Public Governance Committee

Working Party of
Senior Budget Officials

Restoring Fiscal Sustainability : Lessons for the Public Sector

OECD
ORGANISATION FOR ECONOMIC
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Restoring Fiscal Sustainability:

Lessons for the Public Sector

"[E]ven as important steps have been taken to address the recession and the intense threats to financial stability, maintaining the confidence of the public and financial markets requires that policy makers begin planning now for the restoration of fiscal balance."

Ben S. Bernanke, Chairman, Federal Reserve Board, July 2009

"[T]he G20 must make every effort to support the recovery and plan co-ordinated exit strategies from current expansionary measures to make sure the recovery is not put at risk."

Supporting Global Growth, a preliminary report on the responsiveness and adaptability of the international financial institutions by the Chair of the London Summit, Prime Minister Gordon Brown, September 2009

"Overall, unprecedented policy efforts appear to have succeeded in limiting the severity of the downturn and fostering a recovery to a degree that was largely unexpected even six months ago. It is now time to plan the exit strategy from the crisis policies, even if its implementation will be progressive. Radical policy action will be required in the years to come to restore sound macroeconomic balance, healthy growth and low unemployment. Only when that has happened will the crisis have been fully overcome."

Jorgen Elmeskov, Acting Head, Economics Department,
OECD Economic Outlook 86, November 2009

While the "process of growth is now beginning", that fledging growth still needs to be reinforced to create jobs and get businesses investing to underpin the recovery in the housing market and elsewhere. "If we put the brakes on too quickly, we will weaken the economy and the financial system, unemployment will rise, more businesses will fail, budget deficits will rise, and the ultimate cost of the crisis will be greater. It is too early to start to lean against recovery."

United States Treasury Secretary Timothy Geithner
at the meeting of G20 Finance Ministers and Central Bank Governors,
St. Andrews, Scotland, November 2009

As the world economy begins to recover, the world's political and financial leaders have begun to emphasize the importance of fiscal consolidations in promoting sustainable global growth. Record debt levels have already impacted the borrowing costs of several countries, including some G20 countries. Gross general government debt for advanced economies is projected to rise from 75% to 115% of GDP between 2008 and 2014 with most of that increase up front. By 2014, debt ratios will be close to or exceed 90% in all G7 countries except Canada. The fiscal outlook is better for emerging economies, but it is unlikely that they would be shielded from a loss of confidence in public sector sustainability in the developed economies; as the recent crisis has amply demonstrated, crises in confidence easily spill across borders.

It is thus critical to avoid a surge in interest rates that concerns about high debt ratios might prompt. High deficits and debt can all too easily trigger such a surge if markets perceive a more relaxed attitude toward fiscal solvency. Thus, an exit strategy to plan the transition from the current levels of fiscal imbalances to more sustainable levels is clearly needed.

However, as stated in the last quote above, the timing to begin "putting on the brakes" is not clear. The G20 Finance Ministers and Central Bank Governors agreed at their meeting at St. Andrews, Scotland, in early November 2009 that reductions in fiscal support should not begin until the economic recovery is assured and public confidence in the viability of financial markets is further strengthened.

Yet preparing exit strategies cannot be put off. Many of the fiscal actions taken during the crisis, while appropriate at that time, would be harmful if they stayed in place for too long. "Preparing and communicating well-articulated exit strategies will increase confidence that there is a way out. That in itself will allow for greater flexibility in the implementation of the strategy. Spelling out exit strategies is also useful because many of the policies that will form part of such strategies can be expected to have international spillovers, calling for various degrees of co-ordination across countries ranging from *ex ante* information sharing to collective policy approaches. Against this background it is regrettable that so few exit strategies have so far been articulated – with, for example, less than half of OECD countries having announced medium-term fiscal consolidation programmes with a clear description of the instruments to achieve the final target."[1]

OECD has a long history of analysing the fiscal positions of countries – in both good times and bad – and in helping countries plan and implement fiscal consolidations. The size, duration and composition of such plans have varied enormously, depending on a country's particular situation. Although there have been many plans that have involved small adjustments, there have been more than 300 episodes of fiscal adjustments of above 5% of GDP in both developed and developing countries over the past 30 years. To help each country grapple with its own – often unsustainable – fiscal position, OECD has found a number of lessons taken from the experiences of other countries that may be useful.[2]

1. Jorgen Elmeskov, "Editorial: Preparing the Exit", in *OECD Economic Outlook 86*, 16 November 2009.

2. The lessons and references in this paper were adapted from: "Deficit Reduction: Lessons From Around the World", Committee for a Responsible Federal Budget, Washington DC, 2009; "Fiscal Consolidations: Lessons from Past Experience", *OECD Economic Outlook 81*, 2007; Jocelyne Bourgon, "Program Review: The Government of Canada's Experience Eliminating the Deficit, 1994-1999 – A Canadian Case Study", The Centre for International Governance Innovation, Waterloo, Ontario, Canada, 2009; "Red Ink Rising: A Call to Action to Stem the Mounting Federal Debt", The Peterson-Pew Commission on Budget Reform, Washington DC, December 2009; Andrew Lilico, Ed Holmes, and Hiba Sameen, "Controlling Spending and Government Deficits: Lessons from History and International Experience", Policy Exchange, London, 2009; Carlo Cottarelli and Jose Vinals, "A Strategy for Renormalizing Fiscal and Monetary Policies in Advanced Economies", IMF Staff Position Note, 22 September 2009; and comments from the chair and delegates of the OECD Working Party of Senior Budget Officials.

Deficit reduction

1. Countries should establish a credible[3] deficit reduction plan that is integrated into a comprehensive economic policy.

Creditors and taxpayers seek confidence in a country's fiscal management in order to continue financing public expenditures. Facing a deteriorating fiscal position, a country should re-establish its fiscal credentials by adopting a serious deficit reduction plan; otherwise, the country cannot sustain its fiscal programme and will be punished by financial markets. And countries should not try to assuage markets by assertions that they can count on future economic growth alone to "grow out of" their problems: the fiscal problems in most countries are far too large to be solved by economic growth by itself.

Over the past 30 years, many countries have adopted deficit reduction plans to put their public finances on a sustainable fiscal path. Some countries have taken pre-emptive steps to avoid a full-blown fiscal crisis. In other cases, countries have made adjustments in the midst of a crisis. In the 1990s, some countries pursued fiscal consolidation strategies to shift resources to the private sector and make their economies more competitive. In particular, several European countries cut deficits in order to qualify for the new euro currency.

Deficit reduction has important benefits:

- By getting its finances in better order, a country can make sure that it can sustain its fiscal policies down the road.
- By adopting a serious plan to reduce its borrowing needs and debt service, a country can reassure creditors and taxpayers in a transparent manner that it is prudently managing its fiscal house. If a country does not have fiscal credibility, it will have much more difficulty in continuing its fiscal programme because creditors will refuse to continue lending or will demand a higher risk premium.
- By following a more sustainable fiscal path, a country can create fiscal space that can provide room to address future economic and financial shocks and to fund new priorities.

3. Credibility in this case is a function of: the fiscal plan itself and the objectivity of the economic forecasts on which the plan is based; the past record of fiscal transparency and discipline; deficit and debt levels; future liabilities; and the perceptions that financial markets have about the country's fiscal future.

2. The announcement of a credible deficit reduction plan can have positive effects on consumers, businesses, and financial markets.

The announcement of a credible deficit reduction plan can lead to a shift in the expectations of key economic and financial players. This shift, in turn, can have a positive impact on the economy. If credible, the plan will help manage medium-term expectations of creditors, which will keep down financing costs by reducing risk premiums demanded in the form of higher long-term interest rates.[4] Providing that spending cuts dominate over tax increases (see below), fiscal consolidation appears to be more likely to promote recovery than impede it, particularly when deficits are large and spending is high. Nevertheless, an important aspect of successful deficit reductions is to create not just a "defensive" consolidation strategy, but to combine it with "offensive" elements (infrastructure, R&D) that may strengthen future economic development.

The importance of expectations in successful fiscal consolidations can be seen, for example, in the cases of Denmark (1983-86) and Ireland (1987-89). **Contrary to conventional wisdom, their large adjustments (expected to be contractionary in the short run) had positive effects on the economy.** Other countries have had similar experiences. In 1996, when Sweden faced a cyclical downturn, it turned to new deficit reduction measures that had an expansionary impact on the economy through a boost in confidence. Similar effects were seen in Finland.

As the Danish, Finnish, Irish, and Swedish experiences illustrate, the announcement and adoption of a credible consolidation plan can lower the risk premium on government debt instruments demanded by creditors, boost investment through lower interest rates, and/or have a positive wealth effect as lifetime tax expectations are lowered by the perception of diminished financing needs. Although the current low rates on government debt may mitigate the benefits from lower risk premiums for some countries, the effects of the announcement and adoption of a credible consolidation plan have been particularly pronounced for countries with substantial fiscal problems in the past. **Even large fiscal contractions can be expansionary because they can signal a permanent and decisive change in fiscal policy.**

4. Angel Gurria, OECD Secretary-General, press conference for the *OECD Economic Outlook 85*, 24 June 2009.

3. Eliminating a sizable deficit is a “social project”, not a normal budget exercise.

A budget exercise often involves a small number of people working in relative secrecy. The purpose of eliminating a sizable deficit is to reconcile fiscal capacity with demands for funding, including funding for new government priorities. Eliminating a sizable deficit involves a realignment of the role of government in society, as the Canadian experience in the 1990s clearly demonstrated. As such, this kind of project requires a more open and inclusive approach, one that engages the whole of government. And this approach should place an even greater emphasis on programme evaluations, value-for-money assessments, and cost/benefit analyses than occurs in a normal budget process.

4. However, sizeable deficit reduction plans should be implemented from the centre of government and in an all-inclusive, whole-of-government package.

The development of savings proposals cannot be left to officials of line ministries, as it is not in their interest to identify programmatic proposals with large savings. Savings proposals should come from the centre – the Minister of Finance and/or the Prime Minister. However, since the centre has less information about policy details, special procedures – such as programme or spending reviews – are needed to provide important programmatic information about the operation of programmes to help the centre develop proposals. These reviews have been used in Australia, Canada, the Netherlands, and the United Kingdom.

Related to the need to implement deficit reduction plans from the centre, such plans also should be implemented in an all-inclusive, whole-of-government package. Individual ministers and beneficiaries have long been successful at insulating their programmes from cuts because the benefits to them are larger than the costs to everyone else. Cuts that affect individual programmes unleash a strong reaction on the part of beneficiaries. But the scale of Canada’s *Program Review*, for example, helped to balance single interests with the collective interest. Public judgment about the merits of the approach hinged on the relative fairness of the proposals among regions, groups, and income levels. In general, successful consolidations can be achieved only when a package of reforms encompassing all programmes are considered together.

5. The most successful plans involve large, multi-year adjustments; in fact, scale can make possible reforms that alone would not be politically feasible.

A sample of countries with large adjustments includes: Sweden (17% of GDP); Denmark (13.5% of GDP); Greece (12% of GDP); Canada (10% of GDP); and Portugal (8.5% of GDP). Of the large adjustments, roughly half lasted one to two years and half lasted longer. Among the most successful were those in Canada (a four-year programme), Denmark (four years), Sweden (seven years), and Finland (nine years).

Factors regarded as critical to the success of fiscal adjustments are:

- the size of adjustment (larger adjustments have had a more positive impact);
- the duration (particularly successful adjustments have been multi-year);
- the composition (spending cuts have tended to provide the most durable deficit reduction and to increase the likelihood of a positive macroeconomic impact, but tax changes have often played an important role);
- the state of public finances (the worse the situation, the more likely that the effects will be positive); and
- the starting levels of spending and taxation (most plans have included both tax and spending provisions).

6. A crisis can make it easier to adopt a deficit reduction plan.

"[T]he worse the public finance situation, the higher the probability of implementing a lasting fiscal correction."[5] This is based on the public being more likely to see the benefits of responsible fiscal policy and support a tough programme when times are obviously precarious.

Contrary to conventional wisdom, deficit reduction can be politically advantageous in certain circumstances. In Denmark, public support for the government's fiscal consolidation programme was galvanized by concern that Denmark's credit rating in global financial markets would

5. Martin Larch and Alessandro Turrini, "Received wisdom and beyond: Lessons from fiscal consolidation in the EU", *Economic Papers 320*, Directorate-General for Economic and Financial Affairs, European Commission, April 2008.

be downgraded after a leading credit rating agency issued a warning. In Ireland, when the first attempt at fiscal consolidation failed, the government was thrown out. The party returned to power several years later on a fiscal austerity platform even though the economic and fiscal situation had worsened. Public support for fiscal consolidation in Finland and Sweden was related to widespread perception of a crisis and the need for a solution.

7. Put everything on the table. Deficit reduction is more likely to be sustained when politically sensitive areas – including transfers and subsidies – are tackled.

Both spending and revenue must be on the table to have any hope of a "grand bargain" in which all sides have an incentive to negotiate a comprehensive package of reforms. In many countries, the scope of the problem is so large that tax increases and spending cuts will have to be part of any final package. And given that transfer payments to businesses and citizens make up such a large portion of public expenditures, cuts in these areas have been an instrumental part of many deficit reduction plans. For example, important components of the consolidations in Canada and Sweden involved lasting reforms in their social security systems, which were put on a sound financial basis with their financial integrity guarded by automatic triggers. Moreover, cuts to transfers and subsidies tend to increase the chances of stabilizing the debt-to-GDP ratio, perhaps because such cuts demonstrate a strong commitment to reducing expenditures.

8. Fiscal consolidations should be biased towards spending cuts.

Successful consolidations have typically placed about 80% of the burden on spending and 20% on tax increases.[6] This rule of thumb may not apply in all cases; important factors affecting the mix include the state of the domestic and global economies and the monetary policy stance. However, spending restraint (notably with respect to government consumption and transfers) is more likely to generate lasting fiscal consolidation and better economic performance than tax increases.

6. Andrew Lilico, Ed Holmes, and Hiba Sameen, "Controlling Spending and Government Deficits: Lessons from History and International Experience", Policy Exchange, London, 2009.

Selected deficit reduction success stories

Denmark (1983-86): Public debt exploded in the early 1980s from 29% of GDP to 65% as stimulus measures were adopted during the global recession. High interest costs made the situation even more difficult. The government turned to severe fiscal retrenchment (both tax hikes and spending cuts) after a credit rating agency put a credit watch on its external debt and the public became worried about fiscal sustainability. Four years after fiscal consolidation began, the primary budget position improved by over 15% of GDP and the debt-to-GDP ratio declined. Real GDP rose by an annual average of 3.6% during the consolidation period.

Ireland (1982-84, 1986-89): Like that of most other European countries, Ireland's fiscal position had deteriorated sharply by the early 1980s. In 1981, Ireland faced a debt-to-GDP ratio of 87% and debt service required 8.3% of GDP. After an initial attempt at consolidation failed (the economy did not improve and political support was lost), a second try was made later in the decade using a tough austerity programme of cutting spending and widening the tax base accompanied by a sharp devaluation that resulted in a large reduction in the deficit and in the debt-to-GDP ratio.

New Zealand (1986-2001): With persistent deficits that exceeded 6% of GDP in the 1980s, New Zealand accumulated an unsustainable level of government debt. The country had virtually no economic growth, high inflation, and lost consumer confidence, leading to a currency crisis that forced government action in the mid-1980s and again in the early 1990s. New Zealand instituted major economic and fiscal reforms to regain foreign investor confidence and increase future fiscal flexibility. The government reduced regulations – including wage and price controls – cut spending by more than 7% of GDP, and reduced the number of public employees by half. From 1986 to 2001, the debt-to-GDP ratio was reduced from 72% to 30%.

Finland (1992-2000): Following a major banking crisis, Finland faced large deficits (around 8% of GDP) and a rapidly rising debt (58% of GDP). Motivated by strong political support to get its house in order to qualify for participation in the euro and by the need to address external financing concerns, the government pursued a fiscal consolidation programme consisting of a medium-term budget framework, entitlement reforms, spending cuts, and tax reform. By 2000, the debt-to-GDP ratio was under 45% and the cyclically adjusted primary fiscal balance improved cumulatively by 10% of GDP from 1992.

Spain (1993-97): Spain's fiscal position had been deteriorating since the late 1980s. By 1995, its fiscal deficit exceeded 7% of GDP and its public debt exceeded 70% of GDP. Facing external financing concerns and strong public support to adopt fiscal disciplinary measures to prepare for euro area membership, the government adopted a fiscal consolidation plan that emphasized cuts in spending (including cuts in social transfers, government wages, and health care spending) but also included tax reform. Fiscal balances improved cumulatively by around 4% of GDP since 1993.

Selected deficit reduction success stories *(cont'd)*

Canada (1994-99): Using an extensive *Program Review* exercise in the mid-1990s, Canada eliminated a sizable budget deficit between 1994 and 1997. As a result of the programme reviews, programme spending declined in absolute terms by over 10% between 1994-95 and 1996-97 – from 16.8% of GDP in 1993-94 to 12.1% in 1999-2000. Half of these reductions were the result of changes to statutory programmes, including employment insurance benefit payments to individuals and fiscal transfers to the provinces. Canada ran surpluses until 2007-08, and reduced its debt-to-GDP ratio from almost 70% in 1995-96 to below 30% in 2007-08.

Sweden (1994-2000): Sweden's fiscal situation deteriorated severely in the early 1990s as a result of a banking and economic crisis. In the midst of a recession, the government adopted a fiscal consolidation programme to achieve fiscal balance through a tightening of household transfer payments and an increase in various taxes. As a result of these efforts, the fiscal position shifted from a deficit of over 11% of GDP to a surplus of 5% of GDP and the debt-to-GDP ratio was reduced from 72% to 55% in 2000.

9. Timing is critical: a deficit reduction plan generally should be phased in, but a fiscal policy that is counter-cyclical is most important.

In countries undertaking large fiscal adjustments, more gradual implementation has often led to better macroeconomic effects. A gradual phase-in usually also allows for a more orderly adjustment, which is particularly important politically and economically when the amount of the adjustment required is large. However, a gradual phase-in can induce organised resistance that grows over time. Austria, for one, has had good experience with "big bang" solutions.

In current circumstances, the question of timing is especially critical. Normally a delay in adjustment is not regarded as good policy. Simply as a financial matter, delay increases the debt – and therefore the cost to the public – through higher debt service. As a result, the fiscal adjustment eventually required will be larger. Moreover, in some circumstances, a fiscal crisis may require immediate and dramatic adjustments to restore short-term financing. Denmark, Finland, Ireland, and Sweden, for example, faced immediate pressures from the withdrawal of external credit. Under current conditions, however, withdrawing fiscal stimulus should perhaps wait until the economy is stronger and until public confidence in the viability of financial markets has been restored.

10. Do not use a sluggish economy as an excuse for delaying the announcement of a plan.

Concern over the recovery does not mean that policy changes cannot be announced in advance. In fact, "[c]redible medium-term consolidation programmes should be announced already now, in order to strengthen market expectations about the determination of governments to return to sustainable fiscal positions. This would help to ensure that inflationary expectations remain stable and mitigate the increase in long-term interest rates that the withdrawal of monetary stimulus is likely to bring about."[7] Excessive delay in crafting, announcing, and enacting a plan could prove destabilizing to the economy and ultimately derail the recovery.

11. Fiscal rules and institutions can provide additional fiscal discipline, which could be particularly useful during multi-year adjustment programmes.[8]

A multi-year programme combined with clear fiscal rules that limit spending (including tax expenditures) can enhance policy credibility by being counter-cyclical and by increasing fiscal discipline, transparency, accountability, and certainty.[9] Such a fiscal programme can also help policy makers adhere to an appropriate fiscal path. For example, in the case of Sweden, when the government's finances had improved after the adoption of a fiscal programme, a medium-term target (a surplus of 2% of GDP over the cycle) was announced to avoid repeating fiscal problems. Fiscal rules with embedded expenditure targets have tended to be associated with larger and longer adjustments, and with higher success rates.

7. *OECD Economic Outlook 86*, November 2009.

8. "The strongest rules have a constitutional base with no margin for adjusting the objectives, are monitored and enforced by independent authorities, include automatic correction and sanction mechanisms in case of non compliance, and are closely monitored by the media." (*OECD Economic Outlook 81*, 2007)

9. Barry Anderson and Joseph J. Minarik, "Design Choices for Fiscal Policy Rules", *OECD Journal on Budgeting*, Volume 5, Number 4, 2005.

12. The more involvement of the public, relevant agencies, sub-national governments, and other stakeholders, the more successful the plan will be.

Creating public understanding and support for restoring fiscal sustainability through deficit reductions is hard, but not impossible. A communication strategy that emphasizes social balance and fairness – between all levels of government, government entities, income classes, and generations – should be part of the consolidation plan. Co-ordinating with sub-national governments to ensure consistency in deficit reductions is particularly relevant. Interaction with other stakeholders can also help: the creation of peer pressure through the use of fiscal sustainability watchdogs or through the co-ordination of fiscal policies with other countries can support the difficult political actions required.

But public policy debate should also be emphasized. The Canadian experience is a reminder that a strong consensus among opinion leaders does not guarantee the best policy decisions and the best policy outcomes. In fact, the stronger the consensus, the more reason there is to challenge the status quo and examine different policy choices. Debate elevates public understanding of policy options and improves the likelihood of sound public policy decisions. However, the extensive involvement of the public in formulating consolidation plans should not be allowed to delay the development of medium-term consolidation programmes.

13. It is preferable for a country to take specific actions to reduce deficits on its own terms before actions are forced upon it by others.

Full-blown fiscal crises have typically been experienced by developing rather than developed countries, as developing countries usually have less margin to manoeuvre fiscally and financially. Fiscal policy mistakes in developing countries cannot be sustained. Because they are more dependent on external financing (primarily short-term capital, as creditors seek to minimize risk), developing countries are usually more vulnerable to capital flight. Industrial countries are not immune, however. For example, France’s creditors attacked the currency, and the government was forced to devalue twice after it stimulated fiscal policy to fight the global downturn of the 1980s – the opposite policy taken by its EU currency system partners. France then reversed course to adopt a fiscal austerity programme.

Whether faced by a developed or a developing country, the classic fiscal-related stabilization crisis occurs as investors flee a country in the face of debt sustainability challenges and solvency concerns, with fears of hyperinflation or even default. In response, governments can be required to make immediate and dramatic adjustments: raise interest rates sharply to defend the currency and undertake rapid fiscal consolidation through large tax increases and/or sharp government spending cuts to stabilize the fiscal position. These steps can result in output losses and hardships for citizens, and it can take a long time to rebuild investor confidence until external financing is again available. It is obviously much better to avoid this situation.

Reductions in public employment

14. Staff reductions can be long-lasting if they are based on explicit policy decisions to undertake programmatic reductions or on credible productivity gains.

The difference between staff reductions that are a result of arbitrary decisions and those based on good programmatic reasons cannot be overemphasized. Governments change what they do and government staffing can and should reflect these changes. But staffing changes not based on fundamental programmatic analysis do not last and can end up adding to future deficits. Staff cuts can also be driven by organisational performance reforms including the redefinition of missions and expected outputs (business and delivery planning), new workforce planning policies, and a move towards competency management.

15. Across-the-board cuts and freezes that affect programmes and services in an undifferentiated way can have perverse effects and may not help promote fiscal sustainability.

Such cuts can erode the quality of public services, reduce the quantity of available services for the same level of taxpayer contribution, and affect morale in the public service. Over time, they can erode citizens’ confidence in government, in the public sector, and in public organisations. Moreover, cuts done in this manner have generally not helped reduce deficits in a way to promote fiscal sustainability. The reasons for this include:

- Arbitrary staff cuts have generally been restored within five to ten years if the public’s demand for services was not reduced or if no change in the operational delivery modes was undertaken. Even in the cases where there were successful cuts, the impacts have been limited, as the compensation of government employees generally represents only about a quarter of government expenditures.

- Some staff cuts are in fact the result of “hidden” institutional changes, in which government entities are transformed into other types of organisations that may have some sort of hybrid status but are still funded by government or mandatory fees, or are at best semi-private organisations.
- Staff cuts tend to produce a huge level of anxiety. During implementation, staff tend to focus on saving their jobs and careers rather than on the delivery of public services. Moreover, it may be a mistake to carry out such programmes in times of economic crisis when the public sector can be a stabilizing factor in the economy and in society. This is even more relevant if unemployment is high and is increased by staff cuts, or when unemployment benefits are limited.
- The best staff tend to leave first, and the public sector ends up with the least productive people. In addition, when the government starts hiring again, it has to train people and devote scarce resources to hiring procedures.
- Politically-driven staff cuts may also affect continuity in policy implementation by diminishing the professional culture of some organisations, a culture that can provide the values, capacity, knowledge, and memory necessary for effective service delivery.
- Many countries have ageing public services (older than the rest of the population) and are using retirements to cut staff. This can be less disruptive than across-the-board cuts, but if combined with incentives for senior workers to retire, it can lead to higher pensions. And if increased rates of retirement are combined with across-the-board cuts, there can be a significant impact on the ability to provide public services.

16. Efficiency measures may help with internal reallocations from lower to higher priorities, but they are not likely to be major contributors to eliminate a sizable deficit.

There is no real substitute for making choices about the relative importance of government programmes to eliminate a large deficit. Staffing decisions can and should follow these choices, not lead them.

Nevertheless, countries should not miss out on the opportunity to achieve managerial savings, including in programmatic priority areas. A deficit reduction plan provides a potential platform for a renewed focus on increasing public sector productivity and value for money – through the use of ICT investments, process re-engineering, market-type mechanisms, and shared services – and for reallocating harvested gains through the budget process.

One way to create an incentive for process innovation is to share productivity dividends between public sector bodies and treasuries. While reducing the share of savings per programme, such an approach can increase buy-in and acceptance of productivity efforts and therefore the long-term sustainability of reductions. In addition, productivity efforts can include the use of market-type mechanisms to drive both internal and external incentives through a broad range of tools such as contracting out and performance pay.

Productivity improvements can also be obtained at a whole-of-government level by locating potential economies of scale. A review of Australia’s efficiency programme, for example, found that small agencies did not have the same capacity as larger ones to absorb cuts and to improve processes. As public sector bodies reach the limit of the efficiencies that they can achieve within their own organisational boundaries, a cross-government approach can help to find further efficiencies for the government as a whole – for example, through shared service centres and central procurement.

The ratio of staff employed at the central and sub-central levels also needs to be considered. The majority of government employees work at sub-central levels of government; in 2005, 62% of government employees worked at state, regional or local levels of government with often different employment and working conditions than their central government counterparts.

Regulatory reform

17. Reducing regulation inside government can also help.

Simplifying regulation inside government can improve efficiency and productivity, contributing to fiscal consolidation. The administrative burdens that governments impose on their own units and officials – regulation inside government – can represent a significant cost. The multiplication of reports and procedures can cause delays, reduce staff time on substantive work, and contribute to a culture which discourages initiative and risk taking. Fiscal consolidation will push governments to re-examine their internal ways of working. Many governments of OECD countries are examining the frequency of internal reporting, and even the original justification for certain rules and reporting requirements in the first place.

This can be done while respecting legitimate accountability and transparency concerns. The methods and strategies to reduce regulation inside government can be adapted from “cutting red tape” programmes applied to regulation of the private sector. These include measurement of existing regulatory burdens by ministry, target setting, a whole-of-government approach, data-sharing protocols and system re-engineering, and *ex post* evaluation.

Outsourcing

18. Outsourcing has produced long-term savings only when it is based on sound economic analysis and reflects non-political judgments about the most efficient way to provide public services.

Similar to the arbitrary staff cuts mentioned above, outsourcing programmes motivated by staff reduction goals usually end up adding to deficits after a few years and/or providing significantly poorer quality and quantity of services. However, there is potential for savings from outsourcing based on sound economic analysis: on average, 45% of goods and services used in government production have been contracted out in OECD countries – a figure that has been relatively stable in the last 20 years. At the same time, governments are increasingly using private and non-profit entities to provide goods and services directly to citizens. In 2008, 19% of all government-financed goods and services were provided by private actors directly to citizens, compared to 13% in 1995. Nevertheless, the use of outsourcing and private sector providers, in and of itself, is no guarantee of improved public sector efficiency. Even successful outsourcing contracts are very difficult to manage, as the risk of non-delivery requires additional resources that can reduce the amount of any savings obtained.

Yes you can!

19. Perhaps the most important lesson of all is that large deficit reduction programmes can be done.

With strong political support that encourages a “**just do it**” culture, the experiences of many countries show that it is possible to implement ambitious, successful reforms and to make choices in a principled and defensible way for citizens and public servants. Transparency is a crucial feature for any successful programme. If the public understands why actions are being taken and is convinced of their necessity, the likelihood of sustained success is greatly increased. And doing what you say you’ll do appears to be a strategy more commonly associated with success than either talking tougher than you act or under-promising and over-delivering.

It is also good to know that several successful consolidations 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 United Kingdom's cuts of the late 1970s and mid-1980s followed previous failures. In sum: **don't give up**!

Conclusions

As countries come out of the economic and financial crisis with a sharp deterioration in their public finances, they need a fiscal recovery plan to reduce debt burdens before long-term pressures (especially ageing and health care) hit with full force. As the examples cited above suggest, the adoption of a fiscal consolidation plan is important – and necessary. A multi-year deficit reduction programme allows citizens and creditors to adjust gradually and provides a disciplinary framework to achieve more sensible government finances. Although it should not be implemented until the economy is on stronger footing and public confidence in financial markets has been restored, agreement on, and announcement of, a credible deficit reduction plan can help encourage the recovery by reducing the fears of inflation or currency instability. In the absence of a plan, creditors will eventually begin to demand an increasing risk premium for holding government debt, which could slow or even choke off the recovery. If the fiscal position continues to deteriorate, at some point the risk premium will be insufficient to induce creditors to invest in government instruments. This point could occur if inflation accelerates, fear of default rises, or financial instruments elsewhere look more appealing, leading investors to shift their funds to safer countries.

It is not too early to plan for the future. In fact, it is critical that countries get started now.

OECD can help the G20 monitor fiscal consolidation plans and can assist countries in formulating and implementing such plans. In the public governance area, two OECD activities are of particular relevance. The OECD Working Party of Senior Budget Officials has experience in providing countries with in-depth peer reviews of their budget policies and processes to help them identify best practices and strategies for fiscal consolidations. And OECD comprehensive public management reviews can provide countries with whole-of-government strategies for programme reviews and help improve the implementation of reductions by taking into account interactions across public management areas.