Policies to Achieve Fiscal Sustainability

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What promotes successful fiscal adjustment?

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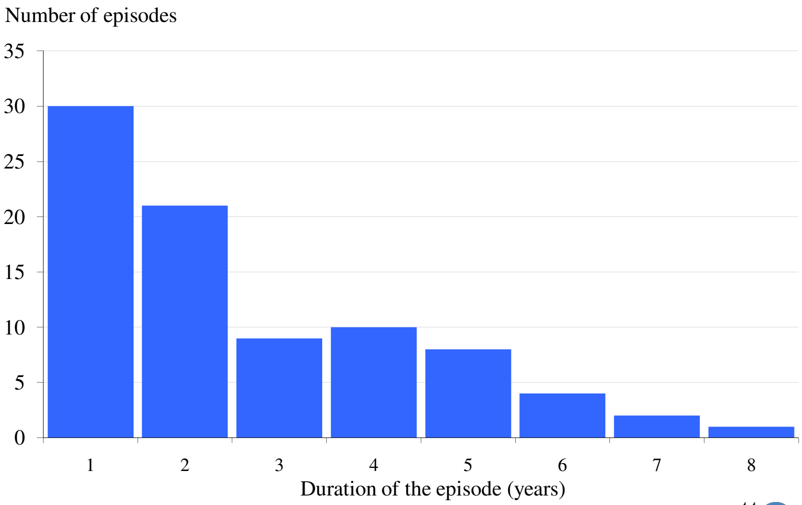
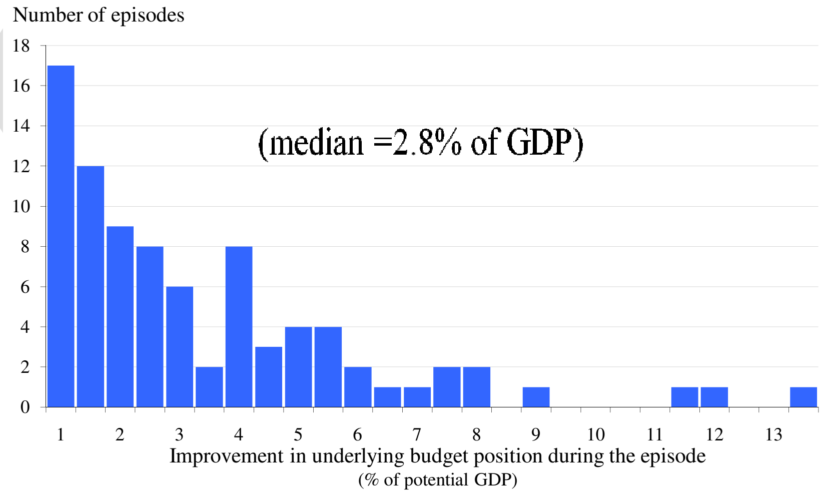
OECD country experiences

- OECD working paper by S. Guichard, M. Kennedy, E. Wurzel and C. André (2007)
- 24 OECD countries studied (incl. Portugal)
- *A "consolidation" episode:* an improvement of the primary structural balance ≥ 1% point of GDP over 1 or 2 years.
- =>85 consolidation episodes over 1978-2005

Most episodes were short…



…and did not involve large gains



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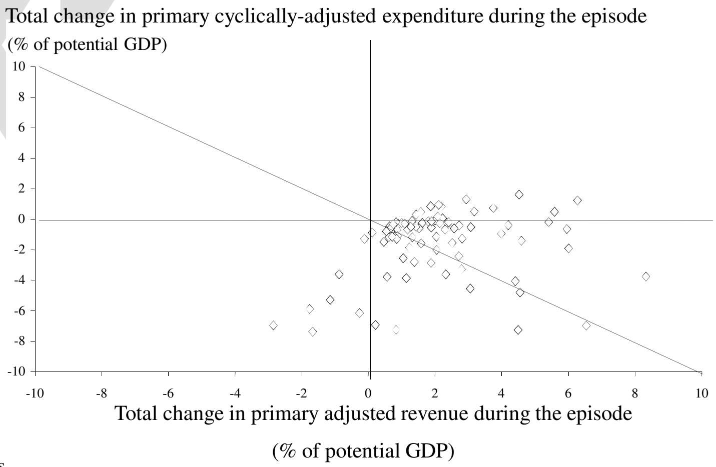
Revenue increases accounted for a larger share than spending cuts…



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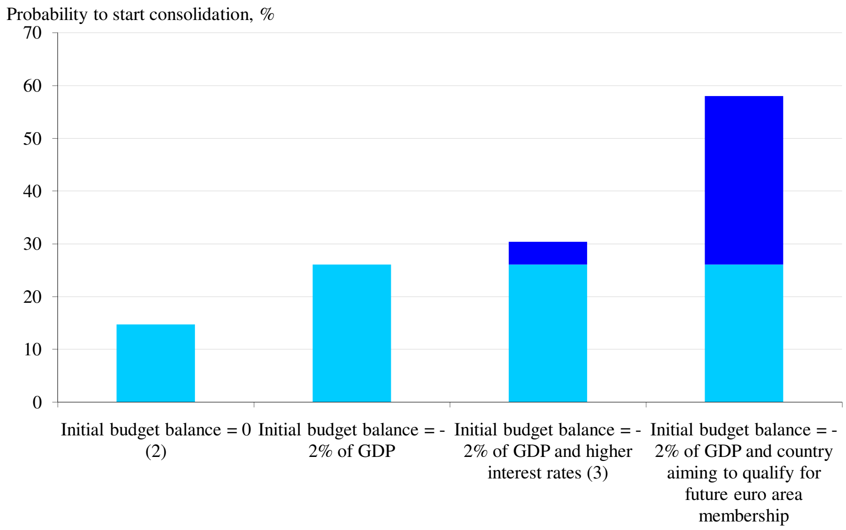
Success was uneven

Criteria for success	% of success cases
1. Stabilisation of the debt-to-GDP ratio	53%
2. = 1. + maintained for at least 2 years	41%
3. No substantial backtracking	49%

An econometric approach to explain consolidation

	Probability to start the episode	Size of the adjustment	Intensity of the adjustment	Probability to stop the episode	Probability to reach debt-stabilizing primary balance
Year before the episode started					
Cyclically adjusted primary balance	- - - -	- - - -	- -	++++	
Gap to primary balance sufficient to stabilize debt (actual-target)					++++
Long term interest rates(domestic rate - foreign reference)	+	++	+++		
Output gap		-	++	+	- -
Elections	+++				
Composition of the adjustment					
Share of primary current expenditure cuts		++++			
Share of social spending cuts					+++
Share of public investment cuts			- -	- -	
Share of direct tax increases					
Other					

Factors that prompted consolidations



Consolidations were larger and more intense

- *When the fiscal situation deteriorated*
- *Long term interest rates were high*

Larger

- Weak economic activity precedes consolidation
- Large share of current expenditure cut
- Combination of budget and expenditure rule

More intense

- Strong economic activity precedes consolidation
- Low share of capital expenditure cut

Successful debt sustainability was more likely when consolidation:

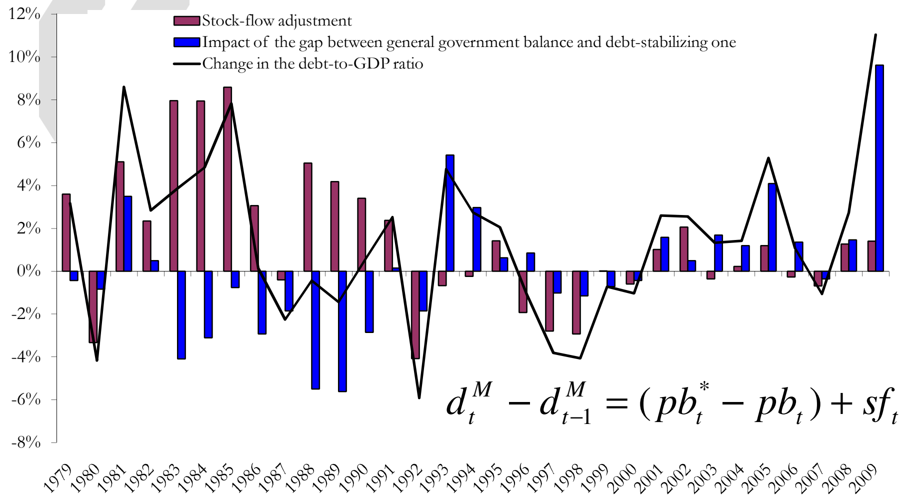
- was launched at a time of weak activity
- involved a high share of social spending cuts
- combined budget and expenditure rules

Some lessons for Portugal

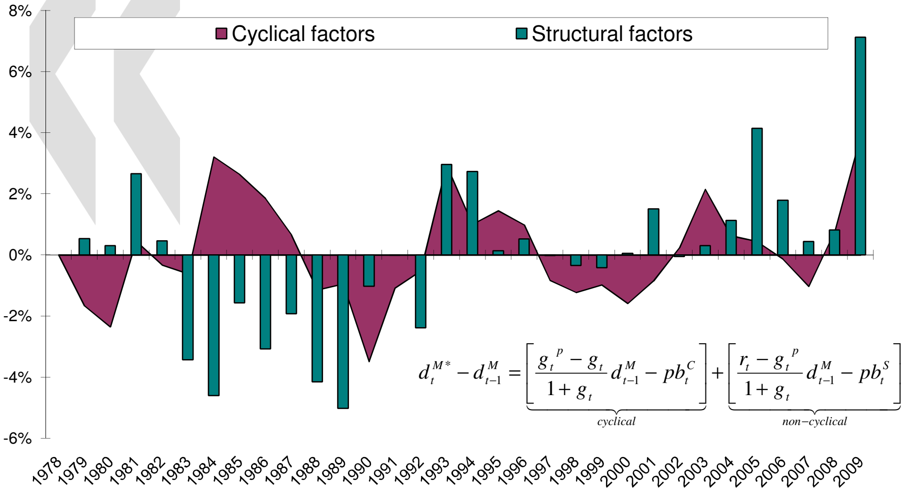
Past episodes of fiscal consolidation were numerous but brief

- OCDE cited study identified 6 consolidation periods : 1981-84; 1986; 1988; 1992; 1995; 2002-03
- More recently: period 2006-07
- Adjustment was moderate in size (3.2%) on average, except during 1981-84: +8.5%
- Mostly through revenue, with occasional expenditure restraints (e.g. ~1993-98; ~2006-07)
- Debt ratio: roughly stabilized from 1984 to 2005-07

Since 2001, fiscal deficit worse than the debt-stabilizing balance



The gap between the fiscal balance and the debt-stabilizing balance is also structural since 2001



$$d_t^{M*} - d_{t-1}^M = \underbrace{\left[\frac{g_t^{\,p} - g_t}{1+g_t} d_{t-1}^M - pb_t^C\right]}_{cyclical} + \underbrace{\left[\frac{r_t - g_t^{\,p}}{1+g_t} d_{t-1}^M - pb_t^S\right]}_{non-cyclical}$$

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Beyond the crisis, sustainability issues will require a consolidation framework

- Fiscal position will strongly deteriorate:
  - ❑ Fiscal deficit projections (OECD, EO-86):
    - -6.7% in 2009
    - -7.6% in 2010
    - -7.8% in 2011
  - ❑ Worsening fiscal position leads to a strong deterioration in sustainability estimates:
    - EU estimates (with similar deficit projections): between 4.7 (S1) and 5.5 (S2)
- Question: should we pre-fund fully or partly? And how?

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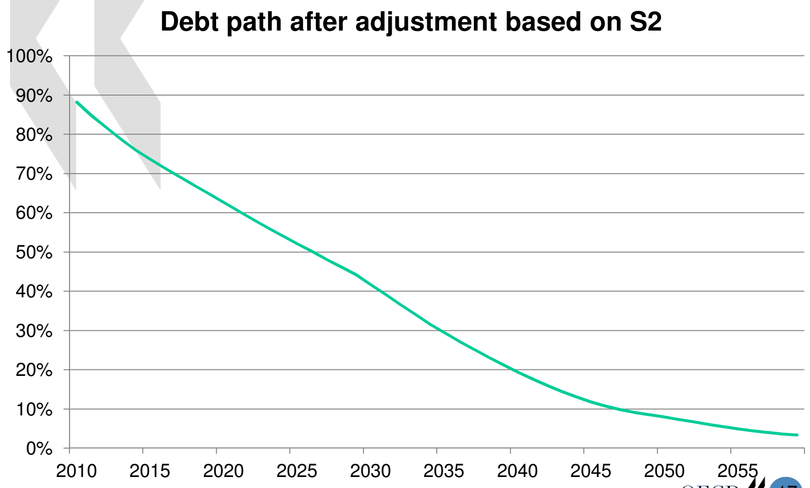
Adjusting the primary balance based on S2 could lead to temporary asset accumulation…



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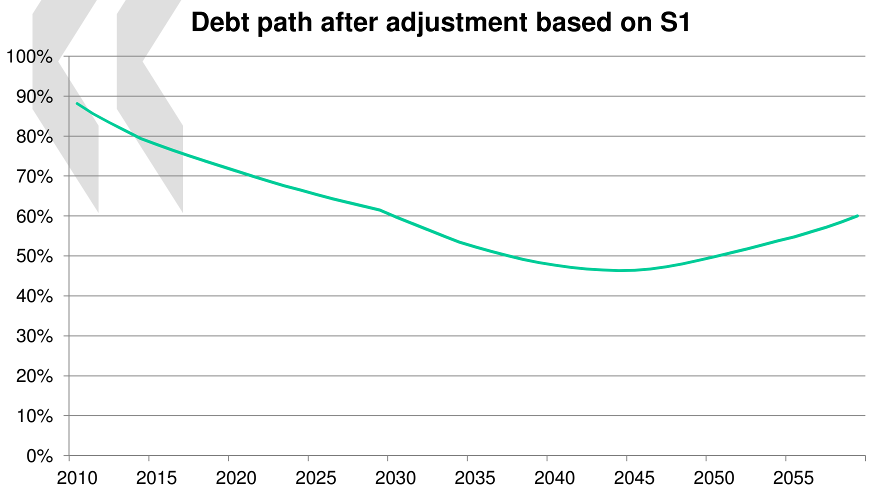
…while the debt ratio remains positive with an adjustment based on S1



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Are fiscal rules an efficient tool to achieve sustainability?

OECD study => Combining a budget balance and an expenditure rule seem to improve fiscal consolidation

Limits

- Interpretation of results on rules not obvious
- Treatment of fiscal rules very simplistic compared to actual complexity and diversity of rules

Overall still not a magic recipe.

- Observance of rules has been uneven
- There is no one-size-fits-all rule.

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Some important features of fiscal rules

- Rules have to be simple to understand, manage and control, transparent, but also take account of the cycle.
- There should be costs associated with breaching of rules
- Rules have to adapt to changing circumstances
- Mechanisms to deal with revenue windfalls can play a supporting role

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An internal « stability » pact is also crucial

- Social security and local expenditure growth particularly dynamic since 2001 in real terms:
  - Total public expenditure growth: +1.8%
    - But social security expenditures: +4.6%
      - While local expenditure growth: +1.4%
      - and central government: +0.4%

- How to achieve a structural adjustment of 0.5 percent per year?
  - If real potential growth is about 1% and no tax increases:

    => total expenditure has to remain *constant* in real terms;
  - If local and social security expenditure keep past trend:

    => Central government expenditure should decrease by ***3%*** in real terms!

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