

# EU FISCAL CONSOLIDATION STRATEGIES IN TIMES OF CRISIS – COMPARATIVE APPROACHES

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## **Abstract:**

*On the background of the crisis, public finances rapidly deteriorated in many EU Member States struggling with economic recession. Therefore, fiscal consolidation was needed for improving public finances and turning them to a sustainable path. Authorities considered two main possible actions (decreases in budgetary expenditures or increases in revenues), but implementing them proved not to be so easy when government's engagements were already made. This paper reveals the main theoretical requirements of fiscal consolidation strategies, in relation with some EU Member States' fiscal consolidation plans, taking into discussion the fiscal background, the consolidation needs and the commitments and intentions of governments as an expression of their strategies.*

**Key words:** *fiscal consolidation, fiscal strategies, economic crisis, EU Member States*

**JEL classification:** *H6, H12*

## **1. Introduction**

The concept of fiscal consolidation is often ignored in theory and practice in times of economic development, but becomes almost too often invoked in times of economic and financial crisis. On such grounds, the consolidation strategies often end up being excessively characterized by the results proposed (rapid increases in GDP, consistent reductions in current public spending, important increases in tax revenues, increases in production or exports, etc.), thereby neglecting the concern for the realism of these predictions.

Our paper assumes that when designing such consolidation strategies, some accepted theoretical criteria should be followed, criteria that we intend to look at in the first section of this paper. Once these benchmarks established, we will analyze the strategies adopted by some EU Member States during the current economic crisis, with the aim to highlight the factors of success and eventual public policy slippages, possible lessons for other states or the future.

In our analysis we will refer to both qualitative issues, arising from strategies related regulations and their correlation with the considered theoretical benchmarks, and quantitative issues, concerning the dynamics of some relevant indicators (public spending, budgetary revenues, public debt, etc.), before and during the crisis, with the end to support for the expressed conclusions and policy recommendations.

## **2. Characteristics of fiscal consolidation strategies and possible options in times of economic crisis**

There are many aspects customizing a “successful” fiscal consolidation strategy, from its technical content to the rationality requirements applicable to its construction [Barrios, 2010].

Considering the imperative need for the aim of such a strategy to be fostering economic growth and sustainability, a first issue of debate regards the strategy's subject (author). Deep crises generally entail the need for coalition between different stakeholders' capacities and efforts, in order to identify the best solutions to overcome

the crisis. Although we do not question the theoretical value of such an approach, we cannot overlook, in practice, the partisan position of different actors (interest groups), frequently contradictory to the common interest or objective. In some cases, the struggle to impose their own point of view gets to distort the purpose of the approach itself and the initial reason for collective action weakens, thus wasting time and energy. Based on these findings, we consider that such a strategy should be the product of a single (high confidence) public authority and not the result of various political parties or interest groups' proposals (sometimes impossible to correlate). In this respect, it is also important which political actor will make public or support for the strategy, as of the mastery of its elements and of the consistency with which the anti-crisis measures and their expected positive impact will be stated, will depend the expected positive impact in the eyes of the public (consumers, businesses, banks, investors, creditors, etc.).

As a support for fiscal consolidation strategy's credibility, the consistency of measures also implies avoiding, over time, the trap of emotional reactions, as possible improvements of the situation more consistent than the ones anticipated by multiannual strategy could encourage policymakers to weaken constraints. The strategy's credibility is, in itself, an engine for upward trends, raising positive expectations on interest rates, taxes, consumer spending and investment, etc. It may be supported by enacting a multiannual calendar of adjustments, so as to create the certainty of ensuring the premises for the stabilization of the economy and resuming its upward trend. It is obvious that without regulations (in some cases, even in these cases), the reverse of some anti-crisis measures, which would worsen the situation, could more easily occur.

A similar issue concerns the strength and capacity of the fiscal institutional system to support for the measures to be applied [Hagen, 2001]. In practice, fiscal discipline is not just a problem deriving from fiscal regulations, but equally a problem deriving from the institutions' weaknesses, being imperative for hard budget constraints to be associated with firm and objectivity-oriented institutions and mechanisms of control, punishment or reward. Otherwise, a weak institutional system, based on rules or control mechanisms that can be breached or excessively exploited, will most likely face the inability to implement the fiscal consolidation strategy and will lose itself in unnecessary political or economic conflicts. On this basis, multi-annual budgetary expenditure frameworks and multi-annual fiscal plans, along with setting costs standards for some public activities, prove to be of great importance.

Another important issue concerning the viability of fiscal consolidation strategies is whether they are accompanied by complementary policies and structural reforms, harmonizing their action with. The persistence of fiscal consolidation's effects in time is questionable as long as it is not accompanied by the structural reforms required for complementing it and supporting for the "ceiling" of government expenditures, increase in budgetary revenues or improvement of markets' functioning. Otherwise, fiscal adjustments may have only a short-term impact and not a medium and long-term one, as desirable, especially under the future pressures on public budgets (such as the aging of population).

We must also bring into discussion the need for a balanced (equitable) distribution of fiscal adjustment's sacrifices between different members of the society. It is possible for imbalances to fuel social and political tensions that may become "electoral weapons", in the sense that candidate political parties will promise, with the aim to win the elections, to consistently reconsider some adjustment measures, and newly formed governments will jeopardize the viability of the consolidation strategy by abandoning some less popular adjustment measures or even reversing them. It is worth mentioning in this respect, that some studies disprove the existence of a direct correlation between harsh austerity programs and the loss of elections [Alesina, 2010].

In terms of the direct (technical) content of the fiscal consolidation strategies, it is important to analyze the structure or composition of the adjustment measures, comprising either increases in budgetary revenues, decreases in public expenditures or some kind of a mix. As a premise for any assessment, we must mention that solutions to national crisis must be national in kind, as there is no universal recipe for success. However, we can draw some comparative judgments on different available options, on the basis of their expected effects resulting from different countries' experiences or experts' opinions.

A first, and decisive factor to be considered when designing the composition of fiscal adjustment measures, will be the fiscal situation of the economy at the onset of the crisis, expressed by its public revenues, public expenditures, budget balance and public debt. In other words, the starting position will consistently influence what will follow, orienting, from the beginning, public authority's stabilization plans. Studies on fiscal consolidation episodes in different countries and moments in time, reached the conclusion that fiscal consolidation strategies mainly focusing on public expenditure cuts had more consistent results than those focusing on revenue adjustments [Afonso, 2006]. Among these strategies, more convincing in terms of their effects and durability proved to be those focusing on reducing current or sensitive to elections expenditures (public transfers). However, in practice it is often easier as political decision to reduce investment ones, with negative medium and long term effects.

Ceiling (reducing) budgetary expenditures has a smaller negative effect on economic growth, when compared to an increase in tax burden. It also reveals, in terms of credibility, a more serious commitment of the authorities in their consolidation efforts. The need to reduce the level of public expenditures must not necessarily involve giving up some destinations, but mainly rationalizing expenditures, which would allow, while some government expenditures decrease, for others to grow without jeopardizing economic growth. Basically, a careful analysis of the public expenditure system of any country may at any time reveal the existence of some expenses that could be reduced.

The strict control over public expenditure ceilings must be accompanied, in many cases, by an increase in budgetary revenues, achieved not by the means of increasing tax burden, but by complementary ways. It stands out, as main possible option, tax base broadening, achieved mainly through the reconsideration or cancellation of some tax privileges (exemptions, deductions, etc.). In addition, authorities must continuously seek to improve the degree of taxpayers' compliance to paying taxes. To the extent that the above listed features are met, there are good premises for the fiscal consolidation strategy to produce the effects expected.

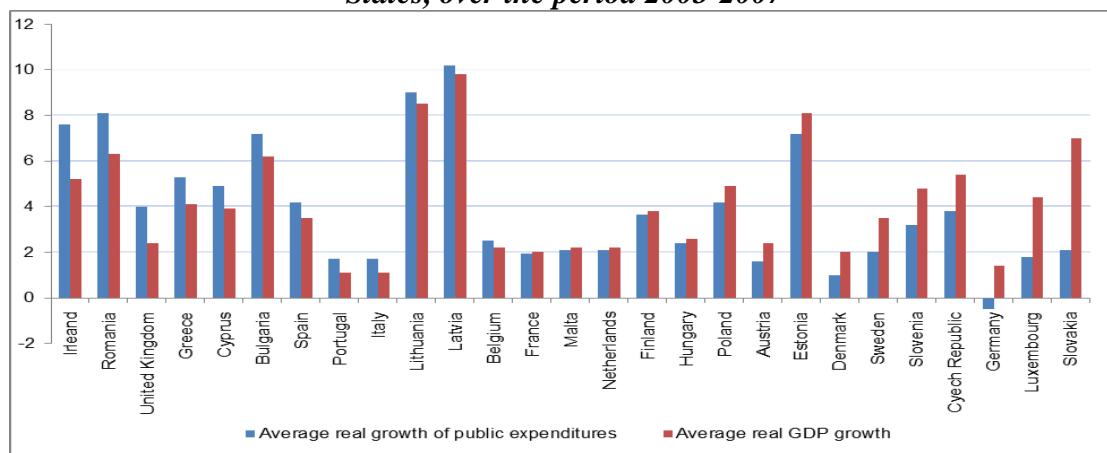
### **3. Particularities of the background and content of fiscal consolidation strategies in some EU Member States**

The EU economic performances recorded after 2000, questionable in comparison to the average or even some particular OECD countries, are presently accounted for by the pre-existence of some structural deficiencies, globally considered as sources of vulnerability for the later manifestation of the economic and financial crisis. The analysis of official data for 2003-2007 shows that the fiscal policies of several EU Member States lacked necessary rationality, containing imbalances between the growth rates of primary public spending and real GDP growth rates.

As results from the data presented in figure no. 1, 2003-2007 was, with respect to tax revenue developments, a fertile ground for fiscal adjustments. However, in almost half of EU Member States (12 countries), these extra revenues went to additional expenditures, which reduced the room for fiscal maneuver required by the economic contraction, on background of the economic and financial crisis. Thus, at the onset of the crisis, many EU Member States had disadvantageous fiscal positions, which called

for more severe consolidation strategies, with higher sacrifices (costs) over the short term and substantial public debt growth anticipated over the medium and long term, while economic recovery is still fragile today.

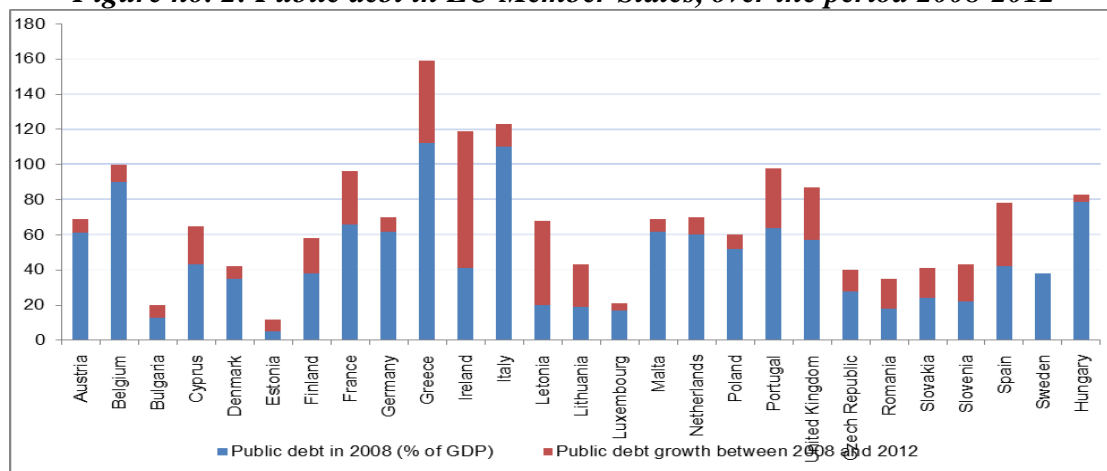
**Figure no. 1: Comparative dynamics of public expenditures and GDP in EU Member States, over the period 2003-2007**



Source: European Commission

According to the (optimistic) estimates of some European officials, production levels similar to those at the onset of the crisis could be recorded only at the end of 2012, while employment will still be below its initial value. On the background of high unemployment rates in many countries and low productivity, substantial public debt growth can be anticipated, as results from figure no. 2.

**Figure no. 2: Public debt in EU Member States, over the period 2008-2012**



Source: European Commission

Against the concerns raised by such data, we must draw attention to a situation quite often seen on the scene of public decision making, that current problems (generated by the crisis, in our case) become predominant and come to be judged singularly, forgetting the importance of some unsolved issues existing prior to the crisis. In addition, we must not forget that the macroeconomic variables used in assessing the effects of the economic and financial crisis are also under the impact of other factors of influence, with wider persistence, out of which we have to mention at least population ageing. It is widely recognized that, in the future, this factor will exert high pressure on public budgets, by means of reducing tax revenues and increasing public spending.

Apart from the unfavorable predictions resulting from the effects of the crisis, the ageing of population adds even more pressure for consistent structural reconsiderations. Thus, assuming that there will be no major public policy changes, it is anticipated that within the next five decades, aging population will lead to an average

pensions and other social benefits payments growth of 5% of GDP in EU as a whole and of more than 7% in one third of the Member States.

On such a background, the position of many EU Member States with respect to public debt and required consolidation efforts was not a comfortable one in 2010. According to European Commission's Annual Growth Survey published in 2011, Member States were classified on the basis of their budget deficit to GDP ratios and net imports of goods and services as follows: only three of them recorded no visible imbalances (Luxembourg, Sweden and Estonia), eleven recorded fiscal imbalances (Austria, Belgium, Denmark, Finland, Germany, Lithuania, Malta, Netherlands, Czech Republic, Slovenia and Hungary), while the others, among which Romania, recorded both fiscal and macroeconomic imbalances. On the basis of public debt and external account deficit data, the same report found that only eight EU countries benefited, in 2010, from some fiscal and macroeconomic space (Luxembourg, Estonia, Lithuania, Latvia, Sweden, Czech Republic, Denmark and Finland), five of them had limited fiscal space (Netherlands, Austria, Germany, Hungary and Belgium) and five others limited macroeconomic space (Bulgaria, Romania, Slovakia, Slovenia and Poland), while most states (nine) were confronted with both fiscal and macroeconomic limited space (Spain, Portugal, Cyprus, Malta, France, United Kingdom, Ireland, Italy and Greece).

Despite this grouping, countries do not face similar conditions and therefore, it is neither possible nor adequate to come with identical solutions (budgetary consolidation strategies). With ambitious and rigorous adjustment programs, EU Member States must still engage consistent and sustained consolidation efforts, as it is anticipated that a return of the average value of public debt to GDP to the conventional limit of 60% might occur (optimistically, with 1% each year) at the end of the two next decades.

Looking at the main ingredients of EU budgetary consolidation strategies, we can see that many Member States resorted to both public revenues and budgetary expenditures adjustments, although the specific measures, targets and effects were different. A comparative picture of their dimensions is shown in table no.1.

**Table no. 1: Fiscal adjustments between 2008 and 2010 (% of GDP)**

Country	Net result	Public revenue adjustments					Public expenditure adjustments					
		Total	Housing sector	Businesses sector	Consumption	Social contributions	Total	Final consumption	Investments	Transfers to housing sector	Transfers to business sector	Transfers to local authorities
Austria	-1.2	-0.8	-0.8	-0.1	0.0	0.0	0.4	0.0	0.1	0.2	0.0	0.1
Belgium	-1.4	-0.3	0.0	-0.1	-0.1	0.0	1.1	0.0	0.1	0.5	0.5	0.0
Denmark	-3.3	-0.7	0.0	0.0	0.0	0.0	2.6	0.9	0.8	0.1	0.0	0.0
Finland	-3.2	-2.7	-1.9	0.0	-0.3	-0.4	0.5	0.0	0.3	0.1	0.0	0.0
France	-0.7	-0.2	-0.1	-0.1	0.0	0.0	0.6	0.0	0.2	0.3	0.0	0.0
Germany	-3.2	-1.6	-0.6	-0.3	0.0	-0.7	1.6	0.0	0.8	0.3	0.3	0.0
Greece	0.8	0.8	0.8	0.0	0.0	0.0	0.0	-0.4	0.1	0.4	0.1	0.0
Ireland	8.3	6.0	4.5	-0.2	0.5	1.2	-2.2	-1.8	-0.2	-0.1	0.0	0.0
Italy	0.0	0.3	0.0	0.0	0.1	0.0	0.3	0.3	0.0	0.2	0.1	0.0
Luxembourg	-3.9	-2.3	-1.5	-0.8	0.0	0.0	1.6	0.0	0.4	1.0	0.2	0.0
Netherlands	-2.5	-1.6	0.2	-0.5	-0.1	-0.8	0.9	0.0	0.5	0.1	0.0	0.0
Poland	-1.2	-0.4	0.0	-0.1	-0.2	0.0	0.8	0.0	1.3	0.2	0.1	0.0
Portugal	-0.8	-	-	-	-	-	-	0.0	0.4	0.0	0.4	0.0
United Kingdom	-1.9	-1.5	-0.5	-0.2	-0.6	0.0	0.4	0.0	0.4	0.2	0.0	0.0
Czech Republic	-2.8	-2.5	0.0	-0.7	-0.4	-1.4	0.3	-0.1	0.2	0.0	0.2	0.0
Spain	-3.9	-1.7	-1.6	0.0	0.0	0.0	2.2	0.3	0.7	0.5	0.7	0.0
Sweden	-3.3	-1.7	-1.3	-0.2	0.0	-0.2	1.7	1.1	0.3	0.1	0.0	0.2
Hungary	7.7	0.2	-0.6	-0.1	2.3	-1.5	-7.5	-3.2	0.0	-3.4	-0.4	-0.5

The above summarized data show that all considered countries implemented adjustment measures aimed at both public expenditures and revenues, the average adjustment being greater in the latter case. Among the results obtained during this period, they detach themselves as extremes on the one hand Ireland and Hungary and, on the other hand, Italy, France and Portugal. Also, Ireland stands as a good example for revenues oriented fiscal adjustment, while Denmark for public expenditure adjustment.

Among the measures initiated we can mention the introducing of accelerated amortization, the exemption of reinvested profits, giving up favorable tax treatment of some incomes or activities (Austria, France, Greece, Italy, Latvia, Luxembourg), rate reductions for certain transactions or paying facilities for VAT (Belgium, Finland), exemptions or deductions for individual incomes or profits taxation or subsidies for interest payments (Bulgaria, Finland, France, Germany, Ireland, Luxembourg, Netherlands, Portugal), reductions in corporate or individual income tax rate or social security contributions (Czech Republic, France, Germany, Poland), deferred payments of taxes (Denmark), tax incentives for creating new jobs (Finland, Luxembourg), increases of some direct or indirect tax rates (Hungary, Romania, Italy, Lithuania), reduction or cancellation of some social benefits (Romania, Hungary, Germany, France, Portugal, Spain), reducing and ceiling certain categories of public expenditures (particularly those for goods and services or transfers).

During the high economic growth period of 2004-2008, Romanian authorities engaged themselves in quite large public expenditure programs, which became impossible to finance from ordinary public resources, as GDP declined once the crisis unfolded. It thus became imperative to reconsider both public revenue policy and, especially, public expenditure one, either by reducing some categories (such as transfer expenditures) or by increasing others (investments), our country assuming a considerable consolidation strategy. The targeted measures were correlated with the requirement of establishing a more appropriate framework for fiscal discipline, by creating the Fiscal Council and legitimizing as instruments the Medium-term expenditure framework and the Fiscal-budgetary strategy, over a 3 years timeframe.

Among the most important measures that aimed at reducing public spending we can mention the dismissal of public sector employees, public sector wage cuts, pension and social assistance benefit cuts, as well as the removal of some forms of social protection. These measures were accompanied by the 5 % increase in VAT rate, following a decision of unconstitutionality of some expenditure measures (concerning the pensions of magistrates).

As for personnel spending, although job cuts apparently were massive and public sector wages reduced by 25%, one could notice however that, in 2010 the expenditures in question dropped only by 0.1% of GDP in comparison to 2008. The main reasons are that cuts initially were made rather on the number of "positions" than of employees and that at the end of 2008 some consistent wage increases were regulated (especially for local authorities), sometimes even with the aim to offset the reductions announced by the Government (in our opinion an irrational approach, since autonomous local governments are supported by grants from the state budget). Another explanation (perfectly available for public pension spending) is that it was legally impossible to diminish some expenditures, the courts of law or the Constitutional Court ruling against cuts and forcing the Government to pay the increases provided by the law (especially problematic were the 50% increase in the wages of teachers and the pensions of magistrates). As for social security spending, although reductions were made and benefit criteria were reconsidered, total expenditures increased in 2010 by 3% of GDP. On such a background, some of the projections reflected in the Fiscal-budgetary

strategy raise suspicions (the case of personnel expenditures), if it is not quickly solved the issue of hard budget constraints.

The budgetary projections assumed by the Government imply, as natural, measures to increase public expenditures, mainly investment ones (see table 2).

**Table no. 2: The dynamics of overall and investment public expenditures in Romania, over the period 2008-2014**

Category	Overall public expenditures		Public investment expenditures	
	% of GDP	% of 2008 level	% of GDP	% of 2008 level
2008	37.0	100	6.3	100
2009	39.4	106.49	7.2	108.73
2010	39.1	105.68	6.5	102.47
2011p	36.8	99.46	6.3	104.94
2012p	36.9	99.73	7.0	129.20
2013p	36.5	98.65	7.3	147.00
2014p	36.1	97.57	7.1	143.00

*Source: processed data from the Fiscal-budgetary strategy, 2011-2013 and 2012-2014*

In nominal terms, the general consolidated budget investment expenditures grow every year between 2010 and 2011. Also, investment expenditures are projected to growth at a higher pace than all expenditures, which is nothing but positive. However, a sensitive issue is how realistic these targets are, mainly the estimated GDP growth rates (the expected nominal values are 6.4% in 2011, 10% in 2012 and 10.1% in 2013, which correspond to real growth rates of 1.5% in 2011, 3.9% in 2012 and 4.5% in 2013). At this moment, the signs of worry must not be very acute, at least unless the measures undertaken will be reversed. Continuing to implement favorable measures to support for these figures (such as the car scrappage scheme, the “First House” program, the “Green House” program, starting or continuing the construction of several highway sections) proves to be very important. There are still needed, however, some more coherent complementary measures for the positive effects to be felt in Romania, such as continuing budget sector resizing process, disciplining public procurement, reconsidering the relationship between public and private social utilities (e.g. health sector), generalizing multi-annual budgeting, improving fiscal discipline and budgetary revenues collection rate and better results in the fight against tax evasion.

#### **4. Conclusions**

A fiscal consolidation strategy should not limit, in any way, at counteracting the negative effects of the economic and financial crisis, but should be proactive, eliminating the sources of fiscal vulnerability or the capacity to create favorable conditions for crises to occur or exacerbate. Thus, fiscal consolidation should be a concern of major importance for public authorities not only in times of economic crisis, but also in times of high growth. A greater concern for the fiscal position in times of economic prosperity (coupled with updating and reevaluating crisis management mechanisms), should not be considered a simple requirement of rationality, but a pre-condition for economic cycles to be managed without important disruptions. From this perspective, we consider that efforts should not ground only on government’s sense of duty, but must be enacted, becoming a legal obligation.

The example (not singular) of our country proved that in absence of a coherent, restrictive but proactive regulatory framework to support for crisis prevention, pro-cyclical fiscal policies favored the amplification of the negative effects of the crisis, making it harder to stabilize the economy and resume its upward trend. Also, the sacrifices to be made are of higher proportions, which could be avoided if caution prevailed.

By reference to the content of the budgetary consolidation strategies adopted by different countries, it is our opinion that some structural reforms should be given higher importance. We refer here to the financing of scientific research, given that the human capital investment is one that considerably supports for obtaining positive effects on medium and long term. We also want to draw the attention on the fact that eventual emotional responses at the improvement over expectations of some macroeconomic indicators, which could result in giving up on some of the measures or even reversing them, should be entirely excluded.

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