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The European experience with large fiscal adjustments

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The key question for European policy-makers and financial markets alike is now whether "Greece can make it" (Burda, 2010).

There is consensus that Greece must cut its deficit by about 10-12% of GDP in order to put the country's public finances back to a sustainable path (see Gros & Alcidi, 2010). The Greek government has promised that it will achieve this adjustment, but is this promise credible in the light of the experience in the EU? Our results suggest that an adjustment of this size is not without precedent, but it will probably take at least five years, and, even if the headline goal is reached, it might still leave the country in a highly unstable position.

What is the European experience?

Table 1 shows the 12 largest fiscal adjustments observed over the last decades in the EU. We concentrate on the cyclically adjusted primary balance as the main metric because it provides a better measure of the adjustment effort of the country by correcting adjustments that were achieved to a large extent through the operation of the fiscal multipliers (e.g. Sweden). The data we use are those published by the European Commission (which differs somewhat from the OECD data widely used in financial market commentaries (see, for instance, Boone et al., 2010)).

Inspection of Table 1 shows that at first sight there should be no problem. Greece has already achieved an adjustment of the size required today, namely in the early 1990s (then the improvement in the primary balance was almost 11% of GDP over five years). Other EU countries, namely Denmark, Sweden and Italy, have come close in terms of the overall adjustment. Others (Portugal, Finland and Belgium) would not be far behind with adjustments totalling about 8-9% of GDP.

This seems to suggest that, even if painful, a fiscal adjustment of 10% of GDP is (or rather has been in the past) possible.

But how? There are interesting differences in the way the fiscal adjustment was achieved (i.e. through cuts in spending or increases in taxes) and in the extent to which debt was actually stabilised.

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Table 1. Primary balance adjustment

Country	Primary balance adjustment period	Years	PB, start (% GDP)	Primary balance, adjustment (% GDP)	PB adjustment, per year (% GDP)
Denmark	1982-86	4	-1.3	10.0	2.5
Greece	1989-94	5	-6.0	10.8	2.2
Sweden	1993-98	5	-2.5	9.0	1.8
Ireland	1985-89	4	-0.9	5.9	1.5
Portugal	1986-80	6	-5.8	8.2	1.4
Italy	1989-97	8	-3.3	10.4	1.3
UK	1993-99	6	-3.6	7.4	1.2
Finland	1992-2000	8	0	8.2	1.0
France	1993-97	4	-2.4	3.6	0.9
Belgium	1981-90	9	-4.3	8.1	0.9
Austria	1995-2001	6	-1.5	4.7	0.8
Netherlands	1990-2000	10	-0.8	4.5	0.4

Note: Primary balance figures are adjusted for the cyclical component (adjustment based on GDP trend).

Source: European Commission (AMECO) and authors' calculations.

Expenditure cuts versus tax increases

Table 2 shows that in the Mediterranean countries (Greece, Portugal and Italy) the adjustment tends to occur through increases in government revenue, with small, if any, cuts on the expenditure side. This is in stark contrast with most other countries, and even more markedly with the Nordic ones, where the corrections tend to be based on large reductions in government expenditure. France qualifies on this account as a member of the 'Club Med', since about 71% of its adjustment in the 1990s (total 'only' of 3.6% of GDP, see Table 1 above) was achieved through revenue increases.

Table 2. Government revenue and expenditure adjustments as a share of total primary balance adjustment

Country	Primary balance adjustment period	% of total PB adjustment through increase in revenue	% of total primary balance adjustment through cut in expenditure
Portugal	1986-80	110.6	-10.6*
Italy	1989-97	85.3	14.7
Greece	1989-94	84.0	16.0
France	1993-97	70.7	29.3
Denmark	1982-86	28.2	71.8
UK	1993-99	20.0	80.0
Austria	1995-2001	12.2	87.8
Belgium	1981-90	1.8	98.2
Sweden	1993-98	-25.7*	125.7
Ireland	1985-89	-46.9	146.9
Finland	1992-2000	-63.4	163.4
Netherlands	1990-2000	-89.1	189.1

*Negative sign implies that expenditure increased.

Source: European Commission (AMECO) and authors' calculations. *Note*: General Government revenue and expenditure figures are adjusted for the cyclical component (adjustment based on GDP trend).

Stabilisation of the debt to GDP ratio

The goal of the large fiscal adjustments is to make public finances sustainable. However, as Table 3 shows, this goal was rarely achieved, especially if the primary balance was in large deficit at the beginning of the adjustment process.

For example, as shown in the first row of Table 3, during the 10 years of its fiscal adjustment, Belgium's gross debt ratio increased by more than by 50 percentage points of GDP. Something similar happened during the adjustments in Greece, Portugal and Italy, where the debt-to-GDP ratio continued to increase by more than 20 percentage points of GDP. This implies that if Greece were to repeat over the next few years its performance during the early 1990s, it would end the adjustment process with a debt ratio of over 150% of GDP.

However, the data also suggest that the adjustment periods considered did at least succeed in stabilising, or nearly stabilising, the debt ratio in most countries (it continued to increase, by a small amount, only in Belgium and Greece).

The case of Italy is exceptional; debt kept increasing at a fast pace during the time of the big correction and then, in the following years, a significant shift took place as the effect of a lower interest rate materialised.

Table 3. The effect of the primary adjustment on debt

Country	Primary balance, adjustment period	Debt, start (% GDP)	Implicit interest rate spread	Change in debt (% GDP)	Durable? Change in debt, 5 years after (% GDP)
Belgium	1981-90	74.1	na	51.6	4.2
Greece	1989-94	64.2	7.5	32.1	4.0
Portugal	1986-80	30.5	na	28.2	-1.2
Italy	1989-97	93.1	3.9	25.0	-12.4
France	1993-97	46.5	0.2	13.0	-0.5
Finland	1992-2000	40.0	1.5	3.8	-2.0
Denmark	1982-86	64.5	na	2.0	-3.7
Sweden	1993-98	69.9	0.9	-0.9	-16.8
UK	1993-99	44.5	1.0	-0.9	-3.1
Austria	1995-2001	68.3	-0.3	-1.3	-4.8
Ireland	1985-89	100.7	na	-1.3	-10.7
Netherlands	1990-2000	76.8	0.9	-23.1	-2.0

Source: European Commission (AMECO) and authors' calculations. *Note*: Implicit interest rate (interest paid as % of gross debt) spread is the difference between the average implicit interest rate of the country and the German average over the same time period.

Concluding remarks

Two patterns emerge from this brief review:

- Fiscal adjustments of the size now required by Greece (and probably soon by Portugal and Spain) have been possible in the past.
- Adjustments of this size require time, typically at least five years; and the debt-to-GDP ratio keeps on increasing during the adjustment process.

For Greece, the historical precedent suggests that a fiscal adjustment of 10 percentage points of GDP ought to be possible. But it might be based only on tax increases without reductions in expenditure, which would likely leave the debt-to-GDP ratio at such a high level (150% of GDP) that the country would be excluded from financial markets for a long time.

References

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