Box 4

Challenges concerning fiscal consolidation

The current situation

Current projections for 2002 point to a considerably weaker fiscal outcome than previously projected. While part of the deterioration is due to the weaker-than-expected economic conditions and all countries have been negatively affected by this development, there are eight countries where this deterioration has not given rise to renewed imbalance. However, in the case of four countries deficits are still very high and the risk of an excessive deficit has increased.

Factors behind the difficulties and future challenges

The main reason why some countries are experiencing budgetary difficulties at present lies in the fact that they did not use the past period of higher growth to improve their fiscal position substantially. Given that this opportunity was missed, there is now no alternative but for all countries with remaining imbalances to make firm commitments to avoid excessive deficits and attain close to balance or in surplus budgetary positions.

In the past, consolidation deadlines have been postponed with negative effects on their credibility. According to the original commitments, all countries should already have attained fiscal positions close to balance or in surplus by 2002. For some countries this deadline was extended to 2003/04 to allow them to complete the transition phase within a reasonable period of time. However, it has now emerged that the countries have not been using the additional time to put their public finances on a lastingly sound footing. The current situation of public finances in some countries is also partly the result of overly optimistic growth assumptions and, consequently, insufficiently ambitious consolidation efforts. In previous stability programmes, some countries relied on too high growth projections. With growth lower than projected, these countries are now finding themselves with balances below their originally planned path and closer to the deficit limit of 3% of GDP.

In addition, excessive reliance on one-off measures has proven to carry particular risks for consolidation. First, such measures do not improve the structural fiscal position. Even if they are implemented as planned, they can only provide some short-term alleviation of fiscal pressures, but leave public finances vulnerable to adverse economic developments. Second, returns from projected asset sales are subject to changes in market conditions and these sales do not therefore represent a reliable source of revenue. They should thus not be relied upon as the foundation for ambitious consolidation plans.

Finally, the most recent developments have revealed the importance of timely and accurate reporting on fiscal developments. For a number of countries, fiscal balance estimates have had to be revised downwards substantially and were only submitted with considerable lags. Inaccurate projections induce a delayed implementation of policy measures and reduce the value of multilateral surveillance procedures.

Overall, there is now the need for decisive action in order to set up credible adjustment paths on the basis of realistic assumptions on the economic environment and of well-specified consolidation measures. Such adjustment paths must entail significant yearly improvements in the cyclically adjusted balance, to be followed strictly and completed within the shortest possible time frame. To underpin this process, strict monitoring procedures for the implementation of the consolidation strategies, the full use of the excessive deficit procedure and the application of rigorous accounting rules are warranted.

Fiscal consolidation and the outlook for growth

The call for the completion of the fiscal consolidation process also in those member countries where fiscal imbalances persist, i.e. to avoid excessive deficits and to attain budgetary positions close to balance or in surplus in the medium term, is by no means detrimental to the outlook for economic growth. Reaching budgetary positions in line with the Stability and Growth Pact will improve fiscal sustainability and create the much needed room for manoeuvre to cope with the long-term costs of population ageing. This prospect will support growth in the medium to longer term. As concerns the short term, the attainment of budgetary positions in balance or in surplus creates the flexibility to let actual balances fluctuate with the economic cycle. This is already the case in those member countries complying with the Stability and Growth Pact. Calling for the transition to be completed in the few remaining countries, at an ambitious but reasonable pace, should also not negatively affect growth, as direct effects on short-term demand are counteracted by higher credibility of the conduct of fiscal policy – boosting confidence and thus private spending.

In summary, appropriately designed fiscal consolidation measures foster confidence and enhance the potential for growth, thus increasing the chances of their lasting success and supporting the sustainability of public finances. In particular, consolidation strategies are likely to be more successful if they focus on measures that are growth-friendly and emphasise expenditure adjustment rather than revenue increases.