



# Limiting Central Government Budget Deficits: International Experiences

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## Summary

The global financial crisis and economic recession spurred national governments to boost fiscal expenditures to stimulate economic growth and to provide capital injections to support their financial sectors. Government measures included asset purchases, direct lending through national treasuries, and government-backed guarantees for financial sector liabilities. The severity and global nature of the economic recession raised the rate of unemployment, increased the cost of stabilizing the financial sector, and limited the number of policy options that were available to national leaders. In turn, the financial crisis negatively affected economic output and contributed to the severity of the economic recession. As a result, the surge in fiscal spending, combined with a loss of revenue, has caused government deficit spending to rise sharply when measured as a share of gross domestic product (GDP) and increased the overall level of public debt. Recent forecasts indicate that should the current economic rebound take hold, budget deficits on the whole likely will stabilize, but are not expected to fall appreciably for some time.

The sharp rise in deficit spending is prompting policymakers to assess various strategies for winding down their stimulus measures and to curtail capital injections without disrupting the nascent economic recovery. This report focuses on how major developed and emerging-market country governments, particularly the G-20 and Organization for Economic Cooperation and Development (OECD) countries, limit their fiscal deficits. Financial markets support government efforts to reduce deficit spending, because they are concerned over the long-term impact of the budget deficits. At the same time, they are concerned that the loss of spending will slow down the economic recovery and they doubt the conviction of some governments to impose austere budgets in the face of public opposition. Some central governments are examining such measures as budget rules, or fiscal consolidation, as a way to trim spending and reduce the overall size of their central government debt. Budget rules can be applied in a number of ways, including limiting central government budget deficits to a determined percentage of GDP. To the extent that fiscal consolidation lowers the market rate of interest, such efforts could improve a government's budget position by lowering borrowing costs and stimulating economic growth. Other strategies include authorizing independent public institutions to spearhead fiscal consolidation efforts and developing medium-term budgetary frameworks for fiscal planning. Fiscal consolidation efforts, however, generally require policymakers to weigh the effects of various policy trade-offs, including the trade-off between adopting stringent, but enforceable, rules-based programs, compared with more flexible, but less effective, principles-based programs that offer policymakers some discretion in applying punitive measures.

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## Overview and Background

In its recent economic outlook,<sup>1</sup> the International Monetary Fund (IMF) indicated that fiscal balances, or the annual budget balance, of the economically advanced G-20<sup>2</sup> countries weakened by 6 percentage points of GDP between 2007 and 2009, rising from 1.9% to 7.9% of GDP. The largest impact on the fiscal balances of the advanced G-20 countries was projected to occur in 2009 and 2010. Also, the forecast indicates that government debt, or the accumulated amount of government deficits, among the advanced G-20 countries will rise on average by 14.5% of GDP by the end of 2009, compared with 2007, as indicated in **Table 1**.<sup>3</sup> This forecast is considered by the IMF to represent the middle of the range of estimates, and it is based on the assumption that the economic recovery will continue at the pace experienced in mid-2009. In the same forecast, the annual budget deficits for the emerging G-20 countries were projected to widen on average from a surplus of 0.2% of GDP in 2007 to a deficit of 3.2% of GDP in 2009, while government debt was expected to remain at a constant share of GDP. For European governments, the rise in government budget deficits and the increase in the total amount of government debt is undermining their efforts to reduce the size of their annual central government budget deficits. These estimates for the growth in government debt could change, depending on the success governments have in liquidating at favorable prices the assets they acquired during the financial crisis, the timing and strength of the economic recovery, and the extent of any payout on official guarantees.

The magnitude and pervasive nature of the government deficits is unsettling international capital markets. In general, public sector debts are rising relative to national gross domestic product (GDP), the broadest measure of a nation's economic output. The international markets also have become increasingly wary of rising government deficits due to an increased perception of risk. In particular, these perceived risks are viewed as being especially high in Europe where financial institutions are exposed to economic troubles in Greece, Portugal, and Spain. According to the Bank for International Settlements (BIS) the euro area banks hold more than 70% of the outstanding public sector debt of Greece.<sup>4</sup> Furthermore, the uneven pace of the economic recovery is adding to perceptions of risk.

Generally, the rising level of public sector debts in most countries do not reflect profligate spending, but reflect measures policymakers adopted to avert a more serious and protracted economic recession. Nevertheless, policymakers and financial markets are especially concerned over the situation in Europe, where some investors view the rising deficits in Portugal, Spain, Greece, and Ireland as increasing the risks for a default and the potential for additional turmoil in the financial markets.<sup>5</sup> In some cases, these countries have borrowed heavily from the European Central Bank (ECB). The ECB requires borrower countries to provide government bonds rated

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<sup>1</sup> *World Economic Outlook*, International Monetary Fund, October 2009.

<sup>2</sup> Members of the G-20 are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States, and the European Union.

<sup>3</sup> *The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crisis*, International Monetary Fund, March 6, 2009.

<sup>4</sup> *BIS Quarterly Review*, The Bank for International Settlements, March 2010, p.1.

<sup>5</sup> Faiola, Anthony, Debt Concerns Weigh on Europe, *The Washington Post*, February 6, 2010, p. A1.

above BBB- as collateral, but that minimum rating is expected to rise to A- by the end of the 2010 and would rule out Greek bonds if rating agencies continue to downgrade the sovereign bonds.

For this and other reasons, the economic conditions of Portugal, Greece, Spain, and Ireland were a key topic at the early February 2010 meeting of G7 finance ministers and the exchange value of the euro has depreciated against the dollar recently amid broader concerns over the impact budget deficits will have on the larger economies in the Eurozone.<sup>6</sup> Such concerns could tighten credit and raise borrowing costs for a broad number of countries. Rather than relying on the International Monetary Fund to provide loans to the four countries in the most immediate danger, the richer economies of the Eurozone, particularly France and Germany, may well step in and provide loans and other assistance to those nations in trouble. Prospects of a default by any member of the Eurozone, however, could severely strain the cohesion of the zone and challenge some aspects of European economic integration.

In addition to the IMF's projections, the latest Economic Outlook<sup>7</sup> by the Organization for Economic Cooperation and Development (OECD) also projects an economic recovery to begin in 2010. The OECD estimates, however, that economic performance among OECD countries on average after 2010 will be below that experienced in the period prior to the financial crisis. According to the OECD, most developed countries will continue to face severe imbalances within their economies, including low levels of output, low levels of private investment, high rates of unemployment (including a higher rate of permanent unemployment), low inflation, and large central government deficits. As OECD economists have noted,<sup>8</sup> economic downturns that follow a banking crisis typically last longer and involve greater losses in economic output and a greater deterioration in the fiscal balances of central governments than economic recessions not associated with a banking crisis. In most of the cases studied by OECD economists, the banking crises usually involved a single country or a small group of countries. As a result, those countries were able to export their way out of their economic recession. In the current environment, however, one could argue that few of the large number of countries that are concurrently experiencing an economic recession likely will succeed in exporting their way to an economic recovery.

**Table 1. Fiscal Balance and Government Debt of G-20 Countries**  
(expressed as a percent of national GDP)

Fiscal Balance						Government Gross Debt				
Country	2007	2008	2009	2010	2014	2007	2008	2009	2010	2014
Argentina	-2.3%	-0.5%	-3.6%	-2.3%	-0.4%	65.9%	49.2%	38.6%	33.7%	23.5%
Australia	1.6	1.7	1.8	1.7	1.7	8.9	8.1	7.9	7.2	4.2
Brazil	-2.2	-1.1	-1.3	-1.2	-0.6	67.7	65.4	64.7	62.9	54.1
Canada	1.4	0.5	-1.5	-1.9	2.1	64.2	60.8	63.0	62.6	46.5
China	0.9	-0.1	-2.0	-2.0	-0.5	20.2	17.9	22.2	23.4	18.6

<sup>6</sup> The sixteen members of the Eurozone are: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Slovenia, and Spain.

<sup>7</sup> *OECD Economic Outlook*, Organization for Economic Cooperation and Development, June 2009, p. 212.

<sup>8</sup> Haugh, David, Patrice Ollivaud, and David Turner, *The Macroeconomic Consequences of Banking Crises in OECD Countries*, Organization for Economic Cooperation and Development, March 6, 2009.

Fiscal Balance						Government Gross Debt				
Country	2007	2008	2009	2010	2014	2007	2008	2009	2010	2014
France	-2.7	-3.3	-5.5	-6.3	-2.7	63.9	66.1	72.3	77.1	79.4
Germany	-0.2	-0.1	-3.3	-4.6	0.1	65.0	68.7	76.1	80.1	77.2
India	-5.2	-7.8	-8.5	-7.4	-4.5	80.5	80.6	82.7	82.9	71.6
Indonesia	-1.2	0.1	-2.6	-2.0	-1.6	35.0	32.5	31.8	31.3	28.3
Italy	-1.6	-2.7	-3.9	-4.3	-4.2	104.1	105.6	109.4	112.4	118.0
Japan	-3.4	-4.7	-7.1	-7.2	-6.4	195.5	202.5	217.0	225.1	222.3
Korea	3.8	1.4	-0.8	-0.8	0.6	32.1	32.8	32.9	33.0	29.3
Mexico	-1.4	-1.7	-2.9	-2.8	-2.3	38.3	39.3	42.1	42.5	42.0
Russia	6.8	5.3	-2.6	-2.0	-3.5	7.3	5.8	6.5	6.5	6.4
Saudi Arabia	15.8	35.0	-1.2	1.7	2.6	18.7	12.9	11.6	9.7	5.8
South Africa	0.9	-0.2	-1.9	-1.7	-0.3	28.5	27.2	27.0	26.7	22.2
Spain	2.2	-3.1	-6.1	-6.0	-2.1	36.2	38.6	48.6	53.8	56.3
Turkey	-2.3	-2.5	-2.3	-2.0	0.3	38.9	38.7	40.4	40.4	29.7
United Kingdom	-2.7	-4.2	-7.2	-8.1	-4.8	44.0	50.4	61.0	68.7	76.2
United States	-2.9	-6.4	-12.0	-8.9	-5.1	63.1	68.7	81.2	90.2	99.5
G-20	-1.1	-2.6	-6.2	-5.3	-3.0	63.5	65.5	72.5	76.7	76.8
Advanced G-20 Countries	-1.9	-4.1	-7.9	-6.8	-3.8	78.8	83.2	93.2	99.8	103.5
Emerging Market G-20 Countries	0.2	-0.1	-3.2	-2.8	NA	37.7	35.7	37.6	37.8	32.0

**Source:** *The State of Public Finances: Outlook and Medium-Term Policies After the 2008 Crash*, the International Monetary Fund, March 6, 2009, Table 6.

## Impact on Central Government Budgets

The current financial and economic crises have worsened the financial position of the central government budgets of the G-20 countries, although the impact of the crises has varied by country. The two crises are affecting the balance sheets of the central governments in three broad areas. First, governments adopted a broad range of special measures to support the financial system. Second, policymakers adopted discretionary fiscal stimulus measures to spur economic growth in order to stem the effects of the sharp drop in economic activity. Third, most economies experienced a loss in tax revenue and a surge in non-discretionary spending, referred to as automatic stabilizers, including such activities as unemployment insurance, that rise without direct legislative authorization. As a result of these factors, the financial crisis has undermined the

effectiveness of budget rules as government budgets are affected by large or prolonged internal or external shocks.

**Table 2** displays the combination of these three spending activities on the overall balance of G-20 countries. The data indicate that over the 2009-2010 period, the overall fiscal balance for the United States is expected to fall from -5.9% to -8.9% of GDP as automatic stabilizers kick in and as discretionary policy actions, in the form of deficit spending, increase. Additionally, the data indicate that the U.S. budget balance is being affected almost equally by automatic stabilizers, discretionary fiscal policy actions, and by other actions, including extraordinary measures, that were taken to shore up the financial sector. In comparison, Saudi Arabia and Russia experienced a double-digit deterioration in their budget balances as their government budgets shifted from running a surplus to being in deficit, due in large part to the drop in oil revenues as the price of oil fell during the economic recession. Saudi Arabia also adopted other discretionary fiscal measures that contributed to its budget deficit. Great Britain, as is the case with other G-20 members, adopted discretionary spending measures. Those measures, however, were less a factor in driving up its budget deficits than spending associated with automatic stabilizers.

**Table 2. Overall Central Government Budget Balances, Automatic Stabilizers and Discretionary Measures of G-20 Countries**  
(as a percent of GDP)

	Overall Balance				Average Annual Change in 2008-2010 compared to 2007			
	2007	2008	2009	2010	Overall Balance	Automatic Stabilizers	Discretionary Measures	Other
Argentina	-2.3	-0.5	-3.6	-2.3	0.2	-0.6	-0.4	1.2
Australia	1.6	0.1	-2.2	-2.8	-3.3	-1.7	-1.5	0.0
Brazil	-2.2	-1.5	-1.0	-0.8	1.1	-0.7	-0.2	2.0
Canada	1.4	0.4	-3.2	-3.7	-3.6	-1.8	-0.9	-0.9
China	0.9	-0.3	-3.6	-3.6	-3.4	-0.6	-2.1	-0.7
France	-2.7	-3.1	-6.0	-6.2	-2.5	-2.4	-0.4	0.3
Germany	-0.2	-0.1	-4.0	-5.2	-3.0	-1.6	-1.1	-0.2
India	-5.2	-8.4	-10	-8.6	-3.8	-0.4	-0.4	-3.0
Indonesia	-1.2	0.1	-2.5	-2.1	-0.3	-0.1	-0.6	0.5
Italy	-1.5	-2.7	-4.8	-5.2	-2.7	-2.6	-0.1	0.0
Japan	-3.4	-5.0	-8.1	-8.3	-3.7	-2.2	-0.7	-0.9
Korea	3.8	1.2	-2.2	-3.2	-5.1	-1.5	-1.6	-2.1
Mexico	-1.4	-1.9	-3.2	-2.9	-1.3	-1.3	-0.5	0.6
Russia	6.8	4.2	-5.2	-5.1	-8.8	-1.4	-1.3	-6.1
Saudi Arabia	15.8	35.5	-8.3	-6.5	-8.9	-0.5	-3.1	-5.4
South Africa	0.9	-0.1	-2.7	-3.4	-3.0	-0.6	-1.0	-1.5
Turkey	-2.1	-3.0	-4.2	-3.3	-1.4	-2.1	0.0	0.7
United Kingdom	-2.7	-5.5	-9.5	-11.0	-6.0	-2.5	-0.5	-2.9

	Overall Balance				Average Annual Change in 2008-2010 compared to 2007			
	2007	2008	2009	2010	Overall Balance	Automatic Stabilizers	Discretionary Measures	Other
United States	-2.9	-5.9	-7.7	-8.9	-4.6	-1.6	-1.6	-1.4
G-20 PPP GDP-weighted average	-1.1	-2.6	-5.9	-6.3	-3.8	-1.4	-1.2	-1.2
Memorandum item: EU G-20	-1.6	-2.7	-6.0	-6.9	-3.5	-2.2	-0.6	-0.7

**Source:** *Global Economic Policies and Prospects*, IMF Staff Note for the Group of Twenty Meeting, March 13-14, 2009, the International Monetary Fund.

**Notes:** PPP stands for purchasing power parity, or the data have been adjusted to account for exchange rates. The three spending areas are: 1) automatic stabilizers, or those governments payments that are ratcheted up automatically as the rate of economic growth slows (unemployment insurance, for instance); 2) discretionary measures, or macroeconomic policy actions that were taken specifically to address the economic downturn; 3) other expenditures, such as fiscal expenditures to shore up distressed banks; and 4) the overall balance, or the combination of the three effects. Negative numbers indicate deficit spending as a percent of GDP.

The OECD also has estimated the impact of spending increases and the loss of tax revenue on the budget balances of major economies that are associated with the fiscal stimulus packages that the developed economies adopted, as indicated in **Table 3**. On average, a decrease in tax revenue and an increase in spending due to the stimulus packages adopted by the developed countries in 2008 to counter the economic recession and the financial crisis are expected to have a relatively equal impact on the budget balances of the developed countries. For the United States, the loss in tax revenue is expected to have a larger negative impact on the budget balance than the negative effect associated with a higher level of spending. The OECD estimates indicate that the economic recovery that began in 2009 will stem the continued deterioration in budget balances in 2010, but that it likely will not be a strong enough recovery to turn around the budget balances in most of the larger economies.

This continued erosion in budget balances through 2010 is raising concerns among some policymakers who contend that the budget deficits will undermine market confidence in their governments. As a result of these concerns, some analysts argue that capital markets will grow reluctant to finance the budget deficits without greater compensation in the form of higher returns, which would add to the overall cost of the deficits. In a recent report, however, the IMF concluded that a rise in the level of the central government's debt, by itself, does not necessarily have a major adverse impact on a government's solvency and, therefore, on financial markets. Nevertheless, the IMF cautions that the rise in government debt represents an important challenge that should not be ignored. The IMF contends that the source of the rise in government debt is a factor in market confidence. According to the IMF, the current rise in government deficits for most countries does not represent an explosive upward path in spending, but represents targeted and necessary policy responses to the financial and economic crises. A rise in government debt that is directed at stemming an economic recession or a financial crisis does not necessarily undermine market confidence as long as governments can undertake credible programs to reduce spending once the crisis has been averted. With some notable exceptions such as Greece, the rise in spending generally is not viewed as representing profligate spending by central governments, but is attributed to measures to address the financial crisis, including spending on social programs



that rise without overt discretionary actions. Such automatic stabilizers have an especially large impact on the spending of governments within the European Union, where the government sector accounts for a larger share of total GDP.

**Table 3. Size and Timing of Fiscal Packages**

(Change in central government budget balances by component and period)

	2008-2010 net effect on fiscal balance			Distribution over the period		
	Spending	Tax revenue	Total	2008	2009	2010
	Percent of 2008 GDP			Percent of total net effect		
Australia	-4.1%	-1.3%	-5.4%	13.0%	54.0%	33.0%
Austria	-0.4	-0.8	-1.2	0.0	79.0	21.0
Belgium	-1.1	-0.3	-1.4	0.0	51.0	49.0
Canada	-1.7	-2.4	-4.1	12.0	41.0	47.0
Czech Republic	-0.3	-2.5	-2.8	0.0	56.0	44.0
Denmark	-2.6	-0.7	-3.3	0.0	33.0	67.0
Finland	-0.5	-2.7	-3.2	0.0	47.0	53.0
France	-0.6	-0.2	-0.7	0.0	68.0	32.0
Germany	-1.6	-1.6	-3.2	0.0	48.0	52.0
Greece	0.0	0.8	0.8	0.0	100.0	NA
Hungary	7.5	0.2	7.7	0.0	51.0	49.0
Iceland	1.6	5.7	7.3	0.0	28.0	72.0
Ireland	2.2	6.0	8.3	6.0	39.0	55.0
Italy	-0.3	0.3	0	0.0	15.0	85.0
Japan	-4.2	-0.5	-4.7	2.0	74.0	25.0
Korea	-3.2	-2.8	-6.1	17.0	62.0	21.0
Luxembourg	-1.6	-2.3	-3.9	0.0	65.0	35.0
Mexico	-1.2	-0.4	-1.6	0.0	100.0	NA
Netherlands	-0.9	-1.6	-2.5	0.0	49.0	51.0
New Zealand	0.3	-4.1	-3.7	6.0	54.0	40.0
Norway	-0.9	-0.3	-1.2	0.0	100.0	NA
Poland	-0.8	-0.4	-1.2	0.0	70.0	30.0
Portugal	..	..	-0.8	0.0	100.0	0.0
Slovak Republic	-0.7	-0.7	-1.3	0.0	41.0	59.0
Spain	-2.2	-1.7	-3.9	32.0	44.0	23.0
Sweden	-1.7	-1.7	-3.3	0.0	43.0	57.0
Switzerland	-0.3	-0.2	-0.5	0.0	68.0	32.0

2008-2010 net effect on fiscal balance				Distribution over the period		
Spending	Tax revenue	Total		2008	2009	2010
Percent of 2008 GDP				Percent of total net effect		
Turkey	-2.9	-1.5	-4.4	17.0	46.0	37.0
United Kingdom	-0.4	-1.5	-1.9	11.0	85.0	4.0
United States	-2.4	-3.2	-5.6	21.0	37.0	42.0
Major seven	-2.1	-2	-4.1	15.0	47.0	38.0
OECD average	-0.9	-0.9	-1.7	12.0	60.0	28.0

**Source:** Official Packages Across OECD Countries: Overview and Country Details, Organization for Economic Cooperation and Development, March 31, 2009.

## Fiscal Consolidation: Country Efforts

Since 1990, numerous national governments in developed countries have undertaken fiscal consolidation efforts, often by adopting a budgetary rule that restricts the size of the annual amount of the government budget deficit to a certain percentage of GDP. The reasons for fiscal consolidations are as varied as the governments themselves. Most often, policymakers are motivated to reduce the government's budget deficit due to a variety of concerns. These include: the rising pressure on public finances of aging populations; the cost of financing a rising amount of debt; the impact on price inflation; the crowding out of private investment; and the reputation and credibility of the government and its economic policies in the financial markets. **Table 4** details fourteen instances between 1990 and 2005 identified by the IMF in which governments in developed countries undertook fiscal consolidation. As is indicated, these efforts generally were initiated for a short period of time and were designed to meet a specific objective. The details provided by the IMF include the political and macroeconomic environment in which the fiscal consolidation occurred and the condition of the central governments' budget. In a number of cases, budget consolidation can be associated with a change in governments in which the budget deficit was an issue in the preceding election.

The IMF concluded that successful fiscal consolidation efforts generally were accompanied by a supportive domestic and international environment, including, but not limited to, periods of sustained positive economic growth among trading partners. While fiscal consolidation generally tends to reduce the overall rate of growth in an economy in the short run due to the drop in the central government's contribution to GDP growth, the IMF authors concluded that: 1) this negative effect was not as pronounced as had been indicated in previous studies; 2) that in some cases fiscal consolidation had a positive impact on the rate of economic growth; and 3) that the long-term impact on economic growth from a reduction in central government spending depended on a range of factors, including the strength of private domestic demand.<sup>9</sup>

<sup>9</sup> Kumar, Manmohan S., Daniel Leigh, and Alexander Plekhanov, *Fiscal Adjustments: Determinants and Macroeconomic Consequences*, International Monetary Fund, IMF Working Paper WP/07/178, July 1007, p. 22.

To reduce the size of the government's deficit spending, policymakers have a number of options. These options include reducing current spending, increasing current revenue, reducing capital spending, or some combination of spending reductions and revenue increases. While the record on the economic effects of these various approaches to fiscal consolidation is mixed, a study by the OECD concluded that "spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation and better economic performance" than revenue enhancements.<sup>10</sup> Despite this general result, the OECD study also concluded that the experiences of OECD countries was that revenue increases "accounted for a larger fraction of the total reduction,"<sup>11</sup> than did reductions in government spending. In addition, the study concluded that three-fourths of the episodes involved a combination of cuts in government expenditures and increases in government revenues. Reductions in capital spending generally played a small role in such fiscal consolidation efforts, according to the OECD study.

**Table 4. Fiscal Consolidation Efforts in Selected Developed Countries**

Episode	Political Background	Macroeconomic Background	Government Finances
Canada, 1994–97	Majority federal government elected in 1993 to address fiscal issues; similar election result in 1994-95 in the two largest provinces.	Recovery from recession; low inflation; high output gap and unemployment; exchange rate depreciation; improving current account balance.	Sizable deficit and debt stock; large share of debt held at short term and by nonresidents; high tax-to-GDP ratio; expending entitlements; sub-federal fiscal issues.
Denmark, 2004–05	The ruling center-right coalition entered the second half of its term with a diminishing voter support.	Continued economic slowdown (since 2001) characterized by gradually rising unemployment.	A moderate level of public debt (of about 50% of GDP), a near-balanced budget.
Finland, 1998	Both the coalition elected in 1991 and the grand coalition elected in 1995 had a clear mandate for EMU membership.	Gradual consolidation (from 1992) started at the time of deep recession characterized by high output gap, rising unemployment, low inflation, and depreciating exchange rate. By 1998 the economy had recovered and enjoyed a growth rate well above the EU average.	High deficit and medium-level but rapidly increasing debt, high tax-to-GDP ratio and expanding entitlement programs.

<sup>10</sup> Guichard, Stephanie, Mike Kennedy, Eckhard Wursel, and Christophe Andre, *What Promotes Fiscal Consolidation: OECD Country Experiences*, the Organization for Economic Cooperation and Development, Working Paper No. 553, May 28, 2007, p. 7.

<sup>11</sup> *Ibid.*, p. 10.

<b>Episode</b>	<b>Political Background</b>	<b>Macroeconomic Background</b>	<b>Government Finances</b>
France, 1996–97	The president brought forward parliamentary elections by one year to ensure that the new government had a clear mandate for fiscal consolidation and that domestic elections did not interfere with the pre-EMU meeting of the European Council in early 1998.	The consolidation was launched against the background of a slow recovery from a recession, characterized by relatively high unemployment, low inflation, and exchange rate depreciation.	The expansionary policy in response to the 1993 recession left France with a large fiscal deficit and a medium-level but rapidly rising public debt, falling short of the EMU criteria.
Germany, 2003–05	The coalition led by the Social-Democratic Party narrowly won the elections in September 2002. The comprehensive reform plan (Agenda 2010) was unveiled in March 2003.	Three years of static output, high unemployment, concerns about possible deflation, heavy losses in the financial sector.	Fiscal deficit widened to about 3.7% of GDP in 2002, with public debt hovering around 60% of GDP.
Ireland, 2003–04	The coalition government enjoyed a strong parliamentary majority since 2002. In addition, there were few differences of views within the coalition.	After a decade of strong growth, economic activity (excluding profits of multinationals) decelerated markedly in 2002 and remained subdued in 2003.	Relatively low level of public debt (below 35% of GDP), a near-balanced budget, a relatively low tax-to-GDP ratio.
Italy, 1997	The consolidation was preceded by the electoral reforms at both the central and regional levels, which resulted in more stable governments with longer political horizons.	The consolidation attempt was launched during the time when growth turned negative in late 1996 - early 1997 after strong performance in 1995, and the return of the recession of the early 1990s was perceived as likely. Inflation was declining but the unemployment remained high.	Very high debt (of over 115% of GDP in 1997), rising in spite of fiscal consolidation attempts since early 1990s.
Japan, 2004	Ruling coalition since 2000. In 2004, the positions of the ruling party in both houses of parliament shrank as the government's approval rating hit the low of 36 percent (compared to 70–90% in 2001), partly due to the passage of pension reforms.	Gradual economic recovery since mid-2002, with contributions from both exports and domestic demand, characterized by gradually declining unemployment and easing of deflation.	A decade of high fiscal deficits (about 8 percent of GDP in 2003) led to a rapid accumulation of public debt, which reached 160% of GDP. The revenue-to-GDP ratio remained below 30%, while social security outlays kept rising.

<b>Episode</b>	<b>Political Background</b>	<b>Macroeconomic Background</b>	<b>Government Finances</b>
Netherlands, 2004–05	As a result of early elections in January 2003, center-right coalition government took office.	There had been a significant downturn in activity since 2000. During the two years, growth averaged barely 0.2%, with unemployment rising. Activity began to pick up in 2004 and growth was projected at about 1% in 2004 and 1¾% in 2005. The authorities had the challenge of nurturing the emerging recovery while ensuring fiscal sustainability.	There had been a sharp deterioration in the fiscal position with the 3 percent Maastricht deficit ceiling breached in 2003. The general government balance worsened by almost 5½ percentage points during the first three years of the decade, as a result of the 2001 tax reform, increases in health care and education spending, and a higher deficit of local governments (reaching 0.6 percent of GDP).
New Zealand, 2003	Competitive political environment, with the opposition calling on the ruling Labor Party to introduce more tax cuts and improve the quality of health and education services. However, the September 2005 elections did not lead to any significant relaxation of fiscal policy and the incumbent party was re-elected with a confirmed mandate for continued fiscal consolidation.	Solid and accelerating economic growth, narrowing current account deficit, unemployment at a 16-year low.	A slight budget surplus and a moderate level of public debt (of about 40% of GDP), which exceeded, however, the government's long-term target of 30% of GDP.
Spain, 1996–97	Elected in March 1996, the coalition government had a mandate for fiscal consolidation.	A relatively rapid economic recovery after the recession that culminated in a negative growth in 1993. While economic activity was on the rise and inflation gradually subsided, high unemployment (at above 20% of labor force) proved to be persistent.	Public finances have gradually deteriorated since 1988 with annual fiscal deficits exceeding 7% of GDP in 1995. Public debt has rapidly risen to over 70% of GDP.
Sweden, 1994–98	The Social Democrat minority government launched fiscal consolidation following the 1994 general elections.	The deepest recession since the 1930s, accompanied by high inflation, quickly rising unemployment, exchange rate depreciation and associated improvement in the current account balance.	Fiscal deficit exploded to over 12% of GDP as a result of the cyclical downturn and the underfinanced tax reform of 1990–91, with public debt reaching 80% of GDP.

Episode	Political Background	Macroeconomic Background	Government Finances
United Kingdom, 1995–98	The popularity of the conservative party by the middle of the term was low. After 18 years of being in opposition, the Labor Party won elections in May 1997 with an overwhelming majority in Parliament. The new government confirmed the course of fiscal consolidation and introduced a number of new policy reforms, including transferring the responsibility for setting interest rates from the Treasury to the Bank of England.	Three successive years of solid economic growth, led by private consumption. Unemployment was falling rapidly, while inflation remained relatively low.	Public sector fiscal deficit increased to over 7 percent of GDP by 1994, the debt-to-GDP ratio was on the rise and already exceeded the target level of 40% by about 8 percentage points.
United States, 1994	New Democratic President took over in January 1993. The Congress was also Democratic and there was expectation of an initiative to reduce debt.	Economic activity had been weak for some time, and unemployment was rising.	The federal government fiscal situation had been deteriorating at a sharp pace. The deficit was almost 5% of GDP. In nominal terms federal debt had quadrupled over 1980–92 and the debt ratio was projected to continue rising at a high rate.

**Source:** Kumar, Manmohan S., Daniel Leigh, and Alexander Plekhanov, *Fiscal Adjustments: Determinants and Macroeconomic Consequences*, International Monetary Fund, IMF Working Paper WP/07/178, July 1007, p. 10–11.

## Budget Rules

One approach developed countries have used to address government budget deficits has been to adopt some type of a budget rule. A study by the OECD on fiscal consolidation concluded that most developed countries have at some time adopted budget rules that restrict the amount of deficit spending to a specified percent of GDP and that constrain the overall level of the central government's debt, as indicated in **Table 5**.<sup>12</sup> One common feature of these rules is that most of them were applied for a relatively short period of time. In contrast, members of the European Union (EU), which account for half of the total number of developed countries, have adopted both short-term, country-specific budget rules, and long-term EU-wide budget rules.

In general, the OECD concluded after observing fiscal consolidation efforts among OECD countries since 1990 that the more successful of these efforts combined rules to balance the budget with requirements to reduce expenditures. The study argues that no one rule fits all countries and all circumstances, but that successful programs of consolidation seem to have some common features. These features include rules that are simple to manage, while incorporating enough flexibility, or discretion, to respond to downturns in the business cycles. The OECD study

<sup>12</sup> Guichard, Stephanie, Mike Kennedy, Eckhard Wursel, and Christophe Andre, *What Promotes Fiscal Consolidation: OECD Country Experiences*, Organization for Economic Cooperation and Development, May 28, 2007.

also observed that budget rules that rely on reducing expenditures generally have been more successful. By focusing on expenditures, the rules were more successful because: 1) they were not reliant on cyclically volatile revenues; 2) they were designed to let economic stabilizers work during a downturn; and 3) they saved windfall gains during an upturn. The data in **Table 5** also indicate if the budget rules include provisions for dealing with windfall surpluses and a “Golden Rule” provision. A golden rule provision requires that the central government’s current expenditures match its current revenues, exclusive of capital investments.

**Table 5. Fiscal Rules Being Applied in Developed Countries**

Country	Name and date	Characteristics of the set of rules			
		Budget target	Expenditure target	Rule to deal with windfall revenues	Golden rule
Australia	Charter of Budget Honesty (1998)	yes	no	no	no
Austria	Stability and Growth Pact (1997) Domestic Stability Pact (2000)	yes	no	no	no
Belgium	Stability and Growth Pact (1997) National budget rule (2000)	yes	no	yes	no
Canada	Debt repayment plan (1998)	yes	no	yes	no
Czech republic	Stability and Growth Pact (2004)  Law on budgetary rules (2004)	yes	yes	no	no
Denmark	Medium term fiscal strategy (1998)	yes	yes	no	no
Finland	Stability and Growth Pact (1997) Spending limits (1991, revised in 1995 and 1998)	yes	yes	no	no
France	Stability and Growth Pact (1997) Central Government Expenditure Ceiling (1998)	yes	yes	Since 2006	no
Germany	Stability and Growth Pact (1997) Domestic Stability Pact (2002)	yes	yes	no	yes
Greece	Stability and Growth Pact (1997)	yes	no	no	no
Hungary	Stability and Growth Pact (2004)	yes	no	no	no
Ireland	Stability and Growth Pact (1997)	yes	no	no	no
Italy	Stability and Growth Pact (1997) Nominal ceiling on expenditure growth (2002)	yes	yes	no	no
Japan	Cabinet decision on the Medium Term Fiscal Perspective (2002)	yes	yes	no	no
Luxembourg	Stability and Growth Pact (1997)	yes	no	no	no

		Characteristics of the set of rules			
Country	Name and date	Budget target	Expenditure target	Rule to deal with windfall revenues	Golden rule
	Coalition agreement on expenditure ceiling (1999, 2004)				
Mexico	Budget and Fiscal Responsibility Law (2006)	yes	no	yes	no
Netherlands	Stability and Growth Pact (1997)	yes	yes	yes	no
	Coalition agreement on multiyear expenditure targets (1994, revised in 2003)				
New Zealand	Fiscal Responsibility Act (1994)	yes	yes	no	no
Norway	Fiscal Stability Guidelines (2001)	yes	no	yes	no
Poland	Stability and Growth Pact (2004)	yes	no	no	no
	Act on Public Finance (1999)				
Portugal	Stability and Growth Pact (1997)	yes	no	no	no
Slovak Republic	Stability and Growth Pact (2004)	yes	no	no	no
Spain	Stability and Growth Pact (1997)	yes	no	no	no
	Fiscal Stability Law (2004)				
Sweden	Fiscal Budget Act (1996, revised in 1999)	yes	yes	no	no
Switzerland	Debt containment rule (2001, but in force since 2003)	yes	yes	yes	no
United Kingdom	Code for Fiscal Stability (1998)	yes	no	no	yes

**Source:** Guichard, Stephanie, Mike Kennedy, Eckhard Wurzel, and Christophe Andre, *What Promotes Fiscal Consolidation: OECD Country Experiences*, Organization for Economic Cooperation and Development [EC/WKP(2007)13], 2007.

**Notes:** The Golden Rule generally restricts central governments from borrowing to fund current spending. Borrowing to fund investments generally is exempted from the budget rules. Essentially, the rule attempts to equate current spending with current revenues.

## Budget Rules in Europe: The Stability and Growth Pact

In contrast to the short-term, country-specific budget rules most OECD countries have adopted at various times to address rising central government budget deficits, the members of the EU also operate within the requirements of the Stability and Growth Pact, which was adopted in 1997. EU members decided that, due to the disparate performance and composition of their economies, it was necessary to adopt a fiscal rule in lieu of relying on market forces to coordinate their economic policies. The Pact consists of preventive measures that include monitoring the fiscal



policies of the members by the European Commission and the European Council so that fiscal discipline is maintained and enforced in the Economic and Monetary Union (EMU). The Pact also includes corrective measures that provide for fines for countries that fail over a number of years to meet the Pact's requirements. The European Union comprises the largest single bloc of countries that collectively have applied a long-term set of rules. These rules require the members to apply corrective measures to reduce their annual budget deficits and to reduce the overall level of their government debt if the annual deficits or the overall amount of debt exceed certain prescribed percentages of GDP. Since the Stability and Growth Pact was adopted, however, it has not always been applied consistently, which eventually led the EU to amend the Pact.

The basic elements of the Stability and Growth Pact did not originate with the Pact itself, but were part of the original Maastricht Treaty that served as the founding document for the present-day EU. The budget rules are based on Articles 99 and 104 of the Treaty, and related decisions, including the excessive deficit procedure protocol. Article 99 of the Treaty requires the members to "regard their economic policies as a matter of common concern." They also are required to coordinate their economic policies in order to have "similar economic performance." Article 104 requires EU members to "avoid excessive government deficits." EU members are expected to follow established guidelines regarding the ratio of the government deficit relative to GDP and the ratio of government debt to gross domestic product. The Protocol on Excessive Deficit Procedure established the specific guidelines that are applied under Article 104. Under this protocol, EU members are expected to have an annual budget deficit no greater than 3% of GDP at market prices and government debt no more than an amount equivalent to 60% of GDP. The number of member states with a fiscal deficit above 3% of GDP increased from two in 2007 to twenty in 2010.<sup>13</sup>

All of the members of the EU are expected to meet the requirement of the budget rules. Nevertheless, the rules are of especial importance to the group of countries known as the euro area, because the members have adopted the euro as their common currency. Typically, countries have a set of economic policy tools available to them to manage their economies. These macroeconomic policy tools generally include such monetary and fiscal policy measures as control over the nation's money supply, adjustments in tax rates, and control over government spending. In addition, nations have tools to affect the international exchange value of their currency. By adopting a common currency, however, the euro area countries ceded control of their currency to the European Central Bank. Consequently, the euro area countries agreed that the loss of the exchange rate tool meant that they would need to make greater efforts to control their government spending and their government budgets in order to restrain inflationary pressures and to promote similar economic performance among countries that have widely disparate economies. As a result, the euro area countries adopted budget rules as a component of their common policy approach.

As the Pact took effect in 1999, EU members began criticizing the rules-based approach of the Pact for being too stringent and they questioned whether the rules could be enforced. In 2003, the weaknesses of the Pact were exposed when the European Council voted not to apply the punitive procedures under the Excessive Deficit Procedure to France and Germany, which had experienced rising levels of government debt. Some EU members argued that the Pact focused too heavily on the rules-based percentage guidelines associated with the Pact without regard for the circumstances under which a government's level of debt or its deficit spending may rise, for

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<sup>13</sup> Public Finances in the EMU 2009, p. 30.

instance as a result of a temporary increase in government spending to counter an economic downturn.<sup>14</sup>

The EU experience with the Pact demonstrates the policy tradeoffs that generally are involved in adopting such programs. In order to have a fiscal consolidation program be effective, the program needs to have stringent rules and penalties for violating the rules. At the same time, the current economic recession and financial crisis have demonstrated that policymakers need some flexibility and discretion in implementing budget rules in order to adjust the policy mix and generally to respond to differences in economic conditions. A fiscal deficit during periods of economic recession or very slow growth, for instance, likely would require a different policy prescription than one that arises during periods of strong economic growth when revenues would be high and payments made through automatic stabilizers would be low.

In 2005, the EU members adopted a number of changes to the Stability and Growth Pact. These changes shifted the enforcement of the Pact from a rules-based regime to one based more on a set of principles with more latitude for discretion in enforcing the corrective requirements. In the area of prevention, the modified Pact provides for each EU member to develop its own medium-term objectives to bring its deficit spending and its debt level into compliance based on the unique economic conditions of each member. The modified Pact also relaxes the annual deficit targets as Members move their budget balances into compliance and the Pact factors in the effects of cyclical economic activity. The corrective measures also were modified in a number of important ways. The changes allow Members to avoid the corrective measures if their annual fiscal deficit is above 3% of GDP if they can demonstrate that the deficit is caused by “exceptional and temporary” circumstances. In addition, members can argue that their budget deficit should be exempt from the penalties of the Excessive Deficit Procedure if they can demonstrate that the deficit is the result of “other relevant factors.” Among the other relevant factors that are listed as fiscal expenditures are: 1) officially sponsored research and development; 2) European policy goals; 3) support for international objectives; 4) capital expenditure programs; 5) pension reform; 6) fiscal consolidation programs; and 7) high contributions to EU-wide initiatives.

In 2008 as the financial crisis was unfolding, EU members were asked to provide a fiscal stimulus to their economies in ways that would comply with the Stability and Growth Pact. These efforts were part of a \$256 billion Economic Recovery Plan<sup>15</sup> proposed by the European Commission to fund cross-border projects, including investments in clean energy and upgraded telecommunications infrastructure. In order to comply with the Stability and Growth Pact, the EU asked its members to make their fiscal stimulus plans timely, temporary, and targeted, so they would not have a permanent impact on tax rates or on spending commitments beyond that necessary to counter the effects of the two crises. As a result, each EU member was asked to contribute an amount equivalent to 1.5% of their GDP to boost consumer demand. In addition, members were tasked to invest in such capital projects as energy efficient equipment in order to create jobs and to save energy, invest in environmentally clean technologies to convert such sectors as construction and automobiles to low-carbon sectors, and to invest in infrastructure and communications. This plan also proposed official support measures to increase the rate of

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<sup>14</sup> Beetsma, Roel M.W.J., and Xavier Debrun, *Implementing the Stability and Growth Pact: Enforcement and Procedural Flexibility*, IMF Working Paper WP/05/59, International Monetary Fund, March 2005.

<sup>15</sup> *A European Economic Recovery Plan*: Communication From the Commission to the European Council, Commission of the European Communities, COM(2008) 800 final, November 26, 2008. The full report is available at: [http://ec.europa.eu/commission\\_barroso/president/pdf/Comm\\_20081126.pdf](http://ec.europa.eu/commission_barroso/president/pdf/Comm_20081126.pdf)

employment and to focus investments on such high technology sectors as telecommunications and environmentally safe technologies.

## Conclusions

Financial markets and policymakers are growing increasingly concerned over the high level of deficit spending and the growing amount of government debt among a large number of advanced and developing economies. Unlike previous bouts with rising government deficits in developing countries, most of the current increase in government spending does not reflect out of control spending, but represents a calculated response to a severe economic downturn and a global financial crisis. In general, the two crises have affected the balance sheets of the central governments in three broad areas: 1) special fiscal measures to address the financial crisis; 2) discretionary fiscal stimulus measures to spur economic growth; and 3) a surge in non-discretionary spending and a loss of tax revenue. As a result of these factors, the financial crisis has undermined the effectiveness of budget rules as government budgets are affected by large or prolonged internal or external shocks. Most estimates indicate that such deficits will stabilize in 2010, but will not decline appreciably for some time after that. On balance, losses in tax revenue and an increase in spending associated with fiscal stimulus measures to counter the economic recession and the financial crisis are expected to have a relatively equal negative impact on the budget balances of the developed countries.

One approach most developed countries have used to address government budget deficits has been to adopt a budget rule. In general, most developed countries have at some time adopted budget rules to restrict the amount of deficit spending to a specified percent of GDP and to constrain the overall level of the central government's debt. One common feature of these rules, however, is that most of them were applied for a relatively short period of time. In contrast, members of the EU have adopted both short-term, country-specific budget rules, and long-term EU-wide budget rules. Academic studies seem to indicate that the more successful budget efforts combined rules to balance the budget with requirements to reduce expenditures. In developing such budget rules, policymakers are caught between designing rules that are enforceable, but inflexible, versus rules that are flexible and responsive to discretion, but less enforceable.

For national policymakers, the rising budget deficits and nascent economic recovery present a challenging policy mix. Various governments have budget rules in place to limit the budget deficits, but the necessity of continuing to provide stimulus to their economies to keep the recovery on track has put these budget rules on hold. For policymakers, the challenge is to unwind the fiscal stimulus measures that were adopted to prop up the financial sector and boost economic growth without short-circuiting the economic recovery. The strength of the economic recovery will determine the extent to which these dual policy goals are in conflict. A faster pace recovery will reduce the size of the government's budget deficits, which should work to ease the concerns of financial markets. Over the short-term, however, financial markets have displayed increased weariness over the magnitude and the pervasive nature of the deficits, especially in Europe. This could result in tighter credit and higher interest rates for all market participants. Investors are particularly concerned over the exploding government debts and public unrest in Spain, Greece, Portugal, and Ireland. Eventually, the wealthier economies of Europe, particularly France and Germany, may feel compelled to step in and provide financial assistance to the four struggling economies. This incident may well provide one more challenge to European economic integration.

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