

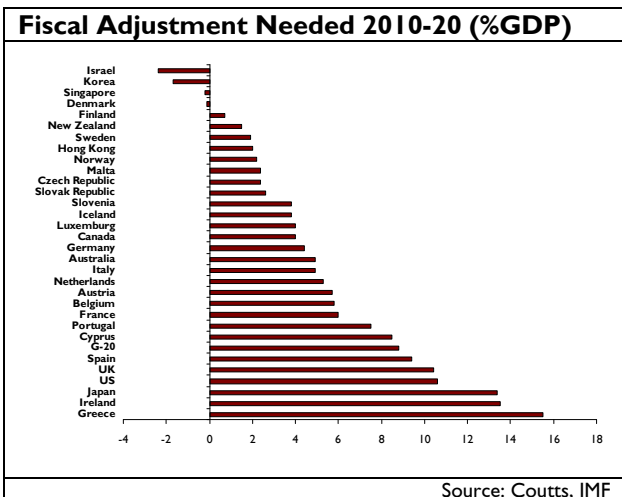
**Lessons from previous large fiscal adjustments**

The task facing advanced economies in shedding their massive debt loads is indeed daunting, but there are precedents for overcoming such a challenge. Ambitious policies for delivering the required adjustment will be needed, as mentioned in our previous Daily Theme. Although this will be the first time that most advanced economies have had to undertake such a large and simultaneous debt reduction, there are several historical examples of individual countries undergoing similar adjustments.

Put another way, the average fiscal position would have to improve from a projected deficit of 4 pp of GDP in 2010 to a surplus of almost 4 pp of GDP in 2020. Within the G20 the need for fiscal consolidation varies widely, from just under 0.5 pp of GDP for Switzerland to just over 10 pp for the UK and the US, 13.4 pp for Japan, 13.5 pp for Ireland and 15.5 pp for Greece.

**Thorough fiscal reform is needed...**

For many advanced economies, fiscal adjustments will have to go well beyond merely ending huge stimulus measures, to a sustained improvement in public finances. A solution to long-run challenges posed by the rising cost of health and pensions are becoming increasingly urgent, while at the same time reforms are necessary to increase tax revenue while simultaneously cutting spending in other areas.



Unless tough measures are taken, the collective debt-to-GDP ratio of G7 governments looks set to surge to about 110% by 2014, up from 73% in 2007. Strategies to bring debt ratios to sustainable levels need to be comprehensive. A reasonable target would be to bring debt-to-GDP levels to below 60%, the median pre-crisis level for the 20 most advanced economies (G20), by 2030. For some countries this would mean targeting a fiscal position that is stronger than before the crisis.

**...but it's been done before**

Although this will be the first time that a majority of advanced economies have had to undertake a simultaneous adjustment on such a large scale, this magnitude of fiscal consolidation has several historical precedents at the individual country level. Over twenty advanced and thirty emerging economies have achieved fiscal adjustments of at least 5% of GDP at least once over the past four decades. Moreover, nine advanced economies and twelve emerging economies have achieved fiscal adjustments of 10% of GDP or more. However, it is worth noting that the process of adjustment has on average taken eight years.

To achieve a target of 60 percent by 2030, advanced economies would need to trim their budget deficits by 8 percentage points (pp) of GDP between 2011 and 2020, or 0.75 pp per year.

Large Fiscal Adjustments (% GDP)						
	End-Year	Size	Revenue Increase	Spending Cut	Duration (Years)	Debt at End Year
Ireland	1989	20	8	12	11	99
Sweden	2000	13	3	10	7	54
Finland	2000	13	3	11	7	44
Sweden	1987	13	7	5	7	
Denmark	1986	12	6	6	4	77
Greece	1995	12	10	2	6	99
Israel	1983	11	0	11	3	158
Belgium	1998	11	0	11	15	117
Canada	1999	10	4	6	14	91
<b>Average</b>		<b>13</b>	<b>5</b>	<b>8</b>	<b>8</b>	<b>92</b>

Source: Coutts. IMF

### The medicine won't taste nice...

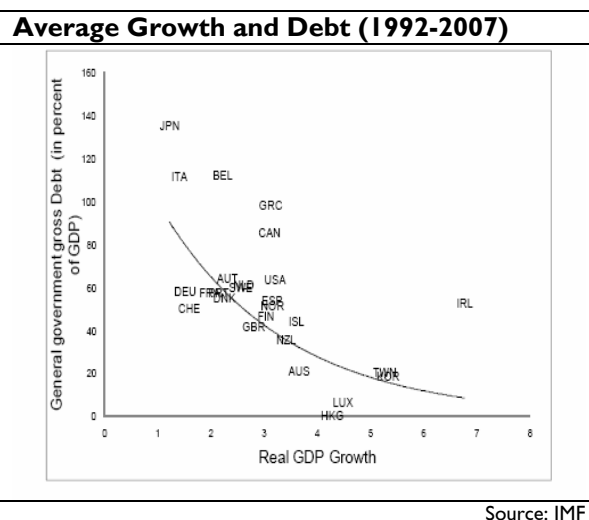
Not renewing the stimulus measures put in place during the crisis will improve the primary balance by 1.5 pp of GDP on average. This should be relatively easy to achieve, because an estimated four-fifths of the fiscal stimulus in the G20 countries are temporary measures – things like one-off infrastructure projects and tax rebates. But doing this will only deliver part of the 8 pp adjustment envisaged. The tax burden is already high in several advanced economies, which means that a large part of the adjustment will have to take place on the spending side.

In addition, pressures from population ageing mean that spending on health and pensions will have to be reformed in many countries. This spending already represents in excess of one third of total government spending in the G7 countries. Moreover, the net present value of future spending increases due to ageing is estimated at more than ten times the fiscal cost of the crisis. In the absence of significant reform, spending on pensions and health could rise by 4-5 pp of GDP by 2030.

Academic studies on large and successful fiscal consolidations stress the importance of reducing public spending, particularly public sector pay and benefits, rather than increasing taxes. Indeed, the table opposite illustrates that large fiscal adjustments have on average been achieved via a 60:40 split between spending cuts and tax increases.

### ...but the patient won't get better without it

History shows that high debt can hamper growth. Italy and Japan, the G7 countries with the highest debt ratios prior to the crisis, have experienced slow growth for at least the past two decades. As the chart below illustrates, for the 15 years prior to the onset of the current crisis, there seemed to be a negative correlation between debt ratios and growth for most advanced economies, with the notable exceptions of Ireland and Singapore.



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