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Karl Aiginger and Margit Schratzenstaller*

Consolidating the Budget under Difficult Conditions – Ten Guidelines Viewed Against Europe's Beginning Consolidation Programmes

There is evidence that a budget consolidation strategy can work with only a small and short-lived negative impact on growth. However, many countries are currently trying to consolidate at the same time as firms and consumers are deleveraging. We develop ten guidelines for consolidation during such a difficult economic period and cross-check whether the upcoming consolidation programmes being implemented in the EU countries comply with our guidelines. We propose following a "high road" on cutting deficits, which includes an active growth-enhancing component during the consolidation period. The active component should be financed by deeper cuts in subsidies, by eliminating obsolete government expenditure as well as by increasing the efficiency of the public sector. Taxes should not be raised permanently – a temporary contribution to consolidation will be needed, but tax structures in general should be made more growth and employment friendly.

The year 2011 will put to the test the robustness of the recovery of industrialised countries following the financial and economic crisis.[1] Tailwinds from Asia will slow down some, and much of the impact of the stimulus programmes which have boosted growth deep into 2010 will fade away.[2]

Budget consolidation will definitely start in Europe and probably in the USA as well, if the President has to cooperate with a Congress less inclined toward expenditures. We believe that consolidation is absolutely necessary. It has to start after a year in which the world economy has grown by 4%, the USA by 3% and Europe by 2%. In the aftermath of the financial crisis, permanently higher growth is unlikely to be experienced soon. But the current economic situation is characterised by old and new burdens and by big disequilibria; unemployment is about 10% in Europe and the USA, and some countries also have large deficits in their current accounts. Therefore it will be all the more important to fine-tune the consolidation strategy in order not to aggravate unemployment and growth. Budget consolidation is a demanding task, and it must be taken into consideration how the crisis came about and which problems were already on the economic agenda before the crisis.

In this paper, we briefly underline why consolidation is necessary, which guidelines it should follow and whether the guidelines we develop are replicated in the national consolidation plans already revealed by the EU member states.

The Necessity of Budget Consolidation

The consolidation of public budgets is necessary, since debt relative to GDP has reached about 80% of GDP in Europe and over 90% of GDP in the USA, and it will increase further. Current deficits (of general government)

* Austrian Institute of Economic Research WIFO, Vienna, Austria.

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1 For a comparison of the recent crisis (sometimes called the "Great Recession") see K. Aiginger: The Great Recession versus the Great Depression: Stylized Facts on Siblings That Were Given Different Foster Parents, in: Economics, E-Journal, Vol. 4, 2010-18, http://www.economics-ejournal.org/economics/journalarticles/2010-18.

2 In the EU27, the stimulus programmes reached about 1.5 per cent of GDP in both 2009 and 2010. In 2009 about 75 per cent and in 2010 about 40 per cent of the stimulus measures were and are temporary and are intended to expire by 2011 (European Commission: Public Finances in EMU, Brussels, 2010). In the USA, of the $787 billion stimulus package, about one fifth had been spent by September 2009, another $400 billion was to be spent in 2010, $100 billion in 2011 and the rest in the following years (J. Weber: Stimulus Impact will Fade in 6 Months, in: The Washington Times, 14 January 2010).

reached 6.8% of GDP in the EU and 11.3% of GDP in the USA in 2010. However, structural deficits existed before the crisis started. Neither Europe[3] nor the USA have had a single year of balanced budgets since 2000. In the EU27, structural deficits are estimated to have amounted to 2% on average in 2007[4], and in the USA, this figure is about 3%[5].

Those economists and politicians who are in favour of stimulus programmes in a crisis must ultimately also favour budget consolidation, if for no other reason than to bring economic policy back into a position from which it can be used to fight the next crisis. Government expenditures over GDP have risen from 45.6% in the EU in 2007 to 50.6% in 2010. Some of this hike will subside in the ongoing recovery; the lion's share, however, will have to be eliminated by cuts in discretionary expenditures if the government's share of GDP is not to be permanently higher than at the start of the crisis. In particular the rapidly increasing interest payments associated with rising debt ratios seriously restrict the government's short- as well as long-run room for manoeuvre.

At the same time, unemployment rates are rather high and persistent in Europe. Economic growth is inhibited by low aggregate demand: consumption will rise slowly due to low wage increases and high consumer debt, and investment is dampened by low capacity utilisation. There is a one-time loss of potential output plus the uncertainty of whether the lower investment in physical and human capital will also reduce the growth of medium-term potential output. In such a macroeconomic environment, budget consolidation is not an easy task, especially if we keep in mind that climate change and the ageing of societies are also important challenges which existed prior to the crisis and will become more and more important in the future. Against this background, we develop ten guidelines for budget consolidation.

Ten Guidelines for a Growth- and Employment-friendly Consolidation

There is an extensive body of literature on the conditions for successful budget consolidations. It is on the one hand encouraging, as it shows that successful consolidation is possible and that economic growth can be resumed rather quickly; on the other hand, the literature tells us that the preconditions for success are not easy to meet.[6] Moreover, the more favourable results might be easier to achieve in an environment where few countries are consolidating and where neighbouring countries grow fast and boost demand. In the current situation, many countries will consolidate at the same time (and the Southern European countries will do so earlier and more vigorously).[7] Outside support may come from Asian countries (plus Africa and South America). Nevertheless, consolidation will only be successful if it incorporates past experience and follows strict rules.

Table 1
The Public Sector Before and After the Crisis

	2000	2007	2010	2011	2012	2000/2007 Average	2010/2007 Absolute change
Public expenditures/GDP							
EU15	44.9	45.9	51.1	49.7	48.9	46.5	6.2
EU27	44.8	45.6	50.6	49.2	48.4	46.3	5.8
USA	33.9	36.8	43.2	41.2	40.3	35.8	9.4
Budget surplus/deficit/GDP							
EU15	0.8	-0.8	-6.8	-5.1	-4.1	-1.6	-7.6
EU27	0.6	-0.9	-6.8	-5.1	-4.2	-1.8	-7.4
USA	1.5	-2.8	-11.3	-8.9	-7.9	-2.5	-12.8
Public debt/GDP							
EU15	63.1	60.5	81.6	84.3	85.8	62.6	18.5
EU27	61.3	58.8	79.1	81.8	83.3	61.2	17.8
USA	55.1	62.4	92.2	98.4	102.1	59.4	37.2

Source: WIFO calculations using Eurostat (AMECO).

3 This holds true for the EU on average; several countries, e.g. Finland and Denmark, could realise significant budget surpluses.

4 European Commission: Public Finances in EMU 2010, Economic and Financial Affairs, European Economy, No. 4, 2010.

5 OECD: Economic Outlook 2010.

6 A. Alesina, S. Ardagna: Large Changes in Fiscal Policy: Taxes versus Spending, NBER Working Paper 15438, Cambridge MA 2009; A. Afonso: Expansionary fiscal consolidations in Europe: new evidence, in: Applied Economics Letters, Vol. 17, No. 2, London 2010, Routledge, pp. 105-109; F. Giavazzi, M. Pagano: Non-Keynesian Effects of Fiscal Policy Changes: International Evidence and Swedish Experience, in: Swedish Economic Policy Review, 1996, Vol. 31, pp. 67-103. For an overview, see N. Gruber, H. Pitlik, E. Walterskirchen: Erfolgsfaktoren der Budgetkonsolidierung im internationalen Vergleich, WIFO-Monatsberichte, No. 3, 2010. For a cautionary evaluation of an "expansionary consolidation", see International Monetary Fund: World Economic Outlook (WEO), Rebalancing Growth, Washington April 2010, Chapter 4.

7 M. Marterbauer: Budgetpolitik im Zeitalter verminderter Erwartungen, WIFO Working Papers, No. 366, 2010; K. Aiginger, M. Böheim, K. Budimir, N. Gruber, H. Pitlik, M. Schratzenstaller, E. Walterskirchen: Optionen zur Konsolidierung der öffentlichen Haushalte in Österreich, Vienna, 2010.

1. Consolidation is Not the Only Priority; a Coherent Strategy Is Needed

   Consolidation is not the only priority at the top of the list of economic goals, and problems which already existed before the crisis should not be forgotten. Fighting unemployment is also high on the agenda; long-term-oriented programmes to boost innovation, to improve education, to cope with the consequences of an ageing society and to deal with environmental problems are urgently needed. If each of these priorities is pursued separately, instruments solving one problem may impair the probability of achieving the other goals. Furthermore, policy instruments would be too expensive if problems were solved independently of each other in isolated approaches. Only an integrated strategy can serve three main goals (budget consolidation, employment creation and future-oriented investment) at a time when there are limited policy instruments and resources available.

2. Communicating the Goal, the Strategy and the Vision Is Important

   Successful consolidation strategies should be well communicated, follow a strict timetable, be positively motivated and be seen as a chance to eliminate inefficiencies in the public sector as well as outdated expenditures and tax privileges. The time schedule should fit the problems at hand and not be dictated by financial markets. The size of consolidation packages should be ambitious and the timeframe short.[8] While effective consolidation should not be frontloaded (too much reduction of deficits in the first year), approval of the policy measures should be. The ultimate goal of consolidation is to regain fiscal room for manoeuvre and to ensure long-term sustainability (in an ageing society). No negative rhetoric of a long period of austerity should be used.

3. A Proactive Component Is Needed

   The consolidation package should incorporate a proactive component. Future-oriented investment to stimulate long-term growth should not be stopped but should rather be specifically enhanced by extra spending as well as organisational changes to improve the outcomes. If there is a five-year freeze or even cuts in expenditure on growth drivers, budget consolidation will never work, since lower growth will reduce tax receipts and increase expenditure. Therefore cuts of "obsolete or inefficient" expenditure should be rather ambitious to allow room for future-oriented investment. Consolidation has to be accompanied by expansive monetary policy. If the business environment (and the world economy) deteriorates, the reforms should not be stopped, but future-oriented investment including activation and requalification (active labour market policy) should be increased.

4. Fair Burden Sharing and Equity Considerations Are Important

   A consolidation strategy should be fair. This does not mean that "everybody should pay", but rather that equity issues are actively addressed. Before the crisis, income and wealth distribution had shifted in favour of high incomes at the expense of low incomes. This problem has been aggravated by the crisis, since unemployment and income losses hit less qualified people harder. Therefore, groups with lower incomes and groups with higher unemployment risk should be exempted from tax increases, and expenditures that are most important for the low income groups should not be cut. Measures to combat unemployment (activation, flexicurity, improving matching) should be continued. A consolidation package guided by the idea of fair burden sharing may not rely exclusively on expenditure cuts; it should also include a (smaller) share of tax increases in order to be perceived as fair by interest groups and the general public, particularly if tax evasion, loopholes and tax exemptions favouring high income groups have been present. Under the fairness commandment, Blanchard and Cottarelli include fighting tax evasion, with which we agree, but they use this to implicitly advocate an increase in the value added tax.[9] We oppose the latter conclusion, since the burden of value added taxes is higher for lower incomes (high consumption rate). Fairness considerations may include lowering the taxes on low incomes and increasing the taxation of property and capital gains. This stronger fairness postulate seems appropriate, as the income share of labour has been decreasing for a long time and income as well as wealth distribution have become more unequal, which may have contributed to higher volatility and increased speculation, two of the roots of the crisis.

5. Consolidation Should Be Growth-sensitive and Underpinned by Structural Reforms

   Consolidation has to be growth-sensitive. Non-financial measures promoting economic growth should be given a high priority, specifically promoting the creation of new

8 See O. Blanchard, C. Cottarelli: Ten Commandments for Fiscal Adjustment in Advanced Economies, 2010, http://blog-imfdirect.imf.org/2010/06/24/ten-commandments-for-fiscal-adjustment-in-advanced-economies/.

9 Ibid.

businesses and fostering competition, thereby taking advantage of globalisation. Many of the countries with high budget deficits have current account deficits or their sectors of new and innovative firms are too small. Competition should be enhanced, labour markets reformed, new spending priorities set, and the tax burden shifted from taxes strongly inhibiting economic growth to taxes with a less negative impact. The consolidation package should be complemented by structural reforms. Government expenditure should be shifted from public consumption to expenditure on growth drivers. Incentives should be switched from unconditional transfers towards qualification and activation in the labour market. According to empirical growth equations, economic growth depends on human capital, innovation, R&D, good institutions and efficient innovation systems (plus good health systems). Labour market reforms may contribute to growth, but they are far from the strongest component, and they are significant in particular if interacting with human capital and R&D expenditures.

6. Consolidation Should Be Demand-sensitive

Consolidation has to be aware of short-run negative demand effects. If government reduces its net expenditure, private consumption, investment or exports have to substitute for lost demand. Thus cutting transfers to low incomes is no part of a demand-sensitive strategy. Low income groups should be exempted from wage cuts in the public sector or pension cuts. Wage increases in the private sector could be higher for low-wage groups. Incentives to save could be reduced, particularly for higher incomes. Incentives for private investment in general and for environmental investments (households and firms) in particular should be increased. In principle there will be a period of lower demand in a consolidation period, but it has to be kept as short as possible. Boosting exports in growing markets in Asia will stabilise demand.

7. Expenditure-based Consolidation Is More Likely to Be Successful

Consolidation is more likely to be successful in the long run if expenditure cuts dominate rather than tax increases.[10] This is specifically the case in Europe, where taxes are high already and where public expenditure has risen considerably during the crisis (from 46% in 2007 to 51% in 2010). One problem with focusing on expenditure cuts is that some of the reforms take time, specifically those lowering long-run expenditures via structural systemic changes (e.g. health care and school reforms, fiscal regime changes). In the short run, taxes may help to achieve the consolidation goals more quickly. Structural reforms in the public sector which help to contain expenditure in the long run should be started even if there are upfront costs. Privatisation can also lead to quick revenues if expenditure cuts are insufficient or come into force too slowly, but here long-run considerations (dividend losses, steering capacity) should not be neglected.

8. Boosting Domestic Demand Specifically in Countries with External Surplus Is Required

During consolidation, domestic aggregate demand should be stimulated, specifically in countries with low growth and high trade surpluses. If investment remains sluggish (cash flows are not used for investment due to unused capacities), wage increases and/or in-work benefits would stimulate consumption. Following a strategy whereby wages are raised less than productivity has led to a decreasing wage share in national income. This makes no sense if extra profits are not used for investment. Strategies to boost domestic aggregate demand may differ according to the situation in individual countries; tax credits for green technologies could help, too. Export-promoting strategies should concentrate on countries which do not have to consolidate.

9. The Structure of Expenditure Cuts Matters

Linear cuts of expenditures are clearly suboptimal, even if they are easier to get through politically. Expenditure on individual activities should be treated very differently. Those for bureaucracy should be reduced and inefficiencies have to be eliminated, while future-oriented expenditures should be increased at rates significantly higher than nominal growth. This implies rather deep cuts where state intervention is no longer necessary and where inefficiencies exist. Public sector studies (e.g. using frontier analysis) show that there are abundant efficiency reserves in the public sector of most countries and large subsidies to be cut. The social system can and should be fine-tuned (terminating early pension schemes, encouraging preventive health investment), but there should be no across-the-board cuts which would endanger the basic elements of the European Welfare State and which would harm aggregate demand.[11] Cuts in transfers as well as in the public wage

10 A. Alesina, S. Ardagna: Large Changes in Fiscal Policy: Taxes versus Spending, NBER, 2009, Working Paper 15438; F. Giavazzi, M. Pagano: Can Severe Fiscal Constraints be Expansionary? Tales of Two Small European Countries, in: O.J. Blanchard, S. Fischer (eds.): NBER, Macroeconomic Annual, 1990, pp. 75-116.

11 See K. Aiginger, H. Pitlik, M. Schratzenstaller: Optionen zur Konsolidierung der öffentlichen Haushalte in Österreich. Ausgangslage und Erfolgsbedingungen, WIFO-Monatsberichte, No. 3, 2010.

bill should be structural, i.e. reductions in expenditure on public employees should not stem simply from wage cuts and/or reducing the number of public employees, but should rather be effected by efficiency-enhancing reorganisation within the public sector. In order to contain expenditure on transfers, particularly in the pension system, structural measures with a long-term impact (e.g. adjusting the pension age to changes in life expectancy or abolishing special entitlements of specific interest groups) should be favoured over short-term cuts.

10. The Structure of Tax Increases Matters

Any tax increases have to be growth- and demand-sensitive. If there are tax increases, taxes with double dividends should be the first choice (financial transaction tax, levies on public bads such as environmental taxes). Some taxes inhibit growth strongly (taxes on labour and business), some far less (taxes on consumption, property, financial transactions). Shifting taxes from labour to property and from distorting taxes to those on "public bads" increases the long-term growth potential. However, increasing potential growth is not the only goal. Aggregate demand is another one, and reducing unemployment and strengthening social cohesion and equality are all important for the acceptance of the consolidation. This shifts the balance against a general increase of the value added tax as part of a consolidation package. An increase in the value added tax will burden in particular lower income households and will reduce consumption, which up to now has been a relatively stable component of aggregate demand (as compared to investment). Specifically important would be to reduce the tax wedge for lower incomes (for the purposes of lowering unemployment and increasing equality). After the consolidation period, any additional tax revenues raised for reducing the deficits now should be used to decrease taxes on labour and investment. This improves the overall tax structure and provides investors and consumers with the long-run perspective of a constant overall tax ratio.

A First Preliminary Evaluation of Budget Consolidation Plans for Europe

Measured by the intended reduction of structural deficits in 2011 compared to 2010, the volume of budget consolidation measures will amount to about 1.5 per cent of GDP in 2011 and 0.5 per cent of GDP in 2012 for the EU27 on average, according to the European Commission's autumn forecast published at the end of November 2010. Thus far, no comprehensive overview of the consolidation measures already taken and planned exists, despite the fact that consolidation measures were already taken in late 2009 and 2010.[12] In 2009, the volume of consolidation exceeded that of the stimulus packages in ten countries. This was the case for twelve countries in 2010. Thus any attempt to evaluate the consolidation packages in individual countries based on our ten guidelines is preliminary and will necessarily lead to incomplete results. We are also well aware that each and every guideline is not equally valid for all countries, and that there are important tradeoffs depending on the country-specific fiscal and macroeconomic situation. If the necessity to consolidate is extremely pressing, it is difficult to finance the proactive component. Finally, further analyses have to account for country-specific problems and conditions in individual policy areas, which cannot be done within this first evaluation.

Expenditure-based Measures Look to Dominate Revenue-based Ones

We are not yet able to come up with a quantitative assessment of the structure of consolidation packages concerning the shares of expenditure- and revenue-related measures. From the information available, however, we think we can safely draw three tentative conclusions. Firstly, almost all countries are relying on a mix of expenditure- and revenue-based measures. Secondly, expenditure cuts seem to have a larger weight than revenue increases. Thirdly, revenue increases almost exclusively consist of tax increases, whereas proceeds from privatisation play hardly any role (with Greece and Spain as two of the few exceptions).

Expenditure Cuts Focus on Public Wages and Pensions

Many countries announced cuts in the public wage bill. Most common seem to be general wage freezes (e.g. Greece, Italy, United Kingdom, Lithuania, Slovenia) or across-the-board public wage cuts (Spain, Romania, Germany, Ireland, Czech Republic and Portugal with its new austerity package for 2011). Demand-sensitive and equitable public wage cuts or wage freezes targeted specifically to higher incomes are planned e.g. in Portugal (first consolidation package), Austria and Slovakia. In the announcements made up to now, no long-term structural public sector reforms to remove inefficiencies are discernible. The United Kingdom, where broader reforms to decentralise public expenditures are planned, seems to be an exception.

12 European Commission: Public Finances in EMU, Brussels, 2010. Thus not only those countries with very severe fiscal problems already started consolidating their budgets during the crisis. Overall, consolidation measures reached 0.4 per cent of GDP in the EU27 in 2009, compared to stimulus measures amounting to 1.5 per cent of GDP. In 2010, consolidation measures already amounted to one half of the volume of stimulus packages.

Regarding cuts in social transfers, the focus is on pensions. Many EU countries have agreed on or are planning structural reforms within pension systems. Mostly, these comprise – with very different country-specific transition periods – an increase of the legal pension age. For example, Greece, Bulgaria, Estonia, Lithuania, Malta, Romania, Slovenia and Hungary are increasing the pension age to 65 years; in Denmark, Germany and the Netherlands, the pension age is being increased to 67 years; and in Ireland and the United Kingdom it is being raised to 68 years. France is raising the legal pension age to 62 years. Moreover, practically all EU countries where the legal pension age of women is still lower than that of men decided to harmonise the pension age for men and women in the long run (e.g. Greece, Italy, Malta, Poland, Romania and Slovenia). A number of EU countries (e.g. Greece, Bulgaria, Finland, France, Italy, Portugal, Romania, Slovenia, Estonia and Austria) agreed on efforts to raise the factual pension age.

Besides these structural reforms, which will be effective in the medium term only, there are short-term attempts to contain spending by freezing or only moderately increasing pensions in the public and/or the private sector in a smaller group of EU countries. For the most part, an across-the-board approach is being pursued (Austria is one exception), which is suboptimal from both an equity perspective as well as for aggregate demand.

Depending on the existence and the volume of an expected long-term sustainability gap, these short- and long-term measures may be structurally insufficient in individual EU countries to secure the long-term sustainability of pension systems. A deeper evaluation of the current consolidation measures against a possible sustainability gap in pension systems of individual countries cannot be undertaken in this first preliminary analysis, however. Here we would like to stress that pension systems in the EU are characterised by substantial differences with regard to the legal and factual pension age and that quite a few countries (e.g. Sweden, the Czech Republic, Austria) implemented long-term structural reforms to secure the long-term fiscal sustainability of their pension systems.

Across-the-board cuts in social transfers are nowhere to be found. However, some countries (e.g. Germany) explicitly cut selected transfers for lower incomes, which demonstrates a lack of demand-sensitivity and goes against our guideline of fair burden-sharing. The United Kingdom tried to cut benefits (child benefits) for higher income households. The planned cuts in child benefits and transfers for long-term care in Austria impose an overproportional burden on low income households. Consolidation measures within social transfers should also be integrated into structural reforms.

Rare Signs of Proactive Components

The consolidation packages announced up to now are for the most part not embedded in comprehensive reform efforts to increase long-term growth. In some countries there are selective proactive components. Germany, for example, plans to increase spending on education and R&D significantly over the next few years. Finland is discussing the implementation of a tax credit for research expenditures (not solely in response to the crisis). Greece has removed some obstacles for market access in specific sectors (road transport, etc.). The majority of the consolidation packages revealed thus far do not include measures and reforms to support long-term growth. Countries with large current account deficits (Greece, Portugal) have definitely not started programmes to encourage new firms, foreign direct investment or other programmes to increase the production base. However, the necessity of growth-friendly budget consolidation was recognised in the final document of the last G-20 summit and increasingly is accounted for in documents by the IMF and the OECD (even if growth-friendly is often equated with the implementation of structural reforms to strengthen market efficiency instead of pushing future-oriented expenditures). On the other hand, only few countries plan cuts in expenditure on growth drivers. Greece will spend less on education and public investment; in Ireland, Portugal and Spain, public investment expenditure will be reduced; and in Austria, expenditure on R&D, science and the environment will be cut.

The integration of budget consolidation into a long-term economic policy concept addressing the large future challenges is only rudimentarily discernible in EU member states' consolidation plans. The most significant exceptions are the structural reforms in the pension systems mentioned above and the increase in environmental taxes implemented by many EU countries, whereby no country intends to integrate these into comprehensive ecological tax reforms. Budget consolidation is pursued as a largely isolated strategy which stands largely unconnected beside other long-term oriented policy strategies (for example, Europe 2020). Demand sensitivity as well as a proactive growth-friendly component seem to be of only little importance.

Structure of Tax Increases

The most widespread and – with respect to the revenue effect – most important tax measure is an increase in the standard VAT rate. Since 2009, it has either already taken place or is planned in 13 countries, raising the average VAT rate in the EU by one percentage point to 20.4% between 2008 and 2010 and to 20.7% in 2011. Though VAT may be less distorting and growth-reducing than other taxes in the long run, it is a burden to aggregate demand in the short run and regressive.

Many countries are increasing excises on public bads, mainly environmental and tobacco taxes plus some on gambling or alcohol. No compensation is planned to reduce the regressive effects; some of these taxes are sharing with value added taxes in general.

A few countries are raising property-related taxes, primarily taxes on real estate. A few countries will tax capital gains at a higher rate, and others are planning a tax on luxury goods (e.g. Bulgaria). Spain is reintroducing its wealth tax, which was just abolished in 2008. Measures to combat tax fraud and evasion barely feature at all, with the notable exception of Greece and some attempts in the United Kingdom and Lithuania.

Cyprus, Hungary and Lithuania are increasing the corporate income tax rate. Nine countries are raising the top personal income tax rate; a special tax on bonuses has been introduced (temporarily) in Greece, France and the United Kingdom; and Hungary, Germany, Portugal, Sweden, France and Austria are introducing a bank levy. Initiatives to shift the tax burden to a significant degree from growth-inhibiting taxes (particularly taxes on labour) to more growth-friendly ones have so far not been announced by any country. Moreover, no country has addressed the question of how to use the additional tax revenues after the consolidation period.

Summary

Consolidation is not an easy task. The bad news is that aggregate demand decreases in the short run. The good news is that this period can be kept short and its effects may be mitigated by appropriate policies flanking any consolidation. In the long run, growth does not have to be affected negatively (and in some favourable cases, it can even be positively affected). This is the case only if (i) consolidation is based on a coherent strategy, (ii) this strategy is followed consistently, (iii) it is well communicated and accepted as fair, (iv) growth and demand aspects are addressed, and (v) complementary reforms are implemented.

Consolidation is not an isolated task and not the only priority of an economy. It has to be embedded in a comprehensive strategy for growth, employment creation and solving the long-run problems and challenges of an economy. National fiscal and budgetary frameworks should be adapted to achieve balanced budgets and long-term debt sustainability.

Against this background, we propose ten guidelines for consolidation. These should help to consolidate in a growing economy, stimulating long-term growth drivers, making the system more ecologically sustainable and correcting the trends of higher income divergence and persistent unemployment. We cannot forget climate change, Europe 2020, R&D, education and the ageing of our society for a long period of consolidation.

With the exception of structural reforms in pension systems, consolidation programmes as published so far are going for the "low road" of consolidation: easy cuts in expenditures like public wages, plus the taxation of the largest demand component, i.e. consumption. Both are done without restructuring taxes or expenditures and without solving the problems that existed before the crisis and even contributed to the crisis. A few items are added selectively to increase support for the strategy (banking tax, taxes on bonuses and surcharges for high incomes), but they do not dominate. Little connection exists in the programmes so far between consolidation and fighting persistent unemployment, better matching of qualifications, or combating climate change. The consolidation programmes do not include a determined proactive component to increase the growth potential, for example through the creation of new firms, nor are they reducing inequality or preparing for an ageing society. Consolidation strategies are not sufficiently coordinated internationally; therefore potential "smart" tax revenues from a financial transaction tax or from kerosene (aviation gasoline) are foregone. Currently, there is the danger that those countries with large consolidation needs will dampen domestic aggregate demand (e.g. by increasing the VAT or the corporate income tax) and will then not be able to reach their consolidation targets due to the contractionary effect of these measures.

Going for the "high road" would imply trying to increase the growth path during the consolidation period. Economic growth was low in Europe before the crisis, and potential output had been lost. If there is anaemic growth, consolidation will never work. An activation component in any consolidation would mean fostering research and education, but also improving the qualification of the workforce and boosting energy efficiency and alternative energy. Going for the high road would further mean reducing rather than increasing income differentials, which widened before the crisis and contributed to the instability of demand and of the financial sector. Going for the high road in a period in which the share of the government sector has soared in the EU from 45.6% to 50.6% of GDP means primarily that expenditures should be cut by screening subsidies, streamlining administration and making the public sector more efficient. Increasing some taxes might help, but this should be done only temporarily, and the taxes raised should be those which yield double dividends for the environment or health. On the other hand, the tax structure should be boldly changed to focus less on growth inhibiting taxes and more on growth, employment and investment-friendly expenditures.