KPMG

GOVERNMENT

Meeting the Deficit Challenge

Strategies for Fiscal Sustainability

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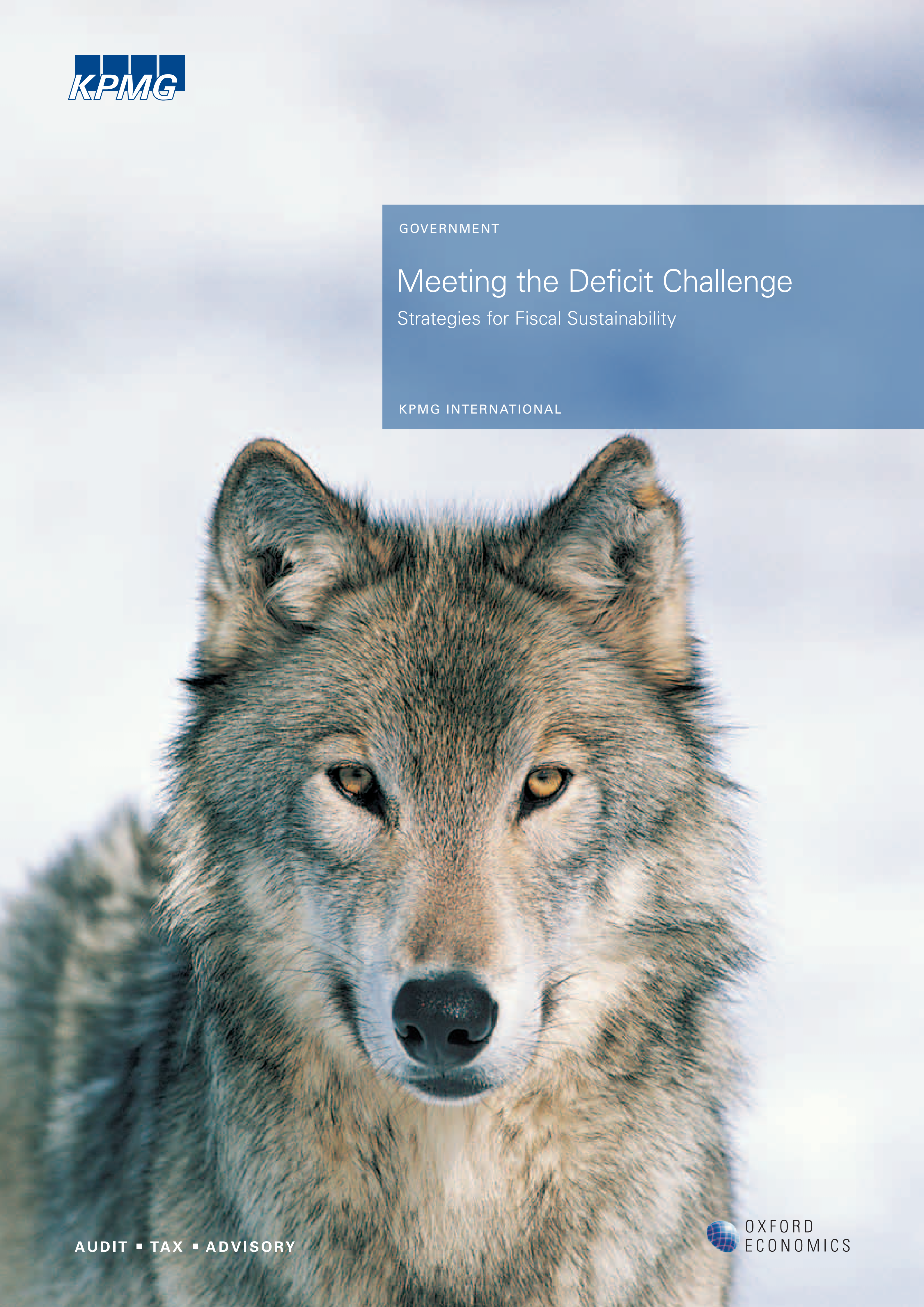

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OXFORD ECONOMICS

Contents

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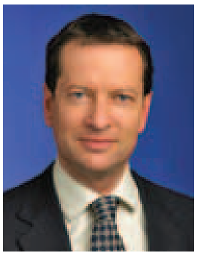

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Foreword

It is time for governments to address the challenge of high debt and budget deficits. The need to prepare for future spending commitments to manage demographic changes, clean energy/climate change goals and required infrastructure investments make meeting these fiscal challenges all the more difficult — and critical. Governments should develop detailed deficit recovery strategies and plans for ongoing fiscal sustainability. Now is the time to act to meet that challenge.

The objective of this report is to examine approaches and discuss options for deficit reduction, and to review strategies for ongoing fiscal sustainability. Our goal is to add to the conversation as our public sector peers evaluate their options, build their strategy and potentially re-engineer their sector. We draw on international data from previous experiences of fiscal adjustment, economic research, insights from KPMG partners and directors around the world, as well as interviews with senior academics and public sector leaders in the US, UK, Germany, Canada and Spain.

Meeting the Challenge: Strategies for Fiscal Sustainability is the third and follow-on report to *Tough Choices Ahead: The Future of the Public Sector*, and *The Wolf is at the Door* publications. These previous reports were based on insights from a survey of public sector leaders around the world, along with detailed in-depth interviews. This follow-up research looks at the options facing public sector leaders as they build strategies for fiscal sustainability.

Executive summary

The need for detailed deficit recovery strategies in the industrialized economies has become a pressing one. Increasing concerns in financial markets about debt sustainability, the risks to growth from high debt and deficits, and the need to prepare for future spending commitments, all point to the need for action.

Background

- In 2009 the average deficit/GDP ratio exceeded 10 percent in the G7 economies, and the average debt/GDP ratio exceeded 100 percent. These are levels that may put at risk significant long-term growth prospects.
- Moreover, large age-related spending increases in the decades ahead, combined with the need to spend significant amounts to upgrade infrastructure, add further to the pressure for fiscal change.

This Report

- Seeks to examine approaches to deficit reduction and highlight the challenges. It draws on international evidence from previous experiences of fiscal adjustment, economic research, insights from KPMG partners and directors, and interviews with senior academics and public sector leaders in the US, UK, Germany, Canada and Spain.

Key Findings

- Although the scale of deficit recovery necessary is large, it is not unprecedented. Countries like Denmark, Sweden, Ireland and Canada have achieved very large fiscal turnarounds in recent years — without major damage to economic growth. However, conditions for deficit recovery may be more challenging this time around, given that a large number of countries are attempting to deal with deficits at the same time and the global growth backdrop is more uncertain.

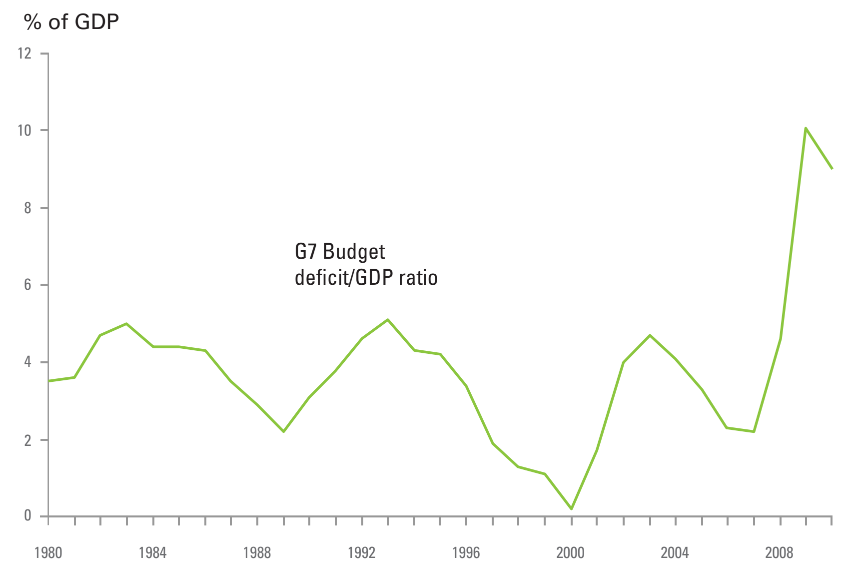
- Examination of historical budget consolidation efforts suggests that strategies based on spending cuts, especially cuts to current spending, tend to be more successful than those centered on tax increases. Decisive, front-loaded efforts are also more likely to succeed than gradual ones.
- Some tax increases nevertheless look inevitable, but these can be structured in a way to minimize the risks to growth.
- 'Conventional' tax and spending measures may be insufficient to meet the challenge of deficit recovery, especially over the long-term. Governments may need to consider radically re-engineering the scope and scale of their activities. This might include:
  - Reforms to drive up productivity growth in public services
  - Extending private involvement 'deeper into the heart of government'
  - Privatization of infrastructure and other key assets
- 'Fiscal rules' which aim to bind governments into responsible behavior provide a possible approach to preventing deficit problems from recurring, but their record to date is mixed.
- The 'right' approach to fiscal adjustment could be hard to sell, politically. It may require an atmosphere of crisis to allow major cuts to government payrolls or transfers and pensions.
- Building the necessary support for fiscal change will require different approaches in different countries, depending on their social and political structures. Historical experience suggests deficit reduction efforts can succeed under a variety of political dispositions, implying that outlining clear goals and following through on them is a critical factor.

The deficit challenge

This report reviews options for deficit reduction and strategies for achievement of fiscal sustainability. Drawing on lessons from previous fiscal retrenchments and economic research, it identifies the key elements for successful and sustained deficit reduction. Given the scale of adjustment needed, it also suggests an agenda for a re-engineering of government, drawing on insights from a number of roundtables and in-depth interviews with experts in the US, UK, Germany, Canada and Spain. This first section sets out the deficit recovery challenge, and is followed by sections looking at lessons from past fiscal turnarounds, options to be considered for structuring deficit recovery strategies and the re-engineering of government.

Many of the industrialized countries[1] currently face a major challenge of potential fiscal adjustment to reverse the huge expansion in budget deficits that has resulted from the global financial crisis and recession. In 2009, the average budget deficit in the G7 countries reached 10 percent of GDP — five times higher than in 2007 — and it is expected to remain close to that in 2010 (see chart 1). And government debt exceeded 100 percent of GDP on average across the G7 countries in 2009 (see chart 2). Against this background, the recent G20 summit meeting featured a commitment by the participating countries to halve budget deficits over three years.

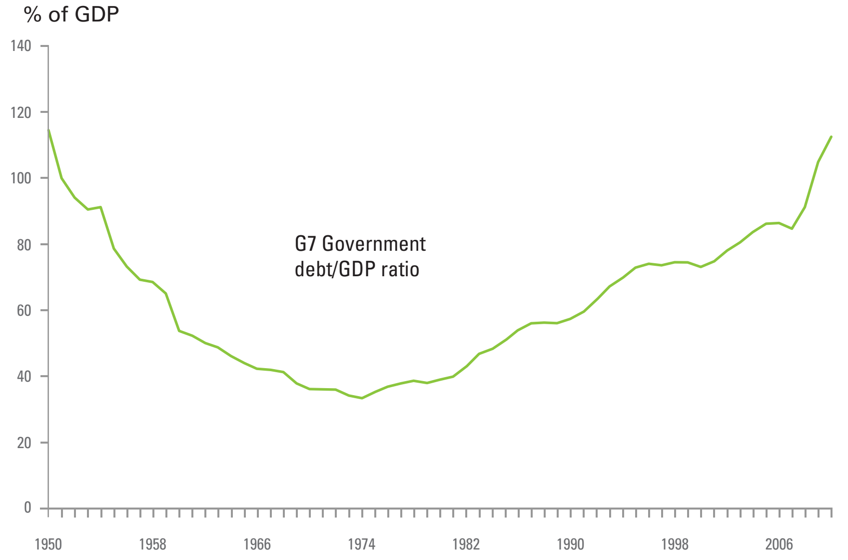
Chart 1: G7 Budget deficit



Source: Oxford Economics/Haver Analytics

[1]The term 'industrialized economies' in this report refers to the US, Canada, Australia, the west European economies and Japan

Chart 2: G7 Government debt ratio



Source: Oxford Economics/Haver Analytics

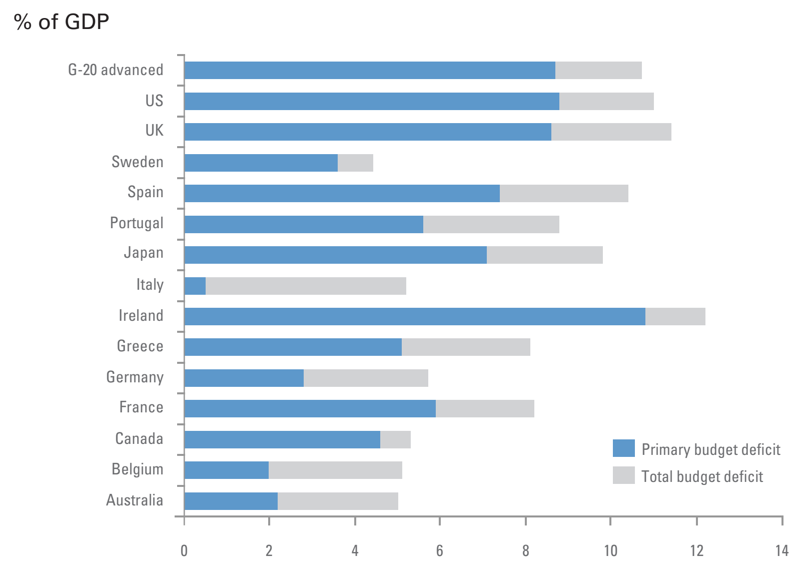
Widening deficits resulted in part from government stimulus efforts in the face of weakening growth and the cost of financial sector support. But compelling strategies to achieve deficit recovery without undermining the recovery are a priority because the conclusion of stimulus packages and a return to economic growth will not be sufficient to restore the public finances. The average structural primary deficit (i.e. adjusted for the effects of the economic cycle and netting out interest costs) is expected by the International Monetary Fund (IMF) to be over five percent of GDP in the G7 this year[2], with especially large deficits in the US, Japan and the UK (see chart 3). The Bank for International Settlements (BIS) estimates suggest that, on unchanged policies, debt/GDP ratios could rise to 150 – 200 percent of GDP in the G7 countries over the next 10 years, and over 300 percent in Japan.[3]

[2]IMF 'The State of Public Finances Cross-Country Fiscal Monitor: November 2009' *IMF Staff Position Note*, November 2009
[3]Cecchetti, S, Mohanty, M & Zampolli, F 'The Future of public debt: prospects and implications' BIS Working Papers No. 300, 2010

Further rises in debt levels pose considerable risks in the broader political and socio-economic landscape, as clearly demonstrated by the fiscal crisis in the Eurozone. Rising costs of financing government debt not only exacerbate the fiscal challenge facing governments, they also have adverse impacts on economic growth. It is particularly worrying that an increasing number of industrialized economies now have government debt over or approaching the 90 percent of GDP threshold, beyond which research by Reinhart and Rogoff suggests there is a risk of a marked downward effect on GDP growth.[4]

To reduce the debt/GDP ratio to 60 percent by 2030, the IMF estimates the G20 countries would, on average, need to improve their structural primary budget balances by over nine percent of GDP from 2010 – 20 and then maintain this improvement for a further decade. Even just stabilizing the debt/GDP ratio at the 2014 projected level — which is still expected to be very high in many cases — would require an improvement in the budget balance of over four percent of GDP.[5]

Chart 3: World Budget deficit 2010F — GDP by country

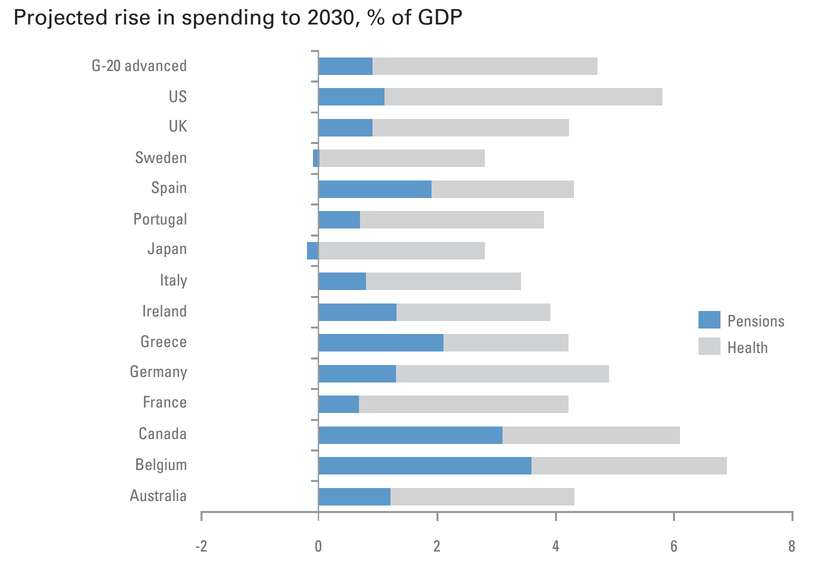


Source: IMF
Note: Primary deficit is deficit excluding interest payments

[4]Reinhart, C & Rogoff, K 'Growth in a time of debt' *American Economic Review Papers & Proceedings*, December 2009
[5]IMF op. cit. (2009)

Moreover, the challenge facing governments is even greater than headline debt and deficit figures imply. Spending on pensions and health is expected to have to rise a further five percent of GDP by 2030 in the advanced G20 economies (see chart 4), as populations age.[6] Also, OECD estimates suggest that US$3.7 trillion will be needed over the next 20 years to upgrade infrastructure across the OECD countries.[7]

Chart 4: World age-related spending pressures



Source: IMF

The analysis above makes clear the scale of the deficit recovery challenge facing governments, and also the importance of designing credible and comprehensive strategies to meet it. The next section draws on lessons from past fiscal turnarounds in order to help elaborate how such deficit recovery strategies could be structured.

[6]IMF op. cit. (2009)
[7]OECD *Infrastructure to 2030*

Lessons from previous fiscal adjustments

Although the scale of the necessary budgetary adjustment appears daunting, it is not unprecedented. Large debt/GDP ratios were cut rapidly in the period after World War II (thanks in part to the 'Peace Dividend'), and over the last four decades the IMF has identified around twenty cases of advanced economies improving their structural primary balances by more than five percent of GDP and nine cases of improvements exceeding 10 percent of GDP (see Table 1).

Table 1: Notable previous fiscal adjustments

	Change in structural primary balance, % of GDP	Time to complete adjustment (years)
Ireland 1989	20.0	11
Sweden 2000	13.3	7
Finland 2000	13.3	7
Denmark 1986	12.3	4
Israel 1983	11.1	3
Belgium 1998	11.1	15
Canada 1999	10.4	14
Cyprus 2007	8.5	4
UK 2000	8.3	7
Japan 1990	8.1	12
Portugal 1985	7.5	4
Netherlands 2000	6.3	10
Australia 1988	5.8	4

Source: IMF 'The State of Public Finances Cross Country Fiscal Monitor' (2009)

Note: Year next to country indicates final year of adjustment

A great deal of evidence exists on what might be termed ‘leading practice’ approaches to reducing budget deficits, based on cross-country empirical studies and individual country efforts. These studies, combined with the key lessons from previous periods of large-scale adjustment in countries like Sweden, Canada and Ireland (see Appendix 1), suggest eight key lessons:

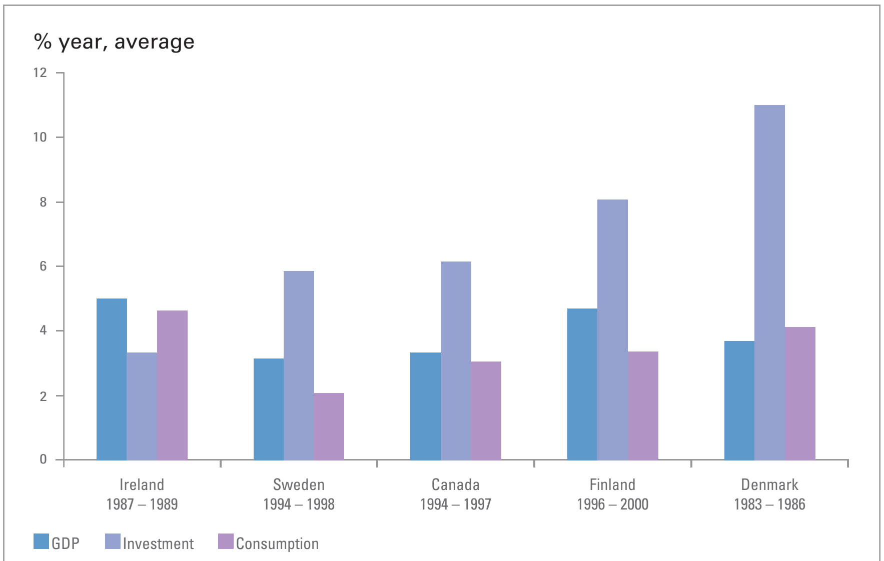
1) A crisis can be an opportunity to challenge fiscal taboos.

Crisis conditions can create the opportunity to challenge long-standing fiscal taboos. This was the experience of successfully adjusting countries in the 1980s and 1990s such as Ireland and Sweden, which were forced by circumstances to radically re-evaluate the priorities of the public sector and tackle previously politically difficult areas including pension reform.

2) Healthy growth is possible while achieving fiscal adjustment.

Successful fiscal turnarounds in countries like Ireland, Canada, and the Nordic countries in the 1980s and 1990s, were achieved while maintaining healthy growth (see chart 5). Repeating this will be more challenging now, however, given the scale of public deficits and the need for simultaneous retrenchment across almost all major economies. Only China among the major economies, has a sufficiently robust fiscal position to act as a sustained support for global demand. There is a risk that simultaneous fiscal adjustment across the major economies could damage global growth and reduce the scope for a cyclical recovery in government revenues.

Chart 5: Growth during successful fiscal adjustments



Source: Oxford Economics/Haver Analytics

3) Build a political and social consensus around the need for adjustment.

As well as facilitating the necessary tax and spending measures to restore public finances, building a broad social and political consensus around the need for adjustment can result in other agreements (e.g. wage moderation in both the public and private sectors) which help to mitigate the economic impact of retrenchment.

4) Choose decisive cuts over gradual fiscal strategies.

Gradual spending cuts tend to be inferior to decisive, front-loaded ones because they can run out of steam in the face of social and political opposition.[8] In addition, they do not deliver the positive 'shock' to consumer and business confidence which can be experienced in a decisive adjustment. By prolonging uncertainty about future tax levels, they can induce higher precautionary saving by the private sector.

5) Focus fiscal strategy on spending cuts rather than tax increases.

Historically, most successful fiscal turnarounds have focused on the spending rather than the revenue side. Examples of successful spending-driven adjustments include Ireland in the late 1980s, and Sweden and Canada in the mid-1990s. There is also evidence that expenditure-driven adjustments are more benign in terms of their effects on growth and in the right conditions such adjustments can actually be expansionary. This latter effect comes as a result of deficit reductions improving business and consumer confidence, reducing interest rates by lowering risk premiums (thus boosting interest-sensitive private spending), raising asset prices and in some cases weakening the exchange rate.[9]

In addition, cuts to public sector jobs and wages can help hold down unit labor costs in the wider economy, boosting corporate competitiveness. Examination of past successful spending-driven adjustment experiences suggests particularly strong positive effects on private investment, resulting from reduced interest rates and improved business expectations.

[8]See Alesina, A & Perotti, R 'Fiscal adjustments in OECD countries: Macroeconomic Effects' NBER Working Paper 5730, 1996
[9]See Alesina, A & Ardagna, S 'Large changes in fiscal policy: taxes versus spending' Tax Policy & the Economy, 2010, and Alesina, A & Perotti, R op. cit. (1996)

By contrast, tax-driven adjustments have tended to have a more depressive impact on growth, raising the chances of ultimate failure. The Organisation for Economic Co-operation and Development (OECD) reports that successful fiscal consolidations have typically been comprised of around 80 percent spending cuts and 20 percent tax increases.[10] In the industrialized economies, where pre-existing tax burdens were often relatively high, the risks to growth associated with a tax-driven approach are likely to be especially significant. In the words of *a senior UK policymaker*, "Fiscal tightening should not be a business burden."

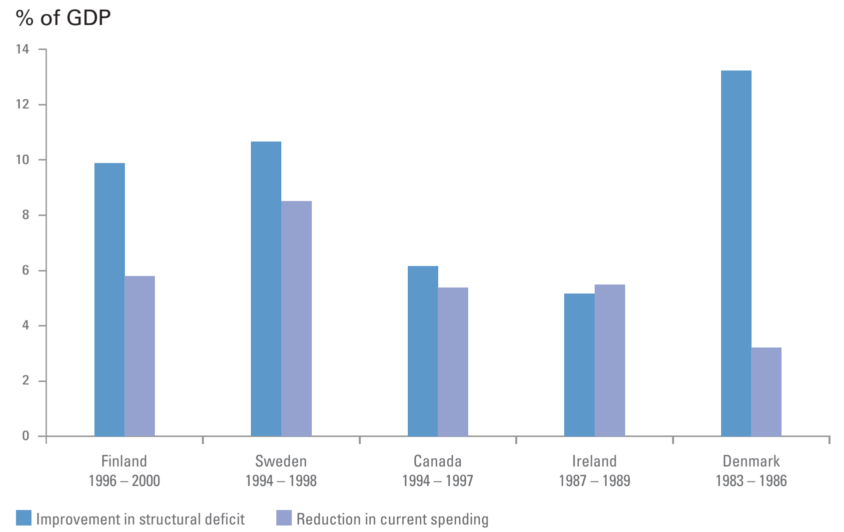
6) Concentrate on cutting current spending — not capital spending.

Past experience of successful adjustments suggests governments should aim to concentrate spending cuts on current government spending; transfers, social security and government wages and employment. One advantage of concentrating on areas like government wages and welfare programs (including pensions) is that it means attacking the areas which have the strongest 'natural' tendency to increase.

Tackling these areas, which account on average for around two-thirds of government spending in the industrialized economies,[11] also increases the chances a fiscal adjustment will prove durable, and be seen as such by financial markets and the domestic private sector. Reforms that reduce long-term costs in areas like health and pensions could be especially useful given the pressures in these areas (e.g. from aging populations). Successful fiscal turnarounds in Canada, Ireland, Finland and Sweden were mostly based on cuts to current spending (see chart 6) and Alesina & Perotti's 1996 study of a broader sample of successful adjustments over the last four decades finds 60 percent of spending cuts were in current spending.[12]

[10] OECD — 'Preparing Fiscal Consolidation', 2010
[11] See Appendix 2, Table 3
[12] Alesina & Perotti, op. cit. (1996)

Chart 6: Structure of successful adjustments



Source: Oxford Economics/Haver Analytics

By contrast, cutting government investment, often a relatively easy option (e.g. by postponing/canceling large projects) is less optimal. It can have a negative impact on growth, reducing revenues and undermining attempts at adjustment. Cuts to public investment may also be unsustainable and can only tackle the deficit problem to a limited extent as government capital spending accounts for an average of only two percent of GDP in the advanced G20 countries.[13] More generally, spending cuts with a permanent flavor (e.g. welfare cuts obtained by changes in eligibility rules) are preferable to 'one-off' measures, even if the initial magnitude of adjustments is similar.

7) Structure tax increases in ways that minimize growth risks.

Tax increases have also played important parts in past deficit recovery efforts. Although they risk damaging growth through reducing incentives to work and harming business and consumer confidence, they can also have a beneficial effect in the right circumstances — for example if they help reduce the perceived risk of bigger and more disruptive tax rises later.

The successful Danish fiscal adjustment of 1983 – 86 is one example of a program that had a substantial tax-raising element. The International Monetary Fund (IMF) has identified 29 episodes over the last 30 years where revenues rose more than three percent of GDP for two consecutive years, of which 14 episodes saw this gain maintained for a decade.[14] Four of these latter episodes involved natural resource taxes, however, and others relied on comprehensive tax reforms including the introduction of VAT.

[13]See Appendix 2, Table 3 based on IMF op. cit. (2009)
[14]IMF — 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies' 2010

OECD research suggests taxes on corporate and personal income are most damaging for growth, with taxes on immovable property the least damaging.[15] Successful adjustments studied by Alesina & Perotti (1996) also tended to feature a low share of tax rises on households and low social security tax rises.[16] Within income taxes, there is, however, also scope for action which is relatively benign for growth. For example, some countries allow substantial deductions for items such as mortgage interest (e.g. the US and the Netherlands) which arguably have a distorting effect on those markets.

The IMF estimates substantial extra revenues can be raised from indirect taxes in the G7 economies, worth 4 – 6 percent of GDP. A further 0.5 – 1 percent of GDP could come from higher carbon taxes (see Annex 3).[17]

8) 'Fiscal Rules' have a mixed record.

'Fiscal rules' aim to bind governments into responsible future budgetary policies and secure fiscal sustainability through caps on the size of deficits, spending or bond issuance, mandated by statute or in some cases constitutional amendment. An IMF study of fiscal adjustment episodes since 1980, argues that adjust- ments in countries with rules were on average larger and more front-loaded than in those without. The OECD has also argued that rules can aid fiscal adjustment efforts.[18] *One senior German public official* refers to good fiscal rules as, "'The alpha and omega' of successful long-term policymaking" and *a former senior US policymaker* also sees statutory spending controls as, "The only way to contain elected officials."

The effectiveness of such rules is nevertheless controversial and the case for them has been damaged by recent events. In particular, fiscal rules in the Eurozone (the Stability and Growth Pact) and the UK (the Code for Fiscal Stability) failed to prevent either the build up of large structural deficits prior to the onset of the global recession or the massive rises in deficits seen since.

A typical problem is that such rules have 'get-out clauses' that allow them to be circumvented relatively easily in difficult times. As such, fiscal rules seem unlikely to directly rein in government behavior unless they are very rigid, in which case political opposition to their introduction is likely to be very strong. Fiscal rules are more likely to work by raising the 'reputational cost' to government of diverging from a sustainable fiscal policy. This appears to be the thinking behind the new Office for Budget Responsibility in the UK, which will produce independent forecasts of growth and fiscal trends.[19]

[15] Heady, C, Johansson, A, Arnold, J, Brys, B & Vartia L 'Taxation and Economic Growth' *OECD Economics Department Working Papers* No. 620, 2008
[16] Alesina & Perotti, op. cit. (1996)
[17] IMF op. cit. (2009)
[18] IMF op. cit. (2010), OECD — 'Fiscal sustainability: the contribution of rules' in OECD Economic Outlook No. 72, 2002
[19] See UK Office of Budget Responsibility, Terms of Reference, June 2010

Moving towards fiscal sustainability

The previous section laid out some important lessons based on previous experience, which should be considered in designing a deficit recovery strategy. In addition, a number of other issues need to be considered by policymakers facing the challenge of reining in large fiscal deficits and achieving fiscal sustainability:

- **Inflation offers little scope to reduce deficits.**

An alternative approach sometimes suggested for reducing government indebtedness is allowing inflation to rise significantly. In the right conditions (e.g. when the average debt maturity is long and debt is largely in domestic currency), this approach can cut the debt/GDP ratio. However, in current circumstances this approach looks to be a non-starter. The IMF estimates that raising inflation to six percent per annum for five years would erode less than a quarter of the rise in the debt ratio which it projects for the G20 economies up to 2014.[20]

There are other drawbacks. If a country has a short average debt maturity, attempts to erode the debt burden by inflation will be ineffective as interest payments will tend to rise sharply. Among the G20 this approach would be especially challenging for the US, with an average debt maturity of just four years. Attempting to engineer a sustained high inflation could also prove difficult given the institutional context (i.e. the existence of legislatively or constitutionally protected independent central banks). Finally, such an inflationary period would eventually have to be brought to an end, a process that would entail substantial output costs — the lesson of the 1970s and early 1980s.

- **Monetary policy of limited use to offset the growth impacts of fiscal tightening.**

Fiscal adjustment efforts in the past have been helped by aggressive use of monetary and exchange rate policy to cushion the negative effects on growth. A problem faced by governments today, however, is that typically there is very little room for monetary policy to loosen further — official interest rates in most major economies are already at record lows. For the economies in the Eurozone, exchange rate adjustment is also not an option. Regardless, with sizeable fiscal retrenchment required in almost all countries, currency depreciation is not possible for all.

- **Tax measures will need to reflect country-specific features.**

Looking at the structure of government revenues in the industrialized economies, there is considerable variance, implying that different countries may have to take different approaches to increasing taxation. The share of income taxes in GDP is generally quite high, averaging nine percent and much higher in some countries such as Canada and the Scandinavian states. Exceptions include Japan and Greece, where revenues are well below average, suggesting scope for increases. Social security taxes are also relatively high at 10 percent of GDP, while corporate tax

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[20] IMF op. cit. (2009)

revenues average around five percent of GDP, once again with considerable variance. Indirect taxes including excises and VAT average around 10 percent of GDP but vary from less than five percent of GDP in the US to over 16 percent in Denmark. Property taxes average around 2.5 percent of GDP, varying from less than one percent of GDP in Germany to 4.5 percent in the UK.[21]

- **Implementation challenges will need to be overcome.**

There are considerable challenges to the successful implementation of a deficit recovery strategy. Interest groups, such as trades unions and parts of the electorate, are likely to resist many of the necessary changes. Overcoming this resistance will require governments to effectively make the case for change and maximize the political 'buy-in' to the process of change across different groups in society.

In the words of *one senior academic*, "Governments need to develop a political 'cover story' for deficit recovery related, for example, to an aging society or environmental issues." Selling the need for change in this way will require successful leadership from policy makers. *Senior Canadian and German officials interviewed*, also emphasized the need for political leaders to communicate the importance of fiscal consolidation to the public.

Governments also need to consider how to ensure a deficit recovery program maintains momentum over time. One danger is that if measures are introduced individually, each one may be successfully resisted in turn by organized opposition. This implies the need for a strategy to be composed of a comprehensive set of measures. Outlining clear goals for the strategy at the outset, tracking progress, ensuring the execution of key changes and preventing the build-up of 'inertia' and adjustment fatigue are also important. Front-loading deficit recovery packages may help in this latter area.

There also needs to be a change in the mindset of parts of the public sector, institutionalizing the need for deficit reduction in ministries and bureaucracies. To identify and implement savings on the scale required, public sector organizations and individuals within them need to be encouraged to challenge the status quo as opposed to the more traditional goal of defending existing budgets and programs. An adjustment strategy needs to have the achievement of fiscal sustainability at its heart and this goal also needs to be taken on board across the public sector. This presents a significant challenge, as in the words of *one senior US public official*, "The political paradigm is lagging the economic paradigm."

- **'Conventional' measures unlikely to be sufficient.**

The scale of the fiscal adjustment needed in the industrialized economies raises serious questions about whether 'conventional' tax and spending changes will be enough to get on top of the deficit problem. In the next section we will examine the more radical approaches that come with re-engineering.

[21] See Appendix 2, Table 4 based on IMF op. cit. (2009)

Re-engineering government

The scale of the fiscal adjustment needed in the industrialized economies raises serious questions about whether 'conventional' tax and spending changes will be enough to effectively address the deficit problem. **Do the authorities need to go further and consider a radical re-engineering of government?**

There is a certain amount of 'low hanging fruit' in the area of deficit recovery. Governments can move quickly to halt capital spending projects, impose wage freezes on public servants or shed marginal public sector headcount. But some of these approaches are only temporary in nature or could prove unsustainable beyond the short-term. By contrast, the re-engineering agenda focuses on transforming the delivery of public services in a way that can reduce the future burden on the government budget and yield significant efficiency gains.

In this section, we examine this question by drawing on the results of a series of roundtables, expert panels and interviews with public sector officials and representatives to provide additional insights.

The re-engineering agenda encompasses a number of components:

- **Efficiency and productivity gains**

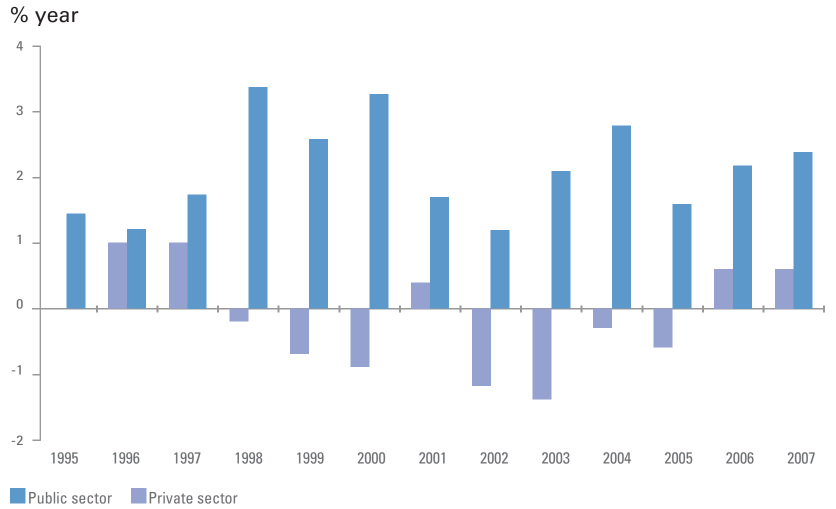
The problem of rising long-term costs in key areas of spending partly reflects poor productivity performance in the public sector. For example, in the UK, public sector productivity actually fell in 1997 – 2007 by 0.3 percent (see chart 7) per annum while private service sector productivity rose two percent per annum.[22] *Paul Kirby, Partner at KPMG in the UK,* notes that "Had public sector productivity grown at even half the pace seen in the private sector, public spending could have been lowered by as much as £30 billion or two percent of GDP."

Developing a culture of cost control is also important. *In Canada, a senior public servant* notes that, "The burden of efficiency savings in coming years will be placed on individual departments, which will have to identify five percent of their programs that are currently under-performing and should be reviewed or scrapped."

The same senior Canadian official also sees considerable scope for strategic transformation in areas such as consolidating functions such as human resources, finance and data collection as well as back office and administrative staff. In his view, Canada has too many service delivery networks that could be consolidated relatively easily. **This kind of focus on control of overhead costs is common in the private sector and needs to be rolled out in the public sector as well.** *A senior UK policymaker* suggests, "Public sector managers should be given the target of achieving the same level of service for unchanged cash budgets" — implying a significant squeeze over time.

[22]Reform — Public Sector Productivity briefing note, April 2010

Chart 7: UK public and private sector productivity



Source: Oxford Economics/Haver Analytics

Paul Kirby of KPMG in the UK, further argues that "We are entering 'the age of the unit cost'." He suggests that examination of a number of public sector areas in the UK reveals substantial variations in cost performance across different units, with the top 25 percent of units having costs 20 – 25 percent lower than average. *Kirby* further notes that plans are afoot in the UK health sector to set payments to hospitals for acute treatment at the level of the top performing 25 percent rather than the average. **This could cut £11 – 12 billion from the £40 billion annual care cost.** This kind of unit-cost based analysis also could be rolled out across other parts of the public sector.

- **Rethinking the role of government**

According to a former senior US policymaker, "Most of the existing US Federal government programs … are based on conditions that existed 50 years ago." The same observation can be made of other industrialized economies. The role of government needs to be reassessed and re-focused, with the emphasis on making it 'future-focused and results-oriented'. *Paul Kirby of KPMG in the UK* echoes these points, pointing to the need to, "Shift from 'traditional' public sector budgeting to payment of public sector bodies on the basis of results."

As part of the process of re-focusing government, *Paul Kirby* argues that, "Private involvement may need to go deeper into the heart of government." This could involve a switch from a 'providing' state to an 'enabling' state — which helps fund but does not directly provide services. Private sector involvement in the provision of services could go beyond 'traditional areas' to encompass activities such as registration and licensing, and the ownership or management of schools.

- **Developing new revenue streams**

Raising substantial additional revenues may require governments to look for new revenue sources. Possible target areas include energy, environmental taxes, land value taxes or national resource taxes such as those being contemplated in some resource-rich countries. Also worthy of consideration are increased co-payments for public services or charging for previously 'free' items such as road use.

- **Empowering public service providers and receivers**

Existing public sector managements and workforces could prove an obstacle to radical reforms, but this problem could be sidestepped by making empowerment of service providers part of the reform package. Devolution of operational decision-making to public sector managers and workers can be part of the reform, as well as more radically shifting the 'ownership' of services, for example by creating employee co-ops and giving well-performing units the possibility to expand. As well as helping service providers buy into the reform process by giving them a stake in successful outcomes, this process could help develop a culture of continuous improvement in the public sector — and get away from a situation where, in the words of *a senior US public official,* "Much of the public sector currently has 'no incentive to save money'."

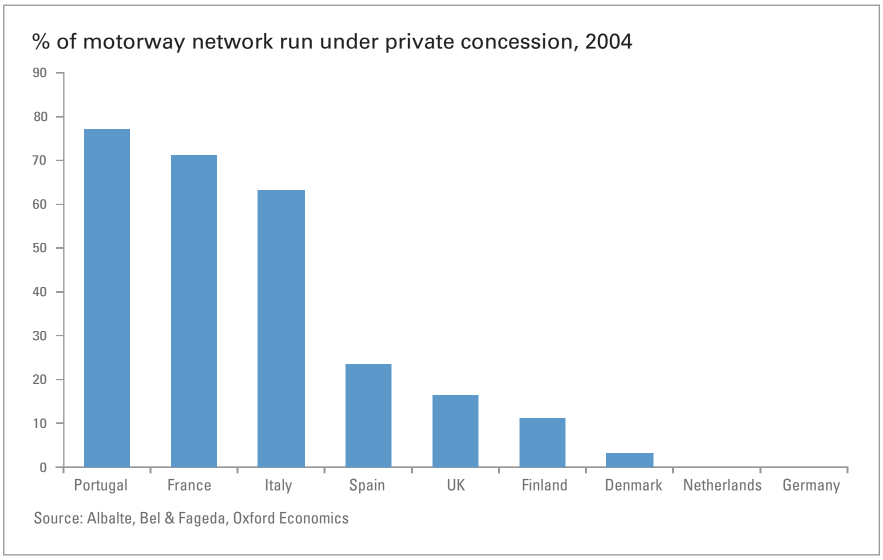
Putting the recipients of public services in charge of their own dedicated budgets could yield substantial savings. For example, in the UK social care sector, *Paul Kirby* states that "one pound in every three of the £12 billion budget is spent on deciding internally in government how to spend the other two. Giving individuals their own budget to spend as they see fit could thus eliminate a large portion of current spending."

- **Infrastructure privatization**

KPMG's John Herhalt of KPMG in Canada, emphasizes the significant opportunities in the sphere of infrastructure privatization, "Investment requirements in the decades ahead are substantial. In the transport sector, congestion charges, toll roads and contracts to build, operate and maintain highways have all been used in recent years." Private involvement in the highway network is substantial in a number of European countries (see chart 8), and has in part been driven by financial pressures on government. By contrast, in the UK and Germany, private sector involvement in this area is very modest. **The potential sums involved are large — for the UK, it is estimated that privatization of the motorway network could raise £100 billion.**[23] Involving the private sector more in infrastructure also meets a growing demand for access to the stable revenue streams infrastructure assets can generate.

[23]Sunday Times, London, UK, August 30, 2009.

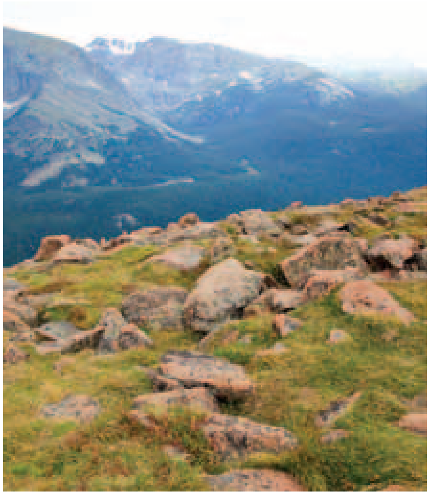
Chart 8: Private sector involvement in European highways



Radical transformational change in the public sector faces practical barriers. As *a senior German public official* states, "A radical rethinking and reshaping of the public sector is unlikely at the political level. Implementing incremental changes in the right areas is probably the only way to get it done." Many fiscal adjustments are, in the words of *Alan Downey of KPMG in the UK*, "Managerially easy, but politically hard," such as curbing welfare spending. Improving public service productivity is by contrast 'politically easy but managerially hard'. Successful outsourcing or public-private contracts can be hard to manage and the public sector may lack the skills and competencies needed to design and deliver radical changes — so these skills and competencies need to be embedded to ensure success.

Creating an environment where competitive or managerial structures exist that will drive continuous improvements in productivity may also take time and involve substantial set-up costs. **As a result, governments may have to 'ride two horses at once',** engaging in significant 'conventional' fiscal adjustments while also laying the foundations for a step-change in future productivity performance in the public sector which will support the public finances in the medium-term. In the opinion of *a former senior US policymaker*, the long-term re-engineering of government needs to be "a separate process [to conventional deficit reduction] run by respected and non-government figures with experience in transforming organizations".

Conclusion



The problem of large budget deficits and rising debt levels is widespread among industrialized economies, although problems are clearly more severe in some countries than others. In many cases, governments face a dual challenge: cutting expenses and raising revenues in the near-term, and tackling the rising pressures from age-related spending and the need for infrastructure investment in the long-term — while laying the foundation for fiscal sustainability.

Examination of historical episodes in deficit recovery confirms that large adjustments can be made, and if well-structured, need not be harmful to economic growth. Successful adjustment efforts have generally focused on the expenditure-side, but tax increases probably need to be part of the package too. Large increases in revenue may be hard to achieve without significant tax reforms, or tapping new streams of revenues. The picture varies across different countries and each will need to consider its individual circumstances in designing recovery strategies.

In many cases, conventional tax and spending measures may not be enough to ensure medium-term fiscal sustainability, and governments may have to 'ride two horses at once', squeezing budgets today while also putting in place plans to re-engineer the public sector in order to support the public finances in the medium-term.

This involves pursuing options including forcing up productivity growth in the public sector, taking private sector involvement deeper into the heart of government activity, and exploring new opportunities in areas like infrastructure privatization.

The political challenge of 'selling' the need for major fiscal cutbacks is significant, as is the practical challenge of designing and carrying through radical transformational change in public services. But the current atmosphere of deep concern over the trajectory of public finances may provide the opportunity to cut through traditional political and social taboos in the fiscal sphere in order to make a real difference.

Appendix 1 — Case studies in deficit reduction

Ireland (1987 – 89)

Ireland had a serious fiscal problem at the start of the 1980s, with a double-digit deficit/GDP ratio and a steeply rising debt/GDP ratio which reached 120 percent in 1987. These fiscal problems weighed heavily on growth, which averaged only 1.5 percent of GDP from 1980 – 87[24] despite a favourable global backdrop. Also contributing to this weak growth was a failed attempt at fiscal adjustment in the early 1980s which focused on the revenue side and had significant contractionary effects on domestic demand.

In 1987, a new adjustment program began based on expenditure-side measures. This program improved the structural primary balance by five percent of GDP over 1987 – 89, with the whole improvement due to reductions in current primary spending. Cuts focused on transfer payments, government consumption, and government wages, with only education excluded. Government employment fell 10 percent from 1986 – 89. The debt/GDP ratio fell sharply to 90 percent of GDP after five years, and despite the spending cuts, GDP growth averaged five percent per annum, well above the OECD average.[25] This was helped by substantial exchange rate depreciation.

The Irish experience yields a number of lessons. The first is that it may take a crisis to force governments into taking the necessary measures. The emphasis of the 1987 – 89 program on spending cuts was the result of the failure of previous efforts and growing problems of raising financing in bond markets. The Irish experience also shows the value of building political and social consensus. A key feature of the program's success was that wage moderation was achieved via an agreement between government and unions. This helped bring down labor costs and boost investment and exports.

Sweden (1994 – 98)

In the early 1990s, Sweden suffered a collapse in the real estate market, a banking crisis and a deep recession, all of which left the public finances in a poor state. With international confidence in the Swedish economy at an all time low, the authorities were forced into a severe fiscal adjustment which proved remarkably successful — turning a budget deficit of 11 percent of GDP in 1993 into a surplus of one percent of GDP by 1998. The debt/GDP ratio, which had risen steeply in the preceding years, was stabilized at around 70 percent.

The Swedish adjustment was heavily weighted to the expenditure-side, with over 80 percent of the improvement in the deficit coming from spending reductions. Current spending fell by almost nine percent of GDP from 1994 – 98,[26] driven by a large reduction in social transfer payments linked to greatly tightened eligibility criteria.

[24] Alesina & Perotti op.cit. (1996)
[25] Alesina & Perotti op.cit. (1996)
[26] Alesina & Perotti op.cit. (1996)

Despite the scale of the adjustment, GDP growth averaged over three percent in 1994 – 98,[27] above the OECD average. Exports and investment both performed very well, as a result of a weaker exchange rate but also because the fiscal adjustment appears to have boosted private sector activity by bringing down interest rates and raising business and consumer confidence.

The Swedish experience once again suggests that crisis conditions can be the catalyst for major breakthroughs in policy terms. The adjustment program tackled head on the high-level of social spending that had been a feature of the country and a politically sensitive area.

Canada (1994 – 97)

Canada's budgetary problems became steadily worse in the 1980s and early 1990s, with the deficit reaching 9.2 percent of GDP by 1992.[28] A series of revenue-based attempts to control the deficit failed before a successful adjustment began in 1994 under the leadership of a new Liberal government elected at the end of 1993, which ran explicitly on a ticket emphasising fiscal reform.

From 1995 – 97 the structural primary deficit improved by over six percent of GDP, with the budget balance moving into surplus by 1997. Once again this was largely the result of expenditure-side measures, which accounted for around 80 percent of the improvement. Federal departmental budgets were cut back by 20 percent on average over four years. However, government investment was protected, falling by only 0.5 percent of GDP. There was a large cut of 23 percent in public sector employment, but despite this, overall employment rose. GDP growth at 3.4 percent per annum was above the OECD average for the period.[29]

Like Ireland and Sweden, the growth performance during adjustment was helped by exchange rate depreciation. But another important factor was that the adjustment program helped keep unit labor costs in the broader economy under control, boosting corporate profitability and investment — another example of the 'crowding in' of private sector activity. The Canadian experience again demonstrates that a sufficiently negative starting point can allow the political space for radical measures to be undertaken.

Italy and Argentina

In contrast to the above examples, it is also worth noting some examples of failed adjustments. **Italy** in 1989 – 93 saw an attempted adjustment based on tax rises, which led to low growth and a collapse in private investment. The debt/GDP ratio continued to rise until 1994, when a program of spending cuts was introduced. More dramatically, **Argentina** saw a series of revenue-led attempts at fiscal adjustment in 1999 – 2001 fail to 'stick',[30] draining market credibility and contributing to the major debt default at the start of 2002.

[27] OECD op. cit. 2010
[28] Alesina & Perotti op.cit. (2010)
[29] Alesina & Perotti op.cit. (2010), OECD op. cit. (2010)
[30] OECD op. cit. (2010)

Appendix 2 — Detailed tables

Table 1: Debt and required fiscal adjustment in G-20 advanced economies

	Gross debt, % of GDP 2010F	Structural primary balance, % of GDP 2010	Required adjustment for debt sustainability 2010 – 2020
Australia	20	-4.6	5.2
Belgium	100	-1.1	4.7
Canada	83	-2.2	4.4
Denmark	51	-3.1	4.3
France	84	-4.6	8.3
Germany	77	-1.6	4.0
Greece	133	-2.4	9.2
Ireland	79	-6.0	9.8
Italy	119	0.9	4.1
Japan	227	-6.5	13.1
Netherlands	64	-3.4	5.5
Spain	67	-5.8	9.4
Sweden	43	-1.6	2.3
UK	78	-5.4	9.0
US	93	-7.6	12.0
G-20 advanced	***104***	***-5.3***	***9.3***

Source: IMF, 'The State of Public Finances Cross-Country Fiscal Monitor: November 2009' IMF Staff Position Note, November 2009

Table 2: Industrialized economies gross financing needs 2010

	Maturing debt	Budget balance	Gross financing need	Average debt maturity (yrs)
Australia	2.0	-5.0	7.0	4.8
Belgium	20.8	-5.1	25.9	5.4
Canada	15.9	-5.3	21.2	5.6
France	16.9	-8.2	25.1	6.5
Germany	10.2	-5.7	15.9	6.0
Greece	13.4	-8.1	21.5	7.4
Ireland	7.7	-12.2	19.9	6.7
Italy	21.2	-5.2	26.4	6.7
Japan	54.2	-9.8	64.0	5.2
Portugal	13.0	-8.8	21.8	6.2
Spain	10.3	-10.4	20.7	6.7
Sweden	6.8	-3.3	10.1	6.0
UK	8.6	-11.4	20.0	12.8
US	21.2	-11.0	32.2	4.4

Source: IMF — 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies' 2010

Note: Column 3 is sum of columns 1 & 2.

Table 3: Structure of industrialized country public spending 2007 – 2008

	% of GDP				
	Public spending	Employee compensation	Social benefits	Capital spending	Other spending
Australia	30.4	8.8	9.6	2.6	9.4
Belgium	46.2	12.1	23.3	1.7	9.1
Canada	36.1	11.6	7.5	1.4	15.6
Denmark	50.5	17.3	16.4	1.8	15.0
France	49.9	12.7	23.3	3.2	10.7
Germany	41.0	6.9	24.3	1.5	8.3
Greece	43.7	11.5	19.1	2.9	10.2
Ireland	41.0	11.1	13.8	5.3	10.8
Italy	43.6	10.9	20.4	2.2	10.1
Japan	33.5	6.2	17.7	3.6	6.0
Netherlands	43.8	9.1	20.2	3.5	11.0
Spain	39.5	10.8	15.0	3.8	9.9
Sweden	51.3	14.9	18.2	3.3	14.9
UK	45.0	11.0	13.1	2.3	18.6
US	36.1	10.2	12.9	1.0	12.0
G-20 advanced	***37.7***	***9.5***	***15.2***	***2.0***	***11.1***

Source: IMF — 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies' 2010

Table 4: Structure of industrialized country public revenues 2007 – 2008

	% of GDP					
	Total Revenue	Income taxes	Corporate taxes	Social security taxes	Indirect taxes	Property taxes
Australia	37.1	11.3	7.1	1.5	8.2	2.8
Belgium	48.1	6.2	10.2	13.6	11.0	2.3
Canada	40.5	12.4	3.7	5.5	7.9	3.3
Denmark	55.6	14.8	14.0	1.2	16.4	1.9
France	49.6	7.5	7.5	17.4	10.8	3.5
Germany	43.9	9.1	2.2	13.2	10.6	0.9
Greece	40.0	4.7	2.6	11.7	11.3	1.4
Ireland	35.8	8.7	3.4	4.9	10.9	2.5
Italy	46.9	11.1	3.8	13.0	11.0	2.1
Japan	31.1	5.5	4.8	10.3	4.9	2.6
Netherlands	45.8	7.7	3.3	13.6	11.0	1.2
Spain	41.0	4.6	7.5	12.1	9.5	3.0
Sweden	53.6	14.9	3.8	15.3	12.9	1.2
UK	37.8	10.9	3.4	6.6	10.5	4.5
US	29.9	10.8	3.1	6.6	4.7	3.1
Average	***42.4***	***9.3***	***5.4***	***9.8***	***10.1***	***2.4***

Source: IMF — 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies' 2010

Table 5: Possible revenue gains from tax increases

	Extend VAT	Tobacco & alcohol excise	Fuel excise	Property tax	VAT at 10%	Full taxation of carbon	*Total*
France	3.8	0.1	0.3	1.0	-	0.2	**5.3**
Germany	2.4	0.2	0.3	1.0	-	0.6	**4.5**
Italy	3.1	0.3	0.3	1.0	-	0.5	**5.1**
Japan	0.3	0.9	0.3	1.0	2.6	0.0	**5.0**
UK	3.3	0.0	0.2	0.0	-	0.5	**4.0**
US	0.0	0.3	0.6	0.0	4.5	0.8	**6.1**

Source: IMF — 'From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies' 2010

VAT extension — reduce current exemptions by half
Excise taxes — tobacco & alcohol excises raised to 2006 average level for the six, where existing level lower
Fuel excise — raised by 10 cents per litre
Property taxes — raise to average level (as % of GDP) in Canada, US, UK
Carbon — based on full auctioning or taxation of carbon emissions on 2007 levels of emission

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