budgetary and economic challenges associated with the retirement of the baby-boom generation and continued increases in the costs of Medicare and Medicaid."
- Ben S. Bernanke, Chairman, Federal Reserve Board, July 2009[1]

Countries must run sustainable fiscal policies. If government programs cannot reasonably be paid for out of a country's economic and financial resources over time, that country will be forced to change course. In the worst case, a fiscal crisis will occur.

Over the past 30 years, many countries have adopted deficit reduction strategies (also known as fiscal consolidation strategies) to improve their fiscal positions. As the United States grapples with its own unsustainable fiscal position, there are a number of lessons it can take from the experiences of other countries.

Lesson 1: Countries with weak fiscal credibility should establish a deficit reduction (fiscal consolidation) plan.

Lesson 2: The announcement of a credible deficit reduction plan can have positive effects on consumers, businesses, and financial markets.

Lesson 3: The most successful plans have involved large, multiyear adjustments, but the composition of the plans has varied.

Lesson 4: A fiscal consolidation plan should be phased in gradually.

Lesson 5: A crisis can make it easier to adopt fiscal consolidation.

Lesson 6: It is preferable to make fiscal adjustments on your own terms before they are forced upon you by creditors.

How Is the U.S. Doing?

In terms of fiscal sustainability, the United States is not doing well. The economic and financial crisis has made the U.S. medium-term fiscal outlook precarious — even before aging and health-related problems worsen the situation. Without policy changes, public debt is estimated to grow from around 55 percent of Gross Domestic Product (GDP) today to 87 percent by 2020. By then, public debt will be larger relative to the size of the economy than at any time since shortly after World War II. Without significant adjustment, debt is projected to continue heading upward, hitting 181 percent of GDP in 2035. Countries have not been able to finance debts of this magnitude for long without negative consequences, particularly if domestic savings fall short. The International Monetary Fund recently called the U.S. situation "unsustainable."[2]

Creditors of the U.S. are understandably nervous about the country's projected debt path. Domestic bondholders and foreign creditors have increasingly expressed concern over the U.S. fiscal situation. As the economy heads toward full employment in the next few years, we can expect to see our creditors demand a risk premium in the form of higher long-term interest rates, reflecting their worries that we will inflate our way out of debt or even — in the very worst case — default.

The trick will be for policymakers to take steps now to put future U.S. fiscal policy on more sustainable footing without jeopardizing the economic recovery, despite economic and financial weakness that may well continue for awhile.

Lessons from Other Countries

The circumstances facing the United States, while unprecedented in our fiscal history, are not unique. Most countries faced with deteriorating fiscal positions have adopted *fiscal consolidation strategies*—plans to reduce the deficit and at a minimum stabilize the debt relative to GDP—to improve their fiscal positions and avoid a fiscal crisis. What lessons can we learn from other countries' experiences?

Lesson 1: Countries with weak fiscal credibility should establish a deficit reduction (fiscal consolidation) plan.

Creditors and taxpayers must have confidence in a country's fiscal management in order to continue financing public expenditures. Facing a deteriorating fiscal position, a government must reestablish its fiscal credibility credentials by adopting a serious deficit reduction plan. Otherwise, the country cannot sustain its fiscal program and will be punished by the financial markets.

Over the past 30 years, many countries have adopted fiscal consolidation plans as a standard remedy to put their public finances on a sustainable fiscal path. Countries have often taken steps preemptively to avoid a full-blown fiscal crisis. In other cases, countries have made adjustments in

[1] Ben S. Bernanke, Chairman, Federal Reserve Board of Governors, "Semi-Annual Monetary Policy Report to Congress," testimony, Committee on Financial Services, U.S. House of Representatives, July 21, 2009, p.2, http://federalreserve.gov/newsevents/testimony/bernanke20090721a.htm.

[2] International Monetary Fund (IMF), "United States: Staff Report for the 2009 Article IV Consultation," July 9, 2009, p.34, http://www.imf.org/external/pubs/ft/scr/2009/cr09228.pdf.

the midst of a crisis. In the 1990s, many countries pursued fiscal consolidation strategies to shift resources to the private sector and make their economies more competitive. European countries also undertook fiscal consolidation in order to be members of the new euro currency area.

Deficit reduction, or fiscal consolidation, has important benefits. By getting its finances in better order, a country is making sure that it can sustain its fiscal policies down the road. Second, by adopting a serious plan to reduce its borrowing needs and debt service, a government is reassuring creditors and taxpayers in a transparent manner that it is prudently managing its fiscal house. If a government does not have fiscal management credibility, the country will not be able to continue its fiscal program because its creditors will refuse to continue lending or will demand a higher risk premium. Third, by following a more sustainable fiscal path, a country can create *fiscal space*, which provides room for maneuver to address future economic and financial shocks and to fund new priorities (for example, health care and infrastructure modernization).

Successful fiscal consolidation has usually been followed by periods of strong growth; and many of the fiscal consolidation plans were initiated during recessions or early stages of recovery.[3]

Lesson 2: The announcement of a credible deficit reduction plan can have positive effects on consumers, businesses, and financial markets.

The announcement of a credible fiscal consolidation plan can lead to a shift in the expectations of key economic and financial players. This shift, in turn, can have a positive impact on the economy. If credible, the plan will help manage medium-term expectations of creditors, which will keep down financing costs by reducing risk premiums demanded in the form of higher long-term interest rates.[4]

The importance of expectations in successful fiscal consolidations can be seen, for example, in the cases of Denmark (1983–86) and Ireland (1987–89). Contrary to conventional wisdom, their large adjustments (expected to be contractionary in the short-run) had positive effects on the economy. Their experiences set in motion a new body of research on "expansionary fiscal contractions or stabilizations". Other countries have had similar experiences. In 1996, when Sweden faced a cyclical downturn, it turned to new deficit reduction measures, which had an expansionary impact on the economy through a boost in confidence. Similar effects were seen in Finland around the same time.

As the Danish, Irish, Swedish, and Finnish experiences illustrate, announcement and adoption of a credible consolidation plan can lower the risk premium on government debt instruments demanded by creditors, boost investment through lower interest rates, and/or have a positive wealth effect as lifetime tax expectations are lowered by the perception of diminished financing needs. Effects are

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[3] Manmohan S. Kumar, Daniel Leigh, and Alexander Plekhanov, IMF, "Fiscal Adjustments: Determinants and Macroeconomic Consequences," *IMF Working Paper*, WP/07/178, July 2007, p.28, http://www.imf.org/external/pubs/ft/wp/2007/wp07178.pdf.

[4] Angel Gurria, Secretary General, Organization for Economic Cooperation and Development (OECD), "Economic Outlook No. 85," press conference, June 24, 2009, p.4, http://www.oecd.org/dataoecd/41/33/35755962.pdf.

particularly pronounced for countries with substantial fiscal problems. Large fiscal contractions can be expansionary "because they signal a permanent and decisive change in the stance of fiscal policy."[5]

Lesson 3: The most successful plans have involved large, multiyear adjustments, but the composition of the plans has varied.

Fiscal consolidation plans have come in many shapes and sizes. The size, duration and composition have varied enormously, depending on a country's particular situation. With regard to size, many deficit reduction plans have involved small adjustments, although surveys have identified more than 300 episodes of "large" fiscal consolidations (adjustment above 5 percent of GDP) in both developed and developing countries over the past 30 years.[6] Countries with large consolidations include: Sweden in the 1990s (17 percent of GDP); Greece in the 1990s (12 percent of GDP); Canada in the 1990s (8 percent of GDP); and Portugal in the 1980s (8.5 percent of GDP). Of the large adjustments, roughly half lasted one to two years and half lasted longer. Among the most successful consolidations were those in Denmark (a four-year program), Sweden and Finland (respectively, seven and nine years). Most plans have included both tax and spending provisions.

Factors regarded as critical to the success of fiscal consolidation are: the size of adjustment (larger adjustments have had a more positive impact); the duration (particularly successful adjustments have been multiyear); composition (spending cuts have tended to provide the most durable deficit reduction and to increase the likelihood of a positive macroeconomic impact, but tax changes have often played an important role); and the state of public finances (the worse the situation, the more likely effects will be positive); and whether a country is high tax or high spending.

Many experts have also found that deficit reduction is more likely to be sustained when politically sensitive areas including transfers and subsidies are tackled. For example, important components of consolidations in Canada and Sweden involved lasting reforms in their social security systems. They were put on a sound financial basis and their financial integrity was guarded by automatic triggers. Experts also agree that fiscal improvements can be achieved through the adoption of tax and spending policies to boost long-term growth, but views on the best policies and policy mix vary. Fiscal rules and institutions can provide additional fiscal discipline, which could be particularly useful if "consolidation fatigue" sets in during a multiyear adjustment program.

Non-budget factors considered important include the state of the domestic and global economies, the monetary policy stance, and exchange rate policy. Experiences have shown that adopting and implementing fiscal consolidation during an economic recovery increased the likelihood that deficit reduction would have a positive economic impact. In many of the most successful fiscal consolidations, deficit reduction shifted resources to a recovering private sector as demand picked up. At the same time, greater investor confidence in fiscal management resulted in lower interest

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[5] Giuseppe Bertola and Allan Drazen, "Trigger Points and Budget Cuts: Explaining the Effects of Fiscal Austerity," in American Economic Association, *American Economic Review*, 1993, quoted in Alberto Alesina and Roberto Perotti, IMF, "Fiscal Adjustments in OECD Countries – Composition and Macroeconomic Effects," *IMF Working Paper*, WP/96/70, p.4.

[6] George C. Tsibouris, Mark A. Horton, Mark J. Flanagan, and Wojciech S. Maliszewski, IMF, "Experience with Large Fiscal Adjustments," IMF, *Occasional Paper 246*, Abstract, 2006, p.1, https://www.imf.org/external/pubs/nft/op/246/op246.pdf.

rates, which reinforced the recovery. A supportive global economy and appropriate exchange rate have also been important, but we may not be able to count on the global environment this time. Most countries will be consolidating their fiscal, monetary and financial positions at the same time – which has never happened before. The sequencing of exit strategies may be crucial.

Fig. 1: Fiscal Consolidation Success Stories

The most relevant models for the United States are the countries that have undertaken large, multiyear fiscal consolidations — particularly industrial countries whose economies and financial structures are similar and which are considered fiscal consolidation success stories. Certain countries are often singled out as success stories because they experienced fiscal adjustment that was larger and lasted longer than the median average. Several notable examples also had above average growth and adopted consolidation plans during a recession.

Denmark (1983–86): Public debt exploded in the early 1980s from 29 percent of GDP to 65 percent when stimulus measures were adopted during the global recession. High interest rate costs made the situation even more difficult. The government turned to severe fiscal retrenchment (the usual recipe of tax hikes and spending cuts) when a credit ratings agency put a credit watch on its external debt (normally AAA) and the public became worried about fiscal sustainability. Four years after fiscal consolidation began, the primary budget position improved by over 15 percent of GDP and the debt/GDP ratio declined. Despite a very large fiscal contraction, real GDP rose by an annual average of 3.6 percent during the consolidation period.

Ireland (1982–84, 1986–89): Like that of most other European countries, Ireland's fiscal position had deteriorated sharply by the early 1980s as a result of running large deficits. In 1981, Ireland faced a debt/GDP ratio of 87 percent and debt service required 8.3 percent of GDP. After an initial attempt at consolidation failed (the economy did not improve and political support was lost), a second try later in the decade via a tough austerity program of spending cuts and tax base widening (marginal tax rates fell slightly) accompanied by a sharp devaluation resulted in a large reduction in the deficit and debt/GDP ratio.

Finland (1992–2000): Following a major banking crisis, Finland faced large deficits (around 8 percent of GDP) and a rapidly rising debt (58 percent of GDP). Prior to the crisis, Finland was running surpluses of around 6 percent of GDP. Motivated by strong political support to get its house in order to qualify for eurozone participation and by the need to address external financing concerns, the government pursued a fiscal consolidation program. A medium-term budget framework, entitlement reforms, spending cuts and tax reform were part of the program. By 2000, the debt/GDP ratio was under 45 percent. The cyclically adjusted primary fiscal balance improved cumulatively by 10 percent of GDP from 1992.

Spain (1993–97): Spain's fiscal position had been deteriorating since the late 1980s. By 1995, its fiscal deficit exceeded 7 percent of GDP. Its public debt exceeded 70 percent of GDP. Facing external financing concerns and strong public support to adopt fiscal disciplinary measures to prepare for euro area membership, the government adopted a fiscal consolidation plan that emphasized spending (including cuts in social transfers, government wages and health care spending) but also included tax reform. Fiscal balances improved, cumulatively by around 4 percent of GDP since 1993.

Sweden (1994–2000): Sweden's fiscal situation deteriorated severely in the early 1990s as a result of a banking and economic crisis. In the midst of a recession, the government adopted a fiscal consolidation program to achieve fiscal balance through a tightening up on household transfer payments and an increase in various taxes. As a result of its fiscal consolidation efforts, the fiscal position shifted from a deficit of over 11 percent of GDP to a surplus of 5 percent of GDP and the debt/GDP ratio was reduced from 72 percent to 55 percent in 2000.

Sources include: Kumar et al, IMF, op.cit; Jens Henriksson, "Ten Lessons About Budget Consolidation," Bruegel Essay and Lecture Series, 2007, http://www.scribd.com/doc/2931923/Jens-Henriksson-Ten-lessons-about-budget-consolidation-Bru; IMF, Fiscal Affairs Department, "The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis", March 6, 2009, p.42, http://www.imf.org/external/np/pp/eng/2009/030609.pdf; OECD, "Fiscal Consolidation: Lessons from Past Experience," *OECD Economic Outlook*, No.81, June 2007, http://www.oecd.org/dataoecd/21/33/38628499.pdf.

Lesson 4: A fiscal consolidation plan should be phased in gradually.

In countries undertaking large fiscal adjustments, more gradual implementation has often led to better macroeconomic effects.[7] A gradual phase-in also allows for more orderly adjustment, which is particularly important politically and economically when the amount of adjustment required is large.

A multiyear program presented as part of a medium-term framework can enhance policy credibility by increasing fiscal discipline, transparency and certainty. To accomplish this, the IMF recommends that a government sets targets over four to five years and defines policy steps that will achieve them.[8] A medium-term fiscal program can also help policymakers adhere to an appropriate fiscal path and stay out of "trouble". For example, in the case of Sweden, when the government's finances had improved after the adoption of a fiscal program, a medium-term target (a surplus of 2 percent of GDP over the business cycle) was announced "to avoid getting into problems again."[9]

In current circumstances, the question of timing is also critical. More specifically, should fiscal consolidation be delayed in the United States due to weak economic conditions? Normally, a delay in adjustment is not regarded as good policy. Simply as a financial matter, delay increases the debt – and therefore the cost to the public – through higher debt service. As a result, the fiscal adjustment required down the road will be larger. Moreover, in some circumstances, a fiscal crisis may require immediate and dramatic adjustment (a "cold shower") to restore short-term financing. Denmark, Ireland, Sweden, and Finland, for example, faced immediate pressures from the withdrawal of external credit. Under current conditions, however, it makes no sense to withdraw aggregate demand until the economy is stronger. Economic growth and the financial sector are expected to be weak for the next few years as recovery takes hold. As the "1937 lesson" of the Great Depression in the United States illustrates, fiscal and monetary policy can be tightened too soon following a financial crisis-induced downturn.

Concern over the recovery does not however mean that policy changes cannot be announced in advance. *Today, the United States could announce fiscal consolidation measures that would not take effect immediately. Such changes would have no immediate effect on aggregate demand, but would have a salutary effect on investor expectations and would give citizens time to plan for the future.*

Lesson 5: A crisis can make it easier to adopt fiscal consolidation.

According to experts surveying fiscal consolidation episodes, "[T]he worse the public finance situation, the higher the probability of implementing a lasting fiscal correction."[10] Their explanation is that the public is more likely to see the benefits of responsible fiscal policy and support a tough

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[7] Tsibouris et al, op.cit., p.1.

[8] IMF, Fiscal Affairs Department, "Fiscal Implications of the Global Economic and Financial Crisis,"*Staff Position Note*, SPN/09/13, June 9, 2009, pp.41-43, http://www.imf.org/external/pubs/ft/spn/2009/spn0913.pdf.

[9] Henriksson, op.cit., p.16.

[10] Martin Larch and Alessandro Turrini, "Received wisdom and beyond: Lessons from fiscal consolidation in the EU," European Commission, Directorate-General for Economic and Financial Affairs, Ec*onomic Papers 320*, April 2008, p.16, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1284378.

program when times are obviously precarious. Similarly, IMF experts report that "[t]imes of crisis in the past provided opportunities for enacting politically difficult reforms."[11]

Contrary to conventional wisdom, fiscal consolidation (deficit reduction) can be politically popular in certain circumstances. In Denmark, public support for the government's fiscal consolidation program was galvanized by concern that Denmark's credit rating in global financial markets would be downgraded after a leading credit ratings agency issued a warning. In Ireland, when the first attempt at fiscal consolidation failed, the government was thrown out. The party returned to power several years later on a fiscal austerity platform even though the economic and fiscal situation had worsened. Public support for fiscal consolidation in Sweden and Finland was related to widespread perception of a crisis and the need for a solution.

Lesson 6: It is preferable to make fiscal adjustments on your own terms before they are forced upon you by creditors.

Full-blown fiscal crises have typically been experienced by developing rather than developed nations, as developing countries usually have less margin to maneuver fiscally and financially. Fiscal policy mistakes in developing countries cannot be sustained. Because they are more dependent on external financing (primarily short-term capital as creditors seek to minimize risk), developing countries are usually more vulnerable to capital flight. Industrial countries are not immune, however. In an example commonly cited, when France stimulated fiscal policy to fight the global downturn of the 1980s (the opposite policy taken by its EU currency system partners), its creditors attacked the currency and the government was forced to devalue twice. It then reversed course to adopt a fiscal austerity program. In the 1980s, many top experts had expected that creditors would stop financing the "large" twin budget and current account deficits of the United States, and that it would face a stabilization crisis and draconian contraction ("hard landing") as a result.[12]

Whether faced by a developed or a developing country, the classic fiscal-related stabilization crisis has occurred as investors fled a country in the face of debt sustainability challenges and solvency concerns, with fears of hyperinflation or even default prospects. In response, the government has usually taken a "cold shower" approach: it has raised interest rates sharply to defend the currency and undertaken rapid fiscal consolidation through often very large tax increases and/or sharp government spending cuts to stabilize the fiscal position. These steps have resulted in large output losses and hardships for citizens. It has also taken a long time to rebuild investor confidence so that external financing will return. It is better to avoid this situation.

Conclusion

Coming out of the economic and financial crisis with a sharp deterioration in its public finances, the United States needs a fiscal recovery plan to get its finances in order to unwind debt burdens before the long-term pressures (aging and health care) hit the budget full force. As examples from other

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[11] IMF, SPN/09/13, op.cit., p.45. A similar view is expressed in Kumar et al, op. cit., p.4.

[12] Stephen Marris, *Deficits and the Dollar: The World Economy at Risk*, Washington, DC: Institute for International Economics, 1985.

countries suggest, the adoption of a fiscal consolidation plan is important — and necessary. A multiyear deficit reduction program would allow citizens and creditors to adjust gradually and would provide a disciplinary framework to achieve the goal of more sensible government finances. Although it should not be implemented until the economy is on stronger footing, agreement on and announcement of a credible fiscal consolidation plan would help encourage the recovery now by reducing the fears of inflation or currency instability. In the absence of a plan, creditors will eventually begin to demand higher interest rates on their lending, which could slow or even choke off the recovery.

Federal Reserve Board Chairman Bernanke recently warned, "Unless we demonstrate a strong commitment to fiscal sustainability, we risk having neither financial stability nor durable economic growth."[13] He also advised: "Agreeing on a sustainable long-run fiscal path now could yield considerable near-term economic benefits in the face of lower long-term interest rates and increased consumer and business confidence."[14] The recovery needs all the help it can get.

The administration, too, has recognized that fiscal consolidation is necessary, but has not yet proposed the serious steps needed. According to the IMF, in its most recent consultations with U.S. policymakers, the administration affirmed its commitment to widely accepted medium-term fiscal discipline goals: stabilizing the debt beginning in early 2012; reducing the deficit to 3 percent of GDP over the medium-run; and tackling social security once health care reform is accomplished.[15] However, these commitments are not reflected in its budget proposals: the fiscal deficit/GDP ratio would come down from record highs but would remain around 4 percent of GDP – not 3 percent – for the next 10 years; the debt/GDP ratio would continue to rise; and social security reform is not proposed.[16] According to the IMF, the current crisis has left us with unsustainable fiscal imbalances which need to be addressed.[17]

Looking ahead for the United States, in the absence of fiscal adjustment, creditors can be expected to demand an increasing risk premium for holding government debt as recovery takes hold and the economy approaches full employment. As our fiscal position deteriorates, at some point the risk premium will be insufficient to induce creditors to invest in our government instruments. This point could occur if inflation accelerates, fears over debt default rises, or financial instruments elsewhere look more appealing, leading investors to shift their funds out of the country.

It is not too early to plan for the future. In fact, it is critical that the United States get started now. Similar to what the Fed will be putting in place for monetary policy, we need a fiscal exit strategy. A fiscal consolidation plan to put the budget back on a sustainable path is a key component of both keeping the economic recovery on track and avoiding a future fiscal crisis.

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[13] Bernanke, op.cit., p.4.
[14] Ibid.
[15] IMF, op.cit., pp.35, 37.
[16] Office of Management and Budget, Table S-1, "Mid-Session Review, Budget of the U.S. Government, FY 2010," August 25, 2009, p.25, http://www.whitehouse.gov/omb/assets/fy2010_msr/10msr.pdf. In addition, the administration views health care reform as critical to long-run fiscal sustainability, but, in the absence of a final package, its fiscal significance is not clear.
[17] IMF, op.cit., p.34.