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Experience with Large Fiscal Adjustments

George C. Tsibouris, Mark A. Horton, Mark J. Flanagan,
and Wojciech S. Maliszewski

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The following symbols have been used throughout this paper:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (e.g., 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g., 2003/04) to indicate a fiscal (financial) year.

"n.a." means not applicable.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

This Occasional Paper analyzes the experience of countries that have implemented very sizable fiscal adjustments over the past three decades. It aims to identify key conditions and institutional approaches that have contributed to sustained outcomes and to favorable macroeconomic developments. In this way, the paper may provide operational guidance to policymakers. The paper was prepared by George Tsibouris, Mark Horton, Mark Flanagan, and Wojciech Maliszewski while they were in the IMF's Fiscal Affairs Department (FAD).

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Opinions expressed in this paper are solely those of its authors and do not necessarily reflect the views of the International Monetary Fund, its Executive Directors, or national authorities.

I Overview

There are instances when policymakers may have little option but to consider a sizable fiscal adjustment. In such circumstances, they may be confronted with questions such as, Can a large fiscal adjustment be implemented successfully? How is a large adjustment best designed and implemented? What will be its impact on the economy?

This paper sheds light on these questions by describing the experience of countries that have undertaken large fiscal adjustments over the past three decades. It identifies preconditions, common policy approaches, and institutional arrangements underlying successful and unsuccessful adjustment episodes, thereby providing operational guidance to policymakers.

The key findings of this paper are the following:

- Large adjustments have occurred relatively frequently over the past 30 years. Some 300 episodes of consolidation in excess of 5 percent of GDP were identified over the past three decades, nearly half of which involved an adjustment over a relatively short time span of just one to two years. Sizable consolidations have been implemented under a range of circumstances, including during financial crises, as part of planned adjustments, and in connection with improved economic circumstances. Large adjustments have been undertaken by a diverse group of countries, including G-7 countries, EU member states, resource-rich countries, major emerging market countries, and numerous developing countries.

- Macroeconomic conditions at the outset of large fiscal adjustments were relatively difficult. Countries that undertook large adjustments had significantly higher debt ratios and inflation at the outset, as well as more sluggish growth of GDP, private consumption, and investment, relative to countries that undertook small fiscal consolidations. Restoring sustainability and ensuring access to short-term financing proved to be pressing needs. The structure of the fiscal accounts for countries that undertook large fiscal adjustments showed greater reliance on relatively volatile grants and nontax revenues, less reliance on domestic indirect taxes, and more capital investment outlays in the run-up to the adjustment.

- Durable large fiscal adjustments relied primarily on expenditure reduction. Statistical and econometric analyses suggest that a balanced reduction of capital and current spending, with an emphasis on a durable lowering of the wage bill, worked best in these situations. A high interest burden proved relatively difficult to overcome and led to a lower incidence of success. Medium-term budgetary frameworks tangibly supported the adjustment by providing a road map and a benchmark when additional measures were needed.

- There were also cases of durable fiscal adjustments based on revenue enhancement, particularly in countries with low initial revenue-to-GDP ratios and where the pace of adjustment was more gradual. This allowed for sustained implementation over time of tax policy and administration reforms.

- High political risk had an adverse impact on the duration of adjustment. Case studies confirm that political support was a key element in sustained fiscal adjustments.

- Large adjustments, in contrast with small consolidations, generally had a positive macroeconomic impact. Among large adjustments, a more gradual pace of implementation seems to have led to more favorable macroeconomic outcomes.

The analysis of individual country experiences also highlights the importance of fiscal structural reforms. In particular,

- greater transparency and improved monitoring of the fiscal stance has helped to focus attention on underlying policies at an early stage and to generate stronger political support;

- enhanced legal and institutional arrangements, as well as fiscal indicators such as the nonresource balance in oil-producing countries, have played an important role; and

- countries with more advanced expenditure management systems faced a less arduous task when undertaking fiscal adjustments by being able to better track and control contingent liabilities and tax expenditures, and to improve debt management.