Mastering the fiscal crisis: the role of ambitious expenditure reform *

Sebastian Hauptmeier
European Commission

A. Jesus Sanchez-Fuentes
U. Complutense de Madrid and GEN-Governance and Economics research Network

Ludger Schuknecht
German Ministry of Finance

July, 2014
preliminary, do not cite without permission

Abstract: The study assesses public expenditure strategies of a number of EU economies in the context of the financial crisis compared to the experience with expenditure reform in the 1980s and 1990s. In particular, the study looks at eight countries: three European EU/IMF programme countries, Ireland, Portugal and Greece, the four large euro area countries, France, Italy, Germany, and Spain and the UK. In five of these countries, i.e. Ireland, Portugal, Greece, Spain and the UK, announced fiscal and economic strategies show particular ambition and are in many ways comparable to previous, successful expenditure reform episodes. These include sizeable adjustments in primary expenditure as part of comprehensive reform programmes including institutional reform, labour market reform and privatisation. At the same time, the composition of the spending adjustment - on average - appears less growth-friendly than during the expenditure reform episodes of the 80s and 90s.

Keywords: Expenditure policies, public debt, expenditure rules, sustainability, fiscal stance
JEL code: E17, E61, E65, H50, H60

(*) The views expressed are the authors' and do not necessarily reflect those of the authors' employers. Sánchez-Fuentes acknowledges the financial support of the Spanish Ministry of Economy and Competitiveness (project ECO2012-37572) and the Regional Government of Andalusia (project SEJ 1512)Corresponding author: S. Hauptmeier. European Commission, Rue de la Loi 170, Brussels. Email: sebastian.hauptmeier@ec.europa.eu

Non-Technical Summary

In the aftermath of the financial and economic crisis, public finances in many advanced economies became fragile, following a substantial increase in deficit and debt ratios after 2007. The deterioration in fiscal positions was driven - to a large extent - by increases in public expenditure ratios which in many countries reached or approached historical highs. It is, therefore, straightforward to look at public expenditure when striving to correct fiscal imbalances. It was also the approach used—successfully—by many advanced economies in the 1980s and 1990s to return to sound public finances and at the same time reinvigorate the economy.

The objective of this study is to assess recent public expenditure strategies of a number of EU countries in light of the experience with expenditure reform in the 1980s and 1990s. We argue that on the basis of past cases, ambitious and high quality expenditure reform as part of comprehensive economic reform programmes have the best chance of success. On this basis, the study looks at eight countries: the three European economic adjustment programme countries, Ireland, Portugal and Greece, the four large euro area countries, France, Italy Germany, and Spain[1] and the UK. We find that the three programme countries, Spain and the UK are implementing comprehensive policy reform programmes with the key feature of ambitious public expenditure reductions. The experience from the past suggests that this should bode well for the fiscal and economic prospects of the reforming countries if announced plans are fully implemented. At the same time, the composition of the expenditure adjustment appears less growth-friendly. Amongst the other countries studied, expenditure reform programmes are less ambitious. Prospects for the more timid

[1] Spain has undergone a financial assistance programme for the recapitalisation of financial institutions which - unlike Greece, Ireland and Portugal - was not subject to a specific fiscal conditionality.

reformers and notably those with high public spending, deficits and debt are much more concerning, and a change in strategy is needed notably for France and Italy.

1. Introduction

Public finances in most advanced economies remain fragile after deficit and debt levels increased substantially in the context of the financial and economic crisis. Public deficits in 2009 averaged 6% of GDP in the euro area and exceeded 10% of GDP in several euro area countries, the US and the UK. Public debt in advanced economies increased enormously between 2007 and 2013: by about 30pp of GDP to some 96% in the euro area and so far by over 40pp or more in the US to 105% and in the UK to over 90% of GDP.

Most of the deficit increase since the start of the crisis in 2007 was due to an increase in public expenditure ratios which reached or approached historical highs in 2009/10. By contrast, revenue ratio remained mostly stable. It is, therefore, logical to look at public expenditure when striving to correct fiscal imbalances in industrialised countries. This approach is in fact pursued already by a number of countries with fiscal difficulties. It was also the approach used—successfully—by many advanced economies in the 1980s to return to sound public finances and at the same time reinvigorate the economy.

The objective is this study is to assess the public expenditure strategies of a number of EU Member States in light of the experience with expenditure reform in the 1980s and 1990s. The study argues that on the basis of past cases, ambitious and high quality expenditure reform as part of comprehensive economic reform programmes have the best chance of success. On this basis, the study looks at eight countries: the three European economic adjustment programme countries, Ireland, Portugal and Greece, the four large euro area countries, France, Italy Germany, and Spain and the UK. We find that the programme countries, Spain and the UK are implementing comprehensive policy reform programmes with the key feature of ambitious public expenditure reductions. This should bode well for the fiscal and economic prospects of the reforming countries if announced plans are fully implemented. Amongst the other countries studied, expenditure reform programmes are less ambitious. Prospects for the more timid reformers and notably those with high public spending, deficits and debt, notably France and Italy, are much more concerning.

Section 2 reviews public expenditure trends over the past 30 years. Section 3 reports on the main findings of earlier case studies on public expenditure reforms. Section 4 presents recent expenditure developments and plans in our sample of advanced economies. Section 5 provides the detailed case studies of countries with ambitious reform agendas. Section 6 undertakes a horizontal assessment of the findings before section 7 concludes and draws some policy lessons.

2. Public expenditure trends over the past three decades

To see recent developments in a broader historic perspective, it is worth briefly taking stock of trends in public expenditure and the size of the state over the past 30 years (Table 1).[2] After a strong increase in the size of government in industrialised countries in the 1960s and 1970s, the average total public expenditure ratio across OECD, G7 or euro area hardly changed in 2007-just before the financial crisis-from compared to 2000, 1990 and 1980. The average spending ratio for the euro area remained around 45% of GDP and that of OECD and G7 around 40%.

[2] See also Tanzi and Schuknecht (2000) for more details on historic expenditure developments.

Table 1: Total expenditure developments

% of GDP	1980 or nearest	2000	2007	2010	2013
Austria	49.6	51.9	48.6	52.5	51.1
Belgium	54.9	49.1	48.2	52.6	54.7
Finland	40.2	48.3	47.4	55.7	58.4
France	46.0	51.7	52.6	56.6	57.1
Germany	47.5	45.1	43.5	46.7	44.6
Greece	27.0	47.2	46.5	51.4	47.8
Ireland	49.5	31.1	36.7	45.5	42.7
Italy	40.6	45.9	47.7	50.4	50.6
Luxembourg	39.9	37.6	36.3	43.5	43.5
Netherlands	55.2	44.2	45.3	51.2	50.4
Portugal	32.3	41.6	44.5	49.2	48.3
Spain	39.0	39.2	39.2	46.3	44.4
Euro area (12)	***43.5***	***44.4***	***44.7***	***50.1***	***49.5***
Australia	29.3	34.7	34.4	37.1	37.3
Canada	47.3	43.7	42.1	47.3	44.5
Denmark	52.7	53.7	50.8	57.7	57.2
Japan	32.5	38.8	35.8	40.7	42.5
Sweden	60.8	55.1	51.0	52.3	52.9
Switzerland	25.0	35.6	32.1	33.9	34.3
United Kingdom	47.4	36.4	43.3	49.8	47.1
United States	34.9	33.7	36.9	42.6	38.8
G7	***41.7***	***40.6***	***41.6***	***46.3***	***44.7***
OECD	***39.3***	***38.5***	***39.1***	***44.0***	***42.1***

Source: Ameco, OECD.

However, this masks significant differences across countries. The countries that undertook ambitious reforms in the 1980s and 1990s typically had much lower spending ratios in 2007 than in 1980 or at least than at their peak. A few countries, however, including many of those that we will discuss later (Italy, Spain, Portugal, Greece, Ireland, UK) had significantly increased the size of up to 2007.[3] This occurred notwithstanding an extended economic boom in most of these countries when expenditure ratios should have gone down.

[3] See also Hauptmeier et al, 2011 for an assessment of the expenditure stance in euro area countries since the start of EMU.

With the start of the financial crisis, public expenditure ratios went up everywhere by on average 5pp of GDP. This brought the total expenditure ratio to about 50% in the euro area and 45% in the OECD/G7 in 2010. On the whole and for many countries, public expenditure ratios have reached or came close to historical peaks. This includes the European programme countries, Portugal[4] and Greece but also France and the UK.

These developments show that the challenge of containing the size of the state is more present than ever. And together with deficit and debt figures, the close link between rising public spending, deficit and debt figures is also obvious. But a number of countries mastered the challenge of very large expenditure ratios with ambitious reform programmes in the 1980s and 1990s. This experience will be re-called in the next section. These countries were typically not the same that face such challenges now—except Ireland and the UK.

3. Experiences with expenditure reform in the 1980s and 1990s

In an earlier study, Hauptmeier, Heipertz and Schuknecht (2007) looked at the experience with public expenditure reform in the 1980s and 1990s. They identifed three groups of countries: (i) ambitious, (ii) timid and (iii) non-reformers. Ambitious reformers were those that managed to reduce public primary (non interest) expenditure by more than 5pp of GDP from their peak within 7 years. Timid reformers were those that cut primary spending between 0 and 5pp and non-reformers never undertook much of a cut at all. These countries and country groups, and their change in the expenditure ratio within seven years relative to the peak level are depicted in Table 2.

[4] Portugal has exited the economic adjustment programme in June 2014.

The study argued that conceptually, reforms needed to be ambitious in order to make a significant difference for the resulting public deficits and adverse debt dynamics. The more ambitious they were the more they would even allow tax cuts. Already in the 1980s, Ireland, Belgium, the UK, Luxembourg and the Netherlands had significantly reduced their public expenditure ratio. The UK, Ireland and the Netherlands did so again in the 1990s plus a number of other countries: Finland, Sweden, Canada and Spain. Four countries reduced public primary expenditure by more than 10% of GDP.

It is, however, not just the magnitude of spending and reform that is important but also the composition. The literature (e.g., Alesina and Perotti, 1995 and 1997) argues that reductions in public consumption/wages and transfers and subsidies are particularly "high quality". They increase the chance of success of reform by providing a strong signal of government determination and cuts tend to focus on unproductive expenditure. Most of the expenditure cuts of ambitious reformers came from transfers and subsidies and also from government consumption. At the same time, in most cases, government investment and public education expenditure did not decline disproportionately or in some cases even increased as a share of GDP. Timid reformers did not report much of a decrease in public transfers and subsidies and focussed on public investment in some cases and on public consumption including education in others.

The study by Hauptmeier et al. also argued that public expenditure reform needed to be part of a comprehensive overall structural reform strategy. This would allow the improvement in public finances not only via less spending but also via better growth prospects.

Table 2: Expenditure reform phases 1980s and 1990s

	Max. primary expenditure in year	*Change maximum to T7*
Ambitious' reformers		
Finland	1993	-14.0
Sweden	1993	-14.0
Ireland (Phase 1)	1982	-12.4
Belgium (Phase 1)	1983	-12.3
Canada	1992	-9.5
United Kingdom (Phase 1)	1981	-8.2
Netherlands (Phase 2)	1993	-7.5
United Kingdom (Phase 2)	1992	-7.2
Spain	1993	-6.4
Ireland (Phase 2)	1992	-6.2
Luxembourg	1981	-5.7
Netherlands (Phase 1)	1983	-5.1
Timid' reformers		
Austria	1993	-4.3
Denmark	1993	-3.9
New Zealand	1985	-3.8
United States	1992	-3.4
Italy	1993	-3.0
Japan	1998	-2.7
Belgium (Phase 2)	1993	-2.1
Germany	1996	-0.6
France	1996	-0.5
Switzerland	1998	-0.3
Non' reformers		
Portugal	2004	0.0
Greece	2000	0.4
Australia	1985	0.4

Source: Hauptmeier, S., Heipertz, M. & Schuknecht, L. (2007)

Most of the ambitious reformers undertook major reforms that were complementary to expenditure retrenchment and strengthened their national fiscal institutions. This not only facilitated fiscal retrenchment but also tended to make future budgetary control and thus the avoidance of fiscal problems more likely.[5] A

[5] For the importance of fiscal rules and institutions, see, e.g., Poterba and Von Hagen (1999). Debrun et al. (2008) and Holm-Hadulla et al (2011) focus on the numerical fiscal rules in EU countries..

number of countries devalued their currencies. All ambitious reformers initiated significant labour market reforms that improved work incentives. All but one country reformed the tax system. And most countries reduced the role of the state in the economy via privatisation. Consequently, their impact on public finances and the economy turned out quite positive.

Finally, Hauptmeier et al. (2007) find that ambitious expenditure reforms had very little (if any) adverse growth and consumption impact even in the very short run while the medium to long term impact was very positive. Ambitious reformers experienced a significant increase in trend growth by 1-2 percentage points.

4. Expenditure developments and plans in eight sample countries

a. Pre-crisis expenditure developments

For the rest of this study, we will look at the expenditure developments and plans of a number of EU countries, notably Greece, Ireland and Portugal (economic adjustment programme countries)[6], Germany, France, Italy and Spain (large euro area countries), and the UK. The common feature of most of these countries from the start of EMU up to 2007 was a drawn out economic boom which resulted in a significantly positive output gap. This should have allowed bringing down the public expenditure ratio significantly, first, due to the impact of automatic stabilisers and, second, due to lower interest spending thanks to the euro.

However, this is not what happened. All countries pursued an expansionary expenditure stance, of the order of 1-5pp of GDP except for Germany (Hauptmeier et

[6] Ireland has exited the economic adjustment programme in December 2013, Portugal in June 2014.

al, 2011).[7] This basically "ate up" the interest savings from introducing the euro. As a consequence, total public expenditure only went down significantly in Germany. It even increased strongly in the three crisis countries and the UK between 1999 and 2007 (Table 3). Ireland and Spain maintained the lowest spending ratios (below 40% of GDP), France's public expenditure was the highest, at 52.6% in 2007. The increase in public expenditure becomes even more pronounced when looking at primary spending. For the crisis countries and the UK this went up by 3 to almost 6% of GDP between 1999 and 2007. As a result, most of the sample countries still had significant deficits in 2007 while the debt ratio had hardly declined or even increased between 1999 and 2007 (Schuknecht, 2009).

Expansionary expenditure policies during good times left most of the countries "unprepared" when the crisis hit. As a consequence of the output fall and further expansionary programmes, public expenditure ratios increased strongly between 2007 and 2009. Increases ranged from around 4-5pp of GDP in Italy and Germany, to 7½ pp in the UK to around 9pp in Ireland. The expenditure increase was particularly strong in the countries where a credit-fed real estate and financial sector boom had "artificially" inflated GDP. When this reversed over the crisis, both higher spending and lower GDP drove up the expenditure ratio. Virtually all of the expenditure ratio increase was on public consumption and transfers and subsidies; public investment went up only slightly in a few countries. Greece, Ireland and Spain also reported higher interest expenditure as the rapidly rising debt ratio and higher interest rates started to affect public budgets.

---

[7] One of analysing the expenditure stance of a country is to compare it with the expenditure levels that should have occurred if a country had followed certain fiscal rules. Such an exercise was conducted by us last year (Hauptmeier et al, 2011). The study found that most euro area countries had pursued expenditure policies that were more expansionary than a reasonable expenditure rule would have proposed.

Table 3: Expenditure developments for selected EU countries -

Total expenditure

% of GDP	1999	2007	2009	Change 1999-2007	Change 2007-2009	Memoradum: deficit 2007	Memoradum: deficit 2009
Programme countries							
Greece	44.9	46.5	53.9	1.6	7.3	-5.8	-15.5
Ireland	34.2	36.7	45.6	2.5	8.9	0.2	-11.1
Portugal	41.5	44.5	49.8	3.0	5.3	-3.3	-10.2
Large euro area							
Germany	48.2	43.5	48.3	-4.7	4.8	0.2	-3.1
France	52.6	52.6	56.7	0.0	4.1	-2.8	-7.5
Italy	47.9	47.7	51.7	-0.1	4.0	-1.7	-5.2
Spain	39.9	39.2	46.2	-0.8	7.0	2.0	-11.1
Large non-euro area							
United Kingdom	38.5	43.3	50.6	4.8	7.3	-2.8	-11.0

Primary expenditure

% of GDP	1999	2007	2009	Change 1999-2007	Change 2007-2009
Programme countries					
Greece	37.4	41.7	48.7	4.3	7.0
Ireland	31.8	35.7	43.6	3.9	7.9
Portugal	38.6	41.5	46.9	2.9	5.4
Large euro area					
Germany	45.1	40.7	45.6	-4.4	4.9
France	49.6	49.9	54.3	0.3	4.4
Italy	41.2	42.8	47.1	1.5	4.3
Spain	36.4	37.5	44.4	1.1	6.9
Large non-euro area					
United Kingdom	35.7	41.1	48.7	5.4	7.6

Source: Ameco.

In 2009, none of our sample countries still featured a relatively small public sector of below 40% of GDP (as defined by Tanzi and Schuknecht, 2000). Greece, Portugal, France, Italy and the UK reported public spending ratios of around to significantly above 50%.

It has been argued that the increase in expenditure ratios is not very relevant as it presumably reflects almost solely the crisis and should, thus, reverse itself over time as the economy normalises. This reasoning implicitly assumes that output and growth rates trends more or less return to pre-crisis levels. As a large output gap would be closed, public commitments should decline relative to GDP. However, if the pre-crisis GDP was artificially inflated by booming construction (and other non-tradable) sectors which have to shrink then both GDP level and growth rates may be significantly lower post-crises.

b. Expenditure adjustment post 2009

Before turning to individual country case studies, we want to take a look at the overall pattern of countries' expenditure adjustment following the peak levels in 2009 (see Table 4). Most sample countries with the exception of France and Italy have implemented significant primary expenditure reductions for the period up to 2013. This ranges from around 3pp of GDP for Portugal, Germany and Spain to around 5pp in the UK, Greece and Ireland.

Plans for 2014 and beyond suggest further sizeable expenditure adjustments in some of our sample countries, notably in Portugal and Greece where primary expenditure would decline by another 2½-3½pp by 2015 if plans are fully implemented. Cuts by between 1-1½pp of GDP are also planned by France, Italy and Spain according to the latest Commission forecast.

As a result of these consolidation efforts (and if fully implemented), primary expenditure ratios would not be much above 40% of GDP in most countries by 2015. The exceptions are France (53.7%) and Italy (44.5%).

Fiscal plans until 2015 should also be seen from a longer term perspective. When comparing the 2015 plans with the 1999 primary expenditure ratios it is noteworthy that even with full implementation of fiscal plans, primary expenditure would be 3-6pp of GDP higher in 2015 than in 1999 for all countries but Germany.

This is a sizeable difference and has to be seen against the prospect of further increases in social security spending in future years due to population ageing.

Coming back to the adjustment effort in our sample countries', it is noteworthy that five countries would meet the criteria of ambitious reformers as applied in the earlier study by Hauptmeier et al. (2007). Therefore, Ireland, Greece, Portugal, Spain and the UK are analysed in more detail as "new ambitious reformers" in the following case studies.

Table 4: Primary expenditure plans

% of GDP	***Primary expenditure***								
	Actual					2014		2015	
	2009	*2010*	*2011*	*2012*	*2013*	*SP*	*COM*	*SP*	*COM*
Programme countries									
Greece	48.7	45.5	44.7	45.1	43.9	--	42.9	--	40.4
Ireland	43.6	42.4	39.7	39.0	38.1	36.5	36.1	34.4	34.6
Portugal	46.9	46.3	44.3	42.3	43.9	42.6	42.6	41.5	41.2
Large euro area									
Germany	45.6	44.1	42.4	42.2	42.5	42.5	42.6	42.5	42.6
France	54.3	54.1	53.3	54.1	54.8	54.2	54.4	53.1	53.7
Italy	47.1	45.9	45.1	45.1	45.6	45.3	45.0	44.7	44.5
Spain	44.4	44.4	42.8	41.3	40.9	40.5	40.2	39.4	39.4
Large non-euro area									
UK	48.7	46.9	44.7	45.1	44.1	--	42.7	--	41.4

Source: Ameco.

5. The new ambitious reformers

Greece

Despite the favourable macroeconomic environment following EMU accession in 2001, the Greek fiscal deficit gradually increased from around 3% of GDP in 1999 to almost 6% of GDP in 2007. In this period the expenditure ratio rose from around 45 to 46½%, mainly owing to a strong rise in government consumption and despite a significant decline in the interest burden. Government debt increased to more than 107% of GDP in 2007. When the financial and economic crisis hit the Greek economy in 2008, the sharp contraction in economic growth resulted in significant tax shortfalls which together with sizeable spending overruns led to a rise in the deficit ratio to almost 16% of GDP in 2009. The public expenditure ratio reached almost 54% of GDP in 2009. As a result, the debt-to-GDP ratio was put on a steep upward path

Fiscal adjustment: The medium-term fiscal adjustment strategy that was agreed in the context of the EU/IMF economic adjustment programmes led to a reduction of the deficit ratio from almost 16% in 2009 to 2% in 2013. Latest projections suggest a further decline to somewhat above 1% in 2015. Besides increases in total revenues-to-GDP, the adjustment strongly builds on a decline in the primary expenditure-to-GDP ratio from 48.7 % in 2009 to around 43.9% in 2013. It is projected to drop further to 40.4% in 2015. The expenditure adjustment is mainly based on lower government consumption including through cutting the public sector wage bill and cutting operational spending. Government investment as a ratio to GDP also declined significantly, by around 30%, over the 2009-13 period but is expected to increase again in 2014-15. Transfers and subsidies in the contrary increased as a ratio to GDP in 2009-13 and would remain broadly stable thereafter.

Structural reforms: The structural reform strategy aims at regaining external competitiveness, in particular through labour market reforms with the aim of reducing rigidities by removing unnecessary entry hurdles and reforming the wage bargaining process. Moreover, business environment-related measures include a new investment and competition law. With a view to improving the long-term sustainability of public finances, a number of pension reforms have increased the retirement age and reduced the generosity of benefits while health care reforms target lower administrative and operational cost savings through better governance. Fiscal adjustment efforts were supported by institutional reform efforts to strengthen the efficiency of the tax system and public financial management. Financial sector stability has been supported, e.g. by the creation of a Financial Stability Fund. Moreover, a comprehensive privatisation plan has been agreed in the context of the first adjustment programme.

Table 5: Greece – fiscal developments

(% of GDP, unless otherwise stated)	***Recent developments***						***EC forecast***		
	1999 (1)	*2007* (2)	*2009* (3)	*2010* (4)	*2013* (5)	***2009-13*** (6)	*2014* (7)	*2015* (8)	***2013-15*** (9)
Total revenue	41.8	40.7	38.3	40.4	45.8	**7.5**	45.8	44.5	**-1.4**
Total expenditure	44.9	46.5	53.9	51.4	47.8	**-6.0**	47.5	45.7	**-2.1**
Interest	7.5	4.8	5.2	5.9	4.0	**-1.2**	4.6	5.3	**1.3**
Primary expenditure	37.4	41.7	48.7	45.5	43.9	**-4.8**	42.9	40.4	**-3.4**
Government consumption	17.0	20.5	23.6	21.5	20.0	**-3.6**	18.8	17.7	**-2.3**
Compensation of employees	10.6	11.4	13.4	12.5	12.0	**-1.5**	11.7	10.9	**-1.0**
Social transfers other than in kind	14.4	15.3	18.2	18.2	18.9	**0.7**	20.1	18.8	**-0.1**
Subsidies	0.2	0.1	0.1	0.1	0.3	**0.3**	0.8	0.7	**0.4**
Government investment	3.2	3.4	3.1	2.3	1.9	**-1.2**	2.6	2.5	**0.5**
Fiscal balance	-3.1	-5.8	-15.5	-11.0	-2.0	**13.5**	-1.7	-1.2	**0.8**
Cyclically adj. balance	-3.6	-7.0	-14.8	-8.6	4.0	**18.8**	2.9	0.9	**-3.1**
Public debt	94.9	107.3	129.7	148.3	175.1	**45.4**	177.2	172.4	**-2.6**

Source: AMECO.

Portugal

Since the beginning of EMU Portugal recorded public deficits of close to or above 3% of GDP which drove the steady increase in the public debt ratio from somewhat above 50% of GDP in 1999 to close to 70% of GDP in 2007. The weakening of fiscal positions in the pre-crisis years was mainly explained by a gradual increase in the expenditure ratio from 41½% in 1999 to 44½% in 2007. When Portugal entered the severe recession in 2008 large revenue shortfalls in combination with strong increases in social benefit payments led to a sizeable rise in the government deficit which reached more than 10% of GDP in 2009 and put government debt on a steep upward path. The expenditure ratio increased further to almost 50% in 2009.

Fiscal adjustment: The medium-term fiscal adjustment strategy that was agreed in the context of the EU/IMF economic adjustment programme resulted in a sizeable reduction in the deficit ratio from above 10% in 2009 to around 4½% in 2013 and further to 2.5% of GDP in 2015. The fiscal consolidation targets both the revenue and the expenditure side. The spending ratio would gradually be reduced from around 50% in 2009 to around 48½% in 2013 and further to below 46% of GDP in 2015, despite of a significant increase interest spending and mainly owing to a decline in government consumption and government investment. Measures include wage moderation in the public sector, lower transfers to sub-national government units, pension cuts and lower capital expenditure.

Structural reforms: The structural reform strategy aims at restoring competitiveness, in particular through an internal devaluation supported by labour market reform, including adjustments in the employment protection legislation and more flexible working time arrangements. Structural reform measures also aim at improving the business environment as well as the educational and healthcare system.

Table 6: Portugal – fiscal developments

(% of GDP, unless otherwise stated)	*Recent developments*						*EC forecast*		
	1999 (1)	*2007* (2)	*2009* (3)	*2010* (4)	*2013* (5)	***2009-13*** (6)	*2014* (7	*2015* (8)	***2013-15*** (9)
Total revenue	38.4	41.1	39.6	41.6	43.7	**4.1**	43.1	43.2	**-0.5**
Total expenditure	41.5	44.5	49.8	49.2	48.3	**-1.5**	47.0	45.6	**-2.6**
Interest	2.9	3.0	2.9	2.8	4.3	**1.5**	4.3	4.4	**0.1**
Primary expenditure	38.6	41.5	46.9	46.3	43.9	**-3.0**	42.6	41.2	**-2.7**
Government consumption	18.1	19.8	22.1	21.6	19.0	**-3.1**	17.7	16.7	**-2.2**
Compensation of employees	13.3	12.1	12.7	12.2	10.7	**-2.0**	9.5	9.0	**-1.7**
Social transfers other than in kind	12.2	15.3	17.8	17.8	19.5	**1.8**	19.0	18.6	**-0.9**
Subsidies	1.4	0.8	0.7	0.7	0.7	**-0.1**	0.7	0.7	**0.0**
Government investment	4.5	2.7	3.0	3.8	1.4	**-1.6**	1.8	1.7	**0.3**
Fiscal balance	-3.1	-3.3	-10.2	-7.5	-4.6	**5.6**	-3.8	-2.5	**2.1**
Cyclically adj. balance	-4.2	-3.8	-8.8	-6.8	-1.9	**6.9**	-	-	
Public debt	51.4	68.4	83.7	94.0	129.0	**45.3**	126.7	124.8	**-4.1**

Source: Ameco.

Fiscal consolidation was supported by flanking institutional reform measures to strengthen the fiscal framework and improve the budgetary process. Financial sector measures included a new bank solvency support mechanism while also strengthening the supervisory and resolution framework. Privatisation had reduced the role of the government in the economy and generated receipts of around 4% of GDP by 2014.

Ireland

Ireland mostly recorded budgetary surpluses in 1999 to 2007, leading to a decline of government debt from around 50% of GDP to 25% of GDP. However, boom-related windfall revenues coincided with even stronger expenditure growth, reflected in a relatively strong rise in the primary expenditure ratio from around 32% in 1999 to 35½% in 2007. In 2008, the Irish economy was hit by a severe correction in property prices and substantial bank losses, requiring massive government capital injections into the Irish banking system. Owing mainly to a strong increase in the public spending ratio to around 45½% in 2009, budget deficits and debt grew sharply.

Fiscal adjustment: The medium-term fiscal adjustment strategy agreed in the context of the EU / IMF economic adjustment programme led to a reduction in the deficit ratio from above 11% in 2009 to below 7% in 2013. Latest government projections foresee a further decline to below 3% of GDP by 2015. Fiscal consolidation predominantly focussed on expenditure restraint up to 2013 and latest projections suggest further spending based adjustment in 2014/15. The expenditure ratio declined from around 45½% in 2009 to around 42½% in 2013 and would further drop to 39½% in 2015. Expenditure adjustment over 2009-13 strongly built on lower government consumption, in particular compensation of employees, and government investment as ratios to GDP. Spending based measures included savings in the public sector payroll and reductions in capital spending. Reductions in social transfer spending are projected in 2014/15.

Structural reforms: Reforms of the pension and long-term care system addressed the high risks to the sustainability of public finances. Moreover, sectoral wage setting structures were reformed to improve the functioning of the labour market. A comprehensive reform of the budgetary framework has been undertaken building on a strengthening of fiscal rules, a multi-annual expenditure framework and a system of performance budgeting. Fiscal monitoring has been improved via the creation of an independent Fiscal Council. To address the vulnerabilities of the Irish banking sector a comprehensive banking sector reform supported the deleveraging and restructuring process.

Table 7: Ireland – fiscal developments

(% of GDP, unless otherwise stated)	*Recent developments*						*EC forecast*		
	1999 (1)	*2007* (2)	*2009* (3)	*2010* (4)	*2013* (5)	***2009-13*** (6)	*2014* (7)	*2015* (8)	***2013-15*** (9)
Total revenue	36.6	36.9	34.5	34.9	35.9	**1.4**	35.7	35.2	**-0.7**
Total expenditure	34.2	36.7	45.6	45.5	42.7	**-3.0**	40.8	39.5	**-3.2**
Interest	2.4	1.0	2.0	3.2	4.5	**2.5**	4.7	4.9	**0.4**
Primary expenditure	31.8	35.7	43.6	42.4	38.1	**-5.4**	36.1	34.6	**-3.6**
Government consumption	14.9	17.2	20.5	19.2	18.0	**-2.5**	17.1	16.5	**-1.5**
Compensation of employees	8.7	10.5	12.8	12.2	11.2	**-1.5**	10.4	10.0	**-1.2**
Social transfers other than in kind	9.7	11.2	16.1	16.3	15.6	**-0.6**	14.8	14.3	**-1.3**
Subsidies	1.2	0.9	1.0	1.0	0.9	**-0.1**	0.9	0.9	**0.0**
Government investment	3.1	4.7	3.7	3.4	1.7	**-2.1**	1.6	1.5	**-0.1**
Fiscal balance	2.5	0.2	-11.1	-10.6	-6.8	**4.4**	-5.0	-4.2	**2.6**
Cyclically adj. balance	1.7	-2.1	-9.1	-8.6	-6.2	**2.9**	-4.5	-4.2	**2.0**
Public debt	47.0	24.9	64.4	91.2	123.7	**59.3**	121.0	120.4	**-3.3**

Source: AMECO, 2014 Stability Programme update.

Spain

Prior to the financial and economic crisis, Spain experienced an extended period of favourable macroeconomic developments which supported public finances developments since 2009. Moderate budget deficits turned into surpluses as of 2005, mainly owing to sizeable revenue windfalls related to the pronounced housing boom. Government spending as a ratio remained below 40% of GDP between 1999 and 2007 as strong expenditure growth was more than compensated by booming GDP. Debt declined also on account of a favourable growth/interest rate differential, reaching around 36% of GDP in 2007. The correction in the housing market started in early 2007 and was accelerated by the international financial crisis. The related contraction in economic growth and the unwinding of previous windfall revenues lead to a severe worsening of budgetary positions in 2008 and 2009. This together with strong expenditure growth continuing gradually increased the government deficit to more than 11% of GDP, putting government debt on a steep upward path.

Fiscal adjustment: Since 2009 the deficit ratio was reduced from around 11% in 2009 to around 6½% in 2013. The bulk of the fiscal adjustment was achieved through a decline in the primary expenditure ratio from more around 44½% in 2009 to around 41% in 2013 which more than offset the strong rise in interest spending as a ratio to GDP. During this period, expenditure adjustment strongly focussed on reductions in government investment and government consumption.

Structural reforms: To address the high risks to the sustainability of public finances, pension system reforms led to an increase of the retirement age, an adjustment of eligibility criteria and a number of parametric changes. Labour market reforms have focussed on reducing duality, strengthening internal flexibility and improving employment opportunities for unemployed. The budgetary framework was strengthened the implementation of a new central and local government expenditure rule and an improvement of the authorization system for sub-national debt. Wide-ranging measures have been adopted to strengthen the financial system.

Table 8: Spain – fiscal developments

(% of GDP, unless otherwise stated)	*Recent developments*						*EC forecast*		
	1999 (1)	*2007* (2)	*2009* (3)	*2010* (4)	*2013* (5)	***2009-13*** (6)	*2014* (7)	*2015* (8)	***2013-15*** (9)
Total revenue	38.6	41.1	35.1	36.7	37.8	**2.7**	38.1	36.9	**-0.9**
Total expenditure	39.9	39.2	46.2	46.3	44.4	**-1.8**	43.7	43.0	**-1.4**
Interest	3.5	1.6	1.8	1.9	3.4	**1.6**	3.5	3.5	**0.1**
Primary expenditure	36.4	37.5	44.4	44.4	40.9	**-3.5**	40.2	39.4	**-1.5**
Government consumption	17.1	18.3	21.4	21.5	20.1	**-1.3**	19.7	19.2	**-0.9**
Compensation of employees	10.5	10.2	12.0	12.0	11.3	**-0.7**	11.1	10.5	**-0.8**
Social transfers other than in kind	13.3	12.7	15.8	16.6	17.6	**1.8**	17.7	17.5	**-0.2**
Subsidies	1.2	1.1	1.1	1.1	1.0	**-0.1**	1.1	1.1	**0.0**
Government investment	3.4	4.0	4.5	4.0	1.5	**-3.0**	1.3	1.3	**-0.2**
Fiscal balance	-1.3	2.0	-11.1	-9.6	-6.6	**4.5**	-5.6	-6.1	**0.5**
Cyclically adj. balance	-1.8	0.6	-9.2	-7.1	-2.8	**6.4**	-2.4	-3.9	**-1.1**
Public debt	62.4	36.3	54.0	61.7	93.9	**39.9**	100.2	103.8	**9.9**

Source: Ameco.

United Kingdom

In the UK, a strong economic performance in the years prior to the financial crisis was accompanied by a built-up of sizeable internal and external imbalances. While fiscal positions had improved in the end of the 1990s the balance turned into deficit and reached 2.8% of GDP in 2007. Deficit developments were driven by increases in primary spending and occurred despite of higher revenues as a ratio to GDP. Between 1999 and 2007 total spending increased from 38.5% of GDP in 1999 to more than 43% of GDP in 2007. The crisis-related sharp contraction in economic growth in 2009 then led to a significant further deterioration of public finances which was driven by substantial tax shortfalls and expenditure expansion. Total expenditure jumped to over 50% of GDP and the general government deficit reached more than 11% of GDP in 2010 which put government debt as a ratio to GDP on a steeply rising path.

Fiscal adjustment: Between 2009 and 2013 the UK's deficit ratio was reduced from 11% in 2009 to around 6% in 2013. The bulk of the fiscal adjustment was achieved through a decline in the primary expenditure ratio from around 48½% in 2009 to around 44% in 2013, notably building on reductions in government consumption and government investment as ratios to GDP, notably through a switch to CPI indexation for benefits, tax credits and public service pensions as well as discretionary cuts in tax credits and benefits. Significant further spending cuts on government consumption and social transfers are projected in 20143-15.

Structural reforms: Labour market reform tackled disincentives notably to take up low-paid work. An independent Office for Budget Responsibility (OBR) took over the responsibility for producing the official macroeconomic and fiscal projections of the government which aims at improving budgetary transparency and credibility. The financial regulatory framework was strengthened, in particular with a view to improving macro-prudential supervision.

Table 9: United Kingdom – fiscal developments

(% of GDP, unless otherwise stated)	*Recent developments*						*EC forecast*		
	1999 (1)	*2007* (2)	*2009* (3)	*2010* (4)	*2013* (5)	***2009-13*** (6)	*2014* (6)	*2015* (8)	***2013-15*** (9)
Total revenue	39.4	40.5	39.6	39.8	41.3	**1.7**	40.5	40.2	**-1.1**
Total expenditure	38.5	43.3	50.6	49.8	47.1	**-3.5**	45.6	44.2	**-2.9**
Interest	2.8	2.2	1.9	2.9	3.0	**1.1**	2.9	2.9	**-0.1**
Primary expenditure	35.7	41.1	48.7	46.9	44.1	**-4.6**	42.7	41.4	**-2.7**
Government consumption	18.0	20.7	23.2	22.8	21.3	**-1.9**	20.6	19.9	**-1.4**
Compensation of employees	9.5	10.8	11.5	11.4	10.1	**-1.4**	9.6	9.3	**-0.8**
Social transfers other than in kind	13.1	13.2	15.6	15.6	15.9	**0.3**	15.5	15.0	**-0.9**
Subsidies	0.4	0.7	0.7	0.7	0.6	**-0.1**	0.6	0.6	**0.0**
Government investment	1.3	1.9	2.7	2.5	2.0	**-0.7**	2.0	2.0	**0.0**
Fiscal balance	0.9	-2.8	-11.0	-10.0	-5.8	**5.2**	-5.1	-4.1	**1.7**
Cyclically adj. balance	0.7	-4.1	-8.7	-8.1	-4.6	**4.2**	-4.6	-4.1	**0.4**
Public debt	43.0	43.7	67.1	78.4	90.6	**23.5**	91.8	92.7	**2.1**

Source: Ameco.

6. Horizontal assessment

In this section, we conduct an assessment of countries expenditure consolidation and reform plans from a horizontal and longer term perspective. In particular, we look at the size of adjustment, the quality of adjustment and the comprehensiveness of reform packages. In the charts below we compare the experiences of ambitious reformers in the 1980s and 1990s (square dotted line, seven year period T0-T7) with the adjustment undertaken by new ambitious reform countries (solid line): Developments until 2013, i.e. T4, reflect actual AMECO data while projections from 2014 onwards (T5-T6) are drawn from the latest European Commission forecast (Spring 2014) for the group of "New ambitious reformers. T0 is the year of maximum primary public expenditure (2009).

It is noteworthy that the pace of total expenditure reduction in the past was higher compared to present ambitious reformers, as reflected in a steeper slope of the respective line (see panel a). However, total expenditure in the earlier cases started out at significantly higher average levels (56% of GDP) than today's ambitious adjusters (about 49%). Total public expenditure in past ambitious reform episodes declined by almost 9pp of GDP on average between T0 and T6 as compared to around 5½ for today's ambitious reformers, also taking into account recent projections up to 2015.

We also observe some differences in the composition of the adjustment. A greater share than in the past would now come from lower public consumption (public wages and other consumption). Panel b) shows that more than 4 of GDP or about 2/3 of total adjustment would come from this category compared to 1/3 in the past. At the same time, consolidation via public transfers and subsidies has been significant in past ambitious reform episodes while today's ambitious reformers largely spare this category (panel c).

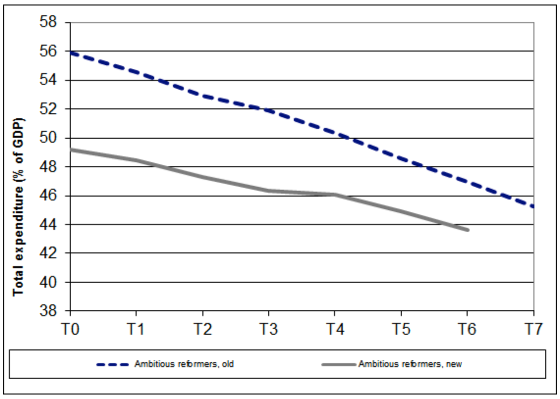
The quality of adjustment is also determined by the development in investment spending. While the starting ratio of investment expenditure was on average relatively similar in earlier episodes and current ones, investment cuts are much deeper for current ambitious adjusters (panel d). The investment ratio would fall from 3½ % of GDP to below 2% over 6 years while it declined by a much lesser extent in the adjustment episodes of the 1980s and 1990s.

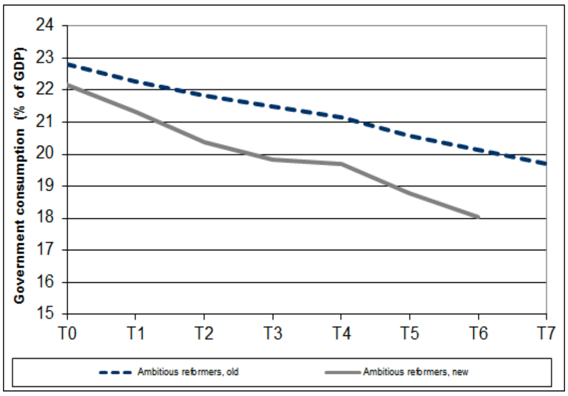
On the whole, much of the planned cuts will come from public consumption. This is perhaps desirable given the strong increase in public wages in a number of euro area countries since the start of EMU (Holm Hadulla et. al, 2009). As the increase has contributed to undermining competitiveness so may strong restraint help to regain competitiveness. However, cuts in (less productive) welfare spending are now being more timid than in the past even though the challenge to contain such spending and underlying entitlements has become more pressing in light of impending population ageing. At the same time, potentially growth-enhancing investment spending is cut more strongly.

When looking at the implications of expenditure reform on the overall fiscal position of past and present case studies, it is noteworthy that improvements in the fiscal balance are even more ambitious today than in the past (panel e). While ambitious adjusters in the 1980s and 1990s reduced the average fiscal deficit from 8 to 1½% of GDP between T0-T6, the deficit is now expected to decline from about 12 to 3% of GDP over the same period.

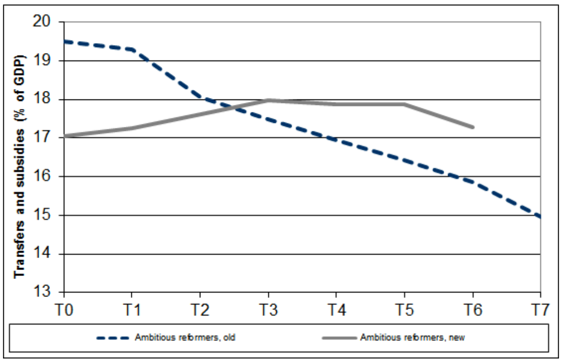
Charts: "New" vs. "old" ambitious reformers

a) Total public expenditures **b) Public consumption**

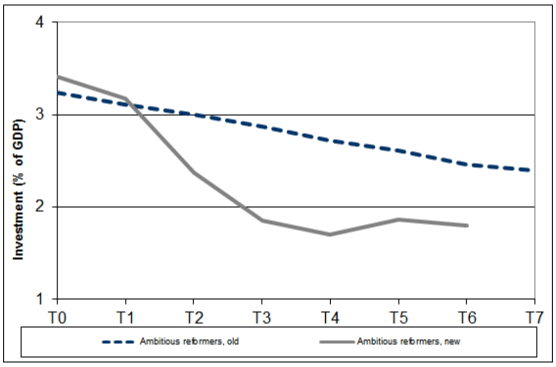




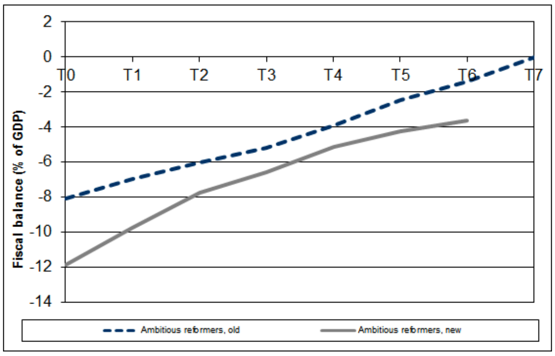
c) Transfers and subsidies



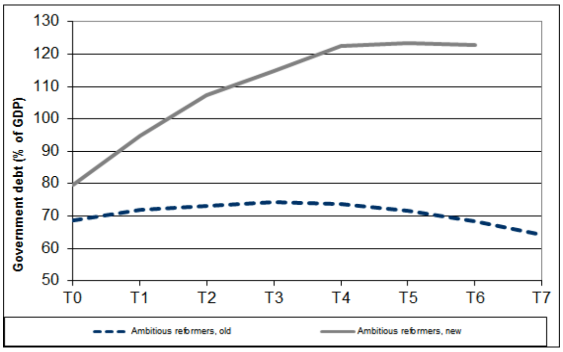
d) Public investment



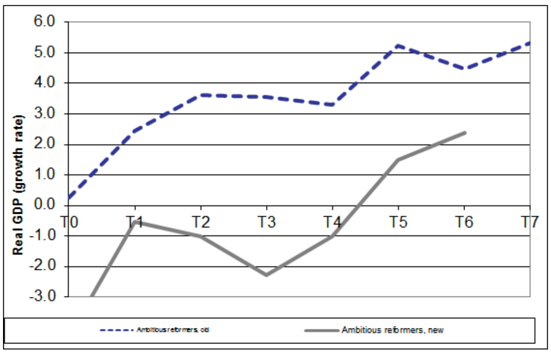
e) Fiscal balance



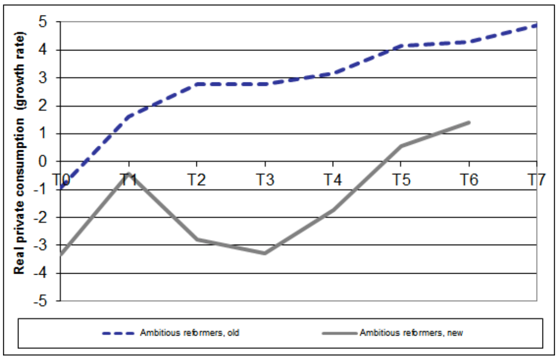
f) Public debt



g) Real GDP growth



h) Real private consumption



Source: own computations.

The most important difference between the previous and the current adjustment episodes is the different debt level (panel f). Earlier case studies revealed an average debt ratio of 70% of GDP that went up slightly further before declining broadly as of the fourth adjustment year. Public debt ratios of current adjustment episodes have been rising until the fifth adjustment year (2014) and reach an average of more than 120% of GDP by then. These differences help explain the urgency of fiscal adjustment.

Expenditure reform needs to be accessed against the implications for the real economy. Some patterns are interesting in this context: ambitious adjusters of the 2010s expect a recovery of economic growth as of the fifth consolidation year. This is much later than in the 1980s and 1990s when growth and private consumption started picking up with the first year of adjustment. Real private consumption would only pick up in the fifth year of the adjustment in Spain, Portugal and Ireland. In Greece, real private consumption growth is expected to turn positive only in 2015, i.e. in the sixth adjustment year.

Finally, the five ambitious adjusters of today are conducting fiscal adjustment as part of a comprehensive reform strategy just as earlier adjusters did (Table 10). All five countries plan to reform their domestic fiscal institutions and conduct financial sector reform. Moreover, all five countries intend to liberalise their labour markets and two of them foresee to complement fiscal reform with privatisation.

Table 10: Summary findings for 'new' ambitious reform episodes

	Expenditure reform		Institutional reform	Finacial sector reform	Structural reform	
	Public consumption 1/	Transfers & subsidies 1/			Labour market	Privatisation
Greece	XX	X	X	X	X	X
Portugal	XX		X	X	X	X
Ireland	XX	~	X	X	X	
Spain	X		X	X	X	
United Kingdom	X	~	X	X	X	
All	**5**	**1**	**5**	**5**	**5**	**2**

1/ Decline in 4 years by: more than 1% of GDP: ~
more than 2% of GDP: X
more than 3% of GDP: XX

All in all, the ambitious expenditure reformers of the 2010s are in many ways similar to those of the 1980s and 1990s. Determined expenditure reduction of reasonable quality is planned to bring down deficits and reverse adverse public debt dynamics. Consolidation is taking place as part of comprehensive reform programmes. If fully implemented it could amount to an important fiscal and economic policy regime change that would reinvigorate confidence and growth and, thus, also help to reverse public debt dynamics. However, at the time of writing, latest forecasts of the European Commission point to risks attached to the achievement of the fiscal targets announced by governments.

7. Conclusions and policy lessons

What are the main findings of this study and what policy lessons can be drawn? Public finances in many advanced economies remain fragile. Fiscal deficits remain high and public debt has reached unprecedented peace-time levels in most industrialised countries. Increasing public expenditure ratios have been the main reason for these imbalances.

In the 1980s and 1990s a number of countries undertook ambitious expenditure reforms. Their experience, which has been briefly reviewed here, has been very positive. Within a few years from the start of expenditure reform, public expenditure ratios went down significantly, fiscal deficits largely or fully disappeared, public debt was brought on a downward path, and economic growth and private consumption resumed. We argue that this was because ambitious expenditure reform was conducted in a growth-friendly manner as part of comprehensive adjustment programmes.

Recent expenditure reform programmes have to be seen against the following background: After very expansionary expenditure policies during a drawn out boom period before the financial crisis, many advanced economies featured rather poor fiscal positions. With the crisis, fiscal deficits increased further as public expenditure continued on their buoyant pre-crisis path. As deficits and debt dynamics became rather threatening, a number of countries started embarking on ambitious expenditure-based reform plans again. This study analyses five such episodes (Ireland, Portugal, Greece, Spain and the UK). It contrasts these with some stylised facts on other countries that are pursuing more timid consolidation strategies.

There are several parallels in the fiscal and economic adjustment strategies between the ambitious reformers of the 2010s and those of the 1980s and 1990s but also differences: significant expenditure reductions have been the main channel to bring down the deficit and arrest the adverse public debt dynamics. Expenditure reforms are also conducted as part of comprehensive reform programmes including institutional and financial sector reform as well as labour market reform and privatisation. At the same time, the composition of expenditure adjustment is somewhat different, focussing more strongly on reducing public consumption (which seems reasonable given strong public wage increases in many countries) while largely sparing transfers and subsidies (which is less desirable). Unlike in previous successful expenditure reform episodes, new ambitious reformers also rely on sizeable cuts in public investment to bring down expenditure-to-GDP ratios.

Despite similarities in the chosen reform strategies, current ambitious reformers - notably the four euro area countries in our sample - are undertaking their adjustment in the presence of more difficult macroeconomic conditions, characterised by protracted low growth and weak domestic demand. Countries in monetary union have to go through internal adjustment where the adjustment of competitiveness, the boosting of the tradable sector and confidence may be rather slow. Moreover, a number of our sample countries had experienced real estate booms the unwinding of which depresses demand via wealth effects. Earlier adjusters had in many cases the “benefit” of an exchange rate depreciation which helped boost external demand and, thereby, also employment and consumer confidence. Private sector indebtedness and real estate booms had also featured in the early 1990s but inflation provided for a faster unwinding of these imbalances.

The policy recommendations from these findings are straight forward: for the five ambitious reformers chosen strategies compare reasonably well to previous successful reform episodes. At the same time, there seems to be scope to improve the quality of the adjustment by focussing more on unproductive spending items, thereby facilitating the necessary adjustment. Full and adequate implementation of the announced reform strategies will be necessary to ensure that long-term gains in terms of improved fiscal sustainability and competitiveness materialise.

The recommendation to the more timid reformers - notably Italy and France - is also clear: reduce public expenditure ratios (which have increased significantly in context of the crisis) more ambitiously. Focus on less productive programmes via efficiency increases and reducing the role of the state. Furthermore, undertake complementary structural reforms, in particular with a view to addressing the ageing-related fiscal burden. Also for these countries, restoring fiscal sustainability and competitiveness will be key to ensure resistance against future economic shocks. In the euro area context with former crisis countries now moving ahead it is even more vital to pursue such a strategy.

Bibliography:

Alesina, A. and R. Perotti (1995), 'Fiscal expansions and adjustments in OECD countries', Economic Policy, vol. 10, pp. 205–48.

Alesina, A. and R. Perotti (1997), 'Fiscal adjustments in OECD countries: Composition and macroeconomic effects', IMF Staff Papers, vol. 44, pp. 210–48.

Debrun, X., Moulin, L., Turrini, A., Ayuso-i-Casals, J. and M. Kumar (2008) Tied to the mast? National fiscal rules in the European Union, *Economic Policy*, 23: 297–362.

European Central Bank (2011), *Ensuring Fiscal Sustainability in the Euro Area*, ECB Monthly Bulletin, April 2011, Frankfurt.

Hauptmeier, S., M. Heipertz and L. Schuknecht (2007), Expenditure reform in industrialised countries: a case study approach, *Fiscal Studies*, 28 (3), 293-342.

Holm-Hadulla, F., S. Hauptmeier and P. Rother (2011), The impact of numerical expenditure rules on budgetary discipline over the cycle, *Applied Economics*, forthcoming.

International Monetary Fund (2011), *Shifting Gears Tackling Challenges on the Road to Fiscal Adjustment,* IMF Fiscal Monitor, April 2011, Washington D.C.

Poterba, J. and J. Von Hagen (eds.) (1999). Fiscal Institutions and Fiscal Performance, University of Chicago Press, Chicago.