Chipping Away at Public Debt
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Sources of Failure and Keys to Success in Fiscal Adjustment

EDITED BY
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Foreword

“A plan is nothing, but planning is everything.” A quote from U.S. President Dwight D. Eisenhower in 1957, referring to a military context where a shifting situation can rapidly make a plan obsolete and worthless, yet the process of thinking ahead through all possible contingencies and the appropriate response to them is extremely valuable. The former general’s wisdom carries through, if appropriately adapted, to the context of economics and public finance.

Ever since the beginning of the global financial and economic crisis that broke out in the late 2000s, my colleagues and I at the IMF have consistently called for the announcement of credible medium-term fiscal adjustment plans. In the early stages of the crisis, when a new Great Depression loomed as a real possibility, we called for fiscal stimulus (in those countries with sufficient fiscal space to afford it), but simultaneously advised the announcement and publication of fiscal adjustment plans that would gradually restore the state of the public finances to a more sustainable situation. As the world economy began to recover, we called on countries to begin implementing fiscal adjustment plans.

To us, not just planning, but also plans are everything, if they are well designed. Plans to adjust the public finances are a way to commit to the long and hard task ahead, to explain to the public at large how the government intends to ensure the solidity of the public finances, and to anchor market expectations. In the absence of plans and their implementation, market participants would become more concerned about fiscal sustainability and would, sooner or later, demand high-risk premia on government bonds, thus causing an increase in borrowing costs for the government and perhaps interest rates more generally.

But the important point implicit in Eisenhower’s observation—that the situation often changes—applies just as forcefully to the economics context. The list of possible types of surprises that may imply costs for the fiscal deficit is vast: in particular, it includes shocks to macroeconomic variables, such as economic growth or interest rates; occasionally, banking crises or natural disasters also inflict a major toll on the public finances.
In view of these possible surprises, fiscal adjustment plans must thus be designed in a way that makes them sufficiently flexible to accommodate the impact of shocks, but also sufficiently resilient so as to preserve their medium-term fiscal consolidation objectives even when the underlying economic environment turns out differently than initially expected.

This book tells the stories of many fiscal battles of the past and the shifting situations that influenced the course of events. Some of these battles were fought almost without a plan; some with plans that were drawn up in greater detail but had to be abandoned; and some where plans proved resilient and instrumental to ultimately bringing the public finances under control. The stories are important, informative, and interesting in themselves, and thus deserve to be written and read. The book records the motivation, objectives, and ultimate success or failure of the plans and of the people—capable civil servants and politicians—who designed them and sought to implement them. The lessons are valid today and will continue to be relevant for a long time to come, not only because the fiscal implications of this most recent crisis will take many years to resolve, but also because no doubt further crises and new fiscal challenges will emerge in the future.

One of our main tasks at the International Monetary Fund—and its Fiscal Affairs Department in particular—is to help countries design and implement fiscal policies that promote strong, sustained, and balanced growth. We do so through policy advice and technical assistance grounded in decades of collective operational experience as well as research, such as the work reported in this book. Our counterparts and everyday interlocutors are primarily country officials. Yet, one of the key findings in this book is that, ultimately, for fiscal adjustment to succeed, it has to be supported by the public at large. Thus the stories in this book are relevant not just for technical experts, but also for taxpayers, investors, and voters who want to be better informed about how the lessons of the past can guide the fiscal policies planned by their governments today and in the years to come. I hope you find this work interesting and helpful.

Carlo Cottarelli
Director, Fiscal Affairs Department,
International Monetary Fund.
Acknowledgments

This book is the outcome of a large team effort. Although the individual chapters bear the main authors' names, the team that produced this book met numerous times to establish and consistently apply its common approach, exchange ideas, compare notes, and share feedback. In addition to the authors listed in the individual chapters, several people deserve special mention and warm thanks. Carlo Cottarelli, Director of the International Monetary Fund’s (IMF’s) Fiscal Affairs Department, was highly supportive throughout the project. Ricardo Velloso and Mauricio Villafuerte played a key role in shaping the overall project and providing guidance and detailed comments to several of the country case study teams. Our assistants’ team, consisting of Patricia Quiros, Katia Chen, and Alica Dzelilovic, provided excellent editorial and logistical support and was of great help in conducting archival searches. The project was initiated and led by Paolo Mauro. Many colleagues in the IMF, other institutions, and academia provided insightful and constructive comments: in particular, Masatsugu Asakawa, Alan Auerbach, Roel Beetsma, Benoît Coeuré, Carlo Cottarelli, David Heald, Paul-Henry Lapointe, and others acknowledged in the individual chapters. Sean Culhane and Patricia Loo of the IMF’s External Relations department liaised effectively with our publisher. Natasha Andrews-Noel, Timothy Burgard, and Stacey Rivera of Wiley were helpful and efficient throughout the editorial and production process.

The opinions expressed in this book are those of the authors and editor alone and should not be attributed to the International Monetary Fund, its Board of Directors, its management, or any of the institutions with which they are affiliated.
Introduction

General public interest in government debts and their consequences is now at an all-time high in the advanced economies. Indeed, with the global financial and economic crisis that began in the late 2000s, the state of the public finances in the advanced economies has experienced its most pervasive and pronounced worsening since the Second World War. Government debts as a share of gross domestic product (GDP) in the G-7 countries are now higher than they were in the early 1950s, that is, in the immediate aftermath of the Second World War (see Figure I.1). Spending pressures in aging-related areas—pensions and, especially, health care—will add to the challenge in the years ahead.

Until the “Great Recession” of 2008–09, developments in public debts and deficits had seldom been the stuff of high drama in the advanced economies. Occasionally, budget negotiations had led governing coalitions to fall apart or even governments to shut down. Austerity measures had sometimes triggered public demonstrations or strikes, and even severe violence. But as fiscal variables such as overall revenues and expenditures usually change slowly from year to year, the perception by and large had been that public debts were a bit like cholesterol: high levels would increase the chances of serious trouble, but there was no guarantee that trouble would occur, at least not in the near term. It was well understood that high levels had to be gradually brought down at some point: ultimately, fiscal adjustment is motivated by the need to avoid debt reduction through disruptive means such as default or inflation. However, the temptation to postpone adjustment was strong, implying that (as shown later in the book) fiscal adjustment plans often lacked ambition in their design or implementation. Fiscal crises precipitating fiscal adjustment—those associated with sharp increases in interest rates, refinancing difficulties, support by international financial institutions, or sovereign defaults—were the domain of developing and emerging countries.2

With fiscal crises having recently begun to affect some advanced economies (albeit relatively small ones, thus far), there is now greater realization that the need for fiscal adjustment in the years ahead is at its highest and will no doubt remain a key issue for a long time to come. In response, many
FIGURE I.1 General Government Gross Debt Ratios in G-7 Economies, 1950–2010

Sources: Data are drawn mainly from the International Monetary Fund’s (IMF’s) Fiscal Affairs Department Historical Government Debt database supplemented by the following: Canada (1950–60)—Federal Gross Government Debt (Haver Analytics); France (1950–77)—National Debt (Goodhart, 2002); Germany (1950–75)—Credit Market Debt and Loans (Statistisches Bundesamt Deutschland); Italy (1950–78)—National Government Debt (Banca d’Italia); Japan—Central Government Debt (Ministry of Finance of Japan); United Kingdom (1950–79)—National Debt (Goodhart, 1999); United States—Gross Federal Debt (Office of Management and Budget; and U.S. Census Bureau). G-7 average is weighted by gross domestic product at purchasing power parity.
governments have prepared and are still refining medium-term fiscal adjustment plans for the period ahead. Academic research on fiscal policy, after languishing for several years, is experiencing a revival.

The objective of this book is to inform the public debate on how to ensure successful fiscal adjustment in the period ahead, through systematic analysis of past adjustment plans and their outcomes. Our belief is that although today’s circumstances may be different from those experienced in the past, history may nevertheless provide useful guidance. Our hope is that the design and implementation of today’s plans may be improved by avoiding the pitfalls that plagued the plans of the past, and by learning from past successes. In some ways, our work is especially motivated by today’s difficult challenges. But we think the lessons to be drawn will be relevant for many years to come. It will take years, if not decades, of fiscal adjustment to place the public finances of the advanced economies back on a sustainable path: we are in this for the long haul. Moreover, fiscal adjustment has had to be undertaken on many occasions throughout history, and it is safe to expect that the issue will come back to the fore many times in the future.

Indeed, high and growing government debts have long been a recurring concern for policymakers and the public at large, calling for periodic attempts at fiscal adjustment, and this is the past experience we leverage in this book’s analysis. The extent to which the issue has come to the fore in public debate has varied over time and across countries, depending on economic developments, financial market conditions, and perhaps even social and cultural norms and attitudes vis-à-vis public savings. Nevertheless, it is fair to say that, for a good part of the past four decades, most advanced economies have sought to grapple with increasing government debts and deficits, as fiscal revenues often failed to keep pace with rising government expenditures, which in turn largely stemmed from the expansion of social spending on welfare benefits, pensions, and health care.

In particular, the 1980s and early 1990s saw rapidly rising debts in many advanced economies, leading to the design and implementation—with varying degrees of success—of several large fiscal adjustment plans. In the mid-to late 1990s, attempts at fiscal adjustment were a frequent topic of household discussion in many European countries, as part of the drive toward meeting the prerequisites for European Monetary Union. Concerns were temporarily alleviated in some other advanced economies by economic and asset price booms in the late 1990s and the early to mid-2000s, as revenues rose, government deficits shrank, and economic growth reduced debt/GDP ratios. In hindsight, however, it is now clear that public debts remained an important policy challenge all along. Public concern with the issue has been reflected in myriad debates on the appropriate fiscal stance and policy measures to attain it, as well as attention-grabbing initiatives such as the billboard-sized “United States national debt clock” in Manhattan, along with
various similar clocks and debt-tracking resources online for the United States and other countries.

From an analytical perspective, this book seeks to change the way in which we look at large fiscal adjustments, by shifting the focus of empirical analysis to large fiscal adjustment plans, and a comparison of plans versus outcomes. Previous studies focused on ex-post successes, identifying successful fiscal adjustment episodes on the basis of the largest observed improvements in the government debt or the fiscal balance. That traditional approach asked important questions—such as whether fiscal adjustments are longer lasting and more successful when they rely on expenditure cuts rather than on tax hikes—and yielded useful information. However, important pieces of the puzzle were still missing. In our view, useful lessons can be drawn not only from successes, but also from failures. Moreover, it is important to understand not just outcomes, but also whether the outcomes turned out as intended. In this regard, our results will shed further light on the interpretation of some of the findings that had been obtained through the traditional, outcomes-based approach.

Our project takes an alternative, complementary approach. It starts from ex-ante, fiscal adjustment plans, rather than actual, ex-post outturn data. It identifies large fiscal adjustment plans on the basis of large planned reductions in debts and deficits. The empirical analysis then tracks ex-post outcomes compared with ex-ante plans. It looks at the extent to which macroeconomic variables (growth, interest rates, etc.) deviated from those projected at the time when the plans were drawn up. It also looks at whether spending exceeded expectations, or revenues fell short of expectations, and why, as well as whether planned debt reductions proceeded faster or slower than projected in the plan.

In light of the book’s emphasis on the benefits of an ex-ante approach in analyzing large fiscal adjustments, we selected the sample of countries for the case studies solely on the basis of ex-ante criteria. We wanted the experiences described in the book to resonate especially with readers in advanced economies, which at the time of writing face the most acute need for fiscal adjustment. We also wanted the countries to be analyzed in the case studies to have two or more large medium-term fiscal adjustment plans, with a reasonable degree of specificity, available to the public, and with a horizon of at least three years. Finally, and perhaps most importantly, we wanted to bring back to life the motivation for fiscal adjustment, the constraints faced by policymakers, and the real-world choices they had to make given the information that was available to them at the time. In other words, to inform today’s choices, we wanted the readers (and today’s policymakers) to be able to put themselves in the shoes of their predecessors, so as to be able to learn from their experience. To permit that in-depth treatment, our country sample thus had to focus on a relatively small number of
case studies. This led us to choose the G-7 countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), a long-established and well-known group of the largest advanced economies.

For each country, we had to identify the largest, or most significant, fiscal adjustment plans to be analyzed in the case studies, again, solely on an ex-ante basis. The broad criteria we used are the following:

- Large size of fiscal adjustment, measured by the improvement of the fiscal balance (or the cyclically adjusted fiscal balance, or the cyclically adjusted primary balance, the fiscal measure that is most closely under the control of the government)
- Public announcement of the plans and their visibility in the media
- Formal and detailed presentation of the plans
- Medium-term orientation of the plans

Within these broad criteria, the teams for individual case studies adopted more specific ex-ante criteria to selecting the plans, tailored to country-specific circumstances and availability of information. Each case study explains its approach in detail, but in a nutshell:

- **Canada.** Although fiscal adjustment was a recurring policy objective, only two medium-term fiscal adjustment plans were presented to the public.
- **France.** The case study briefly analyzes two austerity packages of the 1970s and 1980s, and then delves into the details of the two most ambitious plans, both undertaken in the context of European initiatives linked to Euro membership: the plan aimed at meeting the Maastricht criteria for Euro entry and the plan to correct the fiscal deficit under the European Union’s Excessive Deficit Procedure.
- **Germany.** Medium-term fiscal adjustment plans have long been prepared each year (on a rolling basis). The authors of the case study computed the ambition of each plan (measured by the targeted improvement in the cyclically adjusted primary balance, where the cyclical adjustment was computed by the authors using only real-time data that would have been available to contemporaries), They then analyzed the four plans displaying the most ambitious fiscal adjustment according to that ex-ante measure.
- **Italy.** Here, the public debt has been chronically high and medium-term fiscal adjustment plans have been published every year, but governments have been short-lived. The case study analyzes (i) the most important and ambitious fiscal adjustment plan (to meet the Maastricht criteria for Euro entry); and (ii) the only plan designed and fully implemented by the same government.
- **Japan.** Formal medium-term fiscal adjustment plans were introduced as recently as the late 1990s, and only two plans were sufficiently detailed and well publicized to merit analysis.

- **United States.** There has traditionally been little emphasis on, and formality in, medium-term fiscal adjustment plans. Nevertheless, three initiatives combining efforts by both the administration and Congress to contain fiscal deficits stood out as especially relevant: the Gramm-Rudman-Hollings in the mid-1980s and the two Omnibus Budget Reconciliation Acts (OBRA) of the early 1990s.

- **United Kingdom.** The four chosen medium-term fiscal adjustment plans are those presented by new chancellors of the exchequer at the beginning of the legislature and government cycle. Each of these plans displayed significant ex-ante ambition with respect to improving the fiscal balance.

The main features of the large fiscal adjustment plans analyzed in detail by the case studies are summarized in Table 1.1. Although the plans are selected entirely on the basis of ex-ante considerations, the table also briefly gives a sense of the wide range of outcomes, in terms of ex-post performance, with respect to meeting the plans' initial objectives. This is to whet the reader's appetite for the analysis in the case studies, which will compare ex-ante objectives with ex-post outcomes and will seek to identify the factors underlying such discrepancies.

To complement the case studies, we cast the net to a wider set of countries and undertake a systematic cross-country statistical analysis of large fiscal adjustment plans. Again, we are careful to select our sample on an ex-ante basis and analyze the countries of the European Union (EU), which have to produce fiscal adjustment plans as part of their obligations as EU members. Specifically, we use a comprehensive database that we assembled, consisting of all the three-year “convergence” or “stability and growth” programs produced by each EU country for every year over the past couple of decades. In addition to fiscal variables (revenues, primary and interest expenditures, etc.) for the next three years, the programs include underlying macroeconomic assumptions (growth, inflation, etc.). This permits a comparison of expectations and outcomes not only for the fiscal variables, but also for the macroeconomic variables. Using real-time data, we thus analyze plan implementation errors and ratios (actual adjustment versus planned adjustment) and their economic and political determinants.

Throughout the remainder of this book, one finding is clear: all plans encountered large surprises. In particular, differences in economic growth compared with expectations embedded in the plans had a sizable, direct impact on the fiscal accounts, and also an indirect impact by altering policymakers' and the public's perceptions of the relative merits of fiscal adjustment versus stimulus. In addition, other macroeconomic shocks,
TABLE I.1 Summary of Large Fiscal Adjustment Plans

<table>
<thead>
<tr>
<th>Country</th>
<th>Large Fiscal Adjustment Plan</th>
<th>Objectives/Design</th>
<th>Comments/Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>1985–91</td>
<td>❘ Reduce overall deficit by 3.5% of GDP over 6 years.</td>
<td>Overall deficit objectives met, but not sufficiently ambitious to halt the rise in debt.</td>
</tr>
<tr>
<td></td>
<td>§ Across-the-board cuts and freezes.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1994–97</td>
<td>❘ Reduce overall deficit by 3% of GDP over 3 years.</td>
<td>Successfully met objectives and attained long-lasting reversal of debt dynamics.</td>
</tr>
<tr>
<td></td>
<td>§ Major restructuring of spending,</td>
<td></td>
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</tr>
<tr>
<td></td>
<td>including reforms of unemployment</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>insurance, transfers to provinces,</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>and pensions.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>Plan Barre, 1976–77</td>
<td>❘ Austerity packages to curb inflation and current account deficit.</td>
<td>Effective in reducing deficits and containing aggregate demand, but impact short-lived.</td>
</tr>
<tr>
<td></td>
<td>§ Not set in multi-year frameworks.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Virage de la Rigueur, 1982–84</td>
<td>❘ Combination of tax hikes and spending curbs.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>§ Reforms in 1982–84.</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Maastricht criteria</td>
<td>§ Quantitative objectives aimed at meeting Maastricht criteria.</td>
<td>Difficulties in controlling expenditures.</td>
</tr>
<tr>
<td></td>
<td>2003–07 Consolidation</td>
<td>❘ Fiscal adjustment focused on expenditure control.</td>
<td>Some expenditure slippages, partly offset by revenue developments.</td>
</tr>
<tr>
<td></td>
<td>under the Excessive Deficit Procedure</td>
<td>§ Legally binding zero real growth rule for central government spending; health and pension reforms.</td>
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<thead>
<tr>
<th>Country</th>
<th>Large Fiscal Adjustment Plan</th>
<th>Objectives/Design</th>
<th>Comments/Outcome</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>1976–79 Plan</td>
<td>Cut deficit by 2.75% of GDP. Back-loaded; focus on expenditures (generalized cuts; cuts in labor market expenditures; wage restraint).</td>
<td>Weak economic growth led government priority to shift from fiscal adjustment to stimulus.</td>
</tr>
<tr>
<td></td>
<td>1981–85 Plan</td>
<td>Cut deficit by 1.25% of GDP. Front-loaded expenditure cuts (reduction in entitlement and wage bills).</td>
<td>Largely successful.</td>
</tr>
<tr>
<td></td>
<td>1991–95 Plan</td>
<td>Cut deficit by 1.5% of GDP while minimizing tax increases needed to finance unification. Mainly expenditure-based (defense, social spending). Revenue package from 1990 plus Value Added Tax (VAT) rate hike.</td>
<td>Did not meet objectives.</td>
</tr>
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<td></td>
<td>2003–07 Plan</td>
<td>Cut deficit together with “Agenda 2010” structural reforms (labor market, pensions). Back-loaded. All on expenditure side: reducing unemployment insurance, transfers to pension system, firing benefits, and subsidies.</td>
<td>Largely successful. Higher-than-expected costs of labor market reforms. Increase in VAT made it possible to meet objectives while reducing the tax burden on labor.</td>
</tr>
</tbody>
</table>
2002 EFPD for 2002–05

- Planned limited improvement in fiscal balance (by 1% of GDP), together with a 2% of GDP reduction in the revenue ratio, thus implying the need for a 3% of GDP expenditure cut.

Japan 1997—Fiscal Structural Reform Act

- Reduce deficit to 3% of GDP by fiscal year (FY) 2003.
- 3-year expenditure ceilings on initial budget by major policy area.
- No revenue-enhancing measures announced. Future policy decisions needed to achieve targets.


- Aim for primary surplus by early 2010s.
- Introduced 5-year rolling frameworks.
- 5-year expenditure cut plans by major policy area introduced in FY 2006.
- No revenue-enhancing measures announced. Future policy decisions needed to achieve targets.


- Curb government borrowing to rein in the money supply and inflation.
- Envisaged 5.5% of GDP cut in the deficit, through lower spending and an expected rise in oil revenues.

Revenue ratio remained unchanged. Large expenditure and fiscal balance overruns.

Immediately derailed by Asian crisis and domestic banking crisis.

Partially successful in the initial stages. Ultimately derailed by the global crisis.

Expenditure overruns in social security, public wages, and support to public enterprises.

(continued)
<table>
<thead>
<tr>
<th>Country</th>
<th>Large Fiscal Adjustment Plan</th>
<th>Objectives/Design</th>
<th>Comments/Outcome</th>
</tr>
</thead>
</table>
■ Shrink the State (Thatcher government agenda).  
■ Reduction in public sector manpower. | Expenditure cuts beyond what was envisaged. Privatization of large public enterprises. |
■ Increases in national insurance contribution rate and excises, broadening of the VAT base. Freezes on running costs combined with zero-based budgeting “fundamental expenditure reviews.” | Delivered a steady reduction in the fiscal deficit. |
| United States  
1985 Gramm-Rudman-Hollings (GRH) (Balanced Budget and Emergency Deficit Control Act) | ■ President to submit budgets consistent with GRH targets each year, and balanced budget by 1991.  
■ If legislated policy was projected to result in higher deficits, automatic “sequestration” with spending cuts would apply. | Did not achieve targets but deficit would have been larger in absence of GRH. |
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<tr>
<td></td>
<td>Introduced discretionary spending caps and pay-as-you-go (PAYGO) mechanism. Included some tax increases.</td>
</tr>
<tr>
<td></td>
<td>Unable to restrain the unexpected growth in spending for entitlement programs (notably, Medicare and Medicaid).</td>
</tr>
<tr>
<td>OBRA–1993</td>
<td>Reduce the deficit by 1.75% of GDP, relative to the no-policy-change baseline, by 1998.</td>
</tr>
<tr>
<td></td>
<td>PAYGO continued and discretionary spending caps extended, with 5-year nominal spending freeze. Some tax increases and measures to close loopholes.</td>
</tr>
<tr>
<td></td>
<td>Deficit reduction well in excess of targets, with stronger-than-expected economic growth and revenues, but also effective spending caps.</td>
</tr>
</tbody>
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revisions to past fiscal data, and political developments all presented significant challenges. This general finding highlights the importance of designing and implementing plans in a way that makes them sufficiently flexible to respond to shocks while credibly preserving their medium-term consolidation objectives.

The busy policymaker who is looking for a quick summary of the main policy implications of our work may now wish to go straight to our conclusions chapter. However, we believe that the devil is in the details and that the in-depth treatment of the case studies in Chapters 1 through 7 should prove not only entertaining, but also informative, by providing some important nuances and country-specific considerations. Chapters 1 and 2 analyze the cases of Canada and the United States, respectively, which present substantial differences in approaches and outcomes, despite similarities in timing of attempted consolidation and underlying macroeconomic developments. Chapters 3 through 5 consist of the cases of France, Germany, and the United Kingdom. Again, underlying cyclical/macroeconomic developments present similarities among these three European countries, with greater commonalities between France and Germany resulting from Euro qualification and adoption. Chapters 6 and 7 focus on two countries “living with” high debt and relatively low economic growth over the past two decades, Italy and Japan. Chapter 8 consists of our cross-country statistical analysis. Chapter 9 summarizes and concludes.

Notes

1. The International Monetary Fund’s *Fiscal Monitor* (published twice a year) reports on developments in fiscal variables and estimates fiscal adjustment needs for a large sample of countries. Throughout the book, the term “fiscal adjustment” refers to a combination of government expenditure cuts and revenue increases that improves the fiscal balance and halts or reverses the growth of public debt as a share of GDP.

2. Highly disruptive reductions in debt/GDP ratios have not occurred in the advanced economies since the 1940s. Hyperinflations occurred in the aftermath of major wars. Partial defaults occurred during the interwar period, for example, in Italy in the late 1920s (Alesina, 1988) and in the United States in 1933, when the abrogation of “gold clauses” in debt contracts prevented a 25 percentage point increase in the government debt/GDP ratio (Kroszner, 2003). The history of most advanced economies over the previous centuries is of course littered with frequent debt crises (Reinhart and Rogoff, 2010).

3. More specifically, our focus is on how to ensure that fiscal adjustment plans meet their intended fiscal objectives. We do not analyze the impact of fiscal adjustment on economic performance. (For a recent study and a review of previous studies on that issue, see International Monetary Fund, 2010).
4. Previous studies include, for advanced economies, Alesina and Perotti, 1995; Alesina and Ardagna, 1998, 2009; and von Hagen et al., 2001; and, for broader samples of countries, Giavazzi et al., 2000; Gupta et al., 2005; Tsibouris et al., 2006; Baldacci et al., 2006.

5. To assemble our database, which consists of 229 three-year plans for 25 countries, covering 1991–2007, we gathered the pre-1998 plans from various archival sources, entering the data from hard copies, and drew the post-1998 plans from an existing EU database (see Chapter 9 for details).
CHAPTER 1

Canada: A Success Story

Cemile Sancak
Lucy Qian Liu
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Introduction

As in most advanced economies, the fiscal pressures in Canada started in the 1970s and became most pronounced in the mid-1980s. Canada stands out among the G-7 countries, however, as it successfully responded to these pressures in the subsequent decades through large and sustained fiscal adjustment. The ex-ante approach adopted in this chapter reveals that the adjustment was underpinned by two substantially different plans in terms of speed and nature of adjustment measures. The chapter compares and contrasts these two plans, based on both ex-ante design and ex-post performance.

The plans are analyzed with regard to:

- The scale of planned adjustment, in particular, whether the scale of the planned adjustment was sufficiently large to stabilize debt
- The comparison of plans vis-à-vis outcomes
- The nature of adjustment measures
- Whether adjustment was sustained in the aftermath of the episode

The main analysis in this chapter focuses on the federal government budget, because fiscal adjustment plans were formulated only at the federal government level, rather than the consolidated general government level including the provinces, territories, and local governments. However, for completeness, a separate section also discusses the consolidation efforts of the subnational governments.
The identification of the federal government adjustment plans is based on an examination of federal budget documents covering 1961–2010. We use three criteria to select an adjustment episode: (i) the adjustment plan is clearly announced to the public (in the budget); (ii) it specifies explicit medium-term fiscal targets involving substantial fiscal adjustment; and (iii) it is formulated in a medium-term framework. Based on these criteria, we identify two adjustment plans in which the federal government announced medium-term fiscal targets against the background of large and increasing debt levels: the 1985 Plan covering 1985–91 and the 1995 Plan covering 1994–97.1

The actual overall balance, the main fiscal target, outperformed plans in both adjustment episodes. In fact, the extent to which ex-post performance conformed to ex-ante design was exceptional in Canada compared to other G-7 countries. That said, the 1985 Plan was criticized both domestically and internationally for not being sufficiently ambitious: it did not make enough effort to reduce the deficit and eschewed tough measures on major spending programs. The 1995 Plan, on the other hand, scored better, building on the lessons learned from the 1985 Plan. The 1995 Plan was highly ambitious in terms of both speed and nature of planned adjustment measures, as it aimed to introduce major changes to government programs and services. Indeed—to give a preview of outcomes—debt stabilization, the main objective of both adjustment plans, was achieved only during the 1994–97 episode. The overall balance improved by almost 5 percent of Gross Domestic Product (GDP) over 1994–97, moved to a surplus in 1997–98, and remained in surplus until 2007–08 (see Figure 1.1). The federal net debt declined to 34 percent of GDP by 2007–08, compared to 74 percent in 1995–96 (see Figure 1.2).

The following elements were key in ultimately bringing about a lasting improvement in Canada’s fiscal position:

- Broad-based public support
- A repositioning of the role of government and profound structural reforms
- Prudent macroeconomic and fiscal assumptions
- Fiscal consolidation at the subnational level

Background

Canada’s debt problems started to emerge in the mid-1970s (see Figure 1.2). Debt accumulation was driven by both the global environment and domestic policies. The main global factors were: (i) the 1973–74 energy price surge, which reduced economic growth through a negative supply-side shock; (ii) higher interest rates in advanced economies; and (iii) the 1973 move to floating exchange rates following the collapse of the Bretton Woods