COMPARATIVE GOVERNMENT RESPONSES TO RECESSIONS: LESSONS TO BE LEARNT FROM FISCAL CONSOLIDATIONS

Report for
The Financial Scrutiny Unit
The Scottish Parliament

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EXECUTIVE SUMMARY

1 This report sets out some of the lessons learnt from past examples of severe Fiscal Consolidations.

2 In some cases these lessons are most relevant to the UK government, with its wider responsibilities for economic and public finance issues. However, many of the most important lessons can be seen as relevant to all levels of government and particularly for the Scottish Government with its wide responsibility for most public service spending.

3 It is important to remember that this exercise does not compare a set of identical, or even similar, exercises in Fiscal Consolidation. The case studies illustrate how every situation is different. Thus, there is no straightforward ‘formula’ or recipe for success that needs to be followed. Judgements can be made on the ‘success’ of returning to fiscal balance or in reducing debt levels, but much less so on the degree to which this has impacted on faster future growth or on the ‘damage’ done to services as a result of the decisions made over where any cuts should take place.

4 That said, some clear examples of ‘good practice’ do emerge from an analysis of the literature in this field of study.

Leadership

5 The issue of leadership is important, in order to make the unpalatable seem inevitable. Decisions may be unpopular but they can still be recognised as necessary. Strong leadership can set out the reasons for why spending restraint is needed and can engage with the public on how best to achieve change. By doing so, the population recognises that there will be some losers and becomes a part of the process in deciding who they should be. This can allow for greater acceptance of radical change and of less likelihood of damaging industrial or social unrest.

6 However, such a course of action is dependent on information being freely available and openly discussed. If the population or the markets feel that information is being distorted or concealed then trust over the reasons for change and the options being proposed can be badly harmed.

7 In addition to the Government and Head of Government showing leadership, cross party support and the use of external sources of discipline can increase both public understanding and acceptance, as well as increasing the chances of success and reducing the risk of backsliding.

Choice

8 Two areas of consideration in particular need to be closely examined in this field, although there is no definitive advice on what course of action should be preferred in either case.

Universal Vs Targeted provision

9 The first concerns the question of whether to provide universal or targeted benefits, which is a more pressing issue in times of reduced funds. The answer will depend on society’s preferences, but the policy impacts will inevitably differ in terms of scope and
scale, dependent on whether they are used in a universal or targeted manner. A fixed sum can provide a small across-the-board coverage or it can provide in depth support for a small minority. Equally, the answer to this question might be thought to vary benefit by benefit.

However, greater targeting, or the introduction of more income dependent variable rates of benefits, can act as a tool to protect the most economically vulnerable.

**Capital Vs Revenue cuts**

The second area concerns the degree to which current or capital spend should be identified as carrying a disproportionate share of the burden. Again, the answer will depend partly on values, as well as on the perceived state of capital related infrastructure. However, in general most governments either intentionally protect investment (e.g. Finland) or inadvertently target it (e.g. the UK). The political advantages of the latter course is that it is less contentious, as it tends to be unrealised future jobs that are most affected. The downside is that necessary investment that could increase the pace of growth in the recovery phase is at best delayed.

Currently the UK government has targeted a relatively large cut in capital spend. The Scottish Government has its own choice to make on whether to follow the UK’s course of action.

**Further choices**

To assist in making the necessary further choices, both across services and within budget lines, the current position would be improved by a greater understanding of what is being spent as well as what this spending is aiming to deliver.

A key issue when considering what to cut is an understanding of the degree of efficiency being shown within existing budgets. This might be done in absolute terms, perhaps by looking at changes in productivity over time, or, in relative terms, by comparing Scotland to other systems, either within the UK or outside of it, or comparing regions within Scotland. Such analysis could provide a very useful source for identifying potential areas of good practice and of spend that might be pared back without impacting on overall quality. While greater efforts have been made at the UK level (although often just for England) to collect this information e.g. by ONS on public services productivity and by the NAO, very little such data or analysis is yet available for Scotland.

To this extent we are flying blind in terms of making ‘smart’ decisions. While eventually a decision needs to be made on budget priorities across services based on political choice, to some extent these decisions can be affected by our understanding of what is currently being delivered. Much more work needs to be done in this area, as soon as possible, to allow for values and knowledge to combine most effectively in making budget choices.

**Process**

Many of the Fiscal Consolidation exercises undertaken in recent decades have spent considerable time and effort addressing budgetary process arrangements that have, over time, become less effective. Such an effort might also prove valuable in the case of Scotland.
The political strength of the Minister for Finance and their Department needs to be reassessed, along with the resources available within the Department. This should be done with an eye to both: assessing whether the political strength exists that means the Finance Minister/Department has the necessary authority to enforce funding decisions based on collective policy priorities; and that it has the tools and staff to properly assess the efficiency of services and the likely impact of spending decisions. There is little evidence, post devolution, that either of these capacities has been satisfactorily developed in an environment of rapidly rising budgets. In general, the challenge function with regards to budgets and policy choices, both internally and externally (with regards to academia, the press or think tanks) appears to be under-developed.

Other issues

Wages

Wages account for over 50% of the Scottish Governments budget and future settlement levels will be important in terms of minimising non-wage related cuts as well as redundancies. Already in Ireland we have seen relatively large scale cuts in real terms take home pay across the public sector. There is no doubt that this eases the pressure on rebalancing the public sector’s books.

It can also serve as a message that the government has the situation under control and that there is widespread public acknowledgement that such a severe rebalancing is needed. As such it can serve to dampen internal (social) and external (financial) pressures that might lead to further disruption.

An asymmetric public wage policy, favouring the lower paid, can also assist in reducing the negative impacts of the economic downturn and fiscal contraction on the most vulnerable in society.

Demographics

Growing long-term pressures, relating principally to demographic changes that will emerge over the next 10-20 years, will put increasing pressure on services like Health, Pensions and Long-term care.

Decisions made in the next few years on how these services are to be paid for and the role of the state in their provision will have knock-on effects for many years to come. Overly generous or badly constructed policies can, over time, exert pressure on public expenditure and end up with a return to public sector fiscal crisis. As far as is possible, decisions on these issues should be based on thorough analysis and, ideally, cross party support. The alternative is more likely than not to lead to unaffordable options whose costs are ratcheted up as political parties end up indulging in a bidding war over who will offer the most.

Independent scrutiny

Academic researchers and their models can play a useful role in providing costed options and the involvement of bodies like the Scottish Government’s Council of Economic Advisers can help in assessing the relative merits and viability of these options.

Conclusions
The coming years will be a difficult time in Scottish politics. A Parliament that has not been used to real terms cuts in budgets, but rather to relatively large year on year increases, now faces one of the most severe fiscal contractions in modern history. Furthermore, this downturn in funding prospects will also be long lasting.

In this environment it can be useful to look back at past, similar, exercises of Fiscal Consolidation and times of disruptive change. This can allow us not only to learn the lessons that remain pertinent from those times but also to remind ourselves that it is possible to undertake these changes and at the same time bounce back relatively quickly in terms of revived economic growth alongside stable public sector finances.
1 INTRODUCTION

1.1 This report was commissioned by the Financial Scrutiny Unit (FSU) of the Scottish Parliament, on behalf of the Finance and Equal Opportunities Committees, in support of their Budget Strategy Phase.

1.2 The remit was to look at “what preparations should be underway now by the public sector to ensure the efficient delivery of public services within a period of tightening public expenditure”.

1.3 Other work by the CPPR has estimated that this tightening of public expenditure could result in a real terms reduction in the Scottish Government’s budget of around 12% in real terms (i.e. excluding inflation) between a 2009-10 peak and 2013-14. Thereafter, real terms public spending increases are expected to remain low, under 2% per annum for example, for another 4 years and possibly for considerably longer. By way of comparison, the Scottish Government’s budget rose, in real terms, by an average of over 5% a year in the first decade of devolution.

1.4 This overall squeeze in funding is to allow, first, the UK’s fiscal deficit to be eradicated and then the level of the UK’s national debt, as a share of GDP, to be considerably reduced. Such a rebalancing of public revenues and expenditures is commonly referred to as a period of ‘Fiscal Consolidation’.

1.5 The purpose of this paper is to answer a series of questions in a way that will prove enlightening and offer assistance to those looking for lessons on how best to introduce the imminent real terms cuts in government funding.

- Why and how often does the need for Fiscal Consolidation arise and is it the same this time?
- What are the general factors that seem to delineate ‘successful’ Fiscal Consolidations from ‘unsuccessful’ ones?
- What are the specific important factors that arise from Case Studies?
- Of these factors, which are most pertinent as lessons for the Scottish Parliament, both in terms of management/strategic lessons and with regards to individual public services?

1.6 The title of the report is deliberately split into two parts. We are interested in how governments respond to recessions, or indeed to depressions, but that interest at present is concentrated in how to bring back greater balance to the government’s fiscal balance post fiscal stimulus.

1.7 Governments wish such an adjustment to be both successful in reducing the fiscal deficit, but also in doing so in such a way that any negative impacts on future growth prospects are minimised and that social cohesion is maintained.

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1 The term Fiscal Consolidation has no exact definition. Instead it is used as a general term to describe a period of fiscal rebalancing, when public sector revenues are brought more into alignment with the level of public expenditure, having previously been well below that level (resulting in a sizeable fiscal deficit).
1.8 Returning to economic growth and prosperity is assumed to be the ultimate objective, with the immediate priority being to rebalance government revenues and expenditures in such a way that allows for such growth to return as soon as possible.
2 COMMON FEATURES OF PAST FISCAL CONSOLIDATIONS

2.1 Fiscal Consolidations have occurred throughout history but it is only since the 20th century that data has become available to study these consolidations in detail, and only since around the 1970s that this data has allowed for cross country analysis of such exercises.

2.2 Thus, this paper concentrates on findings derived from analysis of Fiscal Consolidations conducted over the last 40 years in advanced economies.

2.3 In addition, we are concentrating on those Fiscal Consolidations that were largest in size, as the current consolidation is expected to be historically large.

2.4 It is also important to differentiate between Fiscal Consolidations that are undertaken in order to get a burgeoning fiscal deficit under control and ones that are undertaken in order to promote growth.

2.5 In the light of successful Fiscal Consolidations that led to rapid long-term growth rates in countries like Ireland and Denmark (both starting in the 80s), there arose a literature on the potential positive impacts of Fiscal Consolidations on growth, strongly connected to the Laffer Curve related theoretical benefits of the impact of a smaller public sector on the overall growth rate of an economy.

2.6 However, almost all deep Fiscal Consolidations are initiated by some form of fiscal crisis that forces a government to take action in order to turnaround an untenable situation with regards to long term fiscal prospects. As a result of such a Fiscal Consolidation there may be faster and sustained growth but in this work we are assuming that the Fiscal Consolidation is being forced on countries who would otherwise not be undertaking them, but where the underlying primary balance is unsustainable.

2.7 What then seem to be the economic and financial conditions that help bring about a deep fiscal consolidation? In general terms, we would highlight 5 such conditions (Note: these are not all necessary features but rather are the most common ones):

- Past financial deregulation, which ultimately led to…;

- Rapid, unsustainable, price rises with regards to key wealth assets such as property and shares (i.e. ‘bubbles’ and their bursting);

- High general inflation and related interest rates;

- A period of sustained national economic weakness (i.e. a recession usually lasting at least two calendar years of negative growth);

- A wider international downturn in economic growth.

2.8 The balance in importance of these factors will change, case by case, but most examples exhibit each of these conditions to some extent.
3  IS IT THE SAME THIS TIME?

3.1 It is easy to look at the previous list of conditions that bring about deep Fiscal Consolidations and recognise most of them this time round in the UK.

3.2 In the post 2007 UK example, the differences in tendency and balance would be:

- in terms of financial innovation and deregulation this might be seen to be more international than national in scope, with much greater use of fast flowing, and short term, wholesale international money markets for example;

- the bubbles were long in the making, over a decade for housing, and so the down side of their bursting was all the more dramatic (although shares have bounced quickly back, at least for the time being);

- the problem of high general inflation, encouraging a high interest rate to tame it, is missing this time round. Very unusually, this has been an inflation free period of boom and bust. The lack of a warning sign from this usually reliable source of impending doom\(^2\) may well have been a factor in its building up for so long and to such an extent;

- we are currently in the midst, or possibly near the end, of at least two years of negative growth for the UK and Scotland;

- the world economy is in a broad and deep slump. This general downturn is significantly worse than in other post 1970 downturn periods of the mid 70s, early 80s or early 90s. To put this into context, the growth rate for the OECD as a whole had never turned negative, 1971 through 2007, and was only twice below +1% (1975 and 1982). Latest forecasts are that it rose by only 0.6% in 2008, followed by an unprecedented 3.5% fall in 2009.

3.3 Of the above “this time its different” elements, the one that stands out most clearly is the lack of high inflation/interest rates; in fact the reverse, with worries over deflation and over the lack of traction of interest rate policy. So instead of interest rate hikes geared to curbing inflation, slowing unsustainable growth and defending a national currency, we are now faced with extraordinarily low interest rates in an attempt to support demand and output levels.

3.4 This is good news in that there is no inflation dragon to be slain, with all the difficulties that come with that. But it is bad news in that the traditional set of economic ‘tools’ used to extricate ourselves from an economic downturn are largely ineffective. Given that these tools are used to try and return a country to stable growth, and as a result to raise the level of associated government revenues, then their inability to work could impact on the pace at which the revenue side of the fiscal balance will come to government’s aid in assisting with Fiscal Consolidation.

3.5 The other big difference this time round is the uncertainty over the general world economic position. In past cases of severe Fiscal Consolidation, countries have generally benefited from the fact that the downturn is not universal and certainly not long-lived. For example, in the previous worst year, 1982, most countries exhibited reasonable growth

\(^2\) Inflation warnings could clearly be seen in asset prices but not in the RPI/CPI type measures that most countries targeted in relation to monetary policy.
outside of North America and it was followed by around 8 years of above average growth. Equally in the early 90s both the USA and China started above average growth spurts in 1992.

3.6 With the possible exception of China and some of the ‘less-developed’ economies, the current downturn offers no such succour. At present, we still have to ‘hope’ for growth in 2010 and beyond and the level of any such growth is highly uncertain. This means that the lessons from the past, while valid, may not provide us with a complete template for how to deal with the situation this time round.
4 WHAT ARE THE FACTORS THAT SEEM TO DELINEATE ‘SUCCESSFUL’ FISCAL CONSOLIDATIONS FROM UNSUCCESSFUL ONES?

4.1 Since the beginning of the current economic difficulties there has been an increasing interest in the mechanics of Fiscal Consolidations and in the lessons that can be learnt from past examples. In the June 2007 preliminary edition of its Economic Outlook, the OECD published a chapter on “Fiscal Consolidation: Lessons from past experience”, which presented “evidence on the factors that in the past were associated with successful consolidation and with the preservation of these gains”.

4.2 The OECD found that:

- Fiscal Consolidations were larger when the initial situation was difficult; in the past this has tended to mean that the deficits were large and that real interest rates were high;

- Countries with fiscal rules achieved better results. These rules emphasised: transparency over the size of the problem and how it was to be addressed; along with clear targets and how they were to be enforced;

- Putting the emphasis on cutting current expenditures (rather than raising taxes) is associated with successful large Fiscal Consolidations. Despite this evidence on success, most past Fiscal Consolidations involved larger contributions from revenues being raised;

- In particular, expenditure restraint with respect to government consumption and transfers is more likely to generate lasting Fiscal Consolidation and better economic performance. The reason for this is interpreted to be that by addressing these more politically difficult areas, a government is showing how serious it is in its Fiscal Consolidation;

- Most Fiscal Consolidations were short and of limited magnitude, while sizeable Fiscal Consolidations tended to last for long periods, although at a lower “intensity” of effort;

- ‘Success’, in terms of stabilising the debt-GDP ratio, has occurred in around half of the Fiscal Consolidation episodes;

- Backtracking is almost always brought about by a return to increases in expenditure as a share of GDP.

4.3 These lessons have, in general been supported in a number of papers published since then. However, subsequent papers have uncovered some further interesting findings.

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3 Definitions of success and failure vary across studies, but in general terms they are seen to be that (i) fiscal balance is attained and sustained, leading to (ii) a sustained reduction in the level of public sector debt as a share of GDP and (iii) a return, in the short to medium term, to average, or above average, growth in GDP. However, a degree of subjectivity remains over what is seen as successful, often depending on the degree of change and/or longevity of such perceived change.

4 It should be noted that these reports vary somewhat in terms of episodes reviewed due to differences in: geographical coverage, time period coverage and definitions of what constitutes a fiscal contraction and whether they have been successful. As a result the findings can vary report by report, especially in terms of emphasis on the relative importance of
4.4 In April 2008 a European Commission paper highlighted “the factors that determine the success or failure of fiscal adjustment”, concentrating on examples from within the EU. It highlighted:

- On the whole the old strategies for Fiscal Consolidation (as highlighted by the OECD) still work, but…

- The importance of cutting benefits/social security and government wages is downplayed in comparison to previous studies. The latter effect may be due to the selection of countries (EU vs OECD, where the latter non-EU, English speaking countries tend to emphasise wage cuts more). Nevertheless both are still important and reductions in benefits still tends to be the largest single contributor;

- The recipe for a successful Fiscal Consolidation has altered over time with the emphasis on expenditure cuts over revenue rises becoming less important. This may be explained by the fact that past expenditure cuts have reduced the capacity for further cuts to be made. Also, the move to more unsuccessful Fiscal Consolidations following the expenditure led route may be hiding the fact that while ‘weak’ governments are paying lip service to the ‘best way’ they still lack the conviction to make them work;

- Emphasising investment cuts over current expenditure reduces the chances of success, in part due to the ease with which they can be raised once again;

- Where sensitive areas, like government wages, are addressed then Fiscal Consolidations tend to be more gradual;

- It found little evidence, in comparison to previous studies, that coalition governments were less successful (see later for further reference to this subject);

- The importance of political leadership in promoting Fiscal Consolidation and the way consolidation is communicated to the public is also highlighted (see later for more elaboration on this difficult to quantify element), including the willingness to explore fiscal governance and structural reforms.

4.5 In February 2010 the IMF published a paper on “Strategies for Fiscal Consolidation in the Post – Crisis World”. In a section on “Lessons from the Literature”, it reiterated many of the findings from the OECD report but it also found that:

- On revenues, business tax increases that were offset by cuts in other direct taxes improved the success of the adjustment effort (from Alesina and Ardagna, 2009) and that revenue increases can help in the early phases of adjustment;

- ‘Adjustment fatigue’ can lead to longer adjustment periods, increasing the probability of its ending. This point emerges in other literature, however, the evidence is limited on the effectiveness of different approaches to this and on whether cuts should be front or back loaded. The context of how bad the initial situation is and how open and committed the government is, will inevitably impact on any feeling of ‘adjustment fatigue’ and on reactions to it;

different factors in achieving success. Hence, the above is very much a synthesis of these findings rather than a comprehensive coverage of them.
- Fiscal Consolidations that focus on government wages being cut are more likely to expand output.

4.6 Furthermore, the IMF (2010) offers a modern interpretation, based on these findings, of “what policies will deliver the needed fiscal adjustment in advanced economies”:

- Not renewing stimulus measures;

- Fiscal structural reforms which reflect specific country circumstances, in particular (i) where tax burdens are already high that much of the adjustment takes place on the spending side and (ii) population ageing pressures imply reform of entitlement spending;

- Reductions in public spending should be concentrated more on wages and transfers and less on public investment;

- Reforming pension and health entitlements is critical, if not to reduce it as a share of GDP at least to keep any demographics related increase under control;

- Given the difficulty in reducing pension and health spending, as opposed to keeping increases in them under control, then other areas of primary spending will need to be cut back. However, in order to enhance the social and political sustainability of the overall strategy it is important to protect the poor and the unemployed;

- Increased revenue will be part of the solution, through broadening the tax base by fighting tax evasion and reducing exemptions;

- Strong budget institutions which (i) understand the scale of the challenge and clearly report it, (ii) have a clear plan of fiscal objectives (iii) with independent fiscal agencies holding the government to account.

4.7 The survey and précising of recent international work in this area is of great use in understanding what lessons can be learnt from past examples of Fiscal Consolidation. However, it is important to understand that every circumstance leading up to a Fiscal Consolidation is different and every reaction to it is different. For that reason it is necessary to look at individual cases of Fiscal Consolidation in order to understand the specifics better of what a successful Fiscal Consolidation entails, both in terms of government actions and in terms of how these actions translate into changing budgets for public services.
5 CASE STUDIES

5.1 There are many examples of Fiscal Consolidation throughout economic history. In this report we have chosen to concentrate on a few, based on the following criteria:

- State of economic development, so that we look at other advanced economies
- Timeliness, so that the more recent examples are deemed to be more relevant
- Scale, looking at other large scale periods of Fiscal Consolidation

5.2 As a result of applying these criteria we come up with the following case studies:

- UK and Scotland in the early 80s and mid 90s
- Sweden in the 90s
- Finland in the 90s
- Canada in the 90s
- Ireland now

5.3 The remainder of this section looks at: how each country got into trouble; how bad the problem was; what actions they took to rectify matters; and how ‘successful’ these actions were deemed to have been.

5.4 What is more difficult to set out is the impact of cuts on specific public services. To do so would require a much more detailed piece of work. Even then it would be difficult to differentiate between cuts that rested largely on efficiency savings, with little impact on the underlying quality of the service provided, and cuts that had noticeable impact on the quality and/or quantity of service being provided.
The UK (and Scotland) in the 80s and 90s

How did it happen and how bad was it?

5.5 In the lead up to the first episode of Fiscal Consolidation that occurred in the early to mid 1980s the UK was afflicted with a number of problems.

5.6 Relative productivity and GDP per capita had been falling for decades in comparison with most other ‘developed’ economies. This was generally put down to: misdirected state intervention in older industries; ineffective exploitation of new technologies; unreformed and deteriorating industrial relations; poor management; and a highly distortionary tax system. In addition, the UK and world had suffered the oil price shocks of the mid 70s and early 80s and the resulting economic slowdowns.

Figure 1: Total Managed Expenditure (TME) & Public Sector Net Investment as a % of GDP

5.7 Government expenditure (i.e. Total Managed Expenditure) rose to almost 50% of GDP from 1974-75 to 1976-77, with Public Sector Net Borrowing (PSNB) rising to between 5.5 to 7 % of GDP (see Figure 1). The, not unrelated, currency crisis of 1976 led to an emergency loan from the International Monetary Fund (IMF), to which terms were attached that involved immediate spending cuts and tax rises. As a result expenditure fell back to around 45% of GDP until 1979-80 but then rose again as the recession started to impact on falling GDP and rising unemployment related benefits. It was not until 1985-86 that this ratio fell, and by 1988-89 it had been reduced to below 40% of GDP.

5.8 Meanwhile, government revenues as a share of GDP rose to a peak of around 45% between 1981-82 and 1984-85, before steadily declining, along with tax rates, to under 40% by 1989-90 and to around 35% by 1993-94.

5.9 As a result PSNB remained between 4 to 5 % of GDP from 1977-78 to 1980-81 and between 2 to 3.7% of GDP from 1981-82 to 1986-87. The following 4 years saw the
expenditure and revenues roughly in balance, with two years each of a small surplus and a small deficit.

5.10 The second episode of Fiscal Consolidation came soon after, with the PSNB rising to between 4.7 and 7.4% of GDP over the period 1992-93 to 1995-96. The genesis of this fiscal crisis was more in line with the conditions laid out in Section 2: a bust in booming property and share prices, high inflation and interest rates, a world and national downturn.

5.11 However, this time the situation was brought under control much more quickly with the PSNB being falling to under 1% of GDP by 1997-98 and the government’s finances in balance or in surplus for 4 years thereafter.

**What did they do?**

5.12 Both periods of Fiscal Consolidation were dominated by expenditure-based consolidations. In the first phase this was due to the very high level of taxes that already existed. Although within this policy of trying to reduce, or maintain, lowered tax rates there was a shift from direct to indirect taxation. It was also the case that new North Sea hydrocarbon related taxes assisted in the rebalancing.

5.13 In the first episode of Fiscal Consolidation, the largest departments to lose out were Industry (where privatisations reduced subsidies and budgets) and Agriculture, while Health and Defence (via the Falklands conflict) gained in funding. Benefits tended to grow, due to high and continuing unemployment, partially offset by lower and tighter benefit levels and eligibility.

5.14 Public employment fell by more than 12% between 1981 and 1988 as a result of these changes, partly due to the movement of some employment from the public to the private sector via large-scale privatisations.

5.15 In the second phase, in the mid 90s, there were contributions, in terms of falling shares of GDP, from Defence, Transport and Housing in particular (see Figure 2). Tighter eligibility criteria for benefits also reduced the Social Protection budget.

5.16 The path of public sector net investment (i.e. capital spend) is worth looking at over a longer period (see Figure 1). Starting off at 5% or above of GDP between 1967-68 to 1975-76, this fell to between 1 to 2% over 1980-81 to 1985-86, before slumping again to below 1% of GDP from 1986-86 to 1988-89. It recovered to between 1-2% of GDP again from 1989-90 to 1995-96, then returned to under 1% of GDP a year from 96-97 to 2000-01. Thereafter it stood at 1 to 2% of GDP until 2006-07 then rose to 2 to 3% up to 2010-11, from where it is forecast to decline sharply.

5.17 This pattern shows a dramatic decline in investment over the whole period and that despite some partial returns to higher spending as a share of GDP in more prosperous times the advent of spending pressures culminates in investment cuts. While the early days of the first period of Fiscal Consolidation saw public investment holding up, possibly due to the very large cuts already seen in the late 70s, they subsequently fell to record lows in the second half of the 80s. The second period saw government resorting more quickly to investment cuts and the second half of the 90s saw a return to record lows.
In terms of process there were also a number of changes.

5.18 The first period of Fiscal Consolidation saw the introduction of a ‘Medium Term Financial Strategy’, spending caps and the use of ‘cash’ rather than ‘real’ spending limits i.e. not adjusted for inflation. Taxation reform reduced income and corporation tax rates in particular. Monetary targets to reduce inflation were also introduced. Labour market reforms led to less disruption in industrial relations.

5.19 In the second period, the new Labour Government introduced multi year budgets, targets for debt and borrowing limits and the independence of the Bank of England in setting interest rates.

How ‘successful’ was it?

Table 1: UK Key Indicators – all shown as a % of GDP

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<td>Employment ratio</td>
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<td>Transfers &amp; Subsidies</td>
<td>15.4</td>
<td>0.3</td>
<td>16.5</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Source: ECB Working Paper Series No 634
5.20 Government expenditure, as a % of GDP, stood at 51% in 1981 (see Table 1). This fell by 2% points by 1983 and by 10.5% points by 1988. By 1992 it had risen back to 46.5%, subsequently falling by 1.6% points by 1994 and 7% points by 1999.

5.21 Government revenues, as a share of GDP, were 46.3% in 1981 and fell by 5.6% points by 1988. They remained about this level in 1992 but then fell by 2% points to 1994 but were back up to 40.5% by 1999.

5.22 The fiscal balance was -4.4% of GDP in 1981, which improved by 1% point by 1983 and by 4.8% points by 1988. In 1992 the deficit had risen again to 6.5% and had not improved by 1994 but was back in surplus by 1% point by 1999.

5.23 There was a strong and fast rebound in real economic growth in both periods, moving from -1.4% in 1981 to +3.6% (ie, up 5% points) in 1983 and +5% (ie, up 6.4% points) by 1988 (with similar, well above average, rises in between), while in the 1990s it was still slightly positive in 1992, then rose to 4.4% in 1994 and was still over 3% in 1999 (with over 3% p.a. rises in between).
The Scottish Experience

5.24 The general picture over the state of the economy and the fiscal situation for Scotland mirrors that of the UK as a whole. Arguably, Scotland could be seen as being more deeply affected than the UK as a whole in the 1980s due to the reduction or ending of state support for industries like steel and coal mining.

5.25 The Scottish Office had responsibility over the allocation of the Scottish Block pre-devolution and so also over decisions with regards to where any cuts would be applied.

5.26 There is little information available going back to the 1980s’ Fiscal Consolidation. However, with respect to the more recent Fiscal Consolidation, of the mid 90s, we are better served.

5.27 The 1997-98 Departmental Report (of March 1997), sets out spending allocations within the Scottish Block over a 10-year horizon.

5.28 This shows that, as with the UK, Transport and Housing were particularly hard hit. For example, plans for 1999-2000 in comparison to the peak spend year of 1994-95 showed:

- a cut in the roads and transport budget of 35%, and within that a cut in the ‘Motorways and Trunk Roads construction and improvement’ budget of almost 50%;

- a cut in ‘Scottish Homes Grant-in-aid’ (the major component of the housing budget) of over 25%;

5.29 This suggests a similar pattern to the UK where capital related transport and housing budgets took a share of the cuts that was well above the average.

Current Scottish Government Budget

Capital Vs Revenue

5.30 The most recent Scottish Government’s budget was originally established in 2007, at a time when expectations were for continued growth in public sector revenues and expenditures. The speed and depth of this most recent recession encouraged an acceleration in the capital programme into both 2008-09 and 2009-10. This took total capital spending in 2009-10 to over 12% of the overall budget, reversing some of the decline in its share since 2006-07, when capital investment amounted to over 16.5% of Scottish Total Managed Expenditure (TME)5.

5.31 Scotland has been spending more of its TME on capital compared to the UK as a whole (although due to differences in composition the two are not directly comparable). The recent capital acceleration means the 2010-11 budget allocation now favours revenue spending over capital (see Figure 3). The UK Chancellor has indicated that there will be a severe decline in the proportion of the UK’s future budgets that will be allocated to investment. If the Scottish Government follows suit, this will mean capital investment in Scotland is unlikely to reach the 2009-10 levels for some years to come.

5 The 2006-07 draft budget included a reclassification of the Scottish Government’s budget making early year comparisons invalid (see the earlier CPPR paper on the Scottish Government’s draft budget 2010 for more on its capital spend intentions over time, www.cppr.ac.uk/media/media_133555_en.pdf).
Budget winners and losers

5.32 As Table 2 confirms, the biggest winner in the most recent budget is Scotland’s health services with £96 million more in real terms compared to its 2009-10 budget whereas, the main losers were in those areas that conventionally support economic growth such as housing, regeneration, transport and enterprise, energy and tourism.

Table 2: Scottish Budget – Selected Winners & Losers, £ million (2009-10 prices)

<table>
<thead>
<tr>
<th></th>
<th>2009-10</th>
<th>2010-11</th>
<th>Change £m</th>
<th>Change %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing &amp; Regeneration</td>
<td>701</td>
<td>441</td>
<td>-260</td>
<td>-37.1%</td>
</tr>
<tr>
<td>Health Capital Investment</td>
<td>679</td>
<td>566</td>
<td>-113</td>
<td>-17.0%</td>
</tr>
<tr>
<td>Transport</td>
<td>1,907</td>
<td>1,782</td>
<td>-125</td>
<td>-6.6%</td>
</tr>
<tr>
<td>Enterprise, Energy &amp; Tourism</td>
<td>522</td>
<td>451</td>
<td>-71</td>
<td>-13.6%</td>
</tr>
<tr>
<td>Scottish Water &amp; Climate change</td>
<td>364</td>
<td>346</td>
<td>-23</td>
<td>-6.2%</td>
</tr>
<tr>
<td>Other Lifelong Learning</td>
<td>277</td>
<td>266</td>
<td>-11</td>
<td>-4.1%</td>
</tr>
<tr>
<td>Schools</td>
<td>136</td>
<td>131</td>
<td>-5</td>
<td>-3.4%</td>
</tr>
<tr>
<td>Total Health</td>
<td>11,084</td>
<td>11,180</td>
<td>96</td>
<td>0.9%</td>
</tr>
<tr>
<td>Environmental Protection &amp; Sustainable Development</td>
<td>85</td>
<td>94</td>
<td>9</td>
<td>11.2%</td>
</tr>
<tr>
<td>Third Sector &amp; Social Enterprise</td>
<td>33</td>
<td>35</td>
<td>2.5</td>
<td>7.6%</td>
</tr>
<tr>
<td>Total Equalities &amp; Inclusion</td>
<td>26</td>
<td>27</td>
<td>1</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

Source: CPPR, 2009
Revenue raising options

5.33 In deciding how to fund its spending priorities, the Scottish Government may now wish to reassess the level and degree to which it utilises the revenue raising powers available to it, in order to provide a buffer against any UK Barnett reductions.

- The Scottish Variable Rate Income Tax allows the Scottish Parliament to vary the basic rate of income tax by plus or minus 3p. The value of this varies year to year but HMT estimate a 1p change would amount to £400 million in 2011-12;

- Ending the council tax freeze, which has applied for the last 3 years, could allow local authorities to raise more income. This amounted to just under £2 billion in 2009-10;

- Business Rates raise a further £2 billion per annum. The willingness to raise more from this source may be somewhat tempered if private sector growth is viewed as an essential requirement to help counter any negative impact coming Scotland’s way as a consequence of the public sector budget cuts;

- User charges at both a national and local government level add additional, albeit smaller, incomes streams to support government spending plans. Some of these have been declining in recent years due to conscious policy changes eg, reduced prescription charges and abolished bridge tolls, whilst other have fallen because of the recession eg, planning fees and the sale of assets.

5.34 As the Scottish Government’s budget rose over the last 10 years, the ability to introduce universal provision on a number of spending areas was made easier. Taking these benefits away again will not be a politically simple task.

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6 See HM Treasury Budget 2010, Annex A
Sweden (1993-2000)

How did it happen and how bad was it?

5.35 Sweden first suffered a rapid upturn in its fiscal deficit and public debt in the late 70s and early 80s. This led to near trebling of public debt as a % of GDP between 1978 and 1985, rising to near 70% of GDP. As a result, fiscal consolidation started in 1982, initially based on a tax increase strategy with real expenditure not starting to decrease until the mid 80s. This led to a fall in the debt-GDP ratio to under 50% by 1990. However, after 4 years of decreases, real expenditure started to rise in 1989.

5.36 This backsliding in the consolidation process scenario was compounded in the early 90s by economic problems which led to 3 consecutive years of negative growth, starting in 1990. These economic problems were brought about by the bursting of a real estate and financial bubble, which had been driven by a rapid increase in lending, and which also coincided with an international economic slowdown. During this phase there was a run on the Swedish currency which pushed up interest rates (at one point to a notional 500%!). As a result of all these problems, the debt:GDP ratio rose from under 50% in 1990 to 80% in 1995.

5.37 Some fiscal reforms emerged in 1992-93, however, a stronger period of fiscal consolidation occurred in 1994, when a centre-right coalition was replaced by a minority Social Democrat Party government, elected on a manifesto of tough cuts.

What did they do?

5.38 Fiscal consolidation reforms started in earnest in 1993 and were further boosted in 1994. These combined tax increases with public expenditure cuts, but unlike the 1980s were more heavily weighted, especially in the early years, to expenditure cuts. Overall though, the contribution of each side was roughly the same.

5.39 The Consolidation Programme of 1994 was designed according to 3 basic principles: it was to take effect swiftly; its distribution should mean that those with high incomes contributed most; and priority (i.e. some degree of protection) was to be given to education, health and social services over transfers to households. Furthermore ‘investment’ which promoted future growth should also be protected.

5.40 All of these principles were adhered to (for example the richest 20% contributed 43% of budget reinforcements while the poorest 20% contributed 11%), although cuts in education, health and investment (as a % of GDP) all contributed to some extent.

5.41 The main expenditure cuts were to transfers and subsidies, particularly with respect to pensions, social security and public employment.

5.42 State transfers to municipalities were frozen at the nominal 1994 level until 2000 along with a ban on local government borrowing.

5.43 Tax rates, in particular with respect to income (via increased national insurance contributions) and capital, were increased substantially.
5.44 There were significant changes to the budget process, including the introduction of a top down process, multi-year nominal terms expenditure ceilings, medium term targets and the use of ‘carry over’ budgets.

5.45 As a result, the standing of the Minister of Finance and the position of the minority government were seen to be strengthened and the tradition of pro-spending budgetary agreements with the opposition discontinued. Budgetary control became shared between the government and the budgetary committee in Parliament.

5.46 Budgetary retrenchment was put on a legal foundation and the EU’s Maastricht Convergence criteria surveillance process came into effect. This meant that the government’s fiscal goals were supervised by an external body and exposed to greater peer pressure. In addition, a fiscal policy council was introduced to independently evaluate the government’s fiscal policy.

*Other important aspects of the consolidation*

5.47 As Sweden has a decentralised system of government it was up to each authority to figure out how to fulfil service obligations while still achieving the required spending cuts. A good degree of co-operation and transparency was required for this.

5.48 An efficiency factor, based on productivity in the private-service sector (average productivity growth of white collar workers in this sector over the last ten years) was built in to future budgets, which public agencies had to match. For 2010 this productivity deduction amounts to 1.5%.

*How ‘successful’ was it?*

**Table 3: Sweden Key Indicators - all shown as a % of GDP**

<table>
<thead>
<tr>
<th></th>
<th>Phase 1 1993</th>
<th>Change from 1993</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>1993-95</td>
<td>1993-2000</td>
</tr>
<tr>
<td>Total Government revenue</td>
<td>61.6</td>
<td>-0.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Total Government expenditure</td>
<td>73.0</td>
<td>-5.2</td>
<td>-15.7</td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>-11.4</td>
<td>4.4</td>
<td>16.5</td>
</tr>
<tr>
<td>Public debt</td>
<td>71.3</td>
<td>2.4</td>
<td>-18.4</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>-2.0</td>
<td>6.0</td>
<td>6.3</td>
</tr>
<tr>
<td>Inflation (CPI growth %)</td>
<td>4.7</td>
<td>-2.3</td>
<td>-3.8</td>
</tr>
<tr>
<td>Employment ratio</td>
<td>73.2</td>
<td>-0.3</td>
<td>1.4</td>
</tr>
<tr>
<td>Education</td>
<td>7.6</td>
<td>-0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Health</td>
<td>7.5</td>
<td>-0.4</td>
<td>-0.4</td>
</tr>
<tr>
<td>Transfers &amp; Subsidies</td>
<td>27.1</td>
<td>-2.8</td>
<td>-8.0</td>
</tr>
</tbody>
</table>

*Source: ECB Working Paper Series No 634*

5.49 Government expenditure as a % of GDP stood at 73% in 1993. This fell by 5% points by 1995 and by 16% points by 2000 (see Table3).

5.50 Government revenues remained flat at about 61-62% over the same period but this hid rises in taxes being offset by lower economic activity.\(^7\)

\(^7\) It is important to understand the difference between the impact that tax rises make to rebalancing, as opposed to expenditure cuts, and the change in their shares as a % of GDP. In the former case a government budget will calculate the relative impact of changes to the tax system, which could be large. However, in terms of its impact on tax as a % of GDP any such increase will be offset by lower economic activity thus reducing tax revenues. It can also be affected in later years.
5.51 The fiscal balance was -11.4% of GDP in 1993, which improved by 4.4% points by 1995 and by 16.5% points by 2000.

5.52 There was a strong and fast rebound in real economic growth, moving from -2% in 1993 to +4% (ie, up 6% points) in 1995 and slightly above that rate in 2000 (the intervening years were generally not as good but still fairly strong). This was in part helped by the improvement in the international economic situation and by the rapid growth of IT which Sweden benefited from.

Other issues

5.53 Sweden experienced (a) significant depreciation of the krona, (b) undertook a privatisation programme and (c) encouraged labour market liberalisation.

5.54 Although their electoral position was weakened the Social Democrat Party remained in power until 2006.

Personal reflections from Sweden

| There have been a number of personal reflections outlining the lessons to be learnt from the Swedish experience from the 1990s. The following is a synthesis of three of these taken from the current Minister of Finance (Anders Borg), the previous Finance and Prime Minister (Goran Persson) and a senior adviser at the Ministry of Finance (Jens Henriksson). |
| All three writers agree with a number of key lessons: |
| The electorate must understand that drastic measures are required |
| - sound public finances are a prerequisite for growth |
| - being heavily in debt constrains economic policy freedom |
| - politicians need to commit themselves to resolving the problem i.e. put their jobs on the line |
| The consolidation programme needs to be a firm and comprehensive package |
| - set goals and stick to them |
| - act structurally i.e. try to protect capital investment, education and health services |
| - strengthen fiscal institutions |
| - use both tax increases and expenditure cuts |
| - front load the program of cuts and start with the most difficult ones |
| - maintain social cohesion by sharing the burden fairly, with the wealthiest contributing the most |
| - do not simply hand the problem on to local authorities |
| Be transparent and consistent |
| - be honest to citizens and to financial markets |
| - avoid over optimism and create credibility by delivering on targets |
| - stick to one message, that this will be difficult and will hurt |
| - stick with consolidation, even once things start to improve |

Underlying many of these points is the need for strong political leadership in portraying the issue as the most salient problem facing the country.

Henriksson sums up the lessons learnt as showing (i) why it is important to get your public finances in order (ii) genuine commitment, (iii) the nuts and bolts of a consolidation programme, (iv) how to
communicate during consolidation and, (v) how to avoid getting back in trouble.
Canada (1992-1999)

How did it happen and how bad was it?

5.55 Canada’s fiscal position deteriorated throughout most of the 80s and into the 90s, and was brought about in large part by the mounting cost of implementing social reforms of earlier decades that resulted in better state pensions, healthcare and unemployment insurance. Such increases were built upon the assumption of the maintenance of strong productivity growth seen in previous decades. This deterioration in its fiscal balance was in spite of repeated political efforts to address the situation.

5.56 In 1984 a new government made specific cuts and tried again the following year, but these were undermined by public opposition and by a faltering economy. Again in 1989 the further deterioration of the fiscal balance led to new measures to restrain it and in the 1990 budget an ‘Expenditure Control Plan’ was introduced but this was again challenged by the severe downturn in the economy starting in 1990 (the start of 3 poor years but only in 1991 was economic growth negative).

5.57 Only after the election in 1993 of a new government (led by Jean Chretien of the Liberal Party), who were strongly committed to lowering the deficit, did the situation start to improve. This was aided by a public mood, which had shifted to recognising the urgency of reducing the deficit.

What did they do?

5.58 The government were very open in their intentions in order to generate public understanding of the actions required.

5.59 Due to the strong federal nature of Canadian government, different parts could respond in different ways, although central direction and budget ceilings were important.

5.60 Unlike previous, more balanced, retrenchments, this time the burden was placed heavily on the side of reduced expenditure. The main cuts were to government consumption, in particular to employees. As a share of GDP, compensation of employees fell by 25% in 7 years.

5.61 Transfers, in particular in relation to unemployment insurance, and subsidies (often by privatisations or transfer of functions to freestanding agencies), were severely cut back.

5.62 The largest cuts (94-95 to 97-98) of over 50% were to Regional Agencies, Industry and Transport. Health and education, although protected to some extent, both experienced significant cuts, especially the latter.

5.63 On taxes, some governments reduced their revenue-GDP ratio while others raised it. Most provinces raised it, Nova Scotia for example introduced an income tax surcharge; higher and more broadly based provincial sales tax and a higher gasoline tax, all in 1993.

In terms of process:

5.64 A hard budget constraint was introduced and a Programme Review used to comprehensively assess the role of government. The review had many new features and was
headed by a special ‘Minister Responsible for Public Service Renewal’ and reported to a special Cabinet Committee.

5.65 It was based on 6 criteria:

- Does the programme serve a public interest?
- Is this an appropriate role for the government?
- Could this be done better by another level of government?
- Could this be left to the private or voluntary sectors?
- Could the programme be delivered more efficiently?
- Is it affordable?

5.66 These, now famous, criteria, can seem fairly generic and unexceptional. However, it was the respect they were given and the seriousness with which they were applied that led to them being successful.

5.67 In addition to these 6 criteria, two-year rolling fiscal objectives were introduced and prudent economic assumptions were used throughout to ensure targets were met and to guard against unbelievably optimistic future scenarios being developed.

**How 'successful' was it?**

<table>
<thead>
<tr>
<th>Table 4: Canada Key Indicators - all shown as a % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Phase 1</strong></td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td>Total Government revenue</td>
</tr>
<tr>
<td>Total Government expenditure</td>
</tr>
<tr>
<td>Fiscal balance</td>
</tr>
<tr>
<td>Public debt</td>
</tr>
<tr>
<td>Real GDP growth</td>
</tr>
<tr>
<td>Inflation (CPI growth %)</td>
</tr>
<tr>
<td>Employment ratio</td>
</tr>
<tr>
<td>Education</td>
</tr>
<tr>
<td>Health</td>
</tr>
<tr>
<td>Transfers &amp; Subsidies</td>
</tr>
</tbody>
</table>

*Source: ECB Working Paper Series No 634*

5.68 Government expenditure as a % of GDP stood at 53% in 1992. This fell by 3.5% points by 1994 and by over 11% points by 1999 (see Table 4).

5.69 Government revenues stood at 45% of GDP in 1992 and fell initially by over 1% point.

5.70 The fiscal balance was -9.3% of GDP in 1992, which improved by 2.5% points by 1994 and by almost 11% points by 1999. After 27 consecutive years of deficits, Canada experienced over a decade of fiscal surpluses.
5.71 There was a rebound in real economic growth, moving from 1% in 1992 to almost 5% in 1994 and just above that in 1999 (the intervening years were not as good but still fairly strong).

5.72 Canadian authorities cite 3 key reasons for the success of the Programme Review: the crisis atmosphere; the realisation that across the board cuts were inappropriate; and the change in process by which the review was carried out.

Other issues

5.73 The Liberal Party won the following 3 general elections.
Finland (1993-2000)

How did it happen and how bad was it?

5.74 Finland’s fiscal position deteriorated as a result of the ending of its late 80s bubble economy and the disruption of trade with the Soviet Union/Russia. The bubble had arisen from financial market deregulation, which led to excessive private consumption via borrowing and to asset and house prices rocketing (real house prices rose by 50% from 1985 to 1989). After the crash, stock market prices collapsed by 70% and house prices by 50%.

5.75 In addition, social reforms in the late 80s were introduced which were underpinned by overly optimistic assumptions on the trend rate of growth.

5.76 GDP fell for 3 years from 1990-93, by a cumulative 13%. Despite this the 1990 proposals for the 1991 budget were for fiscal expansion.

5.77 Public and political opposition to expenditure cuts remained until a new (centre-right coalition) government was elected in 1991. However, even then savings often still failed to be passed in Parliament, as they required a two-thirds majority. 1992 became a crisis year with financial markets exerting strong pressure for reforms. Even by 1993 the budget proposal was met by a threat of a general strike. The election in 1995 of a new “rainbow” government affirmed the government’s commitment to fiscal consolidation and reform.

What did they do?

5.78 Rolling reforms were introduced from 1992, mainly through a series of expenditure reduction programmes. In contrast to Canada, spending reductions were more across the board than specifically targeted.

5.79 On the expenditure side, these affected compensation of public sector employees and transfers and subsidies. (It should be remembered that in the case of federal states like Finland such transfers incorporate budgets for services like health and education.)

5.80 On employment, contractual pay increases were frozen for 4 years from 1991 and the next settlement in 1995, up to 1999, was contracted on condition it would not imply any increase in budget spending. In addition, staff numbers fell dramatically, although this was caused in part by transfers out due to the privatisation of many public bodies in the 90s.

5.81 Unemployment and other such benefits and subsidies (e.g. to housing, agriculture and industry) were cut back, through reductions in the level and tightening of eligibility. Pensions were also reformed.

5.82 Spending on education and health both fell significantly, by 2000 both down by 20% of their 1993 share of GDP. In contrast R&D spend was deliberately protected and indeed continued to grow.

5.83 Expenditure cuts dominated the retrenchment and any taxation system changes were subservient to them in achieving fiscal soundness. Nevertheless labour taxes were raised, 1992-95, via employers’ contributions rising. In later years, faster economic growth allowed taxes on labour to be cut by 2% of GDP, between 1995-99.

5.84 Reforms to budgetary process saw:
- More emphasis put on multi year budgets

- A shift in the transfers system to local government to a new lump sum subsidy system that was seen as giving strong incentives for cost efficiency over the earlier cost based system that incorporated retrospective reimbursements

- A move to a simple majority to pass budget changes

5.85 Although the Maastricht treaty imposed exterior supervision on Finland, the self-set national goals were aimed at even stricter rebalancing of public finances.

**How ‘successful’ was it?**

**Table 5: Finland Key Indicators - all shown as a % of GDP**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Government revenue</td>
<td>57.4</td>
<td>-1.7</td>
<td>-1.3</td>
<td></td>
</tr>
<tr>
<td>Total Government expenditure</td>
<td>64.8</td>
<td>-5.1</td>
<td>-15.7</td>
<td></td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>-7.3</td>
<td>3.4</td>
<td>14.4</td>
<td></td>
</tr>
<tr>
<td>Public debt</td>
<td>56.4</td>
<td>0.7</td>
<td>-11.8</td>
<td></td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>-1.2</td>
<td>4.7</td>
<td>6.2</td>
<td></td>
</tr>
<tr>
<td>Inflation (CPI growth %)</td>
<td>2.2</td>
<td>-1.4</td>
<td>0.9</td>
<td></td>
</tr>
<tr>
<td>Employment ratio</td>
<td>60.2</td>
<td>0.1</td>
<td>6.2</td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>7.8</td>
<td>-0.7</td>
<td>-1.8</td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td>6.3</td>
<td>-0.7</td>
<td>-1.3</td>
<td></td>
</tr>
<tr>
<td>Transfers &amp; Subsidies</td>
<td>27.4</td>
<td>-2.5</td>
<td>-9.4</td>
<td></td>
</tr>
</tbody>
</table>

*Source: ECB Working Paper Series No 634*

5.86 Government expenditure as a % of GDP stood at 65% in 1993. This fell by 5% points by 1995 and by over 15% points by 2000 (see Table 5).

5.87 Government revenues stood at 57.4% of GDP in 1993 and fell initially by over 1% point, remaining lower by over 1% point of GDP by 2000.

5.88 The fiscal balance was -7.3% of GDP in 1993, which improved by 3.4% points by 1995 and by 14.4% points by 2000.

5.89 There was a rebound in real economic growth, moving from 3 years of contraction and -1.2% in 1993 to 3.5% (ie, up 4.7% points) in 1995 and 5% in 2000 (the intervening years were equally as strong). The Finnish recovery was helped by the upturn in IT and by the high IT-related R&D funding that had been maintained.

**Other issues**

5.90 There was a considerable devaluation (30%) of the Finnish markka from its 1992 peak level.

5.91 There were considerable reforms in the banking sector and labour market.

5.92 Despite the cuts to health and education:
- Finnish education has consistently topped the OECD’s league table of educational standards.

- Finnish life expectancy grew quickly throughout the 90s, (rising by 2.7 years, above the OECD average and much faster than most other EU countries e.g. the UK rose by 2.2 years) as earlier preventative issues offset any deterioration in service (eating habits and physical activities both improved). Nevertheless, some strong concerns have been expressed over the impact of the Health cuts on the quality of service.

How bad was it and what did they do?

5.93 The Irish story begins in the 1980s when an attempt at fiscal consolidation was first made. This reform was brought about by concerns over low growth, high unemployment and widening fiscal deficits (see Table 6). The 1982-84 strategy, which mixed expenditure cuts with tax rises, was not enough to stop debt levels rising and in 1987 a ‘Programme for National Recovery’ was introduced which was based on deep rooted expenditure reform. As a result, public employment declined by 14% between 1982 and 1989 and subsidies were cut by two-thirds in 1988 alone. Spending on health and pensions was reduced considerably, and user fees for universities and hospitals were established.

5.94 A second reform phase started in 1994, principally expenditure based.

5.95 Phase one involved a radical strengthening of the position of the Minister of Finance and virtually unconditional Parliamentary support, following the ‘Tallaght Strategy’ of 1987 (a commitment by the main opposition party not to oppose the government when appropriate fiscal action was being taken). Phase two was underpinned by the continuation of a series of fiscal contracts between governing coalitions and beyond.

5.96 In the early 80s taxes were raised, indeed revenues as a % of GDP were actually 2.5% of GDP higher in 1984 over 1982. Thereafter tax movements were, in general, down rather than up, in order to improve incentives, further emphasising the role of expenditure cuts in bearing the adjustment burden. There were very significant cuts in corporation tax and income tax rates. As the economy boomed this in turn allowed further tax reductions to be permissible.

How ‘successful’ was it?

Table 6: Ireland Key Indicators - all shown as a % of GDP

<table>
<thead>
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<tbody>
<tr>
<td>Total revenue</td>
<td>41.9</td>
<td>2.5</td>
<td>-1.6</td>
<td>42.4</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>56.2</td>
<td>-1.6</td>
<td>-13.3</td>
<td>45.3</td>
</tr>
<tr>
<td>Fiscal balance</td>
<td>-15.2</td>
<td>4.4</td>
<td>12.5</td>
<td>-3.0</td>
</tr>
<tr>
<td>Public debt</td>
<td>84.6</td>
<td>14.1</td>
<td>15.7</td>
<td>92.5</td>
</tr>
<tr>
<td>Real GDP growth</td>
<td>2.3</td>
<td>2.1</td>
<td>3.9</td>
<td>3.3</td>
</tr>
<tr>
<td>Inflation (CPI growth %)</td>
<td>17.2</td>
<td>-8.6</td>
<td>-13.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Employment ratio</td>
<td>57.8</td>
<td>-3.4</td>
<td>-5.0</td>
<td>53.0</td>
</tr>
<tr>
<td>Education</td>
<td>5.8</td>
<td>-0.3</td>
<td>-0.9</td>
<td>5.22</td>
</tr>
<tr>
<td>Health</td>
<td>6.3</td>
<td>-0.4</td>
<td>-1.7</td>
<td>5.04</td>
</tr>
<tr>
<td>Transfers &amp; Subsidies</td>
<td>15.7</td>
<td>1.1</td>
<td>-2.2</td>
<td>14.1</td>
</tr>
</tbody>
</table>

Source: ECB Working Paper Series No 634

5.97 The success of these reforms is the phenomenon known as the ‘Celtic Tiger’, with strong growth rates in GDP from 1987 until the current downturn. At its peak, growth of real terms GDP rose above 9% a year from 1995 to 2000. It was this performance that helped spark the academic debate on the possible expansionary effects of fiscal contractions, as opposed to the, conventional, contractionary effects.
The current situation

5.98 The current problems have their origins in the same causes outlined in section 3. However, in Ireland the housing boom to bust cycle was exceptional and this in turn impacted heavily on the banking system. As a result, the position of the economy and the fiscal balance deteriorated very rapidly, (GNP output per head in 2010 is around the level it was in 2001), and to such an extent that no real fiscal stimulus package was deemed viable. The Irish government moved straight into fiscal consolidation mode.

5.99 Starting with the 2009 Budget of late 2008, this consolidation consisted initially of large increases in revenues via income and health levies and rises in VAT and capital gains tax rates. This was followed in the 2010 Budget (of 2009) with an adjustment which concentrated on reducing expenditure. In the light of work done by the new An Bord Snip (see below), it is expected that future adjustments will also be biased towards expenditure cuts. This bias towards expenditure cuts is reinforced by a reference in the Irish Pre Budget Report of 2009 to international evidence that “consolidation driven by cuts in expenditure is more successful than consolidation based on tax increases”.

5.100 The report of the ‘Special Group on Public Service Numbers and Expenditure Programmes’, (more commonly known as the new An Bord Snip, after a similar body set up in 1987 to recommend cuts in state spending) published in July 2009, identified a wide range of savings options which were taken into account in the context of the 2010 Budget. The report, in two volumes, recommended approaches to a potential €5.3bn in savings, including for 17,300 public service job cuts.

5.101 These proposals for cuts were made on the back of cash terms budget increases over the period 2003-2009 of: +59% for Education; +77% for Health and Children; and +96% for Social Welfare.

5.102 As part of these increases, public service employment had risen by almost 40% for both Education and Health Services, 2000-2008 (i.e. up by 26,000 and 30,000 respectively). It was no great surprise then that the largest cuts recommended, in absolute terms, were in the areas of Health, Education and Social Welfare

5.103 Recent events have led, between 2007 and 2010*, to:

- GDP/GNP falling by over 10/15%
- Unemployment rising from 4.6% to 13.75%
- Fiscal balance moving from a surplus of 0.2% of GDP to a deficit of 11.5%
- Government debt deteriorating from 25% of GDP to 78%.

5.104 It is impossible to tell at present what effect the current Fiscal Consolidation will have in the long run on either the current deficit or on future growth. With a very open, export driven, economy Ireland is heavily dependent on a worldwide recovery in trade.

5.105 In terms of process and co-operation, Ireland has repeated some of the positive lessons it learned in past consolidation episodes. It has been transparent in its workings and has led an open debate in public on the depth of the problem and how to confront it. It has

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8 source: ESRI Quarterly Economic Commentary, Winter 2009
also engaged with external experts (via An Bord Snip) in trying to make the difficult and unpopular decisions over spending cuts. However, it has not yet reached the sort of cross party and cross social support that was an essential part of past successes.
6 LESSONS TO BE LEARNT FROM PAST FISCAL CONSOLIDATIONS

6.1 The UK is at the start of a period of inevitable deep Fiscal Consolidation. The Treasury highlight this through their long term projections for government revenues and expenditure. These will need to be brought back into balance in coming years and this fiscal balance, or surplus, sustained for some considerable period of time beyond in order to reduce the UK’s debt:GDP ratio (currently forecast by H.M. Treasury to peak at 75% of GDP in 2013-14) to somewhere within the ‘acceptable’ range of 40-60%.

6.2 The Scottish Government, with its limited powers, has no such fiscal balance to restore or debt position to reduce. However, as part of the UK it will contribute to this period of consolidation through the Barnett Formula’s impact on reducing public expenditure funds available through the Scottish Block Grant. Recent estimates are that such a consolidation might amount to a real terms reduction of around 12% by 2013-14 over the peak spending year of 2009-10.

6.3 As a result, many of the difficult decisions to be made with respect to Fiscal Consolidation will lie with the Scottish Government and Parliament. Many of the lessons outlined in Sections 4 and 5 therefore apply to Scotland.

6.4 But first it is worthwhile looking at lessons that need to be learnt by national governments with full powers, i.e. that apply at the UK level and which, presumably, are some of those lessons reducted in H. M. Treasury’s own study of other examples of deep fiscal contraction.

- Sticking to transparent fiscal rules and to targets that are not overly optimistic will (re)gain confidence in the government’s ability and determination to take appropriate action.

- Increases in taxes are likely to play less of a role than cuts in expenditure but will play some role. These tax rises should not to be growth inhibiting, nor should they exacerbate inequalities in society. However, achieving both these desired results while raising taxes is not straightforward and it may be that disincentives for those on higher incomes are, at least temporarily introduced.

- Cuts in subsidies and in transfers, which come largely from central government, are often disproportionately large contributors to rebalancing.

- Currency depreciation can improve competitiveness and assist export led recovery, should other countries’ consumption rates recover.

6.5 Lessons that will apply to both UK and devolved levels of government within the UK include:

- The importance of leadership in framing the debate and in enhancing understanding of the difficult choices to be made. However, this ‘leadership’ can take different forms. It can come from the government and political leader of the day. It can come from cross-party (or wider) support of ‘crisis’ decisions. It can also come from forces

9 H.M. Treasury’s “International examples of spending consolidations”, (September 2009), also looked at what lessons could be learnt from the literature and from case studies. However, when the relevant powerpoint presentation was made publicly available, via a Freedom of Information request, all such lessons were redacted from the published document. Unfortunately, therefore, we are unable to compare findings in this paper with those from the Treasury’s analysis.
outside of politics, like the IMF or the EU or from bodies like An Bord Snip. In this last respect the Scottish Government and Parliament can be said to have responded positively with the setting up of an Independent Budget Review to conduct a review of public expenditure in Scotland, which is due to report back on practical options by end July 2010.

- The need for openness in allowing all interested parties and citizens to be fully aware of the depth of the problems and of the options for repairing the damage. A lack of transparency can affect belief in the commitment of the government to take on board difficult changes, and therefore confidence in general.

- The role of changes in process, including accountability to external bodies, the setting of targets and the influence of specific Ministers and Committees. Other process elements, like setting multi-year budgets and budgets with strict ceilings set in cash terms have already been introduced in the UK.

- An emphasis on expenditure cuts over tax rises. If the majority of the rebalancing comes from expenditure cuts at the UK level, that will feed through to Scotland via the Barnett formula.

- All areas of expenditure should be open to scrutiny for savings. As Ireland and Finland, for example, have shown, areas like health and education have received very large increases in funding in years leading up to the fiscal crisis and there are no obvious reasons to exempt them from some degree of cuts, especially as the corollary of this would be even higher cuts in the remaining public services. Education, in particular, has often contributed substantially to overall consolidations.

- Expenditure on capital investment should not be especially targeted for cuts, although it may need to fall as a share of GDP. In previous UK and Scottish downturns capital investment has suffered disproportionately and the current UK profile for future investment spend suggests that this approach is being repeated. However, the Scottish government has the power to decide its own level of cuts in this area.

- While transfers and subsidies are principally UK determined there are a range of subsidies in Scotland that exist. From health (e.g. free eye tests) to transport (free bus passes) to higher education (subsidised fees) decisions could be made which allow for savings in these areas. While these decisions might overturn policy introduced post devolution, this would not be different to some of the recent decisions made in Ireland, which reversed decisions made when the budget was in a healthier state. In order to avoid increasing the pressure on vulnerable, low income citizens, these changes might involve a move away from universal provision of such benefits to more targeted, based on income, provision.

- Equally, most taxes are the responsibility, at present, of the UK government. However, significant sums are raised via the council tax and non domestic rates and some degree of the Scottish Fiscal Consolidation might be expected to come from these being raised. In addition, the ability to increase revenues through the use of the Parliaments tax raising powers, with respect to the basic rate of income tax, is another potential source of revenue.

- Decisions made over large elements of the budget, like the level of compensation of employees (wages), will be important in terms of both the overall split of cuts
between capital and current spend and the trade off between the level of pay and the number of jobs.

- Decisions now on areas of spending like long term care and pensions, which face rising future pressures, will be important in avoiding backtracking into fiscal problems further down the line.

**Some other points of interest in relation to the findings in this paper are:**

- Some of the actions taken in previous Fiscal Consolidations are no longer, or at least less, relevant. For example, throughout the 80s and 90s there was a strong move towards privatisation of previously publicly owned bodies and industries, which reduced subsidies and gained revenues from asset sales. It could be argued that there is considerably less scope for such moves now, or even that they may be reversed in some cases.

- Equally, the reduction in social benefits from reduced levels and tighter eligibility has been a common thread through the 80s and 90s in times of Fiscal Consolidation and the scope for further tightening may be constrained.

- Both of 1 and 2, emphasise the probability that funding of public services (particularly those under the direction of the Scottish Parliament) is likely to be the primary source of upcoming UK expenditure cuts.

- In addition, and as discussed earlier, the depth and width of the economic downturn make it very uncertain the degree to which increasing revenues from recovery in GDP will contribute to a narrowing of the fiscal gap and so more likely that expenditure levels will remain low for longer.

- The issue of whether or not it is more difficult to achieve successful Fiscal Consolidations without a parliamentary majority has been much discussed in the lead up to the next UK general election. The case studies show that some of the strongest Fiscal Consolidation’s were undertaken under coalition governments. This finding is reinforced by a piece of research by the House of Commons library which showed that 7 of the 10 largest fiscal consolidations in OECD member countries since 1970 were undertaken by coalition or minority governments.
7 FOCUSSING ON THE VULNERABLE

7.1 To assist the Equal Opportunities Committee in their assessment of what the recession might mean for Scotland’s most vulnerable, the following summarises what responses appear to be most effective in helping to support those at risk.

7.2 While there is often much concern expressed over the impacts of deep Fiscal Consolidations on the poorest in society there is little research that looks directly at how this has affected those who might be classed as vulnerable. While economic models can estimate the impact of tax and benefit changes on different sections of society, it is much more difficult to calculate the relative impact of cuts to public services. Furthermore, these more knowable tax and benefit impacts are very much in the remit of the UK rather than the Scottish Parliament and so the impact of any changes in Scottish spending is particularly difficult to discern.

7.3 The sparsity of research evidence in this area may be due to difficulties in collecting consistent international data on such sub-sets of the population, as well as the uncertainty over what constitutes the ‘vulnerable’ section(s) of society (for example, whether to concentrate on those most vulnerable to economic poverty or on those with existing physical or mental conditions that may make them especially ‘vulnerable’ to public service cuts).

7.4 As a result, the evidence that we have collected relies heavily on what has been happening in English local authorities, whilst the international perspective is limited to the Irish An Bord Snip’s budget cutting recommendations.

The impact of recession on the UK labour market

7.5 In assessing the effects of the 1990-91 recession on English local communities (ie, post-code sectors with working-age populations of c4,500) the Joseph Rowntree Foundation (JRF) found that while unemployment was greatest amongst those in the manufacturing sector it was also concentrated in communities where unemployment was already high. Not surprisingly perhaps, those areas where public sector employment was greatest had greatest immunity from these recessionary effects. Even as the economy started to grow, high unemployment neighbourhoods remained disadvantaged.

7.6 The Audit Commission’s (2009) study of the impact of the current recession on communities in England indicates that the greatest job losses have been in manufacturing, but distribution and hospitality and, finance and business services have also been hit hard. In contrast, employment in both the health and education sectors increased. In the period June 2008 to 2009, unskilled workers made up half of all new Job Seekers Allowance (JSA) claimants but only 25% of the workforce. Finally, the areas worst affected were those that already had the weakest economies, with many still to recover fully from the last recession.

7.7 Recessions usually involve not only increased levels of unemployment but also a reduction in the number of hours worked; during the first 3 quarters of the 1980s and the 1990s total actual hours worked fell 2.5% and 2.8% respectively, depressing household incomes even further.

7.8 Financial services contributed greatly to the current recession but the finance and business services sector was a major contributor to growth in both employment and GDP throughout the last 30 years; in 1981, finance and business services accounted for around 11% of UK jobs and by 2008 this figure was over 20% (see ONS, 2009). In this latest
recession this sector is now contracting and it is not yet clear which, if any, sector(s) will be growing fast enough to fill any associated employment gap. The likelihood of a swift increase in what historically has been relatively well-paid employment seems low.

7.9 ONS analysis of the recessionary effects on the labour market supports the emerging picture of a slow return to pre-recession unemployment levels. After the 1980s recession, unemployment did not return to its pre-recession position until the onset of the next recession (ie, in the early 1990s). Following this second recessionary period, it took from the re-emergence of growth in late 1991 until the beginning of 1997 before unemployment levels returned to their pre-recession positions.

7.10 Finally, the current recession appears to having greatest impact on the low-skilled workers alongside process, plant and machinery operatives. These two cohorts have experienced the largest increases in unemployment since 2008. Skill trades and salespersons are following close behind but the expected reduction in employment for the skilled-university educated, that might be more closely linked to financial services jobs, has not been as great.

7.11 The younger workers coming to the jobs market for the first time just as the recession started also appear to have been disproportionately affected. Unemployment for the 18-24-year old workers has been growing faster than that for those in the 25-49 or 50+ age groups.

The impact of recession on living standards

7.12 Real earnings growth has generally been negative during the first two quarters of a recession, before returning to positive growth as falling inflation compensates for low wage increases. This trend appears to have continued in the first three quarters of this recession. Unit wage costs and output per worker in past recessions have responded quickly to upturns in output and fits in with the pattern of slower falls of unemployment as firms make use of any spare capacity once the economy begins to grow.

7.13 The Institute for Fiscal Studies indicates that in at least the last two recessions unemployment did not rise until the 2nd year of the downturn and so the full impact on living standards was not felt for several quarters after the start of both recessions. The IFS also present evidence to support the view that the costs of any downturn are disproportionately borne by active participants that are in low-skilled, low paid jobs and less so for those receiving fixed-income benefits associated, for example with retirement.

7.14 Average household incomes fall in real terms during recessions but this is not felt uniformly across all household types. Those less dependent on the labour market (eg, pensioners and lone parents) have benefited from relatively higher incomes during period of low economic growth. However, single people without children and couples with or without children face greater variations in their income levels.

7.15 In previous recessions, those educated beyond age 21 benefited from flat or even slightly rising income levels whereas, those who left education earlier saw incomes stagnating or falling. The IFS also points out that income inequalities rose markedly in the 1980s and have remained historically high. Moreover, whilst relative poverty remained broadly the same both for children and working-age adults without dependent children, indicators of absolute poverty did still increase during previous recessions.
The impact of recession on communities

7.16 The JRF assessment of the impact of the recession on disadvantaged communities (in England) confirms, not surprisingly perhaps, that tenants in rented accommodation (both social as well as and private rented) were most likely to experience higher JSA claims either because, it suggests, those affected were in more insecure employment or because had fewer qualifications making them more vulnerable to job cuts.

7.17 The 1990-91 recession was housing-market related and it took 7 years before this sector was back to it pre-collapse levels. Since then the development of social-rented properties has been greatly supported through collaborations with private builders. However, by late 2008, new building planning applications have fallen dramatically and the renegotiations or cancellation of public-private house-building arrangements have become common. Demand for social housing grows in recessions but with less funding available to support new build programmes, the speed at which such demand might be met is further reduced.

7.18 By late 2008 JRF found that almost three-quarters of all English LAs believed local voluntary organisations had seen an increase in the demand for services such as debt counselling, housing advice, employment advice and relationship counselling. This appears at odds with a number of LAs also looking to reduce contributions to voluntary organisations.

7.19 The Audit Commission found that most LAs were increasing their support to individuals and this was taking various forms including: the provision of advice on benefits and debt; changing policies on council tax or rent payments; and providing support for credit unions. They were also working closely with other unemployment and training service providers including Jobcentre Plus, learning and skills councils and relevant third sector bodies to provide a more joined-up service for people needing help.

7.20 In England, the Homes and Communities Agency (the national housing and regeneration agency for England) has responded to stimulate the housing market both for housing association support but also by providing funding for local authorities to deliver new council housing, something the Scottish Government has sought to do with its capital acceleration programme.

7.21 Perhaps more worryingly, the Audit Commission’s survey saw limited preparation for the possible increasing social impact of the recession. It was accepted by most LAs that the full social cost of the recession was yet to be felt. Those that were planning were actively working with primary care trusts to identify increasing reports of depression, or with the police to identify recession-related crime. Others, it noted, were developing preventative schemes, for example, enabling GPs to prescribe financial advice to patients with debt-related stress.

Role for Local Government

7.22 The implementation of policy changes during any period of Fiscal Consolidation will inevitable involve Local Authorities, as they are responsible for delivering many of the services that will be affected. This is particularly true of the services that many ‘vulnerable’ citizens rely on, for example, in terms of social care services.
7.23 Unfortunately, the likely upward impact of the recession on the demand for some public services, combined with anticipated budget cuts, can also result in local government experiencing conflicting pressures. For example, the JRF reported that by mid 2009 more than 20% of English local authorities had made compulsory redundancies and one-third had voluntary redundancy or job freeze schemes in place. This has the effect of not only increasing unemployment but has a serious impact on service provision (ie, service cuts were likely) across the community. The Audit Commission (AC) confirmed that freeing up internal resources to help balance the books will increase the likelihood of a negative impact on the local economy.

7.24 To help minimise these negative effects, particularly on those more vulnerable members of the community, both the JRF and the AC offer suggestions that local authorities should at least consider:

- Minimise employment cutbacks wherever possible
- Maintain recent public and private investment in order to protect the physical fabric of the community
- Maintain local housing and property development activities
- Maintain and expand local job creation
- Maintain and expand services for young (under 25) people
- Maintain and expand public and semi-public transport
- Maintain and expand crime prevention activities
- Consult on difficult issues
- Monitor the impact of actions
- Encourage partnership working (ie, between LA and health bodies or Job Centre Plus)

7.25 However, many of these recommendations will clash with the overall objective of managing on a smaller budget.

7.26 To maximise the potential from any actions, it stressed there were serious barriers to effective action needed to be removed including: a lack of good data on and an understanding of the local economy; what types of economic activity are likely to drive recovery; and what evidence exists of the types of social and economic intervention that are likely to be most effective.

7.27 Gordon, Travers and Whitehead (2008) argue that the most positive and appropriate role for LAs in a recession is to:

- “concentrate on incentivising the private sector (even if it means more short term support) [and] avoid area discrimination (ie, “shield” people and assets, rather than protecting places)”.
7.28 The AC also highlighted the vital need for strategic and financial planning in times of recession. This should include: planning for long-term recovery; planning to prevent social problems from rising or inequalities widening as the recession deepens; and planning for other changes (eg, how to accommodate greater numbers of children moving from private to state schools).

7.29 All levels of government also need to provide leadership and to encourage debate around how budgets will be prioritised and additional demands met; will this be done through improving efficiency of service provision, will demand be controlled by changing eligibility criteria or, if not a statutory service, will services be stopped or charged at full cost?

Recent Irish experience – the An Bord Snip Review

7.30 In responding to the downturn in Ireland, the Irish Government turned to an independent special group – An Bord Snip - whose aim was to assess all options and priorities open to the Government to allow it to cut its budget deficit by 2011.

Its key objective was:

- To review the scope for reducing or discontinuing Expenditure Programmes with a view to eliminating the current budget deficit by 2011.

7.31 As the earlier chapter on the Irish experience indicates, recommended cuts were substantial in order to help achieve the overall economic objective. Few if any spending areas have been spared.

As a result:

- The Department of Social & Family Affairs (S&FA) saw its budget cut by 9% or by €1.84 billion. This department helps citizens and families access all eligible benefits and supports, enables active participation and promotes social inclusion.

- The Enterprise Trade and Employment department had a 12% budget cut, a fall of €238 million.

- The Community budget was halved, a fall of over €80 million.

7.32 A large proportion of the Irish budget pays for wages, pensions and welfare benefits. With a rise in the demand for the latter inevitable as the impact of the recession is felt, to achieve the targeted budget deficit cut means benefits will need to be even more targeted and the levels provided even less generous.

7.33 In addition to the short-term budget cuts, the Bord also highlight the need to have a review of structures across the public sector as a means of reducing staff costs and administrative burdens. Eliminating duplication was a key element of this strategic review, in particular at the local level, where mergers between local delivery bodies are viewed as essential not only to delivering much needed efficiency savings but also to improving the services for users.

7.34 Improving the quality of performance monitoring was also seen as a key factor in ensuring scarce resources are used efficiently and effectively. Cost benefit analysis, value for
money audits, post implementation evaluations, sunset clauses, alongside clear business cases, were all viewed as vital management tools that should be applied, at least in part, to help decide future budget allocations.

For example, it suggests:

“All capital projects above €30m should be subject to a ‘look-back’ evaluation within a reasonable period of their entry into use to check realised costs and benefits as against the original CBA projections.”

“Every proposed new spending programme should be accompanied by a Public Service Performance Charter, which sets out clearly the business case for the programme, the resources that will be required and output / impact indicators that can be used to measure success or failure of the programme. The Annual Output Statement should be subject to independent audit / verification by the Comptroller & Auditor General [C&AG] in respect of the outputs actually delivered in the previous year; the efficiency and effectiveness of delivery; and the quality and measurability of the outputs selected for the year ahead. This initiative would also facilitate the Dáil Committees in the exercise of their independent role in holding Government expenditure up to scrutiny.”

Conclusion

7.35 The available evidence on the direct impact of recessions on vulnerable groups in society is limited.

7.36 The forthcoming budget reductions look likely to be deep and last for some time to come. Consequently, it seems unlikely that many, if any, budget areas will remain unaffected and all will have to accommodate some cuts in spending. The Equal Opportunities Committee could usefully take a leaf out of the An Bord Snip’s book and

- ask the Scottish Government for the evidence that supports its budget intentions and;

- seek assurances from the Scottish Government’s that what is currently being spent on Equal Opportunities is both efficient and effective.
8 CONCLUSIONS AND RECOMMENDATIONS FOR THE SCOTTISH PARLIAMENT

8.1 This report has attempted to set out some of the lessons learnt from past examples of severe Fiscal Consolidations.

8.2 In some cases these lessons will be most relevant to the UK government, with its wider responsibilities for economic and public finance issues. However, many of the most important lessons can be seen as relevant to all levels of government and particularly for the Scottish Government with its wide responsibility for most public service spending.

8.3 However, before deliberating further on these issues it is worth reminding ourselves over some of the limitations of the lessons to be learnt.

8.4 In particular, this exercise has not compared a set of identical, or even particularly similar, examples in Fiscal Consolidation. The case studies illustrate how every situation is different. Some of the contributing factors may repeat themselves but the country by country circumstances within which these factors apply will also be important. Such differences can range through: type of economic system in place; economic structure; the nature of the underlying fiscal imbalance; political system; etc, and each factor can have an impact on what policies need to be implemented and on how effective those policies might be. Thus, there is no ‘formula’ or recipe for success that needs to be followed.

8.5 Furthermore, the degree to which one country has been more successful than another is difficult to discern. Judgements can be made on the ‘success’ of returning to fiscal balance or in reducing debt levels, but much less so on the degree to which this has impacted on faster future growth or on the ‘damage’ done to services as a result of the decisions made over where any cuts should take place.

8.6 Each government needs to decide for itself the best route to returning growth and which services it wants to prioritise within current budget limits.

8.7 All that said, and it is quite a lot, some clear ‘good practice’ measures do emerge from an analysis of the literature in this field of study. These measures are the most relevant for the Scottish Parliament to reflect on when considering what action to take in the coming months and years.

Leadership

8.8 The issue of leadership is important, in order to make the unpalatable seem inevitable. Decisions may be unpopular but they can still be recognised as necessary. Strong leadership can set out the reasons for such a course of action and engage with the public on how best to achieve change. By doing so, the population recognises that there will be some losers and becomes a part of the process in deciding who they should be. This can allow for greater acceptance of radical change and of less likelihood of damaging industrial or social unrest.

8.9 However, such a course of action is dependent on information being freely available and openly discussed. If the population or the markets feel that information is being distorted or concealed then trust over the reasons for change and the options being proposed can be badly harmed.
8.10 In addition to the Government and Head of Government showing leadership, cross party support and the use of external sources of discipline can increase both public understanding and acceptance, as well as increasing the chances of success and reducing the risk of backsliding.

Choice

8.11 Two areas of consideration in particular need to be closely examined in this field, although there is no definitive advice on what course of action should be preferred in either case.

Universal Vs Targeted provision

8.12 The first concerns the question of whether to provide universal or targeted benefits, which is a more pressing issue in times of reduced funds. The answer will depend on society’s preferences, but the policy impacts will inevitably differ in terms of scope and scale, dependent on whether they are used in a universal or targeted manner. A fixed sum can provide a small across-the-board coverage or it can provide in depth support for a small minority. Equally, the answer to this question might be thought to vary benefit by benefit.

8.13 However, greater targeting, or the introduction of more income-dependent variable rates of benefits can act as a tool to protect the most economically vulnerable.

Capital Vs Revenue cuts

8.14 The second area concerns the degree to which current or capital spend should be identified as carrying a disproportionate share of the burden. Again, the answer will depend partly on values, as well as on the perceived state of capital-related infrastructure. However, in general most governments either intentionally protect investment (e.g. Finland) or inadvertently target it (e.g. the UK). The political advantages of the latter course is that it is less contentious, as it tends to be unrealised future jobs that are most affected. The downside is that necessary investment that could increase the pace of growth in the recovery phase is at best delayed.

8.15 Currently the UK government has targeted a relatively large cut in capital spend, although to be offset to some unknown degree by asset sales. This follows a short period (2007-08 to 2010-11) when public sector net investment (PSNI) was above 2% of GDP, but prior to that there was two decades where it was below 2% of GDP. By way of comparison, PSNI in the late 1960s and throughout the 1970s averaged about 5% of GDP. The Scottish Government has its own choice to make on whether to follow the UK’s course of action, as the Barnett formula allows for funds to be shifted from current spend to capital spend (although not the other way around).

Further choices

8.16 To assist in the further choices that need to be made, both across services and within budget lines, the current position would be improved by a greater understanding not only of what is being spent but also what this spending is aiming to deliver.

8.17 A key issue when considering what to cut is an understanding of the degree of efficiency being shown within existing budgets. This might be done in absolute terms, perhaps by looking at changes in productivity over time, or, in relative terms, by comparing
Scotland to other systems, either within the UK or outside of it, or by comparing regions within Scotland. Such analysis could provide a very useful source for identifying potential areas of good practice and of spend that might be pared back without impacting on overall quality. While greater efforts have been made at the UK level (although often just for England) to collect this information e.g. by ONS on public services productivity and by the NAO, very little such data or analysis is yet available for Scotland.

8.18 To this extent we are flying blind in terms of making ‘smart’ decisions. While eventually a decision needs to be made on budget priorities across services based on political choice, to some extent these decisions can be affected by our understanding of what is currently being delivered. Much more work needs to be done in this area, as soon as possible, to allow for values and knowledge to combine most effectively in making budget choices.

8.19 In general, this last, information based, point is further addressed in the following ‘good practice’ area of Process.

Process

8.20 Many of the Fiscal Consolidation exercises undertaken in recent decades have spent considerable time and effort addressing budgetary process arrangements that have, over time, become less effective. Such an effort might also prove valuable in the case of Scotland.

8.21 Since 1999, the Scottish Government has experienced a budget growing in real terms by an average of over 5% a year. Alongside such largesse there has been little effort made in understanding how efficiently this money has been spent.

8.22 The political strength of the Minister for Finance and their Department needs to be reassessed, along with the resources available within the Department. This should be done with an eye to both: assessing whether the political strength exists that means the Finance Minister/Department has the necessary authority to enforce funding decisions based on collective policy priorities; and that it has the tools and staff to properly assess the efficiency of services and the likely impact of spending decisions. There is little evidence, post devolution, that either of these capacities has been satisfactorily developed in an environment of rapidly rising budgets. In general, the challenge function with regards to budgets and policy choices, both internally and externally (with regards to academia, the press or think tanks) appears to be under-developed.

8.23 Such process weaknesses are in contrast to other aspects of process and enquiry which are well developed along recommended international lines. That is, that the Parliament has a robust budget process with considerable scrutiny by Committees and debate and, via the UK system, looks at the budget across a number of years and with access to between year flexibility. However, such positive aspects are undermined by a lack of basic information, in terms of both data and its analysis, on (relative) performance.
Other issues

8.24 Two other issues are worth mentioning in addition to the three areas already discussed.

Wages

8.25 The first is wages. This item accounts for over 50% of the Scottish Governments budget and future settlement levels will be important in terms of minimising non-wage cuts as well as redundancies. Already in Ireland we have seen relatively large scale cuts in real-terms take home pay across the public sector. There is no doubt that this eases the pressure on rebalancing the public sector’s books.

8.26 It can also serve as a message that the government has the situation under control and that there is widespread public acknowledgement that such a severe rebalancing is needed. As such it can serve to dampen internal (social) and external (financial) pressures that might lead to further disruption.

8.27 An asymmetric public wage policy, favouring the lower paid, can also assist in reducing the negative impacts of the economic downturn and fiscal contraction on the most vulnerable in society.

Demographics

8.28 The second issue is the importance of long-term pressures. These pressures relate principally to demographic changes that will emerge over the next 10-20 years, putting strong pressure on the funding of services like Health, Pensions and Long-term care.

8.29 Decisions made in the next few years on how these services are to be paid for and the role of the state in their provision will have knock on effects for many years to come. The country examples from Section 5 showed how overly generous or badly constructed policies can, over time, exert pressure on public expenditure and end up with a public sector fiscal crisis. As far as is possible, decisions on these issues should be based on thorough analysis and, ideally, cross party support. The alternative is more likely than not to lead to unaffordable options whose costs are ratcheted up as political parties end up indulging in a bidding war over who will offer the most.

Independent scrutiny

8.30 Academic researchers and their models can play a useful role in providing costed options and the involvement of bodies like the Scottish Government’s Council of Economic Advisers can help in assessing the relative merits and viability of these options.

Conclusion

8.31 The coming years will be a difficult time in Scottish politics. A Parliament that has not been used to real-terms cuts in budgets, but rather to relatively large year on year increases, now faces one of the most severe fiscal contractions in modern history. There is some doubt as to whether the Government and the civil service is currently structured and staffed in such a way as to effectively deal with this downturn.
8.32 Furthermore, not only will this cut in funds be relatively severe in the short term but it will also be long lasting, in that post 2013-14 any return to growth in the Scottish Government’s budget is likely to be modest, well below those rates seen in the first decade of devolution.

8.33 There will be a change in decision making, moving from a choice being made over what budget increases to implement across services to one of what budget cuts to impose. This can be a difficult psychological shift for participants to make. But a rapid acceptance of its inevitability is necessary in order to begin the process of widening the understanding amongst the population of the difficult choices that need to be made.

8.34 In this environment it can be useful to look back at past, similar, exercises of Fiscal Consolidation and times of disruptive change. This can allow us not only to learn the lessons that remain pertinent from those times but also to remind ourselves that it is possible to undertake these changes and at the same time bounce back relatively quickly in terms of revived economic growth alongside stable public sector finances.
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