The duration of fiscal consolidations: a review of selected literature

This note reviews case study and econometric evidence on the duration of fiscal consolidations and finds that careful attention to the timing of fiscal consolidations can be an important component of success. A programme that occurs over a brief period may suffer from poor implementation, requiring further rounds of expenditure control or tax rises. However, consolidations that occur over a long, drawn out period are susceptible to consolidation 'fatigue' which can undermine the effectiveness of the programme. As a result, there is likely to be an inverted U-shaped relationship between timing and effectiveness which involves diminishing marginal returns for longer cases. The evidence is drawn from three international cases of successful fiscal consolidation including Canada (1994-98), Sweden (1993-98) and New Zealand (1991-94) as well as studies using econometric methods with larger samples.

In describing Canada's successful fiscal consolidation from 1994-98, former Cabinet Secretary Jocelyne Bourgon (2009:32) pointed out, 'Speed is important. Successful public sector reforms are incrementally implemented over time. However, where a high level of societal consensus has been achieved, it is preferable to move expeditiously. It creates hope at the end of the tunnel.' The former Swedish PM Göran Persson who led Sweden's successful fiscal consolidation from 1994-98 also drew attention to the time sensitivity of the programme. When Persson was asked about how much time is available for a politician to implement a reforms programme, he responded, 'You have two years. If you are not in command of the process by then, you will lose momentum and soon face the next election—where you will be replaced. We survived the 1998 election and were rewarded politically for what we had done by being reelected once more in 2002, when the good times returned and we were in firm control of the public finances' (Levy and Lovegrove 2009: 4)

Prior to New Zealand's successful fiscal consolidation from 1991-94, the New Zealand Treasury's (1990: 3) advice to the incoming government focused on the time sensitive nature of the programme. 'The incoming Government faces an awesome challenge in dealing with this situation. The fiscal problem is very large and it should be dealt with as quickly as is practicable. The timing of actions should be as fast as is consistent with careful decision-making and sound implementation. Even at that pace it would not be realistic to expect a rapid improvement in economic prospects. Experience shows that significant policy change takes a long time to design, implement, observe in action and 'de-bug' before the full benefits come through…It is important to establish realistic expectations of what the Government can expect to achieve and by when. Past experience with policies aimed at quick results suggests that in most cases the outcome is disappointing and the longer-term cost considerable...Meeting this challenge will call for careful policy preparation, well-designed decision-making processes, leadership and careful explanation'.

The New Zealand Treasury (1990: 77) went on to point out '…An optimal rate of reduction in the fiscal deficit will do a number of things. It will:

- be fast enough to gain early credibility so as to achieve a marked reduction in the pressures on inflation objectives, on activity in the exposed sectors of the economy and on investor confidence
- be fast enough to reduce significantly the exposure of the economy to shocks and future fiscal problems by slowing the build up in debt
- not be so quick as to require policies which are poorly designed or which jeopardise the achievement of longer term goals'

The case study evidence can be complemented by a review of empirical studies on fiscal consolidation. The empirical literature on budget consolidation uses descriptive statistics and regression models to analyse the factors that influence whether a budget consolidation is successful. In this literature, the start of a fiscal consolidation is defined by a change in the cyclically adjusted primary budget deficit[1] with some studies taking account of debt to GDP ratios.[2] These indicators are typically measured in the two to three years after a consolidation as an indication of 'sustainability' or 'success'.[3]

Wagschal and Wenzelburger (2008: 66) looked at 23 OECD countries from 1945 – 2000 and found 26 cases of consolidation[4] noting 15 successful[5] and 10 unsuccessful cases. They find that the average consolidation period lasts 3.1 years.

Zaghini (1999) looked at 98 consolidation episodes[6] in 14 European countries from 1970-1998. The study found that 'on average, successful[7] adjustments lasted 2.7 years, while unsuccessful consolidations were implemented over a much smaller time period, 1.6 years. Among the 12 successful cases there were 6 adjustments of more than 2 years (exactly 50 percent of the total) whereas just one was implemented in a single year (8 percent). By contrast, only 4 out of the 37 unsuccessful consolidations (11 percent) lasted more than two years, the majority being implemented in one year (54 percent)' (23).

Guichard, Kennedy, Wurzel and Andre (2007) looked at 85 fiscal consolidation episodes[8] in 24 countries from 1978-2005 and found that the median duration was two years. However, for successful[9] consolidations, the median duration was approximately four years (10). Two of the longest episodes under study were the seven years in Sweden (1981-87 and 1994-2000) and the eight years in Japan (from 1980-87).

EC (2007) analysed a sample of 27 European countries from 1970 - 2006[10]. This provides 146 years of consolidation[11] with one third of those being judged as successful[12]. This study compared the

[1] The budget deficit before interest payments on the national debt are taken into account.

[2] The change (as a proportion of GDP) varies and is generally in the range of ½% to 2% over a period of one to three years. Some studies also take account of debt-to-GDP ratios, and the change varies from a constant ratio over the period to a reduction of 10%.

[3] The definition of a sustainable consolidation focuses on both budget surplus (looking for around a 2% reduction) and debt-to-GDP ratios (ranging from the measure staying constant to 10% improvements).

[4] Type A: if a negative primary balance (i.e. primary deficit) improves during at least two years by a minimum of one percentage point per year and, at the same time, the public debt ratio during this period remains at least constant)

Type B: if there is an average primary surplus of at least two percent of GDP during at least two years and, at the same time, the public debt ratio falls by an average of two percentage points per year during two years. In total, the reduction in the public debt ratio ofver the whole consolidation period must be at least 10 percentage points. In order to fulfill the criteria a buffer of 0.2 percentage points must be maintained.

[5] Success is defined where the public debt ratio in the third year after the consolidation phase is at least at the same level as in the last year of the consolidation phase

[6] A period of very tight fiscal policy is such that either the GDP improves by at least 1.6% in one year or the GDP improves by at least 0.8%a year for two or more years. A period of very loose fiscal policy is where either the CPB worsens by at least 1.4 percent over one year or the CPB worsens by at least 0.7 percent a year for two or more years. (17)

[7] A period of tight fiscal policy is successful if three years after the end of the adjustment the public debt/GDP ratio has been reduced by at least 5% relative to the average value of the same ratio computed during the whole consolidation period

[8] An episode 'starts if the cyclically adjusted primary balance (CAPB) improves by at least one percentage point of potential GDP in one year or in two consecutive years with at least ½ percentage point improvement
occurring in the first of the two years, continues as long as the CAPB improves. An interruption is allowed without terminating the episode as long, at the deterioration of the CAPB does not exceed 0.3% of GDP and is more than offset in the following year (by an improvement of at least 0.5 % of GDP) and terminates if the CAPB stops increasing or if the CAPB improves by less than 0.2% of GDP in one year and then deteriorates.' (7)

[9] Defined where a fiscal adjustment is large enough to stabilise the debt-to-GDP ratio (10)

[10] Although for some countries data was available for a shorter period.

[11] Define an episode of consolidation as 'an improvement of the CAPB of at least 1.5% of GDP which is either achieved in one single year [cold shower consolidation] or over a period of three years where in each single year the improvement of the CAPB is less than 1.5 % of GDP and the CAPB does not deteriorate by more than 0.5 % of GDP compared to the year before [gradual consolidation]' (201).

[12] 'A consolidation in line with Definition 1 is successful if the following condition applies: in the three years after the end of the consolidation episode the CAPB does not deteriorate by more than 0.75 % of GDP in cumulative terms compared to the level recorded in the last year of the consolidation period. In other words, at least half of the overall minimum fiscal correction required to qualify as consolidation has to be safeguarded three years after. A consolidation is deemed unsuccessful if this condition is not met' (202).

prevalence and effectiveness of shorter consolidations, termed ‘cold showers’[13] to longer ‘gradual’[14] consolidations. In its analysis, it found that cold showers account for approx two-thirds of all consolidation years (99/146); however, while the success rate is slightly higher for ‘cold shower’ episodes than for ‘gradual’ consolidations, the difference is not statistically significant.

Both the case studies and econometrics highlight the important role that timing plays in developing a successful consolidation. The duration should be long enough to ensure that reforms are effectively designed and implemented but does not create prolonged disruption and unpopularity.

[13] A ‘cold shower’ consolidation is defined by an improvement of the Cyclically Adjusted Primary Budget (CAPB) of at least 1.5 % of GDP which is achieved in one single year

[14] A gradual consolidations is defined where it is ‘achieved over a period of three years where in each single year the improvement of the CAPB is less than 1.5 % of GDP and the CAPB does not deteriorate by more than 0.5 % of GDP compared to the year before’.

References

Bourgon, J. (2009), Program Review: The Government of Canada's experience eliminating the deficit 1994-1999: a Canadian case study, Institute for Government

European Commission (2007), European Economy: Public Finance in EMU, Directorate-General for Economic and Financial Affairs, No. 3

Guichard, S., Kennedy, M., Wurzel, E., and Andre, C. (2007), What promotes fiscal consolidation: OECD country experiences, OECD Economics Department Working Papers No. 553

Levy, A. and Lovegrove, N. (2009), Reforming the public sector in a crisis: An interview with Sweden's former prime minister, McKinsey Quarterly No.3

New Zealand Treasury (1990) Briefing to the incoming government 1990, ISBN 0-477-01557-3 Wellington

Wagschal, U. and Wenzelburger, G. (2008), *Successful Budget Consolidation: An international Comparison*, Guetersloh: Verlag Bertelsmann Stiftung

Zaghini, A. (1999), 'The economic policy of fiscal consolidations: the European experience', Temi di Discussione del Servizio Studi, Banca d'Italia, No 355