

FISCAL CONSOLIDATION – LESSONS FORM THE PAST

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Abstract: *Fiscal consolidation is one of the most commonly used instruments of fiscal policy in order to "recover" the economy of a country. Successful implementation of the fiscal consolidation plan leads to a reduction of the budget deficit and public debt, with expansive effects primarily related to GDP growth. However, the success of fiscal consolidation does not depend only on a good plan or precise strategy. The complexity of fiscal consolidation requires knowledge of the entire macroeconomic system. The aim of this paper is to, based on previous experience, define the conditions which determine successful fiscal consolidation. Also, the paper will emphasize the most common mistakes which prevent consolidation from going in the desired direction. It should be mentioned that there is no unique fiscal policy and that each country has the opportunity to formulate a fiscal consolidation strategy based on its predispositions, expecting to bring the best results.*

Key words: *Fiscal consolidation, fiscal policy, budget deficit, GDP growth, fiscal consolidation strategy*

INTRODUCTION

Fiscal consolidation is a process of improving the fiscal "health" of the state. Priority goal, in most countries that implement fiscal consolidation, is to reduce the fiscal deficit in an economical and rational way for economic stability. The fiscal deficit produces a number of negative effects, for the government of one country (higher interest payment cost) and for the economic situation in the country (increase in interest rates leads to an inflationary effect). With a clear, precise and concrete fiscal consolidation strategy it is possible

to stop negative trends in the medium and long term, although a large number of fiscal consolidations in the short term have negative effects. (Philippopoulos et al., 2016).

The fiscal consolidation strategy which country chooses depends on a number of factors. However, the empirical literature finds that most authors consider the macroeconomic environment to be an extremely important factor in fiscal consolidation. (Leigh et al., 2010; Luca Agnello, 2013; Yang et al., 2015). In particular, higher GDP per capita, lower real interest rates and greater trade openness help to shorten the time of the consolidation process.

1. TYPES OF FISCAL CONSOLIDATION

The simplest definition of fiscal consolidations is that it is a process of harmonization public revenues and public expenditures. Accordingly, consolidation can be done by adjusting on the revenue side or adjusting on the expenditure side. From this point of view, we get two basic types of fiscal consolidation. Often, fiscal consolidations are a combination of these two types of adjustment (Alesina, Azzalini, et al., 2017).

Respecting a leading journals and studies in this area, it is evident conclusion that the most of successful fiscal consolidations were conducted on the side of public expenditures. Fiscal consolidations with expenditure adjustment had long-term positive effects. (Alesina, Barbiero, et al., 2017; Alesina & Ardagna, 2009; Bosworth, 2010). The measures were mainly related to: reduction and / or freezing of salaries and pensions, reduction of employment, reduction of administrative costs and similar. Contrary, there are countries with successful fiscal consolidation

plans based on increased taxes and other contributions. The conditions for the success of consolidations are that the share of tax revenues in GDP was relatively low and that the increase in tax rates was introduced gradually. (Tsibouris et al., 2006). A basic argument for fiscal consolidations on the expenditure side is that tax increase will reduce household income and their private consumption, which later reflects on private investment and triggers a whole spiral of negative effects.

Reducing government spending and transfers have fewer negative effects than increasing taxes. Standard new Keynesian models correspond to these results if the effects of fiscal shocks are permanent. The effects of wealth on aggregate demand mitigate the impact of permanent consumption reductions. Consolidation plans based on tax increases are characterized by the highest intertemporal correlation, which indicates that tax plans usually contain a series of tax changes that are spread over time. Overall, expenditure-side fiscal consolidations appear to be more successful and have more favorable effects on long-term economic growth than revenue-side fiscal consolidations.

2. PRECONDITIONS FOR SUCCESSFUL FISCAL CONSOLIDATION

When we talk about fiscal consolidation, based on the empirical and theoretical literature, it is necessary to take into account the time of implementation of the consolidation plan. A large number of consolidations are being carried out after a certain economic crisis, all with the aim of getting out of the crisis faster. Empirical research shows that consolidations take place mainly in recessive periods and that this leads to its pro-cyclical character.

Successful fiscal consolidation, in addition to a good plan and strategy, depends on a number of other factors and circumstances that may be internal or external: the composition of the consolidation program, its size and durability, the severity of the debt situation, the impact of the international macroeconomic environment and the contribution of previous devaluation. Consolidation is more likely to succeed if consolidation: takes place in a favorable international macroeconomic environment with high economic growth and low real interest rates, if it involves a reduction in transfers and if it does not rely on increased taxes on households and labor or reduced government investment (Heylen & Everaert, 2015).

Fiscal consolidations based on expenditure reforms accelerate output growth, especially in combination with structural reforms. Considering that the tax burden is already high, the scope of revenue-based consolidation may be limited for a number of euro area countries (ECB, 2010). Episodes of fiscal adjustment are usually accompanied by large reductions in public investment, so reforms under fiscal rules aimed at protecting growth-adjusted expenditure should be supported by protective measures which enable effectively managing public investment at all phases of the cycle.

Most successful fiscal consolidations have been expansive and long-term. Fiscal consolidation is successful if the reduction of public debt in GDP is greater than 4.5% of GDP, in the period after three years from the beginning of the implementation of fiscal consolidation measures. Alesina et al (2015) showed that the implementation of multi-year measures indicates the existence of non-Keynesian effects. This implies that reducing public spending, with the aim of reducing the budget deficit, can have positive effects on economic growth. The reduction in public spending is associated with increased efficiency in the public sector, and this may be a signal to financial markets regarding improved long-term fiscal sustainability.

Fiscal consolidation depends on the channel of expectations. The implementation of the fiscal consolidation plan leads to the expectation that taxes will be lower in the future. It should be emphasized that if public debt levels are relatively low and consumers do not expect significantly lower taxes in the future, Keynesian effects occur (current consumption decreases, so there are negative effects on production in the short term). However, in the case of high levels of public debt and larger reductions in public spending, individuals behave in line with non-Keynesian effects (expecting to pay lower taxes in the future, individuals increase current spending and thus induce growth).

In addition to the "traditional" Keynesian and non-Keynesian effects, fiscal policy affects trust and demand through the "fiscal-financial" channel. Consolidation can have positive effects on consumption or increase the collateral value of assets which, in turn, increases the benefits of financial intermediation, consumption and investment. Consolidation at the right time compensates potential errors regarding the estimated size of output gaps and basic budget positions (Rother et al., 2010).

The establishment of a public finance information system, which should be able for the proper collection of detailed data on state budget

revenues, as well as the control of the execution of revenues and expenditures of the government sector, can also make a great contribution to the process of successful fiscal consolidation. This would guarantee better liquidity management and more precise plans in the future, which relate to assessing and managing the stability of public finances. Modern literature is increasingly exploring how governments and their organization have an impact on fiscal consolidation, but also on their re-election results. The general conclusion is that all fiscal adjustments are not recessive. There are examples where sharp reductions in the budget deficit are accompanied by constant growth, not recessions, even in the very short term. These are the most common consolidations that have occurred on the consumption side and have been rigorous. The governments of these countries, despite sharp cuts, have been re-elected (Alesina, 2010).

3. FACTORS THAT REDUCE THE POSSIBILITY OF SUCCESS OF FISCAL CONSOLIDATION

The importance of the fiscal consolidation plan has already been mentioned. However, regardless of the quality of the plan, if there is inconsistency in implementation, fiscal consolidation has a high chance of failure. A significant reduction in government investment has been observed, especially when debt is high and the country is in a restrictive phase of the economic cycle. In that case, fiscal consolidation aimed at short-term stabilization could harm the economy in the long run. Fiscal consolidation may have unintended consequences for economic growth. If we reduce consumption and investment, globally, additional public savings can have greater negative consequences than usual. Again, it could be concluded that it would be more efficient to postpone fiscal consolidation until the economic recovery begins. In fact, at the height of the crisis, it is better not only to postpone savings, but to increase public spending and finance it with additional borrowing in countries where the fiscal space allows.

There are a number of empirical studies showing that a relatively high share of unstructured rigid spending contributes to the likelihood of adverse fiscal flows and reduces the likelihood of fiscal consolidation success. Moreover, the effect of rigid costs seems to be more relevant for economies with higher inequality, lower margins and countries with lower institutional quality. In addition, observing the composition of rigid expenditure measures, there is some evidence that higher pension expenditures reduce the probability

of fiscal consolidation success more strongly than higher wage expenditures (World Bank, 2019).

If the mistakes which lead to the failure of fiscal consolidation were systematized, the following could be stated: delay of the consolidation process, overestimated ability to reduce public spending, inconsistency in the implementation of the fiscal consolidation process, lack of structural reforms that should accompany this process, unfavorable political situation in the country and the environment, the inadequate role of budget institutions and similar.

CONCLUSION

Fiscal consolidation that relies on a reduction in current expenditures is usually more permanent than consolidation on the revenue side. Greater government stability and better institutional quality are also associated with successful fiscal consolidations. Regarding the macroeconomic effects of fiscal consolidation on economic activity, it has been shown that, although consolidations tend to moderately affect growth in the short run, the effects have not been as pronounced as generally expected. In addition, fiscal consolidation can have positive long-term effects, especially when more fiscal space is used to reduce capital taxes, after debt reduction. However, these long-term gains may not occur if consolidation involves a reduction in public spending on infrastructure. A significantly larger reduction in government investment in relation to government spending works especially when debt is high and the economy is at a low stage of the economic cycle. Therefore, in this context, fiscal consolidation aimed at short-term stabilization can harm the economy in the long run, negatively affecting public investment, calling for reflection on how to properly define a fiscal consolidation strategy, to avoid such unintended consequences.

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SUMMARY

Fiscal consolidation is a process of improving the fiscal "health" of the state and its priority goal, in most countries that implement it, is to reduce the fiscal deficit in an economical and rational way for economic stability. The fiscal deficit produces a number of negative effects, both for the government of one country (higher interest payment cost) and for the economic situation in the country (it means an increase in interest rates and leads to an inflationary effect). With a clear, precise and concrete strategy of fiscal consolidation, it is possible to stop negative trends in the medium and long term, although a large number of fiscal consolidations in the short term have negative effects. The fiscal consolidation strategy that a country will choose depends on a number of factors, but the empirical literature finds that most authors conclude that the macroeconomic environment is an extremely important factor in fiscal consolidation. In particular, higher GDP per capita, lower real interest rates and greater trade openness help to shorten the time of the consolidation process. Fiscal consolidation that relies on current expenditure reductions is usually more lasting than revenue-based consolidation. Greater government stability and better institutional quality are also associated with successful fiscal consolidations. Regarding the macroeconomic effects of fiscal consolidation on economic activity, it has been shown that, although consolidations tend to moderately affect growth in the short run, the effects have not been as pronounced as generally expected. In addition, fiscal consolidation can have positive long-term effects, especially when more fiscal space after debt reduction is used to reduce capital taxes. However, these long-term gains may not occur if consolidation involves reductions in public spending on infrastructure. Significantly stronger reduction in government investment related to government spending has effects especially when debt is high and at a low stage of the economic cycle. Therefore, in such contexts, fiscal consolidation aimed at short-term stabilization can harm the economy in the long run, adversely affecting public investment, calling for reflection on how to properly define a fiscal consolidation strategy, to avoid such unintended consequences.