WHAT FAILED AND WHAT WORKED IN PAST ATTEMPTS AT FISCAL ADJUSTMENT

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A systematic and comprehensive analysis of past adjustment plans and their outcomes provides useful insights for fiscal consolidation going forward: although today's circumstances may be different from the past, history offers lessons in terms of pitfalls to avoid and successes to be replicated. This short paper summarizes the main findings of individual country case studies and a cross-country statistical analysis, and puts forward some implications for the design and implementation of current fiscal adjustment plans.

1 Analytical framework

Previous empirical studies have typically identified fiscal adjustment episodes on the basis of *ex post* outcomes: that is, the largest observed improvements in government debt or fiscal balance.[1] This paper identifies fiscal adjustment plans on the basis of large envisaged reductions in debts and deficits. It thus goes beyond past successes, focusing also on attempts that eventually failed. The analysis tracks *ex post* outcomes compared with *ex ante* plans, looking at deviations from targets in revenues or expenditures and the factors underlying such deviations.

Case studies focused on each of the G7 countries. Specific *ex ante* consolidation attempts in those countries were selected based on the large size of planned adjustment, formal and public commitment to adjust, detailed formulation, and medium-term perspective. Table 1 summarizes the plans analyzed and their main features. The case studies were complemented by a cross-country statistical analysis drawing on the three-year "convergence" or "stability and growth" programs produced by European Union countries during 1991-2007 (covering 66 plans that envisaged a general government balance improvement of at least 1 percent of GDP cumulatively over the three-year period).

2 Key findings

The analysis yields findings in three dimensions: rationale for and design of the envisaged fiscal adjustment; degree of implementation and underlying macroeconomic factors; and political and institutional determinants of the implementation record.

3 Rationale for and design of fiscal adjustment plans

Rationale. Adjustments in the 1970s and early 1980s focused on fiscal deficits to tackle macroeconomic imbalances, such as rising inflation and external current account deficits (e.g., France, Germany, and the United Kingdom). Since the mid-1980s, plans have usually been

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The opinions expressed herein are those of the author and should not be reported as reflecting the views of the IMF, its Executive Board, or its management.

1 See, for example, Alesina and Perotti (1995); Alesina and Ardagna (2009); and Giavazzi *et al.* (2000).

Table 1

Main Features of Selected G7 Fiscal Adjustment Plans

Country	Adjustment Plan	Objectives/Design	Comments/Outcome
Canada	1985–91	Reduce overall deficit by 3½ per cent of GDP over six years. Across-the-board cuts and freezes.	Overall deficit objectives met, but not sufficiently ambitious to halt the rise in debt.
	1994–97	Reduce overall deficit by 3 per cent of GDP over three years. Major restructuring of spending, including reforms of unemployment insurance, transfers to provinces, and pensions.	Successfully met objectives and attained long-lasting reversal of debt dynamics.
France	Plan Barre, 1976–77	Austerity packages to curb inflation and current account deficit. Not set in multiyear frameworks. Combination of tax hikes and spending curbs. Reforms in 1982–84	Effective in reducing deficits and containing aggregate demand, but impact short-lived.
	Virage de la Rigueur, 1982–84		
	1994–97 Plan aimed at meeting the Maastricht criteria	Introduced multiyear framework. Quantitative objectives aimed at meeting Maastricht criteria.	Met Maastricht criteria, partly through last-minute revenue measures. Difficulties in controlling expenditures.
	2003 – 07 Consolidation under the Excessive Deficit Procedure	Fiscal adjustment focused on expenditure control; revenue-to-GDP ratios targeted to remain stable. Legally binding zero real growth rule for central government spending. Health and pension reforms.	Some expenditure slippages, partly offset by one-off revenues.
Germany	1976–79 Plan	Cut deficit by 2¾ per cent of GDP. Back-loaded; focus on expenditures (generalized cuts; cuts in labor market expenditures; wage restraint).	Weak economic growth led government priority to shift from fiscal adjustment to stimulus.
	1981–85 Plan	Cut deficit by 1¼ per cent of GDP. Front-loaded expenditure cuts (reduction in entitlement and wage bills).	Largely successful.
	1991–95 Plan	Cut deficit by 1½ per cent of GDP while minimizing tax increases needed to finance unification. Mainly expenditure-based (defense, social spending); revenue package from 1990 plus VAT rate hike.	Did not meet objectives.
	2003–07 Plan	Cut deficit together with "Agenda 2010" structural reforms (labor market, pensions). Back-loaded. All on expenditure side: reducing unemployment insurance, transfers to pension system, firing benefits, and subsidies.	Largely successful. Higher-than-expected costs of labor market reforms. Increase in VAT made it possible to meet objectives while reducing the tax burden on labor.
Italy	1994 Economic and Financial Program Document (EFPD) for 1994–97	Reduce the debt-to-GDP ratio beginning in 1996. Strong interest in joining EMU. Initial plan did not aim at meeting Maastricht criterion of 3 per cent deficit, but objectives made more ambitious in mid-course.	Attained lasting reduction in debt-to-GDP ratio, albeit at high levels. Maastricht criterion met through last-minute efforts.
	2002 EFPD for 2002–05	Planned limited improvement in fiscal balance (by 1 percent of GDP), together with a 2 per cent of GDP reduction in the revenue ratio, thus implying the need for a 3 per cent of GDP expenditure cut.	Revenue ratio remained unchanged. Large expenditure and fiscal balance overruns.

Japan	1997–Fiscal Structural Reform Act	Reduce deficit to 3 per cent of GDP by FY2003. No revenue-enhancing measures announced. Future policy decisions needed to achieve targets.	Immediately derailed by Asian crisis and domestic banking crisis.
	2002– Medium-Term Fiscal Adjustment Plans. (Two sub-periods: 2002– and 2006–.	Aim for primary surplus by early 2010s. Introduced five-year rolling frameworks. Three-year expenditure ceilings on initial budgets by major policy area introduced in FY2006. No revenue-enhancing measures announced. Future policy decisions needed to achieve targets.	Partially successful in the initial stages. Ultimately derailed by the global crisis.
United Kingdom	Howe's 1980 Medium-Term Financial Strategy (FY1980–83)	Curb government borrowing to rein in the money supply and inflation. Envisaged 5½ per cent of GDP cut in the deficit, through lower spending and an expected rise in oil revenues.	Expenditure overruns in social security, public wages, and support to public enterprises.
	Lawson's 1984 Budget (FY1984–88)	Rebalance the tax burden from direct to indirect taxes and reduce marginal tax rates. Shrink the state (Thatcher government agenda). Reduction in public sector manpower.	Expenditure cuts beyond what was envisaged. Privatization of large public enterprises.
	Clarke's November 1993 Budget (FY1994–98)	Eliminate the 8 per cent of GDP deficit by 1998. Increases in national insurance contribution rate and excises, broadening of the VAT base. Freezes on running costs combined with zero-based budgeting "fundamental expenditure reviews."	Delivered a steady reduction in the fiscal deficit.
	Darling's 2007 Pre-Budget Report and Comprehensive Spending Review (FY2008–12)	Planned modest reduction in the deficit, by reducing the growth of spending.	Derailed by global crisis: revenue underperformance, expenditure overruns, capital injections to banks.
United States	1985 Gramm-Rudman- Hollings (Balanced Budget and Emergency Deficit Control Act)	President to submit budgets consistent with GRH targets each year, and balanced budget by 1991. If legislated policy was projected to result in higher deficits, automatic "sequestration" with spending cuts would apply.	Did not achieve targets but deficit would have been larger in absence of GRH.
	OBRA–1990 (Omnibus Budget reconciliation Act)	Reduce deficit by cumulative US$500 billion (equivalent to 8.5 percent of 1991 GDP) in 1991–95. Introduced discretionary spending caps and pay-as-you-go (PAYGO) mechanism. Included some tax increases.	Unable to restrain the unexpected growth in spending for entitlement programs (notably, Medicare and Medicaid).
	OBRA–1993	Reduce the deficit by 1988 by 1¾ percent of GDP, relative to the no-policy-change baseline. PAYGO continued and discretionary spending caps extended, with five-year nominal spending freeze. Some tax increases and measures to close loopholes.	Deficit reduction well in excess of targets, with stronger-than-expected economic growth and revenues, but also effective spending caps.

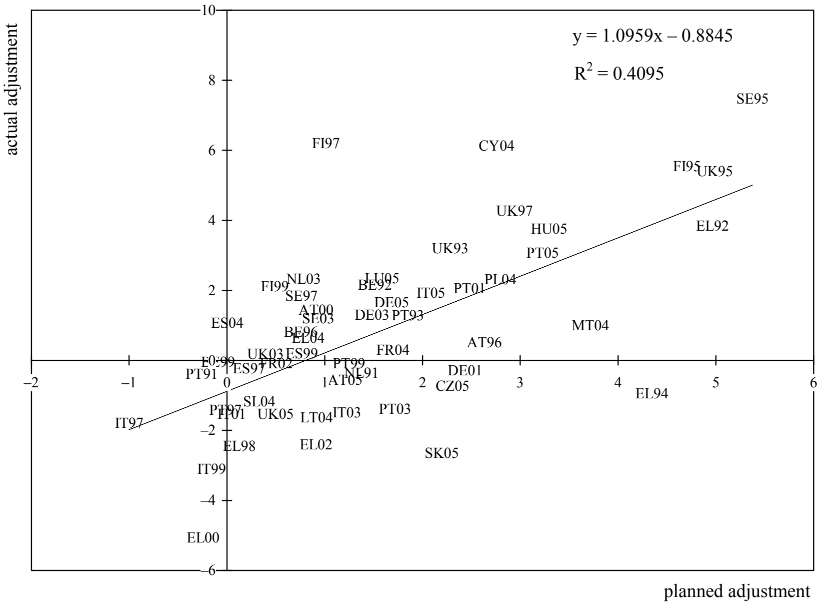
Source: IMF staff compilations.

introduced in response to high or rising public debts. Refinancing concerns have not been a major factor in these countries, but in some cases (e.g., Canada in the 1990s, Italy in the run-up to European Monetary Union, EMU) rising interest costs and spreads relative to neighboring countries were a motivating factor. In Europe, an enhanced focus on fiscal adjustment was driven by the Maastricht criteria, the Stability and Growth Pacts, and the Excessive Deficit Procedure.

Figure 1

European Union: Planned and Actual Adjustments, 1991-2007

(percent of potential GDP)



Source: EU countries' convergence plans and stability and growth plans; European Commission's Annual Macroeconomic Database (AMECO); and IMF staff estimates.
Note: Austria (AT), Belgium (BE), Cyprus (CY), Czech Republic (CZ), Finland (FI), France (FR), Germany (DE), Greece (EL), Hungary (HU), Italy (IT), Lithuania (LT), Luxembourg (LU), Malta (MT), Netherlands (NL), Portugal (PT), Slovak Republic (SK), Slovenia (SL), Sweden (SE), United Kingdom (UK). The two-digit numbers indicate the year when the plan was drawn up.

3.1 *Envisaged composition of fiscal adjustment*

Most plans focused on spending cuts, consistent with the relatively large initial size of government, particularly in Europe. Indeed, only 10 out of the 66 plans in the EU sample envisaged increases in the revenue-to-GDP ratio backed up by revenue measures. Furthermore, several plans envisaged a reduction in the revenue ratio, requiring expenditure cuts larger than the targeted deficit reduction.

3.2 *Macroeconomic assumptions*

Macroeconomic assumptions were mostly in line with those of independent observers (such as *Consensus Forecasts* and the IMF's *World Economic Outlook*). In other words, any surprises in economic growth (see below) and other macroeconomic variables were largely surprises for all observers.

4 Implementation record and underlying macroeconomic factors

Implementation record and degree of ambition. For the 66 plans in the EU sample, the average annual planned improvement in the structural fiscal balance was equivalent to 1.7 per cent of GDP (cumulative over the three years), whereas the outturn was a 0.9 per cent improvement. On

Table 2

Actual versus Planned Structural Fiscal Adjustment, G7
(percent of potential GDP; means reported, except for implementation ratios, which are medians)

	ΔPLAN	**ΔACTUAL**	**Error = ΔACTUAL *minus* ΔPLAN (0 is perfect implementation)**	**Median Implementation Ratio = ΔACTUAL/ΔPLAN (1 is perfect implementation)**
Revenues	0.1	1.0	0.9	0.5
Cyclical	0.2	0.5	0.3	1.2
Structural	–0.1	0.5	0.6	…
Expenditures	–2.3	–1.0	1.3	0.4
Primary	–1.8	–0.3	1.5	0.2
Interest	–0.5	–0.6	–0.1	1.0
Structural Primary Balance	1.7	0.9	–0.8	0.8

Sources: "Convergence" and "Stability and Growth" programs (plans); European Commission's AMECO database (outturns).
Note: ΔPLAN and ΔACTUAL refer to the planned and actual *change* in each item, in percent of potential GDP.

a positive note, actual implementation was not weakened by greater ambition: higher planned adjustment was associated with higher actual adjustment by a factor of one (observations are scattered closely around the 45 degree line in Figure 1). This evidence suggests that it is "OK to plan big" because ambitious plans do tend to produce more adjustment than do more modest ones.

Revenue-expenditure mix in outcomes versus plans. In most of the case studies, expenditure cuts did not materialize to the extent initially envisaged; by contrast, revenues often turned out above expectations, because of favorable cyclical developments in macroeconomic or asset price conditions and/or the introduction of (temporary) revenue measures to offset difficulties in implementing expenditure cuts. The cross-country statistical evidence confirms these findings: while plans envisaged cuts in the ratio of structural primary spending to potential GDP of 1.8 per cent on average, actual cuts amounted to 0.3 per cent. In contrast, revenues overperformed, partially offsetting the expenditure overruns (Table 2).

Role of economic growth. Deviations of economic growth from initial expectations were a key factor underlying success or failure. Some adjustment plans (e.g., Germany in the 1970s, Japan) were derailed, almost immediately, by unexpected economic downturns. Lower growth had a direct negative impact on cyclical revenues (and, to a lesser extent, caused an increase in some expenditure items), thereby worsening the headline fiscal balance. In addition, it had an indirect impact by tilting the authorities' perception of the relative merits of fiscal consolidation versus fiscal stimulus. Conversely, the success of some plans (e.g., in the United States in the 1990s) was facilitated by higher-than-expected growth and asset price developments. In the cross-country analysis, a 1 percentage point improvement in growth compared with expectations resulted, on average, in a ½ per cent of GDP strengthening in the headline fiscal balance.

Structural reforms. The case studies reveal that fiscal adjustment plans were more likely to meet their objectives when they were grounded in structural reforms. This was evident in Germany in the 1980s and 2000s, with structural reforms to the social welfare system; in the United Kingdom with the "Lawson adjustment" of the 1980s, which curbed expenditures as part of Prime Minister Thatcher's redefinition of the role of the state; and in Canada in the 1990s, in the context of a repositioning of the role of the state supported by a comprehensive expenditure review. In contrast, plans in the same countries that eschewed reforms failed to meet their targets.

5 Fiscal institutions and political factors

5.1 Features of fiscal institutions

Several aspects of fiscal institutions influenced the degree of implementation of fiscal adjustment plans:

- *Monitoring of fiscal outturns and policy response to data revisions*. Shortcomings in these areas were important in Italy, where a significant portion of the deviations of outturns from plans reflected upward revisions to the initial deficit and subsequent medium-term plans did not compensate for such revisions. In the cross-country analysis, upward revisions of deficits generally resulted in larger deficits at the end of the period, whereas downward revisions in the deficit were less likely to result in changes to the end-period deficit targets or outcomes.
- *Binding medium-term limits*. Although the presence of medium-term plans was one of the criteria for choosing the case studies reviewed, the extent to which the plans included binding limits on expenditures varied. As medium-term limits were made more legally binding, actual compliance with spending targets improved. This pattern was most noticeable in the US (where constraints on discretionary expenditure allowed a more rapid improvement in the fiscal balance in the context of favorable growth and asset price developments), France, and the UK.
- *Contingency reserves*. Some plans used contingency reserves to build in space to cope with potential adverse shocks, accelerate the adjustment, or create room for reducing the tax burden in the event that no adverse shocks materialized. Contingency reserves played a role in the extent to which fiscal adjustment targets were met in the United Kingdom and, to a lesser extent, Canada.
- *Coordination across levels of government*. Although most adjustment plans were originally devised for the central government, several involved reductions in transfers to sub-national governments or other public entities. The extent to which those entities undertook parallel fiscal consolidations was an important determinant of whether the general government balance improved (as in Canada) or challenges were encountered (France and the United Kingdom).
- *Fiscal rules*. The cross-country statistical analysis found the intensity of national fiscal rules to be positively associated with the extent to which targets were met.

5.2 Political factors and public support for fiscal adjustment

The cross-country evidence yields mixed messages on the role of political factors: lower fractionalization in the legislative body (parliament, congress) and perceptions of greater political stability are to some extent associated with better implementation of plans; on the other hand, implementation of ambitious plans was not associated with more frequent changes in government. What emerges more clearly from the case studies, however, is the importance of public support. For example, opinion polls ahead of the mid-1990s consolidation in Canada showed broad public support for debt reduction. The authorities took advantage of this to put in place a communication strategy to reinforce support for their adjustment plan. In Germany, a general shift in the economic policymaking paradigm in the 1980s (against active short-term demand management) and a reformist platform of the left-of-center party in the 2000s helped sustain fiscal adjustment.

6 Implications for planned adjustments

These findings have several implications for the design and implementation of fiscal adjustment plans in the years ahead.

Spelling out how policies will respond to shocks. Current fiscal adjustment plans do not sufficiently detail the envisaged policy response to shocks. As seen above, shocks, especially to economic growth, often derail fiscal adjustment. Plans thus need to explicitly incorporate mechanisms to deal with such shocks, permitting some flexibility while credibly preserving the medium-term consolidation objectives. Examples of helpful mechanisms include:

- *Multiyear spending limits*. To anchor the consolidation path, plans should include binding and well-defined ceilings for expenditures and their subcomponents, and would preferably be endorsed not just by the executive but also by the legislature. The ceilings could exclude items that are cyclical (e.g., unemployment benefits), non-discretionary (e.g., interest payments), or fiscally neutral (e.g., EU-funded projects). Many of the current adjustment plans have been framed with multiyear-frameworks, but only a few (e.g., Germany and the United Kingdom) include sufficiently detailed spending ceilings.
- *Cyclically adjusted targets* would let the automatic stabilizers operate in response to cyclical fluctuations. To ensure credibility, the methods used to adjust the fiscal variables for the cycle should be subject to outside scrutiny. Thus far, only the plans for Germany and the United Kingdom include cyclically adjusted targets.
- *Realistic/prudent macroeconomic assumptions* would reduce the risk of missing the fiscal targets. Using more conservative assumptions relative to independent observers could be justified in a context of high uncertainty, but should be relied on sparingly in order not to reduce credibility. In this respect, the November 2010 *Fiscal Monitor* notes that macroeconomic assumptions underlying some countries' current adjustment plans are more optimistic than other publicly-available forecasts.

Monitoring and accountability. Implementation of plans should be supported by reliable and timely information. Targets need to be based on sound information on the initial state of public finances. Any revisions to the initial position should lead to fine-tuning the adjustment path while keeping the medium-term targets unchanged, if possible. Fiscal Councils and peer-monitoring processes can enhance accountability in implementing adjustment plans.[2]

Composition of fiscal adjustment. The revenue-expenditure mix of fiscal consolidation plans needs to reflect country-specific societal preferences and structural fiscal characteristics. As reported in the November 2010 *Fiscal Monitor*, expenditure measures significantly outnumber revenue measures in current consolidation plans. This is consistent with the large size of the state in many advanced economies. Nevertheless, in light of the magnitude of needed adjustments and the implementation record of past plans, where revenue increases partly compensated for expenditure overruns, it would seem desirable to redouble monitoring efforts and enhance institutional mechanisms to ensure that expenditure ceilings are adhered to. It would likewise be prudent to

2 For example, in the European Union, the recently introduced European semester (a six-month period every year during which member states' policies will be reviewed to detect any inconsistencies and emerging imbalances) is expected to reinforce coordination while major budgetary decisions are still under preparation.

prepare additional high-quality measures and reforms on the revenue side, to be deployed in the event of expenditure overruns.

Structural reforms. Structural reforms are needed to underpin successful implementation of large fiscal adjustment plans. Several current plans include measures to reduce the size of the public administration and the social welfare system, but few envisage tackling the thorniest sources of spending pressures: those from pension and, especially, health entitlements. Current plans would benefit from a greater emphasis on reforms in these areas.

Building public support. Public support for fiscal adjustment, rather than a comfortable legislative majority, was a key determinant of successful fiscal adjustments. Thus, a priority going forward will be to build public support through communication campaigns. These would aim at educating the public about the rationale and the scale of the needed fiscal challenges, and explaining what can reasonably be achieved through reforms without overburdening taxpayers or unduly curtailing necessary public services.