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Ten guidelines for budget consolidation

Preamble: the necessity of budget consolidation

The consolidation of public budgets is necessary since interest payments swallow up an ever larger share of revenue. In most European countries the interests payments are higher than expenditure on education. Those economists and politicians who are in favor of stimulus programs in the crisis ultimately have to favor consolidation, if for no other reason than bringing an economy into a position to fight the next crisis. Most countries had deficits even before the crisis and in economically strong times (structural deficits).

Consolidation is not the only priority; a coherent strategy is needed

1. Consolidation is however not the only priority at the top of the list of economic goals. Unemployment is also high on the agenda; programs to boost innovation, to improve education, for child care, to cope with the ageing society and environmental problems are also urgently needed. If each of these priorities is pursued separately, instruments solving one problem may impair the probability to reach the other goals. Furthermore, policy instruments would be too expensive. Only an integrated strategy can serve three main goals (consolidation, employment creation, and future investment) at a time where there are limited policy instruments available and resources.

Communication and vision are important

2. Successful consolidation strategies should be well communicated, follow a strict time table, be motivated positively and be seen as a chance to eliminate inefficiencies and outdated expenditures. The time table should fit the problems at hand and not be dictated by financial markets. It should be internationally coordinated so that not all countries consolidate at the same time at the same speed. The size of consolidation packages should be ambitious and the time frame short (frontloading). No rhetoric of a long period of austerity should be used.

Time to start, economic environment and flexibility

3. The consolidation should start when the economy is in a good position and it should incorporate an po-active component. Future investment to stimulate long-term growth should not be stopped but specifically enforced by financial means but also using organizational changes. If there is a five year moratorium on growth drivers, consolidation will never work since lower growth will reduce tax receipts and increase expenditures. Therefore cuts to "obsolete or inefficient" expenditures should be rather ambitious to allow room for future investment. Consolidation should be flexible, but there should be no stop and go. If the business environment (and the world economy) deteriorates the

reforms should not be stopped, but investments for the future including activation and requalification (active labor-market policy) should be increased.

Burden sharing and fairness

4. The consolidation strategy should be fair. This does not mean that "everybody should pay", but that equality issues are actively addressed. Before the crisis started, income and wealth distribution changed in favor of high incomes at the expense of low incomes. This problem has been aggravated since unemployment hits less qualified people more. Therefore groups with lower incomes and groups with higher unemployment risk should be exempted from tax increases and those expenditures most important for the low income sector should not be cut. Measures to combat unemployment should be continued (activation, flexicurity, improving matching).

Consolidation should be growth-sensitive

5. Consolidation has to be growth-sensitive. The structure of public revenues should be shifted from taxes inhibiting economic growth strongly to those with a less negative impact. The structure of government expenditures should be shifted from public consumption to expenditure on growth drivers. Complementary strategies available to boost long term growth should be given a high priority, specifically promoting the creation of new businesses and competition, taking advantage of globalization, switching incentives towards qualification and activation in the labor market and making regional programs more growth-friendly.

Consolidation has to be demand-sensitive

6. Consolidation has to be aware of the short-run negative demand effects and therefore be demand-sensitive. If government reduces its net expenditures then private consumption, investment or exports have to substitute lost demand. Thus cutting transfers to low income people should be no part of a demand sensitive strategy and expenditure should be prioritized in general according to demand effects. This implies that incentives to save should be reduced, and incentives for private investment or for environmental investments (households and firms) should be increased. In principle there will be a period of lower demand in a consolidation period but it has to be kept as short as possible and the demand diminishing effect has to be kept as low as possible.

Expenditure-based consolidation more likely to be successful

7. Consolidation is successful in the long run, if expenditure cuts dominate rather than tax increases. This is specifically the case in Europe, where taxes are high, and where we have a period where public expenditure has risen (from 45.0% to 51.4% in 2010). One problem with focusing on expenditure cuts is that some of the reforms take time, specifically those lowering the long run costs via system changes (e.g. from curing of diseases to the prevention of illness, school reforms, fiscal regime changes). In the short run taxes may help to achieve the consolidation goals more quickly. But any tax

increases have to be growth and demand sensitive, and taxes with double dividends should be the first choice (financial transaction tax, taxes on public bads including environmental taxes). After the consolidation the taxes should be decreased, specifically those on labor and consumption, so that the long-run perspective for investors and consumers is a constant overall tax share. Privatization can also lead to quick revenues if expenditure cuts are not sufficient or too slow, but here long run considerations (dividend losses, steering capacity) should be considered (so that maybe partial privatization, which yields quick revenues and long term increases in productivity and dividends may be a good strategy).

Boosting domestic demand specifically in low growth countries with current account surplus

8. During consolidation domestic demand should be stimulated, specifically in countries with low growth and high surpluses in trade. In case investment remains sluggish (cash flows are not used for investment due to unused capacities), wage increases and/or in work benefits would stimulate consumption. Following a strategy that wages are raised less than productivity has lead to a decreasing wage share in national income. This makes no sense if the extra profits are not used for investment. Policy differences may apply according to the situation in individual countries. Export promoting strategies should concentrate on countries which do not have to consolidate.

The structure of expenditures matter

9. Expenditure should be shifted towards growth promoting categories (and those stimulating demand over-proportionately). This implies cuts where state intervention is no longer necessary, where inefficiencies exist, and increases where growth drivers are concerned or structural unemployment is reduced. Linear cuts are clearly suboptimal, even if they are easier to be implemented. Any difference should be large in the sense that inefficiencies are eliminated drastically. Investment enhancing future prospects should not only be exempted from cuts, but increased at rates significantly higher than nominal growth.

The structure of taxes matter

10. Some taxes inhibit growth strongly (labor, business), some far less (value added, property, financial transactions). Shifting taxes from labor to property increases growth. However increasing potential growth is not the only goal. Demand is another one, reducing unemployment and equality is all important for the acceptance of this strategy. This moves the bias against a general increase of the value added taxes. These are first a burden specifically for low incomes and secondly they will reduce consumption, which up to now is a relative stable demand component (as compared to investment). Specifically important would be to reduce the tax wedge for lower incomes (for both reasons, lowering unemployment and increasing equality). If a temporary increase in taxes is needed it should eventually be used to lower taxes on labor.

The gist of the matter

Consolidation is not an easy task. The bad news is that demand decreases in the short run. The good news is that this period can be kept short and its effects mitigated by appropriate policies flanking any consolidation and that in the long run growth is not affected negatively (or in some favorable cases it is even positively affected). This is the case only if the strategy is followed consistently, it is well communicated, accepted as fair, if growth and demand effects are addressed, and complementary reforms are implemented. Consolidation is not an isolated task and not the only priority of an economy. It has to be embedded in a comprehensive strategy for growth, employment creation and solving the long run problems of an economy. National fiscal frameworks should be adapted and budgetary rules to maintain budgetary balance and debt sustainability should be established. A comprehensive strategy for consolidation, employment creation and high long-run growth should at least be partly internationally coordinated and should be steered and monitored by the political system and not be driven by the financial markets. The financial markets should be reformed so as to stabilize the financial system and to serve their original function, namely to promote the real economy.

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