

# Strategies and measures aimed at consolidating public finances

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## Introduction

The financial crisis and the resultant economic recession have seriously undermined the health of public finances in almost all the developed economies. Budget deficits and public debt have risen sharply and it is clear that these budgetary problems will not disappear automatically once the economy has fully recovered from the recession. If policy remains unchanged, public debt will continue to increase in many countries. On top of this, the budgetary impact of the ageing of the population could drive up budget deficits and cause public debt to rise even more quickly.

Financial markets have reacted to the situation by casting doubt on the sustainability of some countries' budgetary positions, which was expressed by a rise in the interest rates applying to those countries and even, as far as Greece is concerned, by problems in finding sources of financing. Given these circumstances, the latter country was forced to appeal to its partners in the euro area and the IMF.

A clear and credible strategy for returning to a healthy and sustainable budgetary situation therefore seems to be absolutely essential for many economies. The Greek debt crisis and the threat that it might spread to other countries not only demonstrated the risks associated with budgets

becoming derailed but also acted as a tipping point in the sense that, in its immediate aftermath, many countries drew up concrete consolidation plans.

The first chapter in this article outlines the current budgetary situation. This is followed by an explanation of why consolidation plans are urgently needed and an attempt is made to provide an answer to the question of what form those plans should preferably take. The last chapter contains an insight into the strategies that have been drawn up to consolidate public finances. This last chapter also looks back at the response of the European authorities to the Greek debt crisis and outlines the sometimes very concrete budgetary consolidation measures that a number of European countries have already taken. Lastly, a number of conclusions are drawn.

## 1. Outline of budgetary positions

### 1.1 Current budgetary situation

The economic and financial crisis that began in the course of 2007 and worsened in 2008 had very significant consequences for the public finances of most of the advanced economies. On the one hand, many governments took action to rescue the financial system, and more specifically the banks. On the other hand, they undertook extensive budgetary measures in order to limit the severity of the recession as far as possible, by way of their stimulus plans<sup>(1)</sup>. These complemented the automatic stabilisers so as to prevent the collapse of economic activity, but they

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(1) An article about these economic stimulus plans was published in the September 2009 edition of the Bank's Economic Review.

also adversely affected the budget situation in a great many countries.

Thus, the budget balance of most of the industrial countries has deteriorated sharply since 2007, from an average deficit of 1.7 p.c. of GDP to 8.9 p.c. in 2010, in the advanced countries of the G20. The deterioration was less severe in the emerging countries: there, the budget surplus of 0.3 p.c. of GDP turned into a deficit of 3.7 p.c. of GDP.

The decline is pronounced in the United States and Japan, where the deficit is expected to amount to more than 10 p.c. and about 8 p.c. of GDP respectively in 2010, and even more so in the United Kingdom, where it is likely to come out at 12 p.c. of GDP. In the euro area, very different situations in the respective countries are sometimes concealed behind the expected deficit of 6.6 p.c. of GDP. Specifically, the budget deficit ranges from around 12 p.c. and 10 p.c. of GDP in Ireland and Spain respectively to some 5 to 6 p.c. in Germany, Belgium, Italy and the Netherlands and about 4 p.c. in Luxembourg, Finland and Malta. In China, as in many emerging countries, the budget balance has only deteriorated to a moderate degree.

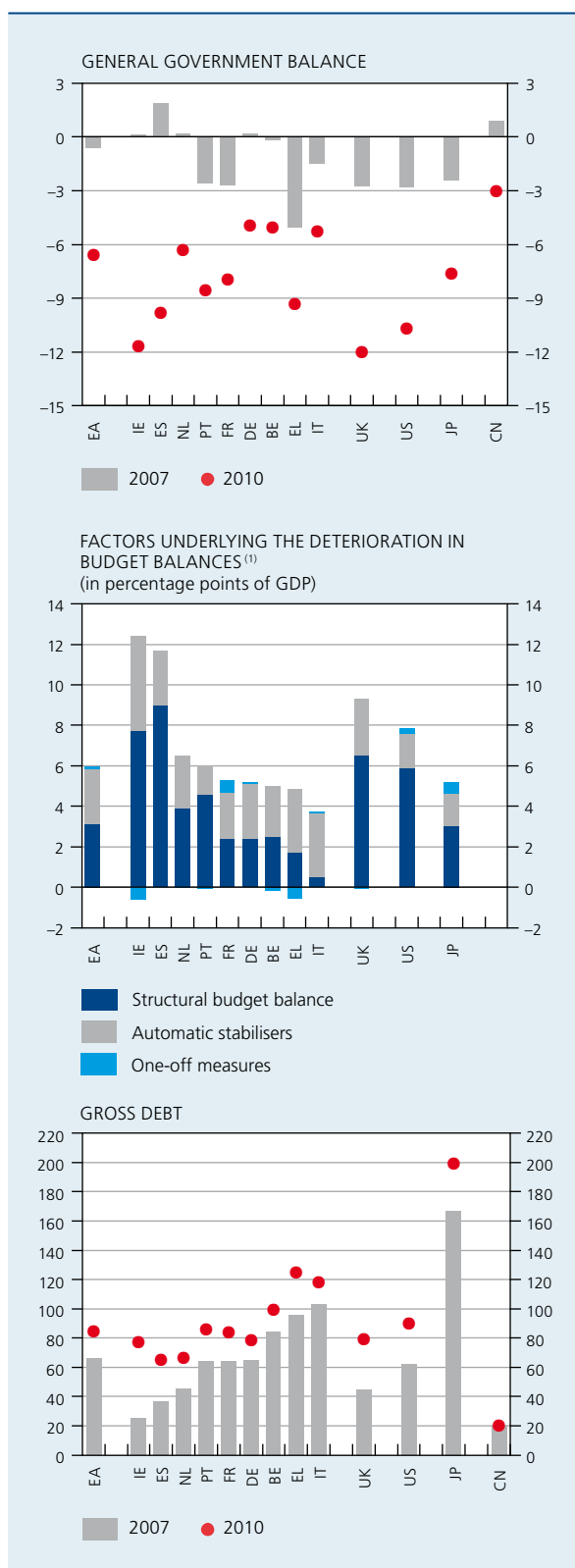
However, the general deterioration cannot be attributed solely to the economic and financial crisis. In some countries, considerable deficits were already being recorded prior to the beginning of the crisis, whilst the favourable business cycle in 2007 put a gloss on the budget situation to some extent. In these countries, the crisis exerted a further adverse effect on what were already structurally weak budget positions in the first place.

Moreover, the weakening of budget positions since the beginning of the crisis is largely structural in nature. This deterioration is even chiefly structural in the United States, the United Kingdom and Japan, whilst in the euro area as a whole, the automatic stabilisers played virtually as significant a role as the structural factors. However, the latter were of critical importance in some countries in the euro area, such as Spain and Ireland, whilst in Italy, for example, these factors only exerted a very limited influence.

The deterioration in the structural budget balance is partly explained by the stimulus packages which the various countries have put together for the years 2009-2010. According to the IMF, the discretionary measures are expected to amount to 3.9 p.c. of GDP on average in 2009-2010 in the countries of the G20. They are likely to be more extensive in China, Japan and, to a lesser extent, the United States than in Europe. The stimulus plan coordinated within the European Union has, according to the

**CHART 1** BUDGETARY DEVELOPMENTS BETWEEN 2007 AND 2010

(in p.c. of GDP unless otherwise stated)



Sources: EC, IMF, OECD.

(1) A positive (negative) sign indicates a deterioration (improvement) in the balance.

most recent EC data, a scope of 2.9 p.c. of GDP, whilst comparable measures achieve 4.7 p.c. of GDP in the United States and 5.8 p.c. of GDP in China.

The level of debt has grown drastically in many countries, primarily as a consequence of the deterioration in public finances in general. Thus, the government debt in the United States increased by about 28 percentage points of GDP between 2007 and 2010, to almost 90 p.c. of GDP. In Japan, where the level of debt was already particularly high in 2007, it is forecast to grow by a further 32 percentage points of GDP, to almost 200 p.c. of GDP. The growth in the United Kingdom's debt amounted to as much as 34 percentage points of GDP but due to the still relatively low level in 2007, the debt ratio is expected to remain more limited there, more specifically around 80 p.c. of GDP in 2010. The rise was smaller in the euro area, albeit starting from a higher debt level in 2007, and so the public debt there is expected to come out at about 85 p.c. of GDP at the end of 2010. The situation diverges relatively markedly in the countries making up the euro area. The strongest increase was posted in Ireland, at more than 50 percentage points of GDP, whilst the increases in Italy, Belgium and Germany remained limited to less than 15 percentage points of GDP. In China, the debt remained small and did not increase, expressed as a percentage of GDP – a finding which can be attributed to continuing strong growth figures.

The rescue operations in the financial sector only explain a small part of the overall rise in public debt since the beginning of the crisis; the most significant determinant of this rise is in any case the increase in budget deficits.

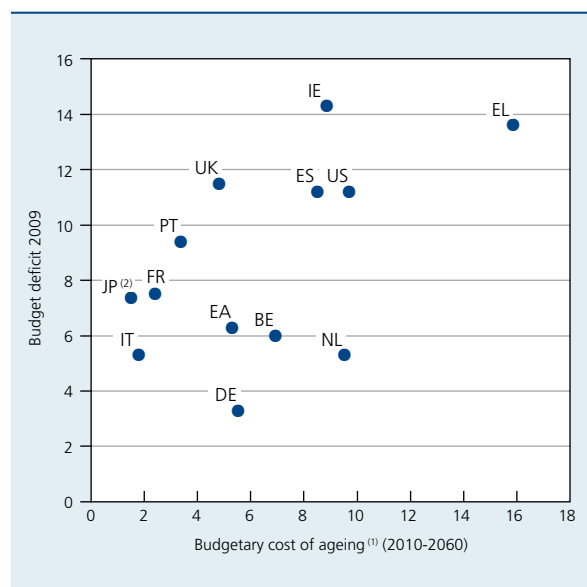
Given that the level of debt rose relatively markedly in those countries that had a relatively small debt in 2007, the degrees of indebtedness tended to converge. However, Japan and China formed an exception to this trend, as did – to a lesser extent – Greece.

## 1.2 Prospects for public finances

The combination of extensive budget deficits and a high level of debt on the one hand, and the anticipated rise in government expenditure as a result of the ageing of the population on the other, casts doubt on the sustainability of public finances over the long term.

The ageing of the population will in any case weigh on public finances – and thus on debt – since it puts a brake on economic growth as a result of the fall in the population of working age on the one hand, and since government expenditure on pensions, health care and care of

**CHART 2** BUDGET DEFICIT AND BUDGETARY COSTS OF AGEING  
(in percentage points of GDP)



Sources: BIS, CBO, EC, IMF.

(1) Costs that are limited to pensions, health care and long-term care.

(2) With regard to Japan, the budgetary costs associated with ageing relate to the period 2010-2050.

the elderly is increasing over the long term on the other. In the euro area, government expenditure associated with ageing is forecast to rise by 5.1 percentage points of GDP on an annual basis between 2010 and 2060.

On average across the euro area, the effort needed to meet the intertemporal budget constraint<sup>(1)</sup> – the sustainability gap – amounts to not less than 5.8 p.c. of GDP. The main determinants of the sustainability gap comprise the current structural budget position and the anticipated change in costs associated with ageing. However, the scope of the corrections required so as to achieve a sustainable situation differs from one country to the next. Some countries, such as Greece, are having to contend with a large initial imbalance and considerable anticipated growth in age-related expenditure simultaneously. The sustainability of budget positions constitutes a severe problem outside the euro area too.

An alternative method of showing that current budgetary policy is unsustainable consists in simulating the increase in the debt if policy remains unchanged<sup>(2)</sup>.

(1) This constraint means that total expenditure over a long period is covered by total revenue over that same length of time.

(2) The EC's simulations are carried out in the context of a partial equilibrium, where the reactions of the agents to such a level of debt are not taken into account. They do not involve realistic scenarios, therefore. The scenarios drawn up by the BIS do not seem to differ in this respect.

Whilst the average level of debt in the euro area still amounted to 78.7 p.c. of GDP in 2009, this level would balloon to more than 400 p.c. of GDP by 2060. The other advanced economies would not escape any more lightly: in the United Kingdom, the debt would climb to more than 750 p.c. in 2060, in Japan to about 350 p.c. by 2030 and in the United States to more than 200 p.c. by 2030.

## 2. Budgetary consolidation is urgently needed

In most of the advanced economies, the present state of public finances is a cause for concern. A situation of this type implies very serious policy risks. It could bring about a sharp rise in interest and could have dire consequences for economic growth over the long term. This chapter looks at both these risks in detail.

### 2.1 Is there a danger of a sharp rise in interest?

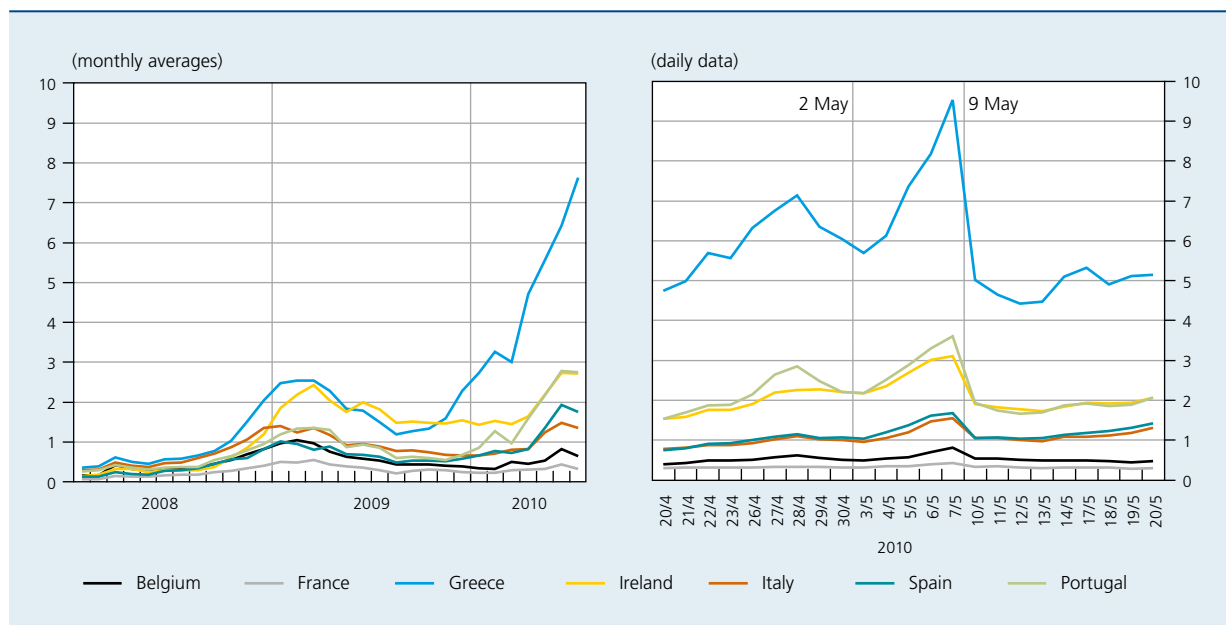
Growing government deficits and public debt have the effect of making interest rates move upwards. The IMF has carried out empirical research investigating what influence budgetary variables have on long-term interest rates (IMF, 2009). This shows that a rise of 1 percentage point in the budget deficit leads to long-term interest rates on public

securities being raised by 10 to 60 basis points. There is a relatively severe impact in countries with an unfavourable starting position with regard to public finances, weak institutions, a low savings rate and limited access to the international capital markets. The expectation that public finances will be more vulnerable as a result of the impact of population ageing also appears to reinforce the effect of government deficits on interest.

Up to now, however, long-term interest rates have remained relatively low in most countries. The upward pressure that emanated from growing government deficits and public debt was counteracted by a number of factors which are also connected to the financial and economic crisis. Indeed, the crisis has caused an increase in the savings ratio of individuals, whilst private investment is running at a very low level. Moreover, the crisis has led to a sharp fall in inflation and expectations regarding inflation which, together with real interest rates, are a component of nominal interest rates. Lastly, the very expansive monetary policy has also made a large contribution to the low interest rates. These factors are nevertheless temporary in nature and therefore do not constitute a lasting counterweight to the upward pressure on interest rates resulting from increasing government deficits and public debt.

Interest rates may rise if investors demand higher risk premiums for their investments in public securities,

**CHART 3** DIFFERENCES IN YIELD ON TEN-YEAR GOVERNMENT BONDS COMPARED TO THE GERMAN BUND



Source : Thomson Reuters Datastream.

namely if the financial markets begin to make more allowance for a higher risk of default by some countries. Thus, in the first few months of 2010, the financial markets moved to a strong upward revision of the likelihood of Greece defaulting. The problems that Greece had to contend with also clearly show that financial markets can react suddenly and very strongly.

Furthermore, higher interest rates may be demanded when investors expect higher inflation. The inflation expectation may be fuelled in two ways. In the first place, the monetary and budgetary policy mix, which has become very expansive in virtually all countries in response to the financial and economic crisis, might be adjusted too late. Should this policy mix remain very expansive whilst economic activity picks up, this could then drive inflationary expectations upwards. Furthermore, investors could allow for a greater likelihood of monetisation of the public debt.

A situation in which investors and other economic actors proceed on the basis of higher inflationary expectations would not only lead to long-term interest rates being raised but would also have consequences for the conduct of monetary policy. In a situation of this type, a tightening of monetary policy in the form of higher short-term interest rates could appear unavoidable in any case. A timely budgetary exit, on the other hand, could dampen the increase in inflationary expectations, which would enable a more gradual tightening of monetary policy.

## 2.2 What is the impact of budget consolidation on economic growth?

A lively debate is being conducted amongst economists about the impact of budgetary policy on growth. There is therefore a very extensive theoretical and empirical literature on this topic. Although this does not provide an unequivocal answer, a number of cautious conclusions can nevertheless be drawn. In this respect, a distinction must be made between the impact over the short term and that over the long term.

### SHORT-TERM IMPACT

It may be anticipated, *a priori*, that the measures that are being taken to consolidate the budget will have a negative effect on the economic cycle over the short term. After all, most empirical studies show that the budgetary multipliers – which indicate the extent to which a certain budgetary stimulus influences the growth in activity – are positive over the short term. However, the impact that

budgetary adjustment has on economic growth varies according to the type of consolidation measure. Thus, it appears that public consumption and investment measures have a relatively marked impact on economic activity, whilst measures involving transfers, such as taxation and social benefit payments, have a smaller impact. The reason is that the latter only alter consumption and investment indirectly, by way of a change in the incomes of individuals and companies. The extent to which households and enterprises have to cope with restrictions on liquidity and credit is also an important aspect of the impact that raising taxation or lowering social benefit payments would have on economic growth.

Furthermore, it appears that the negative impact of consolidation measures on economic growth over the short term is smaller or even almost zero as the state of public finances becomes worse and is perceived as being a cause for concern. This has to do with the fact that consolidating measures may prevent the interest rate rising, which would depress private investment. Moreover, these measures may lead to a fall in the savings ratio, for instance because households start to do less in the way of precautionary savings as their confidence is restored following a period of budgetary problems. In this case, the influence on economic activity over the short term could remain very limited.

The latter elements are very relevant in the present situation; so budget consolidation does not necessarily exert a strongly negative effect on the business cycle.

### IMPACT OVER THE LONG TERM

The long-term effects of a budget consolidation that guarantees the sustainability of public finances are unmistakably positive. These effects comprise amongst other things a fall in long-term interest rates due to a reduction in the quantity of public securities put into circulation. Furthermore, the fall in interest expenditure as a result of budgetary adjustment may release more funds for productive government expenditure or may limit the fiscal and parafiscal burden.

It appears from the economic literature that budget consolidation based on reducing expenditure is more successful and has more favourable effects on economic growth over the long term than consolidation supported by raising government revenues. This applies in particular when the budget consolidation refers to expenditure other than what is often described as productive expenditure, such as expenditure on investment, education and research and innovation.

### 3. How should budget consolidation proceed?

This chapter looks at the question of how the restructuring of public finances – a necessity in most of the advanced economies – needs to proceed. Firstly, an indication is given of the scope of the consolidation effort. Then, consideration is given to what the best timing is for starting to consolidate the budget. Lastly, a number of observations follow about the composition of the budgetary adjustment packages.

#### 3.1 Scope of the necessary consolidation effort

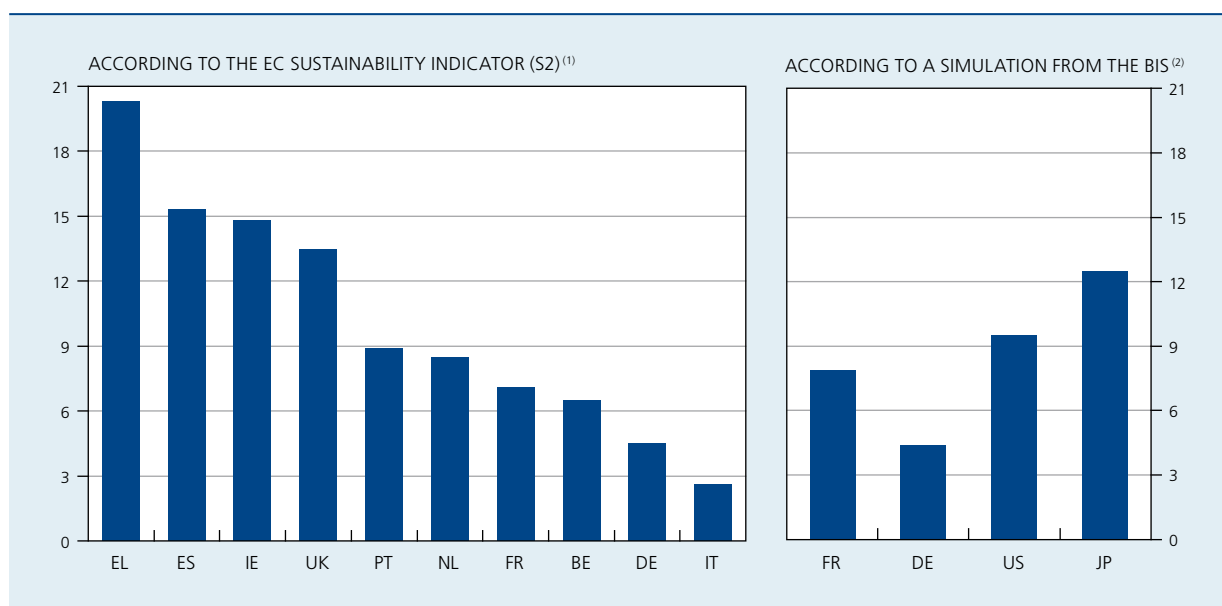
The scope of the required budgetary consolidation can be measured on the basis of the difference between the present budgetary situation and a sustainable situation. One of the indicators of that difference – referred to as “S2” by the EC – specifies the effort that needs to be delivered with regard to the primary balance so as to comply with the budget constraint indefinitely, whilst taking into account the extra expenditure associated with the ageing of the population. The EC (2009a) regularly performs this exercise for all the European countries. The BIS<sup>(1)</sup> has also carried out a simulation which can be used as a basis for measuring the required budgetary effort.

The effort to be made needs to refer to two elements: a lowering of the initial structural budget deficit and the cost of ageing. It appears from these indicators that all the countries under consideration need to deliver a substantial effort with regard to sustainability. According to the EC, the effort in the euro area amounts to 5.8 p.c. of GDP on average; here, the burden of ageing constitutes a greater problem with regard to sustainability than the initial budgetary position, amounting to 3.5 p.c. and 2.3 p.c. of GDP respectively. According to the exercise undertaken by the BIS, which differs to some extent and does not include all the European countries, Japan and the United States would generally have to deliver greater efforts than the countries in the euro area.

According to the S2 indicator, the effort needed to return to a sustainable budgetary position is particularly marked in Greece, where a consolidation of more than 20 percentage points of GDP is required. Spain, Ireland and the United Kingdom also need to make a considerable effort – that is, more than 13 percentage points of GDP. Although Italy, for instance, seems to be less far removed from a sustainable budgetary situation, that country needs to reduce its public debt – the second highest in

(1) Cecchetti et al. (2010). In this simulation, the authors studied the primary balance anticipated for 2011 and the primary balance that needs to be attained within 5, 10 and 20 years so as to stabilise the debt ratio at the level of 2007. The difference between the two balances indicates the effort to be made.

**CHART 4** SCOPE OF THE REQUIRED BUDGET CONSOLIDATION  
(in p.c. of GDP)



Sources: BIS, EC.

(1) S2 indicates the permanent adjustment of the primary balance needed so as to comply with the intertemporal budget constraint indefinitely.

(2) Difference between the primary balance anticipated for 2011 and the primary balance required within 20 years so as to stabilise the debt ratio at the level of 2007.

the European Union – just as much in order to ward off other risks, such as the impact of a renewed interest rate rise on the budget situation.

### 3.2 Timing of budget consolidation

Given that the economic recovery is still fragile at the moment, substantial and rapid consolidation efforts delivered by most countries simultaneously – on top of the ending of the stimulus measures – could entail risks for the economic revival. A postponement of consolidation efforts, on the other hand, could lead to financing risks and rising long-term interest rates.

In view of these risks, there is an urgent need for credible consolidation programmes. These must be aimed at a substantial narrowing of what is in many countries the very wide sustainability gap, which reflects the difference between the current primary balance and the balance needed to guarantee the sustainability of public finances. A distinction can be drawn in this regard between the announcement of consolidation plans and their implementation. To prevent doubt arising about the sustainability of public finances, it is advisable not to delay the announcement of concrete and credible plans, even if they are to be largely put into effect during the years to come. In view of the scope of the consolidation effort required in most countries, spreading it out over a period of time seems in fact to be unavoidable.

The timing of budget consolidation may be different depending on the economic circumstances in the specific countries. Amongst other things, allowance needs to be made in this regard for the economic cycle and the budgetary situation. In countries where public finances have been seriously derailed and are regarded as problematical, and where the confidence of the financial markets in sustainability is damaged or threatens to be damaged, public finances have to be consolidated urgently anyway.

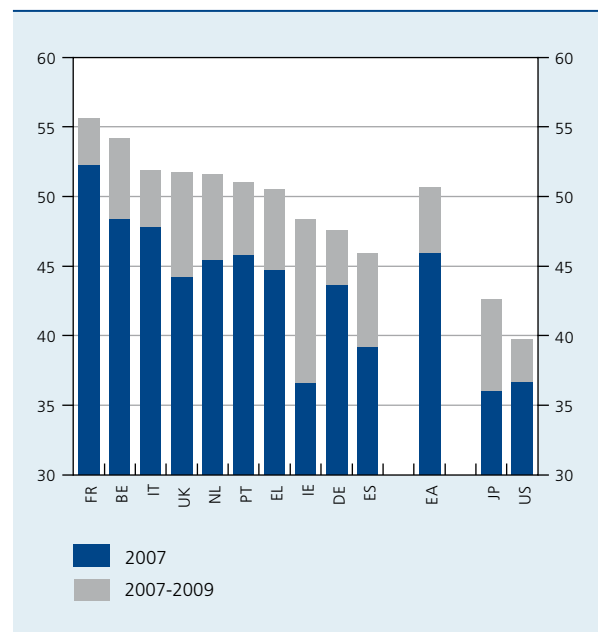
### 3.3 What should the budgetary adjustment plans look like?

Fundamental consolidation measures are therefore required in most of the advanced countries. These consolidation measures have to be aimed to a large extent at the expenditure side. As already mentioned, measures that focus on limiting non-productive government expenditure do in any case have a much more positive effect on economic growth over the long term than raising revenues. Moreover, the financial and economic crisis has caused the expenditure ratio to rise sharply in virtually all countries

concerned. In the euro area and the United Kingdom, the ratio has risen from about 45 p.c. of GDP in 2007 to more than 50 p.c. of GDP in 2009. In Japan too, the expenditure ratio has grown by almost 7 percentage points over the period, to 42 p.c. in 2009. In the United States, the rise remained limited to 3.1 percentage points, with the result that the expenditure ratio increased to about 40 p.c. Together with France and Finland, Belgium belongs to a group of countries where the expenditure ratio has grown to as much as approximately 55 p.c. of GDP.

Combined with the budgetary costs of ageing, which are very considerable in some countries, and the expectation that interest charges will also rise, such high expenditure ratios can barely be financed by way of government revenues, if at all. This would in any case demand very severe fiscal and parafiscal pressure, which would have a negative impact on economic growth. More selective government action is therefore evidently required in most countries. In the face of the unavoidable savings in government expenditure, gains in efficiency have to be pursued anyway. The consolidation also needs to be aimed especially at expenditure that is regarded as non-productive. Productive government expenditure, on the other hand, including that for education, for certain investments and for R&D, preferably needs to be spared as far as possible since it is a significant stimulus for economic growth over the long term.

**CHART 5** TOTAL GOVERNMENT EXPENDITURE BEFORE AND AFTER THE ECONOMIC CRISIS  
(in p.c. of GDP)



Source: EC.



However, due to the scope of the consolidation effort to be made, raising government revenues also seems to be unavoidable. In some countries with a relatively low burden of taxation, there is a useful margin for this. However, the weight of taxation – particularly on earned income – is already very heavy in a great many countries, for example in Belgium. In these countries, the margins for raising revenues and thereby consolidating the budget tend to be limited. Nevertheless, these countries also have a number of options at their disposal. Thus, it is possible to point to the discussions that are currently being held at international meetings about the introduction of a specific tax on financial institutions, which is regarded by some as compensation for the systemic risk that these institutions embody. In addition to this, there are also ample margins with regard to environmental levies or, as a technical variant of these, the sale of emission rights. Using the tool of environmental levies on a greater scale means that both environmental and budgetary objectives could be pursued. Lastly, more efficient collection of taxes must be an aim and a broadening of the tax base can be considered.

The budgetary adjustment plans preferably also need to include measures that are aimed at limiting the budgetary costs associated with ageing, and certainly in countries which have not yet put enough reforms into effect in this regard. If policy remains unchanged, substantial rises are in prospect in many countries for expenditure on health care and pensions especially. Measures that hold down the budgetary costs of ageing may in fact be of crucial importance in some countries, so as to remove doubts about the sustainability of public finances. Moreover, measures that result in pushing up the effective pension age, or other measures with an effect over the long term, do not have a direct negative impact on economic recovery, which is very important in the current circumstances.

#### 4. Budgetary consolidation plans in the United States, Japan and the European Union

In the last few years, the G20 has played a significant coordinating role in combating the financial and economic crisis. As far as budgetary policy is concerned, it was agreed that measures should be taken in support of domestic demand but without losing sight of the sustainability of public finances. At the summit meeting in Pittsburgh in September 2009, emphasis was placed on the need for cooperation and coordination when, at the appropriate time, the extraordinary policy support would be withdrawn. The call therefore went out at that summit of the G20 leaders, and also during subsequent meetings, to develop credible budgetary exit strategies now,

whilst making allowance for the differences between countries and any possible spillover effects. The Toronto summit in June 2010 again underlined the need to draw up credible, well-phased and growth-friendly plans, albeit differentiated and tailored to national circumstances, for the purpose of guaranteeing the sustainability of public finances. In this respect, countries with serious budgetary problems need to consolidate their budgets more rapidly. The world leaders emphasised the fact that healthy public finances are essential for the economic revival, provide flexibility so as to respond to new shocks, safeguard the capacity to face up to the challenges of population ageing and prevent government deficits and public debt being passed on to future generations. However, the consolidation process has to be carefully calibrated so as to support the revival in private demand. The risks that synchronised budget austerity across various major economies may have an unfavourable impact on the economic revival, on the one hand, and that the failure to carry out consolidation plans where they are needed would undermine confidence and would hinder growth, on the other hand, have to be carefully weighed up. As a reflection of this balance, the advanced countries have committed themselves to at least the halving of government deficits by 2013 and the stabilisation of public debt as a percentage of GDP by 2016.

##### 4.1 United States

After considerable amounts had already been allocated to stimulate the economy during the years 2008 and 2009, budgetary stimulus was raised further in 2010. However, measures of this type have met with more and more resistance given that the pressure to prepare a budgetary exit has increased. In mid 2010, the Congress had only approved very few concrete measures in this regard, but the President has already formulated a number of proposals which give an indication of the path intended to be followed.

At the beginning of February 2010, the Obama administration announced a path for public finances over the medium term (up to 2020), together with the federal budget for the fiscal year 2011. At the end of June, this path was updated in the mid-session review of the budget. The federal government deficit is projected to fall to 9.2 p.c. of GDP in the fiscal year 2011, as against 10 p.c. of GDP in 2010. It appears from the budget path for the next ten years that the government subsequently wishes to drive down the deficit to 3.4 p.c. of GDP in 2018. Thereafter, the deficit is projected to rise again to 3.8 p.c. in 2020 due to the influence of increasing costs associated with population ageing. The prospective fall in the deficit would primarily be the result of the expiry of



the support measures that the government took in the context of the crisis and the anticipated economic revival. The deficit will also diminish due to a number of new measures, the most significant of these being the freezing of discretionary expenditure not relating to national security for a period of three years; streamlining existing expenditure programmes; scrapping the tax reduction for the highest income brackets; stopping subsidies to major energy companies and the introduction of a levy on large financial institutions. According to the budget proposals, the federal public debt is forecast to increase from 53 p.c. of GDP in the fiscal year 2009 to 77.4 p.c. in 2020. The OECD predicts that total public debt will grow from 83 p.c. of GDP in 2009 to 94.8 p.c. in 2011.

Moreover, so as to give form to the budgetary policy, a two-party committee was set up (National Commission on Fiscal Responsibility and Reform) which must draw up concrete proposals for even more fundamental consolidation by the beginning of December. The most important objectives of this committee, to be achieved over the medium term, by 2015, are to bring the primary balance into equilibrium and to propose extra measures to guarantee the sustainability of public finances over the long term.

In addition, the so-called PAYGO rule is being re-introduced. This rule requires that new expenditure programmes or tax cuts must be paid for by means of savings or tax rises on other items. This rule will provide additional support for the required budgetary effort.

## 4.2 Japan

The new Prime Minister is setting the restoration of public finances high on the agenda. On 22 June 2010, he announced the broad outlines of his budgetary restructuring plan. The plan contains ambitious objectives, amongst other things to post a primary surplus by the fiscal year 2020 (following a halving of the primary deficit by 2015). The reforms necessary to achieve these objectives are currently being worked out in detail. The tax system would be thoroughly revised; and government expenditure and the issuing of government bonds would be limited for the fiscal years 2011 to 2013.

## 4.3 European Union

### 4.3.1 European authorities' decisions and the stability programmes

In spite of the risks to the sustainability of public finances, the EC came out in favour of a recovery plan for the

European economy at the end of 2008. A European Economic Recovery Plan was approved at the European Council meeting on 11 and 12 December 2008. This urged an immediate and coordinated budget stimulus, and preference was given to action which would help meet the Lisbon targets.

Subsequently, various European authorities fairly quickly advocated budget strategies involving scaling back the support measures for the economy. Thus, the Ecofin Council established formally in October 2009 that the time was right to prepare and map out an exit strategy from the support policy, even though the recovery was still fragile and the assistance measures still had to remain in place. On top of the scrapping of stimulus measures, the Council recommended extensive budgetary consolidation. Within the context of the Stability and Growth Pact, the coordinated strategy needed to make allowance for the specific situation of each country, and to be implemented with effect from 2011 at the latest, and in some countries even sooner. The consolidation plans had to be ambitious and come out substantially above the consolidation benchmark of an annual 0.5 percentage points of GDP in structural terms that is included in the pact. Lastly, the exit strategy should be accompanied by other measures, for example a stronger budgetary framework – which contributes to the credibility of the consolidation –, as well as by measures to promote sustainability over the long term and by structural reforms to improve productivity and to stimulate investment over the long term.

In November 2009, the Ecofin Council also emphasised the fact that the deterioration in the budgetary position made the problems resulting from ageing more complicated. At the time, the Council requested the Member States to concentrate their attention on strategies that were aimed at safeguarding the sustainability of their public finances, amongst other things in their stability and convergence programmes.

At the same time as this gradual change of course by the Ecofin Council and the EC, the Governing Council of the ECB also repeatedly emphasised that it is important to pursue the sustainability of public finances in order to maintain confidence and promote economic recovery. The announcement and, subsequently, the implementation of ambitious exit strategies had to contribute to the realisation of these objectives.

Each time a country's budget deficit exceeds the threshold of 3 p.c. of GDP, the EC investigates whether this overshoot is merely exceptional and temporary, and whether the deficit remains in the vicinity of the threshold. "Exceptional" means that the overshoot is either

**TABLE 1** DECISIONS TAKEN BY THE ECOFIN COUNCIL TO IDENTIFY A SITUATION OF EXCESSIVE DEFICIT FOR SOME COUNTRIES

	Deficit in 2009 <sup>(1)</sup> (in p.c. of GDP)	Time-limit currently identified for correction of the excessive deficit
Germany .....	-3.3	2013
France .....	-7.5	2013
Italy .....	-5.3	2012
Spain .....	-11.2	2013
Netherlands .....	-5.3	2013
Belgium .....	-6.0	2012
Austria .....	-3.4	2013
Greece .....	-13.6	2014 <sup>(2)</sup>
Finland .....	-2.2	2011
Ireland .....	-14.3	2014
Portugal .....	-9.4	2013
Slovakia .....	-6.8	2013
Slovenia .....	-5.5	2013
Cyprus .....	-6.1	2012
Malta .....	-3.8	2011

Source: EC.

(1) Notification dated March 2010.

(2) Insufficient action and subsequent step in the procedure (public notification).

the result of an event that the Member State has no control over or a serious recession. Following this analysis, the Ecofin Council decides whether or not a deficit is excessive.

At the present time, fifteen of the sixteen Member States of the euro area are regarded as countries with an excessive deficit, since their deficits are neither limited nor temporary. Within the euro area, only Luxembourg has a deficit that has not yet been declared to be excessive.

Moreover, whenever an excessive deficit is recorded, the Council imposes a deadline for eliminating that deficit. As a rule, this coincides with the year following the identification of an excessive deficit, but sometimes exceptional circumstances may cause that deadline to be extended. Thus, the deadline has been extended one or more times for all the affected countries except Finland since, on the one hand, the Commission made allowance for the repercussions of the economic and financial crisis and judged that it was necessary to prevent a budgetary consolidation prolonging the recession and, on the other hand, corrective measures were taken in a number of countries which

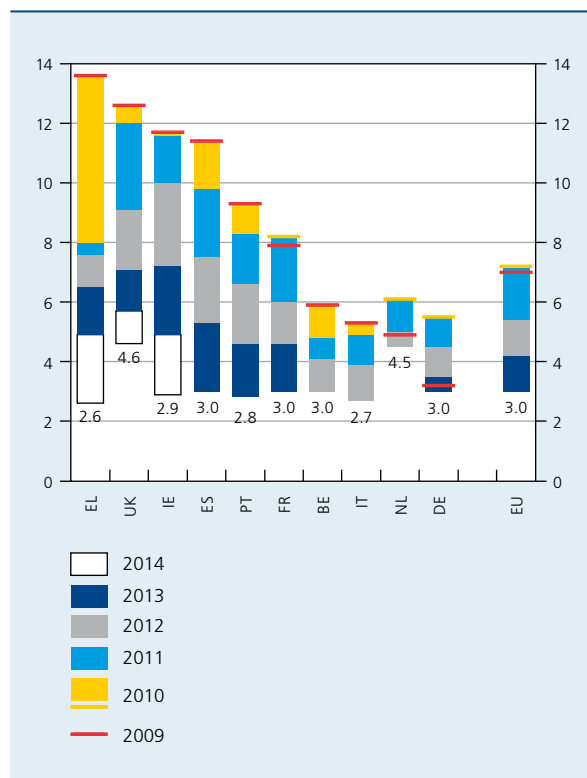
were followed by a significant and unexpected adverse economic event.

The deadline currently imposed for correcting excessive deficits is 2011 for Malta and Finland, 2012 for Cyprus, Belgium and Italy and 2013 for the other countries, with the exception of Ireland and Greece which are being given until 2014. In February of this year, Greece had been given a first deferral until 2012; that deferment was then extended on 7 May to the year 2014. This relaxation has to do with the fact that economic activity is expected to continue to contract into 2011, that the deficit for 2009 turned out larger than initially estimated and that the risk premiums which Greece now has to pay have risen sharply.

As a result of these decisions, the European countries submitted updates to their stability programmes (or to their convergence programmes for those countries that do not participate in monetary union) at the beginning of 2010. According to these updates, the Member States are expected to drive their deficits down to the threshold

**CHART 6** EVOLUTION OF GOVERNMENT DEFICITS ACCORDING TO THE STABILITY PROGRAMMES (OR CONVERGENCE PROGRAMMES)<sup>(1)</sup>

(in p.c. of GDP)



Sources: EC, national stability or convergence programmes.

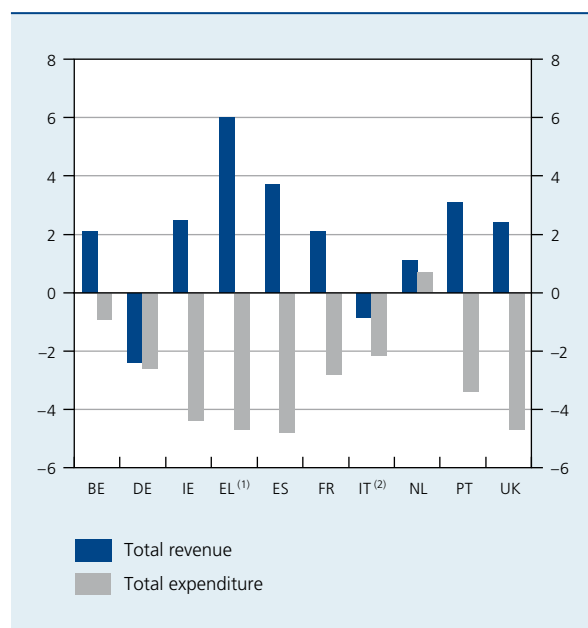
(1) Since the introduction of these programmes, some countries have updated their objectives.

of 3 p.c. of GDP or slightly below by 2013 at the latest. The only exceptions are Greece, the United Kingdom and Ireland, for which the deadline for eliminating an excessive government deficit falls after 2013, whilst the Netherlands would have to accomplish this by 2013 but has submitted a programme limited to 2012.

Most of the countries with an extensive budget deficit want to reduce it with effect from 2010. France is the only one among those where the deficit is projected to continue to rise. The Netherlands, Germany, Finland and Luxembourg – which had to contend with smaller budget deficits in 2009 – are expected to allow their deficits to grow somewhat further in 2010. As for the European Union as a whole, the deficit is projected to continue to increase initially, to 7.2 p.c. of GDP in 2010. At the aggregate level, the consolidation is therefore only likely to become visible in 2011, when only Luxembourg is expected to still post a deterioration in its balance, according to its stability programme. According to the stability or convergence programmes, the average general government balance of the countries in the European Union would fall back to the threshold of 3 p.c. of GDP in 2013. However, there is sometimes a great disparity between the intentions of the Member States to drive down their deficit and the measures required to achieve these objectives actually being put into effect. Thus, for most countries, the budgetary targets identified in the stability programmes cannot be met without new measures, according to the spring forecasts of the EC published on 5 May 2010. With regard to the European Union, the budgetary consolidation effort which still had to be delivered for 2011 amounted to an average of 0.9 percentage points of GDP. Given that some countries have since decided to take new consolidation measures, the total effort still to be made has, logically, diminished.

In many countries, the scope of the required consolidation implies that measures should be put into effect on the revenue and the expenditure sides simultaneously. In countries that already have a high ratio of government revenues, a consolidation effected by raising those revenues would normally be smaller than in countries with a lower ratio. Of those countries where the revenue ratio was already higher than 45 p.c. of GDP in 2009, only Belgium and France are therefore planning to boost that ratio further by 2012-2013. On the other hand, raising revenues is likely to contribute to the consolidation in a large number of countries of the European Union with a government expenditure ratio of less than 45 p.c. of GDP except, specifically, in Germany. With regard to the European Union as a whole, therefore, this ratio is expected to rise slightly, that is to say from 43 p.c. of GDP in 2009 to 43.3 p.c. in 2012.

**CHART 7** PLANNED CHANGES WITH REGARD TO GOVERNMENT EXPENDITURE AND INCOME  
(in percentage points of GDP, between 2009 and 2012-2013)



Sources: EC, national stability and convergence programmes.  
 (1) With regard to Greece, this relates to the obligations arising from the agreements of 2 May 2010.  
 (2) With regard to Italy, part of the effort to reach the targeted balance has not yet been distributed between revenue and expenditure in its stability programme. The effort still to be distributed amounts to 0.4 p.c. of GDP in 2011 and 1.2 p.c. of GDP in 2012.

Lowering the expenditure ratio, on the other hand, is a virtually universal intention which differs, however, in terms of scope. Only the Netherlands, Luxembourg, Cyprus and Malta wish to raise this ratio between 2009 and 2012-2013. At the other end of the spectrum, this lowering is projected to amount to not less than 4.8 percentage points of GDP in Spain. Viewed as an average across the European Union, the expenditure ratio is forecast to fall back by 2.1 percentage points of GDP between 2009 and 2012.

#### 4.3.2 Greek debt crisis and policy responses

Greece has already been in a delicate budgetary position for some time. The Greek public debt is the largest – in proportional terms – of the countries in the euro area. The financial and economic crisis has caused its government deficit and public debt to grow significantly. Moreover, if policy remains unchanged, Greece would have to cope with a steep increase in the expenditure associated with population ageing over the long term, with the result that the sustainability of public finances may be regarded as a cause for concern.

In October 2009, the sharp upward revision of the government deficit in Greece produced tension on the securities market for the Greek public debt. In April 2010, anxiety about the sustainability of Greek public finances increased, with the result that the interest rates at which the Greek State could obtain financing rose sharply, thereby causing a liquidity crisis. Moreover, contagion effects emerged. Operators on the financial markets focussed their attention on the situation of countries with similar, albeit far less acute, problems in the area of public finances and competitiveness, for example Portugal and Spain. In addition, the fear that Greece's insolvency, and possibly that of other countries, would bring about losses that would destabilise the financial sector drove up the banks' financing charges. Lastly, the potential influence of this anxiety on the financing of the economy prompted falls on share markets, a rise in the risk premiums associated with corporate bonds and a depreciation of the euro.

The international authorities have taken various measures to prevent the crisis spreading and to guarantee financial stability in the euro area. They would thereby provide financial assistance to countries which have to contend with a self-fulfilling lack of trust on the financial markets, in order to give them time to win back their credibility, and they would also restore the operation of distorted markets and guarantee that the public finances of countries in difficulties would be thoroughly consolidated.

In the first place, the European budgetary authorities and the IMF have set up a system of conditional financial assistance. On 11 April 2010, following a previous agreement in principle by the heads of state and government leaders of the euro area countries on 25 March 2010, the Eurogroup reached an accord on the concrete methods for providing emergency financing to Greece. This emergency financing was to take the form of bilateral loans by the various other countries in the euro area and the IMF. In the first phase, an overall amount of €30 billion in bilateral loans was under consideration. However, following the official request from the Greek government to activate the support package, the accord was specified in greater detail and substantially expanded on 2 May 2010: in the context of a three-year programme, Greece will be able to borrow €110 billion, consisting of €30 billion from the IMF and €80 billion from the other Member States in the euro area. The loans are subject to the condition that Greece takes vigorous measures to consolidate its budget (see below). The accord also provides for the implementation of structural reforms to strengthen the Greek economy, amongst other things by way of smoother operation of the labour market.

Since this decision only brought a very temporary calm to the financial markets, a decision was taken at the Ecofin Council meeting on 9-10 May 2010 to set up a European Stabilisation Mechanism for a period of three years, in order to provide conditional financial assistance to countries which find themselves in financing difficulties as a result of exceptional events that are beyond their control, and to do so for a total of €500 billion. A sum of €60 billion, which is intended for all EU Member States, could be financed by loans from the EC. Moreover, a Special Purpose Vehicle guaranteed by the Member States of the euro area could contribute up to €440 billion to the financing of assistance for countries in the euro area. The IMF would take part in the support operations and would help to work out the granting conditions. At the same meeting, the Council stated expressly that plans for budgetary consolidation and structural reforms will be accelerated, where warranted. In this connection, the governments of Spain and Portugal announced new budgetary measures.

Once the ECB's Governing Council had adapted the rules regarding guarantees for loans by the Eurosystem, it approved a series of measures on 10 May 2010 to calm the severe tensions on certain markets. Specifically, the ECB decided to undertake interventions on the markets for government and corporate bonds in the euro area, in order to remove the dysfunctional aspects of those markets. It also began once again to provide three-month and six-month funds at a fixed interest rate and for an unlimited amount, as well as funds in US dollars. In the euro area, the aim of monetary policy is still price stability: decisions about the course of monetary policy will be taken on the basis of an evaluation of both the risk of inflation (amongst other things, it is necessary to prevent an incorrect perception of the monetary financing of the public sector giving birth to inflationary expectations) and also the risk of deflation (with regard to which proper allowance is being made for the effect of budgetary consolidation on demand and therefore on prices).

Lastly, the intention is to learn the necessary lessons from the crisis in order to improve management of the euro area, especially with reference to budgetary policy and monitoring. The EC announced a series of proposals on 12 May 2010. In the meantime, a Working Group on Economic Governance, set up by the European Council, has also begun its work. This group has to submit its conclusions to the European Council in October 2010.

## Box – Proposals of the Working Group on Economic Governance set up by the European Council

Based on the finding that the current crisis is partly the result of a lack of respect for the rules applicable within the European Union and of the loopholes in economic policy coordination, the EC has addressed a series of proposals to the European institutions so as to strengthen the coordination between those institutions. Thus, the EC considers it necessary, in a statement dated 12 May 2010, to introduce measures to strengthen the operation of the Stability and Growth Pact, to expand the monitoring to macroeconomic imbalances, to set up a “European Semester” that offers an opportunity to coordinate economic policy at the European level at an early stage, and to put into effect the European Stabilisation Mechanism approved by the Council on 9 May.

On the basis of these same considerations, the European Council meeting in March 2010 set up a working group to look at economic governance. This group, under the leadership of the President of the European Council, consists of representatives of all the Member States of the EU – mainly the Ministers of Finance –, a member of the EC, the President of the ECB and the President of the Eurogroup. This working group, which has partly taken its lead from the EC’s proposals, is seeking to achieve four major objectives: it wishes to strengthen budgetary discipline by making the Stability and Growth Pact more efficient, find methods to reduce the differences in competitiveness between the countries, work out a mechanism to resolve financial crises and improve economic management. An interim report was submitted to the European Council on 17 June, which approved part of the proposed initial guidelines.

Thus – with regard to public finances – coordination would have to take place *ex ante* and the national budgeting procedures would have to include the stability or convergence programmes. In this connection, a “European Semester” will be introduced as from 2011, running from the spring to the presentation of the budgets in the national parliaments. The draft national budgets would be submitted to the EC and the other Member States of the EU, which would then provide their comments on the most significant assumptions adopted for compiling these budgets and on the main budgetary aggregates. This timescale would offer an opportunity to make changes at the national level prior to presentation to the respective national parliaments.

In addition, the Stability and Growth Pact would have to be toughened up, which implies a change of course compared to its relaxation in 2005. The tightening of the rules would have to relate both to the preventive and the corrective components of the pact. Sanctions would have to be coherent and would have to follow a progressive system. Amongst other things, the working group has put forward the possibility of implementing sanctions even if the government deficit does not exceed the threshold of 3 p.c. of GDP, for example if there is no response following warnings or if the level of debt rises alarmingly. However, the Council has not yet approved these elements. The EC too, which had already proposed a more automatic application of the rules and more rapid sanctions, still has to submit proposals. It has also already raised the possibility of new sanctions, for instance suspending the payment of some support amounts or grants, or withdrawing certain voting rights.

Moreover, the debt and – more generally – the sustainability of public finances would gain greater importance in the budgetary monitoring practised. This should prompt the Member States to take up a budgetary position that makes better allowance for the ageing of the population and, even in a favourable economic climate, to seek to meet consolidation targets over the medium term. Specifically, the working group is thinking about the possibility of initiating the procedure for excessive deficits more rapidly for countries where the debt does not come down sufficiently rapidly.

Following this same line of reasoning, the European Council believes it necessary to ensure that the Member States draw up appropriate budgeting rules at the national level and define a budgetary framework over the medium term which is in accord with the Stability and Growth Pact. These rules and this budgetary framework would be submitted to the EC and the Council for approval.



Furthermore, the European Council states that it is essential to have reliable and independently collated statistics available, which implies that the national statistical institutions must not be subject to any political influence whatsoever. In this connection, the EC is proposing to expand the checks that Eurostat can carry out.

Apart from these aspects, which in strict terms are associated with budgetary discipline, the Council has also already approved certain lines of thinking which the working group has launched with regard to macroeconomic monitoring. This is primarily a matter of creating a scoreboard with which distortions of balance can be detected, as well as any possible loss of competitiveness or sharp rises in the prices of assets. The working group is proposing that, if there is an alert, recommendations could be formulated in the areas of budgetary income and expenditure, the operation of the markets and macroprudential measures.

Lastly, the working group is also examining the setting up of a permanent crisis management system, which is thought to be very much needed in the euro area. This system would offer an opportunity to provide financial assistance to those Member States in need of help, but then under strict conditions so as to avoid problems of moral hazard which would prompt the states to behave irresponsibly.

The final report of the Working Group on Economic Governance should be presented at the European Council meeting in October 2010.

#### 4.3.3 Consolidation plans and measures in Europe

It was explained above how a coordinated budgetary exit strategy was worked out for the countries in the European Union, in the context of the Stability and Growth Pact. Some countries have already taken steps fairly rapidly for the purpose of guaranteeing sustainable public finances. Thus, Germany incorporated a so-called "debt brake" in its constitution in mid 2009. This "brake" is regarded as an institutional guarantee of budgetary consolidation. Initially, the adoption of specific measures to flesh out the budgetary exit strategy was still mainly limited to the year 2010 in most countries, whilst only a little in the way of concrete action was planned for the subsequent years. However, this all moved into a higher gear as a result of the Greek debt crisis.

Greece needed to take very far-reaching consolidation measures and put profound structural reforms into effect if it wished to be able to lay claim to international emergency financing. Spain and Portugal for their part, as a reaction to the Ecofin Council agreement on 9 May 2010 to accelerate the plans for budgetary consolidation and structural reforms where warranted, tightened up their budgetary objectives for 2010 and 2011 and announced significant supplementary measures. Shortly thereafter, many other countries accelerated their decision-making and published extensive austerity plans.

The following provides an overview of the most significant recent measures in a number of countries.

##### Greece

Greece's adjustment plan implies an effort that has to result in an improvement of at least 10 p.c. of GDP in the structural balance and which is aimed at reducing the budget deficit to 2.6 p.c. of GDP by 2014. The scope of the actual consolidation effort is preferably estimated on the basis of the progress of the structural primary balance. Given that it may reasonably be assumed that interest charges will rise, these objectives embody a budgetary effort which is estimated at 13 p.c. of GDP, and is on top of the significant measures already taken by the Greek government in 2010.

The specific consolidation measures that the Greek government has to take in order to drive down the budget deficit are already described to a large extent in the conditions for the emergency financing. On the revenue side, they involve, amongst other things, the introduction of a uniform, progressive system of taxation for all incomes, including the abrogation of all tax exemptions and separate taxation arrangements. Another item being introduced is stricter taxation of certain professional categories where tax fraud is thought to be rife. A raising of value added tax is also provided for: after the standard rate of VAT had already been pushed up from 19 p.c. to 21 p.c. on 15 March 2010, it is to be raised again to

**CHART 8** GREECE'S GENERAL GOVERNMENT BALANCE TARGETS  
(in p.c. of GDP)



Source: EC.

23 p.c., and in addition the tax base is to be expanded by, amongst other things, taxing certain services that are exempt at present and moving other goods and services from a reduced rate to the standard rate. Furthermore, it has been decided to raise the excise duties on fuel, tobacco and alcohol and to levy a temporary "crisis tax" on particularly profitable enterprises during the period from 2011 to 2013; the gradual introduction of a new tax on CO<sub>2</sub> emissions is also planned.

On the expenditure side, drastic cuts have to be made in pensions and civil servants' pay. Thus, the monthly amounts of the highest pensions are being lowered. In addition, various bonuses and allowances paid to pensioners and civil servants are being scrapped or reduced. Finally, substantial cost savings are also planned for intermediate consumption and investment. All in all, these involve draconian measures. However, social aspects are being incorporated to a limited extent; thus, minimum pensions are being guaranteed.

The structural reforms affect various areas of activity. Thus, Greece needs to take effective measures so as to strengthen budgetary follow-up and the reliability of macroeconomic statistics, and especially the statistical data with regard to public finances. Furthermore, certain labour market reforms are being imposed, both in the public and the private sector. Lastly, the sustainability of the pension system over the medium and long term must be improved, by way of various clearly delineated actions, by September

2010 at the latest. Amongst other things, these involve the introduction of a uniform statutory pension age of 65, a gradual increase in the number of working years required for a full pension, the introduction of a minimum age for taking retirement (60 years of age), the lowering of the present upper limit on pensions, a reduction in pension amounts for pensions taken before the age of 65, the introduction of the automatic linking of the statutory pension age to life expectancy (with effect from 2020) and the introduction of formulas to strengthen the connection between pension amounts and the contributions paid.

### Spain

In Spain, the consolidation of public finances had already been started with the budget for 2010. This contained a number of discretionary measures, amongst other things a raising of VAT rates with effect from July 2010, higher excise duties and the winding down of a large number of temporary stimulus measures, such as a personal income tax credit. Furthermore, an extensive austerity plan for 2011-2013 was announced in January 2010, but the measures had not yet been worked out in detail. At the time, the government also proposed a reform of pensions, which *inter alia* provides for raising the pension age from 65 to 67. The cutbacks announced were speeded up and extended with a package of supplementary measures in May 2010: the target for the budget deficit in 2010, fixed at 9.8 p.c. of GDP in the stability programme, was tightened to 9.3 p.c. of GDP, and in 2011, the deficit needs to come down further to 6 p.c. of GDP, whereas the target in the stability programme was set at 7.5 p.c. of GDP. The measures in the supplementary package related solely to a reduction in government expenditure this time, of slightly over €5 billion this year and €10 billion in 2011. The most striking cutbacks comprise a lowering of the nominal pay of government officials of 5 p.c. on average with effect from mid 2010 and a freeze in 2011, a fall in public investment, a suspension of the index-linking of pensions in 2011 (with the exception of the lowest pensions), the phasing-out of the reduction in personal taxation in the case of childbirth or adoption and other savings within social security as well as cuts in the transfers to regional and local authorities. In the light of these decisions, the government deficit must come to 4.4 p.c. of GDP in 2012 and 3 p.c. of GDP in 2013.

### Portugal

The Portuguese government also announced a new package of measures in May, with the intention of speeding up the consolidation of the budget. The budget for 2010 already envisaged reducing the government deficit, amongst other things by way of a freeze on the pay of



civil servants. With the new plan, the budget deficit target is being tightened to 7.3 p.c. of GDP in 2010, compared with 8.3 p.c. in the stability programme, whilst 4.6 p.c. of GDP needs to be achieved in 2011, as against a target standing at 6.6 p.c. of GDP according to the stability programme. In contrast to the Spanish package of supplementary savings, the new measures in Portugal relate mostly to the revenue side of the budget. The measures include raising VAT rates by 1 percentage point and raising personal and corporate taxation rates. Government expenditure is also being addressed, *inter alia* by way of a reduction in transfers to public enterprises and regional and local authorities, a reduction in government investment and a lowering of operating costs for central government, amongst other things by way of a freeze in hiring.

### Italy

In Italy, in accordance with the stability programme, the government deficit needs to be reduced to 3.9 p.c. of GDP in 2011 and 2.7 p.c. of GDP in 2012, the year in which the excessive government deficit has to be brought to an end. To do this, supplementary measures were needed, on top of the cutbacks already planned in the three-year package for public finances extending from 2009 to 2011. At the end of May 2010, the Italian government announced a budgetary adjustment plan of around € 25 billion – that is 1.5 p.c. of GDP – which has to be implemented in 2011 and 2012. In principle, taxation is not being raised, but the fight against tax fraud is being stepped up. On the expenditure side, the most significant measures include a freeze on government officials' pay, an extension of the freeze in recruitment and cuts in transfers to regional and local authorities.

### Ireland

Ireland, for its part, has already put several budgetary consolidation packages into effect since mid 2008 and has thus succeeded in limiting the deterioration in public finances. The budget for 2010 contained a significant package of measures, amounting to € 4 billion or 2.5 p.c. of GDP. It is primarily government expenditure that is being cut back, among other things by way of a cut in public sector wages, savings on social benefit payments and lower public investment. Furthermore, the stability programme provides for considerable consolidation measures in order to drive down the government deficit from 11.6 p.c. of GDP in 2010 to 2.9 p.c. of GDP in 2014.

### France

France has taken significant steps in the course of 2010 to restore its public finances. In accordance with

the stability programme, the budget deficit has to be reduced considerably, to 6 p.c. of GDP in 2011, 4.6 p.c. of GDP in 2012 and 3 p.c. of GDP in 2013. At the end of January 2010, the French President convened a national conference on the government deficit, at which various working groups were tasked with formulating proposals. At the beginning of May, a start was made on preparing the three-year budget for 2011-2013. This needs to build on the three-year plan for government expenditure for 2009-2011, in which, as a basic rule, growth in central government expenditure is limited to inflation (zero growth by volume). The three-year budget for 2011-2013 must continue to be based on controlling government expenditure. Expenditure by central government, with the exception of interest charges on the public debt and pension expenditure, is to be frozen in nominal terms until 2013. To this end, the policy of not replacing one out of every two government officials taking retirement must be continued. The current operating expenses of the Ministries have to shrink by 10 p.c. over three years, with a fall of 5 p.c. with effect from 2011. A comparable effort will be demanded from the public-sector operators (universities, museums, etc.). All so-called intervention expenditure – which comprises a set of grants and subsidies – will be re-examined. Although taxes are not being raised in principle, the exemptions, allowances and reductions in the area of taxes and social contributions will be reduced. In May, the President convened the national conference on the government deficit for the second time this year. It was decided that, so as to be able to realise the objectives arising from the stability programme, the pace of growth in expenditure must be slowed down with effect from 2011 in the three government sectors, namely central government, local government and social security. As far as expenditure by central government is concerned, reference is made to the proposals in the framework note for the three-year plan for 2011-2013. The expenditure of local government must be brought under control and the financial transfers from central government to these governments will be frozen in nominal terms with effect from the planning period 2011-2013. For expenditure with regard to health care, the nominal growth target is being gradually slowed down further from 3 p.c. in 2010 to 2.9 p.c. in 2011 and 2.8 p.c. in 2012. The President has also called for a reform of pensions and a revision of the constitution, whereby a compulsory path for the structural public balance would be imposed on every government for its term of office as well as a date for reaching a balanced budget. In mid 2010, the government also proposed a reform of pensions as a result of which, amongst other things, the legal pension age would be gradually raised from 60 to 62 in 2018.

## Germany

At the beginning of June 2010, the German government laid the foundations for converting the budget consolidation planned with effect from 2011 into concrete measures. As mentioned above, Germany had already taken a significant step in mid 2009, which was unique in the European Union, so as to safeguard the sustainability of public finances over the long term, specifically by incorporating the 'debt brake' into its constitution. This new budgeting rule will apply from 2011 onwards and means that, with effect from 2016, the federal government's structural deficit may no longer exceed 0.35 p.c. of GDP, whilst the budgets of the *Länder* must be in structural balance with effect from 2020. A stability council on which the federal government and the *Länder* are represented will monitor the public finances in order to identify and correct potential departures from the set course at an early stage.

The budget operation proposed by the government at the beginning of June 2010 embraces a financial plan with an impact increasing from €11 billion in 2011 to €28 billion, some 1 p.c. of GDP, in 2014. It should enable the objectives of the stability programme and the obligation in the constitution to be respected. According to the stability programme, the government deficit has to be reduced to 4.5 p.c. of GDP in 2011, 3.5 p.c. of GDP in 2012 and 3 p.c. of GDP in 2013. In the measures proposed, investment in education and research is being expressly spared and the extra resources that had been set aside for it remain in place. Income tax and VAT are not being raised. What is being introduced is a tax on electricity generators, which are allowed to keep their nuclear power stations in operation longer; and financial transactions are to be subject to a levy with effect from 2012 which, however, is to be implemented in the wider European context. Furthermore, certain energy tax advantages are being limited and an air traffic charge is included for passengers departing from German airports. However, the most significant cutbacks have to be realised on the government expenditure side, such as on social expenditure. Thus, amongst other things, support to the long-term unemployed is being reduced. The Federal Labour Agency will allocate unemployment benefit payments in a more targeted manner so that their automatic nature disappears. The parent's benefit is being reduced for certain income categories and scrapped for the long-term unemployed. Furthermore, additional cutbacks have to be made in public administration; thus, the number of federal officials has to be permanently reduced by more than 10,000 by 2014. An examination must also be carried out as to how the armed forces can be reduced by 40,000 troops.

## The Netherlands

Like Germany, the Netherlands paved the way at any early point to start restoring public finances to health. Thus, the supplementary policy agreement of March 2009, which still included a considerable extra package of measures so as to stimulate the economy and prevent the consequences of the crisis spreading, already incorporated an engagement about restoring sound public finances and their sustainability over the long term. It was agreed that, in the event of a sufficient economic recovery in 2011, a start would be made on consolidating public finances. This agreement also formulated a proposal to raise the age for the basic pension (AOW) from 65 to 67. In September 2009, the so-called "Fundamental Budget Review" (*brede heroverwegingen*) was announced on the occasion of the presentation of the budget for 2010, the intention being, in the light of the considerable deterioration in public finances, to prepare fundamental choices with regard to community services. The reports on the Fundamental Budget Review were submitted to the lower house of the Dutch parliament on 1 April 2010. They itemise policy variants of cutback measures for 20 areas of policy, where at least one variant in each case leads to a cost saving of 20 p.c. Whereas the stability programme for the Netherlands expects a government deficit of 4.5 p.c. of GDP for 2012, the Netherlands Bureau for Economic Policy Analysis establishes in the medium-term outlook dated March 2010 that, in the light of the ageing of the population in the Netherlands, a budgetary surplus of 1.5 p.c. of GDP is required in 2015 so as to make public finances sustainable. To do this, a structural improvement is needed in the budget balance amounting to a total of approximately 5 p.c. of GDP. The Fundamental Budget Review can be used by the new government as a basis for making substantiated choices.

## United Kingdom

In the United Kingdom, the new government announced a five-year plan at the end of June 2010 with the purpose of strongly stepping up the efforts to consolidate public finances. The intention is to bring down the government deficit – which is estimated at 12 p.c. of GDP in 2010 by the EC, and which is projected to fall to 4.6 p.c. of GDP in the fiscal year 2014-2015 in accordance with the convergence programme submitted in January 2010 – at a faster pace to 1.2 p.c. of GDP in 2015-2016<sup>(1)</sup>. To do this, the recovery plan provides for supplementary measures

(1) The objective of 1.2 p.c. of GDP relates to the so-called "Treaty deficit". With regard to the "public sector net borrowing" concept of the budget used by the British authorities, the intention is to limit the deficit to 1.1 p.c. of GDP in 2015-2016.

that gradually increase from £ 8 billion – about 0.6 p.c. of GDP – in the fiscal year 2010-2011 to £ 40 billion in 2014-2015. The emphasis is primarily on cutbacks in expenditure, the importance of which increases to around 80 p.c. of the measures. These involve, amongst other things, steadily growing savings in social welfare benefits, to £ 11 billion in 2014-2015, and the freezing of public sector pay for two years, except for those earning the least. The raising of taxes includes, amongst other things, raising the standard rate of VAT from 17.5 p.c. to 20 p.c. with effect from January 2011, raising the tax on capital gains for tax-payers in the highest brackets and a levy based on banks' balance sheets with effect from January 2011. At the same time, a number of measures are being taken in support of the economy, for instance a gradual reduction in company taxation from 28 p.c. to 24 p.c. over four years with effect from April 2011 and the raising of personal income tax allowances.

### Belgium

Belgium recorded a deficit of 6 p.c. of GDP in 2009, which is less unfavourable than the European average. According to the last update to its stability programme, Belgium is committing itself to the rapid delivery of an effort to return to the threshold of 3 p.c. as early as 2012. On the one hand, this programme provides for raising revenues by 2.1 percentage points of GDP between 2009 and 2012, without higher taxes on employment, with the exception of the abolition of the tax reduction in the Flemish Region (*jobkorting*). On the other hand, expenditure is set to be driven down by 0.9 percentage points of GDP between 2009 and 2012, primarily in the year 2012. With regard to the years after that, Belgium is committing itself in this programme to post a balanced budget again in 2015, by reducing its deficit by one percentage point of GDP per year between 2012 and 2015.

If policy remains unchanged, the Federal Planning Bureau anticipates that the government deficit would stabilise at about 5 p.c. of GDP. To honour its obligations, Belgium must thus still take significant measures in the context of the budgets for the following years.

## Conclusions

In the aftermath of the financial and economic crisis, budget deficits in most of the advanced economies have risen sharply, with the result that their public debt has increased rapidly. The current state of public finances

in these countries can be regarded as a cause for concern.

To restore the sustainability of public finances, extensive restructuring efforts are therefore required in a wide range of countries. Although a rapid and significant consolidation effort implemented simultaneously by a large group of countries could act as a brake on the economic recovery to some extent, a postponement of consolidation efforts, on the other hand, could shake the confidence of economic agents, give rise to financing risks and trigger a sharp rise in interest rates. The problems that Greece had to contend with are a pertinent illustration of this.

To remove doubts about the creditworthiness of countries, it is therefore advisable not to delay the announcement of concrete and credible consolidation plans, even if the measures will only be implemented in the years to come. The timing and scope of consolidation efforts are dependent on country-specific circumstances. Countries that are confronted with high or rapidly rising interest rates and possibly also financing risks naturally need to put the consolidation measures into effect immediately, whilst the adjustment can proceed more gradually in other countries.

The scope of the consolidation efforts needed in most countries means that no limitations can be imposed with regard to the composition of consolidation plans. However, preference needs to be given to structural measures that reduce non-growth-promoting government expenditure or can dampen the increase in ageing-related expenditure. In spite of the already heavy burden of compulsory taxation in many countries, extra government revenues cannot be ruled out.

Most countries have now begun preparing budgetary exit strategies. In this regard, budgetary objectives that will herald a return to healthy public finances have been announced. In some countries, concrete consolidation measures have already been worked out in the meantime. After Greece had to contend with problems financing its public debt, it has agreed to an extensive consolidation package in the context of emergency financing by the other countries in the euro area and the IMF. In the subsequent period, many countries have elaborated concrete consolidation plans. In other countries, on the other hand, plans of this type have yet to be detailed. However, firm government action is urgently required for this latter group of countries too, all the more so since postponing the necessary consolidation efforts would entail major risks.

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