PEMPAL 2015 BCOP PLENARY MEETING

FISCAL CONSOLIDATION

February 11-13, 2015, Yerevan Armenia

SUMMARY REMARKS BY ZACHARY MILLS

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General Comments

1. The meeting focused on the experience, the lessons, the tools, and country examples of fiscal consolidation. This note provides a summary of the key issues and lessons discussed over the course of the plenary.[1]

Clarifying Definitions

2. There is no standard definition of fiscal consolidation, but it is usually interpreted as a sizeable adjustment of at least 1% of GDP per year. It can include both expenditure and revenue measures to reduce the debt or deficit, and is usually measured by changes in the *cyclically adjusted primary balance to GDP* or the *debt to GDP ratio*.

3. Spending reviews is a tool that has been used to support the fiscal consolidation process. There was misunderstanding of what was meant by spending reviews by some participants who did not attend the previous BCOP events which discussed this topic. A spending review analysis covers the evaluation of programs, policy, and organization from a functional or strategic perspective, and can be interpreted as a comprehensive 'cost-benefit analysis' of an existing expenditure program. For this reason, they are more sophisticated than in-year budget adjustments and follow certain defined methodologies that can be adjusted (ad hoc vs. systemic; comprehensive vs. narrow) to suit both their primary objectives and country-specific institutional arrangements.

Importance of Good Fiscal Data

4. Timely and quality data is needed for fiscal consolidation packages to be designed appropriately. For these reasons, it is necessary to have:

- Accurate multiyear fiscal projections, capturing macroeconomic, expenditure, and revenue variables that capture seasonal and global effects;

[1] Presentations and other information can be accessed at http://www.pempal.org/event/read/130

- Comprehensive and frequent budget execution reporting;
- Debt sustainability analysis.

5. The meeting also discussed the importance of having accurate fiscal risk analysis, covering both explicit and implicit contingent liabilities. For example, unforeseen fiscal risks, especially state-owned enterprises, significantly contributed to the fiscal crisis in Portugal, which required an international bailout to remain solvent.

6. Since fiscal consolidation measures are often designed in reaction to a crisis, it is also important to have units in place to provide fiscal and social impact analysis of policy measures. This analysis could prevent counterproductive measures from being adopted.

Context Matters

7. There is no one size fits all for fiscal consolidation measures. Experience has shown that reform measures are influenced by the initial conditions in a country and the severity of the fiscal situation, including:

- Initial public debt levels;
- Market reaction;
- Political cycle; and
- Social conditions.

8. These contextual factors will also shape the design choices, such as the pace of adjustment (upfront vs. balanced) and the scope of adjustment (expenditure vs. revenue mix). The meeting discussed in length the pros and cons to the different design choices and also shared the experience from regional countries.

Fiscal Consolidation Tools

9. The meeting presented several tools that have been used to support fiscal consolidation. The range of spending review approaches is summarized below in Figure 1. The meeting also discussed how one would carry out a spending review by considering the four key issues:

- Managing and organizing a spending review (who will carry it out and what level of political support will be given);
- How to set clear targets and costing options (guidance on discretionary vs. non-discretionary spending items, frontloading vs. backloading, how to prevent gaming and perverse incentives, etc.);

- Integration with annual and medium-term budget frameworks (important for sustainability); and
- Building and embedding a culture of appraisal and evaluation (a process as part of a greater results-based management orientation to Government).

Figure 1. Spending Review Approaches

		SCOPE	
		Targeted	**Comprehensive**
FREQUENCY	Annual	Strategic Reviews: Australia: 2007- Spending Reviews: Netherlands 1981- Program Evaluations: Korea: 2006-	Zero Base Budgeting: USA: 1970s Activity-Based Costing: USA: 1980s
FREQUENCY	Periodic	Value for Money Reviews (Various NAOs) UK Spending Review (UK: e.g. 2011 Defense Review)	CSR: UK 1997-, Australia 2007 Netherlands, 1981, 2009 Program Review: Canada 1994-98 Expenditure Review: Ireland 2011- RGPP: France 2008

Source: Presentation at BCOP Plenary Meeting 2015 "Country Cases: Thinking about spending reviews in EU new member states (NMS): design choices", Theo Thomas, Lead Economist, World Bank

10. The meeting also presented a customized wage bill forecasting tool, which can accurately forecast the fiscal impact of changes in public pay and staffing policies. Growth in the wage bill has been shown to be a significant driver of overall expenditure growth. This tool can help the authorities to evaluate the tradeoffs between higher pay and higher employment, and also project the winners and losers in a reform scenario.

11. The use of fiscal rules were also discussed. They have proven to be more useful in some contexts than others. This topic will be more thoroughly discussed in the next BCOP plenary meeting.

Success Factors

12. Several key success factors have emerged from previous examples of large fiscal adjustments, including:

- *Sustained political leadership:* The highest levels of Government must be seen to be supporting the reforms to help set the vision, take unpopular decisions, and overcome resistance. This type of support can manifest in various forms to manage the reform process, such as Government (or cabinet) steering committee to lead the fiscal consolidation, which is often chaired by the Minister of Finance.

- *Strategic and long-term vision:* Structural reforms often take several years to be implemented. For example, it is more difficult to make significant reforms to staffing levels, institutional structures, or the revenue administration in just twelve months. For this reason, it is important to have a long-term vision of where the reforms will take the country and what are the needed steps along the way.

- *Build credibility, manage expectations:* Adjustments can proceed at different paces, but they must be seen to be having an impact if support is to be maintained. For this reason, countries have set targets that they were confident of meeting to assuage both the public and the markets that the fiscal consolidation plan was on track and was effective. However, fiscal consolidation by its nature implies expenditure cuts or revenue increases, which will generate resistance from various stakeholders. Thus, a clear and consistent communication strategy is needed to build support and overcome this resistance.

- *Avoid temptation:* Successful examples of fiscal adjustment have not shifted the burden of adjustment to the private sector (delays in payments to suppliers, buildup of payment arrears, etc.) or local governments (unfunded mandates). Similarly, the public investment budget is one of the easier items to cut, but deferring maintenance and delaying investment in critical infrastructure can decrease future growth potential.

- *Inform and empower decision makers in agencies:* Line ministries have more detailed knowledge of their operations than the Ministry of Finance. For this reason, in successful fiscal consolidation examples, the Ministry of Finance has often empowered line ministries, under certain parameters, to take the lead in proposing different reform options. This more flexible approach allows Government to be more strategic in defining its fiscal consolidation package.

- *Transparent fiscal data:* As discussed earlier, timely fiscal is crucial to understand the severity of the fiscal situation, identify fiscal risks, quantify social and impacts of different proposals, and design the appropriate response. This data can provide an early warning sign that the fiscal situation may be worsening.

- *Medium term perspective, strengthened forecasting:* A fiscal consolidation package is usually quantified over several years and crucially depends upon accurate multiyear fiscal projections, which derive from strong forecasting methods. This area has often been identified as an area of weakness in many countries.

- *Spending Review to inform decisions:* As discussed earlier, spending reviews and other fiscal management tools have proven to be a key input into the fiscal consolidation package and can help countries to be more selective and strategic in the design of reform measures.

- *Adjustment in both revenues and expenditures:* Successful experiences from other countries included both revenue and expenditure measures in their fiscal consolidation reforms.
- *Competitiveness and growth enhancing reforms:* Countries have chosen to target expenditure cuts to less priority areas, while safeguarding education spending and other job training to promote future competitiveness. At the same time, they tried to avoid or minimize measures that had negative social or growth impacts.

Be Prepared

13. The 2008/2009 global financial crisis generated significant fiscal stress across the world and continues to negatively impact economies in the Eurozone. This crisis was not foreseen and followed a period of rapid global expansion. As a result, countries were ill-prepared to implement fiscal consolidation measures in a volatile and rapidly deteriorating fiscal environment. For this reason, it is important to put in place systems that monitor fiscal and program performance. Latvia, for example, was severely affected by the crisis, which culminated in a budget deficit of 18% of GDP. Because it had already institutionalized a results-based management system, however, it was able to use its existing performance information to move quickly to implement a reform strategy.