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Public finances in EMU – 2003

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Public finances in EMU – 2003[1].

The most difficult period for budgetary policies since the launch of the euro

2002 and the early part of 2003 has been a difficult period both in terms of actual budgetary developments and as regards the implementation of the EU framework for fiscal surveillance. The nominal deficit for the euro area as a whole increased from 1.6% of GDP in 2001 to 2.2% in 2002 and, according to the latest Commission forecast, it is projected to rise to 2.5% of GDP in 2003. This aggregate outcome is the result of striking contrasts in the performance across Member States. By the end of 2002, only six EU countries, including four euro area countries (accounting for some 18% of euro area output) had achieved budget positions (both in nominal and cyclically adjusted terms) that met the 'close to balance or in surplus' requirement of the Stability and Growth Pact, whereas two euro area countries (accounting for half of the euro area output) had deficits above the 3% of GDP reference value.

The Portuguese authorities succeeded in reducing the nominal deficit from 4.1% of GDP in 2001 to 2.8% in 2002, although very significant challenges remain if the deficit is to remain below 3% of GDP in 2003 as much of this improvement is due to one-off measures which have only led to a transitory improvement in the budget balance. A deficit of 3.6% of GDP in 2002 has resulted in Germany being placed in an excessive deficit position: while the authorities are taking measures aimed at reducing the cyclically-adjusted budget deficit, only a very limited improvement in nominal terms is expected in 2003 as growth conditions deteriorate. Despite clear evidence of budgetary slippage emerging in early 2002, the French authorities did not take corrective measures and a deficit of 3.1% of GDP occurred in 2002 resulting in the excessive deficit procedure being activated. An even higher deficit of 3. 7% of GDP is forecast by the Commission services for 2003 on the basis of current policies. Large deficits remain in Italy (2.3% of GDP in 2002 and in 2003) and by 2004 is projected to rise above the 3% of GDP reference value[2]: budgetary consolidation efforts in Italy continue to rely on one-off measures rather than on reforms of a structural nature needed to ensure a permanent improvement in the budget balance. Deficits have also re-emerged in 2002 in countries that already had reached balanced budget positions, notably Austria (0.6% of GDP), the Netherlands (1.1%) and the UK (1.3%).

Higher nominal deficits are only partly due to the economic cycle

At first sight, these developments compare relatively favourably with previous economic downturns when deficits reached much higher levels and debt ratios entered rapidly increasing trajectories. In addition, governments have not pursued fine-tuning policies and while fiscal policies were slightly looser, monetary conditions have eased thanks mainly to low real interest rates.

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1 See also the report by the Commission services on “Public Finances in EMU 2003”, SEC ……..

2 European Commission Spring 2003 forecast, 2004 figures are based on the assumption of no policy change.

However, a closer consideration of underlying budgetary trends reveals that the deterioration in nominal deficits also results from high and rising cyclically-adjusted deficits in several countries. This indicates a discretionary loosening of the fiscal stance by some Member States over the past two years, brought about by a combination of unfunded tax cuts, discretionary expenditure increases and failures as regards budgetary execution. While the outcome of the euro area in 2002 was unchanged compared to 2001, it should be noted that the cyclically-adjusted budget balance for 2001 has recently been revised upwards to 2.1% of GDP from 1.5% of GDP, implying that the deterioration in the underlying budget balance in that year was considerably worse than earlier estimates showed: moreover, the cyclically-adjusted budget balance includes the impact of one-off budgetary measures which only have a transitory effect on budget positions. The deterioration has been particularly pronounced in Germany (where the CAB increased to 3.2% of GDP in 2002) and France (to 3.3%). In Italy, it remains high at 2.1% of GDP.

In a medium-term perspective, the latest updates of the stability and convergence programmes contain a target by most Member States to reach budget positions of 'close to balance or in surplus' by 2005 or 2006. However, it should be noted that the medium-term targets of Member States are based on growth assumptions, which in light of developments in recent months now appear to be optimistic. In countries where large cyclically adjusted deficits remain, the time frame for reaching the ‘close to balance or in surplus’ objective has been pushed back to 2006 or 2007: even this date will only be met if additional consolidation measures are undertaken.

Commission proposals to strengthen the co-ordination of budgetary policies

The deterioration in budget positions has placed considerable stress on the EU’s framework for fiscal surveillance and three Member States have been placed in excessive deficit positions. In response to these developments, and in line with a mandate from the Barcelona European Council conclusions, the Commission adopted a Communication on strengthening the co-ordination of budgetary policies.[3] It identified a number of shortcomings with the implementation of the SGP in the first four years of EMU and outlined a strategy based on Member States reassuming political ownership of the Pact. *Inter alia,* it called for more account to be taken of underlying economic conditions when assessing budgetary positions, an interpretation of compliance with SGP requirements that would (depending on country specific circumstances) cater for the budgetary impact of reforms that enhance growth and employment, increasing the emphasis placed on the sustainability of public finances and outstanding debt positions, and improving the implementation of the SGP including stricter and more timely recourse to the existing enforcement instruments. At the same time the Commission adopted proposals to improve the governance of budgetary statistics which provide the foundations for effective surveillance.

The European Council of March 2003 endorsed key conclusions of the ECOFIN Council

The Spring European Council of March 2003, endorsed a report of the (ECOFIN) Council which shared many of the Commission’s proposals on strengthening the co-ordination of budgetary policies. It confirmed that the achievement of a budget position of 'close to balance or in surplus' is in the economic self-interest of Member States both individually and collectively. In the short run, it provides room for the automatic stabilisers to operate freely and cushion the effect of economic shocks; in the medium-run it creates room for budgetary manoeuvre to either cut taxes or divert expenditures to more productive items such as

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[3] Communication from the Commission “Strengthening the co-ordination of budgetary policies”, COM (2002)668 final of 27 November 2002.

investment and R&D; in the long-run, compliance will help Member States meet the budgetary costs of ageing population while securing adequate and accessible pensions and health care.

In addition to re-stating their commitment to the goal of the SGP, the Council agreed that compliance with the 'close to balance or in surplus’ requirement should be assessed in cyclically-adjusted terms with due account taken of one-off budgetary measures which only have a transitory impact on budget positions. For euro-area countries, agreement was reached that Member States with deficits should achieve an annual improvement in the cyclically-adjusted budget deficit of at least 0.5% of GDP until the 'close to balance or in surplus' requirement is reached. It underlined the need for automatic stabilisers to operate symmetrically over the economic cycle and the particular importance of avoiding a pro-cyclical loosening of fiscal policies in good times. The Council also confirmed the importance of running down public debt at a satisfactory pace towards the 60% of GDP reference value and that the existing provisions of the Treaty (i.e. the debt criterion of the excessive deficit procedure) can contribute to achieving this goal.

An opportunity to ensure consistent and transparent budgetary strategies

To ensure that the agreement of the European Council represents a real progress towards a consistent and transparent implementation of SGP, it is essential that the policy guidelines endorsed by the European Council, and the specific budgetary commitments given by Member States in their updated stability and convergence programme, are respected.

To this end, policies adopted at national level need to respect the budgetary goals agreed at EU level In doing so, budgetary consolidation strategies need to be designed in a way that tackle, and not exacerbate structural weaknesses leading to slow growth and missed employment opportunities. This requires careful design as regards the balance between measures on the revenue and expenditure side, and choices on the composition of public expenditures. Contrary to what is often argued, the existing framework for budgetary surveillance can simultaneously achieve a consistent approach that balances the need for budgetary consolidation, re-igniting the recovery and strengthening growth potential.

Significant advances have been made in the framework for budgetary surveillance

This year’s report on *Public finances in EMU –2003* highlights three areas where substantial progress has been made in the framework for budgetary surveillance over the past year: (i) the integration of candidate countries into the EU’s fiscal surveillance framework, (ii) an increased focus on the sustainability of public finances, and (iii), an improvement in the governance of budgetary statistics. These advances show that tangible progress can be made to the benefit of Member States and the EU as whole when there is a political will to do so. It also shows that framework for budgetary surveillance is capable of evolving in light of growing experience and new policy challenges.

Integrating acceding and candidate countries into the EU's fiscal surveillance framework

With ten countries set to join the EU in 2004, a major policy challenge is to prepare for their integration into the EU economic policy framework, in particular for budgetary surveillance. A key requirement has been to develop reliable government accounts and economic forecasts on a par with existing EU countries. At the same time, the EU surveillance of budgetary developments needs to develop so that appropriate account is taken of the important structural and institutional changes underway in accession countries. These are partly due to the completion of the transition from a command to a market economy and partly due to the additional effects which EU membership will entail (associated with the need to upgrade public infrastructure and the commitment to implement the *acquis communautaire*).

Clear strides have been taken in recent years, although budgetary data are still neither fully comparable across countries nor completely in line with EU definitions. Data reported by the candidate countries and forecasts prepared by the Commission services indicate that budgetary developments are closely mirroring those in the EU, with nominal and cyclically adjusted budget deficits in 2002 rising in most countries. Looking ahead to 2003 and 2004, the Commission forecast of Spring 2003 envisages an improvement in the budgetary balances of nine countries, with marked deficit reductions forecasted in Hungary, Slovakia and Turkey, and to a more limited extent in Malta. However, very limited improvements in budget balances are projected in the Czech Republic, Poland and Cyprus.

An important step to integrate the candidate countries into the existing surveillance process was completed in November 2002, when the second set of Pre-accession Economic Programmes (PEPs) submitted by candidate countries were examined. The annual programmes outline the medium-term policy framework, including public finance objectives and structural reform priorities, and moreover provide an opportunity for candidate countries to develop their institutional and analytical capacity. The 2002 updates revealed an improved effort to develop a consistent and credible medium-term macroeconomic framework, although further analytical capacity building is called for.

The sustainability of public finances received increased prominence in the assessment of sustainability and convergence programmes.

Progress has also been made as regards placing increased emphasis on the sustainability of public finances in the SGP as requested by the 2001 Stockholm European Council. For the second time, an assessment of the sustainability of public finances was carried out on the basis of budgetary targets and measures announced in the 2002 updates to stability and convergence programmes leading to firm policy conclusions by the Council. The policy conclusions, which are based on quantitative indicators and long-run budgetary projections prepared by the Economic Policy Committee and national authorities, are worrying.

Even assuming all Member States achieve the budget targets for 2006 set down in their stability or convergence programmes, there is a risk of unsustainable public finances emerging in about half of EU Member States, especially Belgium, Germany, Greece, Spain, France, Italy, Austria and Portugal. To ensure sustainable public finances, Member States with deficits first need to achieve and sustain the SGP goal of budget positions of 'close to balance or in surplus'. Furthermore, preliminary estimates by the Commission show that an additional permanent budgetary adjustment of between 1 and 2 percentage points of GDP is needed in Member States where the sustainability of public finances is a concern. To close this financing gap, governments should try to avoid raising taxes (especially on labour), and concentrate efforts on reducing (in terms of ratio to GDP) age-related expenditure by reforming of pension and health care systems and/or reducing non-age related primary spending while increasing employment rates and fostering growth.

Progress has been made on the governance of budgetary statistics

The quality of economic statistics is crucial to ensure an adequate understanding of the economic situation and effective policy making. Budgetary statistics are the foundation of the EU fiscal surveillance tools and their quality has improved considerably over the last decade. Government accounts are now more reliable, complete, transparent and detailed, and are published in a much more timely fashion than when the excessive deficit procedure was set up. However, some weaknesses remain: in several countries, data on government deficit and debt ratios are not yet as reliable as they should be and are subject to large revisions. Furthermore, the government accounts of several Member States are not fully transparent, and there have been problems in terms of their timely submission. These concerns are clearly amplified with the perspective of enlargement.

To address outstanding challenges, the (ECOFIN) Council recently agreed to implement a code of best practice.[4] From the Member States' side, this involves increasing the transparency of government accounts in particular for the lower government subsectors, the strict respect of deadlines, an overall increase in the data quality, but also a clarification of the independence statute of the national statistical offices as the main compilers of government data. The Commission (Eurostat) is aiming at reinforcing its ability to scrutinise the Member States' government accounts in more detail, and accelerating the decision making process for deciding upon the recording of government transactions. The new steps to compile quarterly budgetary statistics is a major challenge for statisticians, but also for economists, policy-makers and budgetary policy analysts that will need to interpret quarterly data with due care, since these will necessarily be more volatile and perhaps less transparent than annual data.

The Commission role in upgrading the analysis of economic and budgetary policies

In its Communication on strengthening the co-ordination of budgetary policies, the Commission committed itself to upgrading the analysis of economic and budgetary policies. To this end, a number of detailed studies are contained in the report *Public finances in EMU – 2003* as follows:

- firstly, the report examines the impact of budgetary consolidation on growth. It considers whether the assertion that budgetary consolidation has a negative impact on output is always valid, or whether fiscal consolidations in EMU under certain conditions can have a positive effect on output;

- secondly, and as part of the effort to focus on the quality of public finances, the report analyses public investment. It examines the reasons why public investment as share of GDP has fallen in recent decades and whether this is in part due the process of budgetary consolidation and the development of fiscal rules at EU level. It also analyses the link between public investment and productivity, and considers the merits and feasibility of developing specific provisions for public investment within the EU's framework for budgetary surveillance; and,

- a third chapter examines various aspects of the challenge facing national authorities in ensuring sound public finances. It reviews the experience of Member States in using expenditures rules as an instrument to better manage public finances and improve their quality. In addition, the chapter examines how the allocation of public finance functions

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4 Conclusions of the 2485th Council meeting, Economic and Financial Affairs, Brussels 18 February 2003.

across different levels of governments influences the capacity of Member States to fulfil their budgetary commitments at EU level. This analysis is a good example of the role of the Commission in undertaking comparative cross-country analyses that enable Member States to learn from the experiences and best practices of other countries.

Is fiscal consolidation always contractionary?

While there is a broad consensus among both academics and policy-makers on the need for fiscal discipline to ensure the smooth functioning of EMU and provide conditions conducive to growth and employment creation, concerns have been expressed that budgetary consolidation could have a negative effect on output in the short run. This issue is relevant given the need for several Member States to reduce large cyclically-adjusted budget deficits, especially against the current background of slow economic growth.

An empirical analysis of the experiences of EU Member States, however, demonstrates that roughly half of the episodes of fiscal consolidation undertaken in the past three decades have been accompanied by an acceleration in economic growth. These findings appear to be consistent with theories that identify a positive impact of budgetary consolidation on consumer expectations of lower taxes in the future inducing them to raise their consumption plans, and/or on business expectations of higher profitability enabling them to raise investment. Confidence factors may play a more prominent role in the future in light of large unfunded pension liabilities.

Simulations using the QUEST model confirm that if appropriately designed, budgetary consolidation can contribute significantly to the goal of Lisbon strategy in terms of raising output and employment in the medium-term. Budgetary consolidation have a slight contractionary effect on output in the short run, depending on the composition of the budgetary adjustment. However, budgetary consolidation has a positive impact on output in the medium-run if it takes place in the form of expenditure retrenchment rather than tax increases. Moreover, the effect of budgetary consolidation on output could be reinforced, and even positive, in the short-run if fiscal consolidation is combined with structural reform of factor and product markets and accompanied with an accommodating monetary stance. Indeed, budgetary consolidation often acts as a catalyst for structural reforms.

Public investment

Public investment as a share of GDP has fallen in most industrialised countries in recent decades. It has been claimed that the budgetary requirements of the Treaty and SGP result in public investment expenditures being at excessively low levels, and that a sustained growth in public investment expenditures would improve the EU's growth potential. However, an analysis shows that the decline in public investment rates is a long-run tendency that started already in the 1970's, and affected all industrialised countries and not just EU Member States. Declining levels of public investment as a share of GDP have been attributed to factors such as increased levels of economic development (with developed countries already having a high stock of physical capital and the emphasis switching towards investment in human capital[5]) and the changing boundaries between public and private investment (in part linked to the process of privatisation). Some of the decline in public investment levels appears to be related to efforts to consolidate public finances, which was necessary irrespective of EMU. A careful analysis of the data, however, fails to show any clear-cut link between change in investment

5 Communication from the Commission *'Investing efficiently in education and training: an imperative for Europe*", COM(2002)779

ratios and the provisions of the EU's framework for fiscal surveillance. Indeed public investment expenditures in many Member States have stopped falling after the beginning of monetary union.

Public investment can make an important contribution to meet the output and employment goals of the Lisbon strategy. However, in considering the links between public investment and growth, it is important to focus on net as opposed to gross investment levels (i.e. taking account of the depreciation of the existing capital stock) and also the interaction between trends in public and private investment level. Existing studies reveal that public investment has a positive impact on output and productivity, although the results are not very strong. This is explained by the fact that only a fraction of public investment expenditures are devoted to projects which aim at directly raising productivity (e.g. investment in transport infrastructure), whereas a significant proportion of public investment is devoted to projects that pursue other objectives such as environmental protection or redistribution across regions, which have an indirect contribution to productivity .

The important role of public investment is recognised in the existing framework for budgetary surveillance: for example, Member States are required to specify planned public investment levels in their annual updates to stability and convergence programmes and the BEPGs frequently recommend that an increased share of public expenditures be devoted to productive items. In brief, the budget balance requirements of Treaty and SGP are compatible with a high share of public spending being devoted to public investment. The recent Commission Communication on strengthening the co-ordination of budgetary polices sought to cater for the budgetary impact of large investment projects while at the same time respecting the commitment to sound and sustainable public finances[6].

Several calls have been made to introduce a so-called golden rule into the SGP, which would allow governments to borrow to finance investment. However, there are strong theoretical and practical arguments against its introduction, especially in a framework of multilateral surveillance such as the SGP. First, a golden rule based on a national accounts system could lead to a bias in expenditure decisions in favour of physical capital and against spending on human capital (education, training) or other productive items (health care, R&D) which also contribute to growth and employment. Secondly, if applied to gross investment, depending on the specific design and implementation of the reform, the adoption of a golden rule into the SGP framework may imply substantially higher deficits, thus compromising the objective of sustainability of public finances. Finally, the relevant concept for the application of the golden rule would be net investment. However, it is not always possible to compute reliable, comparable and timely data on this type of investment.

There is a growing practice of financing public purpose investment projects through public-private partnerships (PPPs). A large share of the PPPs in the EU finance infrastructure and supplement public investment.[7] The main implication for public finances of choosing PPPs as opposed to traditional public investment is in fact that of converting up-front fixed expenditures into a stream of future obligations. This practice has a sound microeconomic rationale in that it can lead to increased efficiency without compromising public objectives. It is important however to avoid recourse to PPPs where this is solely motivated by a desire to bypass budgetary constraints. by putting capital spending outside government budgets. This

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6 The Council has shown some flexibility in interpreting compliance with the "close to balance or in surplus" requirement to reflect significant planned increases in public investment programmes.

7 Also see Communication from the Commission "*Developing the trans-European transport network: innovative funding solutions : interoperatibility of electronic toll collection systems*", COM(2003)132 of 24 April 2003.

could lead to PPP projects which entail higher overall costs, which would not be in line with the objective of sustainable public finances. Efforts are also required to ensure transparency in national accounts.

Efforts at national level to meet EU budgetary requirements: expenditure rules and fiscal relations across different levels of governments

Many Member States in recent years have introduced expenditure rules as a means to improve the management of their public finances, mostly in the form of *ex-ante* targets rather than binding legal obligations. National expenditure rules can enable Member States to meet the budget balance requirements of the Treaty and SGP by helping them to better control expenditure items that are subject to overruns. The specific design and the strength of the enforcement mechanisms are key to their effectiveness. Depending on their design, they can also contribute to other policy objectives such as avoiding a pro-cyclical loosening of fiscal policy in good times, and improving the quality of the composition of public spending.

There is a great deal of variety in the design of expenditure rules across EU Member States, as regards the the types of expenditure covered by a rule, the time frame involved and the robustness of surveillance and enforcement mechanisms. Preliminary empirical analysis indicates that the existing expenditure rules have not had a visible impact on trends in public spending. However, judging compliance with expenditure rules is difficult as in many cases they cover several years and are subject to revisions. In some countries, expenditure rules are not ambitious enough and adherence with them is easily reached: in other cases, the rule has been adjusted or abandoned if it is perceived as being too ambitious. Overall, even a relatively weak expenditure rule can provide useful guidance and signals to actors involved in the budgetary process.

The Treaty and SGP requirements are defined in terms of the budget balance of the general government (i.e. central and local/state governments and social security), although the specific budget targets in stability and convergence programmes are set by the central government. The challenge in meeting EU budgetary requirements is therefore affected by the way in which Member States allocate fiscal functions (both revenues and expenditures) across different levels of government. This is especially the case in federal countries and the Member States where local authorities have considerable budgetary autonomy. The contribution of sub-central authorities to the overall budget position is changing in a number of countries in light of efforts to devolve certain public functions to regional/local authorities.

The direct contribution of lower levels of government to the general government deficit is generally limited since all Member States apply restrictions to local government borrowing: the exception is Germany, where net borrowing by local and state governments accounts for nearly half of the general government budget deficit in 2002. However, it should be borne in mind that *de facto* central government often have to bear the cost of financing difficulties that emerge at sub-central level. To help comply with the EU's fiscal rules, the federal Member States and Italy and Spain have recently introduced arrangements that aim at co-ordinating the budgetary position across levels of government (usually referred to as national stability pacts). More experience with the implementation of these arrangements is needed before conclusions can be drawn on their effectiveness in contributing to the objectives of the EU fiscal framework. *A priori*, a strong legal base and enforcement mechanism would be expected to contribute to the credibility and effectiveness of the arrangements.

The process of decentralising responsibility for some policies raises a second issue in the context of EMU, namely the operation of automatic stabilisers. Experience shows that in general systems are designed to shield sub-national governments from cyclical variations. However, empirical evidence for the US and Germany suggests some degree of pro-cyclical behaviour at the level of the States. Further research would be useful to analyse the possible interaction between fiscal decentralisation and automatic stabilisation and to identify the best practices to reconcile the process of decentralisation with ensuring sound and sustainable public finances