

Ten Commandments for Fiscal Adjustment in Advanced Economies

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Advanced economies are facing the difficult challenge of implementing fiscal adjustment strategies without undermining a still fragile economic recovery. Fiscal adjustment is key to high private investment and long-term growth. It may also be key, at least in some countries, to avoiding disorderly financial market conditions, which would have a more immediate impact on growth, through effects on confidence and lending. But too much adjustment could also hamper growth, and this is not a trivial risk. How should fiscal strategies be designed to make them consistent with both short-term and long-term growth requirements?

We offer ten commandments to make this possible. Put simply, what advanced countries need is clarity of intent, an appropriate calibration of fiscal targets, and adequate structural reforms. With a little help from monetary policy, and from their (emerging market) friends.

Commandment I: *You shall have a credible medium-term fiscal plan with a visible anchor (in terms of either an average pace of adjustment, or of a fiscal target to be achieved within four–five years).*

There is no simple one-size-fits-all rule. Our current macroeconomic projections imply that an average improvement in the cyclically-adjusted primary balance of some 1 percentage point per year during the next four–five years would be consistent with gradually closing the output gap, given current expectations on private sector demand, and would stabilize the average debt ratio by the middle of this decade. Countries with higher deficits/debt should do more, others should do less. Such a pace of adjustment must be backed-up by fairly specific spending and revenue projections, and supported by structural reforms (see below).

Commandment II: *You shall not front-load your fiscal adjustment, unless financing needs require it.*

For a few countries, frontloading may be needed to maintain access to markets and finance the deficit at reasonable rates—but, in general, a steady pace of adjustment is more important than front-loading, which could undermine the recovery and be reversed. Nonetheless, a non-trivial first installment is needed: promises of future action will not be enough.

Current fiscal consolidation plans in advanced G-20 countries imply on average a reduction in the cyclically adjusted deficit of some 1¼ percentage point of GDP in 2011, with significant dispersion around this according to country circumstances. This seems broadly adequate, and consistent with commandment I, at least based on current projections on the recovery of aggregate demand. This said, while front-loading fiscal tightening is, in general, inappropriate, front-loading the approval of policy measures (which would become effective at a later date) will enhance the credibility of the adjustment.

Commandment III: *You shall target a long-term decline in the public debt-to-GDP ratio, not just its stabilization at post-crisis levels.*

High public debt tends to raise interest rates, lower potential growth, and impede fiscal flexibility. Since the early 1970s, public debt in most advanced countries has been the ultimate absorber of negative shocks, going up in bad times, not coming down in good times. In the G-7 average, gross debt was 82 percent of GDP in 2007, a level never reached before without a major war. The current fiscal doldrums are due not only to the crisis, but also to how fiscal policy was mismanaged during the good times. This time, it must be different: the final goal must be to lower public debt ratios, gradually but steadily.

Commandment IV: *You shall focus on fiscal consolidation tools that are conducive to strong potential growth.*

This will require a bias towards (current) spending cuts, as spending ratios are high in advanced countries and require highly distortionary tax levels. Some cuts should be no brainers: for example, shifting from universal to targeted social transfers would involve significant savings, while protecting the poor. Containing public sector wages—which have risen faster than GDP in several advanced countries in the last decade—will be necessary.

This said, nothing should be ruled out. Countries with low revenue ratios and large adjustment needs—like the United States and Japan—will also have to act on the revenue side. Promising “no new taxes,” in all countries and circumstances, is unrealistic.

Commandment V: *You shall pass early pension and health care reforms as current trends are unsustainable.*

Increases in pension and health care spending represented over 80 percent of the increase in primary public spending to GDP ratio observed in the G-7 countries in the last decades. The net present value of future increases in health care and pension spending is more than ten times larger than the increase in public debt due to the crisis.

Any fiscal consolidation strategy must involve reforms in both these areas. This includes Europe, where official projections largely underestimate health care spending trends. Given the magnitude of the spending increases involved, early action in these areas will be much more conducive to increased credibility than fiscal front-loading. And will not risk undermining the recovery. Indeed, some measures in this area—while politically difficult—could have positive effects on both demand and supply (for example, committing to an increase in the retirement age over time).

Commandment VI: *You shall be fair. To be sustainable over time, the fiscal adjustment should be equitable.*

Equity has various dimensions, including maintaining an adequate social safety net and the provision of public services that allow a level playing field, regardless of conditions at birth. Fighting tax evasion is also a critical component to equity. For VAT, a tax that is relatively resilient to fraud, tax evasion averages about 15 percent of revenues in G-20 advanced countries. Evasion for other taxes is likely to be higher.

Commandment VII: *You shall implement wide reforms to boost potential growth.*

Strong growth has a staggering effect on public debt: a one percentage point increase in potential growth—assuming a tax ratio of 40 percent—lowers the debt ratio by 10 percentage points within 5 years and by 30 percentage points within 10 years, if the resulting higher revenues are saved. An acceleration of labor, product and financial market reforms will thus be critical.

In the current context of weak aggregate demand, reforms that increase investment are more desirable than reforms that increase saving. While both have positive long-run effects, investment friendly reforms increase demand and output in the short run, while saving friendly reforms do the opposite. A word of caution, though: the timing and magnitude of the effects of structural reforms on growth are uncertain: fiscal adjustment plans relying on faster growth would not be credible.

Commandment VIII: *You shall strengthen your fiscal institutions.*

Sustaining fiscal adjustment over time requires appropriate fiscal institutions. The current ones allowed a record public debt accumulation before the crisis. They are insufficient. This requires better fiscal rules, including in Europe; better budgetary processes, including in the United States, where, at least for Congress, the budget is essentially a one-year-at-a-time exercise; and better fiscal monitoring, including through independent fiscal agencies of the type recently created in the United Kingdom.

Commandment IX: *You shall properly coordinate monetary and fiscal policy.*

If fiscal policy is tightened, interest rates should not be raised as rapidly as in other phases of economic recovery. Calls for an early monetary policy tightening in advanced economies are misplaced.

Commandment X: *You shall coordinate your policies with other countries.*

In a number of advanced countries, the reduction in budget deficits must come with a reduction in current account deficits. Put another way, if the recovery is to be maintained, the initial adverse effects of fiscal consolidation on internal demand have to be offset by stronger external demand. But this implies that the opposite happens in the rest of the world.

In a number of emerging market economies, current account surpluses must be reduced, and these countries must shift from external to internal demand. The recent decisions taken by China are, in this respect, an important and welcome step. Policy coordination will also be important in some structural areas: for example, over the medium term, it will be critical to protect fiscal revenues from rising tax competition.

Obey these commandments, and chances are high that you will achieve fiscal consolidation and sustained growth.