Reform in the European Public Finances

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The recent economic crisis inflicted substantial damage on the public finances of many countries around the world. Enormous stimulus programmes, bank bail-outs, increased welfare and unemployment payments, and depressed tax receipts weighed heavily on government balance sheets. To make matters worse, some countries were already running substantial deficits before the crisis hit. When fears of another great depression began to recede, news of another crisis began to emerge.

One problem is that, in today's global markets, financial difficulties, whether in large countries or even in relatively small developed countries, can affect the entire financial system. The responses also have to be international.

As in 2008, this truth was again evident in 2009, when rumblings among investors about the size of the Greek budget deficit caused uneasiness in already-fragile financial markets.

In the months that followed, these rumblings turned into a full-fledged crisis that eventually spread to other European countries. In spiral effect, investors, nervous about the ability of some countries to repay their public debts, charged high premiums to hold government bonds. This in turn provoked downgrades on sovereign debt ratings, which made debt even more expensive. Other European countries, including Ireland, Portugal and Spain, repeatedly found themselves having to reassure the markets that their investments were safe. But the downgrades continued and the Euro area seemed under attack, as did the stability of the euro itself. This prompted unprecedented intervention by the European Commission, the European Central Bank, EU member states and the International Monetary Fund.

The EU Members states view is clear. What the recovery needs is for governments to restore order to public finances while enacting reforms in the structure of their

economies to enable growth to take hold. These include changes to streamline administration, activate labour markets, improve competition and bolster spending on social security. It means targeting taxes that favour greener growth, and focusing spending on education, innovation, healthcare and infrastructure. And it means doing all of this while continuing to support development aid and investment in poor countries.

One area that needs more attention is civil service governance. The factors that motivate public servants flow from civil service legislation and procedures, and from a culture which has, in most EU countries, developed over decades, if not centuries.

Yet contemporary public management attention tends to focus on processes such as competencies, contracts, training or pay for performance. There is a danger that the constitutional, legal, cultural and leadership factors which together create what is important and distinctive about public services and the people who work in them, are not considered or, worse, are dismissed as the bureaucratic problem which must be "reformed".

Every organisation, from an assembly line manufacturer to a government office, must rely on informal factors such as staff commitment and the sense of joint purpose if it is to be successful. In complex areas of activity where performance is impossible to measure in any comprehensive way, these informal cultural factors become the prime means of direction, motivation, co-ordination and control. There is no area of activity more complex than the policy domain of government, and it has long been recognized that the core public service is controlled more by culture than by rules, a situation that is likely to continue despite progress in target-setting, performance contracts and measurement

Even when governments have met the challenge of making reforms relevant to the country's situation and set of problems, public management literature provides very little guidance about how to set the order of reforms. It is true that political opportunities for change open up in an unpredictable fashion – usually in response to high-profile public management failures or the emergence of new national challenges.

But when such opportunities do emerge, it is important that the public sector advisers involved understand the systemic consequences of different options, and of the sequence in which action should be taken if the desired results are to be achieved.

Two objectives of budgetary policy are an efficient allocation of resources subject to a fair distribution of income and a stable macroeconomic environment. The work in public finance covers **five main areas:**

- fiscal policy,
- taxation,
- public expenditure and
- fiscal federalism

This Research Report discusses the size of current consolidation requirements and the pace at which budget positions should be strengthened to 2020. It analyses what spending and revenue changes can be used to achieve consolidation, taking into account the scope for each instrument to generate budget improvements, its impact on growth and equity, and its likely political acceptance.

Major changes to the budgeting and financial management process

The budget and accounting process has become the operational planning tool of government and provides the architecture for accountability. The current vogue for including performance targets and measures has further strengthened the role of the budget (and finance ministries) as a lever for change.

Financial crises are not only typically associated with sharp economic downturns, but also with a substantial deterioration of fiscal positions. Declining revenues due to weaker economic conditions and higher expenditures associated with bailout costs and fiscal stimulus measures have historically led to a rapid deterioration of fiscal balances and a substantial increase in public debt.

For most EU countries, present consolidation plans envisage some mix of spending restraint and revenue-raising measures. If current spending and revenue collection arrangements reflect optimal public choice, with the marginal benefit of additional spending equal to the marginal costs of a corresponding tax hike**,** a case could be made to share consolidation efforts equally between spending cuts and tax hikes. Also, with unsustainable revenue buoyancy prior to the crisis having resulted in spending increases in some countries and tax cuts in others, it might be appropriate to revert back to earlier spending and revenue norms. The choice of consolidation instruments needs to take into consideration their impact on a number of policy objectives beyond budget consolidation, including short-term aggregate demand, economy wide efficiency and equity, as well as their political acceptance

Spending cuts

1. *Reducing the government wage bill and raising public sector efficiency*

Given that employment costs account for a large part of government spending, reductions in government wage bills can improve budget positions relatively quickly, even if such measures could have sizeable negative effects on aggregate demand in the short run. Indeed, several recent consolidation plans, in particular in Germany, France, Italy, Spain, Ireland, Greece and the United Kingdom, foresee some savings on the government wage bill.

Reducing government consumption *via* wage cuts (or lower wage increases than would otherwise take place) may be more appropriate and politically easier to implement if government wages are relatively high. In particular, private sector wage restraint during the crisis might have raised relative wages in the government sector, in which case public sector wage adjustment would also involve a realignment. Moreover, government wage restraint can be particularly appropriate for countries in a currency union that need to improve cost competitiveness as it may lower input costs of government services for other sectors of the economy and support wage moderation overall. However, pushing wage levels in the public sector below those for comparable jobs in the private sector would create problems for retaining and attracting qualified personnel, which might not be sustainable in the longer run as the quality of service delivery would suffer.

Many governments also have an opportunity to use the coming wave of retirements in their public sectors to reduce government employment without lay-offs by replacing only a certain fraction of departures. To the extent that cuts in public sector employment are associated with reductions in public sector services, care should be taken that output and quality are not unduly affected in areas that are growth enhancing, such as education, research and development and health care. Moreover, such retrenchment, if associated with lower supply of services rather than with greater efficiency, may be more prejudicial to low-income groups and, hence, conflict with equity goals and raise political resistance. Short-term demand effects of employment cuts will depend on the extent to which private employment can expand to offset employment losses in the public sector which may affect the level of net short-term budgetary savings.

More generally, cost-benefit analysis should become more of a guide for public sector spending programmes than is presently the case. This might include evaluating to what extent market mechanisms can be utilised for the provision of public services. In particular, it might be possible to realise efficiency gains if competition between private producers can be used to lower costs in the provision of public services.

2. Reducing subsidies and tax expenditures

The size of subsidies, as measured in national accounts terms, is relatively small in most EU countries. While this indicates that budgetary and demand-restraining effects of cutting unwarranted subsidies might be relatively modest, it is important to note that the total level of subsidies is likely to be higher than national accounts suggest, both because some transfers that effectively subsidise certain sectors or activities might not be accounted for as subsidies in national accounts terms (notably capital investment grants) and because tax expenditures, unrecorded in the national accounts, add to subsidisation.

In any case, subsidy reduction should rank high on the policy agenda as many subsidies may have surpassed their initial intended objective and may now have adverse economic effects. Cuts in subsidies can thus contribute to raising potential output, involving additional beneficial effects on public sector budgets in the medium term. Experience shows, however, that such cuts are politically difficult to implement as they often conflict with vested interests and stranded investments. The crisis may nonetheless represent an opportunity to tackle issues of subsidization that are difficult to address in normal times. It is important that governments resist replacing unwarranted subsidies and tax expenditures by regulatory measures designed to provide support to the sectors concerned (*e.g.* through price regulation or other competition - restraining measures).

Some tax expenditures (TEs), such as earned income tax credits and payroll tax rebates for low-wage workers, aim at improving social outcomes and are often assessed as quite effective in achieving their objectives, even if they are sometimes associated with adverse incentive effects. Other TEs for social purposes produce highly unequal outcomes or are costly in reaching social targets. For example, deductions in the taxable income of parents for their children's education disproportionately benefit families in high-income segments as they increase in value the higher the families' tax bracket is. Also, the effectiveness of tax reductions for pension saving plans to generate new, as opposed to reallocated, saving for retirement purposes remains highly uncertain, with impacts on national saving likely to be negative in many cases

While in some countries tax expenditures were reduced in the years prior to the crisis, several governments have reacted to the crisis by introducing new tax preferences. Overall, direct budgetary effects from reducing or eliminating distortionary TEs could be substantial, and associated efficiency improvements would contribute to raising potential output in the medium term.

3. Revisiting current social transfers

On average, social transfers account for around 12% of GDP (in 2007), suggesting that they can potentially contribute to the consolidation effort. Indeed, in some countries (including Germany and the United Kingdom), sizable deficit cuts are to be achieved by freezing or reducing some social transfers. While cuts in this area may provide non-negligible savings, they may have adverse consequences for equity outcomes if social transfers go mainly to low-income individuals and families as they should. Another disadvantage is that income cuts for the poor are likely to be swiftly reflected in lower aggregate demand given the higher propensity to consume at lower income levels. Means testing could ensure that cuts in social benefits are targeted on those that are better off, but this may in turn create adverse disincentives if marginal effective tax rates increase in the income range where benefits are phased out, from already high levels in many countries.

Unemployment-related income replacement paid by the general government sector accounts for some 0.8% of GDP across EU countries, with both duration and replacement rates differing significantly from country to country. High replacement rates and, in particular, long periods of unemployment insurance benefits until exhaustion have been found to reduce employment probabilities *ceteris paribus*, which suggests revisiting such income support schemes. Crisis-induced extensions of benefit levels and duration should be unwound as the recovery strengthens and vacancies increase. However, cuts in unemployment-related benefits run the risk of increasing inequalities and can be politically difficult to implement. Any review of income replacement schemes should therefore take into account interactions with other features of labour market policies, notably activation strategies. In particular, there might be scope to raise the effectiveness of core activation measures, such as job-search support and work-availability requirements.

Revenue increases

1. Taxes

Announced consolidation plans generally include some revenue increases to supplement expenditure cuts. This is the case also in countries with already very high tax-to-GDP ratios, mostly the European countries, where the scope to add to the total tax burden may be more limited. The available room for tax increases would seem to be greater in the Czech Republic and the Slovak Republic, in the Greece, in the Poland, where tax-to-GDP ratios are well below the EU average – though at least in the Hungary relatively low tax pressure should be seen in the context of widespread use of tax expenditures to pursue public policy goals.

To the extent that tax increases are necessary they should be implemented in the least distortionary way. Evidence suggests that recurrent taxes on immovable property have the least negative impact on growth, followed by other property taxes and then consumption taxes, whereas taxes on labour and corporate income are most harmful for growth. Countries vary considerably in their reliance on property and indirect taxes,suggesting that for some countries, notably the Greece, the Portugal, the scope to raise indirect taxes is particularly large while for others, including and the Slovak Republic, the scope to increase property taxes is important However, these two tax categories have different equity consequences. As property taxes are inherently progressive, the distributional consequences of raising them appear consistent with equity goals. On the other hand, increasing the weight of consumption taxes in total tax revenues, if conducted in isolation, would reduce the overall progressivity of the tax system, which could conflict with short - term demand objectives and equity considerations and might lead to political resistance. This could be the case, in particular, if lower VAT tax rates motivated by distributional aims were to be raised to the general level. This suggests that it may be more effective to consider a package of taxation measures and to implement it gradually.

In general, tax reforms may affect saving and investment rates by influencing the level of after-tax income/profits, the after-tax rate of return, or the asymmetry between the tax treatment of different types of capital income, with ambiguous and usually weak effects on current accounts:

- To the extent that tax reforms alter the after-tax rate of return on saving (*e.g.* by cutting tax deduction of interest expenses), they should affect the level of saving, with the direction of the impact depending on the relative strength of several offsetting factors.

- A more progressive tax system may lower the aggregate saving rate by disproportionately reducing the income of higher-income households, who tend to have a higher propensity to save. However, new OECD analysis could not find robust evidence for such an effect.

- Tax-deferred retirement saving vehicles may affect the allocation, but do not in general boost the level of private saving: most recent studies on the issue point to sizeable crowding-out. As for pension-unrelated savings accounts, OECD evidence shows that tax-preferred accounts create new savings only when moderate-income households participate in them. Furthermore, whether any such new private saving more than offsets the public dis-saving associated with the tax break is unclear.

- A number of sector and firm-level studies show that corporate tax cuts or increases in depreciation allowances boost investment by reducing the cost of capital.

2. *Environmental taxes*

Environmental taxes and the auctioning of emission permits are potentially important revenue sources. Also, it has been estimated that auctioning emission permits that target a reduction in greenhouse gas emissions by 20% relative to the level prevailing in 1990 would generate revenues of 2.3% of GDP on average in the OECD area by 2020. Indeed, environmental taxes and revenues have the advantages that the potential tax base is wide and that, as long as they do not exceed the cost of the environmental externality, they are welfare enhancing as they help to reduce environmental damage. There is some evidence that low-income groups spend a higher share of their income on energy products than others, so that they would be relatively more affected by energy taxes, although the difference is modest. However, a more comprehensive analysis of the distributional implications would be necessary to take into account other effects as well. For example, low - income residential areas usually suffer relatively more from air pollution, so reductions in such pollutants may benefit those groups more than others.

3. *Privatisation*

Privatisation proceeds can be used to reduce general government gross debt levels. During the two decades or so prior to the crisis several countries engaged in significant privatisations. There is empirical evidence that divested firms often became more efficient and profitable and increased investment spending (Megginson and Netter, 2001). The evidence is mixed as to whether privatisations are associated with employment losses, although employment reductions seem to have been more frequent. On the other hand, cuts in employment appear to have been associated with efficiency improvements that supported the reallocation of resources elsewhere. While privatisations can thus contribute to strengthening the growth potential of the economy, with associated beneficial effects on government budgets in the medium term, important reservations need to be made.

First, enterprises in government ownership often operate in areas where there is market failure; privatising without addressing market failures by appropriate regulatory provisions would be counter-productive with respect to economic outcomes and might undermine acceptance by electorates. In this regard, sales justified merely by revenue needs that leave necessary regulatory changes unaddressed should be avoided.

Second, with significant privatisations having already taken place, successful privatisations of public companies may be increasingly difficult to realise, though sales of governments' holdings of land and buildings could still yield substantial revenue.

Third, the private sector may not yet be in a position to absorb large privatisations (including the sale of real estate) without significant discounts.

These aspects reinforce the need for cost-benefit analyses of potential privatizations.

4. *Structural reform*

Structural reform in labour and product markets can raise potential output and facilitate consolidation *via* various channels on both the revenue and spending sides of general government budgets. More employment increases GDP and tax revenue and reduces unemployment benefits. Furthermore, to the extent the additional employment is in the private sector, the public-sector wage bill falls as a share of GDP. In addition, if non-wage public spending on things other than unemployment benefits does not increase with GDP, then the GDP share also falls. Assuming the higher employment increases GDP and tax revenue proportionally, stylised calculations using the EU's regular elasticities for cyclical adjustments suggest that a 1 percentage point improvement in potential employment may improve government financial balances by between 0.3% and 0.8% of GDP, with the total effect largest in countries where the initial ratio of public to private sector employment and the initial proportion of primary public expenditure to GDP are highest.

However, an increase in productivity might have only muted effects on public finances. This is because productivity gains are likely to be reflected in higher wages in general, including wages in the public sector, and public transfers are likely to follow suit, with the increase in public spending offsetting to some extent the extra tax revenues resulting from higher output. However, even if direct budgetary effects are limited, structural reform may ease adjustments to consolidation.

In general*, fiscal rules can potentially help to keep consolidation efforts on track as the economy improves, revenue picks up and political enthusiasm for consolidation fades. At present, such rules must be tuned to current consolidation needs rather than to imposing fiscal discipline as would be appropriate in more "ordinary" times. As revenues start to improve in the current cyclical upturn, spending needs to be kept under control and tax reductions should be avoided. One option would therefore be to anchor consolidation efforts in a debt rule that specifies, first, a path leading to stabilisation of the debt-to-GDP ratio and, following stabilisation, a path of debt-to-GDP reductions. This might be supplemented by budget rules that can help correct the tendency for slippages to occur and for procyclicality which can lead to a ratchet effect in tax and spending. There are two broad categories of such rules: deficit rules that specify a limit for the annual budget deficit, and expenditure rules that limit discretionary increases or stipulate cuts in* *spending and in some cases limit revenue e- losing changes in tax policy. Simple deficit limit rules have the advantage of being easy to communicate. However, as budget outcomes are closely related to the economic cycle, deficit targets may be met as cyclical conditions improve without changes in underlying balances. This might be addressed by focusing on the cyclically-adjusted balance or a balance "over the cycle", but only at the expense of introducing a further dimension of uncertainty into the budgeting process, as these concepts are unobservable and need to be estimated*. Expenditure rules are less affected by the economic cycle. When revenues rise in an upturn, they will automatically be saved under an appropriately designed expenditure rule, which is not the case with a deficit limit rule (Anderson and Minarik, 2006). Well-designed expenditure rules also have the advantage that violations are relatively transparent and spending ministers can be held directly accountable for their actions (Atkinson and van den Noord, 2001; Guichard et al., 2007; Price, 2010). Expenditure rules can, however, be subject to manipulation, as the frontier between higher spending and lower revenues is sometimes blurred.

EU - performance based budgeting and management

The strongest current performance-oriented trend in EU countries is to use performance-based management, budgeting, and reporting Countries' approaches to performance management are constantly evolving. For example, Finland, the Netherlands, and Denmark began by concentrating on outputs and are now moving to an outcomes approach. France has passed a law which requires the production of results as well as inputs in budget documentation for the majority of programmes.

Governments have introduced performance-based management and budgeting for four main reasons: to improve efficiency; to improve decision making in the budget process; to improve transparency and accountability; and to achieve savings.

Some countries have focused on only one or two of these objectives, while others have embraced all four, aiming to introduce performance-based management and budgeting across central government and to improve performance as well as accountability to the legislature and the public. Denmark, the Netherlands, the United Kingdom and the France are all following this approach.

In some countries, such as the Germany, ministries have developed strategic and performance plans which include performance targets. Other countries have adopted performance contracts, for example between a ministry and a subordinate agency, and in some cases relating performance to pay.

Countries have adopted different approaches to implementation. Some – for example the Netherlands, and the United Kingdom – have taken a top-down and total system approach, mandating change across government. Others including Finland, have taken a more bottom-up and *ad hoc* approach giving agencies freedom to develop their own performance-based methods, with less involvement from the top.

Both performance management and budgeting are subject to diverse interpretations in EU Member states.

Broadly, performance management covers corporate management, performance information, evaluation, performance monitoring, assessment and performance reporting. In the context of the new performance trend however, a stricter definition is a management cycle under which programme performance objectives and targets are determined, managers have flexibility to achieve them, actual performance is measured and reported, and this information feeds into decisions about programme funding, design, operations and rewards or penalties. (OECD, Governance in Transition, 1995).

Performance budgeting can be broadly defined as any budget that presents information on what agencies have done or expect to do with the money provided. (Allen Schick,The Performing State, 2003). In this case it can simply refer to performance information presented as part of the budget documentation or to a budget classification in which appropriations are divided by groups of outputs or outcomes.

A strict definition of performance budgeting, however, is a form of budgeting that relates funds allocated to measurable results. These results are measured in the form of outputs and/or outcomes. Resources can be related to results either in a direct or indirect manner.

Indirect linkage means targets are actively used to inform budget decisions, along with other information. Performance information is very important in the decision-making process but it does not necessarily determine the amount of resources allocated. Direct linkage involves the allocation of resources directly and explicitly linked to units of performance. Appropriations can thus be based on a formula/contract with specific performance or activity indicators. This form of performance budgeting is used only rarely and in specific areas in EU Member countries.

Europe 2020 - What is fiscal sustainability?

Fiscal sustainability is a multi-dimensional concept that incorporates an assessment of solvency, stable economic growth, stable taxes, and intergenerational fairness. It has not only financial implications but also social and political ones related to both present and future generations. The current economic crisis has weakened the fiscal health of many countries around the world. Most of these countries are also facing long-term challenges that could threaten their fiscal futures, especially when these challenges are combined with financing the stimulus packages that were developed to spark an economic recovery.

In facing these challenges and trying to become better prepared for their fiscal futures, EU Member countries have experimented with several institutional budget reforms, including introducing fiscal rules, especially spending rules; using performance information to encourage better value for money and entitlement spending reforms; and, more recently, preparing long-term fiscal projections.

Many European Union countries annually report fiscal projections as part of their stability or convergence programme reports, as required by the EU Stability and Growth Pact. European Commission guidelines establish a minimum reporting requirement, a template, and a deadline for reporting. Reports include projected budget aggregates in a standardised table along with additional information to determine whether the reporting country's public finances are sustainable. While EU member countries may publish fiscal projections solely for the Commission's reporting requirements, some also do so for domestic procedures

Fiscal sustainability implies four main characteristics:

- solvency, or governments' ability to finance existing and probable future liabilities/ obligations;
- growth, or the capacity of government to sustain economic growth over an extended period;
- fairness, or governments' ability to provide net financial benefits to future generations that are not less than the net benefits provided to current generations; and
- stable taxes, or the capacity of governments to finance future obligations without increasing the tax burden.

While the level of government debt and whether it rises or falls are important indicators of fiscal stability in the medium term, they are not sufficient measures of fiscal sustainability. In the long term, fiscal pressures and risks are mostly based on demographic change, global climate change, and contingent government liabilities. Governments need indicators, like long-term fiscal projections, that will help them get a handle on these risks.

Fiscal projections raise the profile of fiscal sustainability, provide a framework to discuss the sustainability of current policies and the possible fiscal impact of reforms, and centralise responsibility for long-term policy analysis. While fiscal projections have been identified as good practice by the European Commission since the late 2005, the EU now suggests that fiscal projections should:

- **Be prepared annually** to draw attention to the long-term fiscal consequences of current policies and to eliminate discretion over when projections are produced. Although publishing fiscal projections may entail some political risks, the long-term benefits brought by the transparency of the government's long-term fiscal position are more important than the short-term political rationales not to publish them.

- **Incorporate comparisons with past government assessments** to highlight whether the government's fiscal position has improved or deteriorated. While many countries prepare regular fiscal projections, most do not provide a comparison with previous projections.
- **Include sensitivity analysis (or "alternative scenarios")** for changes in demographic and macro- and microeconomic assumptions, and other changes, to illustrate the exposure to fiscal risks and the general direction of the impact of this exposure. Sensitivity analysis shows that projections are only projections and are subject to uncertainty.
- **Be used by countries to illustrate the fiscal consequences of past reforms or general policy options.** This has the potential to demonstrate to policy makers that improvements in the country's long-term fiscal position are possible but may not eliminate the long-term fiscal challenge altogether. However, the types of forward-looking simulations used should be reviewed to ensure that policy options are not presented as prescriptions or as a means of circumventing political consultation about reforms.

Importance of Financial Education

Education is an essential foundation for personal, social and economic success in a globalised economy. But how can EU countries offer enough education, particularly quality tertiary education, to their citizens to enable them to play a full part in creating and enjoying such success?

In the aftermath of the financial crisis, financial literacy and education issues have reached a momentum. Policy makers worldwide now increasingly acknowledge the importance of Financial Education both as a life skill and as a key component of financial and economic stability and development. The EU Financial Ministers recognized the

European system work and activities on financial education. In particular, they acknowledge the importance of better financial education and literacy for improving the ability of people to use financial services and to make effective decisions with respect to their present and future welfare.

Financial education is the process by which financial consumers/investors improve their understanding of financial products and concepts and, through information, instruction and/or objective advice, develop the skills and confidence to become aware of (financial) risks and opportunities, to make informed choices, to know where to go for help, and to take other effective actions to improve their financial well-being and protection

In a world of increasing (financial) risks, financial education and awareness issues and policies have become critically important for several reasons:

- Increasing transfer of risks to households which are more directly responsible for essential financial decisions for their future wellbeing ;

- Uncertainties and sophistication of the financial landscape
  - More complex products and increased supply of financial products
  - Overload of financial disclosure;

- Very low level of financial literacy and capability of individuals in all countries.

Main Recommendations:

The development of methodologies to assess existing financial education programs should be promoted:

- Financial education should be part of the good governance of financial institutions, whose accountability and responsibility should be encouraged;
- Financial education should be clearly distinguished from commercial advice; codes of conduct for the staff of financial institutions should be developed;

- Financial institutions should be encouraged to check that clients read and understand information, especially when related to long-term commitments or financial services with potentially significant financial consequences: small print and abstruse documentation should be discouraged;
- Financial education programs should focus particularly on important life-planning aspects, such as basic savings, debt, insurance or pensions.

Whatever development strategy they chose, countries should consider whether Financial education should be part of it, and if yes, how. Financial education can indeed be a helpful capacity development tool.

The reform in the European Public Finances

Conclusions:

- There are arguments to spread the consolidation on both the revenue and the expenditure side of the budget, especially given the required scale of consolidation. However, past experience suggests that budget consolidation concentrated on spending cuts rather than revenue increases is more likely to result in durable retrenchment. Given the size of consolidation needs in many countries, cuts should be considered in most major components of spending. Priority should be given to pension reform, which may have important signalling effects and limited impacts on near-term demand; to expenditure categories where there is scope to increase efficiency, such as education and health care in many countries; and to reducing distortions, such as those created by many subsidies and tax expenditures.

- Beyond eliminating distortive tax expenditures, tax hikes may be necessary to meet the consolidation requirements. They should concentrate on the tax components that have the least harmful impact on growth, such as taxes on immovable property and broad taxes on consumption. Environmental revenues, be it through taxation or through the auction of emission permits, would also bolster both budgets and welfare.

- Structural reforms, especially those that increase employment, would contribute to growth and consolidation. A durable drop in the unemployment rate of 1 percentage point could boost budget balances by ¼-¾ per cent of GDP. Some privatisation proceeds could also be used to reduce gross debt while contributing to higher growth, but should only be considered where and when market conditions are favourable

- Historical evidence suggests that fiscal rules and institutions can play an important role in consolidation. In current circumstances, specifying a debt objective including the path to stabilising and subsequently reducing the debt-to-GDP ratio would be useful. It could be supplemented by a spending and/or deficit rule, with a combination of such rules seemingly giving the best results.

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