TEN LESSONS ABOUT BUDGET CONSOLIDATION

by
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BRUEGEL ESSAY AND LECTURE SERIES

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FOREWORD

Ever since the Danish experience of 1983-86 and the Irish experience of 1986-89 triggered a re-examination of the economic effects of large-scale fiscal adjustments, economists have been debating what determines the cost of fiscal retrenchment. Before these two countries had succeeded in engineering public deficit reductions of exceptional magnitude without incurring significant output losses, it had been taken for granted that fiscal adjustments necessarily and even mechanically involve significant economic costs. The evidence that this did not need to happen prompted a new strand of research whose aim was to determine when and why non-Keynesian effects could override the usual multiplier effects.

Ten years on or so, this literature has not identified ready-made recipes for successful and painless fiscal consolidation. It has found that adjustments are more likely to be comprehensive and sustained when they start from poor initial conditions and put an end to an unsustainable budgetary course. It has established that expenditure cuts are more likely to succeed than tax increases in producing lasting adjustments. It has helped us understand through what channels non-Keynesian effects can influence the outcome of adjustments. It has identified that credibility is just as important for the success of fiscal consolidation as it is for a disinflation*. But it has not equipped policymakers with a basic ABC of fiscal retrenchment.

Jens Henriksson's essay helps us to understand why this is. Fiscal adjustment is an art rather than a science. In this piece, which draws on first-hand experience within the Swedish government throughout one of the most dramatic consolidation episodes of the post-WWII period, he seeks to pinpoint, and to convey to fellow policymakers, what equations and econometrics do not capture.

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* The OECD Economic Outlook of June 2007 devotes a chapter to the lessons from fiscal consolidation episodes which summarises the main findings of empirical research.

Henriksson's overall philosophy is certainly attuned to modern macroeconomic thinking: notions such as credibility, commitment, time consistency and robustness surface at every page. Nor does he ignore recent developments in the political economy of fiscal consolidation: the pages he devotes to the distributional effects of the Swedish programme resonate with what we have learned from studying conflicts over the distribution of the adjustment burden. But he tells the reader what those notions mean in practice and how they can be incorporated into the design of an adjustment package.

What is more, the essay provides a wealth of experience, some of which has not, or not yet, been added to the standard macroeconomic toolbox. Where the evidence is inconclusive, Henriksson is not shy of calling time on controversial issues and telling the reader what he thinks is the right lesson to draw. And he relentlessly emphasises the need for overall coherence in the design and implementation of a fiscal programme.

Sound economic thinking combined with practice in the field are what gives value to this piece. For policymakers in the still many countries where budgetary sustainability remains an issue, there is much to learn in this short essay.

Jean Pisani-Ferry
Director of Bruegel

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INTRODUCTION[1]

In its Economic Outlook of December 1994 the OECD projected that the Swedish public debt would explode. By the year 2000 the public debt was expected to hit a record 128 percent of GDP[2]. Today we know that the gross debt for 2000 turned out to be less than half that figure at 53 percent. And within a few years the budget deficit, from a high of over 11 percent of GDP, turned into a large surplus.

But getting there was not an easy task. During the consolidation of public finances, I had the opportunity to work in close contact with different ministers of finance in Sweden. This paper relates what this experience taught me about the political economics of budget consolidation.

It is not a paper about how to get rid of the welfare state. On the contrary, it is about how to strengthen the economic foundations for whatever kind of social model that is preferred. The budget consolidation in Sweden was dramatic but it preserved, and in many ways modernised and improved, the welfare system.

Some people might say that the Swedish experience was unique. They certainly have a point. Sweden has – at least in the Swede's own eyes - been perceived as a role model. And at the beginning of the 1990s that model was in deep trouble. In 1994 there were even rumours on the financial markets that the IMF would come in and take over.

But Sweden's problems had a fairly long history[3]. During the 1970s and 1980s Sweden tended to combine bad luck with bad economic policy. At the beginning of the 1990s Sweden met the international downturn with a real interest rate shock. And even though more than 90 percent of members of parliament were in favour of a fixed exchange rate with the European currency unit (ECU), they were not the ones to make the call. On 19 November 1992 the financial markets decided that Sweden should devalue.

Sweden experienced negative growth three years in a row between 1991 and 1993, averaging minus two percent. Over three years the debt almost doubled, unemployment tripled and the budget surplus turned into a large deficit. The combined effect of an exploding budget deficit, high interest rates and record-high levels of unemployment was staggering.

In a nutshell, the whole political system was humiliated. Sweden was in deep crisis. The interest rate spread vis-à-vis Germany on a ten year bond was around 4.5 percentage points. The central bank started raising interest rates owing to increased inflation expectations. Crisis package after crisis package was delivered by the government[4]. The borrowing requirement for central government in 1993 was a monumental 17 percent of GDP.

In September 1994 there were general elections, and one month later I started to work as a political adviser to the new, incoming social democratic minister of finance, Göran Persson. In November 1994 the first bill presenting a large consolidation programme totalling 7.5 percent of GDP in concrete measures was presented to parliament[5]. In April 1995 the programme was increased to 8 percent of GDP and unemployment, sickness and parental benefits were cut.

One year after the election Göran Persson was invited to give a speech at the annual central bank conference in Jackson Hole, Wyoming, arranged by the Federal Reserve Bank of Kansas City. Mr. Persson started his talk by saying:

> *"It is with mixed feelings that I participate in this overview panel. On the one hand, it is a real honour for me to participate in*

> *this year's symposium with such distinguished participants. On the other hand, I understand that the reason for my invitation lies in the enormous financial problems Sweden has experienced in the past few years."*[6]

During and after the trip to the US we talked continuously about the politics of budget reinforcement. A few months later the ideas emerged for the 'Ten Commandments of Budget Reinforcement' used by Göran Persson in his book[7]. When he left the ministry to become prime minister I continued to work with the material.

In my twelve years in different positions at the ministry of finance I have presented the ideas in various forums around the world[8]. During that process the commandments turned into humble lessons and evolved.

One might ask whether the lessons learned are only of interest to those who are concerned with Swedish economic policy. I do not think so. I think that there is quite a bit to learn for other countries as well. Consolidating public finance is a general political issue. Even though there is a huge difference between reducing a deficit by one percent and reducing one by 10 percent, the problem is similar. It has to be analysed, explained and solved.

One difference compared to other countries is that the Swedish consolidation was conducted with a monetary regime of an independent central bank and a floating national currency. That was important in the Swedish context.

First, the fiscal contraction was met by a monetary expansion, even though it took quite a while for it to materialise. Swedish short-term interest rates were actually continuously raised by the central bank from around seven percent in the summer of 1994 to around nine percent at the beginning of 1996. Then the bank started bringing down interest rates, so that at the beginning of 1997 short-term interest rates were around four percent.

Second, the long-term interest rate became an important political factor. If you walked into the finance minister's room, or even the prime minister's, the TV set was always on. But it was not CNN. It was the text page of the Swedish television showing a minute-by-minute update of the spread on a five-year government bond vis-à-vis Germany. Politics was seeing who could cut the gap with Germany by being toughest on the budget deficit.

A more challenging question, though, is whether the Swedish experience really matters. A cynical mind – yes, an economist! – could draw the following lesson from Sweden:a country in serious problems faces no trade-off among competing objectives. It is thus easy to communicate what you are doing, since everyone knows and understands that the main priority is tackling the deficit. Since there is no alternative, people will not blame you for your actions. The bottom line may thus be: if you have to consolidate, wait for a deep crisis to occur, and it will be easy to do, easy to communicate and easy to be re-elected afterwards.

My view is that a deep crisis certainly increases the understanding of what needs to be done[9]. It played a huge role in Sweden[10]. But there are other ways of doing it. Never underestimate political leadership. A strong politician can portray important problems as the salient issue in a country.

The so-called Peberau report[11] from France is a very good example of how a government can increase public knowledge about the cost of having a large public debt. A few power-point slides, a report and a good one-liner can have an enormous impact.

The cost of crisis is dramatic. In Sweden long-term unemployment increased dramatically. Sweden is still struggling with the legacy of the 1990's crisis. Ten percent of the labour force became unemployed, and many never came back to an ordinary job. The number of people living permanently on different kinds of benefit scheme increased dramatically.

The same rule that applied to Göran Persson when he was invited to Jackson Hole applies in this paper. Good policy is <u>not</u> knowing how to get out of a crisis. Good policy is avoiding getting into one in the first place.

After leaving the Swedish government offices at the end of 2006 I decided to go back to academia to learn more and continue my graduate studies at the Institute for International Economic Studies, IIES, at Stockholm University. I was then asked by the director Bruegel, Jean Pisani-Ferry, to put my thoughts in a paper.

Needless to say, this paper is based on policy experience and thus not always grounded in economic research. I have tried to single out what aspects have scientific foundations by inserting notes where appropriate. In reality this was not an issue that was discussed during the consolidation.

We just did it.

Jens Henriksson, Brussels, June 2007

LESSON ONE: SOUND PUBLIC FINANCES ARE A PREREQUISITE FOR GROWTH

I really believe that sound public finances are a prerequisite for growth, both in political and economic terms[12]. My main argument is that economic policy is extremely difficult, and that the key to success is to avoid making mistakes.

That might not sound like the boldest statement. But in economic policy, it is. A country which can avoid making policy mistakes is a country that will outperform most others. Risk aversion is king in economic policy.

In the global economy everything is moving faster and faster. Capital, products and labour are becoming more global by the day. As a consequence the degree of freedom for policymakers is diminishing. And the relative cost of mistakes is bound to increase even further.

Strong public finances are intimately connected with strong macroeconomic fundamentals. Economists might talk about structural reforms and their effect on growth and employment. But if there is not a stable macroeconomic foundation, structural reforms will not help.

In the last few years the Scandinavian model has been seen as a model to follow by other countries. There are a lot of explanations why it has been successful[13]. One of the main reasons may be the stable macroeconomic climate, which is an outcome of sound and stable public finances.

A large deficit is by definition an imbalance. This need not in itself be wrong. It is not a problem if the deficit is used for investment with a good – and safe – return. Then it is good policy.

A large deficit can also keep up demand in an economic downturn. It is not a problem if a country runs a deficit in public finances as a part of an active stabilisation policy. But if you argue like that, you have to be consistent and be just as strong an advocate of running a surplus in good times. It is easy to get support and friends when you argue for running a deficit during downturns, but it and they will disappear when the good times come. Then you will be fighting alone. Remember, the future has no lobbyists.

Some might argue that running a large surplus for a prolonged period of time creates a lot of problems since capital formation will be partly public. That is certainly a good point, and I am by no means a proponent of socialisation. But things have to be dealt with in due time. The main problem countries are facing now is not persistent surpluses in public finances. If that problem were to arise, I am certain that there would be a lot of interest groups giving advice on how to get rid of the surplus.

LESSON TWO: IF YOU ARE IN DEBT, YOU ARE NOT FREE

This might sound like a quote from the Bible. It is not. It is politics, and it is economics.

A country with deficit and debt problems is constantly monitored by the financial markets, by international organisations, by other countries and, not least, by its own citizens.

Being closely monitored by the financial markets means that power shifts from the open chambers of the people's elected representatives to the closed rooms of the financial markets in London and New York. This is of course truer for countries that are not members of a currency union. But sooner or later even those countries which are, in the short term, shielded from the turmoil of financial markets will face the consequences of large deficits and debts.

Large deficits and debts have effects on inflation expectations. Creditors might judge that the only way out for the country is to inflate the debt. But even if this is not on the agenda of any serious government, it will be in the back of central bankers' minds[14], meaning that both short-term and long-term interest rates may be affected.

Some people argue that it is undemocratic that markets have this power over elected representatives. That is a view I do not share. A country that each and every day has to borrow money, either to service the debt or to finance the deficit, is in the hands of its creditors.

If you need to borrow money from a bank, entering the bank screaming that you have the right to get a decent loan is not the optimal strategy. When you need to borrow, you are in an inherently weak position. The same thing goes for a state. A state can of course start printing its own money but that creates even larger problems.

Members of a currency union do not face the same constraints as countries which have currencies priced daily on the trading floor. At the time of writing, the largest spread vis-à-vis Germany for a country inside the euro zone is below 0.25 percentage points on a ten-year government bond. The reason is that the risk of default is perceived to be very low by financial markets. The euro ministers do not have to spend time convincing the market that the deficit and debt are under control.

But even though this is true today, you never know what the markets will focus on tomorrow. Besides, there are other watchdogs out there as well.

It cannot be fun to attend the Ecofin (the Council of Ministers of Finance of the EU, which meets on a monthly basis) representing your country if you are constantly barked at by your colleagues, the Commission and the European Central Bank (ECB). It takes time and political capital to defend yourself and your country. Time and capital that might otherwise have been spent in a much more productive way. For non-EU countries, the IMF, OECD and other international organisations perform an analogous role.

A minister of finance representing a country with a large deficit and/or debt is a politically weak minister. Unless she or he actually does something about it – then the reverse can apply. By coincidence, a minister of finance who solves major problems tends to get an even better job afterwards…

Having problems with public finances can also have broader implications. The media will certainly pick it up and put those responsible to the test. One day in 1994 my sister – who was then 13 years old – came to me and asked me how much she was in debt. It turned out that she had read a Swedish newspaper showing a picture of a newborn child and the headline

'Born with a debt of 150,000 Swedish kronor'.

Another example. On one of my first few days at the ministry of finance I witnessed the forecasting people presenting the latest outlook for public finances to the new minister.

The borrowing requirement for the budgetary year 1994/95 was projected to be 240 billion Swedish kronor (SEK). Since I have problems grasping large numbers I made the following calculations on the back of the memo.

The interest rate was around 12 percent, but I rounded it down to 10 percent to make it easier to calculate the cost of borrowing: 24 billion SEK a year. Every year has twelve months, meaning two billion SEK per month. There are roughly four million Swedes who go to work each day, which makes 500 SEK per person per month (US$75 or €55).

So, every Swede who goes to work will to need pay a tax of €55 each month just to pay the interest on the money spent in servicing one year's budget. And the question I kept asking myself was: what moral right do we have to indebt our kids, such that for every month in their whole life they will be paying 500 kronor in extra tax just to pay for the borrowing of one year?

Sometimes we tend to forget the moral dimension of what we are doing. There is no questioning that in a country with a large deficit and debt, citizens will sooner or later lose respect for the political system. In the end confidence in democracy itself will diminish, since everyone knows that something has to be done, but nothing is happening[15].

LESSON THREE:
THE ONE RESPONSIBLE MUST PUT HER OR HIS JOB ON THE LINE

In a deficit situation politicians face a difficult task. Representatives are usually elected to improve the financial situation of voters. But when there is a deficit problem, they have to deal with questions they are not familiar with and perhaps not prepared for. Expenditure has to be cut and taxes have to be raised.

Such issues are extremely difficult to handle. That is why a successful consolidation process must have strong support from the people. The politician must be able to turn the debate against those who do not want to take harsh measures. Therefore, I believe that there must be one woman or one man who takes the lead. And that this politician must put his or her job on the line.

The argument is pretty simple. If a country is in a deficit situation it has probably been so for some time, or it is not the first time. When someone faces the public and states that she or he will solve the problem, they will certainly not be the first person to promise that. How is it possible, then, to convince the public that this time it is for real?

Basically in what you do and in what you say.

Actions have one flaw: it takes time for them to yield results. At the beginning of a consolidation process it is all about talking. So this lesson and parts of the next will be about how you can show that you are committed to tackling the deficit.

The first thing to do is to do like Odysseus. If you have a time inconsistency problem, tie your self to the mast. So that when the Sirens call, you have no chance to follow them. This is the reason why we have independent central bankers.

The second thing to do is to create rewards and punishments. If the one responsible says that she or he will resign if the problem is not tackled, the political cost of not solving the problem increases. This will be noticed by the general public, and certainly also by the media.

By doing this the rewards can also increase. Unfortunately, it is not always an 'election winner' to start raising taxes and cutting expenditure. But tackling the deficit can be[16]. Then there is a double gain. The deficit is cut, and the politician has shown that she or he can deliver. Someone who at the beginning of their mandate makes a bold statement and, at the end of the period, can show that she or he has managed to overcome the problem always gets respect. In politics, respect is hard currency.

Some might argue that promising to quit if the problem is not solved is too extreme, that you never know what the world will be like, even in the near future. That is certainly true, and you can always make your promise conditional. But the chance of the media and the voters registering this conditionality in today's political landscape are pretty slim.

The main argument against promising to leave if you do not succeed is: what happens if you do not deliver?

That is a very good argument if it comes to something as difficult as halving unemployment or increasing growth. These are hard to resolve, and there are no simple unambiguous answers about what instruments should be used to do it. There are as many solutions as there are ideologies.

But cutting a deficit? Every person, household, firm and country knows how to do it. The instruments are there. Cut down on your expenditure and increase your revenue. It is no more difficult than that[17].

LESSON FOUR: SET GOALS AND STICK TO THEM

Solving the problem of time inconsistency is difficult. But in monetary policy the issue has been largely resolved. One of the monetary policy lessons of the past ten years is that transparency is good and that inflation targeting is very effective both theoretically and practically[18].

My view is that there are compelling reasons for not delegating fiscal policy in the same way as has been done with monetary policy, since fiscal policy lies at the heart of democracy. But there are certainly things to learn from monetary policy. Setting transparent goals for the deficit can help in signalling commitment.

Setting goals was not something that was planned from the start, but over the course of the consolidation programme we learned that it was an effective tool. It signalled commitment to the financial markets and the public at large. But maybe even more important, it became a framework for both the civil service and the opposition.

When the cabinet set the objectives, they trickled down all the way through the bureaucracy. Directors General used it to give instructions, heads of department used it, desk officers used it, and so on. It became apparent that dealing with the deficit was on the top of the government's agenda and that the government would reward those who lived up to it.

The same thing happened for the parliamentary opposition. It became an issue that was impossible to circumvent. Every party had to relate to the goals set by the government, and since it was the central issue most of the parties had to be tougher on the goals than the government, even though they of course disagreed about how it was to be done[19].

Our path was the following:

(1) By 1996 gross public debt was to be stabilised as a percentage of GDP.

(2) In 1997 we were to have a deficit less than three percent of GDP.

(3) By 1998 the public deficit should have disappeared.

Setting goals is always very easy. But sticking to them is much harder. At the beginning of 1996 the cyclical situation in Sweden was problematic, which meant that we saw difficulties in hitting the targets. So what did the government do? Instead of blaming business cycle developments, it took new measures. The contraction effect of fiscal policy was then met by the expansion effect of a confidence boost.

As public finances improved and it seemed certain that the path would be adhered to we wanted a medium-term target for public finances to avoid getting into problems again. It was articulated as 'the surplus in public finances should be two percent of GDP over the business cycle'.

Having a goal like that has pros and cons. The good thing is that it creates a standard to aim at, but it is pretty hard to decide whether or not it has been achieved. It can even be ex-post difficult because there is no exact definition of the business cycle.

Many economists, and the European Commission, argue that the optimal target for public finances is the so-called cyclically-adjusted deficit. The basic idea is to try to calculate the output gap in the economy and then adjust the deficit so that it tells you how large the deficit would be if the economy were working at its potential level.

This approach has very positive aspects, since it avoids large cuts if the economy is in a downturn. But there are also problems with it. The main argument against it is that it is very difficult to communicate. Try to explain it to a parliamentary group where half would lose their seats if the opinion polls revealed that the cyclically-adjusted primary deficit is misaligned.

This goes hand in hand with the argument that it is impossible to pinpoint the output gap, since it is a theoretical figure and impossible to measure. Therefore my view is that it is a good indicator, but not more.

Within the European Union there is the so-called Stability and Growth Pact (SGP). In short it can be said that countries are not allowed to run a deficit larger that three percent of GDP and that the gross debt level should fall to below 60 percent. Does that mean that the issue is thus resolved for all European states? I do not think so. When someone sets a goal for you to aim at, there is always a chance that you will start cheating.

Even if the new and revised SGP tells countries that they should have their own national goals for fiscal policy, it is not enough. The important thing is 'ownership', and thus whether you really want to stick to it.

The budgetary goal for 1997 was the same as the convergence criterion set by the European Union (EU). That is not a coincidence. But it was never presented that way, and if the Swedes had voted no to joining the EU in 1994 I am sure that the goals would have been even tougher, since Sweden would then have been alone.

The European Commission's main role in the Swedish budget consolidation was to approve the convergence programmes. It was seen – and used publicly – as a go-ahead signal. Thus it was the political reward that was important, and not the threats.

My conclusion is that the European Commission should be very flexible in allowing countries to set their own rules. They may set different deficit rules, but also different debt rules. One small caveat could be how the country should be judged. In 2004 and 2005 our figures showed that we would have a surplus below the targeted surplus of two percent[20]. As a result Sweden was criticised by the Commission for not living up to its own rule. Fair point, but it felt a bit awkward since the European rules were designed to prevent you from running a large deficit.

The European Commission argues that there are links between numerical fiscal rules and budgetary outcomes[21]. But maybe the causality is the other way around. A country that with a government which really wants to get rid of a budget deficit tends to set goals[22]. So, if you are in a government which does not care about the deficit but which wants for political reasons to been perceived as being tough on deficits, setting fiscal policy goals will not help you very much.

A priority is only of interest when it is tested against other priorities. The same applies for goals. Sweden had a goal for unemployment of four percent by the year 2000. At the same time there were goals for public finances. There were quite heated arguments about which one was the more important.

The government argued that the unemployment target was more important, since that is crucial for an economy. But in order to be able to force down unemployment it was a precondition that public finances should be in order - see lesson one. In the end, both goals were achieved.

LESSON FIVE: CONSOLIDATION SHOULD BE DESIGNED AS A PACKAGE

A consolidation programme has to be designed as a comprehensive package. An ad hoc hodgepodge of measures will only have a limited chance of success. Presenting the consolidation measures in one package makes it clear to all interest groups that they are not the only ones being asked to make sacrifices.

The idea is to signal that you are not partisan and that the budget deficit is a general problem that everyone should participate in solving.

As a politician you can never explain why you need to cut pensions alone. But if, at the same time, you cut child benefits and unemployment insurance and raise income tax for the richest, you are on safe ground. The idea is to not single out the losers.

When one strong interest group complains, you are in trouble. But if everybody complains, you are not.

Bundling the measures together makes it possible to study the combined effects of the package. Let's face it: expenditure cuts mostly hit the not-so-well-off in society. They are the ones who need the state most. The opposite applies to taxes. It is usually the better- off who pay more tax. There are of course many exceptions, for instance state subsidies and VAT, but in general terms this principle still holds.

If a consolidation package consists of both tax increases and expenditure cuts the distributional effect can be fair. When studying the distributional consequences, do not only use the income distribution perspective. There are other dimensions that also are important, such as for instance gender, age and geography.

There is both theoretical and practical evidence that consolidation packages consisting mainly of expenditure cuts are more successful[23]. The higher tax ratio you have, the more likely it will be that the taxes will create distortions and, in the long run, all expenditure has to be paid by taxes.

But, there is also empirical work showing that a right-wing government that raises taxes is more likely to succeed in budget consolidation than a right-wing government that only adheres to expenditure cuts. The opposite goes for left-wing governments: those that mainly rely on expenditure cuts are far more likely to succeed than those who confine themselves to raising taxes[24]. The main argument is that if you dare to confront your own constituency you will signal a greater sense of purpose and thereby obtain a confidence effect.

It is good to frontload the measures to convince the financial markets and the central bank that the government is serious about tackling the deficit[25]. It is also good for political reasons, since it creates momentum.

What about timing? You do not need to be a political genius to understand that starting a budget consolidation right after an election, at the beginning of the mandate, is optimal. If the measures are tough enough it might even create leeway for reforms at the end of the term of office.

The best solution is of course if you have been running an election campaign on the deficit. Such campaigns can be fought and won. But there is a saying in politics that the difficult thing is not winning one election. The difficulty lies in winning two.

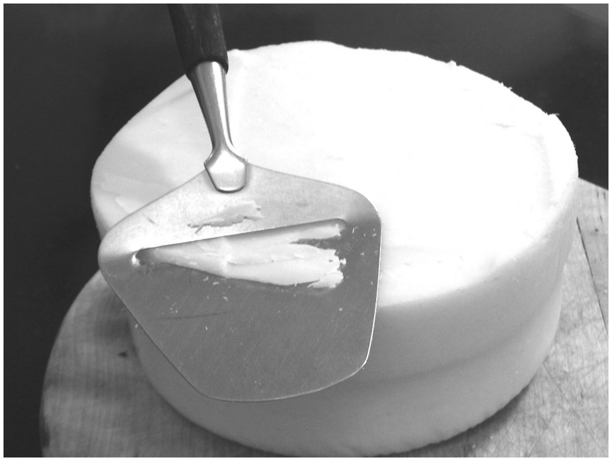
LESSON SIX: ACT STRUCTURALLY BUT BE CONSISTENT

To consolidate public finances there are basically five interesting areas (1) government consumption (2) investments (3) transfers (4) taxes (5) interest payments[26].

When you need to cut down on government consumption there are two different approaches. One way is to take a little bit from everything. The Swedish metaphor for this is to use the cheese slicer. To understand this outside Scandinavia you have to see our cheeses. We mostly eat hard cheese and we slice from the top, as shown in the picture. Thus by using the cheese slicer you take equally from everyone. The other way to decrease spending is to use the cake-slicer, ie to surgically remove selected items.

Most government bureaucrats tend to argue for the latter. In this way, bad programmes can be abolished (but see also lesson 8, arguing the wrong way will lead to demands to have the programme back when the situation looks better). It can also be used to liberalise sectors of the economy and thereby increase productivity.

But the first approach also has some positives to it. It can produce sizeable savings because the base is huge. During the Swedish consolidation a flat



11 percent was taken from all government expenditures with only a few exceptions. This sent a very strong signal to the bureaucracy.

It also serves as political education. Every one has to give something. It creates enduring budget awareness in the whole public sector. There are always pockets within bureaucracies that have been unaffected by budget pressure.

The bad thing is that the structural approach disappears by cutting small pieces here and there. During our budget consolidation I heard a senior Swedish ambassador saying that cutting 11 percent from the ministry of foreign affairs was the worst possible thing to do:

“Now we are cutting down on the innovative stuff. That is bad. Take half of our budget so that we need to reconsider everything we are doing. Or take nothing so we can continue to evolve in the right direction”.

Remember that cutting down on government expenditures means that there have to be cuts at the ministry of finance and the prime minister’s office as well. No exceptions when it comes to your own area. Do not ever forget the law of small numbers. One million here and two million there, and we are talking real money. Never trust a minister of finance who says that you do not need to worry about pocket money.

Some times it is better to cut down on areas that you would actually like to give more money to. We cut down on the money given to tax collectors, even though some argued that giving more money to them would increase tax revenues. It is really important to be consistent, even though it might not be the optimal solution in structural sense.

The next area is investments. This is a difficult area.

If one area should be avoided in the consolidation process, this is the one, as long as the investments have a positive return. By investments I mean both human and capital investments. The argument during the consolidation was that it was much better to cut down on benefits than to cut down on schools. As an adult, you could always live with having had an economically poor childhood but it is much harder to compensate for poor education, as the political argument ran.

Capital investments are a little bit different. As everybody knows this kind of investment is not always driven by cost/benefit analysis. Do not ask me to mention them, but there are always projects that are driven primarily by special interest groups or regions. This means that there are always a lot of projects out there that can be scrapped.

The next area is transfers, and by transfers I mean various kinds of benefits and subsidies to people. This is the area which is the toughest to cut down on. There are usually fairly good reasons why the transfer system is arranged as it is. And even if the system has deteriorated, removing it will create both political problems and, even worse, real problems for ordinary people who already are in trouble.

At least in Sweden, the volume of government spending which goes to transfers is huge, so there is no way of avoiding it. The basic approach should be structural. Try to get rid of poverty traps. Work should always pay more than not working. And so on.

When deciding on what kind of measures should be taken, it is good to use distributional calculations that also examine the gender perspective. Combine the statistical average calculations with calculations involving real people. That is how the man on the street will see it.

The media has another perspective. They will pick out the individuals that lose most from reform. If you cut down on child benefit, they will run a story on a mother of seven. If you raise real-estate tax, it will be about old people that will have to move since they can no longer afford to live in the house they built with their very own hands. That is understandable since a lot of individuals will face serious problems. One way to handle this is to have transitional rules for those already in the system. Another way is to introduce caps, even though this can create harmful marginal effects.

The way to handle the – at best – poor distributional effects is the same as above. Bundle them together and combine them with tax increases. The same argument applies as for transfers. Think structurally, but do not be afraid to do something that the economists would argue against if it fits the political strategy. By the way, if the economists do not complain, you are in trouble. Remember that everyone should complain!

One problem with this area is that economists and bureaucrats do not speak the same language when it comes to action. If you were to ask an economist how much of a consolidation programme consists of expenditure cuts and how much of tax increases, you would get one answer. Asking someone from the budget office in parliament or in government the same question would yield a totally different one.

An economist studying public finances in Sweden from the national accounts perspective would say that in 1994 Sweden had a deficit of 9.3 percent. By 1998 that deficit had turned into a surplus of 1.9 percent[27]. This improvement of 11.2 percentage points can be attributed either to higher revenue or lower expenditure.

Between 1994 and 1998 expenditures decreased by 9.5 percent of GDP and revenue went up by 1.7 percent of GDP. An economist would then argue that 85 percent of the reinforcement came from lower expenditures. Another way would be to look at the primary surplus, ie excluding interest rate payments, for reasons of stabilising or reducing the public debt.

None of this would be the preferred way for a bureaucrat working at a budget office. Every country has its own rules on how to calculate expenditure cuts. The standard way is to decide what year you are talking about and compare the expenditures with and without legislative change. This creates a lot of uncertainty for everybody apart from experts.

One example is foreign aid. Assume for instance that foreign aid is 0.7 percent of GDP. In comes a new government and decides to freeze foreign aid in nominal terms as part of an austerity package. If the consolidation package is a four-year programme, that would mean an enormous cut in expenditure in year four.

But it depends on how the law was written. If the law was written: 'foreign aid should be 0.7 percent of GDP, amounting to x kronor' the base line scenario - a no change policy - is an increase every year by 0.7 times the growth rate. Freezing it in nominal terms would be a huge cut.

On the other hand, if the law was written 'foreign aid is x kronor, amounting to 0.7 percent of GDP' freezing in nominal terms would mean no saving whatsoever since the baseline scenario is a fixed nominal sum. This is another reason why indexation of expenditures and wages is to be avoided at all costs.

When the budgetary experts calculated the Swedish reinforcement programme, expenditure cuts made up 51 percent and increased revenue 49 percent[28].

Which perspective is the right one? I do not know. But I believe in transparency. Show all the different measurements. Strange as it might sound, increased transparency gives you a higher degree of freedom. Any politician knows how to use the right numbers for the right audience.

The last area is interest payments. There are a lot of reasons to expect lower interest rates with a tightening of fiscal policy (more or less *ceteris paribus* depending on the monetary regime). With lower deficits and even surpluses the cost will diminish even further. Here is one area where the rule of conservative forecasting applies, which will be discussed below.

During our consolidation the government did not fully reap the potential gains in this area set out in the forecasts.

A lot of governments tend to privatise state-owned firms. That is good if there are structural reasons for doing so. But if it is only about money, think twice. If the firm delivers a profit, the gain from selling might be much smaller than expected. Going to an investment bank and trying to get some money in cash now can cost a fortune in the long run. And getting help from them to find budget gimmicks is costly, both in terms of reputation and in real money.

LESSON SEVEN: DO NOT LEAVE THE PROBLEMS TO THE LOCAL AUTHORITIES

Above we have looked at different ways of handling public finances. But observe the word 'public', not 'state' finances. There is another way of tackling state finances, and that is to shift the problem to local authorities.

That is something that should be avoided. This is an area where the Swedish budget consolidation was not very successful.

If the central government starts a large budget consolidation it will have an enormous impact on the political climate in the country. One result might be that a lot of local politicians will start to follow the example set by the leading politicians – especially if it is successful and if they are from the same party. Then the local authorities will start their own little consolidation programmes. That happened in Sweden.

The central government's consolidation programme will also have effects on local budgets, both direct and indirect. The effect of direct cuts is fairly straightforward, such as cutting down on transfers from central to local government. There are also plenty more subtle effects, such as lower tax receipts (from laying off state employees), lower real-estate tax (from falling house prices), and higher social costs (from lowering of unemployment insurance) and so on.

The combined effect of being squeezed from all sides can be devastating, depending on the responsibilities of the local sector. In Sweden it meant that we saw big cuts in schools, healthcare and childcare because they are financed through local taxes. This created enormous political problems since one of the main principles of the consolidation was that schools, childcare and healthcare were to be spared the cuts, see lesson 6.

That does not mean that one should not care about local finances. If the state can handle its own problems without moving them to the local level, then the local level tends to be able to sort itself out. It is always possible to help them on their way by introducing local or regional stability pacts.

LESSON EIGHT: BE HONEST TO CITIZENS AND FINANCIAL MARKETS

A consolidation process consists of many different phases. First, the measures have to be presented to the public and then they have to go through parliament. Then it will take some time before the measures become reality.

Even if the first phase of implementation is successful, renewed resistance will appear when the measures affect the voters' own pockets. It is then of vital importance that the government be able to say: 'This is nothing new. We have said all along that getting public finances in order is extremely tough and that it requires large sacrifices from everybody in society'.

Never say that it won't hurt. Never say that it is peanuts. Having been honest about the effects will not make it much easier, but being dishonest can lead to disaster. This will help ordinary people to plan ahead and to limit shocks.

In today's open and transparent world it is not sufficient to be open towards the general public. Every day the government and its deeds are watched by the financial markets. This is even truer if the country has its own currency.

The whole process must be as transparent as possible. Honesty towards the market means always clarifying assumptions and calculations. Never try to fool anybody by using gimmicks or accounting tricks. Only in this way can credibility be recovered, and only then can the programme earn legitimacy. Be transparent and extremely open towards capital markets. Try one budget gimmick and you may lose market confidence that could take years to regain.

It is worth spending some time on how to work with the financial markets. In fact we indirectly appointed one person always to be available for the financial markets, meaning that whenever someone wanted to talk with a political representative of the ministry of finance there was someone willing to meet them.

That person always had the time when someone from the financial markets (like Salomon Brothers, the California Teachers' Pension Fund, Paribas, Moore Capital and so on) came to Sweden to spend one hour with the economist explaining policy, politics and economics. Then the visitors had the chance to ask the questions that they had difficulty understanding at their trading desks in London, Paris or New York.

At the beginning of the consolidation programme the minister of finance travelled around the world to meet 'the sneering 25 year-old traders'[29] in order to tell them about politics and policy. As time passed and the success of the consolidation became more apparent it was enough to send the young advisers to London and New York.

It is quite common that the turn-around of a country (both in a good or a bad direction) be spotted first by someone outside the country. If you live in a country with problems you tend to think that nobody can solve the problem. But if you are living outside it is easier to distinguish the wood from the trees.

Having hedge funds active in a country can be both good and bad. During our consolidation they were among the first to spot that we would succeed. They made a lot of money when our interest rates fell dramatically. That money was well earned and it served the tax payers' interest.

Going back to forecasting, this lesson has one exception. I believe that it is of great importance that the minister of finance is conservative when it comes to prognosis. If forecasts are conservative, it becomes more evident why something has to be done to tackle the problem – thus increasing public understanding.

But the most important thing is that it can create a virtuous circle. If the right measures are taken, things will improve. And when this starts to be seen in the data, it comes as a pleasant surprise.

Positive data will give a perception of movement. That finally there is a solution around the corner. It will then increase public confidence, which can have a positive impact on consumption and interest rates. It will decrease expenditure and increase revenue, which will have an impact on public finances, which will turn out even better. And so on.

The worst thing to do is the opposite. Assume that for one reason or another it is politically impossible to take the necessary decisions and that the consolidation package is thus too small. One way of handling this is to make projections that are on the optimistic side when it comes to interest-rate movements, employment effects or growth. In this way it may be possible to – at least in the world of mathematics – show that the government is capable of managing public finances.

In an ideal world, this trick works. But in the real world, something bad happens. Observers on the financial markets, smart journalists and independent international organisations will sooner or later reveal the truth. This will have a negative effect on confidence, and the risk of getting into a negative spiral is obvious. If the decisions are inadequate, make this clear in the figures. With some luck, it may be sufficient if the country gets into a virtuous circle.

One example of a successful politician in the above regard is the German Minister of Finance Peer Steinbrück who, by being conservative in his pronouncements, succeeded in getting into a virtuous circle. Throughout 2006 he kept on talking about the problems he had in achieving the three percent deficit level set by his colleagues and the Commission. I am certain that he knew that the underlying figures would turn out better than projected.

But he did not use the figures to do what a lot of politicians would do in a similar situation: call a press conference, write an article or release the numbers at a party conference. Instead he kept talking about the problems, and every time new figures came out in the media it was seen as a pleasant surprise. The deficit for 2006 ended up at 1.7 percent of GDP[30], 1.6 percentage points better than his February 2006 projection of 3.3 percent of GDP. Germany had got into a virtuous circle.

LESSON NINE: STICK TO ONE MESSAGE

As must have been clear so far, budget reinforcement is very much about avoiding discrepancies between what you do and what you say. There are at least two pitfalls here that are worth spending some time on.

Do not confuse structural policy with budget reinforcement. Of course you should try to do your expenditure cuts in a structurally sound way. It is a lot better to cut down on systems with poverty traps and large marginal effects than to cut, for instance, on schools and research. Be aware also that if you use the argument that you are cutting down on this or that specific system because you cannot afford it, you are on a dangerous path.

In an ideal world it may work, and when the deficit has disappeared you can refocus on other areas you want to spend money on. But do not be surprised if there are loud voices saying that you should restore the old system. Then it will take some extra political capital to say that the new alternatives are more important. The best thing would of course have been if you had said that the main reason for getting rid of the old system was because it was bad and not because you could not afford it.

The Swedish consolidation was not very successful in this respect. The basic reason is that the main argument for the government to cut down on expenditures was tied to budgetary problems, not structural problems. Of course there were many structural problems, but that was not acknowledged publicly. The result was that, when the consolidation process was over, there was a strong wave of opinion in favour of restoring the old rather than adopting the new.

You need to be consistent. If you need to cut down unemployment benefits because you need the money, you also need to raise taxes for the rich in order to get the money. Here is where a lot can go wrong. In Germany the budget consolidation programme was at times combined with tax cuts. This creates political problems of consistency.

In Sweden similar mistakes were made. At one time the government decided to cut down on expenditures to finance a tax cut in VAT on food. The result was that people became furious. 'You are not cutting down because you need to. You are cutting down because you want to'. That was an impossible argument to handle, since the message was budget discipline, but the action was structural.

Another pitfall is if you try to win over the voters by combining the difficult cuts with some small spending increases. The political idea is that this approach can have a pain- killer effect. It does not. Rather the reverse. People only get even angrier! Or in more brutal terms: if you chop someone's arm off, they do not recover their good humour if you give them candy afterwardsƐ

One mistake made during the Swedish consolidation programme was that, at the time of introducing the package, a small tax deduction was introduced for those who started to save money in special accounts. That was no hit. The general public was prepared to handle expenditure cuts and tax hikes, and when the government came out with a bonus, they just became puzzled.

In the best case nobody will notice the improvement, and then it is wasted money. In the worst case, it will be seen as a sign of inconsistency.

This logic also applies when the consolidation has been successful. Do not declare success until you are ready to change theme. If you are not finished with the budget cuts, do not declare victory and start giving away money. Wait until the last measure has been carried out and felt by the voters. Getting the measures through cabinet or parliament is not enough. People tend to know very little about such processes, but a lot about what happens in real life.

THE TENTH AND FINAL LESSON: STICK TO IT

When you have got this far, you have accomplished the first phase of consolidating public finances. But there is also a second phase: the phase of sticking to the programme and avoiding the same problems again[31]. This phase consists of monitoring public finances, confronting institutional weaknesses and fighting inflation.

Sweden carried out a few structural reforms which I will not spend time on here, such as joining the European Union, reforming the pension system and giving formal independence to the central bank and the national audit office. These are important and fundamental reforms the importance of which should not be underestimated.

But Sweden also had problems with the budget procedures both in parliament and in cabinet. The important analytical contribution came from von Hagen[32]. He ranked the different EU countries depending on how rigid their budget procedure was. Sweden had the second laxest budget procedure. This was picked up by a government study that was published[33] and, as in all ranking issues, this led to a debate about whether the ranking was calculated correctly or not. Thereafter it was time for action.

The new framework consists of a nominal, rolling three-year expenditure ceiling for central government. As a rule, the government proposes to parliament an expenditure ceiling for the third additional year. The ceiling covers all items in the budget, including cyclically sensitive items such as unemployment benefits.

The expenditure ceiling enhances parliament's and the government's control over the size of the public sector. The decision about the total volume of expenditure is taken in one vote in parliament. Thereafter the 27 different sub-ceilings are taken in different votes. This means that if someone wants to add an expenditure item, they must finance that through decreasing funding for another expenditure item. There are even some economists that argue that having spending rules is even more important than having a deficit rule[34].

In the fourth lesson I argued that it is good to have a medium-term goal for public finances. It can be used to help stay in a virtuous circle, since the cost of failing to live up to the goal is high. But it does not, by itself, move a country from a vicious circle to a virtuous one. Only concrete action can do that.

The difficulty with the final lesson is that it never ends. Until the deficit, sooner or later, rears its ugly head again. Then it is time to go back to the first lesson.

CONCLUSIONS

The OECD sums up some evidence for fiscal consolidation in OECD countries[35]:

> *'Large initial deficits and high interest rates have been important in prompting fiscal adjustment and also boosting the overall size and duration of consolidation. These results may reflect that public awareness of fiscal problems and needs can help in overcoming resistance to consolidation, a hypothesis which is also supported by the observation that qualification for euro area membership significantly increased the probability of starting consolidation. The policy implication would be that consolidation may be helped by the provision of transparent information and analysis of the fiscal situation.'*

- An emphasis on cutting current expenditures has been associated with overall larger consolidation. This could be because expenditure cuts, as opposed to revenue increases, are more likely to trigger lower interest rates and a sympathetic response of private saving, helping to bolster activity. But it could also reflect that governments more determined to consolidate are more willing to cut current expenditures, possibly thereby also demonstrating a commitment that makes substantial consolidation more feasible.

- Fiscal rules with embedded expenditure targets tended to be associated with larger and longer adjustments, and higher success rates. This

> could in principle reflect that well-designed fiscal rules are effective or, alternatively, that governments committed to prudent fiscal management are more likely to institute a rule.'

If I were to sum up the lessons I have learned it would be the following:

The two first lessons were about why I think it is important to get your public finances in order. Lesson three and four was on different ways on how to signal commitment, that you really intend to do something about the deficit. Lesson five, six and seven were on the nuts and bolts of a consolidation programme. Lesson eight and nine was on how to communicate while the programme is running. And the tenth and final lesson was how to avoid getting back in trouble.

Do it. Explain it. Avoid it.

Action matters. Avoid making mistakes, and be consistent. A budget consolidation does not need to affect the social model decided on by the voters in a given country. A budget consolidation can even make a country stronger, both in the short and in the long term.

NOTES

1 An essay like this cannot be written without the help and experience of other people, and especially those who I worked with at the ministry of finance in Sweden during 1994 and 2006 and those that have listened to and commented on different versions of this essay. But let me particularly thank Romhányi Balázs, Xavier Debrun, Jon Cunliffe, Andrew Fielding, Harry Flam, Sten Henriksson, Assar Lindbeck, Wolfgang Michalski, Thomas Mirow, Xavier Musca, Sten Olsson, Leif Pagrotsky, Göran Persson, Jean Pisani-Ferry, David Strömberg, Svante Öberg and an anonymous journalist at the New York Times for their useful suggestions on this and earlier versions. Any remaining mistakes and misjudgments cannot be blamed on anyone but myself.

2 OECD Economic Outlook, December 1994.

3 For an analysis of Swedish Economic Policy 1982 – 2000 see 'An account of fiscal and monetary policy in the 1990s' (2001).

4 To understand the magnitude of the problems Sweden faced in the 1990s see Lindbeck et al (1994).

5 Swedish government bill (1994/95:25).

6 Speech at 'Budget Deficits and Debt: Issues and Options', a symposium sponsored by The Federal Reserve Bank of Kansas City (1995).

7 'Den som är satt i skuld är icke fri', Persson (1997).

8 See for instance Oesterreichische Nationalbank (Austrian National Bank) (2003).

9 Drazen and Grilli (1993) see the benefit of crises for economic reforms.

10 Drazen and Easterly (2001) fail to find evidence that a crisis in the form of a high budget deficit or a negative per capita growth rate are followed by periods of better performance.

11 Commission sur la Dette Publique (Commission on Public Debt) (2005).

12 Economic research and theory are by no means as settled as I am. There is no consensus on the optimal debt level for a country.

13 Read for instance 'The lessons from the Nordics' from the Dutch Ministry of Finance (2005). For a more critical view, read the European Economic Advisory Group report on the European Economy (2007).

14 There are good arguments for this, see for instance the seminal contribution by Sargent et al (1981).

15 In economic theory the inability of politicians to tackle the deficit is explained by a model based on a so-called 'war of attrition'. When two different groups in society disagree on how to allocate the cost of stabilisation and both have veto rights, only the passage of time will reveal which of the two groups is the weaker, see Alesina et al (1991).

16 Alesina et al (1998) have found no evidence of political cost in an examination of poll data and cabinet turnover after fiscal adjustments.

17 The real problem is when you cannot use the instruments, for instance, as a result of being in a minority government. But remember that the Swedish con-

solidation was carried out by a minority government. Explaining the interaction between policy and the constitutional framework is the subject of extensive literative of its own, see Persson and Tabellini (2000).

18 The best place to get an overview of the research frontier in monetary policy is the webpage of Lars Svensson at http://www.princeton.edu/svensson/.

19 In the Netherlands this has been taken one step further. In the run-up to general elections, the Centraal Planbureau publishes an independent analysis of the economic effects of the political parties' election platforms. See Grafland and Ros (2003) on the merits of this analysis. This has not been done in Sweden, but my view is that it would be a good idea to have an independent agency calculating the budgetary costs of each party's election platforms.

20 At the end of the day, the average surplus between 2000 and 2006 came in above two percent of GDP.

21 See European Commission (2006).

22 Debrun (2007) argues that fiscal rules and institutions do not seem to affect budgetary outcomes once one controls for the influence of political factors that are generally deemed conducive to a commitment to fiscal discipline.

23 Alesina and Perotti (1996) conclude that fiscal adjustments which rely on spending cuts are more likely than others to be followed by improved macroeconomic conditions.

24 Tavares (2004) concludes that left-of-centre governments gain credibility when they cut spending, while the right becomes more credible when it increases tax revenues.

25 With maximum credibility backloading would be preferable since it would lead to an increase in output due to the effect on expected future output and interest rates, see Blanchard (2006).

26 Fiscal consolidations that concentrate on transfers and government wages are more likely to succeed in reducing the public debt, according to McDermott and Wescott (1996).

27 From March 2007 public finances in Sweden were revised down by roughly one percent of GDP yearly due to a Eurostat decision to include the private elements of the public pension scheme in private savings. In this paper the old definition will be used, as originally approved by Eurostat. Otherwise the goals of economic policy would have to change ex post as well, since they were established at the time when Eurostat thought and decided differently.

28 Out of the net programme totalling 125.5 billion SEK, gross expenditure cuts amounted to 71.2 billion SEK and gross revenues to 69 billion SEK, see Ministry of Finance (2001) p. 27.

29 A phrase coined by Göran Persson to show his discontent with being in the hands of the market, see lesson 2.

30 Spring Economic Forecast by the European Commission (2007).

31 There is research literature in business administration called 'change management' where the last step in a process tends to be 'make it stick'.

32 See von Hagen (1992).

33 See Molander (1992).

34 Anderson and Minarik (2006) argue that spending rules are simpler and less prone to cheating.

35 See for instance OECD Economic Outlook spring 2007, but the following quote comes from the underlying article by Guichard et al (2007).

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by

Jens Henriksson

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