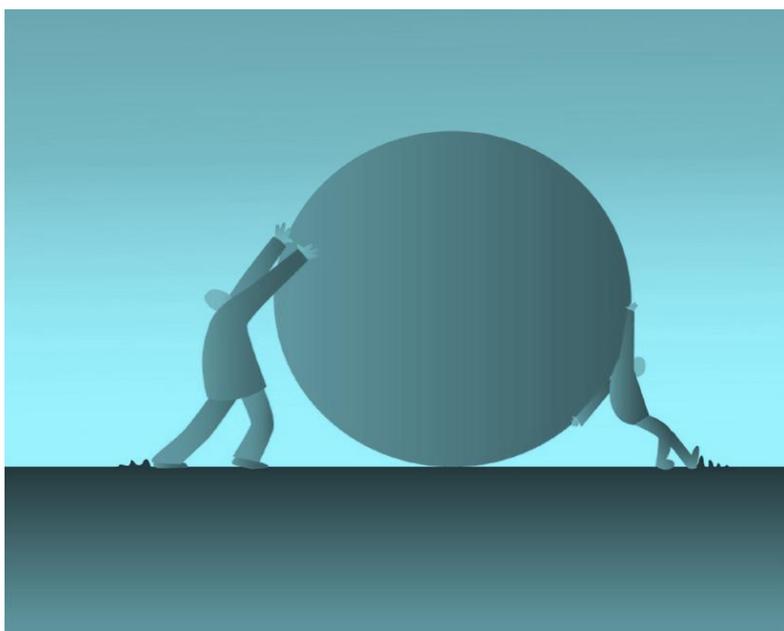


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ECONOMICS DEPARTMENT POLICY NOTE No. 11

FISCAL CONSOLIDATION: HOW MUCH IS NEEDED TO REDUCE DEBT TO A PRUDENT LEVEL?



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FISCAL CONSOLIDATION: HOW MUCH IS NEEDED TO REDUCE DEBT TO A PRUDENT LEVEL?

- Government debt has soared in most countries and will need to be brought down to prudent levels.
- Large fiscal consolidations of over 3% of GDP will be needed in many, though not all countries.
- While a few countries have limited need to consolidate, fiscal tightening of up to 12% of GDP will be required by Japan and of more than 8% by mainly English-speaking countries.
- The toll of the crisis on public finances has contributed to larger needs for fiscal consolidation in most countries, but in many countries this only aggravated existing imbalances.
- Future health and long-term care spending account for consolidation needs of around 2% of GDP on average across the OECD.

Most countries need to consolidate

1. The economic crisis that began in 2008 caused government deficits to surge, and fiscal imbalances were swollen further by stimulus measures and bank rescue operations. Together, these forces led to ballooning public indebtedness, the general government public debt-GDP ratio rising from under 80% of GDP in 2008 to almost 100% of GDP in 2011 (Figure 1). For many countries, just stabilising debt – let alone bringing it down to a sustainable level – is a major challenge.

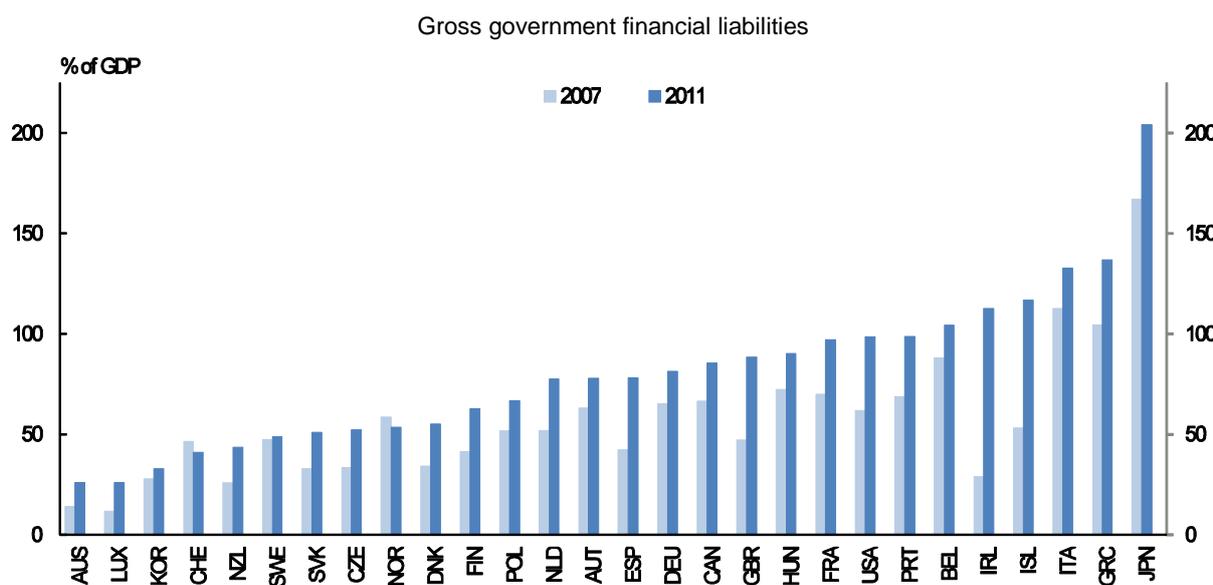
2. While different debt targets will be appropriate for different countries, a target of bringing gross debt down to around 50% of GDP can, nonetheless, be supported by some arguments. For example, empirical estimates suggest that changes in the functioning of the economy occur around debt levels of 70-80% of GDP. Interest rate effects of debt seem to become more pronounced, discretionary fiscal policy becomes less effective because offsetting private saving responses become stronger and trend growth seems to suffer. Hence, for a standard country, building in a safety margin to avoid exceeding the 70-80% levels in a downturn suggests aiming for a 50% or even lower long-term debt target during normal times.

Consolidation needs can be assessed with fiscal gaps

3. The consolidation needed to bring gross debt down to prudent levels – concretely, 50% of GDP – in the long term can be assessed by “fiscal gaps”. Recent OECD work has estimated such fiscal gaps, based on long-run projections that go until 2050. The calculations make the assumptions that the fiscal tightening plans enacted before spring 2011 will be fully implemented in 2013, thereby taking into account OECD projections of near term developments, and that this is sustained. The size of the fiscal gaps differs

across countries mainly because of differences in underlying deficits at the starting point of the gap calculations and to a lesser extent due to differences in the level of debt in 2013. The differential between the growth rate and the interest rate is also an important determinant of long-term sustainability, with higher interest rates on government debt relative to growth rates implying a need for more fiscal consolidation. For the simulations interest rates on government debt are assumed to rise by 4 basis points for every percentage point that debt exceeds 75% of GDP. The calculations do not take into account that the policy instruments used to achieve the necessary consolidation may have side effects on economic growth.

Figure 1. **Debt has jumped during the crisis in almost all countries**



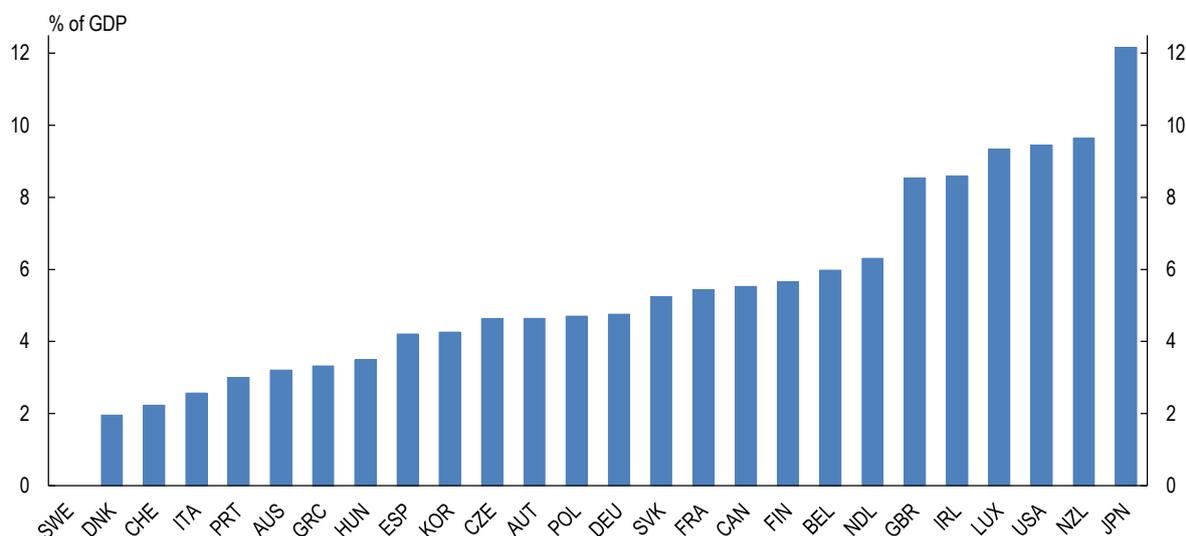
Source: OECD Economic Outlook 89 Database.

Consolidation needs vary a lot across countries

4. The fiscal gaps vary enormously across countries when projections incorporate spending pressures emanating from pension, health and long-term care spending (Figure 2). For example, the fiscal gaps for Ireland, Japan, Luxembourg, New Zealand, the United Kingdom and the United States exceed 8% of GDP. On the other hand, a number of countries – Sweden, Denmark and Switzerland – either face no or low tightening requirements to meet the debt target in 2050. This is based on the assumption that public spending outside the above-mentioned entitlement areas can be kept constant as a share of GDP. The fiscal gaps do not change markedly relative to the baseline if alternative debt targets are used, because even relatively small changes in underlying fiscal positions add up when maintained for 40 years.

Figure 2. **How much consolidation is needed: fiscal gap results**

Immediate rise in the underlying primary balance needed to bring gross financial liabilities to 50% of GDP in 2050



Note: Projections include health and long-term care and also pension spending.

Source: Merola, R. and D. Sutherland (2012), "Fiscal Consolidation: Part 3. Long-run Projections and Fiscal Gap Calculations", OECD Economics Department Working Papers, No. 934, OECD Publishing.

The impact of the crisis on fiscal gaps is varied

5. As noted above, the increase in debt between 2007 and 2012 was largely driven by the impact of the financial and economic crisis. The impact of the crisis can be assessed by evaluating the effect of the changes in the underlying fiscal position, the debt level and the interest rate paid on debt.

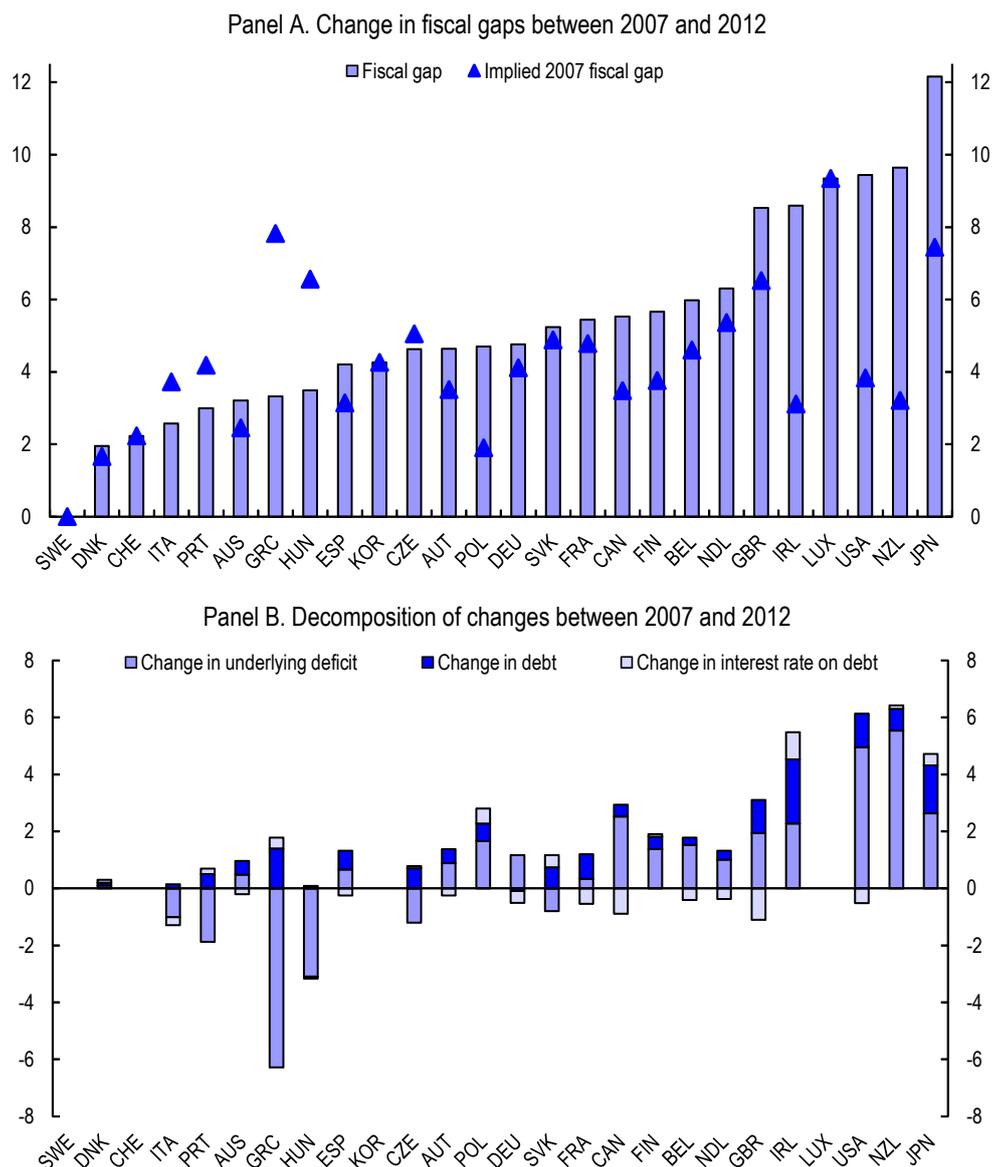
- How the crisis has affected the size of the fiscal gaps can be seen in Figure 3, panel A. While the impact of the crisis has been substantial in some countries, it often represents a relatively small part of the overall fiscal challenge, which is for many countries driven by future pension and health care spending pressures (see below). In a number of countries – Korea, Luxembourg and Switzerland – the fiscal gap does not appear to have been affected at all by the crisis and is driven by projected developments in health and long-term care and pension spending.
- How the crisis altered fiscal gaps between 2007 and 2012 is shown in Figure 3, panel B. Countries where underlying deficits have deteriorated most – for example, New Zealand and the United States – generally face much larger fiscal gaps. In some cases, such as Ireland, debt developments during the crisis have contributed significantly to the fiscal gap. A number of countries, notably Canada, Germany, the United Kingdom and the United States have benefited from declines in the interest paid on government debt. Countries undertaking large fiscal consolidations, such as Greece, Hungary and Portugal, generally face moderate fiscal gaps due to the assumption that the large improvements in underlying balances achieved by 2012 are maintained.

6. It may seem ironic that euro area countries with relatively modest fiscal gaps are the victims of a virulent debt crisis whereas other countries with much larger fiscal gaps enjoy very low bond yields at present. This partly reflects concerns about potential needs for intervention in euro area banking systems,

but also that euro area debt essentially corresponds to foreign currency denominated debt for the individual country. In the absence of corrective action, higher interest rates could lead to substantial increases in debt, particularly in high debt countries (e.g. Japan) but also for those countries running large structural deficits (e.g. the United Kingdom, Ireland, New Zealand and the United States).

Figure 3. **The contribution of developments over the crisis on fiscal gaps**

Immediate rise in the underlying primary balance needed to bring gross financial liabilities to 50% of GDP in 2050, and the impact of the change in the underlying deficit, debt level and interest rate on debt between 2007 and 2012



Note: The fiscal gap calculation includes health care and long-term care costs as well as projected increases in pension spending. The implied 2007 fiscal gap considers the impact of the prevailing underlying fiscal position, debt levels and interest rates in 2007 on the 2012 fiscal gap. The contribution of changes in the underlying deficit, debt levels and interest rates are evaluated as the difference from the fiscal gaps in the baseline simulation. A negative contribution implies that the underlying fiscal position improved or the interest rate paid on government debt fell between 2007 and that projected for 2012.

Source: OECD calculations based on the *OECD Economic Outlook Database*.

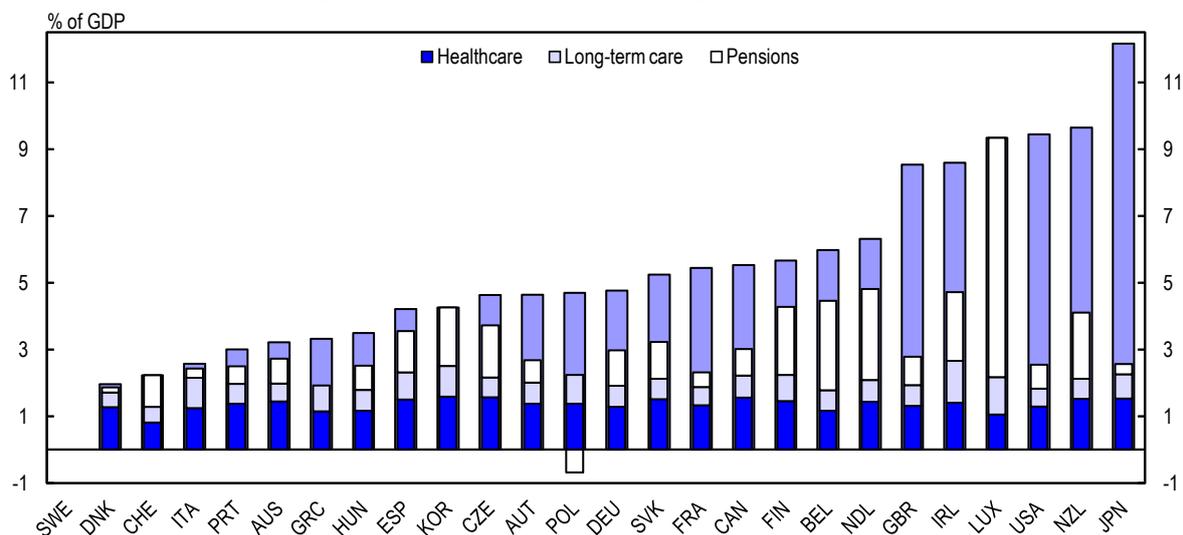
Future pressures on spending undermine debt sustainability

7. Future spending pressures arising from health and long-term care and pensions account for a large portion of fiscal consolidation needs in all countries with the exception of Sweden.

- In the case of health care spending, higher levels of spending are not necessarily undesirable, but its financing can create difficulties. OECD wide, health care spending projections reveal that health and long-term care spending could rise by around 6% of GDP by 2050 (if policies managed to curb spending growth the rise in spending could be limited to 2.5% of GDP). As the projected increases are fairly similar across countries, because health spending is not primarily driven by demographics but rather by expected supply developments, the impact on the fiscal gaps does not vary much across countries. Nonetheless, the fiscal gaps rise by over 1.5% of GDP in Canada, the Czech Republic, Japan, New Zealand and Switzerland (Figure 4).
- The impact of pension spending can account for a large part of the fiscal gaps for many countries (Figure 4). The fiscal gaps of the countries facing the largest pension financing problems, such as Luxembourg, Belgium and the Netherlands underscore that meeting these challenges would be better addressed by reform. In some cases, such as Greece and Spain, reforms to the pension systems in 2010, which are incorporated in the projections, have addressed significant pressures emanating from this source. In Sweden and Poland, however, maintaining the current underlying fiscal position combined with the implications of the notionally-defined contribution pension system means that no additional or less tightening is required to meet a gross financial liabilities target of 50% of GDP in 2050.

Figure 4. **The contribution of healthcare, long-term care and pension spending to fiscal gaps**

Immediate rise in the underlying primary balance needed to bring gross financial liabilities to 50% of GDP in 2050



Source: Merola, R. and D. Sutherland (2012), "Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations", *OECD Economics Department Working Papers*, No. 934, OECD Publishing.

Suggested further reading

The main papers providing background to this note are:

Merola, R. and D. Sutherland (2012), “Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations”, *OECD Economics Department Working Papers*, No. 934, OECD Publishing.

OECD (2012), “What are the Best Policy Instruments for Fiscal Consolidation?”, *OECD Economics Department Policy Notes*, No. 12.

Sutherland, D., P. Hoeller and R. Merola (2012), “Fiscal Consolidation: Part 1. How Much is Needed and How to Reduce Debt to a Prudent Level?”, *OECD Economics Department Working Papers*, No. 932, OECD Publishing.

Additional related papers include:

Barrell, R., D. Holland and I. Hurst (2012), “Fiscal Consolidation: Part 2. Fiscal Multipliers and Fiscal Consolidation”, *OECD Economics Department Working Papers*, No. 933, OECD Publishing.

Blöchliger, H., D.H. Song and D. Sutherland (2012), “Fiscal Consolidation: Part 4. Case Studies of Large Consolidation Episodes”, *OECD Economics Department Working Papers*, No. 935, OECD Publishing.

Hagemann, R. (2012), “Fiscal Consolidation: Part 6. What are the Best Policy Instruments for Fiscal Consolidation?”, *OECD Economics Department Working Papers*, No. 937, OECD Publishing.

Molnar, M. (2012), “Fiscal Consolidation: Part 5. What Factors Determine the Success of Consolidation Efforts?”, *OECD Economics Department Working Papers*, No. 936, OECD Publishing.

OECD (2011), “Chapter 4. Medium and Long-term Developments: Challenges and Risks”, *OECD Economic Outlook*, Vol. 2011/1, No. 89, OECD Publishing.

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