# Controlling Spending and Government Deficits

## Lessons from History and International Experience

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Policy Exchange

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# About the Authors

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He is a member of the IEA/Sunday Times Shadow Monetary Policy Committee, is one of Europe's top experts on the economics of financial regulation (having led the teams assessing for the European Parliament the impact of the Financial Services Action Plan, led one of the two large projects for the European Commission on the same, and led the project for the Financial Services Authority on the impact of the Markets in Financial Instruments Directive) and is a leading UK authority on cost of capital analysis (advising Ofwat on the cost of capital for the water industry, the CAA on the costs of capital for the London Airports, and Ofcom regarding BT, Sky Digital, and others).

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# Executive Summary

Over the last year, there have been a number of media discussions of significant past examples of fiscal consolidations, particularly those in Sweden and Canada in the 1990s. Our view is that whilst it is valuable to draw on historical and international lessons, one should be careful of inferring too much from a few specific cases with their own idiosyncratic features. We therefore felt that it would be of value to have a study based on a broader set of examples and to examine a common set of policy questions about spending control across a wider set of cases. We have chosen a sample of twelve cases.

- **International lessons:** We look at two countries that have recently experienced major financial sector crises: *Sweden: 1993-2000 and Finland: 1994-2000*. We examine two other English-speaking countries which experienced severe fiscal crises: *Canada: 1994-2000 and Ireland: 1987-2000*. We also review evidence from longer running consolidation episodes in two other European medium-sized developed economies: *Germany: 1994-2000* and the *Netherlands: 1983-2000*.

- **Historical lessons:** We also attempt to draw lessons from previous UK attempts to control spending: *1922-29* (the "Geddes Axe"); *1931* (Balancing the Budget in the face of Depression); *1968-69* — (A Credit Crunch and IMF Bailout); 1976-7 (The second IMF bailout in short succession); *1981-88* (the Thatcher years) and *1992-1999* (Ken Clarke and the "Iron Chancellor" years).

In each of the cases we examined there were real terms cuts in spending, as opposed to simply relying on growth to reduce the deficit or reduce spending as a share of GDP. However, the spending cuts programmes we examine differed markedly in their size and how long their effects persisted, as illustrated in the tables below. The lowest longevity of cuts for our sample was that of the UK in 1968: just one year. The most extended period of cuts was the Thatcher spending controls of the mid 1980s – spending in real terms was still lower in 1990/1 than it had been in 1984/5, a remarkable six year period of spending restraint[1]. The closest parallel in our sample was the spending controls in Sweden. In Sweden although spending exceeded its 1995 peak in 1999, it then fell back to around its 1995 level for a further two years.

It is also of interest to understand how deep and how rapidly cuts were introduced. This is set out in the following table and charts. We see that for the UK the deepest cuts were clearly those of the 1920s. The deepest, in any one year, of recent decades in the UK were those of 1976/7, when spending fell 4% in real terms. Real term cuts were achieved elsewhere on a similar scale

1 In the OECD data, statistically speaking, the most extended period of spending cuts was Germany from 1995 – 2002, but this was due to a statistical discrepancy. In 1995 debt relating to unification spending between 1990 and 1995 was taken over by the federal government and was recorded as a flow in the national accounts, which exaggerated total government expenditure in 1995.

– for example, the 1999/2000 cuts in Germany reduced spending by 3.1% in real terms in one year.

2 The OECD national accounts show large hikes in spending in 1995 for the Netherlands and Germany, for purely statistical reasons. We have therefore substituted spending from the EC AMECO dataset for this year.

## Table 1: Depth and duration of spending cuts programmes

| | Cuts beginning in... | Number of years spending was cut till trough | Number of years spending remained less than peak year | Change in Expenditure from peak to trough as % of total expenditure in peak year |
|---|---|---|---|---|
| 1920s UK | 1920# | 3 | 6 | -11.4% |
| 1930s UK | 1931# | 2 | 4 | -5.8% |
| 1960s UK | 1968+ | 1 | 1 | -0.4% |
| 1970s UK | 1976+ | 2 | 4 | -4.0% |
| 1980s UK | 1985+ | 4 | 6 | -3.3% |
| 1990s UK | 1995+ | 2 | 4 | -2.8% |
| Sweden | 1995* | 2 | 3 | -3.1% |
| Finland | 1997* | 1 | 3 | -2.0% |
| Canada | 1995* | 2 | 2 | -4.3% |
| Ireland | 1987* | 2 | 3 | -8.7% |
| Germany | 1999* | 1 | 1[2] | -3.1% |
| Netherlands | 1995* | 1 | 1[2] | -0.7% |

#Figures from ukpublicspending.co.uk
+Figures from HM Treasury public finances databank
*OECD definitions. Note that figures in this table may differ from the national finance ministry data quoted in the case studies below.

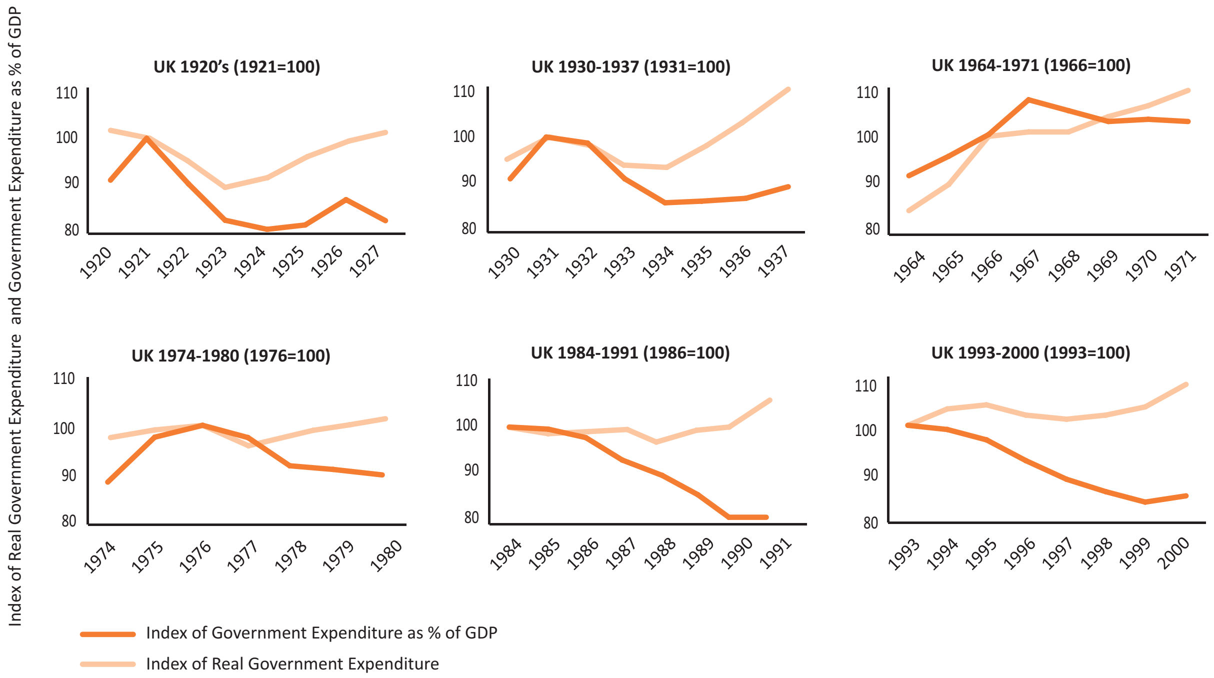
## Table 2: Changes in tax, spending and the deficit

| Country | Period* | Change in tax revenues as a % of GDP | Change in public expenditure as a % of GDP | Change in fiscal balance as a % of GDP | Ratio of spending cuts to tax rises |
|---|---|---|---|---|---|
| 1920s UK | 1921-24 | -1.9% | -5.6% | 3.7% | 150:-50 |
| 1930s UK | 1931-34 | -0.1% | -3.7% | 3.6% | 105:-5 |
| 1960s UK | 1967-69 | 3.7% | -2.0% | 5.7% | 35:65 |
| 1970s UK | 1975-79 | -2.2% | -5.1% | 2.9% | 175:-75 |
| 1980s UK | 1982-88 | -4.9% | -9.2% | 4.3% | 215:-115 |
| 1990s UK | 1993-2000 | 3.2% | -6.3% | 9.5% | 65:35 |
| Sweden | 1993-2000 | 7.0% | -7.8% | 14.8% | 55:45 |
| Finland | 1994-2000 | 5.3% | -6.7% | 12.0% | 55:45 |
| Canada | 1992-1999 | 3.7% | -5.8% | 9.5% | 60:40 |
| Ireland | 1985-1996 | -3.7% | -14.3% | 10.6% | 135:-35 |
| Germany | 1996-2000 | 0.7% | -3.9% | 4.6% | 85:15 |
| Netherlands | 1993-1997 | -2.5% | -3.9% | 1.4% | 280:-180 |

* Determined by the maximum reduction in public expenditure as a % of GDP.
The OECD national accounts show large hikes in spending in 1995 for the Netherlands and Germany, for purely statistical reasons. We have therefore substituted spending from the EC AMECO dataset for this year.

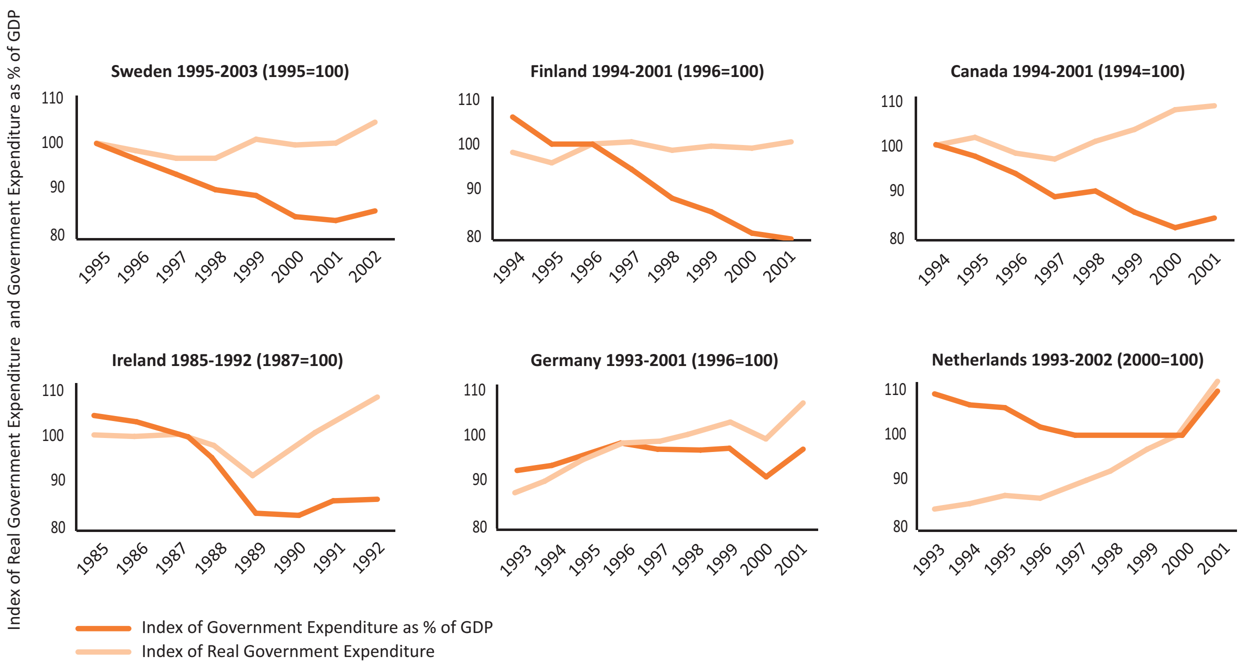
Note that in certain of the cases, the headline ratio shows spending cuts comprising more than 100% of the consolidation and tax rises being negative. This is to be understood as meaning that, at the headline level, taxes were cut as a percentage of GDP, so spending was cut by more than the entirety of the reduction in the deficit, so as to fund not only the deficit fall but also the tax falls.

## Figure I: UK real Government expenditure after the initial consolidation year




Source: Public Finances Databank for 1965 onwards, and Hough, J. 'The Burden of Taxation' (2001), www.ukpublicspending.co.uk for 1920's and 1930's.

## Figure 2: Real Government Expenditure for International case studies after the initial consolidation year

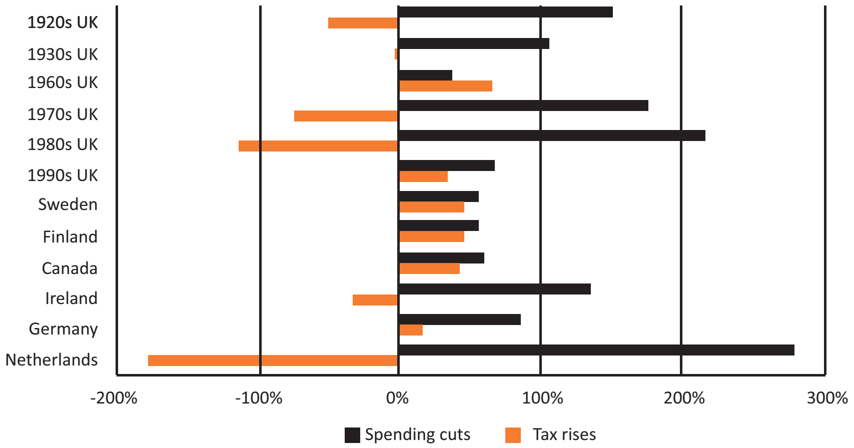



Source: OECD National Accounts Data/AMECO Data. Note that the figures underlying these graphs may differ from the national finance ministry data quoted in the case studies below.

## Overall lessons

**Fiscal consolidations can promote growth and recovery – particularly by enabling a looser monetary policy than would otherwise have been the case.** Provided that spending cuts dominate over tax rises, tightening appears to be more likely to promote recovery than impede it - particularly so when fiscal tightening supports a lower interest rate than would otherwise have been the case; and particularly when deficits are large and spending is high. In all six of our international examples long term interest rates fell substantially after the consolidation. Interestingly the most striking examples are the two cases in our sample which followed financial crises. In Sweden, successful consolidation halved the interest rates on a ten year government bond from 10% to 5% between 1994 and 1998 and in Finland rates fell from 9% to 5%.

### Figure 3: Ratio between headline revenue and spending changes during consolidation years



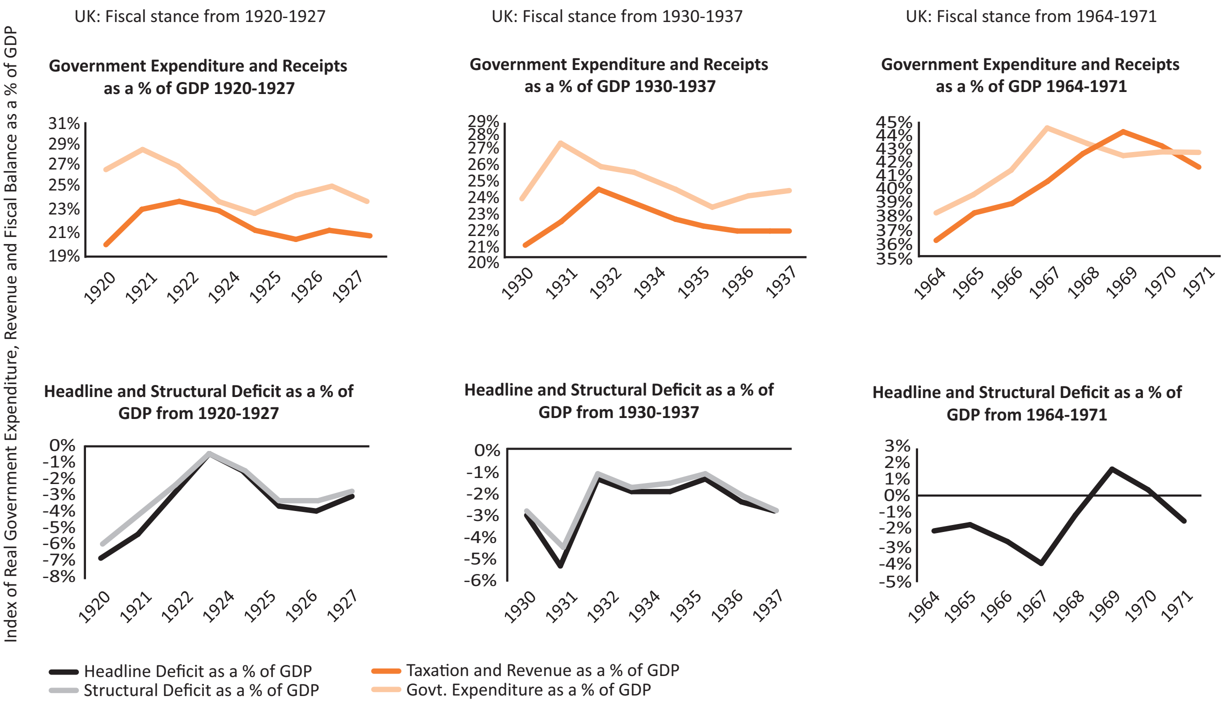

Source: OECD National Accounts Data and Public Finances Database, HM Treasury

**Fiscal correction should be biased towards spending cuts.** Successful consolidations have typically placed around 80% of the burden on spending cuts; 20% tax rises. Britain's first postwar attempt to control spending, after the first IMF bailout of 1968, was heavily biased towards tax rises and proved unsustainable. In the early 1980s Ireland initially tried to close its deficit with a programme heavily biased towards tax rises – but this strategy had to be abandoned in favour of a "Programme for National Recovery" almost entirely based on spending cuts. Our sample of case studies reinforces the conclusion of previous work by the IMF that, "fiscal adjustments which rely primarily on spending cuts on transfers and the government wage bill have a better chance of being successful and are expansionary. On the contrary fiscal adjustments which rely primarily on tax increases and cuts in public investment tend not to last and are contractionary[3]."

**In Britain, spending cuts programmes have typically been centralised and highly differentiated.** Other countries have been better at devolving the process of finding savings down to the departments. The Swedish Government simply gave

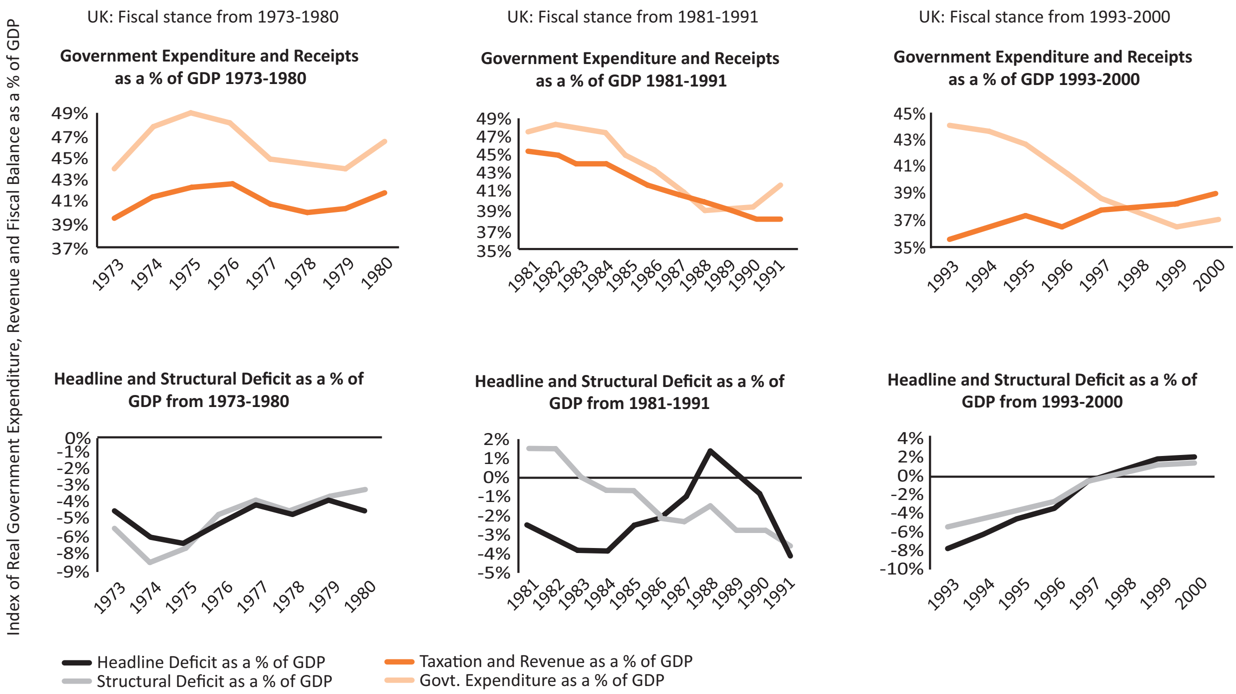
3 IMF, *Fiscal Adjustments in OECD Countries*, 1997. Futhermore, in a recent report by Alberto Alesina and Silvia Ardagna, *Large changes in fiscal policy: taxes versus spending*, the authors contend that the best fiscal consolidations should combine tax cuts with more than compensating spending cuts. This combination is less likely to be associated with short-term recessions.

## Figure 4: Fiscal Stance for the UK in the 1920s, 1930s and 1960s




Source: Public Finances Databank, HM Treasury; ukpublicspending.co.uk and Hough, J. (2001)

## Figure 5: Fiscal Stance for the UK in the 1970s, 1980s and 1990s




Source: Public Finances Databank, HM Treasury.

| Four approaches to controlling spending | Broadly undifferentiated cuts | Broadly differentiated cuts |
|---|---|---|
| Centralised:<br>Cuts programme driven by centre | UK 1930s; Ireland; Canada | UK 1920s; UK 1968/9; UK 1976/7; UK 1980s; Netherlands |
| Decentralised:<br>Initiatives from departments | Germany; Sweden | UK 1990s; Finland; Canada |

each department the same proportional cut (11% off every department's budget). Canada is a particularly interesting case because it combined a decentralised approach (departments finding savings) with a highly differentiated approach (e.g. transport cut by 50%, health by just 3%). There are advantages in putting pressure on departments to think creatively and find saving opportunities which may not be known about by the centre. A related thought is that there is some unproductive spending in all departments. On the other hand, some types of Government spending are likely to be more growth-enhancing and socially useful than others. It might be attractive to try to combine the advantages of differentiated and decentralised approaches – perhaps by devolving to the majority of departments a minimum cut and then targeting some departments with larger one, and pushing certain initiatives through from the centre.

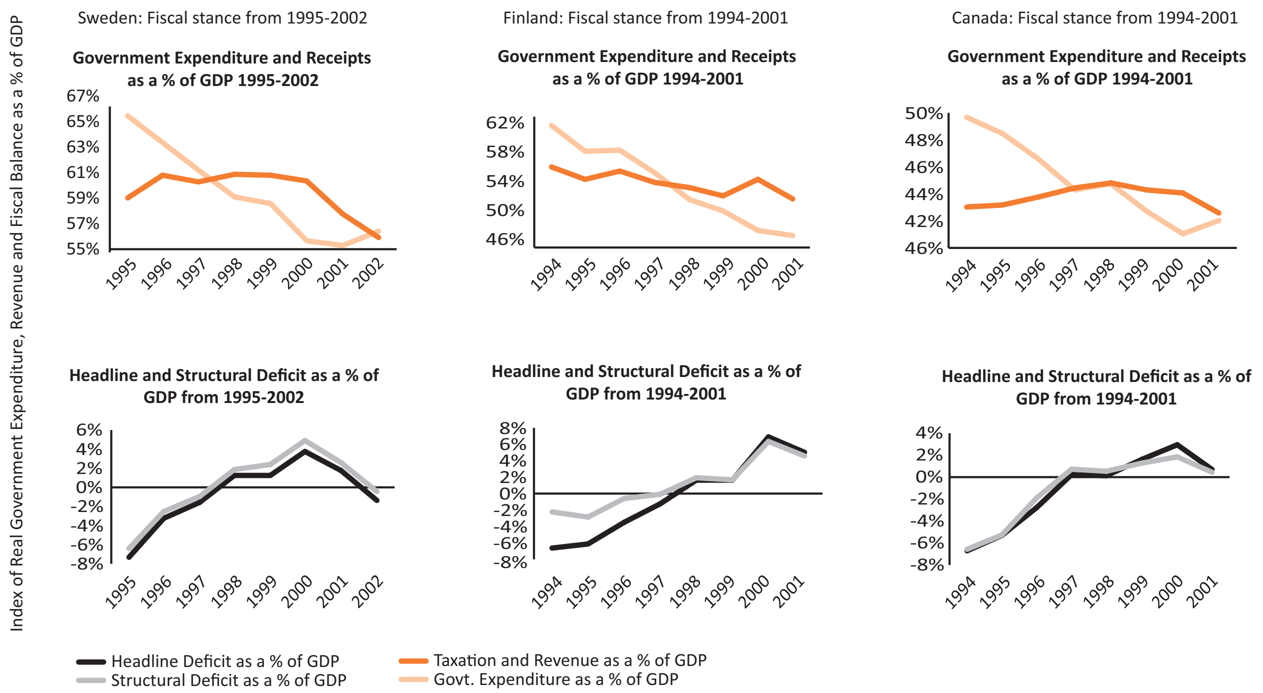
**Don't give up:** Several of the successful consolidation episodes we examine followed previous failed attempts. Canada had three failed attempts before the 1990s consolidation. Ireland and the Netherlands initially failed to control spending before succeeding, and the UK's cuts of the late 1970s and mid 1980s followed previous failures.

**Are some types of expenditure more likely to experience cuts?** There is a huge variety of experiences in our sample. Some common areas to experience cuts include defence, social security benefits, and civil service employment.

**Do bureaucrats need incentives to cut bureaucracy?** It is rare for departments or bureaucrats to have or need explicit incentives to deliver cuts. Almost all the cases we examine involve no financial incentive for civil servants to reduce spending. This is not to say that such incentives are a good or bad idea. However, there have been many spending control packages without any incentive.

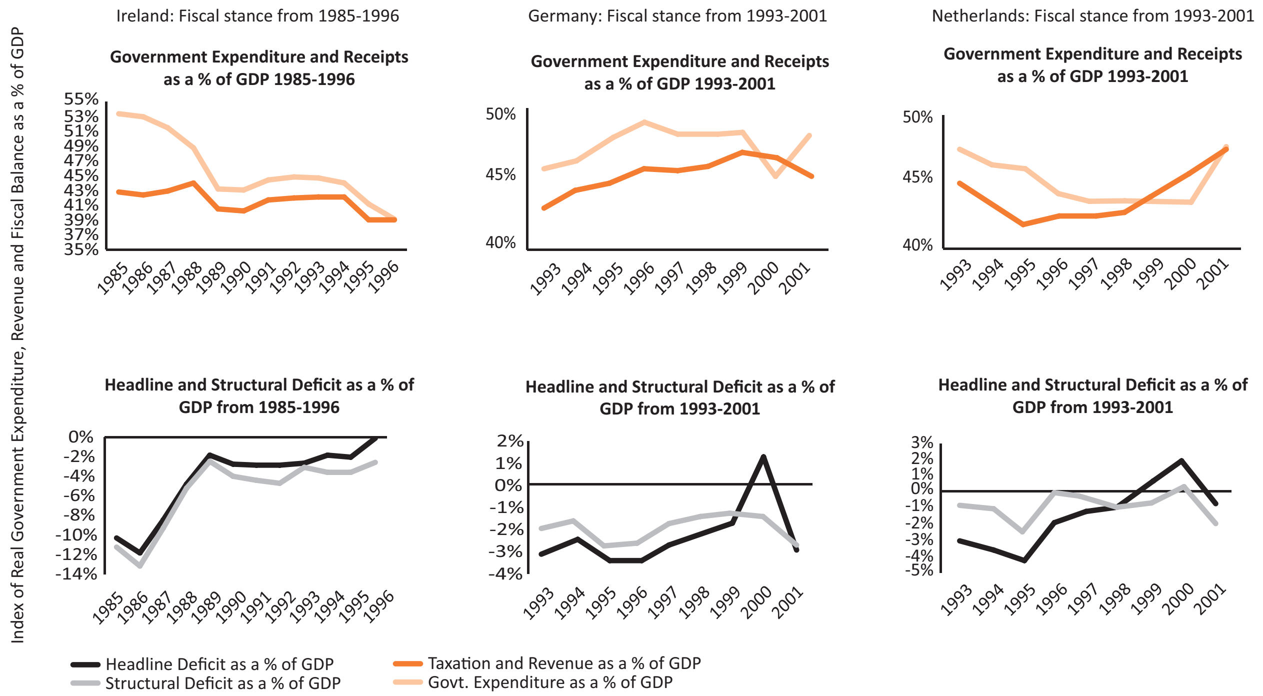
**Do we need fiscal rules or institutions – or just a determination to do it?** During periods of significant cutting, self-imposed fiscal rules seem to have had limited, if any, role compared to a 'just do it' culture. There is a policy division at the time of writing concerning how to establish credibility for spending control and deficit reduction. The Government's policy is to legislate for deficit reductions – a form of fiscal rule. The Opposition, in contrast, states that it will employ an "Office of Budgetary Responsibility" to challenge government fiscal decisions – a form of institutional mechanism. In our study, the main form of institutional mechanisms were exchange rate-related: the gold standard, the Bretton-Woods system, the euro

## Figure 6: Fiscal Stance for Sweden, Finland and Canada




Source: OECD National Accounts Data. Note that the figures underlying these graphs may differ from the national finance ministry data quoted in the case studies below.

## Figure 7: Fiscal Stance for Ireland, Germany and the Netherlands




Source: OECD National Accounts Data. Note that the figures underlying these graphs may differ from the national finance ministry data quoted in the case studies below.

project (and associated Maastricht Convergence Criteria). Such institutional mechanisms have been important in more than half of our cases. Fiscal rules, on the other hand, have tended to be used much more often after successful consolidations, in an attempt to lock in success, and as an expression of a "just do it" culture in respect of spending control. Our view is that rules and mechanisms can have a role, but as expressions of cultural change, not as substitutes for it.

## Short summaries of the key points from each episode

**1921-1923 – The Geddes Axe:** Public spending increased hugely during the war and a vicious recession (about a 10% fall in GDP) further undermined the public finances. Under pressure from the City and Lord Rothermere's "Anti-Waste League", Lloyd George set up a committee of business experts to review Government spending, headed by Sir Eric Geddes. Based on its recommendations spending was cut by 10% in real terms in two years, while tax as a share of GDP remained constant. The budget deficit was reduced from 7% GDP in 1920 to near balance in 1923, followed by a swift recovery. Defence bore the brunt of the cuts. Civil Service numbers were cut by 35% - mostly female staff hired during the war. Lloyd George emphasised that the country had to live within its means.

**1931-1934 – Balancing the budget in the face of recession:** After the 1929 financial crisis unemployment rose sharply. The combination of rising welfare costs and falling revenues led to a deficit of 5% of GDP. Pressure on Sterling's gold standard parity led the Government to set up the May Committee, which recommended 20% cuts in benefit rates and a pay cut for public sector workers. The Labour administration failed to agree the cuts package; a National Government was formed which pushed essentially the same measures through, plus a rise in income tax. Ironically the pay cut for the armed forces led to a navy mutiny, which panicked investors and led to more pressure on Sterling and exit from the gold standard a few days later. However, because of the (unintended) monetary easing, the UK went on to experience a much milder contraction during the Great Depression than other countries: just 5%, compared to 15% in France and 30% in the US.

**1968-1969 – IMF bailout:** A persistent trade deficit led to devaluation within the Bretton Woods system. But sterling came under renewed pressure at its lower level, and the UK needed to seek IMF support to maintain the parity. The IMF pressed the Government to reduce demand in the UK to allow exports. The Government made cuts in defence spending (withdrawing from east of Suez except Hong Kong) and social housing. Income tax was raised. Spending was reduced by 2% of GDP while tax and other receipts raised by nearly 4% of GDP. This worked in the short term, turning a budget deficit of 4% in 1967 into a surplus of nearly 2% in 1969. The budget fell back into deficit by 1971, however.

**1976 – The second IMF bailout:** By the end of financial year 1975/6, total public expenditure amounted to 49.8% of GDP, having risen by an enormous 7.8% of GDP over the previous three years. The left wing of the Labour Party defeated the Public Expenditure White Paper in the Commons in March 1976. Subsequent to Harold Wilson's resignation and James Callaghan's succession, a large-scale sale of sterling began, which rapidly lost value against the dollar. The government approached the IMF for a loan of $3.9 billion in September 1976, the largest amount ever requested of the Fund at that time. The IMF negotiators demanded heavy cuts in public expenditure and the budget deficit as a precondition for the loan. Total managed expenditure fell by more than 4% between 1976/77 and 1977/78, the sharpest real terms fall of recent decades. The main spending cuts fell on the building of new housing, regional employment subsidies, food subsidies, defence and export subsidies. The IMF had to sign off on the programme and negotiated specific cuts with the government, meaning the process was necessarily highly centralised.

**1980s – Thatcher's medicine:** In 1980 the Government set out the Medium Term Financial Strategy, which set linked targets for reducing the growth of the money supply and borrowing. However, it lost credibility as borrowing came in above target. In 1981 Geoffrey Howe raised taxes and cut spending in the middle of a recession, prompting criticism from a letter signed by 364 economists. On a cyclically adjusted basis this was a huge fiscal tightening. Headline spending initially rose because of rising unemployment (and the Clegg pay awards for public servants). However, by the mid-1980s headline spending was brought under control in absolute terms, at which point it started to fall sharply as a share of GDP as growth accelerated. Areas initially targeted for cuts included lending to the nationalised industries. Later there were cuts to the UK net contribution to the EEC budget and benefit spending. The number of people employed in the public sector was cut by 12% between 1981 and 1988.

**1990s – Clarke and Brown:** A global recession and John Major's decision to increase spending on certain public services led to a 10% increase in public expenditure between 1990 and 1992. Driven by the government's determination to reduce inflation and later its commitment to maintain a high parity with the Deutschemark as a consequence of joining the European Exchange Rate Mechanism in 1990, interest rates were consistently above 10% between mid-1988 and mid-1992. Unemployment rose above 3 million, house prices fell by almost 15% and tax receipts fell to just 35.4% of GDP by 1993/4, leading to an unprecedented headline deficit of almost 8% of GDP. The devaluation of sterling following Britain's exit from the ERM in September 1992 combined with improving global conditions led to substantial economic growth from 1993 onwards. At the same time, Chancellors Lamont and Clarke implemented tax rises and restricted expenditure growth to substantially less than the growth of the economy, creating a budget surplus by 1998. Between 1997 and 2000 Gordon Brown stuck to the spending control plans inherited from the Conservatives, taking public spending as a share of GDP to its lowest level in recent decades.

**Sweden – 1993 to 2000:** After a debt fuelled financial boom in the 1980s Sweden suffered a severe recession between 1990 and 1993 with GDP falling by 6%. The budget deficit rose to 11% of GDP and unemployment spiralled from 3% to 12% of the labour force. A large fiscal consolidation package was implemented from 1994 onwards, enacting tax rises and spending cuts amounting to 8% of GDP, aided by three year expenditure ceilings and strengthened legislative scrutiny. This created a budgetary surplus by 1998 and improved the structural primary balance by almost 9% of GDP within seven years. The Government cut evenly across all departments, and also stressed social fairness – all sections of society were to share some of the burden.

**Finland 1994-2000:** Finland's experience in the early 1990s in many ways mirrored that of Sweden, with a sharp recession following the so-called '*Kasinotalous*' – or 'casino economy' of the 1980s. However, the contraction and recovery were both of a greater magnitude due to the collapse of the USSR and attempts to defend the currency. From 1991-93, Finland's real GDP fell 11.4%. One of the major economic policy goals of the new Government formed in the spring of 1995 was to increase labour market efficiency. Unemployment benefits were the main area of expenditure to be cut. General government consumption fell, although this was offset slightly by an increase in new public work programmes. Public expenditure was to be cut by 2% every year of the parliament. Nonetheless the government stressed that controlling spending and improving work incentives were the only way to save the basic structure of Finland's welfare society.

**Canada 1994-2000:** Between 1984 and 1993, there were three unsuccessful attempts at fiscal reforms in Canada. In 1994, the new incoming Liberal Party's Minister of Finance set up a government spending Programme Review ('PR'). It examined all areas of Government spending and applied a set of objective criteria. No area was sacrosanct. The PR sought to maximise the participation of civil servants, and process filtered ideas from the departments up through a number of levels: first, a committee of Deputy Ministers chaired by Jocelyne Bourgon which reviewed submissions and coordinated the process (and installed people who were sympathetic to deficit reduction). Next, a group of Ministers chaired by Marcel Massé reviewed the recommendations and final proposals, which were then endorsed by the Prime Minister and Cabinet. Bureaucrats were incentivised through a 'carrot and stick' approach. Deputy Ministers were appraised annually and they received 30% of their pay on a performance-related basis. If they failed to come up with sensible proposals, the PM threatened that a separate body would impose a top-down 10% cut across the board. To maintain credibility, the strategy was to under-promise and over-deliver. In particular, Canada adopted cautious forecasting to gain credibility with the financial markets. The deficit was over 9% in the early 1990s, but was in surplus by 1997. A number of rules and institutional mechanisms were introduced in order to lock in reform, including contingency reserves and a new Treasury committee.

**Ireland 1987 – 2000:** Driven by growing concern about Ireland's high debt there was an initial failed attempt at consolidation from 1982-4. This consisted of a mixed strategy with some expenditure cuts and large tax increases. After 1987, the opposition Fine Gael Party announced that they would not oppose tough economic reforms to resolve the fiscal crisis and the subsequent strategy was focused almost entirely on spending cuts. Wages were reduced and civil service numbers cut. Public sector employment fell by 10% between 1986 and 1989. To support this the Government provided cheap retraining schemes to those who were made redundant voluntarily. Social, health and pension spending was reduced. Real benefit rates were frozen and the eligibility criteria tightened. Public spending as a share of GDP fell from around 54% to 43% between 1985 and 1989.

**Germany 1990s:** During much of the 1990s, Germany was weighed down by the burden of its 1990 reunification. The cost was initially financed by borrowing (1989-1992) in the hope that a sustained upturn in the former GDR would generate the required additional tax income. However, the subsequent unification boom was relatively short. Public finances subsequently deteriorated and resulted in protracted budget deficits and soaring public indebtedness. The Kohl Government introduced austerity policies, partly motivated by Maastricht treaty criterion, with policy makers seeking to ensure that overall government deficit could be limited to 3% of nominal GDP by 1997. Public sector employment was cut from 4.0 million in 1992 to 3.9 million in 1996. Fixed capital investment by all three tiers of government fell by 13% between 1993 and 1996, down to DM 80 billion. There were sharp cuts in welfare from 1993-95, particularly in unemployment compensation. After 6 years of consolidation efforts, the deficit ratio finally improved to 2.6% in 1997, enabling Germany to meet the Maastricht criterion.

**Netherlands 1990s:** In 1982-3 the newly elected Ruud Lubbers government cut public sector salaries, minimum wages and reduced social benefits by 3.5% across the board. The Dutch recovery during the 1980s was helped by a system of consensual wage restraint known as the 'Polder Model' which helped to restrict wage growth and lower unemployment. A detailed coalition agreement enabled continuing reduction of the salaries of civil servants and the rates of social benefits. Between 1983 and 1990, expenditure had fallen from 57.8% of GDP to 51.7% of GDP. However, budgeting was rather chaotic due to shocks to income and spending. In 1994, the Finance Ministry implemented "trend based budgeting", featuring real expenditure ceilings for the whole term of government (lasting four years) and a "signal value" for the general government deficit of 2 or 2.5% GDP, breach of which causes the ceilings to be re-assessed. A number of other techniques were employed, including ring-fencing some natural gas revenues for debt reduction, and the introduction of incentives and cost-benefit analysis for reorganising and controlling public expenditure. The government also privatised social security, meaning that employers had to pick up the costs of sick pay. This cut absenteeism, which fell by 25% between 1994 and 1997.

## The consolidations in quotes

### 1922-29 — The "Geddes Axe"

*'The need for effecting immediate retrenchment of public expenditure is so imperative, that we think it best not to delay...'*

First Interim Report of the Committee on National Expenditure, ('The Geddes Report'), Command Paper 1581, December 14th 1921.

*'The recommendations we are prepared to make involve very drastic and heavy cuts... It has to be regarded... from the point of view of what the nation at this moment, having regard to the very great depression in trade, can now afford.'*

Prime Minister David Lloyd George, House of Commons, 7th February 1922.

### 1931 — Balancing the Budget in the face of Depression

*'A national Budget has thus come to be regarded as a touchstone of a country's financial stability second only in importance to its international balance of trade; and if, as the case at present with us, we are "down" on our balance of trade with other countries, foreigners to whom we owe money automatically turn a microscope on to our Budget."*

Memorandum to the Cabinet by Sir Warren Fisher,
Permanent Secretary to the Treasury, September 14th, 1931.

*'What the late Government had to be sure of was that there would be sufficient confidence in foreign circles in the determination of the British Government to set their House in order and to balance their Budget.'*

Neville Chamberlain, House of Commons, 29th September 1931.

### 1968/9 — IMF Bailout

*'The measures will be progressively reinforced… to hold back private consumption…These measures accord fully with … a policy of severe restraint in prices and incomes… A detailed and searching review of policy by the Government in every major field of expenditure, with no exceptions, on the basis that no spending programme could be sacrosanct.'*

Prime Minister Harold Wilson, House of Commons,
16th January 1968.

*'In the short term we must have a stiff Budget, followed by two years of hard slog… Excessive growth in the short-run before we have secured the balance of payments, would be the enemy of steady growth for several years to come.'*

Chancellor of the Exchequer Roy Jenkins,
Budget Statement March 1968.

### 1976 — Second IMF Bailout in short succession

*'The crisis that faces us is infinitely more serious than any of the crises we have faced over the past 20 years… the party is over'*

Antony Crossland, Foreign Secretary,
speech in Manchester Town Hall, 9th May 1975.

*'England ist kein entwickeltes Land mehr.' ['England is no longer a developed country']*

West German Chancellor Helmut Schmidt.

*'You cannot now, if you ever could, spend your way out of a recession.'*

Prime Minister James Callaghan, Labour Party Conference,
September 1976.

### 1980s — Thatcher Medicine and Thatcher Miracle

*'To those waiting with bated breath for that favourite media catchphrase, the U-turn, I have only one thing to say: You turn if you want to. The lady's not for turning!'*

Margaret Thatcher, 1980 Conservative Conference Speech.

*'To change course now would be disastrous'*

Sir Geoffrey Howe, Chancellor of the Exchequer, 1981 budget.

*'If Margaret Thatcher wins on Thursday, I warn you not to be ordinary. I warn you not to be young. I warn you not to fall ill. I warn you not to get old.'*

Neil Kinnock MP, speech in Bridgend, Glamorgan, on Tuesday 7 June 1983.

## 1992-99 — Clarke and Brown

*'Business can plan ahead with confidence only if it knows that Government borrowing is under control. My task today is to deliver that confidence... we cannot sit by, simply hoping that faster growth and forecasting changes will come to our rescue... we must stop ever more national debt piling up for future generations to pay... For the next three years, Government expenditure will grow by substantially less than the projected growth of the economy.'*

Ken Clarke, Budget Speech, 30th November 1993.

*'During the 1990s the national debt has doubled. This year alone the taxpayer will pay out 25 billion in interest payments on debt, more than we spend on schools. Public finances must be sustainable over the long term. If they are not then it is the poor, the elderly, and those on fixed incomes who depend on public services that will suffer most.'*

Gordon Brown presenting the 1997 budget.

## Sweden: 1993-2000

*'No other government in Europe has the strength to do what we are doing'.*

Goran Persson, Swedish Finance Minister, unveiling the 1995/6 budget, January 10th 1995.

*'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.'*

Jens Henriksson, former State Secretary, Swedish Ministry of Finance.

## Finland: 1994-2000

*'The economic crisis of the 1990s was deeper in Finland than in any other western country. Since 1995 two successive rainbow coalition governments have successfully carried out fiscal consolidation and reforms in order to save and revitalise the Finnish welfare society.'*

Paavo Lipponen, Prime Minister of Finland, 'Future of Europe – the Finnish model', lecture at the London School of Economics, 14th February 2002.

## Canada: 1994-2000

*'We began to arbitrarily take money out. As that began to happen, people suddenly realised this was serious… They then began to work very hard to identify the savings themselves.'*

Brian Tobin, former Canadian cabinet minister.

*'There was blood on the floor everywhere, but at least everyone could see that others were hurting too'.*

Marcel Massé, former Canadian Minister of Intergovernmental Affairs and Minister responsible for Public Service Renewal.

## Ireland 1987 to 2000

*'There was a real air of crisis in Ireland at that time. During the election, even the man in the street was asking the politicians whether the IMF would have to take over the running of the economy. That is genuinely as bad as the situation was at that time.'*

Ray McSharry, former Irish Finance Minister.

## Germany in the 1990's

*'The German government yesterday unveiled its most painful budget for decades, proposing to slash public spending yet further in an effort to meet the criteria for European Monetary Union.… To close the yawning gap, both in the accounts and the government's credibility, more of the same medicine will have to be prescribed. Or, as one of Chancellor Kohl's MPs summed up: "There is only one way – cuts, cuts, cuts.'*

Independent report November 1996

## Netherlands 1983-2000

*'Mr. Lubbers, are you really intending to cut the salaries of your public employees by more than 3%? That's a disaster. I am supposed to be the toughest in Europe. You are going to ruin my reputation as the Iron Lady.'*

Margaret Thatcher to Ruud Lubbers at The Hague, 1984.

## Table 3: Questions and Answers

| Question | UK 1920s | UK 1931 | UK 1968/9 | UK 1976-9 | UK 1980s | UK 1990s | Swe | Fin | Can | Ire | Ger | Neth | Average | Standard Thought |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Grow it away or real cuts?** | Cuts in real terms | Cuts in real terms | Cuts in real terms | Cuts in real terms | Grow it away | Grow it away | Cuts in real terms | Cuts in real terms | Cuts in real terms | Grow it away | Cuts in real terms | Grow it away | Cut in real terms (8/12) | Grow away, unless recession severe |
| **Did the crisis drive action? How was it used?** | Political pressure forced action in finding cuts | Led to National Government being formed determined to balance the budget | Political need to maintain £/$ parity drove the cuts | Cuts were a condition for IMF bailout. Crisis used to justify wage restraint | 'Winter of Discontent' drove election of new government with mandate for spending cuts and tax rises | ERM crisis drove consolidation to restore credibility; used to justify cuts and tax rises | Banking crisis drove action; scale of the national debt used to justify spending restraint | Earlier failure to grow away the deficit drove and was used to justify cuts and tax rises | Three previous failures and dollar crisis drove action and built consensus | Public awareness of long-term poor economic performance drove action, justified spending restraint | No particular point of crisis; desire to meet Maastricht limit justified the programme | Long-term perception of high spending, wages and unemployment drove action | Crisis drove action; government used crisis to justify consolidation | Action driven by crisis, no cuts before a crisis |
| **Spending cuts: tax rises[4] –** | Headline: 150:-50 Structural: N/A | Headline: 105:-5 Structural: N/A | Headline: 35:65 Structural: N/A | Headline: 175:-75 Structural: N/a | Headline 1982 – 88: 215:-115 Structural 1985 – 89: 85:15 | Headline: 1993 – 00: 65:35 Structural 1995 – 98: 75:25 | Headline 1993 - 00: 55:45 Structural 1994 - 98: 75:25 | Headline 1994 - 00: 55:45 Structural 1998: 85:15 | Headline 1992-99: 60:40 Structural 1994-97: 85:15 | Headline 1985-96: 135:-35 Structural 1987 - 89: 95:5 | Headline 1996-2000: 85:15 Structural N/a | Headline 1993-7: 280:-180 Structural 2004- 05: 75:25 | Approx. 80:20 | Cut expenditure in a recession, raise taxes otherwise |
| **The timing of tightening** | Tightening accelerated recovery | No Impact | Tightening accelerated recovery | Tightening accelerated recovery | Tightening accelerated recovery | Impact mainly after recession over | Tightening accelerated recovery | Impact mainly after recession over | Tightening accelerated recovery | Tightening accelerated recovery | Tightening impeded recovery | Impact after recession over | Tightening accelerated recovery (7/12) | Tightening during recessions worsens them |
| **Fiscal rules / institutional mechanisms / 'Just do it'** | Just do it | Just do it | Institutional mechanisms | Institutional mechanisms | Some fiscal rules, mostly just do it | Just do it | Institutional mechanisms | Both fiscal rules and institutional mechanisms | Just do it | Mostly just do it, some institutional mechanisms by the 1990s | Institutional mechanisms | Institutional mechanisms | Institutional mechanisms & Just do it | Rules |
| **'Talk tougher than act', 'act tougher than talk' or 'what you see is what you get', WYSIWYG?** | Talk tougher than act | WYSIWYG | WYSIWYG | Talk tougher than act | Talk tougher than act | WYSIWYG | Act tougher than talk | WYSIWYG | Act tougher than talk | WYSIWYG | WYSIWYG | Act tougher than talk | WYSIWYG (6/12) | Under-promise and over-deliver |
| **Areas cut? Long-established programmes or recent spending?** | Recent: defence, temporary staff (WW1) and social security | Recent: unemployment insurance, public sector wage cuts, public works | Some recent (social housing), some long-established (defence, NHS) | Various cutting and abandoning of long-established programmes. | Long-established areas were cut or privatised; public sector employees, asset sales, unemployment benefit effected | Politically low-profile areas like community amenities, housing and environmental protection | All departments cut by 11% | Welfare expenditure targeted | Long-established: public sector wages, welfare programmes, subsidies, defence | Cuts in Public Sector employment in particular, though all areas were cut to some degree | Ad-hoc cuts | Social welfare spending was targeted, though cuts were widespread | Welfare spending, public sector employment, defence | Welfare spending and defence |
| **Differentiated or undifferentiated cuts?** | Differentiated cuts | Undifferentiated cuts | Differentiated cuts | Some specific programmes targeted; some undifferentiated cuts | Undifferentiated cuts | Differentiated cuts | Undifferentiated cuts | Some specific programmes targeted; some undifferentiated cuts | Differentiated cuts | Undifferentiated cuts | Undifferentiated cuts | Differentiated cuts | Differentiated cuts (6/12) | Undifferentiated cutsin a crisis; Differentiated cuts when not in crisis |
| **Centrally imposed or devolved?** | Imposed from the centre, recommended by external committee | Imposing from the centre | Imposing from the centre | Imposing from the centre | Imposing from the centre | Imposing from the centre | Imposing from the centre | Inviting initiatives | Inviting initiatives | Imposing from the centre | Inviting initiatives | Imposing from the centre | Imposing from the centre (9/12) | Impose from the centre |
| **Incentives to deliver?** | No incentives | No incentives | No incentives | No incentives | No incentives | No incentives | No incentives | No incentives | Incentives for departments | No incentives | No incentives | Incentives for departments | No incentives (10/12) | Need incentives |
| **Stylised costs** | Badly targeted cuts had social costs. Defence cuts may have led to appeasement in early 1930s | Near-revolution and consequent failure of effort to keep on Gold standard | Loss of British military presence in many parts of the world; increased industrial strife | Total breakdown in industrial relations | Long-term mass unemployment, increased regional affluence differentials | Sense of decay in public services and of quality falling behind public aspirations | Impact on income distribution through wage moderation | Social welfare cuts and wages clamped | Cuts in health and unemploy -ment benefits, civil service salaries reduced | High levels of inflation, criticism by the EU and house price bubble | High levels of unemployment and low levels of economic growth | Lower wages and economic slowdown due to lower domestic demand in the short term | Social tensions and lower public sector provision | Unemployment, social friction, strikes |
| **Political Implications** | Suffered despite consolidation | Flourished despite consolidation | Suffered despite consolidation | Suffered despite consolidation | Flourished despite consolidation | Suffered despite consolidation | Suffered as consequence of consolidation | Flourished as consequence of consolidation | Flourished as consequence of consolidation | Suffered as consequence of consolidation | Suffered as consequence of consolidation | Flourished despite consolidation | Ambiguous | Suffered as consequence |

4 Note that in certain of the cases, the headline ratio shows spending cuts comprising more than 100% of the consolidation and tax rises being negative. This is to be understood as meaning that, at the headline level, taxes were cut as a percentage of GDP, so spending was cut by more than the entirety of the reduction in the deficit, so as to fund not only the deficit fall but also the tax falls.

# 1
# Introduction

Without action, the UK government's budget deficit may exceed £200 billion in 2010/11, more than 14% of GDP. In 2010/11, total managed expenditure, if not cut, is likely to exceed 50% of GDP. On current tax and spending plans, UK government debt may exceed 100% of GDP in 2013/14 (even excluding the nationalised banks). At the time of writing, there have been eight straight months of deflation, interest rates are at an all-time low, much of the banking sector has been taken into state ownership, and the economy is still officially in the deepest recession since World War II.

In this report we shall consider how other governments, faced with analogous situations in the UK and internationally, have dealt with such crises before, as well as drawing insights from the academic and policy literature.

We should emphasise at the beginning that this report will not set out any list of cuts to spending or rises in taxation to be recommended for the UK in forthcoming years.

## The Cases we shall Analyse

We shall explore a mix of six historical and six international cases.

Section 2 draws on six episodes from the UK's own past experience:

- UK: 1922-29 — The Geddes Axe
- UK: 1931 — Balancing the Budget in the face of Depression
- UK: 1968-69 — Credit Crunch and IMF Bailout
- UK: 1976-7 — Second IMF bailout in short succession
- UK 1981-88 —Thatcher medicine and Thatcher miracle
- UK 1992-99 — Deficit correction, Clarke's 'cheerful tightfistedness', and the 'Iron Chancellor'

Section 3 turns attention to six recent international cases:

*Countries that had recently experienced major financial sector crises:*

- Sweden: 1993-2000
- Finland: 1994-2000

*Other English-speaking countries:*

- Canada: 1994-2000
- Ireland: 1987-2000

*Other European medium-sized developed economies:*

- Germany: 1994-2000
- Netherlands: 1983-2000

Two of these cases involved explicitly enforced fiscal consolidations as conditions of loans: the two IMF bailouts of 1969 and 1976. However, the 1931 programme was also undertaken under extreme pressure from lenders and the tactics employed should be understood in that light. The other three UK cases involved fiscal corrections following recessions, though the 1920s episode may also have had a wider motivation of responding to a loss of confidence in the political class after various corruption scandals and a consequent sense of urgent need to address government waste.

We shall explore the background contexts below. As will be seen, none of these cases is directly comparable to the current situation for the UK. A number of the consolidations are associated with currency crises arising from fixed exchange rate regimes (which the UK does not have). Others take place in circumstances in which governments are struggling to control inflation (whilst the UK's current risk is deflation). Most involve very much smaller deficits than those for the UK at present. Few involve reversing a spike in spending on anything like the UK's recent scale.

This should not be taken as meaning it is not fruitful to try to draw lessons from past and international experience. But it does underline the importance of drawing lessons from a variety of differing cases, rather than depending on one or two conducted in circumstances quite different from those in the UK at present. If we were forced to choose which of our twelve are most relevant, we would say: the UK in the 1920s, because of the scale of the cuts involved, because of the aspect of reversing very recent rapid spending rises, and because of the deflationary environment; the UK in the 1930s, because of the background financial context of an international banking sector crisis; and Sweden in the 1990s, because of the similar scale of the deficit there and the context of a recently nationalised banking sector. But we reiterate than no single case is really a good comparator, and we draw our lessons and insights from the set as a whole, along with broader OECD and IMF data.

## The Key Questions we shall Address

We shall structure our analysis around answering the following twelve key questions:

1. **To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?**
2. **How politically significant was the crisis in driving action? How was the crisis used by the government?**
3. **What should be the ratio between spending cuts and tax rises?**
4. **When should a fiscal tightening take place? Should it impact after recession or other crisis, or, if done during, does it aid or hinder recovery?**
5. **What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?**

6. **Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?**
7. **Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?**
8. **What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?**
9. **Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?**
10. **To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?**
11. **What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?**
12. **What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?**

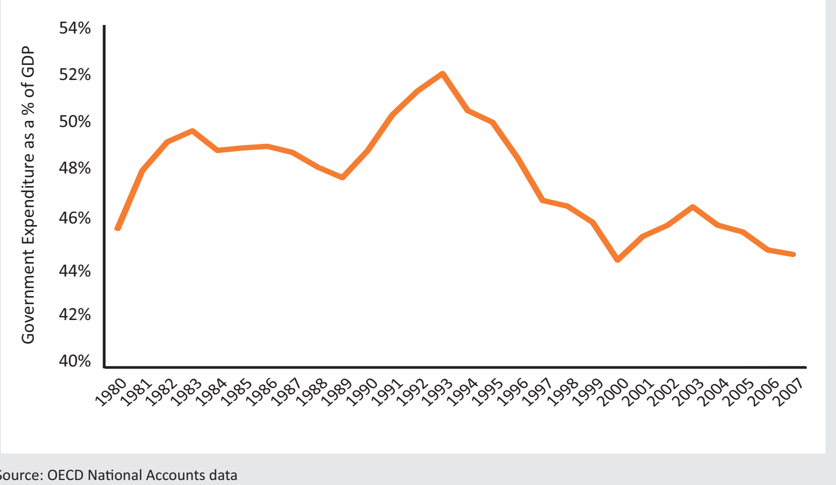
In most cases, the questions above should be fairly self-explanatory. For readers that would like to understand and motivate the interest in these questions, Appendix 1 explores them in more depth.

## Box 1: Background – Spending, consolidation and growth

**The recent history of government spending**

Over the three decades or so up to 2007, spending relative to GDP rose during the 1980s and early 1990s, then fell back during the 1990s and did not return to its previous peaks during the 2000s, as can be seen in Figure 1.1. In recent years, UK public spending as a share of GDP has risen from below the G7 average to substantially above it, as can be seen in Figure 1.2.

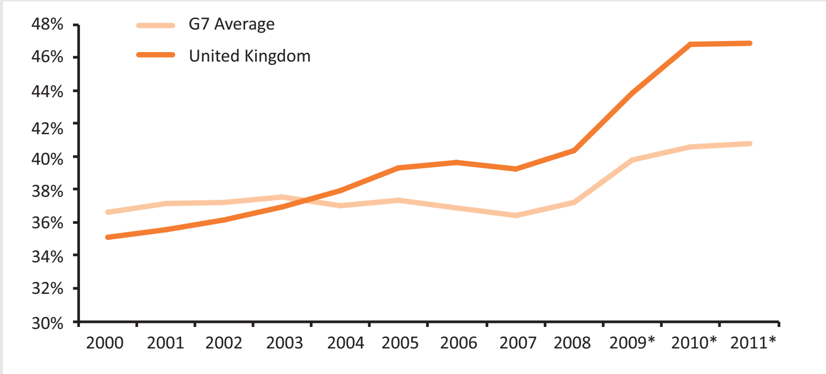
**Figure 1.1: Average Government Expenditure as a % of GDP for 10 OECD Countries***




Source: OECD National Accounts data

*Note: Countries used for average are Austria, Belgium, Canada, Denmark, Italy, Netherlands, Norway, Portugal, UK and the US.

**Figure 1.2: Total Government Expenditure in the UK and G7**




Source: OECD National Accounts data

**Are spending and growth correlated?**

Over the long-term, spending in OECD countries is negatively correlated with growth — i.e. countries with higher proportions of spending grow more slowly. This is illustrated in Figures 1.3 and 1.4. The standard finding of academic studies and studies conducted by bodies such as the ECB and the IMF is that for each additional percentage point of GDP of public spending, the annual growth rate of economies is lower by about 0.15%.[5]

**Figure 1.3: Correlation of growth and public spending in 30 OECD countries, 1970 - 2004**

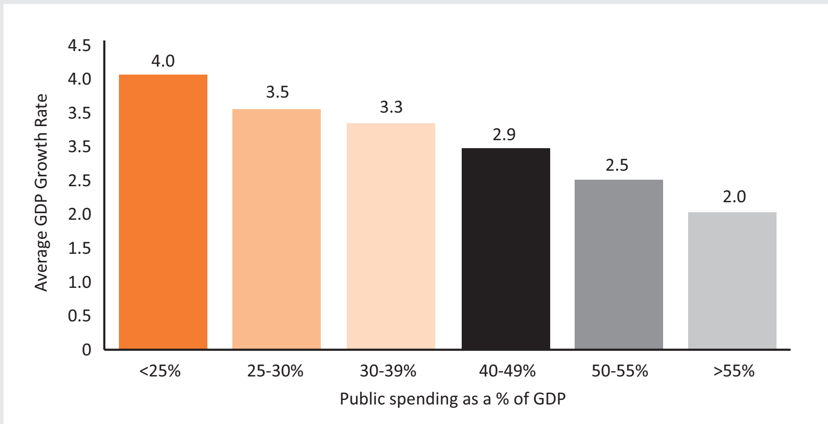
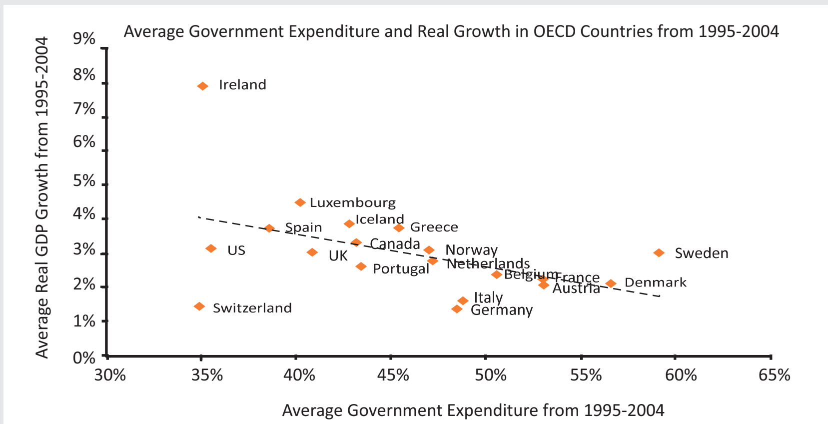



**Figure 1.4 : Government expenditure versus growth**




Source: OECD National Accounts data

5 This point is explored in some detail in *Controlling public spending – the scale of the challenge*, pp12ff. Two particularly relevant references for the interested reader are

- Afonso, A. & Furceri D. (January 2008), "Government size, composition, volatility, and economic growth", European Central Bank working paper 849: *"a percentage point increase in the share of total revenue (total expenditure) would decrease output by 0.12 and 0.13 percentage points respectively for the OECD and for the EU countries"*
- Mo, P.H. (2007), "Government expenditure and economic growth: the supply and demand sides", Fiscal Studies 28 (4), pp497-522: *"a 1 percentage point increase in the share of government consumption in GDP reduces the equilibrium GDP growth rate by 0.216 percentage points"*

## Box 2: Theory of the impact of fiscal consolidation on growth

**The impact on demand of reducing the deficit**

In an efficient economy, with financial markets working well and forwards-looking, reasonably-well-informed households who do not face credit constraints, we would not expect funding government spending through debt (a deficit) rather than funding it with taxes, should stimulate additional demand in the economy. The reason is that, in that sort of economy, households will understand that if the government borrows extra today, it will have to raise taxes tomorrow to pay off that borrowing. In anticipation of those extra taxes tomorrow, households will save extra today – each additional pound of government borrowing should lead to one extra pound of saving. So there will be no "stimulus" from running a deficit. (This effect is called "Ricardian equivalence", after the British economist David Ricardo who first pointed it out.)

If there is no boost to the economy (even in the short term) from running a deficit, then there will be no reduced boost from reducing the deficit – and so we should not expect fiscal consolidation to reduce demand even in the short term.

On the other hand, periods of financial crisis or severe recession are sometimes periods in which financial markets have ceased to work well, or in which the future job prospects of households have become so uncertain that workers have indeed become credit constrained (e.g. during a credit crunch). In such circumstances there may not be Ricardian equivalence – indeed, it is precisely the denial that Ricardian equivalence applies in such cases that motivates the belief in Keynesian stimulus action. So, if there is not Ricardian equivalence, then if deficit reduction is not to result in a reduced boost from the deficit, at least in the short term – in other words, if deficit reduction is not to drive short-term economic slowdown – the mechanism must be a bit more involved than the Ricardian equivalence concept set out above.

The mechanisms by which demand may be affected are through (1) effects on the expected growth rate of the economy; (2) other wealth effects on consumption; (3) credibility effects on interest rates. We will consider these in order.

First, growth effects. If spending reductions are seen as permanent, they may be associated with more rapid growth in the economy in the future. If growth is more rapid, then wages and other sources of income will also grow more rapidly. So over their lifetimes as a whole, consumers will be richer. Hence, reduced public spending may make consumers feel richer and so more willing to spend, even in the short term, boosting demand. (Note that this effect is associated with fiscal consolidation through spending cuts, not tax rises.)

Turning now to other wealth effects. Even if the economy were not expected to grow more rapidly when public spending is lower, when spending cuts are perceived as permanent, consumers anticipate a reduction in their future tax burden (relative to what they had expected) and so a permanent increase in their lifetime disposable income. If the value of these reduced future taxes is greater than the value to consumers of the public spending not now expected to happen, consumers will feel wealthier. In such a case (typically a case in which public spending begins very high or is very inefficient), consumption may increase when government spending is cut (contrary to the Keynesian expectation). (Again, this mechanism is not applicable to fiscal consolidation through tax rises.)

The third source of expansionary effects of fiscal contractions is through reducing interest rates (or limiting the extent to which they rise). If debt is high (and especially if spending is at the same time so high that growth rates for the economy are impeded), public debt may face an interest rate premium associated with inflation or default risks. A fiscal consolidation, if perceived as permanent and successful, can bring about a sustained and material reduction in real interest rates, reducing the burden of debt servicing and promoting investment across the economy. (This effect may occur with either tax rises or spending cuts.)

To summarise what is being said above, the key points to gather are:

(a) that in normal times, economic theory predicts that running large budget deficits will not boost the economy and, likewise, that fiscal contractions will not cause economic slowdown;
(b) that when there are severe recessions associated with financial sector problems, economic theory predicts that a deficit that is large enough but not too large should provide a boost to demand and, similarly, that cutting such a deficit will limit recovery or exacerbate slowdown;
(c) that when deficits are too large and/or spending levels too high, instead of providing a boost to demand large deficits actually impair growth, and so fiscal consolidations, far from driving additional contraction or limiting recovery, actually promote faster growth and more rapid recovery.

Given that a key point of political debate in the UK at the time of writing concerns the timing of fiscal consolidation – specifically, should it begin in 2010 or wait until later, a question of particular interest in our case studies will be under what conditions fiscal consolidations should be expected to have effects more like (b), worsening recession, rather than (a) or even (c).

**The interaction of monetary and fiscal policy**

As a generalisation, periods of fiscal consolidation tend to occur most often during difficult economic times. Budget deficits most often begin to be cut when such deficits are large, inflation is high, the currency is depreciating and recessions have reached their nadirs. It is thus common for monetary policy to be fairly loose during periods of significant fiscal consolidation. This leads us to an interesting question of how monetary and fiscal policies interact in such periods.

Lower interest rates or exchange rate depreciation tend to offset the potentially contractionary short-term effects of fiscal tightening. However, monetary expansion can also ease the government's budget constraint, by stimulating short term revenue and reducing interest payments on public debt (or even, when there is money printing, simply financing the deficit with new money), which may weaken the pressure to consolidate the primary fiscal balance. (In other words, if the government is printing money to finance a deficit, it may have less urgent need to cut that deficit than if it is borrowing money and needs to impress lenders.)

The common idea in the academic and policy literature for developed economies is that fiscal consolidation programmes are more likely to be successful if, at least in the initial stages, they are coupled with loose monetary policy. (A common form of IMF intervention programme will involve spending cuts and a large devaluation of the currency.)

# 2
# Six Historical Episodes

We shall cover six significant episodes of fiscal consolidation from UK history: the 1920s, the 1930s, the late 1960s, the mid 1970s, the 1980s, and the 1990s.[6]

## 1922-29 — The Geddes Axe

### Origins of the crisis

During the Great War, public expenditure increased very significantly, from £306 million in 1913 (12.6% of GDP) to £2,427 million in 1918 (47.5% of GDP). Although much of this was funded by higher taxation and divestment of overseas assets, there was also a very high deficit. While defence spending was cut dramatically after the war's end and throughout 1919, cutting in other departments proved difficult. By 1920 total spending was still £1,592 million (26.6% of GDP). Some of this was accounted for by a rise in public debt interest (from £37.3 million in 1910 to £359.8 million); however spending in several areas was considerably higher than it had been before the war. For example, education spending was £59.3 million in 1920 but only £17.2 million in 1910. The Civil Services and Revenue Departments cost £523.3 million in 1921-2, whereas in 1913-4 it cost £81.3 million. Though spending on the Armed Forces had fallen to £190 million by 1921-2, this was still considerably higher than the £77 million in 1913-14. The UK's public net debt had increased from £625 million in 1913 (26% of GDP) to £5,850 million in 1918 (115% of GDP) and by 1920 was £7,810 million (131% of GDP).

By 1921, there was mounting public pressure for cuts in public expenditure. In the City, this was led by the former Home Secretary and Chairman of Midland Bank, Reginald McKenna. In Parliament, a group of 170 MPs, mostly Conservatives, signed a manifesto demanding economies. That same year, Lord Rothermere set up the 'Anti-Waste League', a one-issue political party campaigning against government inefficiencies. It rapidly gained extensive public support, winning two by-election victories. The combination of these factors convinced Lloyd George's government that urgent action was needed to curb public spending.

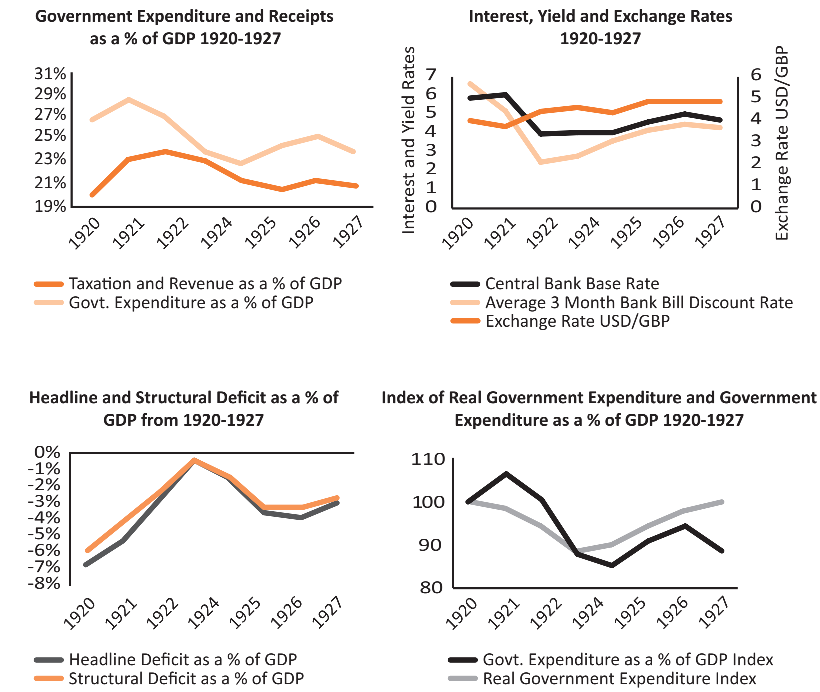
The early 1920s were a period of terrible recession. Money GDP fell from a peak of £6 billion in 1920 to £4.9 billion in 1921 (a contraction of 18% in one year, around 10% in real terms); to £4.6 billion in 1922 (a further contraction of 9%, though real GDP grew at above 5%); and reached its trough in 1923 at £4.3 billion (a further 4.6% contraction). Thus the total money GDP contraction was a remarkable 29% - indeed it was 1940 before money GDP again exceeded its 1920 level.

6 In all cases, many of the figures are drawn from papers and academic studies, some of which are referenced in the Bibliography. It is worth noting that in respect of the overall figures for GDP and levels of tax and spending, the key data sources are HM Treasury website and the ukpublicspending.co.uk website. The data before the 1960s does not perfectly match that of the 1920s and 1930s, so these figures are not straightforwardly comparable to the later data.

### Table 2.1: Summary of key indicators[7]

| | 1921 | 1923 |
|---|---|---|
| **Taxation and other receipts (% of GDP)** | 23.2% | 23.1% |
| **Spending (% of GDP)** | 28.5% | 23.5% |
| **Balance (% of GDP) (headline)** | -5.3% | -0.4% |
| **Balance (% of GDP) (structural)[8]** | -4.1% | -0.3% |
| **Govt. debt (% GDP)** | 154.0% | 181.7% |
| **Growth (%)** | -9.7% | 3.0% |
| **Av. growth over previous 5 years (% p.a.)** | -4.7% | -2.3% |
| **Inflation (%)** | -8.6% | -6.0% |
| **Unemployment (%)[9]** | 10.5% | 7.1% |

### Figure 2.1: Fiscal and Monetary stance from 1920 – 1927




Source: www.ukpublicspending.co.uk and Hough, J (2001); United Kingdom Statistical Extracts

The Treasury proposed savings of £75 million, but Lloyd George went further and set up an independent committee headed by Sir Eric Geddes to review all departmental spending and propose cuts based on assumptions as to which policies the Cabinet would keep or abandon. The Committee was composed of business experts rather than politicians. The Treasury stated that the spending under consideration for the committee stood at £603 million in 1921-2 and the committee was charged by the Chancellor Sir Robert Horne with finding savings to reduce this figure to £428 million in 1922-3. To determine where savings could be made, the committee interviewed civil service staff from all departments. A series of three reports were published in February 1922. These reports

7 Unless otherwise cited, all UK figures for the 1920s and 1930s are derived from Butler D and Butler G, 'Twentieth-Century British Political Facts 1900-2000', (*Palgrave Macmillan 2000*) and ukpublicspending.co.uk.

8 Estimate from available data of output gap.

9 Total insured workers registered as unemployed as a proportion of the workforce. This figure under-estimates the true total.

recommended cuts amounting to around £87 million (known as the "Geddes Axe"). The Cabinet however finally agreed on cuts of £52 million.

In practice, and once the ambition became cutting, aggregate cuts were larger than this. Defence spending fell by a remarkable 36% between 1921 and 1923. Spending on education, housing, pensions and unemployment was reduced from £205.8 million in 1920-1 to £182.1 million in 1922-3. Health spending was left untouched. Government current spending fell by about 23% and did not rise to substantial levels again until 1931. The brunt of jobs cuts fell on civil service temporary staff. Civil service numbers were cut by 35%; mostly temporary female staff hired during the war.

The Geddes cuts did not merely keep spending growth down, rather they actively reversed it. The combination of financial pressure and the political threat of the Anti-Waste League forced the Cabinet into determined active cuts. Total spending fell from £1,563 million in 1921 to a trough of £1,100 million in 1923, a cash fall of almost 30% (over 10% in real terms).

**Table 2.2: Expenditure changes - Two key years**

| | 1921 | | 1923 | | Change | |
|---|---|---|---|---|---|---|
| | Real[10]/ *Nominal*[11] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £1.9bn | 4.0% | £2.2bn | 5.2% | 15.8% | 1.2% |
| | *£63m* | | *£57m* | | | |
| **Education** | £3.6bn | 7.6% | £3.8bn | 8.9% | 5.6% | 1.3% |
| | *£118m* | | *£98m* | | | |
| **Defence** | £9.1bn | 19.2% | £5.8bn | 13.6% | -36.3% | -5.6% |
| | *£299m* | | *£150m* | | | |
| **Welfare** | £7.6bn | 16.0% | £7.6bn | 17.8% | 0% | 1.8% |
| | *£250m* | | *£196m* | | | |
| **Other** | £25.3bn | 53.2% | £23.2bn | 54.5% | -8.3% | 1.3% |
| | *£832m* | | *£599m* | | | |
| **Total** | £47.5bn | | £42.6bn | | -10.3% | |
| | *£1,563m* | | *£1,100m* | | | |

### The consolidation in quotes

*'The need for effecting immediate retrenchment of public expenditure is so imperative, that we think it best not to delay…*

*'We desire to emphasise… the need for immediate action… in the case of the Fighting Services, and the essential importance of energetic Departmental action.'*

First Interim Report of the Committee on National Expenditure, ('The Geddes Report'), Command Paper 1581, December 14th 1921.

10 In 2003 prices.

11 In prices at date.

*'The tendency to waste must be reckoned as an element of original sin… it is better to be dead than to be a 'waster,' or a wastrel.'*

Henry Higgs, 'The Geddes Reports and the Budget', The Economic Journal, June 1922.

*'We are all economists now.'*

H. H. Asquith, Budget debate, 25th April 1921.

*'The recommendations we are prepared to make involve very drastic and heavy cuts…*

*'It has to be regarded as a whole—not from the point of view of what we would like to expend—not even from the point of view of what ought to be spent when the nation can afford it, but from the point of view of what the nation at this moment, having regard to the very great depression in trade, can now afford.'*

Prime Minister David Lloyd George, House of Commons, 7th February 1922.

### *Addressing our questions*

| Question | UK 1920s |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | The Cabinet asked the Geddes Committee to develop a programme of active cuts. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The Government was forced to consider cuts by a political crisis and terrible recession. High spending and taxes had a led to a widespread campaign against waste that threatened Lloyd George's majority. |
| **3. What should be the ratio between spending cuts and tax rises?** | The balance of consolidation fell entirely on spending cuts which counted for 150% of the fiscal adjustment as taxes fell. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | Tightening took place during a major recession. There was a swift recovery from 1924 onwards. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The Geddes Axe was an example of the 'just do it' approach forced upon the Government by the political crisis. No rules or institutional measures were put in place to maintain lower spending levels. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The Government talked tougher than it acted in the sense that it asked the Geddes Committee to come up with a large figure; then only agreed to £52 million of the £87 million recommended. However, in the end, total cuts were larger than either of these figures. |

| | |
|---|---|
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Defence spending bore the brunt of the cuts as Armed Forces consumed a huge amount during the war. Temporary staff – particularly women – formed the main part of the 35% civil service numbers reduction. Social spending remained the same in real terms while health and education spending rose slightly – although this was entirely due to deflation rather than nominal increases. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | The Geddes committee was charged with finding specific areas where there was room for savings. Cuts were differentiated in that they were based on evidence from specific departments. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | The Geddes Report was composed by an independent committee of businessmen based on their interviews with civil servants, but the cuts were ultimately imposed by the Cabinet's implementation of some of its recommendations. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | There were no specific incentives for either departments or bureaucrats. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Cuts may have been hasty and badly targeted – some economists have argued that the scrapping of 14-16 continuation schools plans had a long-term negative impact on national income, for example. The scale of defence cuts may have had a long-term impact on Britain's military capabilities which contributed towards the policy of appeasement in the 1930s. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | Lloyd George's government held together for another few months partly because of the Geddes Axe. Some historians believe the consolidation sped the rise of the Labour Party, and indeed the Liberals never held the administration again. |

### Evaluation: Did it work in its own terms?

This action does appear to have been a success, in its own terms, in both the short and long runs. Spending was reduced very markedly and did not rise again for at least a decade. Even when it did start to rise again, the culture was such that spending cuts were proposed. Growth was considerably stronger subsequent to the consolidation than before it. The severe recession in the immediate aftermath of the Great War gave way to the 'roaring twenties':

**Table 2.3: Growth rates before and after the consolidation**

| | 1918 | 1919 | 1920 | 1921 | 1922 | 1923 | 1924 | 1925 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | 1.9% | -7.9% | -9.8% | -9.7% | 5.3% | 3.0% | 4.7% | 3.5% |

Source: www.ukpublicspending.co.uk.

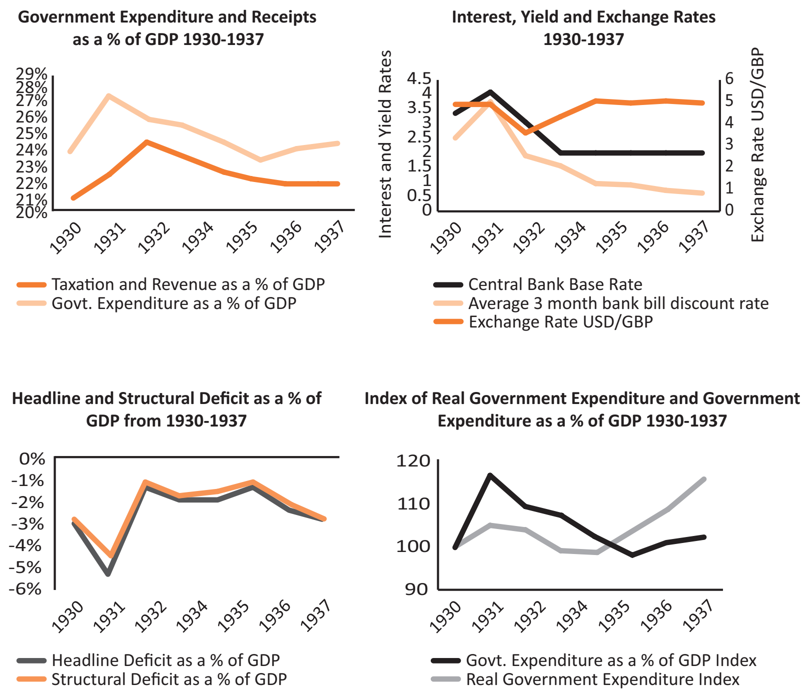
## 1931 — Balancing the Budget in the face of Depression

### Origins of the crisis

After the tumultuous shocks to the international financial system following the stock market crash in October 1929, the British economy came under strain. Credit markets dried up, prices fell and export markets contracted. By the end of 1930, unemployment had more than doubled and the real value of British exports almost halved. The situation worsened with the contraction in money GDP from 1930-2, particularly in 1931 when money GDP fell from £4.6 billion to £4.3 billion (a contraction of 6.5%; 5% in real terms). The combination of rising welfare costs and tumbling revenues generated a significant deficit.

An international banking crisis led to pressures on sterling as the Bank of England sold gold at a rate of £2 million per day in early July 1931 to maintain the Gold Standard. The Bank of England was then forced to lend to Lazards (secretly and as a result of a fraud) as international capital fled London. On 22nd July 1931 gold losses increased to an extraordinary £5 million per day after Sterling's gold parity came under even more pressure. The Treasury sought a foreign loan from J.P.Morgan in the US. However, it became clear that no loan would be forthcoming until the UK sorted out its finances, so the Government set up the May Committee to look at ways to resolve the UK's budgetary position.

**Figure 2.2: Fiscal and Monetary stance from 1930 – 1937**




Source: www.ukpublicspending.co.uk and Hough, J. (2001); United Kingdom Statistical Extracts

## Table 2.4: Summary of key indicators

| | 1931 | 1934 |
|---|---|---|
| **Taxation and other receipts (% of GDP)** | 22.5% | 22.4% |
| **Spending (% of GDP)** | 27.2% | 23.5% |
| **Balance (% of GDP) (headline)** | -4.7% | -1.1% |
| **Balance (% of GDP) (structural)** | -4.1% | -1.0% |
| **Govt. debt (% GDP)** | 171.5% | 172.9% |
| **Growth (%)** | -4.6% | 6.0% |
| **Av. growth over previous 5 years (% p.a.)** | -0.4% | 0.9% |
| **Inflation (%)** | -4.3% | 0.0% |
| **Unemployment (%)** | 13.0% | 10.4% |

The May 'majority Report' concluded that the UK had a budget deficit of £120 million (the Treasury later raised this forecast to £170 million - as context, note that public spending was £1.2 billion in 1931 and GDP was £4.3 billion). The two Labour minority members concluded against expenditure cuts as they echoed the TUC view that social spending was a 'true economy'. However the majority of the committee argued that spending cuts were necessary.

The May Report attacked the previous Conservative and current Labour Government for their social spending aimed at improving conditions for the working classes. It recommended cuts totalling £95.6 million plus an additional £25 million in taxation if necessary but which should not fall on 'productive industry'. Targets included a pay cut for core public employees including police, doctors[12], those who entered the armed forces pre-1925 and a 20% pay cut for teachers. The largest cut fell on unemployment insurance which amounted to £66.5 million. Other areas for spending reductions included housing, social services, road-building and educational grants, land drainage and deforestation as well as administrative savings. Standard benefits were to be reduced by 20% and all those claiming transitional benefits were to be means-tested. The report argued that if schemes had only been introduced in the last few years then they 'cannot be essential'. The Committee added that the overall burden of taxation in the UK was too high and that social spending was at too great a cost to 'industrial enterprise' and 'employment'.

The Labour Cabinet split over the issue of fiscal consolidation. The Labour movement refused to countenance the cuts in social spending recommended by May – particularly in unemployment insurance. A fresh run on sterling started in late August 1931 and on 24th August, a National Government was formed from the three major parties with MacDonald as Prime Minister. The new government announced an emergency budget on 10th September, raising income taxes from 22.5% to 25% and cutting public sector pay by 10%. Unemployment benefit was cut by £12 million per year and applicants were means-tested. Postponing 1,000 road-building schemes saved £7.4 million per year but this came at the cost of 20,000 workers being made unemployed.

The 10% wage cut on public sector workers was worse for lower ranking members of the armed forces. New entrants from 1925 were paid a new rate. The combined effect of the new rate and the 10% cut led to an actual 25% pay cut for

12 It may not be apparent to all readers in what sense the government was responsible for doctors' pay prior to the NHS. In 1911 national health insurance was introduced by the Liberals. It was paid for by a combination of employer, employee and state funds. The insurance entitled people to wage replacement if they were ill, treatment by a panel GP if they were ill but not hospital treatment. In 1930 there were 39,000 panel GP's in England each with up to 1000 patients, the insured had to go to a panel doctor and the doctor had to treat the patient, for a fixed fee set by government. Another source of medical public spending in the 1930's was the network of hospital and specialist clinics, run by local authorities and paid for by local and national taxes.

lower ranking members. This led to a Royal Navy mutiny (including the flagship *Hood*) at Invergordon in Scotland on 14th and 15th September. The mutiny panicked international investors which put even more pressure on sterling. The Bank of England could not afford to keep selling gold to maintain the Gold Standard and so the Government was forced to leave it on 21st September.[13]

Total public spending fell from £1,256 million (27.2% of GDP) in 1931 to £1,082m in 1934 (23.5% of GDP), a cash fall of 9.6% (almost 6% in real terms).

## Table 2.5: Expenditure changes - Two key years

| | 1931 | | 1934 | | Change | |
|---|---|---|---|---|---|---|
| | Real[14]/ *Nominal*[15] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £3.4bn | 6.4% | £3.6bn | 7.1% | 5.9% | 0.7% |
| | *£80m* | | *£77m* | | | |
| **Education** | £5.3bn | 9.9% | £5.3bn | 10.5% | 0% | 0.6% |
| | *£125m* | | *£114m* | | | |
| **Defence** | £5.3bn | 9.9% | £5.7bn | 11.3% | 7.5% | 1.4% |
| | *£125m* | | *£122m* | | | |
| **Welfare** | £12.4bn | 23.2% | £12.7bn | 25.2% | 2.4% | 2.0% |
| | *£292m* | | *£273m* | | | |
| **Other** | £27.0bn | 50.6% | £23.1bn | 45.9% | -14.4% | -4.7% |
| | *£635m* | | *£496m* | | | |
| **Total** | £53.4bn | | £50.4bn | | -5.6% | |
| | *£1,256m* | | *£1,082m* | | | |

### The consolidation in quotes

[Taxation consumes] '*an unduly large proportion of the national income…*

'*definitely restrictive of industrial enterprise and employment.*' – *Report of the Committee on National Expenditure,*

('The May Committee'), 31st July 1931.

'*The May Report… [was] a catalogue of economies for balancing the Budget…The specific, and indeed the only problem was to restore waning confidence, to stop the drain, to secure the loan necessary to give us a chance to rebuild our defences.*'

Prime Minister Ramsay MacDonald,
House of Commons, 8th September 1931.

'*The method of balancing our Budget advocated by Mr. Keynes and other economists which is simply to continue to borrow… shocks hon. Members.*'

Sir Oswald Mosley, House of Commons, 8th September 1931.

13 This was not the end of the economic turmoil. In particular, it is worth noting that, just a few months later in March 1932, the government quasi-defaulted on its debts, with 92% of the value of the War Loans that funded the First World War being converted from paying 5% to instead paying only 3.5%.

14 In 2003 prices.

15 In prices at date.

*'The conditions were merely the conditions under which it would be possible to raise the money. What the late Government had to be sure of was that there would be sufficient confidence in foreign circles in the determination of the British Government to set their House in order and to balance their Budget.'*

Neville Chamberlain, House of Commons,
29th September 1931.

*'A national Budget has thus come to be regarded as a touchstone of a country's financial stability second only in importance to its international balance of trade; and if, as the case at present with us, we are "down" on our balance of trade with other countries, foreigners to whom we owe money automatically turn a microscope on to our Budget. And if the Budget is not really balanced... the epitaph of us English of to-day will be written by historians to come in Shakespeare's words (Richard II, Act 2, Scene 1):*

*'England, bound in with the triumphant sea,*
*Whose rocky shore beats back the envious siege of watery Neptune,*
*Is now bound in with shame, with inky blots and rotten parchment bonds.*
*That England, that was won't to conquer others, hath made a shameful conquest of itself.'*

Memorandum to the Cabinet by Sir Warren Fisher,
Permanent Secretary to the Treasury, September 14th, 1931.

### *Addressing our questions*

| Question | UK 1931 |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | Growing away not an option – spending cuts were a condition of necessary foreign loans. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | Arguments over how to respond to the crisis – whether to try to balance the budget or run a deficit - were a key factor in the collapse of Ramsay MacDonald's Labour government and the formation of the National Government in 1931. This drove strong action from the new government to try to balance the budget and remain on the Gold Standard. The government used the crisis to portray the Labour opposition as reckless: 'Bolshevism run mad'. |
| **3. What should be the ratio between spending cuts and tax rises?** | The balance of consolidation fell entirely on spending cuts, which accounted for 105% of the fiscal adjustment as taxes fell. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The tightening took place well into the recession; the economy had contracted by 6% and the Treasury had to deplete its reserves to main the Gold Standard. The tightening had no obvious impact on the recovery, which appears to have been much more influenced by monetary loosening as the pound came off the Gold Standard. |

| | |
|---|---|
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | No rules or monitoring institutions were formulated. This was very much a 'just do it' consolidation responding to immediate circumstances. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | Talking was very tough – so tough it led to a mutiny of the Navy off the back of exaggerated press reports of wage cuts. Deflation meant that the effect of money spending cuts was eliminated in almost every area, however. It could be argued that excessive rhetoric undermined the effectiveness of the consolidation in the sense of its failing to achieve its notional objective – maintaining Gold parity. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Unemployment benefit insurance, public sector wage cuts and public works are probably the most obvious sources of cuts: most of these recent programmes. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | There was across-the-board pain, but there was particular focus on recently-introduced social spending considered wasteful. Undifferentiated, across-the-board cuts were the main approach. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | Centrally-imposed cuts were imposed; there was little devolution of responsibility. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | Bureaucrats were not consulted at the May Report level, nor were any specific incentives employed. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | The consolidation caused major social dislocation and near revolution. The government was forced to abandon the Gold Standard but this may have resulted in Britain having a shorter, milder recession than otherwise. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | Debate over the cuts severely divided the Labour Party after the collapse of its government in 1931. The Conservative-dominated National Government went on to win the 1935 General Election, and Labour did not hold the administration again until 1945. |

### Evaluation: did it work in its own terms?

The following table illustrates how real growth evolved during and after the recession:

**Table 2.6: Growth rates before and after the consolidation**

| | 1929 | 1930 | 1931 | 1932 | 1933 | 1934 | 1935 | 1936 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | 2.9% | -0.8% | -4.6% | 0.1% | 3.2% | 6.0% | 3.7% | 4.8% |

Source: www.ukpublicspending.co.uk.

Thus, we see that, in contrast with much of the developed world (and indeed with the UK's own experience in the 1920s), the UK's recession in the 1930s was relatively mild (of order 5-6% contraction in GDP — by way of reference, note that the French contraction was around 15%, the German around 17%, and the US contracted by around 30%). Furthermore, in stark contrast to much of the rest of the developed world, which found recovery in the 1930s slow and shallow, the mid-1930s was (in growth terms) a boom period for the UK economy, with an average real growth rate of 4.2%. (However, it is worth noting that growth was not even across the country; unemployment was high and persistent, with the result that politicians gained the collective impression that the 1930s were an era of economic mismanagement and sustained depression — with important consequences for post-war economic management.)

Thus, although the cuts programme clearly failed in its own terms – it did not prevent sterling from being forced off the Gold Standard – and although it would certainly be possible to contend that recovery in 1932 might have been even more rapid had it not been for the spending cuts, it seems more natural to believe that there was no material impact on the recession even from the very deep cuts made and that it was, instead, monetary policy that was crucial: once sterling came off the gold standard and monetary policy loosened, recovery was rapid.

## 1968/9 — IMF Bailout

### Origins of the crisis

The seeds of the 1967 crisis may have been sown even before the Labour government arrived in 1964 by the previous Conservative government's pursuit of growth and suppression of unemployment. The new government adopted an incomes policy and significant intervention in industry. It strongly rejected devaluation and publicly committed to preserve the $2.80 parity for the pound. Public expenditure was increased rapidly, with expenditure rising as a proportion of GDP from 38.1% in 1964/5 to a peak of 44.6% in 1967/8.

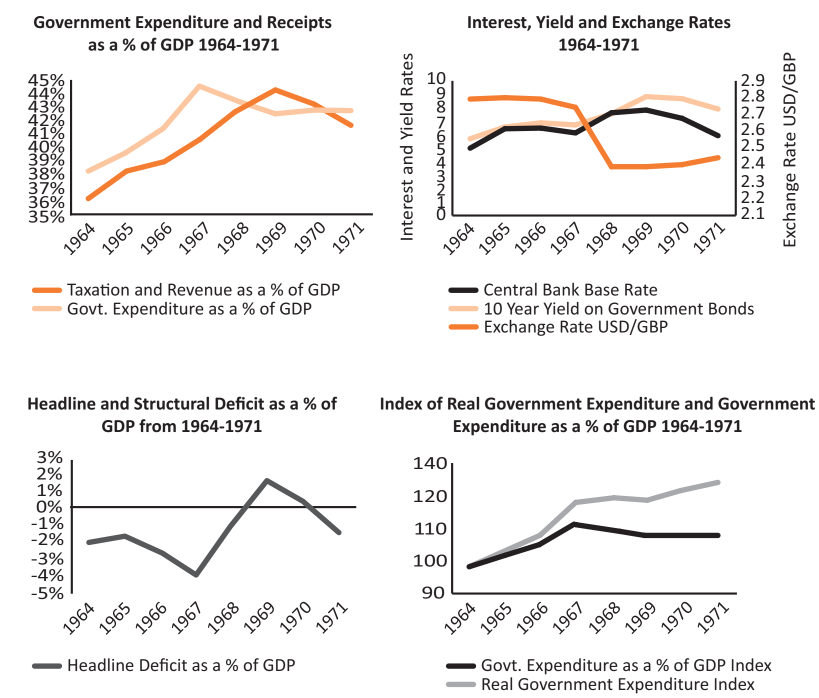
The UK's balance of payments deteriorated and with a fixed exchange rate under the still-extant Bretton Woods system, the pound was unable to depreciate in response. The pressure for devaluation became irresistible with the figures for the fourth quarter of 1967 showing an identified deficit of about £350 million, making the deficit for 1967 as a whole £540 million. In November 1967 the pound was devalued from $2.80 to $2.40 in one day and at the end of that month, the IMF approved a stand-by arrangement for the UK of $1.4 billion.

It proved very difficult to restore confidence in sterling, not least because balance of payments problems often worsen in the period immediately following a devaluation (the so-called "J-curve effect"), because of issues such as the same volumes of imports initially becoming more expensive in sterling terms (as a result of the devaluation) and volumes falling only later in response to their being more expensive. In the case of the 1967 devaluation this effect had been anticipated but Treasury and Bank of England estimates regarded this as a much shorter-term phenomenon than it turned out to be in practice.

The continued balance of payments deficit and credibility lost through devaluation put the pound under ongoing pressure. During December 1967 the Bank was forced to sell dollars to keep the new rate from falling below the floor of $2.38. Officials began to question whether a further devaluation might be necessary to restore confidence.

In March 1968 there was a gold crisis and sterling came under pressure again as speculators bought gold. The UK authorities were forced to seek assistance through the IMF as official reserves were inadequate to deal with the crisis.

**Figure 2.3: Fiscal and Monetary stance from 1964 – 1971**




Source: Public Finances Databank, HM Treasury and OECD Main Economic Indicators

**Table 2.7: Summary of key indicators**[16]

| | 1967 | 1969 |
|---|---|---|
| Taxation and other receipts (% of GDP) | 40.6% | 44.3% |
| Spending (% of GDP) | 44.5% | 42.5% |
| Balance (% of GDP) (headline) | -3.9% | 1.8% |
| Balance (% of GDP) (structural) | N/A | N/A |
| Govt. debt (% GDP) | 80.5% | 73.9% |
| Growth (%) | 2.5% | 2.1% |
| Av. growth over previous 5 years (% p.a.) | 2.5% | 2.2% |
| Inflation (%) | 2.5% | 5.4% |
| Unemployment (%) | 2.2% | 2.2% |

(During the crisis the reserves fell to -$881million (i.e. liabilities greatly outstripped assets). The US and G-10 extended the UK a facility of $4,050 million to protect the pound – a huge sum. Partly in exchange for this, the 1968 budget (which came 6 days after the gold crisis) aimed to eliminate the deficit and pay the cost of devaluation in less favourable terms of trade. It also sought to produce a continuing balance of payments surplus large enough to enable Britain to repay its debts, to rebuild its reserves and give itself some margin in hand in case of short-term fluctuations in future.

The Government aspired to significantly reduce public and consumer expenditure so as to reduce demand for imports, while allowing devaluation to produce a stimulus in exports in order to improve the balance of payments.

### January 1968 expenditure plan

Prime Minister Wilson's January 1968 plan drastically cut the defence budget, massively reducing British overseas commitments. The planned withdrawal of troops east of Suez was speeded up; all troops were withdrawn from Malaysia, Singapore and the Gulf. British forces would thereafter be based only in Europe and Hong Kong.

There were also significant cuts in other areas, particularly housing and transport. The plan also postponed the key policy of raising the school leaving age and reintroduced NHS prescription charging.

### March 1968 budget

To achieve the government's aims of squeezing public and consumer expenditure, Roy Jenkins' draconian budget of March 1968 raised taxes by a total of £923 million:

- A special one-off tax on all investment income over £3,000.
- (The tax rises were estimated to reduce consumer spending by 2%.)
- A 3.5% cap was imposed on wage rises.
- The cost of living was increased by around 5%.
- Investment in nationalised industries was cut and the total number of civil servants was frozen.
- Jenkins kept up his tight fiscal stance right up to the election. Despite pressure to introduce a give-away Budget, he stood firm.

16 Figures derived from Public finances databank and ukpublicspending.co.uk

### IMF role

The key role of the IMF was to give its seal of approval to British policy in order to rebuild confidence.

- Despite the public spending cuts in January 1968, the February IMF mission remained sceptical about British policy, notably in relation to 'firm control' of the borrowing requirements.
- The IMF recommended final expenditure reductions in the order of £500 million in 1968/69 'to put the balance of payments on an unquestionably sound footing.'
- In June 1969, the UK drew the $1.4 billion authorised under its stand-by arrangement.
- In June 1969, the IMF approved another stand-by arrangement for $1 billion.

After devaluation, the spot rate initially remained above $2.40 until the Gold crisis, fell below thereafter and did not stage a sustained recovery until the balance of payments swung into surplus in September 1969. Infamously the balance of payments went briefly back into deficit in 1970 with the official figures being released just before the General Election of that year; indeed this is one of the major reasons often offered for Wilson's defeat. Although spending fell in 1969/70 versus 1968/9, by 1970/1 total managed expenditure was already above its 1968/9 level – thus the period of restraint lasted only one year.

**Table 2.8: Expenditure changes - Two key years**

| | 1967 | | 1969 | | Change | |
|---|---|---|---|---|---|---|
| | Real[17]/ *Nominal*[18] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £19.1bn | 9.2% | £19.7bn | 9.2% | 3.1% | 0% |
| | *£1,600m* | | *£1,771m* | | | |
| **Education** | £25.4bn | 12.2% | £27.3bn | 12.7% | 7.5% | 0.5% |
| | *£2,128m* | | *£2,454m* | | | |
| **Defence** | £32.5bn | 15.6% | £28.4bn | 13.2% | -12.6% | -2.4% |
| | *£2,723m* | | *£2,553m* | | | |
| **Welfare** | £36.3bn | 17.4% | £41.3bn | 19.2% | 13.8% | 1.8% |
| | *£3,041m* | | *£3,713m* | | | |
| **Other** | £95.3bn | 45.6% | £98.5bn | 45.7% | 3.3% | 0.1% |
| | *£7,983m* | | *£8,855m* | | | |
| **Total** | £208.6bn | | £215.2bn | | 3.2% | |
| | *£17,474m* | | *£19,346m* | | | |

17 In 2003 prices.

18 In prices at date.

### *The consolidation in quotes*

> *'The measures will be progressively reinforced… to hold back private consumption…*
>
> *'These measures accord fully with … a policy of severe restraint in prices and incomes…*
>
> *'A detailed and searching review of policy by the Government in every major field of expenditure, with no exceptions, on the basis that no spending programme could be sacrosanct…*
>
> *'By the end of 1971… we shall… not be maintaining military bases outside Europe and the Mediterranean.'*
>
> Prime Minister Harold Wilson,
> House of Commons, 16th January 1968.

> *'In the short term we must have a stiff Budget, followed by two years of hard slog…*
>
> *'Excessive growth in the short-run before we have secured the balance of payments, would be the enemy of steady growth for several years to come.'*
>
> Chancellor of the Exchequer Roy Jenkins,
> Budget Statement March 1968.

### *Addressing our questions*

| Question | UK 1968 |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | Burden was much greater than anything growing away could solve. The fundamental balance of payment problem was due to the inability of sterling to adjust caused by the strict exchange rate conditions set by Bretton Woods. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The government's perceived need to maintain the new dollar parity to preserve its economic credibility drove action to cut consumer demand and imports through tight control of public expenditure, bank credit and high taxation. The crisis was used to justify cuts in the name of building the confidence of international investors. |
| **3. What should be the ratio between spending cuts and tax rises?** | Expenditure cuts made up about 35% of consolidation whereas revenue made up 65% of the adjustment. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The tightening took place when the economy was deep into a currency crisis, depleting its reserves to keep the exchange rate above the floor. The tightening accelerated recovering initially though balance of payments went back into deficit in 1970. |

| | |
|---|---|
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The spending programme was required in order to secure the IMF loan and in order to deflate demand for imports so as to maintain the exchange rate peg. On our definitions, this constitutes an institutional mechanism. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The government talked tough and largely lived up to this in the run up to the 1970 General Election. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Some cuts were in recently established programmes (social housing plans took a big hit); others were long established, such as defence cuts principally in line with a long-term, wide-ranging reduction of Britain's global presence. Income taxes also increased as the goal was to decrease demand. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Attempts were made to target specific areas but cuts affected a wide range of departments and services. Certain specific programmes were targeted such as free school milk, NHS prescriptions, the school leaving age, etc. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | The cuts were dominated by centrally imposed Treasury decisions; little autonomy was given. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | We are not aware of any incentives; this was more of a top down approach. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Increased industrial strife led to greatly increased number of days lost to industrial action in the 1970s. Britain permanently lost a military presence in many parts of the world. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The government lost a great deal of its economic credibility over devaluation. The consolidation may have contributed to its defeat in the 1970 General Election. |

### Evaluation: Did it work in its own terms?

In terms of the immediate objective, the programme was successful. Spending was reduced, the IMF loan was obtained, and sterling maintained its $2.40 parity. However, over the longer term the programme was an abject failure. The entire Bretton-Woods fixed exchange rate regime collapsed in the early 1970s and UK public spending rose wildly, leading to the IMF intervention of 1976. Although there was very little consolidation, there was quarter-on-quarter expansion for the rest of the decade; as the table below shows, full-year growth rates were consistently strong throughout the latter half of the 1960s:

**Table 2.9: Growth rates before and after the consolidation**

| | 1964 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | 5.5% | 2.2% | 1.9% | 2.5% | 4.2% | 2.1% | 2.2% | 2.1% |

Source: ONS Time Series Data

## 1976 — Second IMF Bailout in short succession

### Origins of the crisis

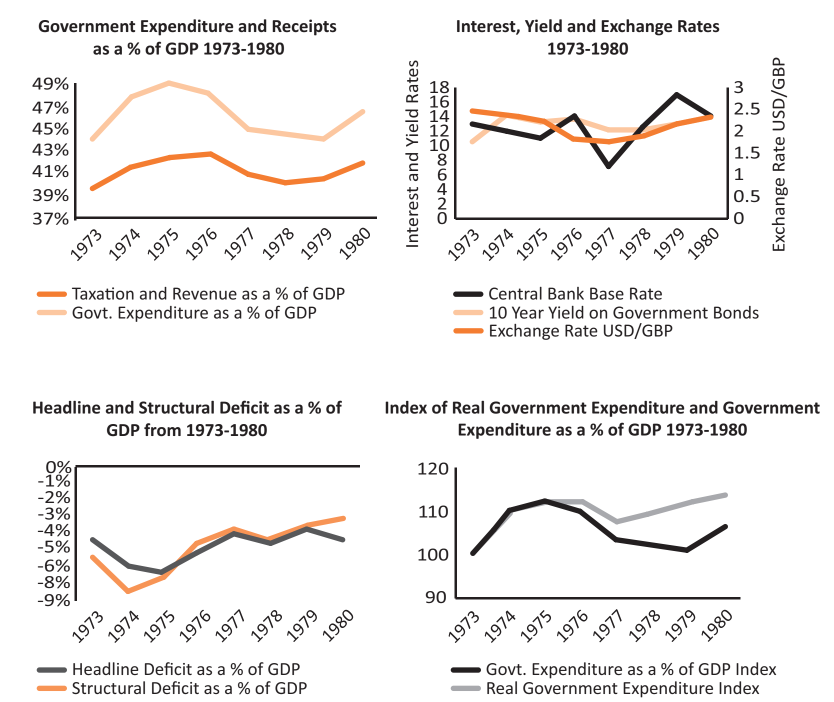
By the end of financial year 1975/6, total public expenditure amounted to £55.8 billion or 49.8% of GDP, having risen by an enormous 7.8% of GDP over the previous three years. The left wing of the Labour Party defeated the Public Expenditure White Paper in the Commons in March 1976. Subsequently, Harold Wilson resigned and James Callaghan took over as Prime Minister. Around this time, investors became convinced that the pound was overvalued and that the government might devalue. A large-scale sale of sterling began, which rapidly lost value against the dollar.

In spite of further efforts to reduce inflation, the pound continued to lose value, reaching a record low against the dollar in June 1976. The US Treasury Secretary now agreed with officials in the International Bank of Settlements that the pound was overvalued. He offered to partially fund a stand-by loan of $5.3 billion to support the pound but insisted on repayment by December 1976. Proposals for further cuts in expenditure and tax increases to reduce the budget deficit were debated in Cabinet in July. By September 1976, Britain had already drawn heavily on the short-term loan and it was apparent that a loan from the IMF would be necessary to fund repayment.

**Table 2.10: Summary of key indicators**

| | 1976 | 1977 |
|---|---|---|
| **Taxation and other receipts (% of GDP)** | 43.0% | 41.3% |
| **Spending (% of GDP)** | 48.5% | 45.6% |
| **Balance (% of GDP) (headline)** | -5.5% | -4.3% |
| **Balance (% of GDP) (structural)** | -5.0% | -4.1% |
| **Govt. debt (% GDP)** | 47.1% | 47.8% |
| **Growth (%)** | 2.6% | 2.4% |
| **Av. growth over previous 5 years (% p.a.)** | 1.6% | 0.6% |
| **Inflation (%)** | 16.5% | 15.8% |
| **Unemployment (%)** | 5.1% | 5.4% |

## Figure 2.4: Fiscal and Monetary stance from 1973 – 1980




Source: Public Finances Databank, HM Treasury and OECD Main Economic Indicators

As pressure on the pound mounted, the government approached the IMF for a loan of $3.9 billion in September 1976. This was the largest amount ever requested of the Fund at that time, which needed to seek additional funds from the US and Germany. The IMF negotiators demanded heavy cuts in public expenditure and the budget deficit as a precondition for the loan. Healey's proposals for a cut of around 20% in the budget deficit were hotly debated in Cabinet, particularly by Anthony Crosland and Michael Foot. Eventually they acceded, as it seemed likely that the refusal of the loan would be followed by a disastrous run on the pound.

In December 1976, the Chancellor announced a mini-budget containing just over £2.5 billion in cuts to be made over two years. The cuts reduced public expenditure to 45.1% of GDP by 1978-9. The deficit to GDP ratio was to be reduced from 9% in 1976-7 to 6% in 1977-8 and then to 5.25% in 1978-9.

In the December 1976 Mini-budget, the Chancellor detailed the areas where cuts would fall:

- Civil Service: £30 million in 1977-78 and £10 million in 1978-79.
- Housing capital programmes: £270 million in 1977-78 and £300 million in 1978-79.
- Land acquisitions under the Community Land Act: £55 million in each year.
- Accelerated phasing out of the Government's food subsidies programme: £160 million in 1977-78 and £60 million in 1978-79.
- Education cuts including school building: £20 million in 1977-78 and £30 million in 1978-79.

- Reduced financing to the nationalised industries by £100 million each year.
- Regional Employment Premium attracting employment to the regions: £150 million and then £170 million.
- Defence budget reduced by £100 million and then £200 million.
- Overseas aid: £50 million each year.
- Export Credits (ECGD): £100 million and then £200 million.
- Sale of BP shares leaving the Government with a 51% shareholding.
- Some tax rises. Income tax cut promised for 1978-79 if the conditions were right.

**Table 2.11: Breakdown of December 1976 mini-budget cuts**

| Expenditure Area | 1977-78 £ million | 1978-79 £ million |
|---|---|---|
| Defence Budget | 100 | 200 |
| Transfers and Subsidies | 420 | 437 |
| Regional | 160 | 215 |
| Education | 42 | 41 |
| Health | 15 | 25 |
| Other | 279 | 595 |
| TOTAL | 1016 | 1513 |

Total managed expenditure fell by almost 4% between 1976/77 and 1977/78, the largest real terms fall of recent decades. Spending was still lower in real terms in 1979/80 than it had been in 1976/7 – a noteworthy 3 year period of spending restraint. Nominal spending rose from £63.7 billion to £69.5 billion, but inflation on the GDP deflator measure was only 13-14% in each of 1976/7 and 1977/8, lower than in either 1974-6 or indeed 1979-81. Thus although inflation was surely a facilitating factor, it does not appear to have been the key factor in explaining these real terms cuts.

### *The consolidation in quotes*

> [The UK faces] '*possible wholesale domestic liquidation starting with a notable bankruptcy…The magnitude of this threat is quite incalculable… The collapses which have occurred up till now, and even those which have been prevented, can really be likened to the tip of a menacing iceberg.*'
>
> Energy Minister and economic adviser Lord Thomas Balogh, written anonymously by a 'minister of state' to Prime Minister Harold Wilson, December 1974.

> '*Good-bye Great Britain. It was nice knowing you.*'
>
> Headline of Wall Street Journal article advising readers to withdraw from sterling investments, 29th April 1975. The article described the British economy as 'sinking', the 'ultimate consequences of the welfare-state-manic-Keynesian syndrome.'

> '*The crisis that faces us is infinitely more serious than any of the crises we have faced over the past 20 years… the party is over.*'
>
> Antony Crossland, Foreign Secretary, speech in Manchester Town Hall, 9th May 1975.

*'You cannot now, if you ever could, spend your way out of a recession.'*
Prime Minister James Callaghan, Labour Party Conference, September 1976.

*'We have [never] been so near to the end of our borrowing powers as we are now.'*
Margaret Thatcher, House of Commons, 11th October 1976.

*'RIGSBY: This country gets more like the boiler room of the Titanic every day: confused orders from the bridge, water swirling around our ankles. The only difference is they had a band.'*
Eric Chappell, Rising Damp, popular TV sitcom, 1977.

*'Jim said it was far worse than the 1968-69 loan. Denis said it was the same. The PM put his hand over the phone and asked Gavyn what the 1969 letter of intent had been like. Gavyn said it was shorter and had many fewer constraints. The PM said to Healey, 'Denis, I have it here in my hand, it is shorter and has many less restraints.'*
Bernard Donoughue, former head of Harold Wilson's Policy Unit (1974-6), Downing Street Diary, Volume Two.

*'In your farewell to 1976, did you see Britain old and worn, on the brink of ruin, bankrupt in all but heritage and hope, and even those were in pawn?'*
Hughie Green, host of popular 1970s light entertainment show 'Opportunity Knocks', December 1976 New Year's Message.

*'England ist kein entwickeltes Land mehr.' ['England is no longer a developed country']*
West German Chancellor Helmut Schmidt.

## Table 2.11: Expenditure changes - Two key years

| | 1976 | | 1977 | | Change | |
|---|---|---|---|---|---|---|
| | Real[19]/ *Nominal*[20] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £29.5bn | 10.6% | £28.8bn | 11.2% | -2.4% | 0.6% |
| | *£6,600m* | | *£7,507m* | | | |
| **Education** | £36.8bn | 13.3% | £34.6bn | 13.4% | -6.0% | 0.1% |
| | *£8,233m* | | *£9,018m* | | | |
| **Defence** | £34.5bn | 12.4% | £34.2bn | 13.2% | -0.9% | 0.8% |
| | *£7,719m* | | *£8,914m* | | | |
| **Welfare** | £58.9bn | 21.2% | £60.4bn | 23.4% | 2.5% | 2.2% |
| | *£13,178m* | | *£15,743m* | | | |
| **Other** | £117.5bn | 42.5% | £100.2bn | 38.8% | -14.7% | -3.7% |
| | *£26,288m* | | *£26,117m* | | | |
| **Total** | £277.2bn | | £258.2bn | | -6.9% | |
| | *£62,018m* | | *£67,299m* | | | |

19 In 2003 prices.

20 In prices at date.

*Addressing our questions*

| Question | UK 1976-9 |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | Growing it away was not an option – immediate spending cuts were a condition of the IMF loan agreement. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | Spending cuts were instigated as a condition of the IMF loan and when the financial crisis had become very acute. This action was strongly opposed in the governing Labour Party from the Cabinet down. The crisis was used to justify attempts at severe wage restraint in the public sector. |
| **3. What should be the ratio between spending cuts and tax rises?** | The balance of consolidation fell entirely on spending cuts, which accounted for 175% of the fiscal adjustment as tax revenue fell. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The tightening took place when the economy was deep in the midst of a financial crisis. Following the agreement with the IMF, the overall economic and financial picture improved. Interest rates were soon reduced and the pound quickly appreciated in value. By the end of 1977, partly as a result of new oil revenues, there were improvements in the balance of trade. Britain did not need to draw the full loan from the IMF. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | By our definitions, the IMF requirements constitute an institutional mechanism. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | As with previous UK consolidations, the Chancellor Denis Healey talked tough with the public – and his Cabinet colleagues – about the need to impose stringent spending cuts. And indeed real terms cuts were delivered (with a little help from high inflation). |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Many areas of public expenditure were hit, especially defence, health and education. There were also considerable cuts in unemployment benefits, pensions and public works programmes. These were largely long established programmes. |

| | |
|---|---|
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Specific areas were targeted – especially those that were not deemed essential. There appeared to have been undifferentiated cuts in specific areas, however. For example there appears to have been across-the-board cuts in defence, unemployment benefits and education investment. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | A centrally-imposed consolidation was the approach taken. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | We are not aware of bureaucrats being closely consulted at Cabinet level or specific incentives being employed. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Resulted in a total breakdown of industrial relations and constraints on wage demands. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | Dealt a severe blow to the government's economic credibility. Created resentment in the Labour Party due to the spending cuts and in particular IMF imposition of spending restraints. Labour lost the 1979 election and was not returned to office for 18 years. |

### Evaluation: Did it work in its own terms?

Spending was cut, very considerably (some 4% of GDP) and the IMF requirements were met. However, once the IMF strictures came off, union wage demands led to considerable industrial strife and mass unemployment (particularly because of the very high wage increases in the pay round of 1980 and the consequent destruction of employee productivity — millions of workers were priced out of the market) and at the same time public spending started to rise very rapidly. Thus the programme cannot be regarded as a success over the longer term. The table below shows that growth rates were not significantly affected by the consolidation and remained strong into 1979 (despite a significant contraction in the third quarter of that year):

**Table 2.12: Growth rates before and after the consolidation**

| | 1974 | 1975 | 1976 | 1977 | 1978 | 1979 |
|---|---|---|---|---|---|---|
| Growth rates | -1.3% | -0.6% | 2.6% | 2.4% | 3.2% | 2.7% |

Source: ONS Time Series Data

## 1980s — Thatcher Medicine and Thatcher Miracle

### Table 2.13: Summary of key indicators

| | 1981 | 1983 | 1990 |
|---|---|---|---|
| **Taxation and other receipts (% of GDP)** | 45.4% | 44.1% | 38.4% |
| **Spending (% of GDP)** | 47.7% | 47.8% | 39.4% |
| **Balance (% of GDP) (headline)** | -2.3% | -3.7% | -1.0% |
| **Balance (% of GDP) (structural)** | -1.5% | 0.0% | -2.6% |
| **Govt. debt (% GDP)** | 45.8% | 43.2% | 35.2% |
| **Growth (%)** | -1.5% | 3.5% | 0.8% |
| **Av. growth over previous 5 years (% p.a.)** | 0.5% | 0.4% | 2.6% |
| **Inflation (%)** | 11.9% | 4.6% | 9.5% |
| **Unemployment (%)** | 9.6% | 11.9% | 6.0% |

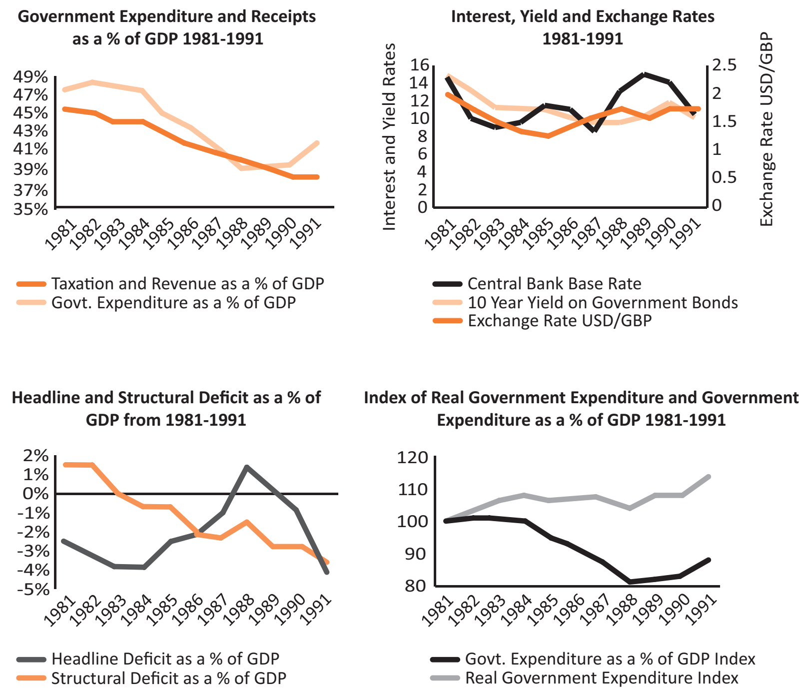
### Origins of the crisis leading up to the 1981 Budget

The late 1970s were a period of extreme industrial unrest and economic dislocation. In July 1978, in an attempt to combat inflation and control public spending rises, the Callaghan government attempted to impose a 5% limit on wage increases. This restriction, known as 'Phase IV', was strongly opposed by the TUC. After an unofficial strike, Ford (seen as a private sector benchmark for wage demands) settled with the TGWU for a 17% increase in November 1978. Even bread rationing was briefly imposed that month when a bakers' strike led to panic buying. Inflation remained high at 13.4% in 1979; the overwhelming majority of trade unions sought to defy the limit. The Ford settlement further emboldened public sector unions who began a series of strikes – from nurses to rubbish collectors, train drivers to – notoriously – some GMWU gravediggers, leaving the dead unburied. The 'Winter of Discontent' as it became known, saw the largest number of working days lost to strike action since the General Strike of 1926 – nearly 30 million for 1979. The combination of trade union unrest, persistently high inflation, rising unemployment and the gathering global recession partly caused by the 1979 oil crisis contributed to a powerful sense of urgency by 1981.

The backdrop to the 1981 budget was the worst recession in the UK since the immediate aftermath of World War II, with quarterly GDP contracting 5.9% from peak (much worse than even the combined effects of the recessions of the 1970s) and unemployment rising above three million.

The UK's structural deficit had peaked at 8.1% of GDP in 1974/5, before high inflation (peaking at 26.9% in August 1975) and the spending cuts associated with the IMF programme began to bear down upon it. But by 1980/1 it still stood at 3.4% of GDP, whilst the headline deficit was 4.8% of GDP. The government's central policy goal was the taming of inflation, which had risen again to exceed 20% during April to June 1980.

**Figure 2.5: Fiscal and Monetary Stance from 1981 – 1991**




Source: Public Finances Databank, HM Treasury and OECD Main Economic Indicators

***Monetary targeting & fiscal policy***

In this era, monetary and fiscal policy were not separate in the way they came to be treated later. Control of the government deficit, specifically the public sector borrowing requirement (PSBR), was seen as an aspect of monetary policy, a way in which money supply growth could be curtailed. One straightforward reason for this was that deficits were not always fully funded by the issuance of gilts — often they were financed at least partially by quantitative easing (printing money), so that running a PSBR meant increasing the money supply in a very direct sense. Out of control spending and out of control budget deficits were thus a direct cause of inflation.

The Thatcher government proclaimed itself “monetarist” — that is to say, it considered that inflation was to be understood as the result of excessive growth in the money supply and the control of inflation was to be achieved by controlling that growth. The key money supply aggregate targeted was £M3, which included the PSBR, sales of gilts and bank lending. The Treasury believed that it understood this measure well, having followed it closely since 1977.

In March 1980 the government introduced its Medium Term Financial Strategy (MTFS). The main objectives of the MTFS were to bring down inflation and to create conditions for sustainable growth and employment. The MTFS set the series of targets for both PSBR and £M3 as percentages of GDP. A path of decelerating money supply growth was projected so that money growth in 1983 – 84 would be about 6% at an annual rate. One idea behind linking reductions in the growth rate of the money supply to reductions in PSBR was to permit tight monetary policy to go together with falling interest rates. This would result in both falling inflation and rising private sector demand. The intention was that these objectives would be achieved gradually.

### Table 2.14: The MTFS as set out in the 1980 Budget

| Financial Year | 1979 – 80 (actual) | 1980 – 81 | 1981 – 82 | 1982 – 83 | 1983 – 84 |
|---|---|---|---|---|---|
| Growth of £M3 (%) | 13.2 | 7 – 11 | 6 – 11 | 5 – 9 | 4 – 8 |
| PSBR/GDP(MP) (%) | 4.8 | 3.85 | 3.0 | 2.25 | 1.5 |

The policy instruments through which the intermediate target was to be influenced were set out in the Green Paper on Monetary Control. The main instrument was to be the PSBR. Over the medium-term it was argued the PSBR was the main source of high monetary growth, therefore it would be reduced as a proportion of GDP. The other instrument for achieving the money supply target was interest rates, but the Treasury wished to avoid placing excessive strain on the private sector so this mechanism was seen as subsidiary to the PSBR. The aim was to construct the strategy around decisions to reduce money growth; the Treasury then calculated a declining PSBR path consistent with this. Each money supply target range for successive years of the strategy had a corresponding PSBR/GDP ratio.

***Inflation expectations, wages and unemployment***

Despite the government's aspirations, there was considerable doubt as to whether public spending would or could really be controlled as it hoped, and thus whether inflation could be tamed. A particular area of concern was the public services wage bill, which increased 50% (in nominal terms) from 1978/9 to 1980/1, largely because of "catching up" commitments arising from the collapse of the outgoing Labour government's incomes policy.

Political history did not seem to bode well. The Heath government had entered office proclaiming tough free market rhetoric and yet in office had increased public spending rapidly and then been forced from office by union action. The Wilson government had been forced to seek assistance from the IMF, leading the West German Chancellor to declare that Britain was no longer a developed country. And the Callaghan government's policy had been overwhelmed, in the end, by union resistance. Indeed, Britain's reputation for ungovernability had led it to be known as 'the sick man of Europe'.

Although not as serious as the widespread unrest of 1979's "Winter of Discontent", 1980 was nonetheless a year of widespread industrial action, with 12 million working days lost to strikes. Despite very severe recession and unemployment rising to levels not seen since the 1930s, the Bank of England's interest rate was at 17% for the first half of the year and fell only to 16% in July. By October, these high interest rates had driven sterling up above $2.40 (versus only around $2.05 at the time Thatcher entered Downing St.), making life particularly difficult for exporters including manufacturers. The government came under strong pressure to reverse its stance, including from within the Conservative Party.

Even though inflation was falling, down to 15.4% by October 1980 from 21.9% in May, expectations of a U-turn in policy were widespread, with average earnings growth peaking in October at 22.6% (very significant real wage growth, almost certainly indicating an expectation that inflation would rise again so that real wage growth was necessary to provide a buffer from erosion by later inflation). Even in its own terms, policy did not seem to be working: the PSBR in 1980/1 turned out to be 5.7% of GDP, compared with a target of 3.85% (and on unchanged policies would have been 5% of GDP in 1981/2 versus the 3% target), whilst monetary growth was running at around 18%, compared with a target of 7-11%.

At the Conservative Party Conference on October 10th, with "Right to work" demonstrators protesting outside, two of whom managed to break into the hall, Mrs Thatcher gave a famous speech, including the following widely-quoted passage:

> *To those waiting with bated breath for that favourite media catchphrase, the U-turn, I have only one thing to say: You turn if you want to. The lady's not for turning!"*

Nonetheless, by November, as Sterling exceeded $2.45 and unemployment approached three million, interest rates were cut again to 14%, below the rate of inflation. Thatcher's advisor Alan Walters argued for the need to cut interest rates further. It became crucial to devise a way to maintain anti-inflation credibility (and so avoid further above-inflation, unemployment-generating wage rises) whilst at the same time allowing interest rates to fall.

### The 1981 budget

The 1981 budget was probably the most controversial of modern times. In its aftermath, 364 economists (including then-unknowns such as Mervyn King and Willem Buiter, alongside giants of the age such as Lords Kahn and Kaldor) wrote to *The Times* to condemn the government's economic policies, stating that:

(a) *"there is no basis in economic theory or supporting evidence for the Government's belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment;*
(b) *present politics will deepen the depression, erode the industrial base of our economy and threaten its social and political stability;*
(c) *there are alternative policies; and*
(d) *the time has come to reject monetarist policies and consider urgently which alternative offers the best hope of sustained recovery."*

What had so animated the economists of the day was the introduction of a considerable fiscal tightening at the peak of a recession. The government raised taxes, reduced spending growth, and set a substantially lower target for PSBR either than had been achieved in 1980/1 or than was forecast for 1981/2 on unchanged policies. In one swoop, the government's fiscal balance went (on current Treasury estimates) from a 3.4% structural deficit to a 1.5% structural surplus – a 5%

turnaround in one year; much the largest change on record. Indeed, some OECD estimates put the tightening even higher, at above 6%.

Key tax raising measures included:

- Income tax: Personal allowances frozen in cash terms, implying a cut in real terms, raising about £1.9 billion.
- Excise duties: Sharp increases (beer and petrol up 24%, cigarettes up 16%). This raised about £1.2 billion.
- A windfall tax on banks (defended on the grounds that the high interest rate policy had left banks with windfall profits), at 2.5% on banks' non-interest-bearing current account deposits (above a minimum threshold). This may have raised about £350-£400 million.
- Changes to taxes on North Sea oil, raising about £1 billion.

The 1981 Budget maintained the stance set out in the Public Expenditure White Paper, for a 4% reduction in spending between 1980/1 and 1983/4. In the event, total managed expenditure grew at 1.9% from 1980/1 to 1981/2 versus 1.6% growth in 1980/1 and 1.9% growth in each of the two previous years. This very steady growth pattern should be understood, however, against the backdrop of extremely severe recession, and to have occurred despite very rapid rises in spending on unemployment benefits and income support payments. Over-shooting of previous budgets was so endemic that expenditure forecasts included a substantial "shortfall provision". Thus for the 1981 Budget not to have raised its formal expenditure targets, except insofar as the total volumes rose because of automatic increases due to unemployment benefits and income support payments, represents, in practice, a very significant tightening of expenditure compared with what would have been the natural expected path.

***Important expenditure reductions or tight controls***

Amongst the areas in which spending was brought under particular control were:

- The UK's contribution to the EEC budget. At successive meetings of the European Council, Mrs Thatcher engaged in lengthy petitions to get "our money back". Eventually, in April 1980 at the Luxembourg meeting an arrangement was agreed under which Britain received a rebate for 1980-82, eventually extended to cover 1983. A more permanent solution was arrived at the Fontainebleau Council meeting in June 1984, which had the effect of reimbursing about two thirds of Britain's net contributions at the end of each year. The value of this rebate was very significant, comprising around £710 million in 1980 alone.
- Government lending to the nationalised industries. This was slashed from £1,900 million in 1979 to a projected £700 million in 1980. The government aimed for a net inflow of £550 million in debt repayments from them by 1983/4.
- A cash limit was placed on financial support for local authorities through the Rate Support Grant and supplementary grants from 1980 onwards.
- A contingency reserve was established from 1979 with additions of £2,000 million projected for 1983/4.

### *Impact on inflation and economic growth*

This considerable fiscal tightening, perhaps in combination with the sheer ferocity of the recession, broke the back of inflationary expectations. By October 1981 wages, which had been rising at more than 7% above inflation a year earlier, were a below-inflation 11.4%, and would fall below 8% by October 1982. Inflation itself fell rapidly, also, to below 10% in April 1982, troughing at 3.7% in May and June 1983.

## Table 2.15: Expenditure Changes - Four Key Years

| | 1981 | | 1983 | | Change | |
|---|---|---|---|---|---|---|
| | Real[21]/ *Nominal*[22] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £33.0bn | 11.6% | £37.0bn | 12.9% | 12.1% | 1.3% |
| | *£13.9bn* | | *£18.9bn* | | | |
| **Education** | £34.1bn | 12.0% | £32.5bn | 11.3% | -4.7% | -0.7% |
| | *£14.3bn* | | *£16.6bn* | | | |
| **Defence** | £35.8bn | 12.6% | £35.1bn | 12.2% | -2.0% | -0.4% |
| | *£15.0bn* | | *£17.9bn* | | | |
| **Welfare** | £73.8bn | 25.9% | £72.3bn | 25.2% | -2.0% | -0.7% |
| | *£31.0bn* | | *£36.9bn* | | | |
| **Other** | £108.4bn | 37.9% | £110.4bn | 38.4% | 1.8% | 0.5% |
| | *£45.5bn* | | *£56.4bn* | | | |
| **Total** | £285.1bn | | £287.3bn | | 0.8% | |
| | *£119.7bn* | | *£146.7bn* | | | |

| | 1985 | | 1989 | | Change | |
|---|---|---|---|---|---|---|
| | Real[23]/ *Nominal*[24] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £38.0bn | 12.8% | £42.1bn | 14.9% | 10.8% | 2.1% |
| | *£19.4bn* | | *£26.8bn* | | | |
| **Education** | £32.2bn | 10.9% | £34.6bn | 12.2% | 7.5% | 1.3% |
| | *£16.4bn* | | *£22.0bn* | | | |
| **Defence** | £37.4bn | 12.6% | £33.8bn | 12.0% | -9.6% | -0.6% |
| | *£19.1bn* | | *£21.5bn* | | | |
| **Welfare** | £77.8bn | 26.3% | £78.1bn | 27.6% | 0.4% | 1.3% |
| | *£39.7bn* | | *£49.7bn* | | | |
| **Other** | £110.5bn | 37.4% | £94.2bn | 33.3% | -14.8% | -4.1% |
| | *£56.3bn* | | *£59.9bn* | | | |
| **Total** | £295.9bn | | £282.8bn | | -4.4% | |
| | *£150.9bn* | | *£179.9bn* | | | |

21 In 2003 prices.

22 In prices at date.

23 In 2003 prices.

24 In prices at date.

Interest rates were cut by 2% in March 1981 (and thus had fallen 4% from the time of the "lady's not for turning" speech), but despite this the government nonetheless came close to hitting its money supply target for 1981/2. At the same time sterling began to fall from the high level it had reached during 1980, possibly partly because of the outlook for oil prices. Annualised growth in the economy troughed in the first quarter of 1981 (i.e. almost precisely coinciding with the Budget), and thereafter began to recover: in the five years from quarter one of 1981 average annual real growth in domestic demand was 3.3%.

### 1985-89

Over the following few years the government's strategy gradually changed. New budgetary rules were introduced in 1985 to maintain the lower levels of spending. It moved away from £M3 as its monetary target, dropping it altogether in 1987. M0 was introduced as an indicator of the stance of monetary policy, but the emphasis was increasingly on looking at a broad range of monetary aggregates rather than a single one, the behaviour of which could be unreliable. This broadened out still further into a policy of considering all the evidence available, including the exchange rate. Monetary targets were eventually abandoned. Policy gradually loosened up despite the government's adherence to its fiscal targets, which were met very soon. By the end of the period the budget was in surplus.

Part of the reason for this success was the privatization programme, the revenues from which served to reduce the PSBR. Beginning with the sale of BP shares by the Labour Government in the 1970s, the Thatcher era involved significant privatisation. Previously publicly-owned companies were sold; their profits could then be taxed in the private sector.

Cuts in expenditure, as in other consolidations, included significant transfer cuts from 1984 and subsidies cuts from 1986 were an important element of expenditure reduction. There were also reductions in public sector staffing. The number employed in the public sector was cut by 12% between 1981 and 1988 – 4.8% in 1985 alone.

There were a number of significant tax reforms. The 1984 Finance Act enacted structural changes in the personal and corporate income taxation. During the period 1985–1988 top personal income tax rates were reduced, on average, from 55 % to 40%. Despite this, in the 1980s, revenue growth made a relatively sizeable contribution to the fiscal adjustment. This is due partly to the increase in revenue generated by the North Sea Oil and partly because GDP growth (and hence tax revenues) outstripped expectations. Total Managed Expenditure actually fell in real terms from 1984/5 to 1985/6 and 1987/8 to 1988/9, troughing in 1988/9 at 38.9% of GDP, its lowest level since 1964/5. Indeed, spending was still lower in real terms in 1990/1, Thatcher's final year in office, than it had been in 1984/5 – an extraordinary six-year period of spending restraint.

***The consolidation in quotes***

> *'The Old Testament prophets did not say 'Brothers I want a consensus'. They said: 'This is my faith, this is what I passionately believe. If you believe it too, then come with me.'*
>
> Margaret Thatcher, 1979.

*'The Government is determined not merely to halt the growth of public expenditure but to progressively reduce it.'*

1980 Treasury White Paper.

*'To those waiting with bated breath for that favourite media catchphrase, the U-turn, I have only one thing to say: You turn if you want to. The lady's not for turning!'*

Margaret Thatcher,
1980 Conservative Conference Speech.

*'Consensus seems to be the process of abandoning all beliefs, principles, values and policies.'*

Margaret Thatcher, 1981.

*'To change course now would be disastrous'*

Sir Geoffrey Howe, Chancellor of the Exchequer, 1981 budget.

*'If Margaret Thatcher is re-elected as prime minister on Thursday, I warn you. I warn you that you will have pain – when healing and relief depend upon payment. I warn you that you will have ignorance – when talents are untended and wits are wasted, when learning is a privilege and not a right. I warn you that you will have poverty – when pensions slip and benefits are whittled away by a government that won't pay in an economy that can't pay. I warn you that you will be cold – when fuel charges are used as a tax system that the rich don't notice and the poor can't afford....*

*'If Margaret Thatcher wins on Thursday, I warn you not to be ordinary. I warn you not to be young. I warn you not to fall ill. I warn you not to get old.'*

Neil Kinnock MP, speech in Bridgend, Glamorgan,
on Tuesday 7 June 1983.

*'The sale of assets is common with individuals and states when they run into financial difficulties. First, all the Georgian silver goes, and then all that nice furniture that used to be in the salon. Then the Canalettos go.'*

Former Prime Minister Harold Macmillan commenting on Thatcher's
privatisation programme, Tory Reform Group, 8th November 1985.

*'Thatcherism is not for a decade. It is for centuries.'*

Margaret Thatcher, 1990.

***Addressing our questions***

| Question | UK 1980s |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | In the early 1980s there were active cuts but in the late 1980s, spending as a percentage of GDP also fell because of the boom in economic growth. Spending fell in real terms during two years of the 1980s. |

| | |
|---|---|
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The Government was elected partly on a mandate to rescue Britain's economy after the 'Winter of Discontent'. Howe, Lawson and Thatcher were determined to take urgent action in the teeth of opposition both in and outside the Conservative Party. They used the crisis to justify real cuts in public spending even as automatic spending increased during the recession of the early 1980s. |
| **3. What should be the ratio between spending cuts and tax rises?** | The balance of consolidation fell entirely on spending cuts, which accounted for 215% of the fiscal adjustment as tax revenue fell. The structural composition of the consolidation fell heavily on expenditure cuts, amounting to 85% of the adjustment. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The 1981 Budget made real cuts in the brunt of the recession. However, the main tightening took place after the recession was over, between 1985 and 1989, when growth accelerated to an average of 3.9% p.a. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | During the Conservative consolidation in the 1980s, budgetary rules were made to maintain lower levels of spending. Nevertheless, the key to enforcement of the spending cuts was the political will of the Government and the will of Thatcher and her Chancellors to overcome Cabinet and Party opposition. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The Thatcher Government tended to 'talk tough' but gave assurances about specific areas; 'the NHS is safe with us'. The tough rhetoric was not always followed through in reality. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Public sector employees and transfers formed the brunt of the cuts. Subsidies to the nationalised industries were cut and eventually eliminated through privatisation. Health spending was always protected. Education, defence and welfare spending fell. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Undifferentiated cuts were used especially in reducing public sector numbers. Specific areas like unemployment benefits, public sector numbers were also targeted. Assets sales (privatisation) was a defining feature of the period. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | Mrs Thatcher had severe difficulties in the early 1980s with many 'wet' departmental ministers. Cuts tended to be imposed by the centre. |

| | |
|---|---|
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | We are not aware of any specific incentives to cut. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | May have contributed to sustained mass unemployment and increased regional income differences. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The government was heading for defeat in 1983 General Election due to mass unemployment and recession but was saved partly by Labour's divisions, the formation of the SDP and victory in the Falklands War. Subsequent boom and support from newly affluent 'C2' voters contributed to victories in 1987 and (despite a further recession), 1992. |

## Evaluation: Did it work in its own terms?

This was a remarkably successful programme, both in the short- and the long-term. In the short-term, very considerable fiscal tightening (some 6% of GDP in the 1981 budget) was achieved. Over the longer term, following two decades of an apparently relentless trend for public spending to rise (the 1960s and the 1970s), and after a decade of political and economic misery with repeated unsuccessful attempts to grapple with the problem (the 1970s), the 1980s were characterised by a consistently falling share of public spending in GDP, down to much more sustainable levels by the late 1980s (indeed, there were two years in the boom in which spending actually fell in real terms), allowing for rapid economic growth. Spending was actually still lower, in real terms, in 1990/1 than 1984/5 – a remarkable six-year period of spending restraint. This is probably the single most successful consolidation in the UK's historical cases. The table below shows that the improvement in growth rates subsequent to the consolidation was considerable (after a contraction for five consecutive quarters from the first quarter of 1980), reaching a remarkable 5% in 1988:

### Table 2.16: Growth rates before and after the consolidation

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|---|---|---|---|
| Growth rates | 2.7% | -2.1% | -1.3% | 2.1% | 3.6% | 2.7% | 3.6% | 4.0% | 4.6% | 5.0% |

Source: ONS Time Series Data

## 1992-99 — Deficit correction, Clarke's cheerful tightfistedness and the Iron Chancellor

**Table 2.17: Summary of Key indicators**

| | 1992 | 1993 | 1994 |
|---|---|---|---|
| **Taxation and other receipts (% of GDP)** | 36.3% | 35.4% | 36.4% |
| **Spending (% of GDP)** | 43.7% | 43.1% | 42.6% |
| **Balance(% of GDP) (headline)** | -7.4% | -7.7% | -6.2% |
| **Balance (% of GDP) (structural)** | -5.5% | -5.4% | -4.7% |
| **Govt. debt (% GDP)** | 35.4% | 39.4% | 45.7% |
| **Growth (%)** | 0.2% | 2.3% | 4.3% |
| **Av. growth over previous 5 years (% p.a.)** | 0.4% | 0.4% | 1.1% |
| **Inflation (%)** | 3.7% | 1.6% | 2.4% |
| **Unemployment (%)** | 10.0% | 10.2% | 9.4% |

As the 1980s ended, UK public finances appeared to be in robust good health. Both the 1988/9 and 1989/90 fiscal years had seen budget surpluses, total managed expenditure was down to around 39% of GDP (versus over 48% in 1982/3), and general government debt was below 35% of GDP. Yet by 1993/4, in a dramatic turnaround, the budget deficit had reached nearly 8% of GDP (unprecedented for the UK), and by 1995/6 general government debt was back above 50% of GDP for the first time since 1981/2. Action was necessary, and action there was.

### Origins of the deficit

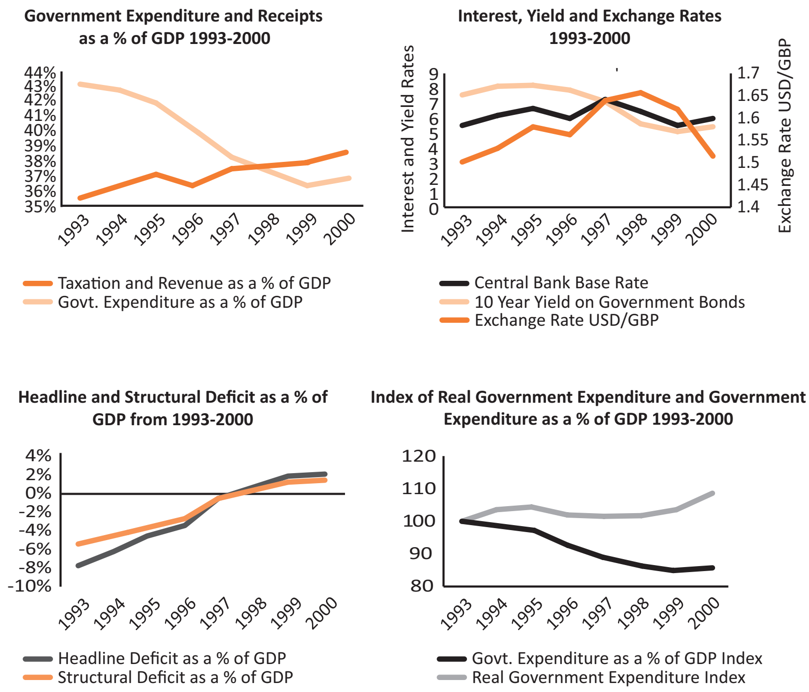
There were two key drivers of the rise in the deficit. First, public spending rose. Total Managed Expenditure, which had been lower, in real terms, in 1990/1 than in 1984/5, rose rapidly after John Major become Prime Minister, rising 10% in real terms in just two years. Partly this was part of a deliberate strategy of increasing spending in areas such as health, which rose 11% in real terms over those two years - an average annual growth rate of 5.4% compared with a growth rate of 3% over the previous six years. And partly it was a consequence of recession, as quarterly GDP contracted by 2.5% and unemployment rose, eventually to 3 million. Recession also had an impact on tax receipts, which had been above 40% in 1988/9 and were still 38.4% in 1990/1 but then fell to just 35.4% of GDP in 1993/4. But the problem was more than just a temporary fall-off in revenue: the structural deficit was 5.5% of GDP in 1992/3 and 5.4% in 1993/4.

#### *The recession and monetary policy*

The three most salient features of the recession of the early 1990s were:

- The period of high interest rates in the run-up to recession and through most of the period of GDP contraction. Interest rates were above 10% from mid-1988 to mid-1992, and were around 15% for a year from October 1989 to October 1990. There were three main drivers of this policy:

**Figure 2.6: Fiscal and Monetary stance from 1993 – 2000**




Source: Public Finances Databank, HM Treasury and OECD Main Economic Indicators

- Inflation, which had been just 3.3% at the start of 1988, rose to above 8% in mid 1989 and then (following a brief lull) above 10% by August 1990.
- As Chancellor from October 1989, John Major proclaimed his desire to take the steam out of the housing market – that is to say, part of his monetary policy was directed at an asset prices target.
- From October 1990 onwards, interest rates needed to stay high in order to maintain Britain's position in the European Monetary System's Exchange Rate Mechanism (ERM).

- The ERM was a quasi fixed exchange rate under which the pound could not fall more than 6% below its notional ERM parity of DM2.95 = £1, i.e. below DM2.778. The UK entered the ERM in October 1990, at the very end of Mrs Thatcher's tenure as Prime Minister and remained until withdrawal on September 16th 1992 (often described as either "Black Wednesday" or "White Wednesday", depending on whether the commentator did or did not welcome the events of that day). By September 1992, inflation was down to 3.5% whilst interest rates were still at 10% (indeed, on September 16th rates were raised to 12% and a further rise to 15% was announced, though never implemented). Though actual trading losses were only £800 million (a 1997 study estimated total losses at £3.4 billion, but £2.4 billion of that was opportunity cost losses on profits that could have been made on foreign currency reserves) – public confusion between amounts of money employed in intervention and actual trading losses led to a widespread belief that many billions or even tens of billions had been lost.

- House prices, which had boomed dramatically in the late 1980s, crashed, falling 14.7% in nominal terms (on the Halifax house price index) from their July 1989 peak to their February 1993 trough, and over 30% in real terms (in real terms the trough was later, in January 1996).

Following exit from the ERM, the UK adopted inflation targeting, aiming to keep inflation within a band of 1%-4%, with a goal of 2.5% or lower by the end of the Parliament (this target was always met). Interest rates were cut, falling to 5.25% by February 1994. Despite exit from the ERM and the consequent depreciation of sterling, contrary to expectations inflation did not rise – indeed, by June 1993 RPI inflation was down to a 30-year low of 1.2%.

Thus, unlike in the early 1980s or indeed the 1970s, although spending control was still conceived as important in a broad sense in order not to create expectations of inflation, it was not being employed as a central tool of quasi-monetary policy.

Furthermore, and perhaps surprisingly, although the level of the budget deficit was unprecedented, there was not really any sense of acute economic crisis in respect of the deficit. Spending had to be controlled, to be sure, and taxes were raised, of course, and there was a political price to be paid for these things, but unlike the 1970s or 1980s there was never any genuine doubt that the government would do what was required. Despite the period being a time of considerable political turmoil, with a government that had only a wafer-thin majority for much of its term and faced widespread rebellion from within its own party (particularly over the Maastricht Treaty and later on the related question of UK involvement in the euro), and despite the Opposition Labour Party highlighting in particular the rises in taxes and (though less so) the tightness of public spending, there was never any serious suggestion of an alternative fiscal path. There was not a serious political constituency for either reducing the deficit faster or reducing it slower, or for changing materially the balance of the consolidation towards more or less tax rises relative to spending cuts. In particular, unlike the early 1980s or the 1970s, although a few specific measures were reversed under internal pressure (probably the best known of these was the application of VAT to domestic fuel), the governing party did not (despite its many other troubles) face serious opposition from within on the issue of fiscal policy.

The key budgets of interest were the two 1993 Budgets and the 1996 Budget.

### 1993 Budgets

There were two Budgets in 1993, in the Spring and the Autumn, owing to a re-organisation of the government's budgetary process.

#### *Tax measures*

There were widespread tax changes, in particular:

- The income tax personal allowances and basic rate limit were frozen for two years.
- The married couples allowance on income tax and mortgage tax relief were restricted in value in two steps, first to 20% from April 1994 and then to 15% from April 1995.

- Contribution rates for national insurance for employees and the self-employed were raised by 1%, whilst the lowest rate of employer NI was cut 1%.
- There were above-inflation increases in excise duties except, notoriously, for spirits.
- There was a commitment to raise tobacco duties by at least 3% p.a. in real terms.
- A commitment was announced in the Spring to increase duties on road fuel by at least 3% p.a. in real terms. (*This came to be known as the "fuel escalator".*) In the Autumn this was raised to at least 5% p.a. in real terms.
- The advance corporation tax (ACT) rate was reduced to 22.5% from April 1993 and to 20% from April 1994. (*Because of changes to dividend taxation introduced at the same time, with the rate set at 20%, this ACT rate reduction was actually a tax raising measure, since the ACT regime was a device permitting pension funds to claim back tax paid on dividends.*)
- VAT was applied to household fuel, which had previously been exempt, initially at a rate of 8%. (*The Spring 1993 Budget announced that a rate of 17.5% would apply from April 1995. Following intense political opposition, the second stage increase was abandoned in the 1994 Budget.*)
- Amongst other measures of note, the community charge ("poll tax") was (as previously trailed) abolished to be replaced by the council tax.

***Spending measures***

- A new system of public spending control from 1993/4 was announced to constrain spending to a pre-planned total, the 'Control Total', whose aim was to ensure 'that total public spending grows by less than the economy as a whole over time' (1993 Red Book).
- Year-on-year cuts were planned as announced in the 1992 Autumn Statement – on transport from £6,750 million in 1992/3 to £5,860 million in 1995/6 and on the environment from £1,560 million to £1,130 million.
- Defence expenditure was planned to remain almost static in nominal terms – a £23 billion budget in 1991/2 was forecast to be £23.2 billion in 1995/6.
- Great restraint was placed on central government funding for local authorities. Current specific grants were to be reduced from an outlay of £19.7 billion in 1991/2 to just £17.8 billion in 1994/5. Credit approval outlay was to be reduced from £4.4 billion in 1991/2 to £4.2 billion in 1995/6.
- In the 1992 Autumn statement, Lamont had announced that public sector pay settlements in the coming year would be restricted to between 0 and 1.5%.
- Clarke announced a freeze on central government running costs and that any pay increases would have to be 'paid for by greater efficiency or by savings in the cost of running government itself.' These measures were largely successful with the median basic pay award falling to 1.5% in 1993 and not rising above 3% again until 2001.

***Outturns***

The deficit fell from 7.7% of GDP (5.4% in structural terms) in 1993/4 to 4.7% (3.8% in structural terms) in 1995/6 (there were further falls subsequently, as described below). General government gross debt peaked in 1995/6 at 50.7% of GDP. Total managed expenditure grew at just 2% per year over those two years, whilst tax receipts, which at 35.4% of GDP in 1993/4 were at their lowest since the early 1960s, had risen back to 37.2% of GDP by 1995/6.

### 1996-9

By the time of the November 1996 Budget, GDP growth recovery was well under way, the spending controls introduced earlier had begun to bite, and the deficit had fallen to just 3.4% (though the structural deficit was still an uncomfortable 2.8%). With a general election due within six months, many commentators expected that there would be tax cuts or a rise in spending.

There was indeed a reduction of 1p in the Basic Rate of income tax to 23p, but overall tax measures were limited. The spending projections were extremely tough and implied real terms cuts. Indeed, they were so tough that expert commentators such as Evan Davis questioned whether they were deliverable.

#### *Spending measures*

- The 1996 Budget kept firm control on the Control Total – reducing spending by £1.9 billion in 1997/8 over what would otherwise have been the case.
- Tight departmental spending projections were announced (which were largely stuck to by Chancellor Gordon Brown after the 1997 General Election). The Budget projected a fall in the PSBR of in excess of 5% of GDP over the following five years; 80% of which was to be achieved through spending controls.
- Allocations to some departments were projected to remain virtually static between 1997/8 and 1999/2000 (Scotland, Wales and Northern Ireland's allocation rising from £29.5 to £29.8 billion, Education and Employment remaining the same at £14.0 billion, the Home Office rising from £6.8bn to £6.9 billion, for example).
- Transport spending was to be cut from £5.2 billion in 1997/8 to £4.3 billion in 1999/2000.

#### *Outturns*

In real terms, Total managed expenditure fell from 1995/6 to 1996/7 and again in 1997/8. Indeed, spending was still lower in 1999/2000 than it had been in 1995/6 – a noteworthy four year period of spending restraint bettered only by the 1984/5-1990/1 period in recent UK history. The fiscal balance went into surplus in 1998/9 and stayed there for three years, peaking at 1.8% of GDP (1.1% in structural terms).

An interesting feature of this period is that it represents real cuts in spending during a boom. It is sometimes suggested that a policy of "automatic stabilisation" – allowing spending to rise in a recession with the expectation of cutting spending back in a boom, so as to offset both boom and recession with government spending changing in the opposite direction – is unrealistic, because when it comes to the boom spending will inevitably rise, not fall, under political pressure. This did not happen in the late 1990s. Spending rose during the recession, but then was cut back during the boom. It is an interesting historical "what if" to ponder what would have been the outcome for the UK economy had such a "leaning against the wind" policy been continued into the 2000s, in contrast to the very large spending rises that actually occurred.

### Table 2.18: Expenditure Changes - Two Key Years

| | 1992 | | 1994 | | Change | |
|---|---|---|---|---|---|---|
| | Real[25]/ *Nominal*[26] | % of Total Expenditure | Real / *Nominal* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | £48.9bn | 14.8% | £54.2bn | 15.5% | 10.8% | 0.7% |
| | *£37.0bn* | | *£43.2bn* | | | |
| **Education** | £38.6bn | 11.7% | £42.0bn | 12.0% | 8.8% | 0.3% |
| | *£29.2bn* | | *£33.5bn* | | | |
| **Defence** | £34.2bn | 10.3% | £33.2bn | 9.5% | -2.9% | -0.8% |
| | *£25.9bn* | | *£25.5bn* | | | |
| **Welfare** | £92.4bn | 28.0% | £109.6bn | 31.4% | 18.6% | 3.4% |
| | *£69.9bn* | | *£87.4bn* | | | |
| **Other** | £116.9bn | 35.2% | £110.1bn | 31.6% | -5.8% | -3.6% |
| | *£88.5bn* | | *£87.8bn* | | | |
| **Total** | £331.0bn | | £349.1bn | | 5.5% | |
| | *£250.5bn* | | *£278.3bn* | | | |

**The consolidation in quotes**

> *'Inflation must go. Ending it cannot be painless. The harsh truth is that if it isn't hurting it isn't working.'*
>
> Chancellor of the Exchequer John Major, October 1989.

> *'Rising unemployment and the recession have been the price that we have had to pay to get inflation down. That price is well worth paying.'*
>
> Chancellor of the Exchequer Norman Lamont,
> House of Commons, 16th May 1991.

> *'What we are seeing is the return of that vital ingredient - confidence. The green shoots of economic spring are appearing once again.'*
>
> Norman Lamont, speech at the Conservative Party Conference,
> 9th October 1991.

> *'It would be equally wrong to expect public investment or an ever-expanding public sector to lead the recovery.'*
>
> Norman Lamont, House of Commons, 10th March 1992.

> *'A Budget for the recovery'*
>
> Norman Lamont, House of Commons, 10th March 1992.

> *'Business can plan ahead with confidence only if it knows that Government borrowing is under control. My task today is to deliver that confidence…*

25 In 2003 prices.

26 In prices at date.

> *'we cannot sit by, simply hoping that faster growth and forecasting changes will come to our rescue… we must stop ever more national debt piling up for future generations to pay…*
> *'For the next three years, Government expenditure will grow by substantially less than the projected growth of the economy.'*
>
> Ken Clarke, Budget Speech, 30th November 1993.

### *Addressing our questions*

| Question | UK 1990s |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | The period following the recession was characterised by significant GDP growth which automatically contributed to reducing the deficit. However, there was a significant underlying structural deficit that was eliminated by policy measures. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | Cuts were not a useful tool as regards the ERM crisis but were important in restoring credibility to public finances after the recession of 1991/2. There was a need to avoid devaluation turning into inflation. The government used the crisis to justify spending restraint and tax rises for several years following. |
| **3. What should be the ratio between spending cuts and tax rises?** | The consolidation consisted of 65% spending cuts to 35% tax rises in headline figures. Structurally, expenditure restraint accounted for 75% of the adjustment, whereas revenue measures accounted for 25%. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The major impact of the consolidation took place after 1992, with the economy experiencing one of the longest business cycles in modern times. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The adjustment was 'just do it'. The main form of rule that was relevant related to public sector pay. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | Lamont talked tough, letting people know that these were budgets to get recovery on the road. He did not make many promises, and made it clear that deficits were going to increase. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Less politically decisive areas such as environmental protection, housing and community amenities saw real term reductions in spending. |

| | |
|---|---|
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Mostly differentiated cuts were used; however some were undifferentiated, such as public sector pay freezes. By focusing on keeping promises to steady wage levels in the public sector, the Chancellor could arguably be seen to be limiting the pressures on inflation. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | The cuts were imposed from the centre. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | We are not aware of any specific incentive schemes. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Perception of public services falling behind increase in living standards experienced in the private sector. Sense of decay and the quality of public services being outstripped by public expectations. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The condition of public services and the "22 Tory tax rises" were key themes in the government's defeat in the 1997 election but may have been outweighed by the 18-year tenure of the administration and the memory of perceived economic incompetence in the 1992 ERM crisis. |

### Evaluation: Did it work in its own terms?

Certainly in the short term this was successful. The recession of the early 1990s was very mild by historical standards, and the consolidation strategy in the aftermath was very successful despite the historically very high levels of government deficit (around 8% of GDP). Once the boom took hold from 1994, spending constraints became firm, as per the concept of using fiscal policy to offset boom and bust, and spending actually fell in real terms in the late 1990s. The strategy appeared to have led to a culture shift in the early part of the New Labour period, with Gordon Brown emphasising fiscal rectitude. However, much of this hard work and good discipline was wasted in the end, as the boom of the 1990s and 2000s eventually led to extreme fiscal laxity with wild spending increases and unprecedented deficit levels. There was quarter-on-quarter expansion for the rest of the decade, as the table below shows:

## Table 2.19: Growth rates before and after the consolidation

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|---|---|---|---|---|
| Growth rates | 0.8% | -1.4% | 0.1% | 2.2% | 4.3% | 3.1% | 2.9% | 3.3% | 3.6% | 3.5% |

Source: ONS Time Series Data

# 3
# Six International Episodes

Next we turn to consider six recent international episodes of fiscal consolidation or spending control. Two of these involve countries emerging from significant financial sector crises (Sweden, Finland). Two are from other English-speaking countries (Canada, Ireland). Two are from other EU member states (Germany, Netherlands).

## Sweden: 1993-2000

### Origins of the Deficit

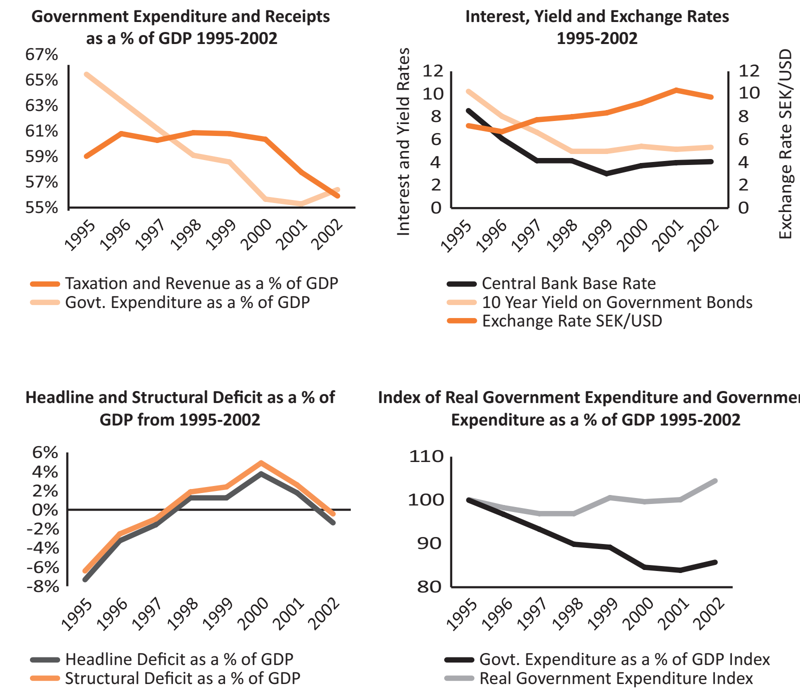
In common with a number of European economies, Sweden suffered a recession in the early 1990s. Between the summers of 1990 and 1993 GDP dropped by a total of 6%. Aggregate unemployment rose from 3% to 12% of the labour force and the public sector deficit ballooned to 11% of GDP. The Swedish case was particularly aggravated through coinciding with or resulting in a financial sector crisis. At the peak of the well-known crisis of the Exchange Rate Mechanism (ERM) in September 1992, the Government and Opposition jointly announced a general guarantee of the whole of the banking system, whilst in November, overnight rates in Sweden were set at 500% in a desperate bid to defend the Swede's fixed exchange rate (N.B. Sweden was not at this time a member of the EU or the ERM). The fixed exchange rate was eventually abandoned in November 1992.

**Table 3.1: Summary of key indicators**

| | 1994 | 1998 |
|---|---|---|
| **Taxation (% of GDP)** | 55.3% | 60.0% |
| **Spending (% of GDP)** | 63.6% | 58.1% |
| **Balance (% of GDP) (headline)** | -8.3% | 1.9% |
| **Balance (% of GDP) (structural)** | -7.4% | 0.1% |
| **Govt. debt (% GDP)** | 78% | 74.2% |
| **Growth (%)** | 3.4% | 3.8% |
| **Av. growth over previous 5 years (% p.a.)** | -0.1% | 3.1% |
| **Inflation (%)** | 2.2% | 1.0% |
| **Unemployment (%)** | 9.4% | 8.2% |

Source: OECD National Accounts data; IMF World Economic Indicators and Government Finance Statistics

**Figure 3.1: Fiscal and Monetary stance from 1995 – 2002**




Source: OECD Main Economic Indicators and National Accounts Data; IMF World Economic Outlook

## Fiscal Consolidation 1994 – 1998

The cost of the crisis was dramatic. In Sweden, long-term unemployment increased dramatically: 10% 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 schemes had increased dramatically.

In September 1994 there were general elections, and the Social Democrats came into power. The first bill presenting a large consolidation was presented in Parliament soon after, totalling 7.5% of GDP. Sweden's Finance Minister, Goran Persson, would announce further measures in the 1995/6 budget of April 1995, forecasting tax rises and spending cuts amounting to 8% of GDP to be achieved by 1998. The programme focused on cuts in unemployment, sickness and parental benefits.

Specifically the consolidation package also concentrated on the following key areas: transfers and subsidies (particularly social security and pensions), government consumption and pension reform. The fiscal consolidation course improved the structural primary balance by 2.5% of GDP within two years and by around 9% of GDP within seven years. Unemployment eligibility criteria were tightened and rates reduced. Sickness and parental benefits were also lowered. State transfers to local authorities were frozen at 1994 levels until 2000 and they were banned from borrowing. Sweden also embarked on a privatisation programme, liberalized labour markets, and reduced marginal income tax rates from 90% to 60-70%.

These measures contributed to a peak growth rate of 3.8%, one of the highest in Europe. The successful consolidation package meant that gross debt in 2000 was actually just 52.9% of GDP – less than half the OECD's forecast; within a few years the budget balance had been transformed from a deficit of 11% of GDP into a surplus. Spending cuts continued well after the recovery got under way – big cuts in the defence budget were announced in 1998, for example. The Swedish consolidation was conducted with a monetary regime of an independent central bank and a floating national currency. Initially the contraction was met by a monetary expansion, even though it took quite a while for it to materialise. Sweden's short-term interest rates were actually continuously raised by the central bank from around 7% in the summer of 1994 to around 9% 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 4%.

It is of interest to note certain constitutional changes relevant to the budgetary process that were introduced to improve the monitoring of the public finances.

- Parliamentary period lengthened.
- Binding three-year expenditure ceilings imposed on particular spending categories within an overall envelope on total expenditure.
- The Minister of Finance's position within the Cabinet and Parliament was strengthened.
- Budgetary reforms included the sharing of oversight between the Government and a parliamentary budgetary committee as well as provisions to 'carry over' a certain proportion of the budget each year which reduced the incentive to spend all earmarked amounts. This provides additional financing for unexpected automatic expenditure increases.

## Table 3.2: Expenditure changes – Two key years

| | 1995 | | 1998 | | Change | |
|---|---|---|---|---|---|---|
| | Real/ *Nominal (in milions of SEK)* | % of Total Expenditure | Real / *Nominal (in milions of SEK)* | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | 130,831 | 9.4% | 135,541 | 9.8% | 3.6% | 0.4% |
| | *112,882* | | *124,884* | | | |
| **Education** | 146,739 | 10.6% | 160,647 | 11.6% | 9.5% | 1.0% |
| | *126,608* | | *148,016* | | | |
| **Defence** | 51,262 | 3.7% | 51,897 | 3.7% | 1.2% | 0.0% |
| | *44,229* | | *47,817* | | | |
| **Welfare** | 557,642 | 40.1% | 505,742 | 36.4% | -9.3% | -3.7% |
| | *481,139* | | *465,978* | | | |
| **Other** | 495,026 | 35.6% | 446,189 | 32.1% | -9.9% | -3.5% |
| | *427,113* | | *411,107* | | | |
| **Total** | 1,389,149 | | 1,300,081 | | -6.4% | |
| | *1,198,571* | | *1,197,862* | | | |

Source: OECD National Accounts data

### The consolidation in quotes

> *'In November 1992, after a heroic defence, the fixed exchange rate regime collapsed. A few months later, in January 1993, the Governing Board of the Riksbank adopted a new monetary policy regime based on a floating exchange rate and an inflation target. In 1991-93, Sweden experienced the most severe recession since the 1930s. Since then the economy has recovered substantially, growing at more than 2.5 per cent a year, which is above the average for recent decades.'*
>
> Lars Heikensten, former Under-Secretary for economic affairs,
> Swedish Ministry of Finance.

> *'In a nutshell, the whole political system was humiliated. Sweden was in deep crisis…*
>
> *'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.'*
>
> Jens Henriksson, former State Secretary,
> Swedish Ministry of Finance.

> *'No other government in Europe has the strength to do what we are doing.'*
>
> Goran Persson, Swedish Finance Minister,
> unveiling the 1995/6 budget, January 10th 1995.

> *'The only thing that held back an avalanche was the hope that the system was holding… In public we stuck together 100 percent, but we fought behind the scenes.'*
>
> Leif Pagrotzky, senior opposition MP.

### *Addressing our questions*

| Questions | Lessons from Sweden |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | Active cuts were deployed in three consolidation packages. Growing it away was not really an option considering the severity of the recession and banking crisis. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The government was driven to begin cutting when the crisis became acute. It used the crisis to justify the nationalisation of virtually the entire banking sector. The fixed exchange rate regime collapsed and in 1994 the OECD predicted that gross debt would be 128.2% of GDP by 2000. It used this to impose much greater limitation on spending increases. This had an enormous impact on the political climate in the country, resulting in local politicians following the example of national politicians. |

| | |
|---|---|
| **3. What should be the ratio between spending cuts and tax rises?** | The consolidation consisted of 55% spending cuts to 45% tax rises in headline figures. Structurally, expenditure restraint accounted for 75% of the adjustment, whereas revenue measures accounted for 25%. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The fiscal tightening took place when the economy was deep in a crisis; the deficit had reached 10% of GDP. Within two years of the consolidation the cyclically adjusted balance improved by 2.5% of GDP and economic growth picked up markedly. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | Constitutional changes were introduced - greater legislative control was placed over budgets. Three year binding expenditure ceilings were placed on certain spending areas with an overall envelope on total expenditure. Budgetary control was shared by the Government and the Budget committee in Parliament. If an amount of one year's budget in mandatory spending areas was unspent, it was allowed to be 'carried over' into the following year's budget. This allowed a reserve to be created to cover any increases in automatic expenditure. Fiscal discipline was maintained by putting this on a legal footing. However the political determination was also there – the Minister of Finance has his position boosted and the Minister put his job on the line in promising to cut the deficit (i.e. promised to resign in the event of failure to deliver). |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The government talked tough but underpromised to achieve a virtuous circle and to persuade the financial markets that government deficit forecasting was serious. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Spending cuts were combined with tax rises on certain higher earners. Cuts included social security benefit, pensions and central government administration. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Consolidation tended to be undifferentiated in terms of cuts to departments, including transfers and subsidies, but specific 'bad' programmes, in pensions and welfare for example, were targeted. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | The consolidation was designed as a comprehensive package. 11% was cut from all government expenditures with only a few exceptions. This sent a very strong signal 'from the centre' to the bureaucracy. This had effects on local budgets, both direct and indirect. |

| | |
|---|---|
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | There were no particular incentives but bureaucrats were trusted to cut costs. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Wage moderation led to a significant impact on income inequalities. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The Swedish Social Democrats lost 31 seats in the 1998 elections, though they did have the largest numbers in parliament. A coalition government was formed, compared to minority government formed by the Social Democrats in 1994. |

### Evaluation: Did it work in its own terms?

The consolidation was a short-term and long term success. The cyclically adjusted primary fiscal balance improved by about 11% over 1994 -1998. During 1994-1995 economic growth picked up markedly, mainly due to an increase in exports. This moderated somewhat in 1996-97 and accelerated once again in 1998-99, while inflation fell from 4% to under 1%. The adjustment programme was a resounding success with the government balance remaining in surplus until 2001. In the first year of the consolidation there were two quarters of minor contraction, and annual growth rates fell sharply from 4.0% in 1995 to 1.5% in 1996 but from 1997 on there was a sustained period of strong growth:

**Table 3.3: Growth rates before and after the consolidation**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | -2.1% | 3.9% | 4.0% | 1.5% | 2.5% | 3.8% | 4.6% | 4.4% |

Source: IMF World Economic Outlook Data.

## Finland: 1994-2000

### Origins of the Crisis

Following large-scale deregulation, the Finnish banking system embarked on a huge credit expansion during the 1980s. Skopbank, the mutually-owned institution of Finland's savings banks, financed significant long-term investments through short-term credit which performed poorly. Skopbank's liabilities became increasingly difficult to meet due to rising interest rates. This resulted in its takeover by the Bank of Finland in September 1991 and a liquidity crisis across the Finnish banking system.

Finland's experience in the early 1990s in many ways mirrored that of Sweden, although the contraction and recovery were both of a greater magnitude. From 1991-93, Finland's real GDP fell 11.4%. The steep decline in Finland's GDP was partly a by-product of the collapse of the Soviet Union: in 1991 trade with Russia (which had been 15% of exports) dropped almost overnight by 70%. Defence of the currency contributed to the problem, pushing up interest rates and stretching an economy that was over-indebted both at home and abroad. The resultant collapse in asset prices sparked a banking crisis and credit crunch.

Unemployment peaked at just under 20% in 1994. Companies were hit by tax increases, at the same time as high indebtedness and exchange rate depreciation, leading to persistently higher unemployment.

There was not a particularly high level of overall debt in comparison to other countries that experienced banking crises, but it did grow rapidly in the three years leading up to the crisis. Net foreign debt moved from a steady level around 20% in the 1980s to 57% by 1994.

### Table 3.4: Summary of key indicators

| | 1995 | 1998 |
|---|---|---|
| **Taxation (% of GDP)** | 55.4% | 54.1% |
| **Spending (% of GDP)** | 59.2% | 52.4% |
| **Balance (% of GDP) (headline)** | -3.8% | 1.6% |
| **Balance (% of GDP) (structural)** | -2.9% | 1.9% |
| **Govt. debt (% GDP)** | 62% | 50% |
| **Growth (%)** | 3.9% | 5.2% |
| **Av. growth over previous 5 years (% p.a.)** | -0.7% | 4.5% |
| **Inflation (%)** | 1.0% | 1.4% |
| **Unemployment (%)** | 15.4% | 11.4% |

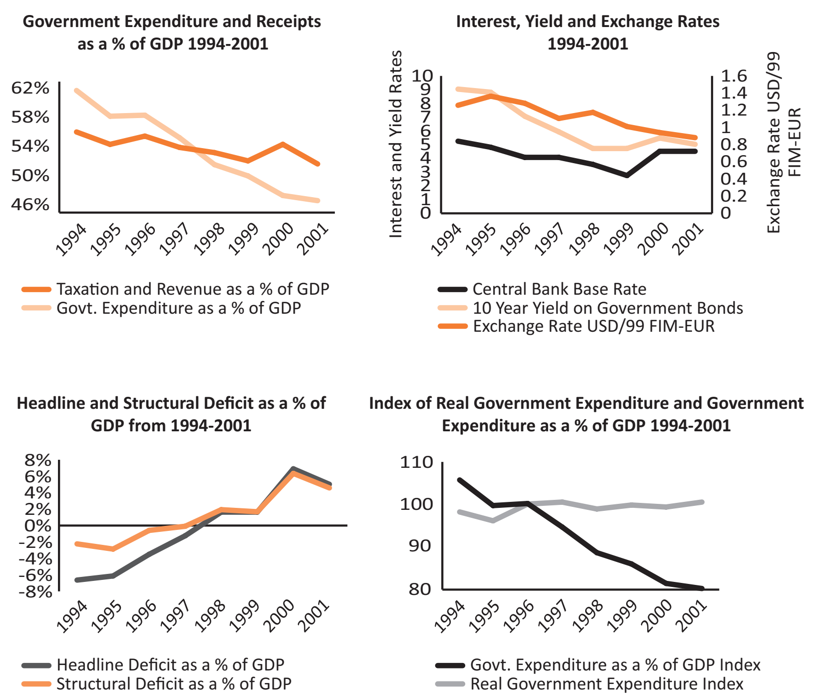
Source: OECD Main Economic Indicators and National Accounts data; IMF World Economic Outlook

The recovery was underpinned by the withdrawal of the markka's peg to the ECU currency basket in 1992 and gained momentum when domestic demand picked up in 1994-1995. Average annual GDP growth was 4.8% from 1994-97. However, even after 5 years of a strong recovery, unemployment remained at 11%.

***Fiscal Consolidation 1995-98***

The Government enacted a fiscal consolidation programme in 1995 (*N.B. this was well into the period of boom*), with the aim of restoring confidence in the Government's solvency. The autonomous nature of Finnish local government means that much expenditure lies outside the scope of central government; therefore much of the decision making about where to cut was devolved to a local level. There was a change in the culture of public spending to one of fiscal restraint, caps on social welfare and wage restraint. Consensus emerged that fiscal consolidation was necessary for EMU membership. Both the coalition elected in 1991 and the grand coalition elected in 1995 had a clear mandate for EMU membership. A target was set for the debt to GDP ratio (to meet the 60% Maastricht criteria) to be reached by 1999. The programme focused on an expenditure freeze, while using the proceeds from the recovery to lower the deficit. Although the deficit shrank from 9.5% of GDP to 7.25% within one year, the debt ratio kept rising.

## Figure 3.2: Fiscal and Monetary stance from 1994 – 2001




Source: OECD Main Economic Indicators and National Accounts Data; IMF World Economic Outlook

## Table 3.5: Expenditure changes – Two key years

| | 1995 | | 1998 | | Change | |
|---|---|---|---|---|---|---|
| | Real/ *Nominal* (*in milions of markka*) | % of Total Expenditure | Real / *Nominal* (*in milions of markka*) | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | 6,721 | 11.1% | 7,367 | 11.2% | 9.6% | -0.1% |
| | *5,941* | | *6,859* | | | |
| **Education** | 7,867 | 13.2% | 8,113 | 12.3% | 3.1% | -0.9% |
| | *6,954* | | *7,553* | | | |
| **Defence** | 2,138 | 3.6% | 2,257 | 3.4% | 5.6% | -0.2% |
| | *1,890* | | *2,101* | | | |
| **Welfare** | 28,009 | 46.8% | 28,134 | 42.6% | 0.4% | -4.2% |
| | *24,760* | | *26,193* | | | |
| **Other** | 18,150 | 32.6% | 20,114 | 28.4% | 10.8% | -4.2% |
| | *17,233* | | *18,726* | | | |
| **Total** | 59,798 | | 65,984 | | 10.3% | |
| | *56,778* | | *61,432* | | | |

Source: OECD National Accounts data

The major economic policy goals of the new Government formed in the spring of 1995 were to increase labour market efficiency, maintain low inflation, reverse the growth of central government debt via expenditure cuts and to shape a tax policy that encouraged work and entrepreneurship. It is of interest to note that 1995 was the year of Finland's accession to the EU, and thus might have been expected to herald a period of structural change in the Finnish economy and increased importance for issues such as competitiveness within the Single Market.

Unemployment benefits were the main area of expenditure to be cut. General government consumption fell, although this was offset slightly by an increase in new public work programmes. Public expenditure was to be cut by 2% every year of the parliament.

The success of the fiscal consolidation helped to pave the way for the markka to join the ERM, which it achieved in 1996. Reducing the deficit had boosted confidence to such an extent that monetary policy could be eased, ensuring a pick-up in domestic demand.

By May 1997, the EU finance ministers agreed unanimously that Finland was no longer plagued by an excessive public sector deficit, although the central government deficit continued to be a problem. Finland had a more rapidly ageing population than the OECD average, which created a headwind against the success of fiscal consolidation.

Consolidation was pursued into 1998. The proceeds of the recovery moved on from reducing the deficit, to lowering the tax burden. As the expenditure ratio dropped (a cumulative 7 percentage points of GDP from 1993), the general government deficit fell to 1% of GDP in spite of cuts in taxes.

By 2000, the government was able to offer income tax reductions, both across the board and targeted at those on lower incomes.

### *The consolidation in quotes*

> *'The economic crisis of the 1990s was deeper in Finland than in any other western country. Since 1995 two successive rainbow coalition governments have successfully carried out fiscal consolidation and reforms in order to save and revitalise the Finnish welfare society.'*
>
> Paavo Lipponen, Prime Minister of Finland, 'Future of Europe – the Finnish model', lecture at the London School of Economics, 14th February 2002.

> *'The resolution is widely regarded as among the most successful in history… the final net cost of assistance to the banks (net of liquidation of assets and including appreciation in the value of government shares) was far smaller than the initial cost… an eventual 5.3 percent of 1997 GDP versus initial outlays of 9 percent of GDP.'*
>
> Richard G. Anderson, Economist.

> *'It was characteristic of the recession in Finland that the ensuing banking crisis turned out to be more severe than in most other countries of Western Europe.'*
>
> Finnish Ministry of Finance.

> *'Kasinotalous'*
>
> 'casino economy'; the colloquial word associated with late 1980s Finland when a major asset price bubble was fuelled by a huge expansion of foreign credit.

*'After a sharp credit boom, it… proved to be a period leading to financial fragility, as lower asset quality and declining profitability eroded banks' balance sheets to the point where the Government in the early 1990s had to support some of the largest banks to preserve financial stability.'*

Bank of Finland Research Discussion Paper.

### *Addressing our questions*

| Question | Lessons from Finland |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | The initial policy goal was to freeze expenditure and, thus effectively 'grow away the deficit'. Eventually active spending cuts were targeted, suggesting that the 'growing it away' policy was insufficient. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | There is no evidence of public expenditure cuts before the crisis hit and it was key in driving action. Once it began the government initially made tax cuts followed by a policy of freezing expenditure, then targets for cuts and, ultimately, tax rises. |
| **3. What should be the ratio between spending cuts and tax rises?** | The consolidation consisted of 55% spending cuts to 45% tax rises in headline figures. Structurally, expenditure restraint accounted for 85% of the adjustment, whereas revenue measures accounted for 15%. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | Fiscal tightening took place when the situation had become increasingly dire in fiscal terms, but well after the main period of recession. The economy contracted 11.4% before the consolidation. Following the fiscal adjustment from 1994 to 1998 the economy grew 4.8%, suggesting that the consolidation did not impede and may indeed have accelerated the recovery. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The institutional mechanism of the Maastricht criteria contributed to Finland's desire to reduce its deficit in order to join the ERM, which it did in 2005. It was also pledged that spending would be cut by 2% every year of the parliament. These rules provided an incentive for officials to achieve the desired targets. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The reforms announced in 1995 were fairly hard-line and largely as originally stated. They were successful enough for the government to reduce taxes in 2000. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Revenue measures included raising payroll taxes and user fees. Social welfare spending was considered particularly wasteful as it contributed to unemployment, and this was the area that was targeted most strongly. |

| | |
|---|---|
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | There were undifferentiated, across the board cuts in social benefits, transfer to municipalities, subsides, wages and capital spending but differentiated cuts by their application to specific programmes such as in welfare expenditure which was considered wasteful. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | There was a mixture of central and local decision-making in what to cut. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | There is no evidence of large scale bureaucratic decision making or specific incentivisation. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Long term low increases for public sector workers and public services. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The coalition government which was elected in 1999 was of a similar composition to its predecessor. The evidence suggests the component parties flourished partly as a result of the successful consolidation. |

### Evaluation: Did it work in its own terms?

The cyclically adjusted primary fiscal balance improved by a cumulative 10% of GDP over 1992 – 2000. The economy experienced strong sustained recovery from 1994, led by investment and exports, in particular in the IT sector. Improved current account balance and strong growth resulted in elimination of net external public debt by 2002. One aim of the consolidation was to reach the Maastricht criteria by 1999 which Finland reached by 1996. In its own terms the consolidation was an overwhelming success, in the short and long term. Though growth rates remained sluggish throughout the mid-1990s, and declined immediately after the first year of consolidation in 1995 (there is even one quarter of contraction), growth improves markedly subsequent to sustained spending restraint from 1997 onwards:

**Table 3.6: Growth rates before and after the consolidation**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | -0.8% | 2.6% | 1.8% | 1.0% | 1.7% | 2.0% | 1.9% | 3.2% |

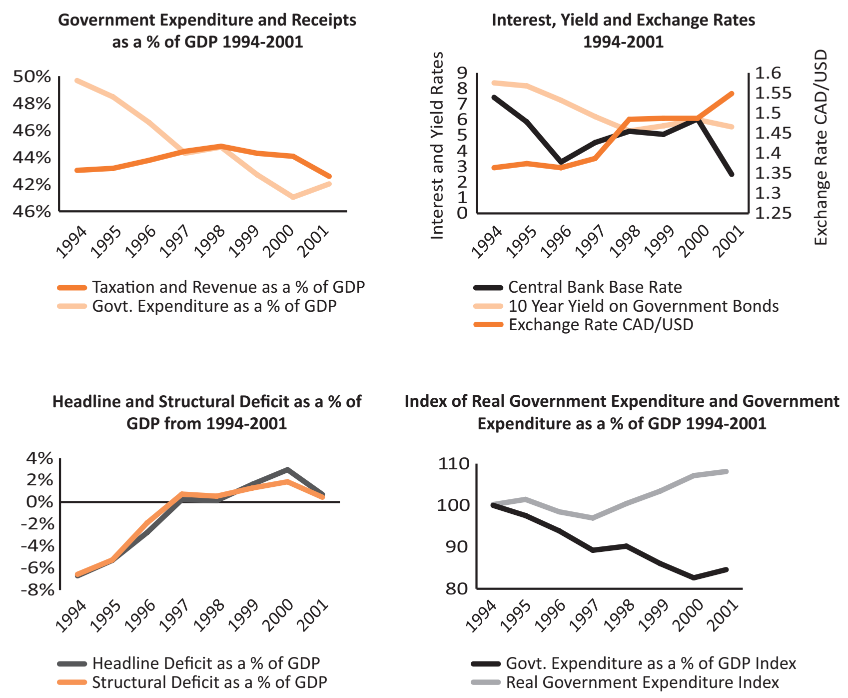
Source: IMF World Economic Outlook Data.

## Canada: 1994-2000

### Origins of the deficit

- Between 1984 and 1993, there were three unsuccessful attempts at fiscal reforms in Canada.
- In 1984 the Conservative Government set up a programme analysis panel led by politicians and non civil servants which called upon private sector analysts. In its report one year later, virtually every department successfully resisted significant cuts.
- In 1988, ten working groups led by senior civil servants were set up and conducted technical reviews within departments. A coordinating committee chaired by the most senior civil servant, the Privy Council and the Deputy Prime Minister. Some processes were streamlined and controls abolished but, according to the head of the civil service later, the reforms were too slow and easy going.
- Finally in 1993, the Prime Minister implemented a secret plan to slash the number of departments from 32 to 23, institute mergers and to cut staff numbers with minimum consultation. More cuts were announced for the following years but these were vague. The deficit continued to rise; by 1994, it had reached 9.2% of GDP.

**Figure 3.3: Fiscal and Monetary stance from 1994 – 2001**




Source: OECD Main Economic Indicators and National Accounts Data; IMF World Economic Outlook

**Table 3.7: Summary of key indicators**

| | 1994 | 1998 |
|---|---|---|
| Taxation (% of GDP) | 43.0% | 44.8% |
| Spending (% of GDP) | 49.7% | 44.7% |
| Balance (% of GDP) (headline) | -6.7% | 0.1% |
| Balance(% of GDP) (structural) | -6.6% | 0.5% |
| Govt. debt (% GDP) | 67.9% | 60.8% |
| Growth (%) | 4.8% | 4.1% |
| Av. growth over previous 5 years (% p.a.) | 1.2% | 3.5% |
| Inflation (%) | 0.1% | 1.0% |
| Unemployment (%) | 9.5% | 8.3% |

Source: OECD Main Economic Indicators and National Accounts data; IMF World Economic Outlook

## Successful reform

In 1994, the new incoming Liberal Party's Minister of Finance set up a government spending Programme Review ('PR'). It examined all areas of Government spending and applied objective criteria – crucially, no area was sacrosanct. Its measures were set out in the February 1995 Budget. Politically, the new Government brought a sense of urgency to the process as it realised the situation was bad, with the Canadian dollar mockingly nicknamed by financial commentators as the 'Northern Peso'. (The Canadian dollar was suffering from a series of downward pressures in the 1990s. The dollar depreciated through 1992 to 1994, reflecting lowered interest rates as a result of easier monetary conditions, budgetary problems, softening commodity prices and large current account deficits. In February 1991, the Bank and the federal government announced a series of inflation-reduction targets. The authorities saw explicit inflation targets, with a clear time frame to achieve them, as a way to shape inflation expectations. This made it easier to reduce inflation and, at the same time, made the central bank accountable for its actions. The inflation-control agreement was extended three times, and in 1995 it called for the Bank to aim to keep inflation at 2%, the midpoint of a 1 to 3% target range.)

The PR aimed to reorganise government so as to achieve the optimum use of existing fiscal resources. Government ministers and civil servants contributed: it was a collective process. The Review aimed to examine public spending critically and to identify the main concerns of federal government. The 'grow it away' approach was rejected.

The balance of consolidation fell overwhelmingly on expenditure cuts — the Review had an overall goal of reducing the size of government by 15%. There were some tax rises on higher earners and on businesses, partly to show that everyone was making sacrifices but it was promised that tax rises would be only temporary and that taxes would be lowered when the situation improved.

There was a fundamental rethink of all main areas of government activity. All departments and programmes were subject to the exercise and where there were exceptions they were announced publicly. There were six criteria by which programs would be judged: public interest, legitimate or necessary area for government activity, a suitable area for federal as opposed to provincial government, potential for part or outright transfer to the private or voluntary sectors, efficiency and affordability.

Marcel Massé, a top civil servant and a former Liberal minister, was appointed to head the Review. The process sought to maximise the participation of civil servants. Very few external experts were used. A committee of Deputy Ministers chaired by Jocelyne Bourgon reviewed submissions and coordinated the process – she installed people who were sympathetic to deficit reduction. Next, a group of Ministers chaired by Massé reviewed the recommendations and final proposals were endorsed by the Prime Minister and Cabinet.

Bureaucrats were incentivised through a 'carrot and stick' approach, whilst proposals travelled bottom-up from departments. Deputy Ministers were appraised annually and they received 30% of their pay on a performance-related basis. If they failed to come up with sensible proposals, the PM threatened that a separate body would impose a top-down 10% cut across the board.

An important feature was the degree of political will. The need for fiscal consolidation was constantly emphasised by the Prime Minister and backed by a public consensus that something had to be done — driven by the combination of an active financial markets crisis and the recognition that past reform efforts had been inadequate. The programme achieved widespread public support; Massé commented 'There was blood on the floor everywhere, but at least everyone could see that others were hurting too'.[27] To avoid conflicts, all decisions were made by the Cabinet which were based on recommendations by a committee of deputy ministers. Changes were implemented over three years and were buffered by temporary compensatory measures.

To maintain credibility, the strategy was to under-promise and over-deliver. In particular, Canada adopted cautious forecasting to gain credibility with the financial markets.

### *Some specific expenditure cuts and reforms*

- Withdrawal from health social programmes and replacement with a block payment scheme.
- Unemployment insurance reform – rates reduced & eligibility tightened.
- Regional development and industrial subsidies reduced.
- Farm subsidies reduced and agricultural R&D greatly reduced.
- Defence budget cut by 15%.
- Transfer of local airports to localities. Overall transport spending fell by almost 50%.
- Sale of Petro-Canada.
- Reduction in subsidies to Crown corporations.
- Civil service numbers and salaries reduced.
- Tax reform. The tax burden was reduced, the tax base was broadened and personal income taxes were reduced at provincial level.

### *Longer-term consequences*

The federal budget went into surplus in 1997-8 — the deficit was running at 9.1% in the early 1990s. Public sector net debt fell from 74% to 49% between 1995-6 and 2002-3. Between 1995 and 2000, just after the PR, the economy grew at just under 4% per year.

27 *The Times*, 7th July 2009.

A number of rules and institutional mechanisms were introduced in order to lock in reform. These included:

- *Contingency reserves*. Every budget has a reserve to be used for paying down the debt. Another reserve was created to cover any new policy programmes dreamt up.
- *Treasury committee*. A committee of 5-6 Cabinet members reviews all programmes line by line as a secondary check.

**Table 3.8: Expenditure changes – Two key years**

| | 1994 | | 1998 | | Change | |
|---|---|---|---|---|---|---|
| | Real/ *Nominal* (*in milions of Canadian $*) | % of Total Expenditure | Real / *Nominal* (*in milions of Canadian $*) | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | 60,797 | 14.3% | 62,684 | 14.3% | 3.1% | 0% |
| | *51,900* | | *56,033* | | | |
| **Education** | 59,826 | 14.1% | 57,557 | 13.2% | -3.8% | -0.9% |
| | *51,071* | | *51,450* | | | |
| **Defence** | 13,324 | 3.1% | 10,019 | 2.3% | -24.8% | -0.8% |
| | *11,374* | | *8,956* | | | |
| **Welfare** | 112,684 | 26.5% | 105,066 | 24% | -6.8% | -2.5% |
| | *96,193* | | *93,919* | | | |
| **Other** | 177,945 | 41.9% | 201,755 | 46.2% | 13.4% | 4.3% |
| | *151,904* | | *180,349* | | | |
| **Total** | 424,577 | | 437,081 | | 2.9% | |
| | *362,442* | | *390,707* | | | |

Source: Statistics Canada

**The consolidation in quotes**

> *'There was blood on the floor everywhere, but at least everyone could see that others were hurting too'.*
>
> Marcel Massé, former Canadian Minister of Intergovernmental Affairs and Minister responsible for Public Service Renewal.

> *'This is butchery, but I voted for you as at least you seem a good surgeon.'*
>
> Marcel Massé, recalling what voters told him in his constituency.

> *'The whole deficit reduction mantra crossed party lines… making a virtue out of balanced budgets.'*

> *'We began to arbitrarily take money out. As that began to happen, people suddenly realised this was serious… They then began to work very hard to identify the savings themselves.'*
>
> Brian Tobin, former Canadian cabinet minister.

*Addressing our questions*

| Question | Lessons from Canada |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | Active cuts were pursued through a programme of review. There was a perception that previous efforts had been slow and inadequate. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The deficit had already driven three ineffective previous efforts to cut spending, thus there was already an acute sense of urgency reinforced by the Canadian dollar crisis. The government used this to build consensus for severe cuts to all programmes. |
| **3. What should be the ratio between spending cuts and tax rises?** | The consolidation consisted of 60% spending cuts to 40% tax rises in headline figures. Structurally, expenditure cuts comprised 85% of the consolidation. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The tightening took place well after the worst of the recession was over, and it accelerated growth rapidly. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The initial cuts programme was driven by the political will of the Prime Minister and a 'just do it' approach of his staff. But subsequently Canada introduced some institutional fixes such as a contingency reserve in future budgets. These appear to have been targeted at locking in gains. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The government 'acted tougher than it talked' since this was considered important for credibility with financial markets. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Stringent cuts were made alongside some tax rises on businesses and the rich. However, the government did make clear its intention to lower taxes later to show 'light at the end of the tunnel'. Cuts included the public sector wage bill, unemployment benefits, defence spending, agricultural and business subsidies and transfers to the provinces. There were also significant reductions in civil service salaries. Revenue measures included broadening the personal income tax and corporate income tax bases and increases in corporate income tax rates. |

| | |
|---|---|
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | All areas were cut but individual programs were judged against six criteria. Budgeting awareness was encouraged in all departments. Deputy ministers in each department devised targeted, differentiated cuts and were incentivised to do so. If they failed, they were threatened with a 10% undifferentiated across-the-board cut to be imposed from above. Some across-the-board cuts proved unsustainable and had to be restored in later years, however. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | Inviting initiatives first was preferred so as to achieve consensus. However, it is worth emphasising that the Canadian approach was very much driven by re-thinking the role of the state, including identifying 'legacy' programmes no longer considered useful (e.g. in relation to ports) but also reconsidering the whole role of government. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | Using bureaucrats was used to achieve consensus and depoliticised the process somewhat. The head of the civil service installed Deputy Ministers who saw the need to cut. Deputy Ministers were then rewarded for cutting back: they were appraised annually and they received about 30% of their pay on a performance-related basis. They were therefore incentivised to clean up their departments rather than defend their empires. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Cuts in federal funding reduced service delivery in the provinces, especially in health and unemployment. Civil servant salaries were reduced and increased only slowly for several years subsequently. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The Government gained considerable credit for carefully targeted cuts and getting public finances in order. The ruling Liberal Party consistently won re-election and remained the dominant force in Canadian politics until 2006. |

## Evaluation: Did it work in its own terms?

The adjustment was a long and short term success. The cyclically adjusted primary fiscal balance improved by 6.6% of GDP over 1994-97. There was an initial growth spurt, led by exports and investment, followed by two years of slower growth, as adjustment was implemented. Sustained high growth followed with low inflation. Improved current account, led by improved public savings, sharply reduced net foreign debt. Unemployment too did not rise significantly. The table below shows that growth slowed in the year of the consolidation, indeed, there were two quarters of contraction, but subsequently annual growth was faster than in previous years.

### Table 3.9: Growth rates before and after the consolidation

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | 2.3% | 4.8% | 2.8% | 1.6% | 4.2% | 4.1% | 5.5% | 5.2% |

Source: IMF World Economic Outlook Data.

## Ireland: 1987-2000

### Origins of the Deficit

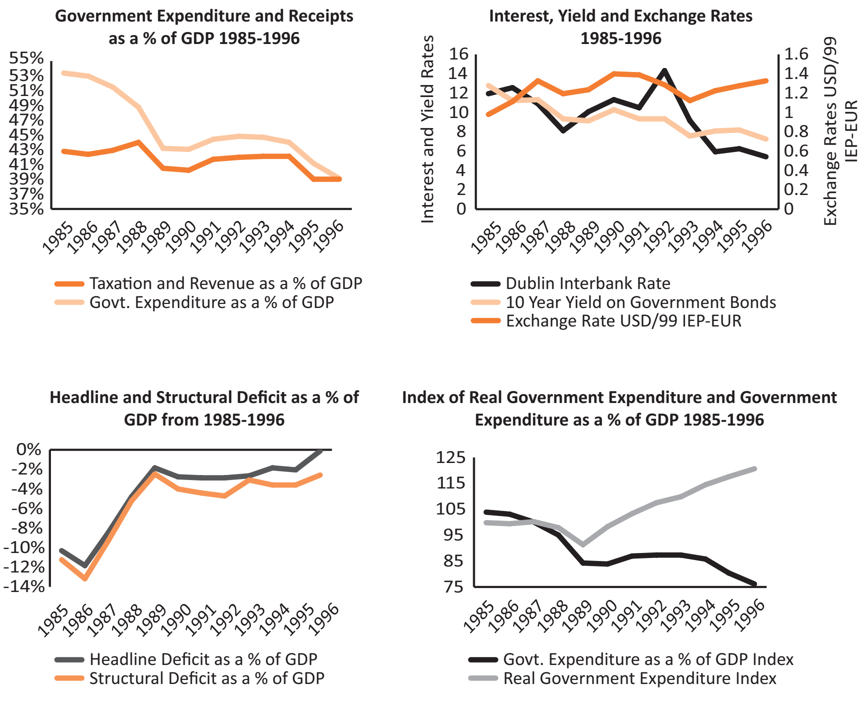
Early attempts at fiscal consolidation in Ireland, in the context of our case here, can perhaps be dated to 1982. That year, the economic situation in Ireland was poor, though it was not in crisis as such. CPI inflation was at 17%, public spending had reached 56% of GDP and the debt to GDP ratio was 85%.

There was an initial failed consolidation programme from 1982-4. This consisted of a mixed strategy of expenditure cuts and revenue adjustments. The programme did not produce results as the debt level rose to 116% by 1986 and the deficit still stood at 10% of GDP. The public finance literature regards this as a textbook revenue-based adjustment — such adjustments typically have less chance of success.

### National Programme for Recovery 1987-1989

From the late 1980s, there was a more successful consolidation, of which the first phase is usually dated from 1987, when the opposition Fine Gael Party announced that they would not oppose tough economic reforms to resolve the fiscal crisis; the so-called 'Tallaght Strategy' which helped to consolidate popular support. This consolidation was formed almost entirely of spending cuts which were made in every department (though there was an increase in household taxes in 1988 due to a one-off tax amnesty).

**Figure 3.4: Fiscal and Monetary stance from 1985 – 1996**




Source: OECD National Accounts data and Main Economic Indicators; IMF World Economic Outlook

### Table 3.10: Summary of key indicators

| | 1986 | 1990 |
|---|---|---|
| **Taxation (% of GDP)** | 42.4% | 40.5% |
| **Spending (% of GDP)** | 52.9% | 43.0% |
| **Balance (% of GDP) (headline)** | -10.5% | -2.8% |
| **Balance (% of GDP) (structural)** | -9.3% | -4.0% |
| **Govt. debt (% GDP)** | 110% | 94.2% |
| **Growth (%)** | 0.8% | 5.7% |
| **Av. growth over previous 5 years (% p.a.)** | 1.3% | 4.1% |
| **Inflation (%)** | 3.2% | 3.4% |
| **Unemployment (%)** | 16.8% | 12.9% |

Source: OECD National Accounts data; IMF World Economic Indicators and Government Finance Statistics

Wages were reduced and civil service numbers cut. Public sector employment fell by almost 14% between 1982 and 1989 due to a hiring freeze as well as early retirement and voluntary redundancy schemes. It fell from 300,000 to 270,000 or by 10% between 1986 and 1989. To support the latter schemes, the Government provided cheap retraining schemes to those who were made redundant voluntarily which proved to be successful. An agreement with the unions in 1987 led to a wage increase of a mere 2.5% — below inflation. Wages fell by 1.5% of GDP between 1987 and 1989.

The largest spending cuts fell on transfers and subsides which amounted to around 2.5%. Social, health and pension spending was reduced. These changes were effected through legislative reforms. Real benefit rates were frozen and the eligibility criteria were tightened.

Other notable measures included:

- *User fees*. User fees for universities and hospitals were introduced.
- *Non-wage public consumption fell*. Consumption fell by 1% between 1987 and 1989.
- *Major public sector projects abandoned*. In the telecoms and energy sectors – projects were culled.

## Phase Two: 1994 on

Phase Two did not occur in a fiscal crisis. Expenditure was merely on the rise again and the Government took action to prevent a rise in the expenditure/GDP ratio. A second round of expenditure cuts was brought in. Cuts were similar in form to those in Phase One. Transfers and subsidies were reduced including social security payments. Public sector recruitment was maintained at a low level.

The deficit was reduced to zero by 1996. The debt to GDP ratio declined to below 40% of GDP by 2000. Between 1982 and 2000, public expenditure fell from over 55% to 35% of GDP. This achievement combined with strong economic growth allowed significant tax cuts to be made — particularly lower corporation and income tax rates as well as a VAT reduction. In Phase One expenditure fell by 12% relative to GDP over the seven-year period after 1982. During Phase Two, public spending fell by over 10% relative to GDP.

During Phase One, the political position of the Minister of Finance was bolstered and he had political ownership of the consolidation process. Between 1987 and 1989, he had the full backing of the Prime Minister and full parliamentary support. Phase Two was marked by fiscal contracts between governing coalitions and the introduction of multi-year budgeting.

#### *Longer term impact*

In considering the longer-term success of this consolidation programme, it is worth reflecting upon two subsequent events: the 2001 criticism, by the EU, of Irish fiscal policy; and the recent series of emergency budgets.

### 2001 Criticism by the EU

The Irish economy expanded rapidly in 2000 and reached a new record high of 10.7% growth, from 9.8% in the previous year. Employment growth amounted to 4.5%, leading to a further decline in unemployment to 4.5%. At the same time inflation accelerated to 5.3%, supported by both domestic demand pull and a strong wages push. The government exhibited a vast surplus of 4.75% of GDP, and public debt declined to an estimated 37%, down from 50% the previous year. Ireland reports the lowest public expenditure ratio in the European Union (32%). With the exception of the high inflation rate this was a formidable performance.

Nonetheless, on February 22, 2001 the Council of the EC urged Ireland to change the course of its fiscal policy in order to curb – rather than stimulate – its high rate of inflation in accordance with Articles 98 and 99 of the EC Treaty. The Articles, ratified by Ireland, stipulate that the member countries conduct and coordinate their economic policies in such a way as to further the objectives of the Community: among them are steady growth, high employment and price stability. In order to safeguard the sustained economic convergence of member countries and the consistency of economic policy with these objectives the Council can issue a formal recommendation.

This criticism should not be understood as indicating underlying weakness in Irish spending controls. Rather, it was part of the tensions early in the period of the euro, and in particular reflected a concern in the late 1990s and early 2000s that there might be divergence of inflation rates. The point was that since countries did not have interest rates to manage their domestic inflation rates, more burden fell on fiscal policy. So, even though Irish spending was well under control and the budget surplus high, the feeling was that Ireland was not tightening enough to address its inflation problem.

### Do recent events show that the Irish fiscal correction was a debt-fuelled mirage?

Between July 2008 and April 2009 Ireland had introduced various emergency measures, through two emergency budgets and the Irish Stability Programme, cutting current expenditure €1.2 billion and raising tax revenue by €3.6 billion in response to a contraction of GDP of 8.5% in 2009 compared to same quarter the previous year, and a budget deficit projected to reach 10.75% of GDP despite the emergency measures in place.

The worsening in the economic environment had significant negative consequences for the public finances. Prior to the corrective action taken in the latest supplementary budget, a General Government deficit of 12.75% of GDP was anticipated for 2009. This would have represented a significant deterioration from the deficit of 7% of GDP recorded in 2008 and from the surpluses recorded in ten of the eleven years up to 2007.

While increases in unemployment related spending have had a negative impact, the large deficits for the last two years are mainly the result of the very poor performance of tax revenues. Even with the new emergency budget measures, tax revenues are expected to be 27% below 2007 levels.

The main component of the decline in tax revenues is capital taxes. From the mid-part of this decade, revenue from these taxes increased significantly, driven by the strength of the construction sector and by increasing asset values. The share of these taxes in total taxation revenue rose rapidly, peaking at nearly 16% in 2006. Revenue from these tax heads has been adversely affected by negative developments in property and financial markets.

This represents a significant structural gap in revenue and reflects that part of the growth in Ireland may have been fuelled by the housing price bubble. Ireland also has very high levels of private debt, lending by credit institutions to private households was at a record €148 billion in 2007. Recent increases in the GDP could be attributed to borrowing from the private sector leading to increases in private debt to speculate on the housing market, and thus were more vulnerable the financial crisis (as it was fuelled in part by the collapse of the housing bubble) and recession. That said, Ireland has made significant gains since 1993, real GDP has increased by 167% and employment has risen by over 75%.

***The consolidation in quotes***

*'The Programme… envisages progress being made [to create] a fiscal, exchange rate and monetary climate conducive to economic growth.'*

*'The following factors give an indication of the extent of the difficulties… a Gross Domestic Product per capita which is only 64 per cent of the European Community average…a National Debt of over 225 billion which is equivalent to more than one and one-half times of our Gross National Product and the servicing of which consumes annually one-third of Exchequer tax revenue… among the highest budgetary deficits in the European Community…an unemployment rate of 18.5 per cent of the work-force… one of the highest rates of unemployment in the European Community.'*

Irish 'Programme For National Recovery', 1987.

*'There was a real air of crisis in Ireland at that time. During the election, even the man in the street was asking the politicians whether the IMF would have to take over the running of the economy. That is genuinely as bad as the situation was at that time.'*

*'The Irish economy was transformed over this period, with the most pleasing aspect of it being a major increase in employment in Ireland from 1.1 million in 1986 to 1.7 million in 2000, an increase of more than 50%.'*

Ray McSharry,
former Irish Finance Minister.

*Addressing our questions*

| Question | Lessons from Ireland |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | In Phase One (1987-89), active cuts were made during a period of major fiscal pressure. Phase Two (during the 1990s) involved controls on expenditure (civil service hiring freeze etc.) due to pressures on expenditure despite economic growth. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | There was a cross-party awareness of the long-term weakness of Ireland's economic performance which built support for the Programme for National Recovery in 1987. During Phase Two in particular, the Government used this to justify cutting actively before a fiscal crisis emerged and while the economy was growing. This, arguably, allowed greater growth in the late 1990s. |
| **3. What should be the ratio between spending cuts and tax rises?** | The balance of consolidation fell entirely on spending cuts, which accounted for 135% of the fiscal adjustment as tax revenue fell. Structurally, expenditure cuts comprised 95% of the consolidation. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | In the first phase of consolidation (1987 -89) tightening took place after the worst of the recession was over, and the fiscal adjustment had highly expansionary affects. The economy grew rapidly, and in phase two the Irish government consolidated the fiscal correction through a second round of cuts in a period of high economic growth. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | During Phase One, the Irish finance minister had the full support of the Government and Parliament. He took political ownership of the consolidation process. It seems that strong political determination came from him and a 'just do it' approach existed. During Phase Two, institutional fixes were brought in including multi-year budgeting and fiscal contracts between government coalitions. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | The Finance Minister in charge of the consolidation tended to talk tough – Ray McSharry was variously nicknamed 'Dr No' or 'Mac The Knife'. In 1987, Prime Minister Charles Haughey faced a no-confidence vote over his Government's cuts and threatened to resign if he lost. He won. He adopted the tactic of putting your job on the line over a consolidation programme. By and large the government took a 'what you see is what you get' approach. |

| | |
|---|---|
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | All areas appeared to have been considered for active cuts. Civil service numbers appeared to bear the brunt. VAT and corporation taxes were cut during Phase Two. Phase Two, however, was not an acute crisis. The period of failed reform during the early 1980s involved tax rises. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Undifferentiated, across-the-board cuts were imposed across all areas. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | Cuts were imposed from the centre. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | Modern civil service management reform was not proposed until the 1990s. The civil service tended to be against spending cuts especially as they fell on their own areas. We are not aware of any specific incentives. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Ireland suffered from persistently high inflation. Its fiscal policy was criticised by the EU. Some economists blame serious internal imbalances for fuelling a private debt boom and the consequent asset price bubble (especially house prices) which left Ireland particularly vulnerable to economic shock. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | Despite the endorsement of the main opposition party, the government did suffer politically as a result of the consolidation from 1987 in terms of number of seats won. However, except for one-term between 1994 and 1997, Fianna Fáil has remained the major ruling party of Irish politics. |

## Evaluation: Did it work in its own terms?

The consolidation of 1987 signalled a major turnaround in the Irish economy. After the deficit was cut the growth rate rose to 5.7%. Unemployment fell, reversing a trend that had lasted for a quarter of a century. A boom in investment and exports were the main driving force behind the expansion that accompanied the adjustment and its aftermath. However, recent developments in Irish economy may lead one to question whether, despite appearing to be very successful for an extended period, structural flaws in the economy have prevented the consolidation from being a long term success. After, the consolidation resulted in an immediate and sustained increase in growth rates, rising to a remarkable 7.7% three years after the initial consolidation; the 'Celtic Tiger' was born:

### Table 3.11: Growth rates before and after the consolidation

| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | 1.9% | 0.4% | 3.6% | 3.0% | 5.6% | 7.7% | 1.6% | 3.6% |

Source: IMF World Economic Outlook Data.

# Germany in the 1990's: the burden of reunification

## Origins of the Deficit

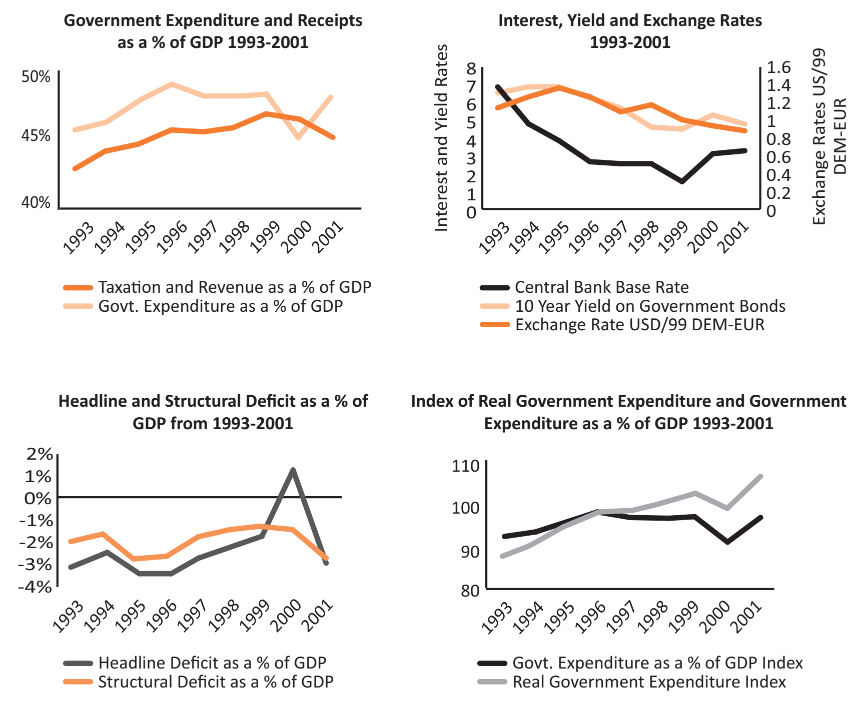
During much of the 1990s, Germany was weighed down by the burden of its 1990 reunification. Annual west-east net transfers reached an average share of about 4.5% of West German GDP in the 1990s.

### Table 3.12: Summary of key indicators

| | 1992 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| **Taxation (% of GDP)** | 40.9% | 45.1% | 46.0% | 45.7% |
| **Spending (% of GDP)** | 43.2% | 47.8%[28] | 49.3% | 48.4% |
| **Balance (% of GDP) (headline)** | -2.5% | -3.2% | -3.3% | -2.6% |
| **Balance (% of GDP) (structural)** | -1.8% | -2.7% | -2.6% | -1.6% |
| **Govt. debt (% GDP)** | 41.7% | 55.1% | 57.9% | 59.1% |
| **Growth (%)** | 2.3% | 1.8% | 0.9% | 1.7% |
| **Av. growth over previous 5 years (% p.a.)** | 4.1% | 2.2% | 1.4% | 1.3% |
| **Inflation (%)** | 5.1% | 1.7% | 1.2% | 1.5% |
| **Unemployment (%)** | 6.3% | 8% | 8.7% | 9.4 |

Source: OECD National Accounts data; IMF World Economic Indicators and Government Finance Statistics

### Figure 3.5: Fiscal and Monetary stance from 1993 – 2001




Source: OECD National Accounts/AMECO data and Main Economic Indicators; IMF World Economic Outlook

28 In the OECD data, 1995 debt relating to unification was taken over by the federal government. This was recorded as a flow in the national accounts, boosting temporarily general government spending and the headline deficit. We have therefore substituted spending from the EC AMECO dataset for this year.

The cost of unification was financed by borrowing (1989-1992) in the hope that a sustained upturn in the former GDR would generate the required additional tax income. However, within twelve months of unification, industrial production in the East slumped to less than half its previous level. The subsequent unification boom was relatively short, while spending grew rapidly in the first half of the 1990s, largely driven by new demands associated with German reunification. Social spending was boosted when the elaborate western German social security system was fully extended to the east, and work provision and training measures were established on a large scale to cushion labour shedding. The wage bill for civil servants surged, on impact due to a larger government sector in eastern Germany, and over the first years of the 1990s on account of buoyant wage increases. Government investment accelerated sharply immediately after reunification. Inter-governmental transfers surged, both for investment and consumption purposes, and aid was extended to enterprises to cope with the comparative disadvantages associated with the transition of the eastern German economy. Large inflows into retirement, a secular trend to increase health spending, persistently high unemployment rates and repeated massive unforeseen shortfalls in tax revenues added to the stress on fiscal balances. In the process, social charges on wages surged, widening the tax wedge on labour. The general government deficit increased, peaking at a ratio of 3.3 percent of GDP in 1996. Debt levels rose rapidly at all levels of government, in particular in the new states. Inherited debt stemming from the GDR contributed to this process.

The government's fiscal strategy after 1992 was to reduce borrowing requirements by raising taxes and social security contributions and by cutting public spending. Public finances subsequently deteriorated and resulted in protracted budget deficits and soaring public indebtedness. This policy of austerity was partly motivated by Maastricht treaty criterion, with policy makers seeking to ensure that overall government deficit could be limited to 3% of nominal GDP by 1997.

### Austerity policy under the Kohl (CDU) government

There were several efforts to consolidate during the mid-nineties. A key feature of the consolidation period was spending cuts. Of particular interest is the sustained low-level of public sector employment, which was reduced to 3.9 million in 1996 from 4.0 million in 1992. Fixed capital investment by all three tiers of government fell by 13% between 1993 and 1996, down to DM 80 billion. There were sharp cuts in welfare from 1993-95, particularly in unemployment compensation.

The federal government was repeatedly forced to revise growth forecast downwards. A number of authors believe that the combination of tight fiscal and tight monetary policy in the period contributed to an extended period of economic stagnation. GDP growth from 1992 to the end of the 1990s averaged only 1.5% per annum. Between 1993 and 1996 the weakness of economic growth and declining employment led to average annual revenue losses of DM 50 billion.

Expenditure to finance the additional unemployment amounted to an average of DM 15-20 billion per annum. There was a 1% increase in VAT in 1993 and 1998. However these tax increases were compensated for by cuts to corporate and personal taxes, leading to a decreasing tax ratio between 1990 and 1998.

## Table 3.13 - Expenditure changes – Two key years

| | 1996 | | 1997 | | Change | |
|---|---|---|---|---|---|---|
| | Real/ *Nominal* (*in milions of DM*) | % of Total Expenditure | Real / *Nominal* (*in milions of DM*) | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | 125149 | 12.9% | 123525 | 12.8% | -1.3% | -0.1% |
| | *119520* | | *118420* | | | |
| **Education** | 87066 | 9.0% | 87517 | 9.1% | 0.5% | 0.1% |
| | *83150* | | *83900* | | | |
| **Defence** | 26062 | 2.7% | 25389 | 2.6% | -2.6% | -0.1% |
| | *24890* | | *24340* | | | |
| **Welfare** | 433099 | 44.7% | 437688 | 45.3% | 1.1% | 0.6% |
| | *413620* | | *419600* | | | |
| **Other** | 297270 | 30.7% | 292008 | 30.2% | -1.8% | -0.5% |
| | *283900* | | *279940* | | | |
| **Total** | 968646 | | 966127 | | -0.3% | |
| | *925080* | | *926200* | | | |

Source: OECD National Accounts data

## Table 3.14: Expenditure changes – Two key years

| | 1999 | | 2000 | | Change | |
|---|---|---|---|---|---|---|
| | Real/ *Nominal* (*in milions of DM*) | % of Total Expenditure | Real / *Nominal* (*in milions of DM*) | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | 127864 | 12.8% | 132133 | 13.7% | 3.3% | 0.9% |
| | *123860* | | *127110* | | | |
| **Education** | 88625 | 8.9% | 90053 | 9.3% | 1.6% | 0.4% |
| | *85850* | | *86630* | | | |
| **Defence** | 26004 | 2.6% | 26071 | 2.7% | 0.3% | 0.1% |
| | *25190* | | *25080* | | | |
| **Welfare** | 448679 | 45.0% | 460963 | 47.7% | 2.7% | 2.7% |
| | *434630* | | *443440* | | | |
| **Other** | 306972 | 30.8% | 257946 | 26.7% | -16.0% | -4.1% |
| | *297360* | | *248140* | | | |
| **Total** | 998144 | | 967166 | | -3.1% | |
| | *966890* | | *930400* | | | |

Source: OECD National Accounts data

Persistent discrepancy between revenue and spending trends led to a rapid increase in outstanding government debt, reaching DM 2,134 billion in 1996 (from DM 1,054bn in 1990). By 1996, the budget deficit was 3.5% of GDP, above the 3% ceiling set by the Maastricht convergence criteria for euro membership. In order to meet the Maastricht criterion by 1997, further fiscal retrenchment was attempted. Savings achieved mainly by lowering transfers of the Federal budget to the pension and unemployment systems, and a further reduction in public-sector employment. There was also an expansion of privatisation efforts- revenues from privatisation amounted to around DM 30 billion between 1990 and 1998.

After 6 years of consolidation efforts, the deficit ratio finally improved to 2.6% in 1997, enabling Germany to meet the Maastricht criterion. Strong growth in trading partners such as the US enabled Germany to avoid another outright recession. But the ratio of debt to GDP continued to rise as nominal GDP growth was as low as 1.7%.

### Red-Green coalition

In 1998 the Kohl government was defeated by the 'red-green coalition' of Social Democrats and Greens under Gerhard Schroeder. The incoming government had made electoral promises to combat unemployment by stimulating aggregate demand and reverse certain of the welfare cuts of the Kohl period.

Federal spending increased by 6% in nominal terms in the first year in office. However, the finance minister resigned after four months and was replaced by Hans Eichel, who committed himself to balancing the budget by 2006. Eichel presented a DM 30 billion austerity package, made up almost entirely of spending cuts. All government departments had to implement cuts in relation to their size.

Notable welfare cuts including the abolition of an unemployment assistance programme, the indexing of pension increases in 2000 and 2001 to the inflation rate rather than wage increases, and a reduction of government pension contributions for the unemployed and other groups.

Privatisation remained important with proceeds amounting to €8.5 billion between 1999-2002.

Despite all this, budget consolidation efforts were insufficient to achieve a balanced budget by 2006.

***The consolidation in quotes***

> *'There is only one way – cuts, cuts, cuts.'*
>
> anonymous pro Chancellor Kohl MP, 1996.

> *'A lasting consolidation of the state finances is not possible without the continuation of structural reforms'*
>
> Irmgard Karwatzki, State Secretary at the Finance Ministry.

> *'Kohl has abandoned consensus politics but he is not into Thatcher style confrontational politics yet.'*
>
> Heinz Schulte, political consultant.

> *'People have finally grasped that we need real changes to stimulate more dynamic growth and overcome obstacles to job creation.'*
>
> Chancellor Helmut Kohl, April 26th 1996.

*Addressing our questions*

| Question | Lessons from Germany |
| --- | --- |
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | The programme aimed at austerity to restrict the deficit through spending cuts and tax/contribution increases rather than seeking to 'grow it away'. These efforts were not always followed after the Kohl government, however. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The cost of reunification was originally financed by borrowing. There was no particular point of crisis; it was not until 1992 that a programme of fiscal austerity was launched. The government used the desire to meet the 3% Maastricht limit to justify the programme. |
| **3. What should be the ratio between spending cuts and tax rises?** | The consolidation consisted of 85% spending cuts to 15% tax rises in headline figures. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | The initial attempt to consolidate took place in 1993 when Germany was in the midst of a recession. From this year on, a successful consolidation took place. A number of economists have argued that excessive tightening promoted stagnation in the German economy during the late 1990s. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The institutional mechanism of the Maastricht Convergence Criteria on deficit limits contributed to a desire to cut spending. However, the ad hoc nature of some of the efforts (namely privatisations and transfer of some expenditures to the pensions and unemployment system) suggest that policies were designed to achieve a certain target (Maastricht) while neglecting long-term sustainability. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | Policy makers made clear that their intention was to reduce the deficit through sharp cuts. Several reductions in the number of public employees signalled some commitment to cutting expenditures. This was largely a 'what you see is what you get' approach. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | The selection of programmes to be cut did not follow larger conceptual considerations but was mostly done on an ad-hoc basis. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | All departments to cut in relation to their size, but they were given internal discretion as to their composition. |

| | |
|---|---|
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | Departments were invited to find areas where they could find saving themselves. |
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | Bureaucrats were trusted to find savings within their departments. The Financial Planning Council (formed by the federal government, the states and representatives of the communities) is charged with monitoring fiscal developments at all government levels and making recommendations in cases of noncompliance. There were no formal sanctions on shortfalls or incentives on windfalls, however. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | Germany suffered from persistently high levels of unemployment and sluggish economic growth. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | Kohl's government fell in 1998, partly blamed for high unemployment some felt was added to by the austerity programme. Schroeder's programme was similarly perceived to be undermining welfare provision and contributing to high unemployment. His government was defeated in 2005. |

### Evaluation: Did it work in its own terms?

Germany was able to reduce its deficit to 2.5% of GDP to meet the Maastricht criteria. In the short term, the German economy largely stagnated – though avoiding recession due to the strong growth in Germany's main trading partners. In the long term, the adjustment was able to meet its goals. However, the consolidation did impact the growth of the economy, as growth rates remained low throughout the 1990s (in fact there were various quarters in the mid nineties where economy contracted marginally):

**Table 3.15: Growth rates before and after the consolidation**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | -0.8% | 2.6% | 1.8% | 1.0% | 1.7% | 2.0% | 1.9% | 3.2% |

Source: IMF World Economic Outlook Data.

## Netherlands: 1983-2000

### Origins of the Deficit

The remarkable recovery of the Dutch economy in the 1980s and 1990s has been referred to as the 'Dutch miracle' and is often attributed to four main policy tracks: consensual wage restraint, reduction of taxes and spending, reduction of social expenditure and programmes of deregulation and privatisation.

In the 1970s and early 1980s, the Dutch economy was in the doldrums. An unsustainable boom in welfare spending prompted by the discovery of lucrative natural gas resources in the 1970s led to soaring wages and skyrocketing unemployment: the archetypal 'Dutch disease'. High taxes increased the problem of wage inflation. Some 300,000 jobs were lost between 1980 and 1983, leading to 17% unemployment in 1984, while government expenditure grew to 58% of GDP in 1983.The government's fiscal position deteriorated rapidly.

However, measures taken in the 1980s and 1990s successfully reversed these trends and returned the Dutch economy to a strong position: though public debt continued to rise: from 60% GDP in 1983 to 77% GDP by 1993, public expenditure was reduced by 3% GDP and the deficit had been reduced slightly from 5% GDP to 3% GDP. Between 1982 and 1997, the average tax burden decreased by 2.8% while the average tax increase across the EU was 2.6%. From 1985-1996, employment increased by 39%, from 4.98 million to 6.92 million. Some of this increase has been attributed to a rise in part-time employment and the dispersion of hourly wages between full- and part-time employees. By 1997, flexible jobs accounted for 10% of Dutch jobs. Within 15 years the Netherlands had changed from a country with an employment rate of little over 50% to a high employment economy.

### 1983-1990

Until the 1980s the Dutch government followed Keynesian deficit norms - the underlying principle was to better manage the national economy by the size of the government deficit. This changed radically in 1982 when the newly elected Ruud Lubbers government froze public-sector salaries, social benefits, and the minimum wage. In 1983 spending restrictions went further: the government announced that it would cut public-service salaries, minimum wages and social benefits by 3.5% across the board.

Policy-makers recommended that the total budget for public expenditure should be broken down by policy area and expenditure ceilings be imposed. They also recommended taking account of increasing ageing-related expenditure and decreasing expenditure for child benefits. (This proposal was not put into practice.)

Reducing the deficit via a time path approach became the new fiscal norm: regardless of the cyclical development, it was decided that the actual deficit should be reduced with 1% GDP per year, while the burden of taxes and social security contributions were to remain stable and at a minimum.

The Dutch recovery during the 1980s was helped by a system of consensual wage restraint, known as the 'Polder Model' which helped to restrict wage growth and lower unemployment. A detailed coalition agreement was set up in order to realize substantial budget cuts, e.g. a reduction of the salaries of civil servants and the rates of social benefits. Setbacks, both from the expenditures and income side of the budget (taxes, social security contributions and natural gas revenues) required frequent new cutbacks, which made the budget process very turbulent.

Between 1983 and 1987 public expenditure fell relative to GDP by 5%, and the ambition at that stage was, according to an agreement by coalition partners in government, a further reduction of 2%. The unions fought these cuts but settled for a 3% wage reduction and a shorter working week in 1986. After spending increases in 1987 and 88, the downward trend continued: between 1983 and 1990, expenditure had fallen from 57.8% of GDP to 51.7% of GDP.

### 1990-1993

The wage consensus began to weaken as unions pushed for higher wages. Job creation flattened and GDP weakened; the government threatened to impose a wage freeze. To avert this, unions negotiated a 2 month 'breathing space' during which all new wage demands were suspended.

The breathing space appears to have worked; prior to its implementation in 1993, wage settlements averaged a 4.6% increase; after the breathing space, the average increase fell to 2.2%. This episode reflects the willingness of Dutch employees and unions to consent to wage controls for the sake of economic growth.

The Netherlands (along with other Benelux countries) also benefited from the expansion of the German economy following reunification. When continental Europe fell into recession, exports remained strong.

**Table 3.16: Summary of key indicators**

| | 1990 | 1993 |
|---|---|---|
| Taxation (% of GDP) | 40.8% | 44.8% |
| Spending (% of GDP) | 45.1% | 47.2% |
| Balance (% of GDP) (headline) | -4.3% | -3.6% |
| Balance (% of GDP) (structural) | -5.5% | -0.1% |
| Govt. debt (% GDP) | 82.5% | 77.2% |
| Growth (%) | 4.1% | 0.7% |
| Av. growth over previous 5 years (% p.a.) | 3.4% | 2.7% |
| Inflation (%) | 2.5% | 2.6% |
| Unemployment (%) | 5.9% | 6.2% |

Source: OECD data; IMF World Economic Indicators and Government Finance Statistics

### 1994-2000

The 1994 elections produced a left-right coalition under Prime Minister Wim Kok. The government intended to cut government expenditure and taxes, reduce regulation, reform the welfare system to move people into the work force and reduce costs through privatisation, including much of the social security system. These measures, together with the consensual wage management, led to what has become known as the 'Dutch miracle'.

In 1994, the Finance Ministry implemented a national policy of trend based budgeting. The major features of this policy were:

- Cautious macro-economic assumptions.
- Net real expenditure ceilings for the whole term of government (four years).
- One main decision-making moment a year, which was intended to create a more stable and less hectic budgetary decision-making process.
- A focus on reducing public debt.

There were also a number of supplementary fiscal rules and principles:

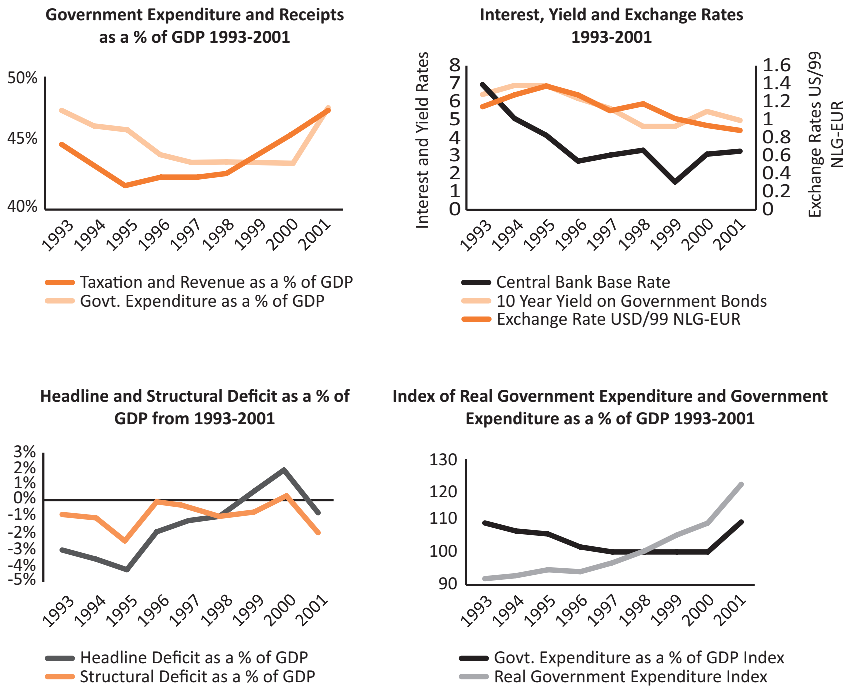
- A monitor showing the expected changes in taxes and social security contributions per billion Euros due to official changes in tariffs and regulations. This was regardless of non-policy factors such as general changes in consumption patterns. Net real expenditure ceilings for the whole term of government (four years).

## Table 3.17: Summary of key indicators

| | 1995 | 1996 |
|---|---|---|
| **Taxation (% of GDP)** | 41.7% | 42.5% |
| **Spending (% of GDP)** | 45.9% | 44.1% |
| **Balance (% of GDP) (headline)** | -4.2% | -1.6% |
| **Balance (% of GDP) (structural)** | -2.5% | -0.1% |
| **Govt. debt (% GDP)** | 80% | 77.2% |
| **Growth (%)** | 3.0% | 3.4% |
| **Av. growth over previous 5 years (% p.a.)** | 2.1% | 2.3% |
| **Inflation (%)** | 2% | 1.4% |
| **Unemployment (%)** | 6.6% | 5.9% |

Source: OECD National Accounts data; IMF World Economic Indicators and Government Finance Statistics

## Figure 3.6: Fiscal and Monetary stance from 1993 - 2001




Source: OECD National Accounts data and Main Economic Indicators; IMF World Economic Outlook

- An investment fund mainly financed via 40% of the natural gas revenues (FES-fund); the remainder of the natural gas revenues were to be used for debt reduction.
- A signal value for the general government deficit of 2 or 2.5% GDP. Surpassing this signal value implies that additional measures are to be taken and that the expenditure ceilings do not apply anymore.
- The use of incentives and cost-benefit analysis for reorganizing and controlling public expenditure.

The combination of cautious macro-economic assumptions and a long-term real expenditure ceiling limited the risk of budgetary turmoil resulting from economic setbacks.

On the income side of the budget automatic stabilizers were allowed to work freely. Income setbacks could be compensated for in the budget balance and did immediately require intervention by reducing expenditure or increasing taxes. The government promised to cut expenditure by 6% between 1994 and 1998, using savings to reduce the deficit and lower taxes. Tax revenues fell from 46.1% of GDP in 1993 to 42.9% in 1995. The deficit fell to 1.6% of GDP in 1996 and 0.7% in 1998. The debt ratio fell from 77.2% GDP in 1996 to 70% GDP in 1998.

The government also privatised social security, meaning that employers had to pick up the costs of sick pay. They therefore had incentives to discourage absenteeism, which fell by 25% between 1994 and 1997. In 1994, a new labour management agreement was brought into effect, under which the unions again accepted wage moderation in exchange for shorter working hours.

This appeared to be successful, with wage increases halving to 0.5%. In 1995 and 1996, increases remained low at 1.4% and 1.8% respectively. This corresponded with increased employment which grew at 2.4% and 1.9% in 1995 and 1996, while employment barely grew in the rest of Europe (0.5 and 0.1%).

## Table 3.18: Expenditure changes – Two key years

| | 1996 | | 1997 | | Change | |
|---|---|---|---|---|---|---|
| | Real/ *Nominal* (*in milions of Euros*) | % of Total Expenditure | Real / *Nominal* (*in milions of Euros*) | % of Total Expenditure | % Change in Expenditure | Percentage point change in balance of spending |
| **Health** | 13786 | 7.1% | 16415 | 8.4% | 19.1% | 1.3% |
| | *11154* | | *13470* | | | |
| **Education** | 19339 | 10.0% | 19507 | 9.9% | 0.9% | -0.1% |
| | *15647* | | *16007* | | | |
| **Defence** | 7101 | 3.7% | 6973 | 3.6% | -1.8% | -0.1% |
| | *5745* | | *5722* | | | |
| **Welfare** | 78770 | 40.8% | 77173 | 39.3% | -2.0% | -1.5% |
| | *63732* | | *63326* | | | |
| **Other** | 74270 | 38.4% | 76087 | 38.8% | 2.4% | 0.4% |
| | *60091* | | *62435* | | | |
| **Total** | 193266 | | 196155 | | 1.5% | |
| | *156369* | | *160960* | | | |

Source: OECD National Accounts data

These reforms and labour market compromises helped spur economic growth to a higher than forecast 3.25% per year between 1994 and 1995 – the growth rate reached 3.9% by 1998 and unemployment rate fell to 4.1% by mid 2000.

### *The consolidation in quotes*

> *'Various coalition governments – that differed substantially in terms of the parties participating – aimed at reducing the budget deficit in the 1980s and 1990s as fiscal policy at the time was generally perceived as unsustainable. Over time, the financial position of the public sector improved substantially.'*
>
> Jakob de Haana et al., 'Policy Adjustment and Sustainability of Public Finances in the Netherlands', 2004.

> *'The budgetary process became chaotic in the 1970s and 1980s. This was due to the drastically increased size and complexity of Dutch public finance, unexpected economic setbacks and substantial fluctuations in natural gas revenues. The introduction in 1994 of trend-based budgeting with expenditure ceilings for the whole term of government, and one decision-making moment a year, turned out to be effective solutions.'*
>
> Frits Bos, OECD Journal on Budgeting.

> *'When the OECD's two-yearly report on the Dutch economy appeared, many journalists converged on Amsterdam as if on a pilgrimage to Lourdes, filing headlines like "Renewed confidence in Netherlands", "Netherlands, Europe's model for a successful economy", "Happiness among the tulips", "Happy as a Dutchman", "Netherlands top of the class", "The lessons of the Dutch miracle" and, of course, "Netherlands - 7% unemployment but how do they do it?"'*
>
> Le Monde diplomatique, July 1997.

> *'Mr. Lubbers, are you really intending to cut the salaries of your public employees by more than 3%? That's a disaster. I am supposed to be the toughest in Europe. You are going to ruin my reputation as the Iron Lady.'*
>
> Margaret Thatcher to Ruud Lubbers at The Hague, 1984.

### *Addressing our questions*

| Question | Lessons from the Netherlands |
|---|---|
| **1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?** | Though spending did fall in real terms between 1995 and 1996, overall the Dutch economy's severe structural problems were dealt with through a 'grow it away' approach, albeit with permanent tax cuts, stringent budgetary increases in some areas and real terms reductions in others. |
| **2. How politically significant was the crisis in driving action? How was the crisis used by the government?** | The problems plaguing the Netherlands were associated with excessive spending, high wages and unemployment rather than a financial crisis per se. The government used this public awareness to build consensus for a consolidation. |

| | |
|---|---|
| **3. What should be the ratio between spending cuts and tax rises?** | The balance of consolidation fell entirely on spending cuts, which accounted for 280% of the fiscal adjustment as tax revenue fell. Structurally, expenditure restraint accounted for 75% of the adjustment, whereas revenue measures accounted for 25%. |
| **4. When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?** | After a failed attempt from 1991 to 1993, the successful consolidation began in 1995 -96. GDP growth contracted to 0.6% in 1993, though the economy never went into a recession. The consolidation accelerated recovery as GDP grew to 4.3% in 1997 from 3% in 1995. |
| **5. What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?** | The Maastricht treaty criteria helped prompt efforts to cut the deficits, although the dire state of the economy pre-recovery also created determination to 'just do it'.<br>From 1994 there was a trends-based budget policy, as well as a coalition agreement on multi-year expenditure targets as well as a rule to deal with windfalls. Separate expenditure ceilings on central government, social security, and labour market and health spending. Automatic stabilisers were allowed to work fully on the revenue side, except if the deficit came close to the Maastricht Treaty's 3% ceiling. |
| **6. Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?** | Conservative growth forecasts allowed the Wim Kok government to 'act tougher than they talked' when their expectations were exceeded. Governments made use of severe threats in order to achieve their goals of slower wage growth. Unexpectedly good growth figures allowed for reductions in both spending and taxes. |
| **7. Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?** | Cuts were widespread but specific areas were targeted, especially social welfare spending which was at a very high level. Reforms focused on features of the system deemed to be inefficient and wasteful. An incomes policy was introduced to cut costs. |
| **8. What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?** | Particularly wasteful programmes, especially welfare programmes, were targeted specifically. |
| **9. Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?** | Cuts were mostly centrally determined and were a key part of both the Ruud Lubbers and the Wim Kok administration's policy from the start. |

| | |
|---|---|
| **10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?** | The budget decentralized budget responsibilities in certain areas. Financial responsibility (obligation to work and need to prevent fraud) for social assistance went to the municipalities instead of the central government. The new rules incorporate a financial incentive for municipalities to reduce the numbers of workless social assistance claimers. Decentralisation cut costs significantly; spending cuts coupled with growth resulted in a sustained 1% surplus for the last 4 years. |
| **11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?** | There is some evidence that, in the short term, consolidation slowed down economic growth by reducing domestic demand. Social welfare provision suffered as did public sector salaries. |
| **12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?** | The government flourished despite the unpopular consolidation, with Prime Minister Wim Kok remaining in office from 1994 to 2002. |

### Evaluation: Did it work in its own terms?

The adjustment programme was largely a success, meeting its own targets of reducing deficit to below 2%. The fiscal consolidation did have a contractionary affect on domestic demand components such as private consumption and investment initially, though output did increase marginally over this period. Once the recession was over, the consolidation had an impact with growth picking up dramatically from 1994 onwards. The deficit fell to 2% of GDP in 1996 and 0.7% in 1998. The debt ratio fell from 77.2% GDP in 1996 to 70% GDP in 1998 while growth rose to 3.8% and unemployment fell to 4.1%. Quarterly data shows there is an initial decline in growth rates (though the economy does not contract) immediately after the first cuts take place but subsequently annual growth does rise to higher levels compared to previous years.

**Table 3.19: Growth rates before and after the consolidation**

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Growth rates | 0.7% | 2.9% | 3.0% | 3.4% | 4.3% | 3.9% | 4.7% | 3.9% |

Source: IMF World Economic Outlook Data.

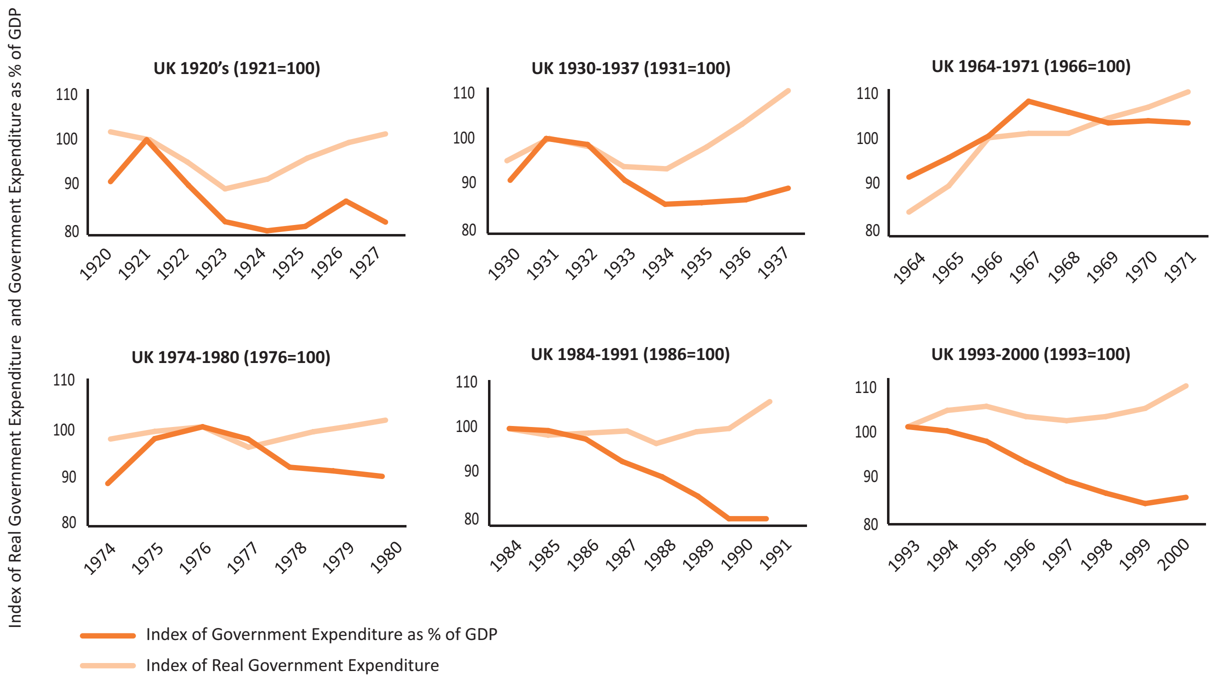
# 4
# Conclusions

Table 4.3 at the end of this section summarises the questions asked of our case studies and the answers found for each. Building on these answers to our key questions, the picture emerging of a good fiscal consolidation is broadly as follows:

- There will be real cuts in spending, as opposed to an attempt to "grow it away".
- It is desirable to cut spending before a crisis becomes acute, but an acute crisis can be used by politicians to achieve more dramatic cuts than would otherwise be politically feasible.
- Fiscal correction should be around 80% spending cuts, 20% tax rises.
- Provided that spending cuts dominate over tax rises, tightening is more likely to promote recovery than impede it. (This is particularly so when fiscal tightening can be combined with monetary easing.)
- During periods of significant cutting, fiscal rules have limited, if any, role compared to a 'just do it' culture. By contrast, institutional mechanisms — specifically, constraints such as an IMF intervention or EU rules — often do have a role. Once spending is down and a low spending culture is achieved, rules or mechanisms may be useful expressions of a culture (though never a substitute for it).
- Doing what you say you'll do appears to be a strategy more commonly associated with success than are either talking tougher than you act or under-promising and over-delivering, though talking tougher than one acts is a fairly common strategy in the UK.
- There is no clear preference for area specific, differentiated cuts or across-the-board, undifferentiated cuts.
- Common areas to experience cuts include defence, benefits, and civil service employment.
- The British tradition has tended to be for cuts to be imposed from the centre, but in other countries inviting initiatives from departments is quite common.
- It is rare for departments or bureaucrats to have or need explicit incentives to deliver cuts.

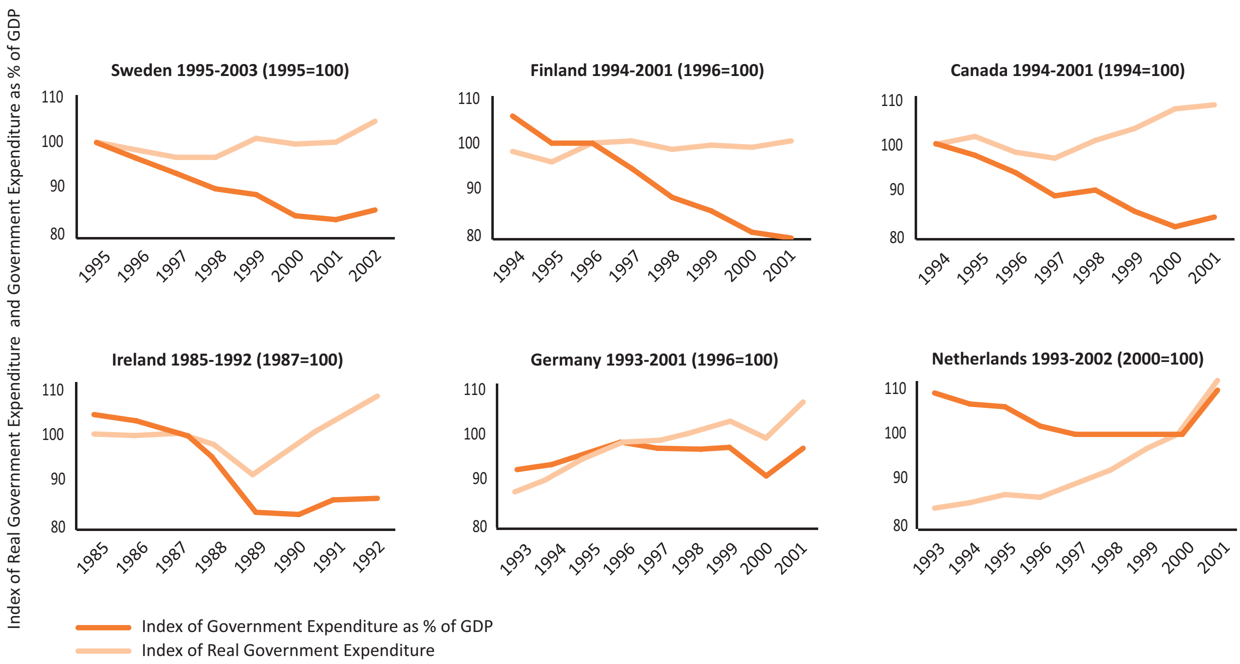
At the time of writing, a key point of political debate concerns the timing of tightening, with the Labour Party arguing for fiscal tightening to occur mainly after solid growth has resumed and the Conservatives arguing for tightening to begin as soon as the worst of the recession is over. In the case studies we have considered,

## Figure 4.1: UK real Government expenditure after the initial consolidation year




Source: Public Finances Databank for 1965 onwards, and Hough, J. 'The Burden of Taxation' (2001), www.ukpublicspending.co.uk for 1920's and 1930's.

## Figure 4.2: Real Government Expenditure for International case studies after the initial consolidation year




Source: OECD National Accounts Data/AMECO Data. Note that the figures underlying these graphs may differ from the national finance ministry data quoted in the case studies below.

overwhelmingly, fiscal corrections promoted recovery rather than creating additional recession. Even notorious cases in which it is commonly believed by non-economists that fiscal tightening promoted additional recession turn out to be more complicated than often thought (e.g. we find no evidence that fiscal tightening promoted additional recession in the UK in the early 1930s).[29]

Given that UK spending levels are at an unprecedented high, provided that fiscal consolidation is focused mainly on spending cuts rather than tax rises, we see no evidence from these case studies to support the idea that cutting spending in the early phase of recovery (or even, if it turns out to be the case next year, during a double-dip recession) would exacerbate recession. (Indeed, it is arguable that, on the basis of the case studies here, one might conclude that a double dip would increase the importance of a fiscal consolidation's beginning early, since double dip would raise the burden of already-excessively-high spending and rising debt upon the economy, placing further pressure upon the UK's ability to service its debts over the medium term and driving it closer in nature to those cases we study in which fiscal consolidations occurred in periods of acute financial crisis.)

That said, fiscal policy (tax, spending, budget deficits) and monetary policy (interest rates, quantitative easing, exchange rates) interact and the UK's current context, with active deflation and very high levels of household indebtedness, is different from those in most of our case studies. In particular, it is very important to note our finding that fiscal consolidations are more likely to be successful when they can be combined with loose monetary policy. Sometimes this may be because the fiscal consolidation itself permits monetary policy to be looser than would otherwise be compatible with controlling inflation (e.g. the early 1980s in the UK), whilst on other occasions it is not so much that monetary policy is loosened at the time of the fiscal consolidation but more that monetary policy was already loose at the time of the consolidation and stayed so (e.g. in the 1993 consolidations in the UK). If further quantitative easing can be pursued into next year, then the combination of fiscal tightening and monetary ease may yet be deliverable. Perhaps it might even be enough if, although there is not scope for additional quantitative easing, nonetheless the quantitative easing already in place is maintained and interest rates stay low. But if quantitative easing has by then reached its (non-inflating) limit and interest rates must start to rise and quantitative tightening commence through 2010-2013, it may prove necessary to face the unpleasant trio of ongoing recession, fiscal tightening, and monetary tightening.

Macroeconomic modelling is complex, and always depends on the specifics of the country concerned. Nonetheless, we believe that it is of relevance that even the economies in our sample (with their – in most cases – much smaller deficits than the UK at present) found fiscal consolidation boosted growth even in the short term (and certainly did not undermine growth). It should also be noted, however, that even though periods of fiscal consolidation based on spending cuts are rarely, in our case studies, associated with exacerbating recessions, they do often coincide with rising unemployment.

Another question concerns the balance between spending cuts and tax rises. In the case studies here, it was often the case that successful fiscal consolidation based principally on spending cuts followed on from an earlier period of unsuccessful attempts to correct deficits by raising taxes.[30] This result goes well beyond these twelve cases: the IMF recommendation, drawing on the consensus of

29 For a discussion of why spending cuts might not necessarily deepen recession, see Box 2 in the Introduction.

30 Note that in certain of the cases, the headline ratio shows spending cuts comprising more than 100% of the consolidation and tax rises being negative. This is to be understood as meaning that, at the headline level, taxes were cut as a percentage of GDP, so spending was cut by more than the entirety of the reduction in the deficit, so as to fund not only the deficit fall but also the tax falls. Futhermore, in a recent report by Alberto Alesina and Silvia Ardagna, *Large changes in fiscal policy: taxes versus spending,* the authors contend that the best fiscal consolidations should combine tax cuts with more than compensating spending cuts. This combination is less likely to be associated with short-term recessions.

31 The OECD national accounts show large hikes in spending in 1995 for the Netherlands and Germany, for purely statistical reasons. We have therefore substituted spending from the EC AMECO dataset for this year.

academic and professional studies based on cases right across the world, is for fiscal consolidations to be dominated by spending cuts. The typical recommendation is for a ratio of 80% spending cuts to 20% tax rises. In a number of the successful cases we study, the proportion of spending cuts is even higher than this.

## Table 4.1: Depth and duration of spending cuts programmes

| | Cuts beginning in... | Number of years spending was cut till trough | Number of years spending remained less than peak year | Change in Expenditure from peak to trough as % of total expenditure in peak year |
|---|---|---|---|---|
| 1920s UK | 1920# | 3 | 6 | -11.4% |
| 1930s UK | 1931# | 2 | 4 | -5.8% |
| 1960s UK | 1968+ | 1 | 1 | -0.4% |
| 1970s UK | 1976+ | 2 | 4 | -4.0% |
| 1980s UK | 1985+ | 4 | 6 | -3.3% |
| 1990s UK | 1995+ | 2 | 4 | -2.8% |
| Sweden | 1995* | 2 | 3 | -3.1% |
| Finland | 1997* | 1 | 3 | -2.0% |
| Canada | 1995* | 2 | 2 | -4.3% |
| Ireland | 1987* | 2 | 3 | -8.7% |
| Germany | 1999* | 1 | 1[2] | -3.1% |
| Netherlands | 1995* | 1 | 1[2] | -0.7% |

#Figures from ukpublicspending.co.uk
+Figures from HM Treasury public finances databank
*OECD definitions. Note that figures in this table may differ from the national finance ministry data quoted in the case studies below.

## Table 4.2: Changes in tax, spending and the deficit

| Country | Period* | Change in tax revenues as a % of GDP | Change in public expenditure as a % of GDP | Change in fiscal balance as a % of GDP | Ratio of spending cuts to tax rises |
|---|---|---|---|---|---|
| 1920s UK | 1921-24 | -1.9% | -5.6% | 3.7% | 150:-50 |
| 1930s UK | 1931-34 | -0.1% | -3.7% | 3.6% | 105:-5 |
| 1960s UK | 1967-69 | 3.7% | -2.0% | 5.7% | 35:65 |
| 1970s UK | 1975-79 | -2.2% | -5.1% | 2.9% | 175:-75 |
| 1980s UK | 1982-88 | -4.9% | -9.2% | 4.3% | 215:-115 |
| 1990s UK | 1993-2000 | 3.2% | -6.3% | 9.5% | 65:35 |
| Sweden | 1993-2000 | 7.0% | -7.8% | 14.8% | 55:45 |
| Finland | 1994-2000 | 5.3% | -6.7% | 12.0% | 55:45 |
| Canada | 1992-1999 | 3.7% | -5.8% | 9.5% | 60:40 |
| Ireland | 1985-1996 | -3.7% | -14.3% | 10.6% | 135:-35 |
| Germany | 1996-2000 | 0.7% | -3.9% | 4.6% | 85:15 |
| Netherlands | 1993-1997 | -2.5% | -3.9% | 1.4% | 280:-180 |

* Determined by the maximum reduction in public expenditure as a % of GDP.
The OECD national accounts show large large hikes in spending in 1995 for the Netherlands and Germany, for purely statistical reasons. We have therefore substituted spending from the EC AMECO dataset for this year.

Note that in certain of the cases, the headline ratio shows spending cuts comprising more than 100% of the consolidation and tax rises being negative. This is to be understood as meaning that, at the headline level, taxes were cut as a percentage of GDP, so spending was cut by more than the entirety of the reduction in the deficit, so as to fund not only the deficit fall but also the tax falls.

There is a policy division at the time of writing concerning how to establish credibility for spending control and deficit reduction. The Government's policy is to legislate for deficit reductions – a form of fiscal rule. The Opposition, in contrast, states that it will employ an "Office of Budgetary Responsibility" to challenge government fiscal decisions – a form of institutional mechanism. In our study, the main form of institutional mechanisms were exchange rate-related: the gold standard, the Bretton-Woods system, the euro project (and associated Maastricht Convergence Criteria). Such institutional mechanisms have been important in more than half of our cases. Fiscal rules, on the other hand, have tended to be used much more often *after* successful consolidations, in an attempt to lock in success, and as an expression of a "just do it" culture in respect of spending control. Our view is that rules and mechanisms can have a role, but as expressions of cultural change, not as substitutes for it.

What to cut and how to cut it are always tricky. There is no clear preference between area-specific highly targeted cuts and across-the-board undifferentiated cuts (either across-the-board in terms of being at the departmental level rather than the programme level, or across-the-board in terms of being right across government as opposed to targeting specific spending areas). Successful spending cuts programmes have often been extremely widespread, but sometimes they achieve their spread by targeting many specific programmes rather than involving simple "minus 10%"-style rules. Common areas to bear the greatest reductions include defence, benefits, and public sector worker numbers and pay. But no area is immune. In the UK, apart from during the IMF-induced cuts of the 1970s, health spending has risen even when cuts were experienced almost everywhere else (as in the 1980s). British cuts programmes have often been imposed from the centre — indeed, sometimes by specially appointed committees. In other countries, in half the cases (Sweden, Ireland, Netherlands) the centralised route was preferred, whilst in the other half (Finland, Canada, Germany) the process involved inviting initiatives from departments.

It is perhaps of interest to understand the pairing of centralised/decentralised versus differentiated/undifferentiated cuts, as in the following table.

| Four approaches to controlling spending | Broadly undifferentiated cuts | Broadly differentiated cuts |
|---|---|---|
| Centralised:<br>Cuts programme driven by centre | UK 1930s; Ireland; Canada | UK 1920s; UK 1968/9; UK 1976/7; UK 1980s; Netherlands |
| Decentralised:<br>Initiatives from departments | Germany; Sweden | UK 1990s; Finland; Canada |

There are two points to note here, perhaps. One is the obvious one that it is rare for the inviting of initiatives to be associated with undifferentiated cuts — the one counter-example being Germany. The less obvious point is that centralised cuts programmes are by no means always undifferentiated. On the contrary, the most single common combination is for a detailed, differentiated programme to be devised and imposed from the centre. An interesting variant on this is the Canadian case, in which initiatives for cuts were invited, but if such initiatives were inadequate, an across-the-board undifferentiated cut was imposed.

Spending cuts programmes differ markedly in how long their effects persist, as illustrated in the charts below. The lowest longevity of cuts for our sample was that of the UK in 1968: one year. The most extended period of spending restraint was the Thatcher spending controls of the mid 1980s – spending in real terms was still lower in 1990/1 than it had been in 1984/5, a remarkable six year period of spending restraint.[32] The closest parallels in our sample were the spending controls in Sweden in the mid 1990s. Although spending exceeded its 1995 peak in 1999, it then fell back to around its 1995 level for a further two years.

It is also of interest to understand how deep and how rapidly cuts were introduced. This is set out in the following table. We see that for the UK the deepest cuts were clearly those of the 1920s. The deepest, in any one year, of recent decades in the UK were those of 1976/7, when spending fell 4% in real terms. Real term cuts were achieved elsewhere on a similar scale – for example, the 1999/2000 cuts in Germany reduced spending by 3.1% in real terms in one year. Over a longer time scale, spending has been reduced as a % of GDP by much larger amounts, for example, Sweden cut spending as a % of GDP by 7.8% between 1993 and 2000.

One more issue is perhaps worth highlighting. It is often assumed that correcting deficits, though important for the economic health of the country, is inevitably politically unpopular. As it happens, our case studies do not bear that out unambiguously. A number of governments have benefited from successful fiscal consolidations, with voters respecting the importance of action and rewarding resolution and success. Unfortunately, none of these governments was British. All but one of the British governments that enacted significant spending cuts lost office thereafter – in most cases for a decade or more. The exception was Thatcher, whose cuts programme was enormously unpopular and seemed destined to lead to her removal from office until, among other things, she was saved by the Falklands War.

Perhaps the British electorate is now more realistic (or forgiving) about this issue, with recent opinion polls showing up to three to one majorities for spending cuts over tax rises. But whether that ultimately converts into political popularity for a government that enacts such cuts (or, if not popularity, at least hatred-with-respect) remains to be seen…

32 In the OECD data, statistically speaking, the most extended period of spending cuts was Germany from 1995 – 2002, but this was due to a statistical discrepancy. In 1995 debt relating to unification spending between 1990 and 1995 was taken over by the federal government and was recorded as a flow in the national accounts, which exaggerated total government expenditure in 1995. Specifically, this debt was due to capital transfers resulting from the take-over of the debt of the Treuhandanstalt and the Wohnungswirtschaft (housing industry) of the Former GDR and amounted to 119.6 Billion Euro.

## Table 4.3: Questions and Answers

| Question | UK 1920s | UK 1931 | UK 1968/9 | UK 1976-9 | UK 1980s | UK 1990s | Swe | Fin | Can | Ire | Ger | Neth | Average | Standard Thought |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Grow it away or real cuts?** | Cuts in real terms | Cuts in real terms | Cuts in real terms | Cuts in real terms | Grow it away | Grow it away | Cuts in real terms | Cuts in real terms | Cuts in real terms | Grow it away | Cuts in real terms | Grow it away | Cut in real terms (8/12) | Grow away, unless recession severe |
| **Did the crisis drive action? How was it used?** | Political pressure forced action in finding cuts | Led to National Government being formed determined to balance the budget | Political need to maintain £/$ parity drove the cuts | Cuts were a condition for IMF bailout. Crisis used to justify wage restraint | 'Winter of Discontent' drove election of new government with mandate for spending cuts and tax rises | ERM crisis drove consolidation to restore credibility; used to justify cuts and tax rises | Banking crisis drove action; scale of the national debt used to justify spending restraint | Earlier failure to grow away the deficit drove and was used to justify cuts and tax rises | Three previous failures and dollar crisis drove action and built consensus | Public awareness of long-term poor economic performance drove action, justified spending restraint | No particular point of crisis; desire to meet Maastricht limit justified the programme | Long-term perception of high spending, wages and unemployment drove action | Crisis drove action; government used crisis to justify consolidation | Action driven by crisis, no cuts before a crisis |
| **Spending cuts: tax rises[4] –** | Headline: 150:-50 Structural: N/A | Headline: 105:-5 Structural: N/A | Headline: 35:65 Structural: N/A | Headline: 175:-75 Structural: N/a | Headline 1982 – 88: 215:-115 Structural 1985 – 89: 85:15 | Headline: 1993 – 00: 65:35 Structural 1995 – 98: 75:25 | Headline 1993 - 00: 55:45 Structural 1994 - 98: 75:25 | Headline 1994 - 00: 55:45 Structural 1998: 85:15 | Headline 1992-99: 60:40 Structural 1994-97: 85:15 | Headline 1985-96: 135:-35 Structural 1987 - 89: 95:5 | Headline 1996-2000: 85:15 Structural N/a | Headline 1993-7: 280:-180 Structural 2004- 05: 75:25 | Approx. 80:20 | Cut expenditure in a recession, raise taxes otherwise |
| **The timing of tightening** | Tightening accelerated recovery | No Impact | Tightening accelerated recovery | Tightening accelerated recovery | Tightening accelerated recovery | Impact mainly after recession over | Tightening accelerated recovery | Impact mainly after recession over | Tightening accelerated recovery | Tightening accelerated recovery | Tightening impeded recovery | Impact after recession over | Tightening accelerated recovery (7/12) | Tightening during recessions worsens them |
| **Fiscal rules / institutional mechanisms / 'Just do it'** | Just do it | Just do it | Institutional mechanisms | Institutional mechanisms | Some fiscal rules, mostly just do it | Just do it | Institutional mechanisms | Both fiscal rules and institutional mechanisms | Just do it | Mostly just do it, some institutional mechanisms by the 1990s | Institutional mechanisms | Institutional mechanisms | Institutional mechanisms & Just do it | Rules |
| **'Talk tougher than act', 'act tougher than talk' or 'what you see is what you get', WYSIWYG?** | Talk tougher than act | WYSIWYG | WYSIWYG | Talk tougher than act | Talk tougher than act | WYSIWYG | Act tougher than talk | WYSIWYG | Act tougher than talk | WYSIWYG | WYSIWYG | Act tougher than talk | WYSIWYG (6/12) | Under-promise and over-deliver |
| **Areas cut? Long-established programmes or recent spending?** | Recent: defence, temporary staff (WW1) and social security | Recent: unemployment insurance, public sector wage cuts, public works | Some recent (social housing), some long-established (defence, NHS) | Various cutting and abandoning of long-established programmes. | Long-established areas were cut or privatised; public sector employees, asset sales, unemployment benefit effected | Politically low-profile areas like community amenities, housing and environmental protection | All departments cut by 11% | Welfare expenditure targeted | Long-established: public sector wages, welfare programmes, subsidies, defence | Cuts in Public Sector employment in particular, though all areas were cut to some degree | Ad-hoc cuts | Social welfare spending was targeted, though cuts were widespread | Welfare spending, public sector employment, defence | Welfare spending and defence |
| **Differentiated or undifferentiated cuts?** | Differentiated cuts | Undifferentiated cuts | Differentiated cuts | Some specific programmes targeted; some undifferentiated cuts | Undifferentiated cuts | Differentiated cuts | Undifferentiated cuts | Some specific programmes targeted; some undifferentiated cuts | Differentiated cuts | Undifferentiated cuts | Undifferentiated cuts | Differentiated cuts | Differentiated cuts (6/12) | Undifferentiated cutsin a crisis; Differentiated cuts when not in crisis |
| **Centrally imposed or devolved?** | Imposed from the centre, recommended by external committee | Imposing from the centre | Imposing from the centre | Imposing from the centre | Imposing from the centre | Imposing from the centre | Imposing from the centre | Inviting initiatives | Inviting initiatives | Imposing from the centre | Inviting initiatives | Imposing from the centre | Imposing from the centre (9/12) | Impose from the centre |
| **Incentives to deliver?** | No incentives | No incentives | No incentives | No incentives | No incentives | No incentives | No incentives | No incentives | Incentives for departments | No incentives | No incentives | Incentives for departments | No incentives (10/12) | Need incentives |
| **Stylised costs** | Badly targeted cuts had social costs. Defence cuts may have led to appeasement in early 1930s | Near-revolution and consequent failure of effort to keep on Gold standard | Loss of British military presence in many parts of the world; increased industrial strife | Total breakdown in industrial relations | Long-term mass unemployment, increased regional affluence differentials | Sense of decay in public services and of quality falling behind public aspirations | Impact on income distribution through wage moderation | Social welfare cuts and wages clamped | Cuts in health and unemploy -ment benefits, civil service salaries reduced | High levels of inflation, criticism by the EU and house price bubble | High levels of unemployment and low levels of economic growth | Lower wages and economic slowdown due to lower domestic demand in the short term | Social tensions and lower public sector provision | Unemployment, social friction, strikes |
| **Political Implications** | Suffered despite consolidation | Flourished despite consolidation | Suffered despite consolidation | Suffered despite consolidation | Flourished despite consolidation | Suffered despite consolidation | Suffered as consequence of consolidation | Flourished as consequence of consolidation | Flourished as consequence of consolidation | Suffered as consequence of consolidation | Suffered as consequence of consolidation | Flourished despite consolidation | Ambiguous | Suffered as consequence |

33 Note that in certain of the cases, the headline ratio shows spending cuts comprising more than 100% of the consolidation and tax rises being negative. This is to be understood as meaning that, at the headline level, taxes were cut as a percentage of GDP, so spending was cut by more than the entirety of the reduction in the deficit, so as to fund not only the deficit fall but also the tax falls.

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# Appendix

The following are explanations and motivations for our twelve key questions. At the end of each question we shall set out a "standard thought" – that is to say, a rough notion of the view we believe it would have been normal to adopt in advance of considering the historical and international lessons here. We should emphasise that it is not true, in all cases, that our own prior view corresponded to the standard thought; the standard thoughts do not represent any kind of conclusion of our study.

***1. To what extent might a public spending burden be reduced by 'growing it away' through GDP rises and tight controls on rises in spending, as opposed to active cuts in real or nominal terms?***

The UK government's Total Managed Expenditure in 2007/8 was 41% of GDP. In 2010/11 it will be above 50% of GDP – an incredible and unprecedented rise in such a short time. We have argued previously that spending at this level will materially reduce the UK's long-term growth rate and make it challenging to service our debts. Spending inandof itself is an issue – it is not merely a matter of the implications of spending for the deficit and for debt.

Let us distinguish between three broad strategies for getting public spending down as a proportion of GDP:

- Allow spending to grow more slowly than the size of the economy (a special case of this would be freezing spending in real terms whilst the economy grows — assuming it does grow rather than shrink). Let's call this the "grow it away" strategy;
- Keep spending constant in nominal terms but allow inflation to erode its real value. Let's call this the "inflate it away" strategy; of course, this is a form of cuts strategy.
- Actively cutting spending even in nominal terms.

During the 1980s and 1990s, when UK public spending fell as a proportion of GDP following recessions (from 48.1% in 1982/3 to 38.9% in 1988/9; and from 43.7% in 1992/3 to 36.3% in 1999/2000), the key driver was growing it away. Total Managed Expenditure did fall in real terms from 1984/5 to 1985/6, 1987/8 to 1988/9, 1995/6 to 1996/7 and 1996/7 to 1997/8 — four years in twenty; 20% of the time. This is more frequent real falls in spending than is often supposed. However, it remains the case that these real terms cuts accounted for only a tiny proportion of the overall reduction in burden.

From 2005-2008, the Conservative Party developed a policy of "sharing the proceeds of growth", a mantra employed by David Cameron during his 2005 campaign for the Conservative Party leadership. Subsequent statements by George

Osborne modified/refined the position, somewhat, to being that public spending should grow at a slower percentage rate than the economy over the economic cycle.

Given that, over recent decades, the key driver of spending falling as a percentage of GDP has been growth, and given that the Opposition's official policy has, until very recently, focused on a grow it away strategy, it is useful to consider how relevant such policies have been in the cases of significant spending control in our sample.

**Standard thought: Normally better to grow away. Severe enough recession might mean cuts become necessary.**

**2.** ***How politically significant was the crisis in driving action? How was the crisis used by the government?***

Some of the cases in our sample involve expenditure cuts made under financial market pressure (e.g. UK in the 1976 IMF intervention period; Canada in 1994). In other cases (e.g. Ireland) spending control was exercised without the need for a crisis. It is natural to think that it would be best to begin exercising control before a crisis arises, but on the other hand (a) it might not be politically feasible to do what must be done until there is actually a crisis — the political classes or voters might not accept the measures needed; and (b) a crisis might be an opportunity to achieve more than mere rectification ("never waste a good crisis."), whilst doing more than is strictly necessary might not be palatable absent a crisis.

**Standard thought: Government will justify action because of a crisis, thus will not take drastic measures before one occurs.**

**3.** ***What was the ratio between spending cuts and tax rises?***

Does an urgent need to reduce the deficit and control debt make it more likely that spending cuts bear the brunt of fiscal consolidation, or does the urgency of the need for action under these circumstances make it more likely that there are tax rises? Do parties act with the cliché, as it were – right-wing governments cutting spending, left-wing governments raising taxes – or do crises create a need to achieve consensus and hence drive parties to act contrary to type – right-wing governments raising taxes, left-wing governments cutting spending?

**Standard thought: In a crisis, balance is likely to be more even between spending cuts and tax rises than would be the case if there were no crisis (i.e. without a crisis, parties of the right would cut spending and parties of the left would raise taxes).**

**4.** ***When should a fiscal tightening take place? Should it impact after the recession, or, if done during, does it aid or hinder the recovery?***

The timing of a fiscal adjustment is critical, though there are political constraints that leave governments with little room to manoeuvre. Severe financial constraints may leave governments little choice but to consolidate, and political considerations may prevent consolidation to take place until public finances are in a crisis situation. But, generally, as rule, it is considered best to consolidate during the expansionary phase of a business cycle. There is evidence though, that suggests tightening during a recession can have expansionary affects and does not necessarily worsen a recession.

**Standard thought: The timing of the fiscal consolidation has to be closely related to the business cycle, and it usually makes a recession more severe.**

***5.What relevance, if any, is there to fiscal and spending rules or institutional arrangements in reducing spending, as opposed to a political determination to 'just do it'? Are such rules or institutional arrangements any more relevant for keeping spending down once initial reductions have been achieved?***

Gordon Brown's fiscal framework famously involved two key rules: that the government should only borrow, over the cycle, for investment (not consumption); and that debt should not exceed 40% of GDP. Some authors have proposed adding a rule that spending, over the economic cycle, should grow no more rapidly than the sustainable growth rate of the economy.

Brown's fiscal rules did not prevent an unprecedented increase in spending as a proportion of GDP; neither did they prevent an explosion in government debt. The fiscal rules framework has collapsed. However, in his Autumn 2009 Conference speech, Gordon Brown proposed a new set of rules. He said:

> *'Our deficit reduction plan to cut the deficit in half over four years, will be made law in a new fiscal responsibility act.'*

In contrast, the Conservative Party now favours institutional mechanisms. Its Autumn 2008 document, Reconstruction – *Plan for a strong economy*, states that:

> *'The failure of the fiscal rules in Britain is consistent with the emerging conclusions of the academic literature on the shortcomings of rules in general. Both on paper and in reality, simple rules have been found to be either too loose to be effective, or so inflexible that governments break them, undermining their credibility. While it might be theoretically possible to design a rule that was right in all situations, it would be so complex that it would be impossible to operate in practice.*
>
> *'Instead, economists increasingly argue that institutional change to introduce a greater degree of independent monitoring into fiscal policy is better than any rules-based system. This would operate through the introduction of an independent "fiscal council" with responsibility for ensuring sustainable public finances. This is the approach that we will take to replace the failed fiscal rules and entrench fiscal responsibility as a permanent feature of British politics.'*

We thus have a clear policy division between an approach relying upon rules and one relying upon institutions. But it is unclear how relevant either party's approach is to situations in which one is making major reductions in spending. Can any institutional or rules-based fix really make up for a lack of will to "just do it"? And if there is adequate will to just-do-it, do institutions or rules really add anything?

Might institutions or rules, perhaps, be of more relevance to the locking in of gains once spending is actually reduced? Or is even that illusory? Might winning the argument and achieving a cultural consensus behind lower public spending or low deficits (perhaps even surpluses) be a more sustainable objective than other fixes liable to be swept aside once the political pendulum swings?

(It should be noted that we define "rules" such that ordinary laws constitute rules, along with announced policy rules of governments. "Institutions" include the requirements of lenders (e.g. the IMF), practical requirements associated with maintaining a currency peg, and the rules of currency regimes (such as the Maastricht Convergence Criteria), along with constitutional amendments or specific bodies appointed to oversee and challenge fiscal decisions. Simple policies count as "just do it".)

**Standard thought: Rules provide an important means of committing to deliver cuts, and enhanced transparency over whether cuts have actually been achieved.**

**6. *Is it better to 'talk tougher than you act', 'act tougher than you talk' or just do what you say you will do ('what you see is what you get')?***

One natural thought on approaching significant spending cuts is that one might need to emphasize the scale of the task and ensure that every departments understands that everyone is in it together and there can be no free riding. This might seem to imply a "talk tough" approach in which one emphasizes very ambitious objectives for the scale of cuts so as to overwhelm resistance to change.

However, such an approach has the obvious drawback that if a public spending reduction programme needs to be sustained, rather than one-off, people will quickly see that over-ambitious targets are not being met and credibility will be lost. Especially if there is already a financial markets crisis such as a gilts strike, a loss of credibility could be very damaging and could undermine the longer-term sustainability of cuts. So another approach might be to under-promise but over-deliver on cuts. A danger there is, of course, that under-promising might lead to under-achieving.

A third option is to be specific about the scale of the cuts to be made in public and simply to stick to these commitments; 'what you see is what you get'. This has the advantage of reinforcing the credibility of the government with financial markets and ensures clarity about its true intentions. However, this may not be politically practical (if the government is close to an election, for example) and may be overly rigid and unresponsive to changed economic circumstances (a government may wish to delay a consolidation if there is a major financial crisis or accelerate cuts in spending if a recovery is unexpectedly rapid).

**Standard thought: Probably better to under-promise and over-deliver, though it may depend somewhat on the details of the situation.**

***7.Which specific spending areas tend to bear the brunt of cuts made? Do these tend to be long-established programmes or more recent spending? Is this inevitable, desirable or damaging?***

Did cuts tend to fall on the most economically inefficient or least economically or socially valuable spending programmes, or did they fall in a less desirable way?

An interesting follow up question is, does the composition of the spending cuts have an impact on the success of the adjustment? There is evidence that suggests that composition of spending cuts may have important consequences on how permanent the fiscal adjustment is and on its macroeconomic consequences. Broadly, there are at least two reasons why the composition of the cuts matter; (1) Long term sustainability of the cuts – different types of spending cuts may be more or less permanent by their nature. For example, consider two types of spending cuts of the same magnitude, for instance in the maintenance of public infrastructures. The second one includes cuts in welfare obtained by changes in eligibility criteria for transfer programmes and by cuts in government employment. Even the though the two types of programmes may have the same magnitude, the second one has more lasting effects than the first. The maintenance of public infrastructure cannot be postponed forever; on the other hand structural changes in the parameters which determine the coverage of the welfare state by influencing the dynamic of entitlement have long lasting effects. (2) Political credibility – governments which are willing to tackle the politically more difficult components of the budgets, public employment, social security, welfare programmes, may signal that they are really serious about the fiscal adjustment, which will inform peoples' expectations about the sustainability of these cuts.

**Standard thought (Or perhaps better, Standard guess): Benefits and defence get cut; health and education are protected. This is not efficient.**

***8.What is the right balance between undifferentiated, across-the-board cuts and differentiated cuts targeted at specific programmes?***

To achieve the maximum level, most sustainable, and most socially and economically efficient spending cuts, is it better to identify some iconic examples of wasteful spending or inappropriate activities of the state to be cut, and build from there to a list of specific programmes to go? (These tend to be known as 'differentiated' cuts.) Or is it, instead, better to set much broader targets for the volume of cuts to be achieved, and work from there to identifying specific ways to achieve the cuts needed (for example, simply naming a percentage figure of cuts to be made in a particular department)?

**Standard thought: Better to target when not in a crisis; undifferentiated, 'all shall have pain' in a crisis. Cut across the board in a crisis; differentiated cuts when not in crisis.**

***9.Where should the proposals for the cuts come from? Should it be centrally imposed or devolved to other bodies?***

Further to the above question, is it better to invite spending-cut initiatives from departments (whether initiated by the bureaucrats within those departments or by the political teams overseeing those departments), or is it better to be Treasury-led, with centrally-imposed volumes or cuts or perhaps even centrally-specified programmes to be cut?

Is it useful to have specific schemes to incentivise politicians or bureaucrats attempting to produce cuts? Or is it enough to put out the understanding that performance will be assessed partly or largely on the basis of cuts-delivery?

**Standard thought: If cuts must be made, there needs to be a clear coordinating demand for them from the centre, otherwise the incentives for individual departments to produce cuts are limited. There may need to be sufficient cuts imposed from the centre to get the message across and establish credibility. When spending has previously been rising too fast or long been too high, there is likely to have been a culture that rewarded high spending. So specific incentives may be necessary in order to emphasize the change in approach.**

***10. To what extent is it necessary or wise to trust bureaucrats to deliver cuts when instructed? Is it useful to incentivise departments or bureaucrats to deliver cuts?***

Building on the previous two questions, can bureaucrats be trusted to deliver cuts if that is the policy? The natural tendency when a government changes, for example, might be to be mistrustful of the civil servants that oversaw a previous phase in which spending and deficits arose. But is such scepticism warranted? Do bureaucrats actually deliver when it comes to it? And are cuts devised by those without the detailed inside knowledge of bureaucrats actually less effective or more damaging than the cuts bureaucrats would come up with if given the chance?

**Standard thought: Bureaucrats are likely to seek to protect their own empires, and so will be resistant to cuts. If invited to produce their own ideas, they may even suggest cuts in politically damaging and absurd areas, in order to discredit the concept of cuts in their area.**

***11. What are the stylised economic and social costs of a consolidation? What long-term consequences should be considered?***

What were the wider costs to society of the consolidation? Did it drive social change (e.g. change regional inequalities, increase social friction, transform the structure of public service provision etc.)? Did the consolidation have a wider historical impact on the nation which should be considered?

**Standard thought: consolidation are likely to cause 'pain' at various levels of society by reducing spending or raising taxes on certain social and economic groups. There is therefore likely to be greater social friction (more working days lost to strikes, higher unemployment, greater income inequalities, etc.)**

***12. What were the political consequences for the government who implemented the consolidation? Did they flourish or suffer and was this because of the cuts or in spite of them?***

How did the government in office during the consolidation fair politically after it? Did it gain credit for accelerating an economic recovery, reducing unemployment, putting state finances back on a sound footing etc., or blamed for prolonging a recession, reducing funding for public services or raising taxes on the certain sectors or income groups? What was their political fate and was this principally determined by the consolidation or did other external factors have a larger role?

**Standard thought: Governments will be disliked for raising taxes and/or cutting spending, and suffer politically. However, in terms of their legacy they may gain respect in the long term for putting state finances on a sounder footing.**

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