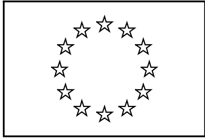

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Public finances in EMU - 2002

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Fiscal policies in the recent juncture: responding to the cyclical slowdown …

2001 proved to be the most challenging period for fiscal policy in the three-year history of EMU as the global slowdown provided the first real stress test of EMU's multilateral surveillance framework, and especially its budgetary dimension. The budget deficit for the euro area reached 1.3% of GDP, up from 0.7% in 2000. Despite this first reversal in the process of budgetary consolidation since 1993 and criticism about perceived failure to strictly adhere to the provisions of the Stability and Growth Pact (SGP), there are several grounds for considering the framework for budgetary aspects of the multilateral surveillance framework have performed well in responding to the cyclical slowdown.

Firstly, Member States had scope to let the automatic stabilisers operate so as to cushion the negative shock. This was especially the case in countries which had already achieved a budget balance or surplus. Automatic stabilisers were also allowed to work in countries that had not yet completed the transition to the close-to-balance target of the SGP. However, deficits in Germany and Portugal started to rise and approach the 3% of GDP reference value.

Secondly, countries did not embark on unwarranted expansionary policies. Fiscal authorities came under considerable pressure to relax consolidation commitments and resort to active demand management in response to the global slowdown. The structural budget deficit in 2001 of 1.5% of GDP is almost unchanged compared with 2000: this illustrates that the deterioration in the actual budget balances was mostly due to operation of the automatic stabilisers. Indeed, it is worth noting that despite the slowdown, actual budget balances were unchanged in Belgium, Denmark and Italy and indeed improved in Greece, Spain, Austria and Sweden.

Thirdly, Member States have been able to continue with planned tax reforms designed to remove supply side rigidities, despite claims from different quarters that the SGP was unnecessarily tying the hands of the authorities through arbitrary and inflexible rules. What EMU's budgetary rules emphasise is the need to accompany these tax reforms with appropriate measures on the spending side given the fact that tax reductions are seldom self-financing. Such measures are paramount to guarantee the sustainability of tax reforms and thus should reinforce their impact on investment and consumption.

The confirmation of the commitment to the rules and spirit of the SGP helped achieve a balanced policy mix which was supportive to growth while guaranteeing price stability. Whilst fiscal policies remained broadly neutral, monetary conditions eased markedly. Such a policy mix is appropriate not only from a cyclical standpoint, but also in a medium and longer term perspective, considering the need to boost private investment and potential growth and to prepare for the budgetary pressures of ageing populations. Recent short-term indicators point to a turnaround in the European economy, and thus expansionary measures may *ex post* have turned out to be pro-cyclical. This assessment of the performance of the framework for budgetary surveillance needs to be tempered with caution as the recent downturn was neither particularly severe or prolonged. Budgetary positions of "close to balance or in surplus" are still not met in all countries. Rapidly achieving such targets is the best way to ensure that Member States have sufficient room for manoeuvre should a recession arise in the future.

… while continuing to improve EMU's fiscal framework

In early 2002, attention has mostly focussed on the cyclical response to the slowdown and on the procedures for dealing with slippage from budgetary targets, especially the debate on whether an early-warning recommendation should be issued to Germany and Portugal. However, it is important not to overlook a number of significant measures that have strengthened the quality and coverage of budgetary surveillance, and improved the analytical tools available to the Commission and Council for policy assessment. While seemingly technical, these are important advances which will help improve the coherence and effectiveness of EMU's fiscal framework.

Firstly in July 2001, the ECOFIN Council revised the Code of Conduct on the content and presentation of stability and convergence programmes (which dated from 1998) taking into account the experiences of three years in EMU. Member States applied the Code to the recently updated programmes. The revised Code provides for a clustered submission of programmes with budgetary targets based on external macroeconomic assumptions that have been agreed in common. It also clarifies the interpretation as to what constitutes an appropriate medium-term target of 'close to balance or in surplus' for each Member State. Finally, it extends the coverage of programmes to include sections on the quality and sustainability of public finances in line with the Lisbon conclusions. The most important result of the application of the new Code is probably the improved ability to consider the implications for the euro area as a whole of the budgetary policies outlined in the national programmes. This was particularly valuable given the high degree of uncertainty surrounding the economic situation at the end of 2001 and beginning of 2002. In time, this will also allow the euro area dimension to be increasingly factored into national budgetary policies.

Second, the economic downturn underlined the importance of paying close attention to the cyclically-adjusted budget balances when examining the budgetary positions of Member States. While measuring the impact of the economic cycle on budget positions is complex and subject to uncertainties, it is important that all actors involved in the surveillance process have a common view on the underlying budgetary developments. *Inter alia*, the cyclical adjustment of budget balances is used when evaluating the minimum cyclical safety margins under the 3% of GDP reference value and the respect of the "close to balance or in surplus" target of the Stability and Growth Pact. In order to ensure consistency, broad agreement has been reached between the Commission and Council on a method to measure cyclically adjusted budget balances based on a production function approach to estimating the output gap.

Third, a major extension of EU budgetary surveillance was achieved with the first systematic assessment of the sustainability of public finances in light of ageing populations. This was made on the basis of the updated stability and convergence programmes submitted in late 2001. The analysis shows the potential risk for emerging budgetary imbalances in many Member States, and emphasises the importance of achieving and sustaining the medium-term targets set down in their programmes.

The importance of the early-warning system

A critical juncture in the budgetary surveillance process was reached in January 2002, only weeks after the introduction of euro notes and coins, when the European Commission recommended that an early-warning be sent to Germany and Portugal under the SGP. Both countries missed the targets for 2001 set down in their stability programmes by a wide margin (over 1% of GDP), and there was a clear risk of deficits approaching the 3% of GDP reference value for the budget deficit. In the face of such clear-cut slippage from agreed targets, the Commission acted to preserve credibility of the legal and political obligations of the Pact. As a result of discussions in the ECOFIN Council on the Commission's draft recommendation for an early-warning,

Germany and Portugal gave firm political commitments which responded to the substance of the Commission's concerns: the Council therefore decided to close the procedure. Both countries reiterated their willingness to avoid a breach of the 3% of GDP reference value, to resume the process of budgetary consolidation and to reach their medium-term targets by 2004. At the same time the Council restated the importance of the early-warning system in the overall framework for budgetary surveillance and confirmed that the Commission had acted in accordance with the provisions of the Pact.

The credibility of the rules-based framework for the co-ordination of budget policies will have to receive particular attention in the future. A relevant distinction here is between the process of the early-warning and its outcome. It is important to avoid a perception in public opinion that the rules can be changed or at least avoided in challenging circumstances. Commitment to the framework for budgetary surveillance was confirmed by the Council and so was the importance of the SGP. The early-warning procedure can and will be used again if the need arises. Obviously, to maintain the credibility of the SGP, it is important that the commitments of Germany and Portugal are implemented in full. Positive evidence is emerging that these commitments are being taken seriously. In particular, following the agreement in the ECOFIN Council of February 2002, a domestic stability pact between the Länder and the Bund in Germany has been agreed.

Looking to the future: attaining the goal of the Stability and Growth Pact …

Maintaining credibility in the SGP also requires the Commission and Council to demonstrate a capacity to learn from this first experience with the early-warning mechanism. While the SGP has undergone the first real stress test and the economic situation is forecast to improve, there is no room for complacency. Important budgetary challenges remain to be tackled.

First of all, once economic recovery has gathered pace, the budgetary consolidation process to meet the 'close-to-balance' rule of the Pact must start again and any lost ground should be quickly recovered. In the latest updates of stability and convergence programmes, Member States which still have a budget deficit confirm their commitment to reach the medium-term target of the SGP by 2003 or 2004. Moreover, the budgetary adjustment planned for coming years will be achieved via reductions in both revenue and expenditure, in line with the recommendations of the BEPGs. Meeting the budgetary commitments to reach the medium-term targets foreseen in the stability and convergence programmes is paramount to underpin the credibility of the Pact. This is especially the case for the four countries still in deficit (Germany, France, Italy and Portugal).

Second, as past experience shows, budgetary mistakes tend to occur mainly in good times. The debate back in 2000 on how to distribute the so-called "growth dividends" between tax cuts and spending increases defy, as the Commission pointed out at the time, not only the rules of the SGP, but also economic logic. It is important not to consider improvements in the budget balance due to a favourable economic juncture as permanent, thus providing scope for tax reductions or expenditure increases. The budgetary constraint affecting mainly the large euro area countries in 2001 and 2002 have their roots in the missed opportunities of the high-growth period 1998-2000. Preventing a deterioration in structural budget balances during upturns is probably the most daunting challenge for the SGP. Surveillance will need to ensure that countries still not complying with the requirements of the Pact take the opportunity of the recovery to accelerate fiscal retrenchment while the others let automatic stabilisers operate fully. In brief, financing tax reductions and spending rises via the automatic fruit of economic growth or accelerating the tax cuts as soon as growth revives is misguided both from the point of view of fiscal prudence and cyclical stabilisation.

Third, there is a need to discuss the desirability and effectiveness of discretionary fiscal policy. If countries abide by the SGP's fiscal philosophy, they will choose a broadly balanced budget in structural terms and let automatic stabilisers play freely over the cycle. This is based on the well-known pitfalls of active fiscal management (implementation and recognition lags, model uncertainty, measure irreversibility, etc.). The circumstances under which counter-cyclical discretionary fiscal actions (going beyond the operation of the automatic stabilisers) may be both desirable and effective are very narrow: they could be envisaged in the event of large country-specific demand shocks originating domestically and entailing strong inflationary or deflationary pressures. Even in these cases, however, the risk that an *ex ante* counter-cyclical policy becomes *ex post* pro-cyclical is high. Moreover, the room for manoeuvre for the discretionary stimulus would have to be created in order not to breach the 3% of GDP deficit ceiling. For a number of countries, this would imply going beyond the close-to-balance rule of the Pact. A clear agreement between the EMU policy actors on the criteria to assess discretionary fiscal policies would increase the transparency and predictability of budgetary behaviour. While the role for discretionary should be confined to critical country specific shocks, this does not mean that policy co-ordination should be confined to exceptional circumstances. By its very nature, occasional co-ordination is ill-suited for implementing a consistent macroeconomic strategy in both normal and exceptional situations. Policy co-ordination – viewed as a system to attain a common assessment of the economic situation, agree on the orientation of the policy response and monitor their implementation – should be regular, not occasional.

Finally, several Member States are trying to improve the compatibility between their national fiscal rules and EU budgetary commitments. The Treaty and the Pact leave it up to Member States to determine their own budgetary procedures to achieve SGP targets. However, the financial relevance of regional governments and other sub-sectors of the government in the budget process in federal states and strongly regionalised states (Belgium, Germany, Spain, Italy and Austria) has highlighted the necessity for Member States to find solutions to secure sustained discipline at all levels of government. To address this coordination problem, several Member States have already adopted special arrangements among government levels, in what could be termed 'internal stability pacts'. A common characteristic of these pacts is the effort to clarify and share the responsibility for budget discipline among the different levels of government.

… while addressing the long run sustainability of public finances

Fiscal discipline is not only about running sound public finances in the short to medium-term. It also requires that public finances are sustainable in the long run, i.e. that current budget policies do not lead to or risk causing future budgetary imbalances in breach of SGP requirements due to the budgetary effects of ageing populations. Sustainability also requires that age-related expenditures (pensions, health care) do not crowd-out other essential public spending such as investment and R&D. Moreover, future generations should benefit from an adequate public capital stock and should not face an unfair tax burden.

The information included in the stability and convergence programmes shows that ageing populations will have a considerable budgetary impact. Public spending is projected to increase by between 4% and 8% of GDP in the coming four decades in most Member States, although much higher increases are projected in several countries. Increases in public spending due to ageing populations will start as of 2010 as the baby-boom generation enter into retirement, and the steepest increases will occur usually between 2020 and 2035.

The analysis shows that on the basis of current policies, there is a risk of budgetary imbalances emerging in many Member States, and these risks multiply if countries fail to reach the medium-term targets set down in their stability and convergence programmes. All countries will face a budgetary challenge posed by ageing populations, even those which appear to be well placed to

meet the growth in age-related expenditures. In high-debt countries (Belgium, Greece Italy) sustainability is dependent upon running large budget surpluses over several decades, illustrating the continued need to give preference to debt reduction over the long run. Other Member States face a challenge of meeting the additional costs of ageing populations while at the same time pursuing other budgetary objectives, notably keeping the tax burden at reasonable levels.

Faced with this challenge, several countries have put in place comprehensive strategies, including measures to raise employment rates especially amongst women and older workers, reform of age-sensitive transfers programmes, and commitments to run sustained budget surpluses so as to achieve a rapid reduction in public debt levels prior to the impact of ageing populations taking hold. However, the ambitious and comprehensive reforms of some Member States contrast with rather piecemeal approaches in other countries which fail to recognise the seriousness of the policy challenge. Several countries have established pension reserve funds in recent years to meet future expenditure increases. While this is a welcome development, the extent to which they will meet future costs is questionable (with the exception of Ireland) given the limited resources which have already been invested in them and uncertainty as regards the size and frequency of contributions. Overall, policy makers need to be more aware that it is short- to medium-term budgetary choices which determine the capacity of countries to meet the budgetary costs of ageing populations.

New frontiers of budgetary surveillance and coordination: factoring in the "quality" of public spending …

Public spending has risen sharply in the EU over the past three decades to 47% of GDP in 2001, having declined during the Maastricht process of budgetary consolidation from over 51% of GDP in 1995. The average size of the government sector in the EU remains well above levels in other industrialised countries and is 15 percentage points of GDP above that in the US. The aggregate picture, however, hides considerable disparity in the size of the government spending across Member States.

Public spending on the basic function of the State and other measures to improve the allocation of resources (defence, justice, education, health care, R&D, economic services) has remained remarkably stable over the past 30 years, and is very similar (between 14% and 16% of GDP) across EU countries. The difference in overall government spending levels in the EU compared with the US mainly reflects spending on social protection programmes, this being a typical feature of the European Social Model. The largest increases in spending on social protection have been recorded in countries that had relatively immature social protection systems at the beginning of the 1980s. Conversely, countries with high levels of spending in the early 1980s have started in the last decade to reduce the amount of resources devoted to social welfare.

The stricter budget constraint facing Member States in EMU, coupled with efforts to raise the employment and growth performance as part of the Lisbon agenda, requires that greater attention be paid to how public resources are spent and how taxes are levied. However, cross-country analyses have been hampered by the lack of timely and comparable data on the functional classification of public expenditures. As a consequence, while considerable progress has already been accomplished on long term sustainability of public finances, whereas surveillance of the quality of public finances, as required by the European Council, is still at an early stage.

The difficulty in putting in place an effective monitoring of the quality of public spending is also due to the conceptual difficulty in defining what 'quality' actually means. A certain composition of public expenditure could be considered as 'high quality' if it makes a positive contribution to the goals of the Lisbon strategy, i.e. making the Union the most dynamic, competitive, knowledge

based economy, enjoying full employment, strengthened economic and social cohesion and environmental sustainability. On this basis, Member States can promote growth and employment by redirecting public expenditure towards physical and human capital accumulation and research and development. Investment in human capital and infrastructure can have a robust effect on long-term growth and new innovative approaches to financing should be sought, including public private partnerships. Appropriate spending on social welfare, together with an appropriate tax policy, can contribute to equity and can also have a positive impact on growth and economic efficiency.

Countries appear to have been able to improve the composition of public expenditure while at the time containing the size of the public sector during the 1990s. In this context, it is worth mentioning that the EU budget complemented Member States' expenditure in growth promoting categories such as investment and R&D. Before drawing firm policy conclusions about the level and composition of public spending, it is essential to conduct microeconomic analysis that takes into account the specific aims of spending programmes, their design and linkages with other policy instruments. A precondition for doing so is the availability of suitable data, the elaboration of which has already been identified as a priority area by successive European Councils.

… and preparing for enlargement

Accession negotiations are currently underway with twelve of the thirteen candidate countries who wish to join the EU. The Treaty provisions and secondary legislation (the *acquis communautaire*) on economic and budgetary policy will apply to these countries once they join the EU. A major policy challenge is to implement upon accession the EU framework for budgetary surveillance taking into account the specific needs and circumstances of the candidate countries. Key budgetary issues are faced by a sub-set of candidate countries, namely the ten countries from central and eastern Europe (CEECs) as they approach entry into the EU and, differently from the other candidate countries, undergo a transition from a command to a market economy.

The overall relative level and composition of revenues and expenditures in CEECs resemble those in present EU Member States, although significant differences for individual countries and budgetary components exist at times. This is a remarkable fact since CEECs have had only ten years to implement *ex novo* a fiscal system. While the size of CEECs governments is on average higher than in most emerging economies, this can be largely explained by underlying economic factors. There remains, however, a need to reassess the structure of budget revenues and expenditures to foster a growth-enhancing environment providing sufficient space and incentives for private sector development.

A key requirement for budgetary surveillance are reliable and timely government accounts. This has proved to be difficult for countries undergoing a transition to a market economy. From an institutional point of view, treasury departments had to be created and far-reaching modifications were required to accounting and recording procedures. Developing the capability to provide timely and reliable data with an appropriate coverage has been a lengthy task, which is not yet completed and there is scope for further improving the quality of budgetary data. From a conceptual point of view, the transition to a market economy is shifting the boundaries between the state and the private sector, making it somewhat difficult to interpret and compare government accounts in the CEECs. Many of the underlying problems, however, are decreasing as transition advances and the *acquis communautaire* is progressively implemented.

Budgetary surveillance will also need to take into account that the CEECs are undergoing tremendous structural and institutional changes. These changes are not only driven by the completion of a move from a command to a market economy, but also by the liberalisation effects which EU membership will entail, the need to upgrade public infrastructure and the

commitment to implement the *acquis communautaire*, with the related institution building requirements. All of these changes have significant budgetary implications that need to be factored into the evaluation of the budgetary situation. In addition, due consideration must be given to the constraints imposed by the fact that, on average, CEECs are characterised by a higher degree of volatility in output levels compared with EU Member States and are small open economies which rely heavily on foreign capital to finance catching up.

Since 2001, the Commission has implemented a new initiative called the Pre-accession Fiscal Surveillance Procedure (PFSP) which is designed to closely approximate the policy co-ordination and surveillance mechanisms of the EU while giving due regard to the accession priorities of the candidate countries. The assessment of budgetary positions in the run up to accession should therefore be flexible enough to cater for the uncertain and fast changing circumstances facing economies undergoing rapid change, but at the same time rigorous enough to cater for the very real challenge facing the CEECs.

Accordingly, in the run up to accession, candidate countries are required to comply with the Copenhagen criteria rather than fulfilling the Maastricht nominal convergence criteria. The primary concern in the pre-accession period is medium-term macroeconomic stability, rather than achieving any particular target for the budget balance. Medium-term budgetary policy should also pursue a structure of expenditure and revenues that effectively supports economic growth. At the same time, the emphasis on structural and institutional reform should not hide the importance of sound fiscal policies. CEECs' vulnerability to economic shocks and the external constraints they face underline the need for prudent policies. The appropriate deficit level may vary across countries and is likely to be a function of elements such as the speed of structural reforms, the relative speed of economic growth, the extent of real convergence and the level of debt.