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Inhoudsopgave

1 Introduction
J. Donders 149

2 The Dutch fiscal consolidation package in a comparative perspective
A.J. de Geus, D.J. Kraan 151

3 The UK Government's Fiscal Strategy
C. Smewing 167

Colofon

Het Tijdschrift voor Openbare Financiën streeft ernaar het inzicht in de financiële, bestuurlijke en sociaal-economische aspecten van het overheidsbeleid te vergroten en de belangstelling daarvoor te stimuleren. Het TvOF verschijnt een aantal maal per jaar en wordt uitgegeven door de Wim Drees Stichting voor Openbare Financiën. De stichting is een non-profit instelling die grotendeels afhankelijk is van donaties en sponsorbijdragen. Het bestuur hoopt dan ook dat zoveel mogelijk belangstellenden willen toetreden tot de kring van donateurs of van vrienden van de stichting. Van donateurs en vrienden wordt een jaarlijkse bijdrage verwacht van respectievelijk € 40,- en € 80,-.

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Introduction

The Wim Drees Foundation for Public Finances – a not for profit organisation based in The Hague – aims to stimulate the public debate on government spending, issues in taxation, the budget balance and government debt. To this end the Foundation publishes the Journal of Public Finances and the Yearbook on Government Finances. In addition, the Foundation regularly organizes meetings on current issues in the field of public finances. The spring meeting that took place on April 15th, 2011 considered efforts of policy makers in various OECD-countries to improve the public finances. The chairman of the meeting, Chris Buijnk (secretary general of the Ministry of Economic Affairs, Agriculture en Innovation) welcomed two prominent speakers: Aart Jan de Geus (deputy secretary general of the Organisation for Economic Co-operation and Development) and Conrad Smewing (deputy director Fiscal Policy of HM Treasury, United Kingdom). This special issue of the Journal of Public Finances (Tijdschrift voor Openbare Financiën) contains two articles. These contributions are extended versions of the presentations at the spring meeting. Aart Jan de Geus and Dirk Jan Kraan (senior economist, OECD-secretariat) discuss plans for fiscal consolidation in The Netherlands and compare these with similar policy efforts in other OECD member countries. Conrad Smewing presents the fiscal strategy of the UK government.
Last spring, the OECD published its study 'Restoring public finances', with a profound analysis of different consolidation plans, covering 30 OECD member countries. De Geus and Kraan compare, on the basis of this study, the Dutch consolidation package with that of other countries. The Dutch set of budgetary measures is smaller than the package of countries where the public finances deteriorated in recent years most rapidly, such as Greece and Ireland. On the other hand, the Dutch effort surpasses the package of countries with rather sound public finances or countries that did as yet not articulate a substantial medium-term fiscal consolidation plan. The authors try to estimate the chance of success or credibility of the Dutch package on the basis of the results of OECD-research with respect to the conditions that favor reform actually happening. They consider the budget institutions of the Netherlands to be strong and to offer sufficient guarantees that planned savings will be realized. The credibility of the Dutch package is reinforced by the emphasis on structural reforms, the focus on the spending side of the budget and the rather detailed and specific character of most of the proposed measures. Finally, it is important that the package is based on a firm political commitment and that the population seems to be largely convinced that policy action is needed.
In recent years, economic growth in the United Kingdom has been underpinned by the accumulation of unsustainable levels of private sector debt and rising government debt. While rising debt was an international phenomenon, it was more pronounced in the UK than in most other countries. The fiscal deficit rose to more than 10 per cent of GDP in 2009–2010, which explains that deficit reduction is one of the top priorities of the government of the UK. Smewing outlines in his article the consolidation measures that should reduce the deficit. The consolidation package of the British government is, given the greater required consolidation, bigger than the Dutch package. The UK chooses a higher share of revenue measures in its consolidation plan than the Netherlands, although also in the UK the emphasis is on the spending side of the budget. An important

institutional innovation in the UK concerns the establishment of the new Office for Budget Responsibility (OBR). This institute will take on a role in the fiscal framework which is in some ways similar to the role of the Dutch CPB Netherlands Bureau for Economic Policy Analysis. According to the IMF "the establishment of the OBR is a welcome step toward strengthening the budget process."

Jan Donders

The Dutch fiscal consolidation package in a comparative perspective

A.J. de Geus
D-J Kraan

This paper, which was presented at the spring meeting of the Wim Drees Foundation for Public Finance on 15 April 2011, is organized in four parts. First, we shall make some very brief remarks about the current economic situation in the OECD area, with an emphasis on the fiscal situation in member countries. Second, we shall give an overview of the consolidation efforts currently undertaken in a large majority of OECD countries, including the Netherlands. Third, we shall give some impressions of the work that the OECD has done on the political economy of consolidation – that is to say, on the conditions that determine whether consolidation will actually happen. Lastly, we shall make some more normative remarks on the Dutch consolidation package in the light of considerations of political economy. We shall pay attention to the size and the credibility of the consolidation package.

Keywords: fiscal policy, government debt, financial crisis crisis, OECD

1. Introduction

The economic situation in the OECD area

The pace of recovery is uneven across the OECD area. In most countries, the main factors holding back the recovery are high unemployment, high and growing public debt levels, and surging commodity prices leading to inflationary pressures.
A key feature of the current international upswing is that growth in emerging market economies is outpacing the growth in more mature economies. Indeed, OECD countries have barely recovered to pre-crisis levels of output.
Risks tend to be mostly on the down side, particularly with respect to concerns about sovereign debt, capital flow reversals, weak housing markets, and continued rises in commodity and food prices. On the up side, the rebound in private spending, particularly with respect to business investment, may be stronger than expected.
The main immediate challenges for advanced economies are:

- unemployment
- fiscal consolidation
- euro area weakness
- inflation

There are divergent policy requirements across OECD countries. European economies have in common the need for securing fiscal consolidation and implementing structural reform, also in the light of increasing global competition and the ageing of the European population.

2. Overview of consolidation efforts in OECD countries

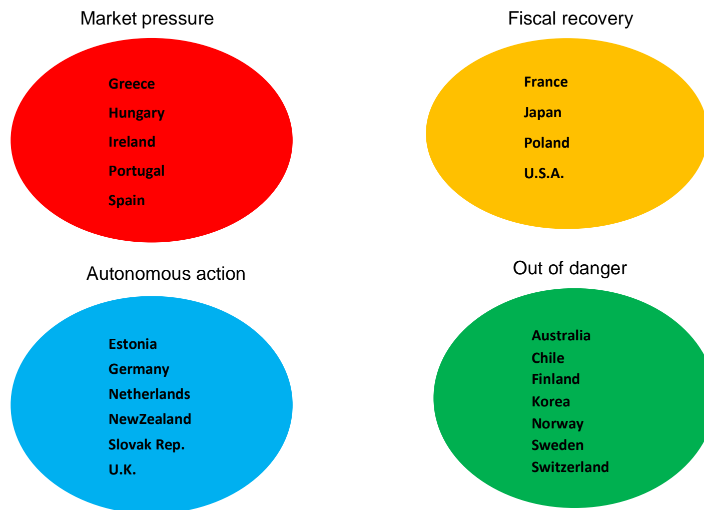
Restoring Public Finances

The publication *Restoring Public Finances* that has recently been published by the OECD Secretariat (OECD, 2011) contains a profound analysis of different consolidation plans, covering 30 OECD member countries. The report presents the current fiscal position and announced fiscal strategies, consolidation plans, and detailed expenditure and revenue measures, quantified if possible, for each country.
The data collection ended in November/December 2010, so updates and additional consolidation measures are outside the scope of this analysis. Fiscal consolidation is defined as concrete policies aimed at reducing government deficits and debt accumulation. Though important, more general structural reforms aimed at improving economic growth are not covered in this report.

Main findings

The main findings of the report can be summarized as follows.
Almost all OECD member countries have announced fiscal deficit reduction targets at least up to the year 2013 and, to a lesser extent, consolidation plans that need to be implemented for these targets to be achieved.
While most consolidation plans provide details of required spending reductions and revenue enhancements in 2011, fewer contain detailed consolidation measures required in the following years; half of OECD member countries have announced measures for 2012 and only eight countries until 2014.
Four groups of countries are emerging. Figure 1 shows the four groups of countries with different colors.

Figure 1. Four groups of countries



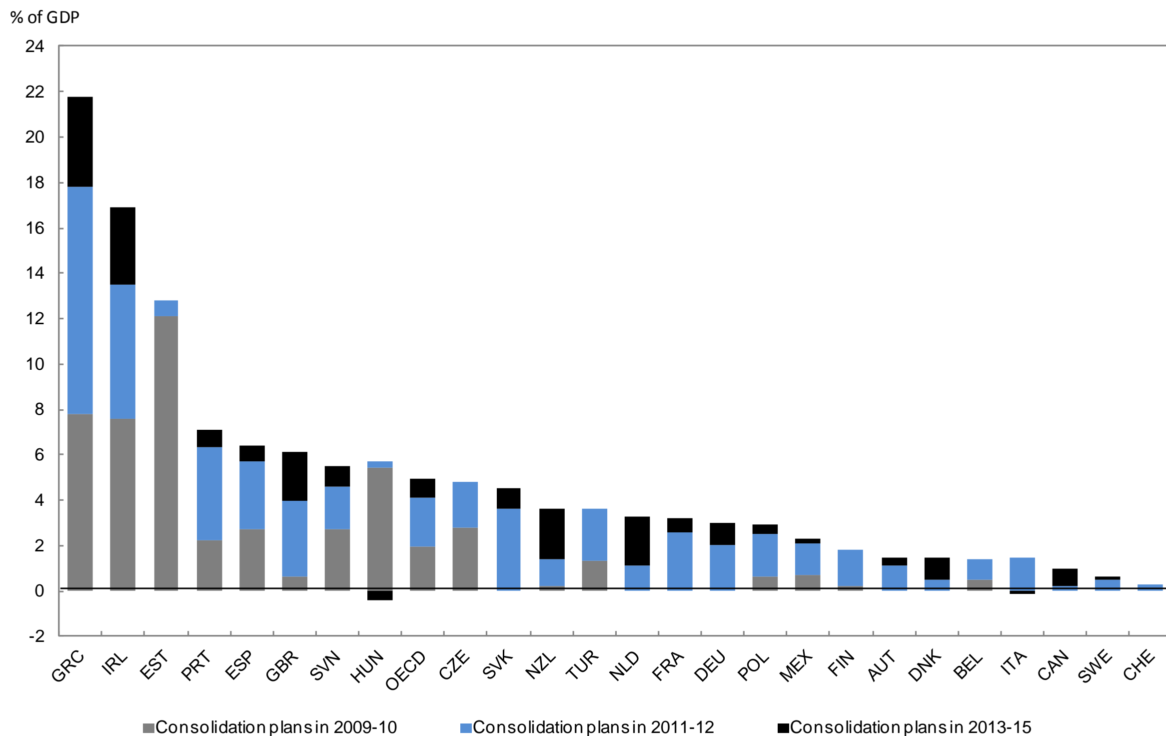
Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

The first group is the group of countries whose public finances or growth prospects have deteriorated at such a rate that substantial front-loaded consolidation packages have been announced to appease the near future demands from bond markets. Market pressure appears to be a key factor in determining the announcement of a consolidation plan in this group – for example in Greece, Ireland and Portugal. These countries are indicated in the red circle in the figure.
The next group is formed of countries that have taken pre-emptive or autonomous action in announcing medium-term fiscal consolidation strategies. Typically, these countries faced substantial fiscal deficits and announced consolidation plans for domestic reasons. Announced consolidation plans in this group reduce the longer-term fiscal sustainability requirement around 50% or more. Examples are Germany and the United Kingdom. The Netherlands is also placed in this group. These countries are indicated in the blue circle.
The third group consists of countries with large consolidation needs that have not yet articulated a substantial medium-term fiscal consolidation plan. Japan and the United States have chosen to delay the announcement until economic recovery becomes self-sustaining. Other countries in this group include France and Poland. These countries are indicated in the yellow circle.
The final group of countries has a better fiscal position and comparatively low need for fiscal consolidation in order to reduce either deficits or debt-to-GDP ratios. Countries in this group include, for instance, Australia, Finland, Norway and Sweden. They are indicated in the green circle in the figure.

For countries with a consolidation plan, the size of the plan varies significantly depending on the country's fiscal position (see Figure 2). The figure shows the total sum of announced expenditure and revenue measures in per cent of GDP, split into three time

periods from 2009 to 2015. Grey column components indicate front-loaded measures whereas black column components indicate back-loaded measures (to be implemented later). Negative numbers for Hungary in the later period mean a planned expansionary fiscal policy in this period.

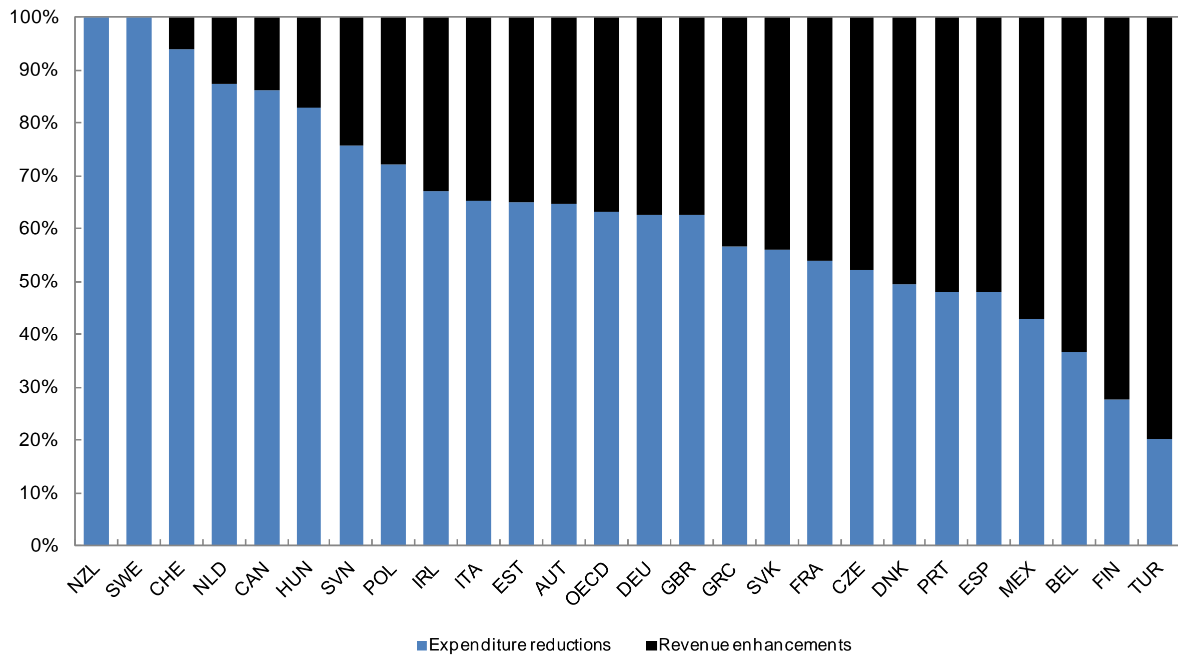
Figure 2. Announced consolidation plans vary



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris. The figures are the sum of annual incremental consolidation for 2009-15 as reported by the national authorities and/or calculated by the OECD Secretariat. The figures include Estonia's and Ireland's 2009 consolidation. Hungary's 2007-08 consolidation is not included. Canada and the Netherlands report consolidation until 2015.

Unsurprisingly, countries with the largest economic imbalances and the most rapid deterioration in public finances require larger fiscal consolidation. Countries in the first category like Greece and Ireland figure notably, with their very large fiscal consolidation plans measured at around 22% and 17% of GDP, respectively. Portugal, Spain and the United Kingdom have also announced large fiscal consolidation programmes that equal 6-7% of GDP. The Netherland's consolidation package is in the middle range in this context and is somewhat back-loaded, with roughly equal annual consolidation efforts up to 2012 and in the period 2013-15.
Fiscal consolidation consists on average of two-thirds spending cuts and one-third revenue enhancement, as shown in Figure 3. There is a significant variation in the composition of consolidation measures. A number of countries have based consolidation mostly on expenditure-based measures, including the Netherlands. These are typically countries with smaller consolidation needs. Countries that require greater consolidation, including Greece, Portugal, Spain and the United Kingdom, are choosing a higher share of revenue measures in their consolidation plans.

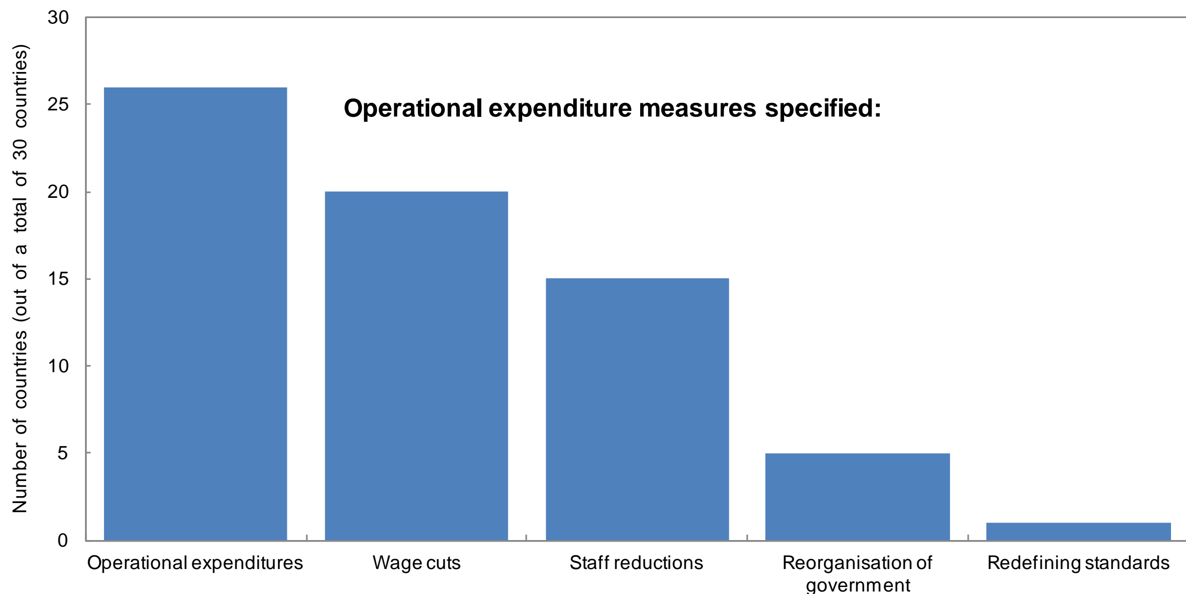
Figure 3. Expenditure-based versus revenue-based measures



Source: OECD (2011), "Restoring Public Finances", OECD, Paris. The figures are the contribution to consolidation from expenditure and revenue measures weighted by the incremental volume of consolidation across each year reported.

Almost all OECD member countries have marked operational expenditures for savings (Figure 4). The Netherlands and the United Kingdom have announced far-reaching and very substantial operational expenditure cutbacks. In the Netherlands, across-the-board savings on operational expenditures will be implemented at all levels of government, amounting to EUR 6 billion by 2015. All ministries' operational budgets in the United Kingdom will be reduced between 33% and 42% by 2014. Around 15 countries have specified operational savings and announced targets for reducing public wages and staffing. In the Netherlands, a modest salary development is envisaged.

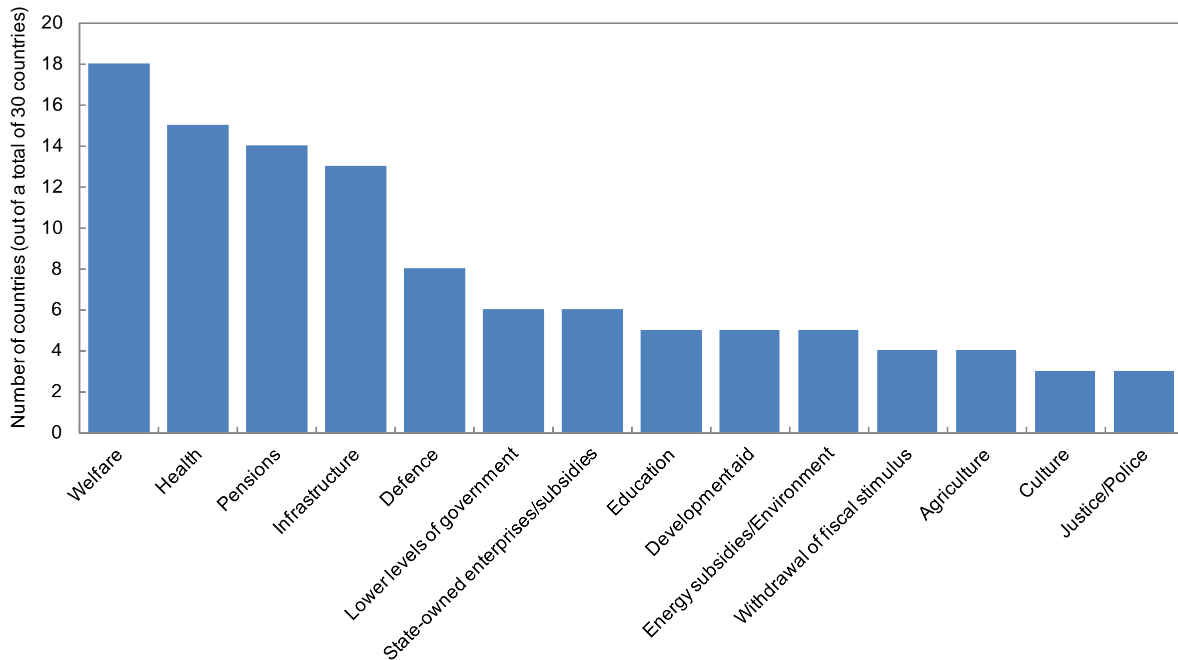
Figure 4. Operational expenditure cuts



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

The largest expenditure reductions come from reducing programme expenditures (Figure 5). Welfare and health expenditure reductions are targeted, albeit to a lesser extent than expected given their large share in public outlays. Countries also scale back public investments in their plans.
Reduced subsidies and support, especially in the agriculture sector, are only included in a few plans and could be targeted to a larger extent with double dividend, due to both improved public finances and reduced economic distortions created by subsidies. The Netherlands is one of these few countries.

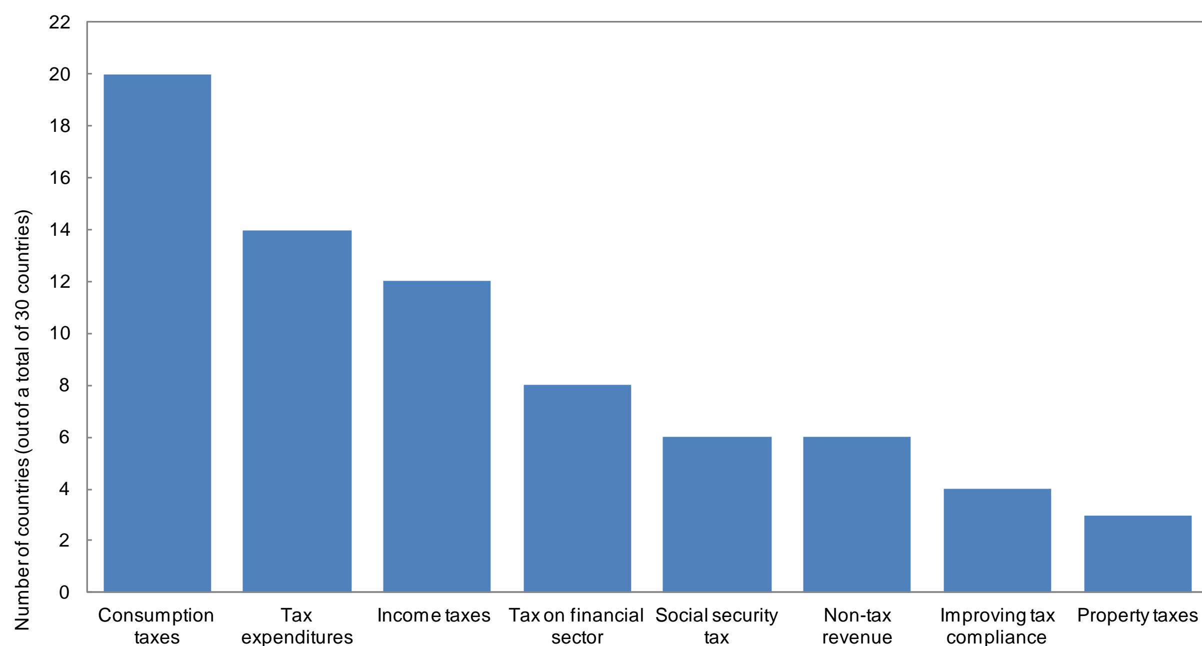
Figure 5. Major programme measures



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

Pension reform is also on the agenda in many countries. A number of countries have announced increasing the retirement age by two to five years, reducing benefits and placing restrictions on early retirement schemes. The Netherlands too has announced pension reform, although less ambitious than recommended by the OECD, only increasing the retirement age to 66 years instead of 67 years, with a little elaborated subsequent link to developments in life expectancy. We hope that the ongoing tripartite discussion in the Netherlands will provide sustainable solutions.
The most frequently announced tax measure is raising consumption taxes followed by reducing tax expenditures and increasing income taxes (Figure 6). In contrast, property taxes are only used by three countries. Frequent use of consumption taxes implies that policy makers believe they are likely to bring in significant revenue in the short term with less of a negative impact on economic growth compared to income taxes.

Figure 6. Major revenue measures



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris. Consumption taxes include value-added taxes, general sales tax, and taxes on specific goods and services (excise duties). Income taxes include personal income taxes and taxes on corporate profits. Non-tax revenue includes raising or introducing user fees (such as tolls for motorways), privatising state-owned enterprises, selling state-owned real estate, etc. Improving tax compliance includes reforms to make tax administration systems effective and transparent, efforts to reduce tax evasion and fraud, etc.

Not surprisingly, countries with the largest economic imbalances and more rapid deterioration in public finances announced larger quantified revenue measures.

3. The political economy of fiscal consolidation

Making reform happen

The OECD has made a considerable effort in recent years to provide insight on the conditions that determine whether reform will actually happen. This has led to a number of studies and a general survey publication, called *Making Reform Happen: Lessons from OECD Countries* (OECD, 2010a). This report contains a special chapter on fiscal consolidation that provides some important insights.
In addition, we mention the publication *Restoring Fiscal Sustainability: Lessons for the Public Sector* that was recently prepared by the OECD Secretariat for the Working Party of Senior Budget Officials (OECD, 2010b). This publication too includes some important messages, which the current paper has drawn upon.
In order to understand what is needed to make consolidation happen, it is important to understand why fiscal deficits arise in the first place.

Why do fiscal deficits arise?

a. Deficit financing as means of macroeconomic policy
In the post-war period up to the second oil shock of 1979, deficit financing was generally seen as a normal instrument of macroeconomic policy. However, this consensus disappeared when prolonged periods of stagnating growth and high inflation (stagflation) – combined with soaring deficits – led to the conclusion that fiscal policy could no longer be seen as the main instrument of macroeconomic policy. This led to the rise of supply-side economics and a more modest role for fiscal policy in the 1990s. OECD countries turned to more "neutral" fiscal policies whereas some of them began to formulate the deficit target in structural terms and based on debt sustainability. Automatic stabilizers both at the revenue and expenditure side of the budget were supposed to contribute to macroeconomic targets. The recent financial crisis has called this neutrality of fiscal policy into question for the first time since 1979.

b. Markets can be too accommodating for too long
It is often thought that, ultimately, financial markets exert a disciplinary effect on fiscal behavior. However, most research finds that the upward effect of government borrowing on bond yields is incremental and very small. Ratings of government bonds also seem to react slowly and give poor anticipatory information about budgetary problems. Markets thus do not always respond proactively to debt accumulation. Rather, there appear to be thresholds that trigger large movements in risk premiums, at which point the penalty for over-borrowing can suddenly become steep. Financial market discipline is thus episodic rather than smooth. For some countries, this can mean that public deficit and debt problems can suddenly turn into financial crises, as has recently become clear in the cases of Greece and Ireland.

c. Financial and economic crisis
The recent financial and economic crisis has obviously exerted an enormous one-off effect on the deficit in a large number of OECD countries. Some of the rescue measures, such as guarantees and acquisition of shares in financial institutions, have not directly affected the deficit, but public accounting rules prescribe that foreseeable permanent losses should be reflected in the expenditure side of the budget and thus in the deficit.

d. Asymmetry of the fiscal response in upturns and downturns
Since the abandonment of deficit financing for macroeconomic reasons, probably the largest single factor responsible for rising deficits is the asymmetry of fiscal behavior in good and bad times. A downturn is usually accompanied by a deterioration of the budget balance, while an upturn does not entail an equivalent improvement of the balance. Particularly, there is OECD evidence that in some countries fiscal policy tends to turn pro-cyclical in upturns, particularly in the euro area (Ahrend, Catte and Price, 2006). Expenditure increases and tax cuts in the expansionary phase of the cycle are politically difficult to resist if windfall revenues are mistaken for structural increases in budgetary income.

e. Lack of budget transparency
The lack of budget transparency is another factor that may affect deficit spending. Electoral considerations may deter politicians from consolidation measures, particularly in the run up to elections. On the other hand, large deficits are no vote-winners either. This may lead to accounting gimmicks and off-budget spending. There is evidence that countries with more transparent budget procedures exhibited greater fiscal discipline in the 1980s and early 1990s. In another study using a transparency index for 19 OECD countries, it was found that during the 1990s weaker transparency is associated with higher deficit and debt levels (Alt and Lassen, 2006).

Which factors are conducive to successful consolidation?

Against this background of politico-economic factors that cause deficit financing and accumulation of debt, questions arise about which factors are conducive to consolidation and, even more importantly, what governments can do in order to counteract in a structural manner the factors that cause the deficit bias. Some of the causes of excessive deficits are beyond government control, but others are not, and then it is important to recognize the remedies that seize upon the causes.

a. The recognition of "fiscal crisis"
Let us start by saying that there is also an important consolidation supporting factor which is beyond government control. This is fiscal crisis. Consolidation occurs mainly where deficits become excessive. In recent decades, there have been frequent interventions by governments of OECD countries to correct excessive borrowing. Recent OECD research has identified 85 consolidation episodes in 24 OECD countries between 1978 and 2004. Such episodes were defined as periods in which actions were taken that resulted in noticeable improvement in the cyclically adjusted primary balance (Guichard et al., 2007; OECD, 2007). The consistent conclusion of this and other empirical studies is that fiscal consolidation is more likely in times of "crisis" than in good times. However, this robust finding does not teach us very much about how excessive deficits can be avoided or, once incurred, how they can be redressed. It hardly seems a viable recipe for governments to engineer a permanent crisis in order to drive consolidation efforts. But – yes – the current crisis is a terrible thing to waste.

b. Budget institutions
Insofar as the deficit bias is caused by asymmetric reactions to upturns and downturns and by lack of transparency, budget institutions can play an important role in neutralizing these factors. Particularly fiscal rules, expenditure frameworks and independent fiscal authorities can contribute to transparency and more symmetric fiscal behavior in good and bad economic times. Fiscal rules generally separate structural from cyclical developments and forbid accounting gimmicks. If they take the form of expenditure rules, they contribute to symmetrical behavior in good and bad times. Expenditure frameworks have the same effects for the period they cover. Independent fiscal authorities strengthen these favorable effects by providing for objective supervision. The Netherlands is an example of a country with strong budget institutions, to which we shall come back shortly.

c. Structural measures

Next to institutional arrangements, there is evidence that also the composition of consolidation packages has an impact on the chance of success, particularly the emphasis that is put on structural measures.

Structural measures can roughly be defined as measures that change the cost parameters of spending programs. One can think of limiting the eligibility for social benefits or social services in kind, or changing the service levels of collective goods such as defense or infrastructure. Structural measures also include changes in the organization of government, leading to savings in operational expenditure. In an analysis of 21 OECD countries, it has been found that structural reform is associated with significantly lower public expenditure in the long run (van den Noord and Cournède, 2006).

d. Focus on the expenditure side of the budget

A number of empirical studies suggest that spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation than a strategy that relies mainly on tax increases. Spending cuts are also more closely connected to the problems in spending programs that caused the deficits in the first place, and they may also show greater commitment and government cohesion (OECD, 2007; Alesina and Perotti, 1996; Alesina and Ardagna, 1998; Guichard et al., 2007; Von Hagen, Hughes Hallett and Strauch, 2001).

e. Specification of measures

Faced with rigid expenditures and high tax levels, consolidation has often come to rely quite heavily on anticipated improvements in public sector efficiency. For some countries, this is also the case in the current consolidation efforts. These are intentions that are easy to sell to the public, though less easy to implement in practice. We are not saying that focusing on operational costs is not a promising way of consolidation. Indeed, OECD studies indicate that there are large differences in ratios of outputs and outcomes to inputs among OECD countries, particularly in areas such as education and health (Sutherland and Price, 2007; Joumard et al., 2008). However, it is essential for success that measures are clearly specified. Simply stating savings targets without specification of measures is not enough for achieving success. Specification of measures often requires painful decisions, not so much for the public, but certainly for the public employees involved, which may generate resistance. Medium-term planning is essential in this respect, since many problems can be solved by gradual reorganization, taking advantage of the natural attrition rate which is in the order of 5% annually in most OECD countries.

f. The most successful plans involve large, multi-year adjustments

The OECD study on consolidation episodes makes clear that some of the most successful adjustments were those in Canada (10% of GDP in four years), Denmark (13.5% of GDP in four years) and Sweden (17% of GDP in seven years) (OECD, 2007; Guichard et al., 2007). Factors regarded as critical to the success of fiscal adjustment included the size of the adjustment (larger adjustments have a greater chance to succeed) and its duration (longer-term adjustments have a greater chance to succeed). The first factor stems from

the fact that larger consolidation operations require more political mobilization and must therefore be promoted as a “social project” rather than as a technical, budgetary exercise. The second factor stems from the fact that large consolidation efforts require changes of laws, including entitlement laws in the sphere of social security, health and pensions, as well as large reorganizations of the public administration. This requires time. Front-loaded consolidations necessarily lean more on temporary measures (wage and employment freezes, social benefit freezes, etc.) than on structural measures.

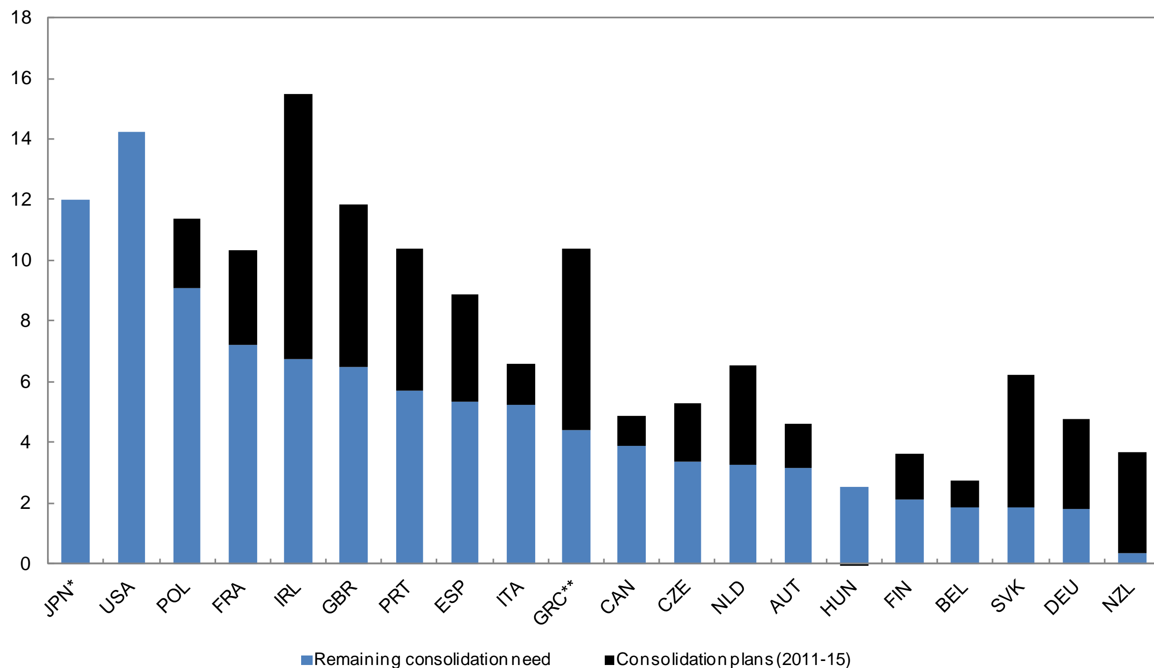
4. Evaluation of the Dutch consolidation package

Size of the Dutch consolidation package

We now come to some more normative remarks on the Dutch consolidation package. We shall first pay attention to the size of the package and subsequently to its chance of success or credibility in view of the mentioned considerations of political economy.

For the OECD area as a whole, it is true that renewed growth will not be enough to stabilize and reduce debt levels and that the consolidation needs are substantial. Figure 7 shows how much the underlying, primary balance must be improved to reduce debt-to-GDP ratios to more prudent levels, notably 60% of GDP by 2025, based on a number of plausible assumptions on economic growth, unemployment and interest rates. Future increases in age-related costs are not included in this calculation. The figure also shows how much announced consolidation plans reduce this requirement, assuming all measures have structural effects.

Figure 7. Fiscal balances need to be improved more to achieve 60% debt-to-GDP ratios



Notes: The consolidation requirement is the underlying primary balance change required to achieve a gross general government debt-to-GDP ratio equal to 60% of GDP by 2025 except for Japan. Iceland is not included in the figure due to missing consolidation data.
* The consolidation requirement for Japan is the total consolidation required to achieve the pre-crisis debt-to-GDP ratio by 2025.
** For Greece, the underlying primary balance is used in the calculation, derived from the government's targeted deficit path, taking into account the baseline assumptions in *OECD Economic Outlook, Volume 2010/2, No.88*, http://dx.doi.org/10.1787/eco_outlook-v2010-2-en.

Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

If implemented as planned, consolidation will be an important step in restoring public finances, in particular for countries like Greece, Ireland and Portugal. For Japan and the United States, the challenge remains to pass a set of fiscal consolidation measures, and for France and Poland, more ambitious consolidation packages have yet to be put on the table.
For the Netherlands, more efforts are needed in order to reach a debt level of 60% of GDP by 2025.

Credibility of the Dutch consolidation package

Turning now to the mentioned considerations of political economy, we focus on conditions of success that the Dutch government can control, namely budget institutions, the emphasis on structural reform, a focus on the spending side of the budget, the specification of measures, and a focus on large, multi-year adjustments.

a. Budget institutions

As far as budget institutions are concerned, the Dutch are certainly in a relatively favorable position from an international perspective.

Apart from the fiscal rules of the Stability and Growth Pact that are applicable to the Netherlands, there are no formal fiscal rules in the Netherlands. Fiscal policy is governed by the medium-term expenditure frameworks and the guidelines for tax policy contained in coalition agreements. However, the requirements flowing from these frameworks and guidelines are substantially stricter than the European fiscal rules. That is also the case in the current coalition program that roughly aims at structural budget balance in 2015, even though this is not enough to stabilize the debt or to take care of the future burden of ageing.

Since 1994, Dutch budgetary policy has been based on fixed expenditure frameworks and tax policy guidelines contained in the coalition agreements of successive cabinets. This practice has led to a separation of the expenditure and revenue sides of the budget, with deficits fluctuating in reaction to GDP developments, and strict budgetary discipline at the expenditure side. Apart from a relatively small stimulus package that was agreed in 2009 in reaction to the financial crisis, expenditures have been kept within the ceilings during the entire period since 1994. Holland belongs to the very few OECD countries, next to Sweden and the United Kingdom, that have worked for a long period with fixed expenditure frameworks. All three countries have largely been able to maintain the ceilings since they were introduced, apart from the recent crisis episode in which stimulus packages were approved. This in itself is a strong indication that a fixed medium-term framework is a powerful institutional device to maintain fiscal discipline and to overcome the deficit bias. The OECD is not aware of any other fiscal institution that performs better in this respect.

Furthermore, we mention the role of independent fiscal institutions. The Netherlands has had such an institution since 1945 in the form of the Bureau of Economic Policy Analysis (Centraal Planbureau).

From the perspective of fiscal discipline, it is essential that the Bureau is responsible for the macroeconomic forecasts and for the forecasts of the economic and budgetary consequences of major policy plans, including the electoral platforms of political parties and the coalition program. The Bureau reports its findings in public documents. Although formally the government is not bound by the conclusions of the Bureau, in practice it follows the Bureau's forecasts and projections almost entirely. This implies that the Dutch arrangement is fully consistent with the independence requirement that has been identified by the OECD as an important condition for the success of fiscal consolidation.

b. Emphasis on structural reform

The Dutch consolidation package consists for a large part of structural measures, including: income transfers, healthcare costs, and international co-operation and adjustment of the organization of government.

c. Focus on the spending side

With a spending side percentage in the consolidation package of between 80 and 90%, the Netherlands belongs to the OECD countries with the most emphasis on spending cuts

versus tax increases. This contributes strongly to the credibility of the consolidation package.

d. Specification of measures
The Dutch consolidation package is very detailed and, as such, belongs to the best specified packages thus far launched in OECD countries. There is only one area where the specification is not yet very detailed: the savings on operational expenditures. A relatively large cut of EUR 6 billion on public administration is not very specific, in particular as far as reorganization of the general government sector is concerned. It remains to be seen whether the reduction will be materialized.

e. Consolidation through large, multi-year adjustments
The Dutch consolidation package of EUR 18 billion (3.3% of GDP) is of a medium size in comparative perspective. Nevertheless, from a more historical and domestic perspective, it is a very large package. Necessarily, it required a substantial political commitment, and the Dutch population is aware of the painful impact it will have, but largely also of its necessity. As I have shown earlier (Figure 2), it is rather back-loaded due to a lot of structural measures that require time to implement, which contributes to its credibility and chance of success.

5. Conclusion

Summarizing, our conclusion as to the size of the consolidation package is that it is in the middle range of volume in percentage of GDP and not yet enough to stabilize the budget at 60% of GDP.
As to the chance of success or credibility of the package, the conditions prevailing in the Netherlands seem relatively favorable. The budget institutions of the Netherlands are strong and contain sufficient guarantees that the planned savings will be realized. The emphasis is on structural reforms, although not all the reforms recommended by the OECD in the last economic survey are taken on board. The focus is very much on the spending side. Apart from some aspects of operational expenditure, the measures are detailed and specific. The package is back-loaded, due to structural measures that require time to phase in. The package is based on a firm political commitment, and the population is largely aware of its necessity.

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The UK Government's Fiscal Strategy

C. Smewing*

Over the pre-crisis decade, developments in the UK economy were driven by unsustainable levels of private sector debt and rising public sector debt. The pattern of unbalanced growth and excessive debt was revealed by the financial crisis and has helped create exceptional economic and fiscal challenges.
This presentation explains how the imbalances developed, and sets out the action the Government is taking to tackle the fiscal position, through carrying out a comprehensive deficit reduction plan and reform of the fiscal framework. Other steps the Government is taking to provide the conditions for sustainable, balanced and private-sector led growth, including through reform of financial regulation and reform of the supply side of the economy though *The Plan for Growth* are not covered in detail.

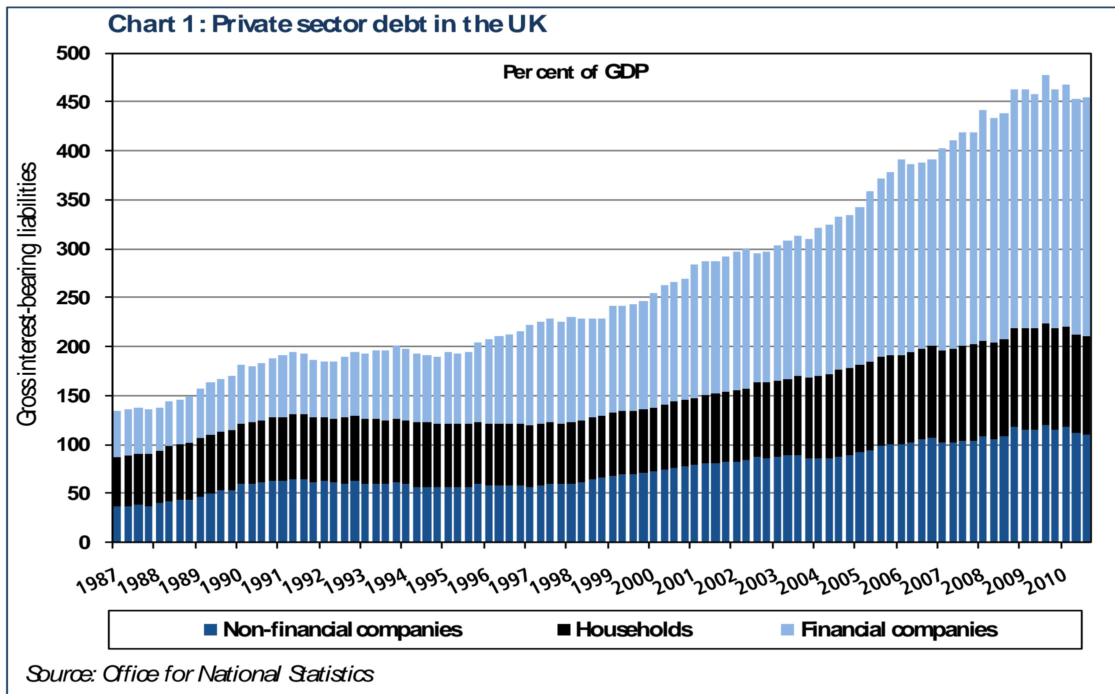
Keywords: United Kingdom, fiscal policy, government debt, financial crisis crisis

1. Unsustainable Growth

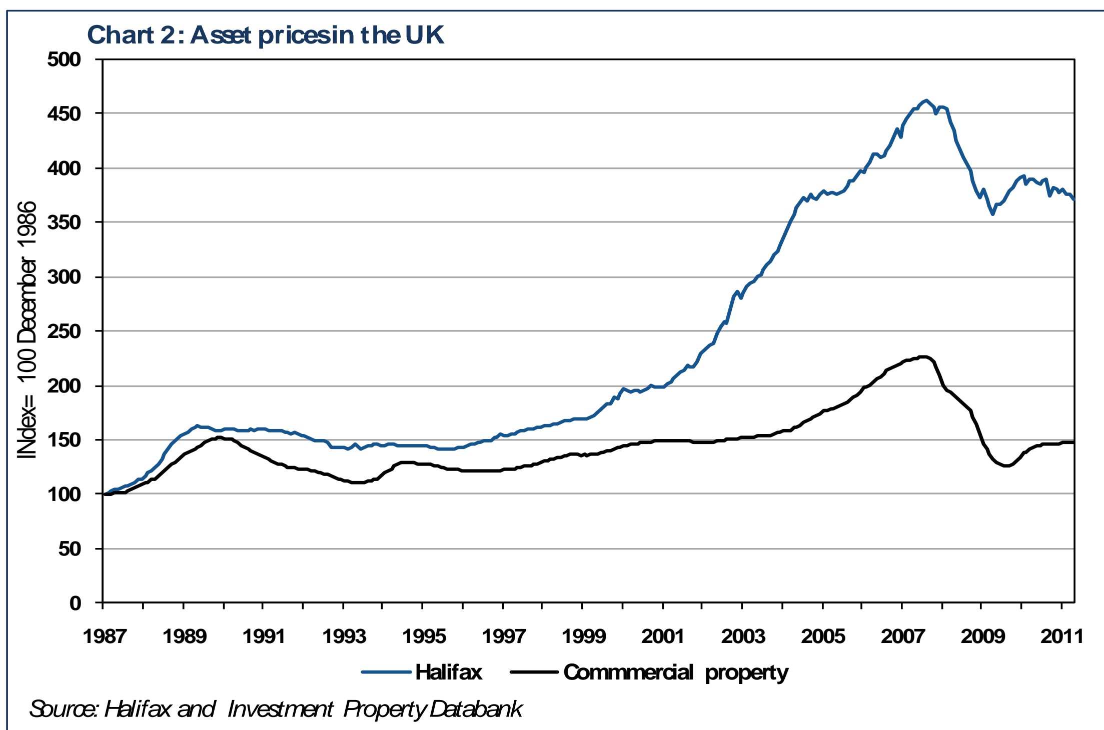
In recent years, economic growth in the UK has been underpinned by the accumulation of unsustainable levels of private sector debt and rising public sector debt.
Chart 1 highlights the rise in private sector debt in the UK. Households took on rising levels of mortgage debt to buy increasingly expensive housing, while by 2008 the debt of non-financial companies reached 110 per cent of GDP. Within the financial sector, the accumulation of debt was even greater. By 2007, the UK financial system had become the most highly leveraged of any major economy.
While rising debt was an international phenomenon, it was more pronounced in the UK than in most other countries. It has been estimated that the UK has become the most indebted country in the world[1].

The unsustainable accumulation of private debt contributed to inflated property bubbles, with property prices rising steeply in the decade preceding the financial crisis, (see Chart 2). This trend was particularly clear in the prices of residential property, which in 2007 were four and a half times as high as in 1987.

1 Debt and deleveraging: The global credit bubble and its economic consequences, McKinsey Global Institute, January 2010.



As the Office for Budget Responsibility (OBR) have stated, over the past decade the UK household sector has, in aggregate been a net borrower, with the sum of household consumption and investment exceeding income. Over this period "*households increased their residential investment spending – effectively borrowing money to purchase increasingly expensive houses*".[2]

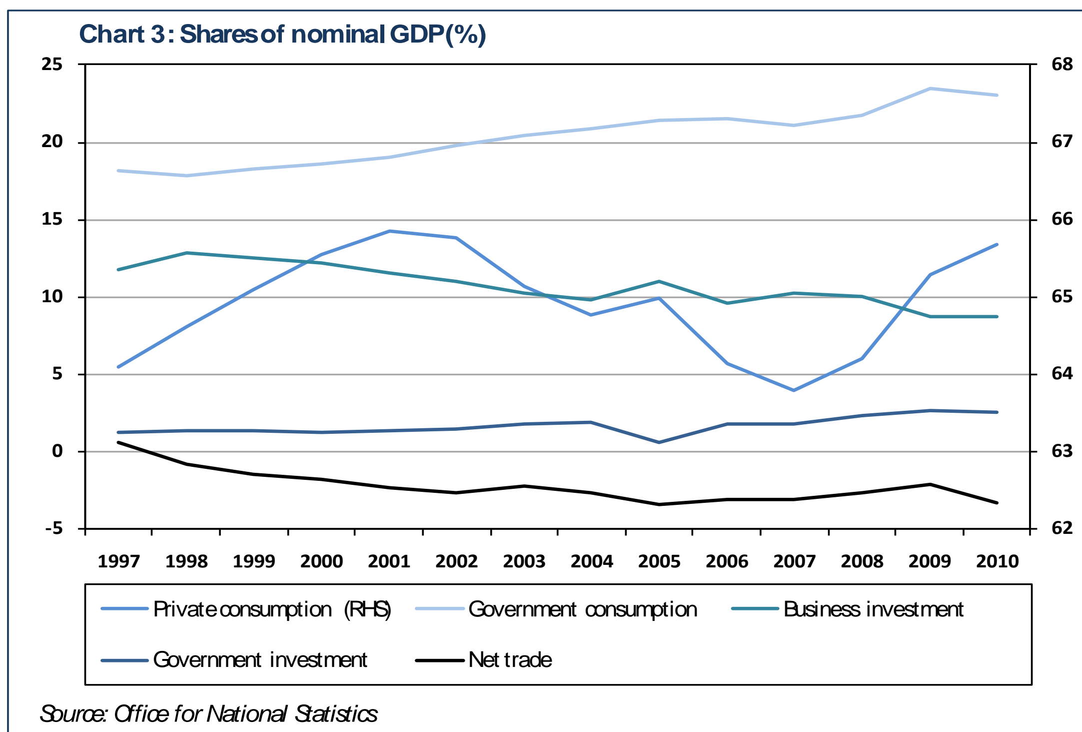


2 OBR (November 2010), Economic and Fiscal Outlook.

Increasing reliance on debt-financed consumer and government spending and on the financial sector also drove growing imbalances elsewhere in the UK economy. From 2001 onwards public spending grew steadily as a share of the economy and a structural deficit began to emerge. According to the OECD, by 2007 the UK had the largest structural budget deficit in the G7[3]. Public and private sector borrowing relied on finance from abroad. The UK's current account went from near balance in 1997 to a deficit of more than 3 per cent of GDP by 2006, which was, in absolute terms, the third largest in the world. The current account deficit was around 2¾ per cent of GDP in 2007, a figure that was flattered by a 2¼ per cent surplus on trade in financial services.

Between 1997 and 2007, government consumption increased from 18 to 21 per cent of GDP, while business investment fell from 11¾ to 10¼ per cent of GDP (see Chart 3). The recession has only compounded these imbalances, with government consumption accounting for 23½ per cent of GDP in 2009 and business investment falling over 25 per cent from its peak, to trough at just 8¾ per cent of GDP.

Chart 3: Shares of nominal GDP (%)



Source: Office for National Statistics

Between 2002 and 2007 there was a near tripling of UK bank balance sheets[4] and the UK financial system had become the most highly leveraged of any major economy in 2007. As a result, the UK was particularly vulnerable to financial instability and was hit hard by the financial crisis. The loss of confidence and withdrawal of credit that followed precipitated the deepest and longest recession since the Second World War: output fell just under 6½ per cent according to the Office for National Statistics (ONS). More than a

3 *OECD* (May 2011), *Economic Outlook No. 89*, OECD.
4 Speech by Mervyn King, Governor of the Bank of England, at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 16 June 2010.

quarter of the GDP per capita growth in the pre-crisis decade to 2007 was reversed during the financial crisis and recession of 2008 and 2009.

2. Public Sector Imbalances

In addition to the trend described within the private sector, imbalances in the public sector also built up over a number of years. In the UK, a property boom and unsustainable profits and remuneration in the financial sector in the pre-crisis years drove rapid growth in tax receipts. The spending plans set out in the 2007 Comprehensive Spending Review were based on these unsustainable revenue streams, and on assumptions about trend economic growth that were later revised down significantly[5].

The level of UK economic activity in current prices (money GDP) is estimated to be around 10 per cent lower in 2010-11 than it was forecast to be at Budget 2008. In other words, the economy is now around 10 per cent smaller than it was forecast to be only three years ago, reducing the resources available for government spending.

As tax receipts fell away during the crisis, the persistent gap between spending and revenue widened, with total public spending rising to around 47½ per cent of GDP by 2009-10.

Chart 4 later in this paper shows both the persistent gap between spending and revenue in the pre-crisis years, and the dramatic widening of that gap in more recent years. The result has been to leave the UK with one of the most rapidly deteriorating fiscal positions of any major economy. This unsustainable fiscal position is a key economic vulnerability, reinforcing the case for urgent action to put the UK's public finances back on a sustainable footing.

This vulnerability is exacerbated by the interaction between the fiscal position and UK's large financial sector. As the IMF have noted, "*any renewed turbulence in sovereign debt markets could trigger an adverse feedback loop between sovereign debt markets and the financial sector, inflicting major damage on the recovery.*"[6] The Government is undertaking domestic reforms to counter such risks; including action to tackle the budget deficit but also radical reforms to the financial regulatory framework. Domestic reforms in the financial services sector are, moreover, complemented by a historic set of international reforms agreed by the Seoul G20 meeting in November 2010.

5 For example, the March 2010 Budget estimated that trend growth between mid-2007 and mid-2010 would average just under 1 per cent, as a result of the financial crisis (and for trend growth to return to 2¾ per cent beyond mid-2010) – compared to a central assumption of 2¾ per cent a year assumed at the 2007 Comprehensive Spending Review. The OBR's forecast at June Budget 2010 was based on the judgment that the current level of trend output was lower still than assumed in the March Budget. See 'Box 1.4': Output gap assessment' of June Budget 2010.

6 IMF (October 2010), *World Economic Outlook.*

3. Role for Government

Given the challenges set out, there is a need for the UK to move away from unbalanced growth reliant on a narrow range of sectors, unsustainably high government spending and an unsustainable accumulation of private debt, which inflated asset prices and ultimately paved the way into the banking crisis and sharp falls in output.
The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries. The Government has announced action to meet this objective. Providing the right macroeconomic conditions will help correct the imbalance between the public and private sectors that built up over a number of years, underpinning a sustainable recovery.
Government policy has an important role to play in supporting the necessary rebalancing toward sustainable, private sector-led growth and minimizing risks to the recovery. The Government has set out a strategic policy response to the UK's exceptional economic and fiscal challenges:

- fiscal policy will bring the public finances back under control over the medium-term, addressing the largest budget deficit in the UK's post-war history. It is essential to mitigate downside risks from rising public debt, promote stability and provide businesses with the confidence they need to invest;
- monetary policy will ensure price stability, and thereby support wider economic stability;
- reform of financial sector regulation will help to prevent the build-up of systemic risks and ensure financial stability, a pre-requisite for sustainable growth; and
- microeconomic policies will drive growth and position the UK at the forefront of the global economy, to meet the Government's ambitions to: create the most competitive tax system in the G20; make the UK the best place in Europe to start, finance and grow a business; encourage investment and exports as a route to a more balanced economy; and create a more educated workforce that is the most flexible in Europe.

The Government has been clear that it is committed to delivering deficit reduction, while continuing to ensure economic recovery. The historically high level of public borrowing risked undermining fairness, growth and economic stability in the UK. A plan was therefore needed to accelerate deficit reduction and bring debt as a share of the economy under control in order to restore sustainability to the public finances. Tackling the budget deficit is essential to:

- reduce the UK's vulnerability to further shocks or a loss of market confidence, which could force a much sharper correction;
- underpin private sector confidence, supporting growth and job creation over the medium term;
- help keep long-term interest rates down, helping families and businesses through the lower costs of loans and mortgages;
- keep debt and debt interest paid by the Government – and ultimately the taxpayer – lower than would otherwise have been the case; and
- avoid accumulating substantial debts to fund spending that benefits today's generation at the expense of tomorrow's, which would be irresponsible and unfair.

The Office for Budget Responsibility's Pre-Budget forecast[7] in June 2010 showed that, without further action to tackle the deficit: public sector net borrowing would remain at 4 per cent of GDP in 2014-15; the structural deficit would be 2.8 per cent of GDP and the structural current deficit still 1.6 per cent; and, public sector net debt would still be rising in 2014-15, to 74.4 per cent of GDP, with debt interest payments set to reach £67 billion in that year.

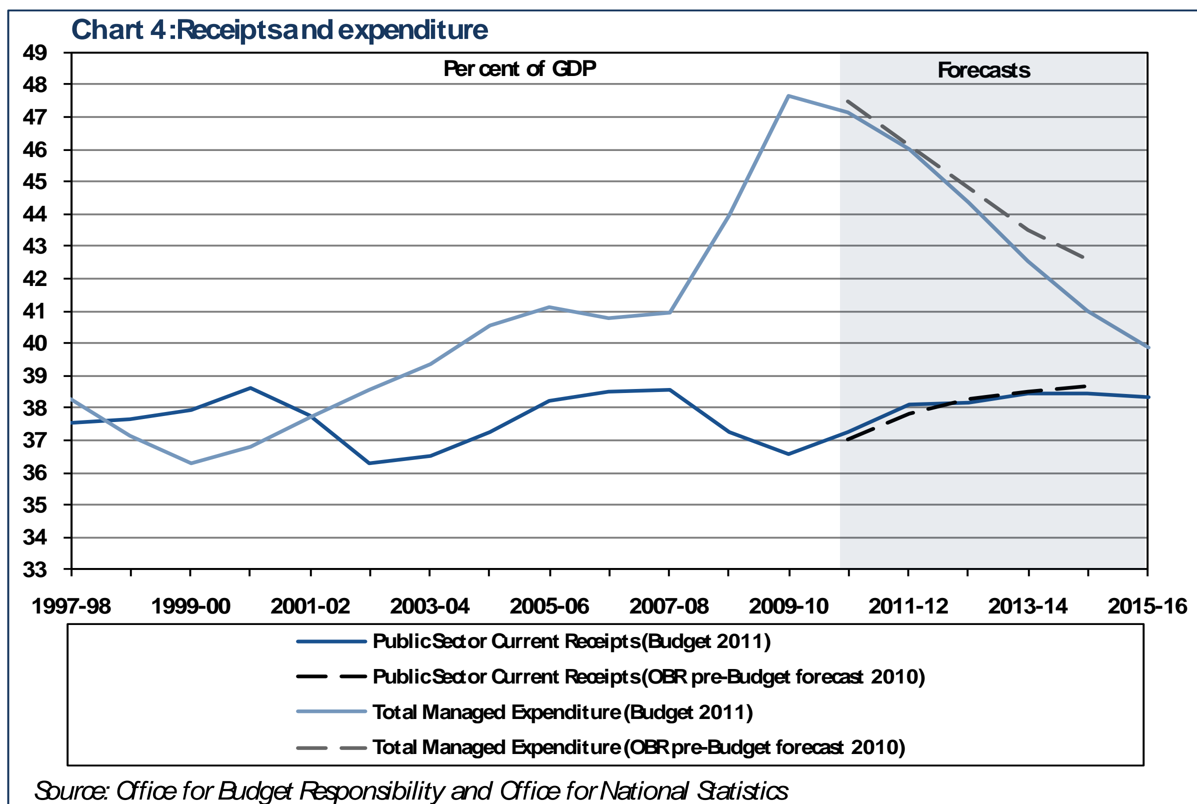
4. Policy and Framework Reform

As a consequence of unsustainable public finances and the need to provide the right macroeconomic conditions to underpin a sustainable recovery, the Government has set out a comprehensive set of policies to bring the public finances back under control.
The Government's Budget in June 2010 delivered additional consolidation plans on top of those set out by the previous Government. These plans totaled £40 billion a year by 2014-15, £32 billion of which were spending reductions. The remaining £8bn is the net effect of changes to tax policy, including the increase in VAT.
When combined with the policies and assumptions set out by the previous Government, and adjusted for the results of the Spending Review, the total consolidation in this Parliament amounts to £80 billion of spending cuts by 2014-15 and a further £30 billion of tax increases. Approximately three-quarters of the planned consolidation is to be delivered through lower spending in 2014-15, with the proportion attributable to spending rising further in 2015-16.
The major contribution to the consolidation from public spending reductions, rather than tax increases, is consistent with OECD and IMF research, which suggests that fiscal consolidation efforts that largely rely on spending restraint are more successful in supporting growth.[8] Tax measures are an effective tool for reducing the deficit quickly and supporting consolidation, allowing for phased reductions in public spending.
Therefore, the Government's fiscal consolidation plans have been designed with growth and fairness in mind, as far as possible:

- protecting the most productive public investment expenditure;
- avoiding punitive increases in tax rates on capital and labor; and,
- reforming the welfare system to reward work.

Budget 2011 reaffirmed the Government's commitment to fiscal consolidation by announcing a set of measures which had a neutral effect on the public finances with all costs of discretionary policy decisions being met by measures to raise revenue.
As a result of the Government's fiscal strategy, spending is now projected to fall from 47½ per cent of GDP to under 40 per cent of GDP by 2015-16 and receipts are expected to rise from 36½ to 38½ per cent. The structural deficit is forecast to be reduced by 8.4 percentage points, from 8.9 per cent of GDP in 2009-10 to 0.5 per cent in 2015-16.[9]

7 Office for Budget Responsibility (June 2010), *Pre-Budget forecast.*
8 See *UK Article IV Consultation*, IMF, May 2009 and OECD (June 2007), *Economic Outlook No.81.*
9 OBR EFO; March 2011.



Source: Office for Budget Responsibility and Office for National Statistics

These plans to accelerate deficit reduction and consolidate the UK public finances, returning them to a sustainable path, are underpinned by significant reform to the UK's fiscal policy framework.

At June Budget 2010, the Chancellor announced the Government's forward-looking fiscal mandate to achieve cyclically-adjusted current balance by the end of the rolling, five-year forecast period. Given the OBR's pre-Budget forecast and the projection of rapidly rising debt, the fiscal mandate was also supplemented by a target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16, ensuring that the public finances are restored to a sustainable path.

The fiscal mandate, supplemented by the target for debt, will guide fiscal policy decisions over the medium term, ensuring the Government sets plans consistent with accelerating the reduction in the structural deficit so that debt as a percentage of GDP is restored to a sustainable, downward path.

The fiscal mandate is based on:

- the current balance, to protect the most productive investment expenditure; and
- a cyclically-adjusted aggregate, to allow some flexibility at a time of economic uncertainty.

The choice of a five-year rolling forecast period for the fiscal mandate, supplemented by the fixed date for the debt target, reflects the exceptional environment in which the Government must address the fiscal challenge. They are designed to ensure that fiscal consolidation is delivered over a realistic and credible timescale. Once the public finances are closer to balance the period over which the deficit target must be achieved could safely be shortened in order to create a tighter constraint. In addition, once the exceptional rise in debt has been addressed, a new target for debt as a percentage of

GDP will be set, taking account of the OBR's assessment of the long-term sustainability of the public finances.

In order to enhance the credibility of the Government's fiscal policy and fiscal mandate, the new Office for Budget Responsibility (OBR) was established in May 2010. Taking on a role in the fiscal framework in some ways similar to the Dutch CPB, the OBR will produce the official economic and fiscal forecasts and also assess the Government's fiscal policy against the likelihood of achieving the fiscal mandate.

The creation of the OBR introduces independence, greater transparency and credibility to the economic and fiscal forecasts on which fiscal policy is based. The OBR has been welcomed by international bodies including the European Commission, the OECD and the IMF, which stated that "*the establishment of a new independent OBR is a welcome step toward strengthening the budget process*".[10]

For June Budget 2010, the independent OBR operated on an interim basis under the chairmanship of Sir Alan Budd. In its pre-Budget forecast, published on 14 June 2010[11] in advance of the June Budget, the OBR transparently laid out the full scale of the fiscal challenge. This included the OBR's judgment that the level of trend output and rate of trend growth were lower than assumed by the previous Government in its March 2010 Budget forecast, such that the projected trend output at the start of 2015 was around 2½ per cent below that implied by the assumption used for the March Budget public finances forecast. The OBR also produced its first Budget forecast on 22 June 2010, on the basis of the measures the Chancellor announced in June Budget 2010.

Legislation to place the OBR on a permanent, statutory footing received Royal Assent on the 22nd March 2011. In September 2010 the Chancellor appointed Robert Chote as the first permanent chair of the OBR, with his appointment approved by the Treasury Select Committee. In October 2010 Graham Parker and Professor Stephen Nickell were appointed as permanent members of the OBR's Budget Responsibility Committee (BRC). The permanent OBR produced its first economic and fiscal outlook on 29th November 2010 and its first Budget forecast on 23rd March 2011.[12]

As well as the official forecasts of the economy and public finances, the Budget Responsibility and National Audit Act 2011 also requires the OBR to make an assessment of whether the Government is on course to achieve its fiscal mandate and supplementary target for debt.

Taking account of uncertainty, the OBR's judgment is that the policies the Government has set out are consistent with a greater than 50 per cent chance of achieving the Government's fiscal mandate. It is also the OBR's assessment that the Government's policies have a greater than 50 per cent chance of meeting the target for debt in 2015-16.[13]

As the OBR highlight,[14] all forecasts are subject to uncertainty, and this applies in particular to economic and fiscal forecasts at the present time. Recognizing this, the Government has set policy to achieve a surplus on the cyclically-adjusted current budget,

10 IMF (September 2010), UK Article IV Concluding Statement.
11 Office for Budget Responsibility (June 2010), Pre-Budget forecast.
12 OBR EFO November 2010 and OBR EFO March 2011.
13 OBR EFO; March 2011.
14 June Budget 2010 and OBR EFO; November 2010.

so that moderate shocks can be absorbed should they arise. The OBR's central forecast[15] is for the fiscal mandate to be achieved in 2014-15, one year early. The forecast also shows the debt target being achieved a year early in 2014-15.
As part of the Stability and Growth Pact (SGP) framework in the European Union, the UK Government currently has an Excessive Deficit Procedure recommendation to reduce the Treaty deficit below 3 per cent of GDP by 2014-15. The consolidation plans are also consistent with reducing the Treaty deficit below 3 per cent of GDP by 2014-15 and placing the Treaty debt ratio on a downward path from 2014-15.

5. Conclusion

Unbalanced growth and excessive debt accumulation in the UK, contributed to the exceptional economic and fiscal challenges that the Government is now acting to address. The Government's economic policy objective is to achieve strong, sustainable and balanced growth that is more evenly shared across the country and between industries.
The Government's first priority is bringing the public finances back under control, by accelerating the reduction of the structural deficit, bolstered by fiscal framework reform. This involves the creation of the new independent Office for Budget Responsibility and setting of the new, forward-looking fiscal mandate.
Restoring sustainable public finances, alongside regulatory reform and microeconomic measures to boost the supply side of the economy through *The Plan for Growth*, will have an important role to play in minimizing the risks to the recovery and supporting the rebalancing of the UK economy.

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15 OBR EFO; March 2011.