The Dutch fiscal consolidation package in a comparative perspective

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This paper, which was presented at the spring meeting of the Wim Drees Foundation for Public Finance on 15 April 2011, is organized in four parts. First, we shall make some very brief remarks about the current economic situation in the OECD area, with an emphasis on the fiscal situation in member countries. Second, we shall give an overview of the consolidation efforts currently undertaken in a large majority of OECD countries, including the Netherlands. Third, we shall give some impressions of the work that the OECD has done on the political economy of consolidation – that is to say, on the conditions that determine whether consolidation will actually happen. Lastly, we shall make some more normative remarks on the Dutch consolidation package in the light of considerations of political economy. We shall pay attention to the size and the credibility of the consolidation package.

Keywords: fiscal policy, government debt, financial crisis crisis, OECD

1. Introduction

The economic situation in the OECD area

The pace of recovery is uneven across the OECD area. In most countries, the main factors holding back the recovery are high unemployment, high and growing public debt levels, and surging commodity prices leading to inflationary pressures.
A key feature of the current international upswing is that growth in emerging market economies is outpacing the growth in more mature economies. Indeed, OECD countries have barely recovered to pre-crisis levels of output.
Risks tend to be mostly on the down side, particularly with respect to concerns about sovereign debt, capital flow reversals, weak housing markets, and continued rises in commodity and food prices. On the up side, the rebound in private spending, particularly with respect to business investment, may be stronger than expected.
The main immediate challenges for advanced economies are:

- unemployment
- fiscal consolidation
- euro area weakness
- inflation

There are divergent policy requirements across OECD countries. European economies have in common the need for securing fiscal consolidation and implementing structural reform, also in the light of increasing global competition and the ageing of the European population.

2. Overview of consolidation efforts in OECD countries

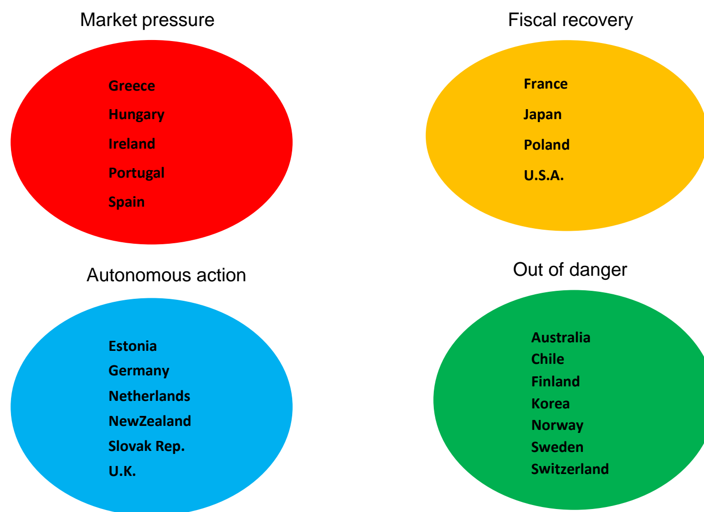
Restoring Public Finances

The publication *Restoring Public Finances* that has recently been published by the OECD Secretariat (OECD, 2011) contains a profound analysis of different consolidation plans, covering 30 OECD member countries. The report presents the current fiscal position and announced fiscal strategies, consolidation plans, and detailed expenditure and revenue measures, quantified if possible, for each country.
The data collection ended in November/December 2010, so updates and additional consolidation measures are outside the scope of this analysis. Fiscal consolidation is defined as concrete policies aimed at reducing government deficits and debt accumulation. Though important, more general structural reforms aimed at improving economic growth are not covered in this report.

Main findings

The main findings of the report can be summarized as follows.
Almost all OECD member countries have announced fiscal deficit reduction targets at least up to the year 2013 and, to a lesser extent, consolidation plans that need to be implemented for these targets to be achieved.
While most consolidation plans provide details of required spending reductions and revenue enhancements in 2011, fewer contain detailed consolidation measures required in the following years; half of OECD member countries have announced measures for 2012 and only eight countries until 2014.
Four groups of countries are emerging. Figure 1 shows the four groups of countries with different colors.

Figure 1. Four groups of countries



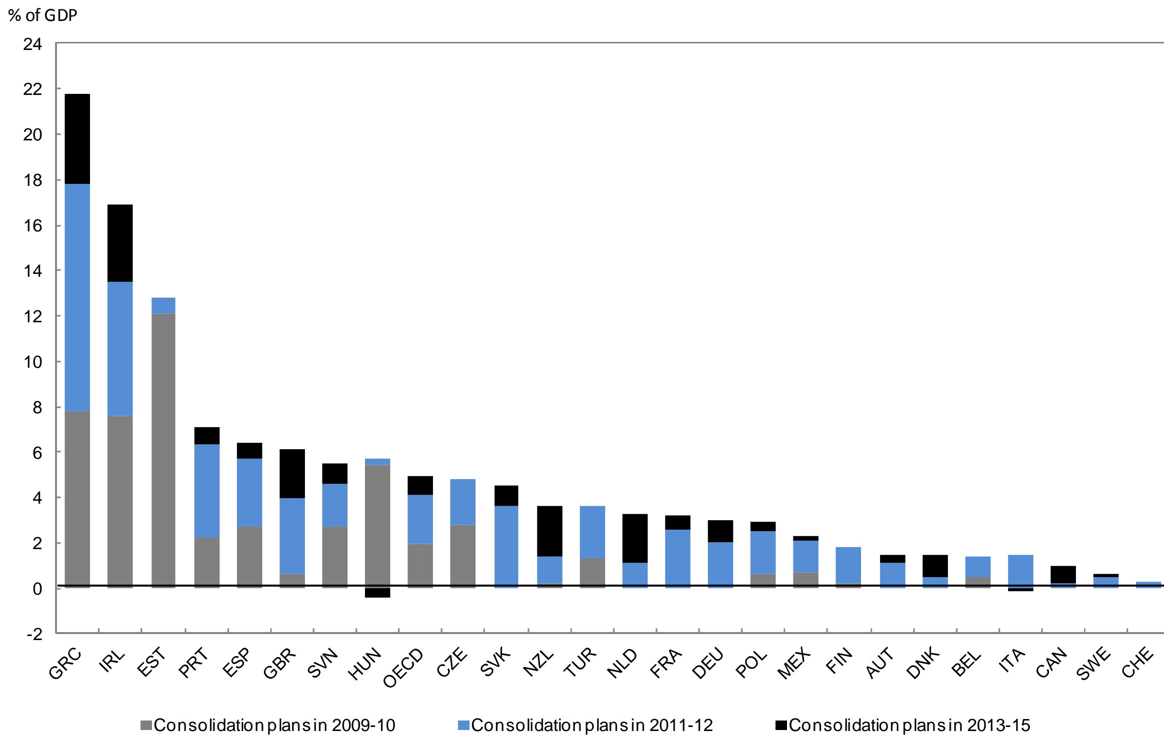
Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

The first group is the group of countries whose public finances or growth prospects have deteriorated at such a rate that substantial front-loaded consolidation packages have been announced to appease the near future demands from bond markets. Market pressure appears to be a key factor in determining the announcement of a consolidation plan in this group – for example in Greece, Ireland and Portugal. These countries are indicated in the red circle in the figure.
The next group is formed of countries that have taken pre-emptive or autonomous action in announcing medium-term fiscal consolidation strategies. Typically, these countries faced substantial fiscal deficits and announced consolidation plans for domestic reasons. Announced consolidation plans in this group reduce the longer-term fiscal sustainability requirement around 50% or more. Examples are Germany and the United Kingdom. The Netherlands is also placed in this group. These countries are indicated in the blue circle.
The third group consists of countries with large consolidation needs that have not yet articulated a substantial medium-term fiscal consolidation plan. Japan and the United States have chosen to delay the announcement until economic recovery becomes self-sustaining. Other countries in this group include France and Poland. These countries are indicated in the yellow circle.
The final group of countries has a better fiscal position and comparatively low need for fiscal consolidation in order to reduce either deficits or debt-to-GDP ratios. Countries in this group include, for instance, Australia, Finland, Norway and Sweden. They are indicated in the green circle in the figure.

For countries with a consolidation plan, the size of the plan varies significantly depending on the country's fiscal position (see Figure 2). The figure shows the total sum of announced expenditure and revenue measures in per cent of GDP, split into three time

periods from 2009 to 2015. Grey column components indicate front-loaded measures whereas black column components indicate back-loaded measures (to be implemented later). Negative numbers for Hungary in the later period mean a planned expansionary fiscal policy in this period.

Figure 2. Announced consolidation plans vary

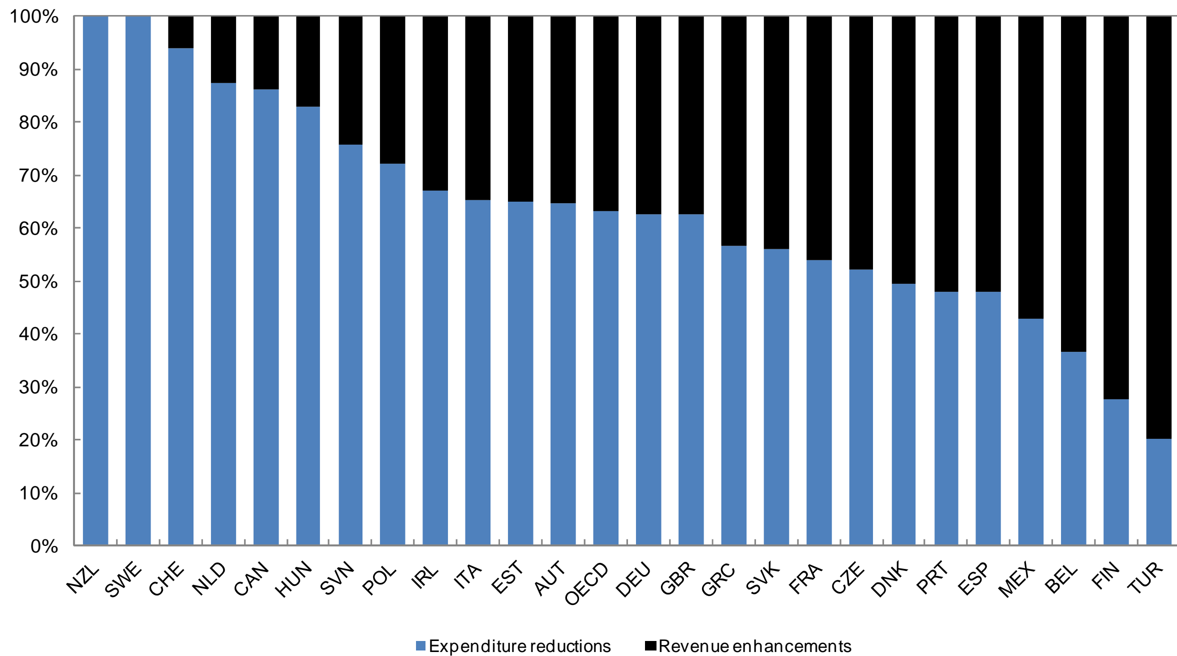


Source: OECD (2011), *Restoring Public Finances,* OECD, Paris. The figures are the sum of annual incremental consolidation for 2009-15 as reported by the national authorities and/or calculated by the OECD Secretariat. The figures include Estonia's and Ireland's 2009 consolidation. Hungary's 2007-08 consolidation is not included. Canada and the Netherlands report consolidation until 2015.

Unsurprisingly, countries with the largest economic imbalances and the most rapid deterioration in public finances require larger fiscal consolidation. Countries in the first category like Greece and Ireland figure notably, with their very large fiscal consolidation plans measured at around 22% and 17% of GDP, respectively. Portugal, Spain and the United Kingdom have also announced large fiscal consolidation programmes that equal 6-7% of GDP. The Netherland's consolidation package is in the middle range in this context and is somewhat back-loaded, with roughly equal annual consolidation efforts up to 2012 and in the period 2013-15.

Fiscal consolidation consists on average of two-thirds spending cuts and one-third revenue enhancement, as shown in Figure 3. There is a significant variation in the composition of consolidation measures. A number of countries have based consolidation mostly on expenditure-based measures, including the Netherlands. These are typically countries with smaller consolidation needs. Countries that require greater consolidation, including Greece, Portugal, Spain and the United Kingdom, are choosing a higher share of revenue measures in their consolidation plans.

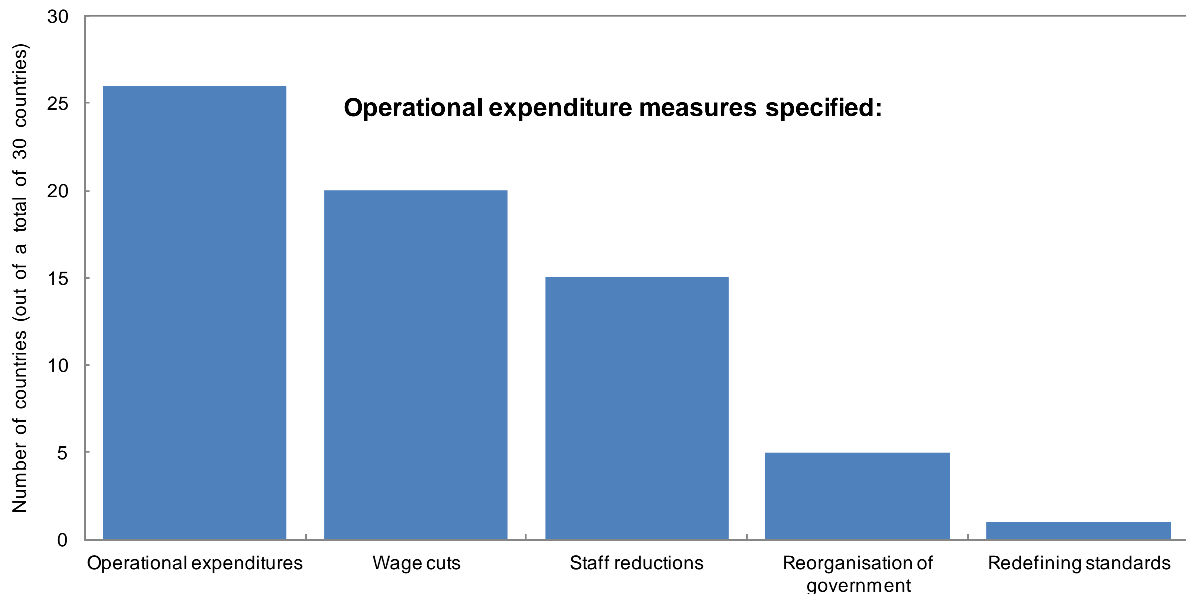
Figure 3. Expenditure-based versus revenue-based measures



Source: OECD (2011), "Restoring Public Finances", OECD, Paris. The figures are the contribution to consolidation from expenditure and revenue measures weighted by the incremental volume of consolidation across each year reported.

Almost all OECD member countries have marked operational expenditures for savings (Figure 4). The Netherlands and the United Kingdom have announced far-reaching and very substantial operational expenditure cutbacks. In the Netherlands, across-the-board savings on operational expenditures will be implemented at all levels of government, amounting to EUR 6 billion by 2015. All ministries' operational budgets in the United Kingdom will be reduced between 33% and 42% by 2014. Around 15 countries have specified operational savings and announced targets for reducing public wages and staffing. In the Netherlands, a modest salary development is envisaged.

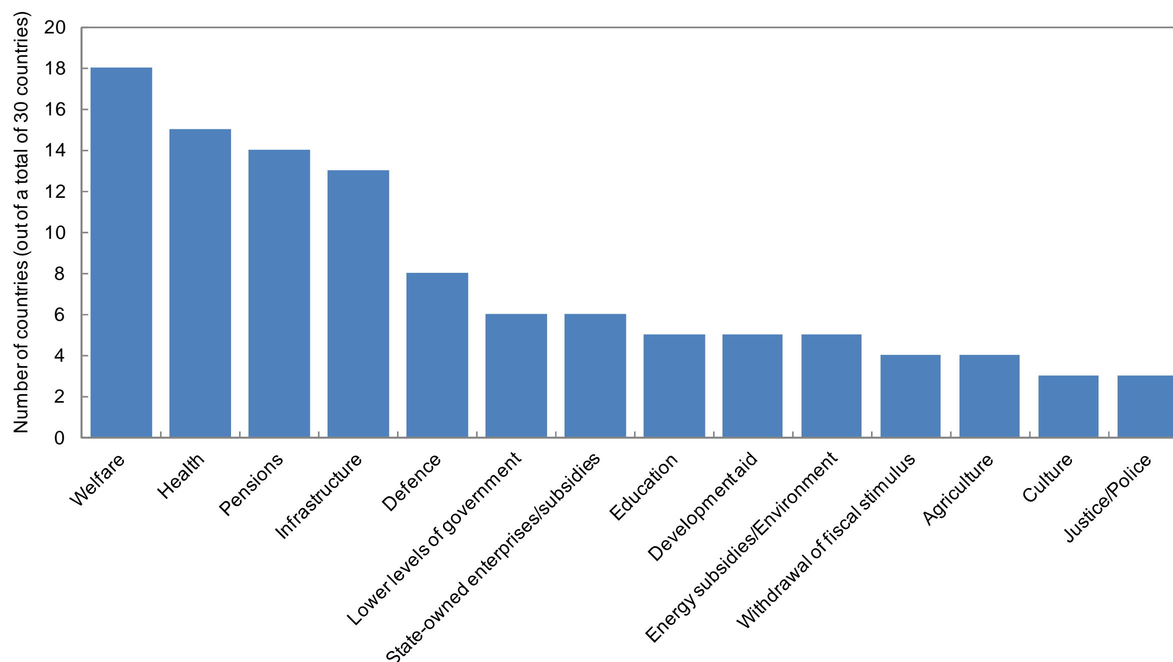
Figure 4. Operational expenditure cuts



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

The largest expenditure reductions come from reducing programme expenditures (Figure 5). Welfare and health expenditure reductions are targeted, albeit to a lesser extent than expected given their large share in public outlays. Countries also scale back public investments in their plans.
Reduced subsidies and support, especially in the agriculture sector, are only included in a few plans and could be targeted to a larger extent with double dividend, due to both improved public finances and reduced economic distortions created by subsidies. The Netherlands is one of these few countries.

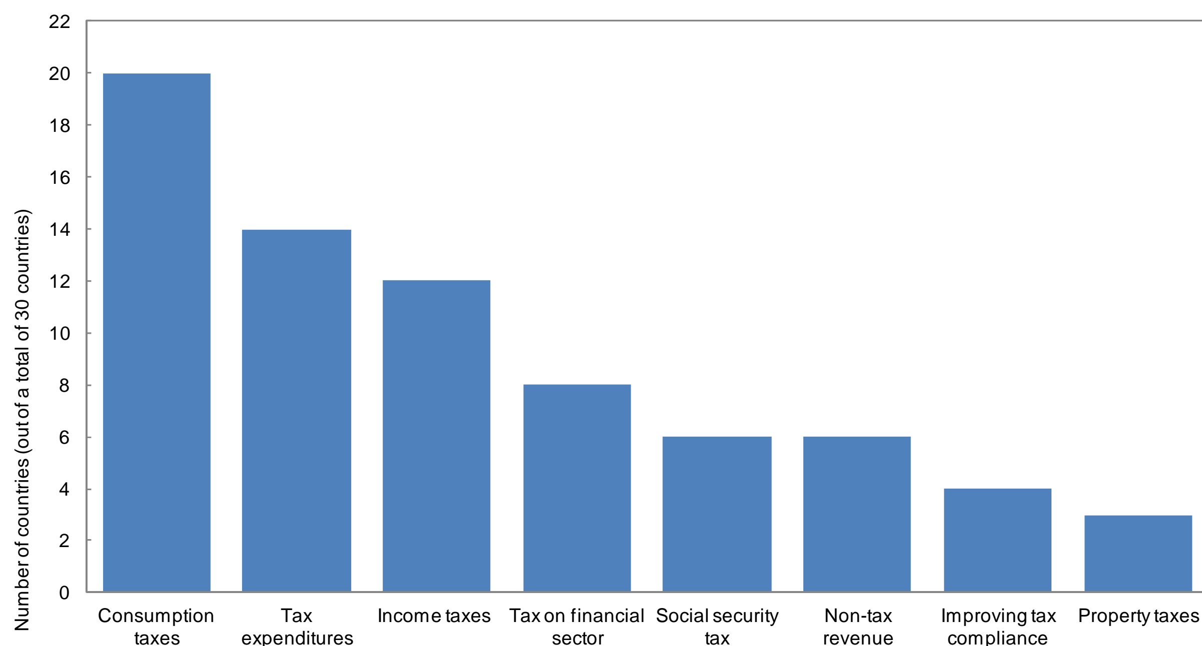
Figure 5. Major programme measures



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

Pension reform is also on the agenda in many countries. A number of countries have announced increasing the retirement age by two to five years, reducing benefits and placing restrictions on early retirement schemes. The Netherlands too has announced pension reform, although less ambitious than recommended by the OECD, only increasing the retirement age to 66 years instead of 67 years, with a little elaborated subsequent link to developments in life expectancy. We hope that the ongoing tripartite discussion in the Netherlands will provide sustainable solutions.
The most frequently announced tax measure is raising consumption taxes followed by reducing tax expenditures and increasing income taxes (Figure 6). In contrast, property taxes are only used by three countries. Frequent use of consumption taxes implies that policy makers believe they are likely to bring in significant revenue in the short term with less of a negative impact on economic growth compared to income taxes.

Figure 6. Major revenue measures



Source: OECD (2011), *Restoring Public Finances,* OECD, Paris. Consumption taxes include value-added taxes, general sales tax, and taxes on specific goods and services (excise duties). Income taxes include personal income taxes and taxes on corporate profits. Non-tax revenue includes raising or introducing user fees (such as tolls for motorways), privatising state-owned enterprises, selling state-owned real estate, etc. Improving tax compliance includes reforms to make tax administration systems effective and transparent, efforts to reduce tax evasion and fraud, etc.

Not surprisingly, countries with the largest economic imbalances and more rapid deterioration in public finances announced larger quantified revenue measures.

3. The political economy of fiscal consolidation

Making reform happen

The OECD has made a considerable effort in recent years to provide insight on the conditions that determine whether reform will actually happen. This has led to a number of studies and a general survey publication, called *Making Reform Happen: Lessons from OECD Countries* (OECD, 2010a). This report contains a special chapter on fiscal consolidation that provides some important insights.
In addition, we mention the publication *Restoring Fiscal Sustainability: Lessons for the Public Sector* that was recently prepared by the OECD Secretariat for the Working Party of Senior Budget Officials (OECD, 2010b). This publication too includes some important messages, which the current paper has drawn upon.
In order to understand what is needed to make consolidation happen, it is important to understand why fiscal deficits arise in the first place.

Why do fiscal deficits arise?

a. Deficit financing as means of macroeconomic policy

In the post-war period up to the second oil shock of 1979, deficit financing was generally seen as a normal instrument of macroeconomic policy. However, this consensus disappeared when prolonged periods of stagnating growth and high inflation (stagflation) – combined with soaring deficits – led to the conclusion that fiscal policy could no longer be seen as the main instrument of macroeconomic policy. This led to the rise of supply-side economics and a more modest role for fiscal policy in the 1990s. OECD countries turned to more "neutral" fiscal policies whereas some of them began to formulate the deficit target in structural terms and based on debt sustainability. Automatic stabilizers both at the revenue and expenditure side of the budget were supposed to contribute to macroeconomic targets. The recent financial crisis has called this neutrality of fiscal policy into question for the first time since 1979.

b. Markets can be too accommodating for too long

It is often thought that, ultimately, financial markets exert a disciplinary effect on fiscal behavior. However, most research finds that the upward effect of government borrowing on bond yields is incremental and very small. Ratings of government bonds also seem to react slowly and give poor anticipatory information about budgetary problems. Markets thus do not always respond proactively to debt accumulation. Rather, there appear to be thresholds that trigger large movements in risk premiums, at which point the penalty for over-borrowing can suddenly become steep. Financial market discipline is thus episodic rather than smooth. For some countries, this can mean that public deficit and debt problems can suddenly turn into financial crises, as has recently become clear in the cases of Greece and Ireland.

c. Financial and economic crisis

The recent financial and economic crisis has obviously exerted an enormous one-off effect on the deficit in a large number of OECD countries. Some of the rescue measures, such as guarantees and acquisition of shares in financial institutions, have not directly affected the deficit, but public accounting rules prescribe that foreseeable permanent losses should be reflected in the expenditure side of the budget and thus in the deficit.

d. Asymmetry of the fiscal response in upturns and downturns

Since the abandonment of deficit financing for macroeconomic reasons, probably the largest single factor responsible for rising deficits is the asymmetry of fiscal behavior in good and bad times. A downturn is usually accompanied by a deterioration of the budget balance, while an upturn does not entail an equivalent improvement of the balance. Particularly, there is OECD evidence that in some countries fiscal policy tends to turn pro-cyclical in upturns, particularly in the euro area (Ahrend, Catte and Price, 2006). Expenditure increases and tax cuts in the expansionary phase of the cycle are politically difficult to resist if windfall revenues are mistaken for structural increases in budgetary income.

e. Lack of budget transparency
The lack of budget transparency is another factor that may affect deficit spending. Electoral considerations may deter politicians from consolidation measures, particularly in the run up to elections. On the other hand, large deficits are no vote-winners either. This may lead to accounting gimmicks and off-budget spending. There is evidence that countries with more transparent budget procedures exhibited greater fiscal discipline in the 1980s and early 1990s. In another study using a transparency index for 19 OECD countries, it was found that during the 1990s weaker transparency is associated with higher deficit and debt levels (Alt and Lassen, 2006).

Which factors are conducive to successful consolidation?

Against this background of politico-economic factors that cause deficit financing and accumulation of debt, questions arise about which factors are conducive to consolidation and, even more importantly, what governments can do in order to counteract in a structural manner the factors that cause the deficit bias. Some of the causes of excessive deficits are beyond government control, but others are not, and then it is important to recognize the remedies that seize upon the causes.

a. The recognition of "fiscal crisis"
Let us start by saying that there is also an important consolidation supporting factor which is beyond government control. This is fiscal crisis. Consolidation occurs mainly where deficits become excessive. In recent decades, there have been frequent interventions by governments of OECD countries to correct excessive borrowing. Recent OECD research has identified 85 consolidation episodes in 24 OECD countries between 1978 and 2004. Such episodes were defined as periods in which actions were taken that resulted in noticeable improvement in the cyclically adjusted primary balance (Guichard et al., 2007; OECD, 2007). The consistent conclusion of this and other empirical studies is that fiscal consolidation is more likely in times of "crisis" than in good times. However, this robust finding does not teach us very much about how excessive deficits can be avoided or, once incurred, how they can be redressed. It hardly seems a viable recipe for governments to engineer a permanent crisis in order to drive consolidation efforts. But – yes – the current crisis is a terrible thing to waste.

b. Budget institutions
Insofar as the deficit bias is caused by asymmetric reactions to upturns and downturns and by lack of transparency, budget institutions can play an important role in neutralizing these factors. Particularly fiscal rules, expenditure frameworks and independent fiscal authorities can contribute to transparency and more symmetric fiscal behavior in good and bad economic times. Fiscal rules generally separate structural from cyclical developments and forbid accounting gimmicks. If they take the form of expenditure rules, they contribute to symmetrical behavior in good and bad times. Expenditure frameworks have the same effects for the period they cover. Independent fiscal authorities strengthen these favorable effects by providing for objective supervision. The Netherlands is an example of a country with strong budget institutions, to which we shall come back shortly.

c. Structural measures

Next to institutional arrangements, there is evidence that also the composition of consolidation packages has an impact on the chance of success, particularly the emphasis that is put on structural measures.

Structural measures can roughly be defined as measures that change the cost parameters of spending programs. One can think of limiting the eligibility for social benefits or social services in kind, or changing the service levels of collective goods such as defense or infrastructure. Structural measures also include changes in the organization of government, leading to savings in operational expenditure. In an analysis of 21 OECD countries, it has been found that structural reform is associated with significantly lower public expenditure in the long run (van den Noord and Cournède, 2006).

d. Focus on the expenditure side of the budget

A number of empirical studies suggest that spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation than a strategy that relies mainly on tax increases. Spending cuts are also more closely connected to the problems in spending programs that caused the deficits in the first place, and they may also show greater commitment and government cohesion (OECD, 2007; Alesina and Perotti, 1996; Alesina and Ardagna, 1998; Guichard et al., 2007; Von Hagen, Hughes Hallett and Strauch, 2001).

e. Specification of measures

Faced with rigid expenditures and high tax levels, consolidation has often come to rely quite heavily on anticipated improvements in public sector efficiency. For some countries, this is also the case in the current consolidation efforts. These are intentions that are easy to sell to the public, though less easy to implement in practice. We are not saying that focusing on operational costs is not a promising way of consolidation. Indeed, OECD studies indicate that there are large differences in ratios of outputs and outcomes to inputs among OECD countries, particularly in areas such as education and health (Sutherland and Price, 2007; Joumard et al., 2008). However, it is essential for success that measures are clearly specified. Simply stating savings targets without specification of measures is not enough for achieving success. Specification of measures often requires painful decisions, not so much for the public, but certainly for the public employees involved, which may generate resistance. Medium-term planning is essential in this respect, since many problems can be solved by gradual reorganization, taking advantage of the natural attrition rate which is in the order of 5% annually in most OECD countries.

f. The most successful plans involve large, multi-year adjustments

The OECD study on consolidation episodes makes clear that some of the most successful adjustments were those in Canada (10% of GDP in four years), Denmark (13.5% of GDP in four years) and Sweden (17% of GDP in seven years) (OECD, 2007; Guichard et al., 2007). Factors regarded as critical to the success of fiscal adjustment included the size of the adjustment (larger adjustments have a greater chance to succeed) and its duration (longer-term adjustments have a greater chance to succeed). The first factor stems from

the fact that larger consolidation operations require more political mobilization and must therefore be promoted as a "social project" rather than as a technical, budgetary exercise. The second factor stems from the fact that large consolidation efforts require changes of laws, including entitlement laws in the sphere of social security, health and pensions, as well as large reorganizations of the public administration. This requires time. Front-loaded consolidations necessarily lean more on temporary measures (wage and employment freezes, social benefit freezes, etc.) than on structural measures.

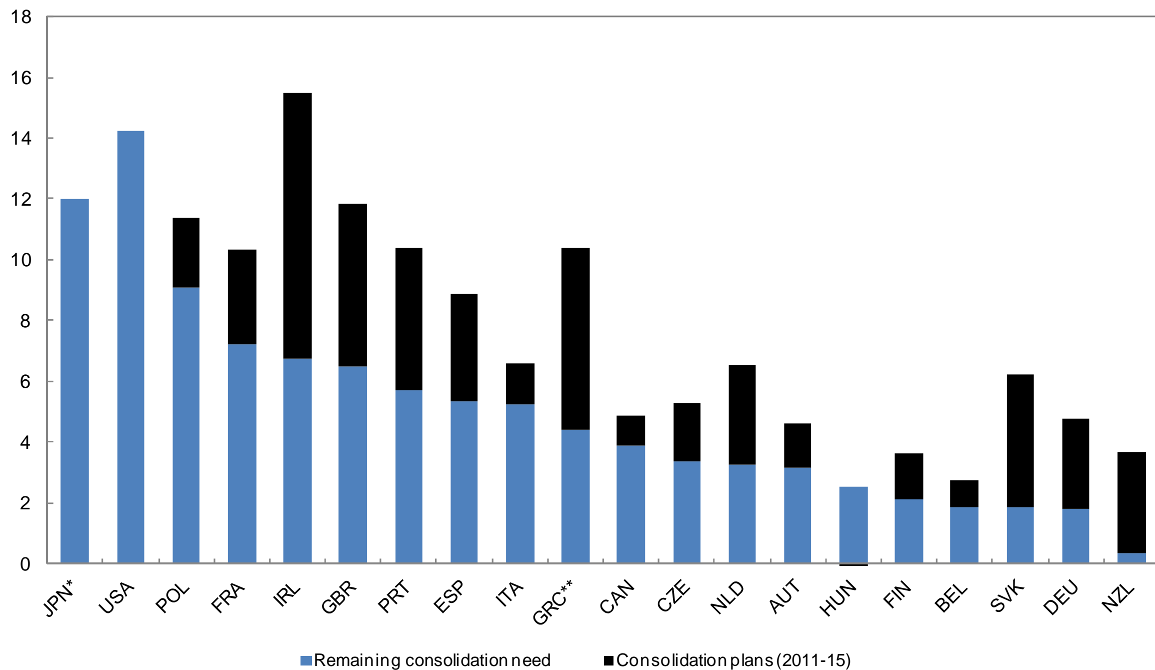
4. Evaluation of the Dutch consolidation package

Size of the Dutch consolidation package

We now come to some more normative remarks on the Dutch consolidation package. We shall first pay attention to the size of the package and subsequently to its chance of success or credibility in view of the mentioned considerations of political economy.

For the OECD area as a whole, it is true that renewed growth will not be enough to stabilize and reduce debt levels and that the consolidation needs are substantial. Figure 7 shows how much the underlying, primary balance must be improved to reduce debt-to-GDP ratios to more prudent levels, notably 60% of GDP by 2025, based on a number of plausible assumptions on economic growth, unemployment and interest rates. Future increases in age-related costs are not included in this calculation. The figure also shows how much announced consolidation plans reduce this requirement, assuming all measures have structural effects.

Figure 7. Fiscal balances need to be improved more to achieve 60% debt-to-GDP ratios



Notes: The consolidation requirement is the underlying primary balance change required to achieve a gross general government debt-to-GDP ratio equal to 60% of GDP by 2025 except for Japan. Iceland is not included in the figure due to missing consolidation data.
* The consolidation requirement for Japan is the total consolidation required to achieve the pre-crisis debt-to-GDP ratio by 2025.
** For Greece, the underlying primary balance is used in the calculation, derived from the government's targeted deficit path, taking into account the baseline assumptions in *OECD Economic Outlook, Volume 2010/2, No.88*, http://dx.doi.org/10.1787/eco_outlook-v2010-2-en.

Source: OECD (2011), *Restoring Public Finances,* OECD, Paris.

If implemented as planned, consolidation will be an important step in restoring public finances, in particular for countries like Greece, Ireland and Portugal. For Japan and the United States, the challenge remains to pass a set of fiscal consolidation measures, and for France and Poland, more ambitious consolidation packages have yet to be put on the table.
For the Netherlands, more efforts are needed in order to reach a debt level of 60% of GDP by 2025.

Credibility of the Dutch consolidation package

Turning now to the mentioned considerations of political economy, we focus on conditions of success that the Dutch government can control, namely budget institutions, the emphasis on structural reform, a focus on the spending side of the budget, the specification of measures, and a focus on large, multi-year adjustments.

a. Budget institutions

As far as budget institutions are concerned, the Dutch are certainly in a relatively favorable position from an international perspective.

Apart from the fiscal rules of the Stability and Growth Pact that are applicable to the Netherlands, there are no formal fiscal rules in the Netherlands. Fiscal policy is governed by the medium-term expenditure frameworks and the guidelines for tax policy contained in coalition agreements. However, the requirements flowing from these frameworks and guidelines are substantially stricter than the European fiscal rules. That is also the case in the current coalition program that roughly aims at structural budget balance in 2015, even though this is not enough to stabilize the debt or to take care of the future burden of ageing.

Since 1994, Dutch budgetary policy has been based on fixed expenditure frameworks and tax policy guidelines contained in the coalition agreements of successive cabinets. This practice has led to a separation of the expenditure and revenue sides of the budget, with deficits fluctuating in reaction to GDP developments, and strict budgetary discipline at the expenditure side. Apart from a relatively small stimulus package that was agreed in 2009 in reaction to the financial crisis, expenditures have been kept within the ceilings during the entire period since 1994. Holland belongs to the very few OECD countries, next to Sweden and the United Kingdom, that have worked for a long period with fixed expenditure frameworks. All three countries have largely been able to maintain the ceilings since they were introduced, apart from the recent crisis episode in which stimulus packages were approved. This in itself is a strong indication that a fixed medium-term framework is a powerful institutional device to maintain fiscal discipline and to overcome the deficit bias. The OECD is not aware of any other fiscal institution that performs better in this respect.

Furthermore, we mention the role of independent fiscal institutions. The Netherlands has had such an institution since 1945 in the form of the Bureau of Economic Policy Analysis (Centraal Planbureau).

From the perspective of fiscal discipline, it is essential that the Bureau is responsible for the macroeconomic forecasts and for the forecasts of the economic and budgetary consequences of major policy plans, including the electoral platforms of political parties and the coalition program. The Bureau reports its findings in public documents. Although formally the government is not bound by the conclusions of the Bureau, in practice it follows the Bureau's forecasts and projections almost entirely. This implies that the Dutch arrangement is fully consistent with the independence requirement that has been identified by the OECD as an important condition for the success of fiscal consolidation.

b. Emphasis on structural reform

The Dutch consolidation package consists for a large part of structural measures, including: income transfers, healthcare costs, and international co-operation and adjustment of the organization of government.

c. Focus on the spending side

With a spending side percentage in the consolidation package of between 80 and 90%, the Netherlands belongs to the OECD countries with the most emphasis on spending cuts

versus tax increases. This contributes strongly to the credibility of the consolidation package.

d. Specification of measures
The Dutch consolidation package is very detailed and, as such, belongs to the best specified packages thus far launched in OECD countries. There is only one area where the specification is not yet very detailed: the savings on operational expenditures. A relatively large cut of EUR 6 billion on public administration is not very specific, in particular as far as reorganization of the general government sector is concerned. It remains to be seen whether the reduction will be materialized.

e. Consolidation through large, multi-year adjustments
The Dutch consolidation package of EUR 18 billion (3.3% of GDP) is of a medium size in comparative perspective. Nevertheless, from a more historical and domestic perspective, it is a very large package. Necessarily, it required a substantial political commitment, and the Dutch population is aware of the painful impact it will have, but largely also of its necessity. As I have shown earlier (Figure 2), it is rather back-loaded due to a lot of structural measures that require time to implement, which contributes to its credibility and chance of success.

5. Conclusion

Summarizing, our conclusion as to the size of the consolidation package is that it is in the middle range of volume in percentage of GDP and not yet enough to stabilize the budget at 60% of GDP.
As to the chance of success or credibility of the package, the conditions prevailing in the Netherlands seem relatively favorable. The budget institutions of the Netherlands are strong and contain sufficient guarantees that the planned savings will be realized. The emphasis is on structural reforms, although not all the reforms recommended by the OECD in the last economic survey are taken on board. The focus is very much on the spending side. Apart from some aspects of operational expenditure, the measures are detailed and specific. The package is back-loaded, due to structural measures that require time to phase in. The package is based on a firm political commitment, and the population is largely aware of its necessity.

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