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Seppo Honkapohja 11 June 2010

**Fiscal consolidations: comments in the panel**
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Current concerns about public debt are a third stage in the global financial crisis. This is unsurprising development as many financial crises in history have three stages: banking and/or currency crisis, recession in the real economy, and public debt crisis. Public debt scenarios are usually done using so-called sustainability calculations. The sustainability computations show that successful consolidations of fiscal imbalances have two crucial parts. Turning primary public balance, i.e. balance between expenditure and revenues excluding interest payments, positive is one key step. Second, it is important to achieve a resumption of economic growth, preferably so that the growth rate of real GDP is higher than the average level of real interest on public debt that a country is paying.

The current fiscal situation is challenging in many countries, as shown by the computations in various reports. Major corrections in the fiscal balances need to be carried out. What is known about the costs and benefits of consolidation measures? There is a large literature estimating the effects of different types of fiscal consolidations.[1] The basic message from this literature is as follows.

Usually a fiscal consolidation has short run costs in terms of reduced growth and often a temporary worsening the public debt-to-GDP ratio. One message is that a consolidation should be relative large. It should also be persistent, i.e. last for several years. Initial conditions also matter – best chances for success are when the fiscal deficit is large and the public debt position is unsustainable in the long run. There are also composition effects and differences in effects between expenditure cuts and tax increases. I will not go into the details. In principle, one should adopt measures that have small fiscal multipliers as this minimizes the negative short-run effects.

Looking the long run, the effects of a fiscal consolidation are often positive. Growth may well speed up in the long run. To achieve this, a consolidation should primarily focus on expenditure cuts rather tax increases. The reason is that tax increases are often distortionary and can thus reduce economic growth. However, in reducing government expenditures one should avoid cuts in productive public spending, as such cuts can have negative effects on growth. Initial conditions of the economy also matter. Best success seems to be in a "difficult" initial situation, i.e. when the government sector is relatively large and the initial public debt-to-GDP ratio is relatively high.

[1] See for example, Alesine and Ardagna (2009), Fatas (2010), and IMF (2010).

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There are even situations with non-Keynesian short-run effects, in which the fiscal multipliers are negative and thus expenditure cuts are expansionary even in the short run. These possible Non-Keynesian effects operate through expectations about improvements in the future fiscal situation and also faster economic growth. The basic idea is that Non-Keynesian effects can arise when a country is in an unsustainable situation (expectations of a "mess" in the future) and the consolidation succeeds in changing these expectations.

Let me next look at a couple of examples of public debt dynamics after a financial crisis (slides 1-3). A key feature of a fiscal consolidation is that the actual process of debt reduction takes many years. The crises of Finland and Sweden, which erupted in 1991, involved major increases in public debt and it then took over ten years to reduce the debt-to-GDP ratios by 20-30 percent. Mexico 1994 is another example with smaller build-up of debt but it took five years to reduce the debt ratio to the pre-crisis level.[2]

Current discussions about public debt problems in many Western market economies reveal the fundamental difficulty in public debt crises. Realistic time horizons for fiscal action by a government and market perceptions of speed of decision making are very different. Carrying out a fiscal consolidation is inherently a very slow process as indicated by the examples just discussed. Even developing a plan for action is a not a very quick process. In the mean time there is considerable uncertainty about future policies and also about their effects on future economic growth. These uncertainties trouble the markets, lead to rumors and occasional herds that move the market sentiments. To minimize these uncertainties it is important to try to anchor expectations about future fiscal developments. Clear multi-year fiscal programs to improve credibility and significant size of the consolidation can help here. Likewise, front-loading may well be a good thing, provided it does not lead to perceptions about significant adverse effects on the economy. Focusing on items with small fiscal multipliers should provide some relief here.

Credibility of the consolidation will depend on its realistic and systematic execution. The plans should not be overly ambitious, so that they can be carried through the political decision-making process. Realism also means that goals are set to be somewhat conservative in order to minimize the probability of disappointments at least in the early years.

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[2] There are also examples of financial crises where increased public debt ratios were not reduced after the crisis (e.g. Korea 1997 and Spain 1977). In these cases debt levels were low or moderate. Malaysia 1997 is an example of a financial crisis in which the public debt ratio did not rise at all.

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Development of better fiscal institutions is vital for improving credibility and, in the longer run, reputation. The experiences of Finland and Sweden during the 1990's crises provide examples of the role of improvement of fiscal institutions.[3] Both countries made reforms that gave better centralized control for policy-making about fiscal decisions, in particular the budget process. One useful innovation was the adoption of multi-year expenditure ceilings and other practices that helped to achieve the fiscal consolidations.

Improvement of fiscal institutions is currently a major objective in the EU and euro-system fiscal institutions. The Stability and growth pact has clearly been very inadequate for the current crisis. Steps are now being taken to strengthen the European fiscal institutions, which is a very welcome move in the resolution of the current problems.

## References

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[3] See e.g. Borg (2010) and Honkapohja et al (2009), chapter 3.