



A case for adjusting fiscal consolidation in the eurozone

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Fiscal consolidation is essential to ensure the sustainability of eurozone countries' public debt. However, as a principle, consolidation should not be pursued at a pace unnecessarily undermining growth in the short term. Repeated downward revisions of growth call for the use of the flexibility foreseen in the EU fiscal framework. The Commission should adapt the deadlines for fiscal correction to prevent excessive, pro-cyclical adjustment in 2013. In turn, adequate surveillance and coordination must ensure structural adjustments constitute the core of fiscal consolidation plans.

Introduction

The public debate on fiscal consolidation is often reduced to an 'austerity' vs 'growth' question. As many claim, excessive fiscal consolidation (or 'austerity') would damage growth and thus not result in lower debt levels. Others rather insist on the inevitability of fiscal consolidation measures by stressing the unsustainable character of high debt

levels and the risk posed by financial markets. This policy brief provides an overview of the question and explores the opportunity of adjusting the path of fiscal consolidation for countries in the Excessive Deficit Procedure (EDP) of the Stability and Growth Pact (SGP).

This brief first puts public debt concerns in perspective by underlining the structural roots of debt increases (part 1). Part 2 explores the alternatives to fiscal consolidation. Particular attention is given to the interaction of fiscal consolidation and growth. As a result of this discussion, some guiding principles for effective fiscal consolidation are suggested. In this perspective, part 3 will deal with some remaining issues of the EU fiscal framework. Practical policy recommendations are provided in conclusion.

1. Structural roots of public debt

In 2012, public debt reached 93% of the eurozone GDP, almost 25 percentage points (p.p.) above the pre-crisis level. In nine eurozone countries, debt levels are above 80% of GDP (notably the four biggest eurozone economies: Germany, France, Italy

and Spain). After a peak of more than 6% of GDP in 2009, aggregate deficits still reach 3.3% of GDP in the eurozone in 2012.

Part of the recent debt rise can be directly imputed to the financial crisis and the ensuing economic recession. The discretionary fiscal stimulus launched in 2009 to counteract the downturn following the financial crisis inflated deficits. Moreover the recession led to an automatic decrease of fiscal revenues and increase of public spending which considerably affected governments' balances. On top of this, banks had to be rescued and might require even more support if the guarantees granted by governments are called upon.

However, next to these one-off and temporary causes, debts also have structural roots. In several 'peripheral' countries, macro-economic imbalances do not result from the crisis, but were instead revealed by the crisis. External financing and cheap credit channelled towards consumption and real-estate bubbles fuelled unsustainable growth. This tended to mask competitiveness issues and allowed public spending to grow excessively. Some rebalancing now appears unavoidable.

Moreover, other structural issues still loom. Debt levels are expected to rise further because of the population ageing. The implicit future liabilities – entitlements whose payments fall due in the future, such as pensions and other age-related public spending – are as much a concern as the debt legacy. Public age-related spending should increase on average by 4.5 p.p. of GDP by 2060 in the eurozone¹. Countries facing the greatest challenges are Belgium, Luxemburg, Slovenia, the Netherlands, Malta and Cyprus,

where age-related spending should increase by more than 8 p.p. of GDP in the most optimistic scenarios².

2. Room for manoeuvre in fiscal consolidation

Is there scope for adjusting the pace of fiscal consolidation? To answer this, we first need to stress the role of financial markets in determining the 'sustainability' of a country's debt.

Debt sustainability

In theory, the sustainability of public debt depends on the country's ability to repay its creditors. This ability relies on the capacity of the country to raise taxes in the future. A country's solvency is thus hard to apprehend in practice. Moreover, a sovereign country may ultimately restructure its debt: willingness to repay – as much as ability – matters.

Hence, assessing the sustainability of a country's debt requires some judgement from the country's creditors. In the end, it is up to them to estimate the price at which it is still sound to lend to a highly indebted country.

From the country's perspective, credibility is thus paramount. The borrowing country must continuously convince financial markets of its commitment to repay. The strengthening of EU fiscal rules and the urge to correct fiscal deficits should be perceived in this context. As Greece, Ireland and Portugal had lost market access and, at times, the sovereign bond yields of Spain and Italy were rising to threatening levels, eurozone governments needed to assure investors of their fiscal discipline.

¹ Table 1 in EU Commission, [The 2012 Ageing Report](#), May 2012.

² Ibid.

Enough room for manoeuvre to adjust the pace of fiscal consolidation?

The concern for high debt levels is thus closely linked to the concern for a possible market ‘sanction’ that would push the country to default. How would financial markets react should a country be allowed more time to reduce deficits and to bring its debt on a downward path – with ‘fiscal discipline’ allegedly relaxed? Two general considerations can be made.

First, in the short-term, risks can be managed differently than by front-loading consolidation to allegedly reassure markets. Monetary policy can notably buy time. The ECB has assuaged much of the risk of a country losing access to the market, by announcing it stands ready to buy bonds of eurozone countries facing excessive market pressure³.

Secondly, credibility should also be anchored in a longer term perspective. Therefore, governments will have to reduce their debt to ‘safer’, more ‘sustainable’ levels. This is not only a commitment under EU fiscal rules but also a necessity. From a financial history perspective, debt levels of most eurozone countries are simply too high to be deemed safe. This implies addressing the structural roots of indebtedness.

There is hence scope to adjust the pace of fiscal consolidation in the short term, if at the same time the objective of structural debt reduction remains anchored in national policies. I now turn to a discussion on the variables - notably growth - that affect this objective.

³ Via its programme dubbed ‘Outright Monetary Transactions’. See Vanden Bosch, X., [‘Preventing the rise of sovereign borrowing costs in the eurozone: what can the ESM and the ECB achieve?’](#), Egmont Paper, November 2012.

3. Reducing debt levels: Alternatives to fiscal consolidation?

Key parameters for reducing debts

The effectiveness of fiscal consolidation in reducing debt levels is basically dependent on a few key parameters and cannot be contemplated on its own⁴. The country’s consolidation effort rise with the interest rate paid on its debt. Moreover, the higher the level of the debt stock, the larger the required effort. Inflation is not neutral either: higher inflation lowers the real debt burden. Finally, higher growth facilitates the debt-reduction effort as it allows for higher fiscal revenues and lower expenses.

Among the variables determining the fiscal effort required, growth receives the most attention in policy debates. Acting on other variables is generally not considered as a viable policy option. Allowing for higher inflation to reduce debt levels is still largely seen as a heretic view at odds with the EMU founding principles. A debt restructuring amounts to a technical default that would spook off remaining investors. As for a better control of interest rates, forms of debt mutualisation that would allow countries to refinance themselves at lower rates were considered but so far without success. Finally, resolving to ‘financial repression’ – measures forcing the financial sector to lend to governments at low rates – contradicts the free movement of capital in the single market (Art. 63 TFEU), and the ban on privileged

⁴ A standard debt accumulation equation provides a useful framework as four variables affect the stock of debt b_t : (i) the interest rate paid on the stock of debt, i_t ; (ii) the inflation rate of the GDP deflator, π_t ; (iii) the real GDP growth rate, g_t and (iv) the primary deficit-to-GDP ratio, d_t .

$$b_t = \frac{1+i_t}{(1+\pi_t)(1+g_t)} b_{t-1} + d_t$$

access of public authorities to financial institutions (Art. 124 TFEU).

Fiscal consolidation and growth

Higher growth should thus facilitate the fiscal consolidation effort. However, conversely, the cuts in spending and tax raises implied by fiscal consolidation tend to negatively affect growth. As such, some claim ‘austerity’ would actually be ‘self-defeating’: debt levels would not be reduced by fiscal consolidation. In economic literature, testing for this assumption involves calculating the size of the so-called ‘fiscal multipliers’, i.e. the change in GDP following a 1% of GDP change in fiscal deficits. For example, if a decrease of one euro in government spending causes 0.5 euro decrease in GDP, then the government spending multiplier is 0.5. If the multiplier is above one, there is a possibility that the debt-to-GDP ratio actually increases rather than decreases because of the effect on GDP.

However, trying to aggregate into a single figure how economic activity would in general be impacted by fiscal policy is inherently delicate. A multitude of factors impact the multipliers across countries and time, and many assumptions underlie the economic models. There is thus no single multiplier but a multitude of multipliers, depending on the composition of the fiscal consolidation over time and across countries, its persistence, and the accompanying monetary and financial conditions. The issue was exemplified in a recent exchange of views between the IMF and the Commission on the possible underestimation by international organizations of fiscal multipliers, leading to forecast errors⁵.

⁵ O.Blanchard and D.Leigh suggested that *actual multipliers may be higher, in the range of 0.9 to 1.7* in the October 2012 [IMF World Economic Outlook](#) (Box

Because of its limitations, the academic debate on the size of fiscal multipliers (mostly useful to produce forecasts) tends to drift towards a mostly ideological one (to suggest policies). Considering the size of fiscal multipliers to design policies can be largely misleading.

Beyond the size of fiscal consolidation, pace and quality matters

Nonetheless, the debate on fiscal multipliers highlights two key points. First, the negative short term effect of fiscal consolidation on growth is larger during a recession. Negative spill-over effects are moreover likely when many countries consolidate at the same time. This essentially suggests that beyond the question of the size of fiscal consolidation, pace and coordination matters. Some fiscal space should be allowed for investments likely to promote future growth, like education, R&D and growth-enabling infrastructure. Moreover, there is no need to systematically try to balance the budget in a recession. Automatic stabilizers should be allowed to freely function whenever possible.

A second important lesson is that the composition of consolidation is paramount. Quality rather than quantity matters. Not all types of tax policies and spending cuts equally affect growth. Most growth-friendly adjustment measures should be favoured. Crucially, consolidation should consist in measures correcting structural problems making the debt unsustainable in the long term, rather than in temporary or quasi-one-off measures aiming at meeting a short-term annual deficit target. The former typically implies coping with the greying of the

1.1). Many inferred this as evidence that austerity would be largely misguided. The Commission contested these results (box 1.5 of [autumn 2012 forecast](#)).

population and a lack of competitiveness. The latter implies spending cuts or tax increases that can hurt growth in the short term while not improving it for the future.

If these principles – quality and pace – are followed, fiscal consolidation will ensure debt levels are credibly and effectively reduced in the long run. Growth is not an ‘alternative’ to fiscal consolidation, but rather an essential complement. Reducing deficits remains unavoidable but this should be done at a pace that does not undermine already low growth in the short term or much needed productive public investments in the long term. As for the core of the adjustment, it should focus on structural measures that can ensure the long term sustainability of public finances.

4. The EU fiscal framework: Ensuring the right pace and quality of fiscal consolidation

Principles in the EU fiscal framework

As discussed, fiscal rules should ideally promote the right pace and the quality of fiscal consolidation. A qualitative adjustment at a steady – yet not necessarily unduly front-loaded – pace should be favoured. Therefore, countries should not be forced to correct the deficit that is due to sub-optimal growth as long as they pursue their structural adjustment efforts. Productive public investments should also be preserved.

The EU fiscal framework broadly recognizes these principles. In particular, both the required yearly adjustment effort to correct deficits and the medium-term objective are expressed in structural terms (i.e. a cyclically adjusted balance net of one-off and temporary measures). Moreover, since its inception the SGP notably recognizes public investments and exceptional circumstances such as a severe economic downturn as

relevant factors when considering the deficit levels⁶. However, some issues remain which at times make fiscal rules function against these principles.

Pace issue: Nominal fiscal targets deadlines should take into account downward revisions of growth

First, what mostly determines the pace of fiscal consolidation is the deadline proposed by the Commission and set by the Council to bring the overall deficit to the maximum 3% of GDP benchmark. Back in 2009, countries were requested to reduce their deficits to the maximum 3% ceiling by 2012 (Belgium, Cyprus, Italy) and 2013 (Austria, France, Italy, Germany, Ireland, Malta, Netherlands, Portugal, Slovakia, Slovenia, Spain) at the latest. Germany left the procedure in 2012. Despite the fact that the eurozone is now forecasted to go into recession in 2013, targets have only been adjusted for Spain (2014), Portugal (2014) and Ireland (2015). Moreover, countries will pursue their nominal targets beyond this deadline. This implies that many countries will consolidate in 2013 when a significant part of the deficit is due to sub-optimal growth (on average 1.1% of GDP⁷).

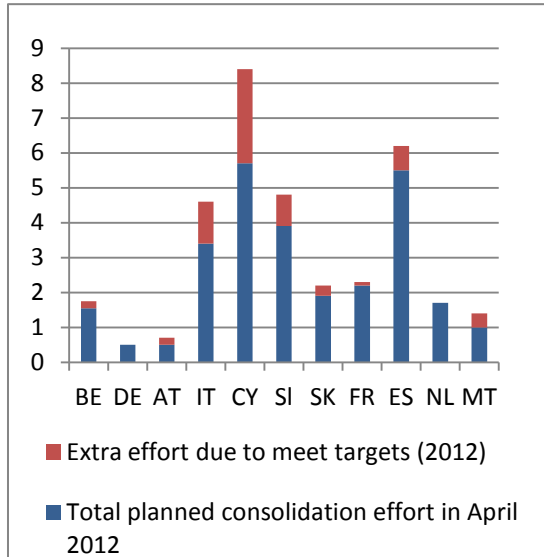
To grossly assess the size of fiscal retrenchment over 2012-2013, we can sum up the planned national consolidation effort mentioned in the 2012 National Stability Programmes to the extra effort required to meet the deficit targets for 2012. The extra effort is calculated as the gap between the 2012 deficit forecast by the Commission and

⁶ According to Art. 126(2) and 126(3) TFEU, and Council Regulation (EC) No 1467/97 and subsequent revisions.

⁷ Average cyclical component of deficit, as forecasted for 2013 in [EC Autumn 2012 forecast](#) for selected countries (see figure 1).

the Member State's own 2012 planned deficit as mentioned in its Stability Programme.

Figure 1: Cumulative size of deficit reduction (2012-13) as % of GDP



Source: Own calculations based on National Stability Programmes and Commission's Autumn Economic Forecast, 2012

Figure 1 shows the resulting total size of the adjustment effort⁸. It is quite substantial in many countries and should raise concerns. As a broad comparison, the much debated US 'fiscal cliff' – automatic tax and spending cuts that were due to take effect in 2013 – amounted to about 3% of US GDP⁹. In Europe, the planned consolidation might entail further contraction of growth in 2013. This is certainly not to be considered as an ideal pace in general.

⁸ As calculated, the total does not take into account any adverse circumstances that would require an extra effort to meet the deficit target for 2013 (e.g. financial sector support, downwards revision of growth, rise in borrowing cost, unanticipated negative effect of fiscal consolidation). Figures also ignore extra measures announced between April and November 2012. Spain obtained a delay, spreading the result over 3 years instead than 2.

⁹ Estimated fiscal tightening for 2013 (as % of US GDP) under fiscal cliff. See US Congressional Budget Office, [Economic Effects of Policies Contributing to Fiscal Tightening in 2013](#), November 2012.

Quality issue: Structural corrections need to be more prominently considered

A second issue is that enforcement of structural consolidation efforts is relatively weak. In the SGP, a country must in principle pursue an annual correction of its structural balance by at least 0.5% of GDP. The target set for each Member States ranges from 0.5 to 1% of GDP, depending on the size of the effort to reduce deficits and debt levels. However, the target of 3% of general government balance dominates this yearly structural adjustment effort target. When a country is about to lower its deficit down to the 3% deficit target – and hence leave the EDP –, despite a yearly structural effort below the set target, the Commission does not in practice judge the structural correction to be insufficient.

Under the Commission autumn forecast, Austria, Belgium, Cyprus and Malta deviate from their structural targets as shown in Table 1¹⁰ (see next page). These countries might insufficiently address their structural fiscal imbalances and possibly rely too much on one-off measures to lower their overall deficit.

Moreover, judging the structural composition of consolidation by setting a structural deficit reduction target has some known shortcomings. The structural deficit excludes two components from the general government balance: first, the cyclical component (i.e. the deficit due to below-potential growth), and secondly, the temporary and one-off measures (i.e. deficit owing to discretionary measures having a

¹⁰ This is purely indicative but demonstrates how the structural effort criteria may lack teeth. Figure for Belgium do not take into account the measures from the 2013 budget, and hence underestimate the reduction of the structural deficit.

‘one-shot’ or ‘non lasting effect’). Calculating the cyclical component implies forecasting potential growth which is a delicate exercise. If ‘potential growth’ is overestimated, so will the cyclical component. The structural deficit might hence turn out to be larger than initially believed. Moreover, judging which measures have a ‘temporary or one-off’ rather than a ‘structural’ effect can be delicate. In an economy, with considerably high tax levels, further tax increases will qualify as structural measures, not temporary ones, while one could assume excessive taxation can only be reversed over time.

Table 1: Structural deficit corrections 2012-2013 (% of GDP)

	Effective yearly structural reduction (1)	Yearly structural consolidation required (2)	Deviation (1)-(2)	Forecast level of structural deficit (2013)
AT	0.1	0.75	-0.65	-2.1
BE	0.35	0.75	-0.4	-2.7
CY	0,55	1.5	-0.95	-4.8
DE	0.5	0.5	0	0.3
ES	1.75	1.5	0.25	-4
FR	1.25	1	0.25	-2
IT	1.65	1	0.65	-0.4
MT	0.15	0.75	-0.6	-3.2
NL	1.15	0.75	0.4	-1.1
SL	1.1	0.75	0.35	-3.2
SK	1.35	1	0.35	-2

Source: Own calculations based on Commission Autumn forecast 2012 and Council recommendations

Finally, while public investments and structural reforms (notably pension reforms) can in principle be accommodated under the SGP, it is still unclear how their impact on deficits should be considered in practice. The Commission has announced a communication on the accommodation of fiscal discipline with public investments for

Spring 2013¹¹. Clarification is indeed much needed on the possibility of running larger deficits in the short term because of productive public investments that can stimulate growth. This also concerns countries under the EDP, and the Commission will hopefully address this issue.

Conclusion

Strengthened fiscal discipline constitutes the core of the European answer to the sovereign debt crisis. The objective is not only to lower debts that have reached high levels, but also to continuously convince financial markets that the debt path remains sustainable. I argued the ECB’s bond buying programme can fend off most of the short-term risks in financial markets, creating more room for manoeuvre for adjusting the pace of fiscal consolidation.

However, if pace can be adjusted, credibility supposes that reducing debt levels must remain an overarching objective. Therefore, fiscal consolidation is unavoidable. Most of the complementary means are simply not considered viable policy options so far (inflation, debt restructuring, financial repression or debt mutualisation). As for growth, it is a complement to fiscal consolidation – rather than an alternative – that can facilitate the debt reduction effort.

To preserve growth in the short term, both the pace and the quality of fiscal consolidation matter. First, the pace should take into account that the negative short-term effect of fiscal consolidation on growth is likely larger in a recession when many countries consolidate at the same time.

¹¹ Announced in [Commission Blueprint for a deep and genuine Economic and Monetary Union](#), COM (2012) 777.

Deficits due to below potential growth should not be systematically corrected as growth is revised downwards.

Secondly, the composition and quality of the adjustment matter to minimize the negative short-term effect on growth while maximising long-term growth prospects. The focus should be on structural adjustments, and notably on the correction of structural deficits.

Adjusting the pace

Although these principles are broadly recognized in the EU fiscal framework, its flexibility is not ideally used in practice. The pace is not optimal if most countries still plan to reach their deficit targets for 2013 despite repeated downward revisions of growth. This would imply excessive corrections concentrated on a short period. On a case-by-case basis, the Commission should recommend the Council to grant a delay for meeting the 3% target owing to a ‘severe economic downturn’¹². Ideally, this should occur before countries introduce their Stability Programme in spring 2013. This – rather technical – Commission initiative would prevent countries to overly focus on their overall deficit targets and to unavoidably miss unrealistic targets.

Ensuring an effective structural adjustment

Adjusting the pace of consolidation should in turn be linked with closer scrutiny of the

quality of corrections. Structural issues owing to lack of competitiveness or the cost of an ageing population must be addressed. Allowing for more time should be conditional on effective structural adjustment plans. This implies effective surveillance and enforcement of the agreed annual reduction of structural deficits.

Since no fiscal indicator can perfectly capture the structural effort, further strengthening policy coordination and surveillance is essential. In this respect, once adopted, the ‘two-pack’ will allow closer surveillance and allow the Commission to voice an early opinion on national draft budget plans¹³. The recently suggested ‘contractual arrangements’ proposed in European Council President Van Rompuy’s report also offer an interesting perspective, linking closer scrutiny with solidarity mechanisms¹⁴.

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¹² According to Article 3(5) of Regulation (EC) No 1467/97, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU, if effective action has been taken and *unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation*. As a rule, the deadline can be extended by one year.

¹³ See COM (2011) 821 and COM (2011) 819.

¹⁴ See [Towards a Genuine Economic and Monetary Union](#), 5 December 2012.