

Budgetary Consolidation and Structural Reforms in Europe: Track Record and Prospects

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Good afternoon. Let me thank the Parliament of Lithuania for organizing this important conference and for inviting me to make this presentation.

Our topic today is budgetary consolidation and structural reforms in Europe. **Both rank high on Europe's economic policy agenda**: consolidation is key to restoring fiscal sustainability and, in some countries, market access; whereas structural reforms are urgently needed to reignite the stalled European growth engine.

Both fiscal consolidation and structural reforms are important. **But does this mean they should proceed simultaneously and at the same pace?** I would like to argue today that the answer to this question depends on the type of structural reforms:

- Regarding **reforms of the fiscal framework itself**, consolidation and reforms complement each other and could be pursued in parallel.
- For **reforms outside the fiscal area**, the story may be different. It can be argued that fiscal consolidation could be more gradual in countries that adopt ambitious labor or product market reforms.

I will now elaborate on these two points.

1. Structural Reforms in the Fiscal Area

Let me start with structural reforms in the fiscal area: by this I mean, reforms of the fiscal framework, or the institutions that underpin the design and implementation of a given fiscal policy. As member of the Fiscal Affairs Department of the IMF, this is a topic of particular importance to me.

Experience shows that successful fiscal adjustments—those that are durable and sizeable—are generally supported by well-designed fiscal institutions. **Three types of institutions** are particularly important:

- First, successful adjustments are those based on **credible multi-year plans**. Parliaments should adopt medium-term budget frameworks that are sufficiently detailed and binding. Too often consolidation packages are designed without proper consideration of their long-term implications.

- Second, successful consolidations incorporate measures that are “sustainable”—measures that are embedded in a **comprehensive fiscal strategy** based on regular expenditure reviews and on the necessary tax reforms. Quick fixes do not do the job; they are often rejected by the populations once the crisis subsides.
- Third, successful adjustments often rely on **fiscal rules**. This is an area where the Fiscal Affairs Department of the IMF has done a lot of work. Our recent research shows that national fiscal rules can play an important role in ensuring that initial consolidation plans are actually implemented and not abandoned along the road.

So, without reforms of the fiscal framework, consolidations are likely to be short-lived and unable to achieve a substantial reduction in public debt. Reforms of the fiscal framework are unlikely to be sufficient for success, but they clearly help.

2. Reforms in Labor and Product Markets

Let me now turn to the second type of structural reforms: those in labor and product markets. Recently there has been a debate on whether **fiscal consolidation and structural reforms are substitutes or complements**. Clearly, the two concepts are related. Structural reforms raise potential output, improving long-term public debt dynamics. And fiscal consolidation reduces public debt, eliminating one of the impediments to higher potential growth.

However, I think **the debate on substitutability vs complementarity is poorly formulated**:

- Consolidation and reforms are not strictly speaking “substitutes,” as their primary objectives are different. Take a loss in competitiveness reflected in a loss of export market share for instance: fiscal consolidation is not the best instrument to address this problem.
- At the same time, consolidation and reforms are not necessarily “complements.” Some reforms, for example, may have large budgetary costs, and they could jeopardize fiscal consolidation. Look at labor market reforms; they may temporarily raise unemployment and increase public expenditure on social protection. Price liberalization may also have a fiscal cost by reducing tax revenues.

I think that a more relevant question is to ask whether there are, in some instances, **trade-offs** between consolidation and structural reforms. And if that is the case, **would it be better for countries to adopt a slower pace of fiscal adjustment if they implement structural reforms at the same time?** You may remember that this was one of the main points of discussion during the **2005 reform of the Stability and Growth Pact**. At that time, some flexibility was introduced in the fiscal rule framework to accommodate the cost of structural reforms. This is still a very relevant topic today.

What does the **experience of past fiscal adjustments** tell us about this trade-off? IMF research **shows that you rarely observe reforms and consolidation *at the same time***. Structural reforms are generally successfully implemented in countries with healthy initial fiscal positions or countries that implement fiscal stimulus. Conversely, fiscal consolidation tends to coexist with a slower pace of structural reforms.

How can we explain that consolidation and reforms rarely co-exist? Let me venture the following **three explanations**:

- **First, political capital is limited.** All of you know of the “Juncker curse:” governments that are too ambitious in terms of reforms are not reelected. For this reason, it may be recommendable to pace fiscal adjustment in countries that already implement large structural reforms.
- **Second, some structural reforms have large budgetary costs.** These costs can be direct, such as funding a public R&D program. But there are also indirect costs—in particular the cost of compensating the losers. All these costs make it more difficult to simultaneously reform and consolidate.
- **Third, structural reforms tend to yield less benefits when the economy is weak.** For instance, when demand is depressed, relaxing employment protection may not stimulate job creation. Or increasing the retirement age may just raise the number of unemployed. For this reason, the European Department of the IMF has generally recommended that structural reforms be complemented by policies to boost aggregate demand. In the current circumstances, this means that the fiscal consolidation should be more gradual, to the extent possible, in the presence of structural reforms.

This accommodation may not always be possible. In some countries, market pressures may require a quick and large narrowing of the budget deficit. This could make structural reforms more difficult to implement, even though they are clearly necessary to raise potential growth and facilitate the recovery.

Let me now conclude. My previous comments suggest that the term “structural reforms” is a bit of a **catch-all concept**. Therefore, we need to be more specific. If we refer to fiscal institution reforms, I would say without hesitation that structural reforms and consolidation could proceed in parallel. If by structural reforms, we mean reforms in labor and product markets, some sequencing may be warranted, if financing allows, in particular in countries with weak demand or where reforms have large budgetary costs. Thank you.