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REPORT

on the Commission communication on Public finances in EMU - 2002
(COM(2002) 209 – C5-0324/2002 – 2002/2168(COS))

Committee on Economic and Monetary Affairs

Rapporteur: Manuel António dos Santos

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PROCEDURAL PAGE

By letter of 14 May 2002, the Commission forwarded to Parliament a communication on Public finances in EMU - 2002 (COM(2002) 209 – 2002/2168(COS)).

At the sitting of 2 September 2002 the President of Parliament announced that he had referred the communication to the Committee on Economic and Monetary Affairs as the committee responsible (C5-0324/2002).

At the sitting of 16 January 2003 the President of Parliament announced that he had referred the communication to the Committee on Budgetary Control for its opinion.

The Committee on Economic and Monetary Affairs had appointed Manuel António dos Santos rapporteur at its meeting of 19 June 2002.

It considered the the Commission communication and the draft report at its meetings of 8 October, 5 November, 3 December 2002, 21 January and 28 January 2003.

At the last meeting it adopted the motion for a resolution by 29 votes to 5 with 0 abstentions.

The following were present for the vote: Christa Randzio-Plath chairwoman; José Manuel García-Margallo y Marfil, Philippe A.R. Herzog and John Purvis, vice-chairmen; Manuel António dos Santos, rapporteur; Hans Blokland, Benedetto Della Vedova, Bert Doorn (for Generoso Andria), Harald Ettl (for Hans Udo Bullmann), Jonathan Evans, Ingo Friedrich, Carles-Alfred Gasòliba i Böhm, Robert Goebbels, Lutz Goepel (for Brice Hortefeux), Lisbeth Grönfeldt Bergman, Mary Honeyball, Christopher Huhne, Othmar Karas, Giorgos Katiforis, Piia-Noora Kauppi, Christoph Werner Konrad, Wilfried Kuckelkorn (for David W. Martin), Werner Langen (for Mónica Ridruejo), Astrid Lulling, Ioannis Marinos, Helmuth Markov (for Armonia Bordes), Hans-Peter Mayer, Miquel Mayol i Raynal, Peter Michael Mombaur (for Renato Brunetta), Fernando Pérez Royo, Alexander Radwan, Bernhard Rapkay, Ieke van den Burg (for Pervenche Berès) and Theresa Villiers.

The Committee on Budgetary Control decided on 21 January 2003 not to deliver an opinion.

The report was tabled on 29 January 2003.

MOTION FOR A RESOLUTION

European Parliament resolution on the Commission communication on Public finances in EMU - 2002 (COM(2002) 209 – C5-0324/2002 – 2002/2168(COS))

The European Parliament,

– having regard to the Commission communication (COM(2002) 209 – C5-0324/2002[1]),

- having regard to the Communication from the Commission to the Council and the European Parliament on Strengthening the co-ordination of budgetary policies (COM(2002) 668)[2])

- having regard to the Communication from the Commission to the Council and the European Parliament on Structural indicators (COM(2002) 551)[3])

- having regard to the Communication from the Commission to the Council and the European Parliament on the need and the means to upgrade the quality of budgetary statistics (COM(2002) 670)[4])

- having regard to the European Commission Autumm Economic Forecasts 2002 - 2004 for the Eurozone and the European Union[5])

- having regard to the European Commissions communication on the budgetary challenges in the euro area, presented in September 2002[6]),

- having regard to the European Commissions communication on the euro area in the world economy in the first three years, presented in July 2002 (COM (2002) 332)[7])

- having regard to the ECOFIN Council decision of 5 November 2002 on the existence of an excessive deficit in Portugal and on the adoption of a recommendation of necessary measures to combat the deficit[8]),

- having regard to the recommendations of the Broad Economic Policy Guidelines adopted by the ECOFIN Council on 21 June 2002[9]),

- having regard to the Presidency Conclusions of the European Council adopted in Lisbon on 24 March 2000 and in Gothenburg on 15 and 16 June 2001, with particular reference to the strategy agreed on economic growth, full employment, sustainable development and

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[1] OJ C not yet published
[2] OJ C not yet published
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[4] OJ C not yet published
[5] OJ C not yet published
[6] OJ C not yet published
[7] OJ C not yet published
[8] OJ C not yet published
[9] OJ C not yet published

social cohesion,

- having regard to the Presidency Conclusions of the European Council in Stockholm on 23 and 24 March 2001 and in Barcelona on 15 and 16 March 2002, with particular reference to the "Stability and Growth Pact" and the budgetary challenges, including the quality of public finance related to the demographic development,

– having regard to Rule 47(1) of its Rules of Procedure,

– having regard to the report of the Committee on Economic and Monetary Affairs (A5-0018/2003)

A. whereas in its Communication on strengthening the coordination of budgetary policies the Commission has presented five proposals for improving and strengthening the interpretation of the SGP, enabling the economic cycle and debt level as a percentage of GDP to be taken into account when carrying out budgetary surveillance and at the same time ensuring a more rigorous adherence to the goal of sound and sustainable public finances,

B. whereas the economic recovery is much slower than anticipated and the average growth rate is estimated to be 0,8% in 2002 and is forecast at only 1,8% in 2003 and whereas the general government deficit is expected to widen to 2,3% of GDP in 2002 in the Eurozone,

C. whereas the economy and finance ministers of the Euro zone countries in their October meeting had agreed on "terms of reference" to ensure that the four Member States that have not yet managed to balance their budget (France, Germany, Italy and Portugal) should reduce their structural deficits by at least 0.5% of GDP annually from 2003;

D. whereas the European Council in Lisbon on 24 March 2000 and in Gothenburg on 16 June 2001 set the strategic goal of Europe acquiring the most competitive and dynamic knowledge-based economy capable of economic growth with better jobs, full employment, sustainable development and greater social cohesion,

E. whereas the creation of the conditions for monetary and financial stability as well as the raise of growth and employment participation rate are equally prerequisites for achieving strong economic and employment developments;

F. whereas public spending on the basic functions of Member States (f.ex. research, education, health and social care, justice, defence) has remained remarkably stable of the past 30 years and is similar between 14% and 16% of GDP across EU Member States,

G. whereas the achievement of a knowledge-based economy presupposes the development**,** speedy adoption and intensive use of highly-efficient high-speed networks of information**,** research and development as well as the development of lifelong education and training, and whereas such efforts require the mobilisation of both public and private investment,

1. points out that the SGP is an instrument which clarifies and confirms the preventive and recommendable nature of the provisions of the Treaty concerning the surveillance and

coordination of the Member States' economic policies and the importance of economic stability for achieving a strong and sustainable European economy; calls, therefore, for its basic principles to be included in the future constitutional treaty so that they become stable and fully credible;

2. stresses Parliament's commitment to the SGP as a major pillar of EMU and supports the necessary adjustments for an intelligent and flexible application of the pact in the manner proposed by the Commission, with a stronger emphasis being placed on the overall debt levels of individual Member States, taking into account public investment requirements and quality of expenditures;

3. welcomes the compromise on the "terms of reference" of an annual reduction of structural deficits by at least 0,5% of GDP, in particular for the four Member States Germany, France, Italy and Portugal; considers that this will ensure that the ground lost is recuperated in order to respect the undertaking to reach situations "close to balance" and to develop further international credibility of the whole Euro area and in particular for the applicant countries;

4. calls upon the Commission to take this economic downturn very seriously and to shape policy so as to ensure that the necessary structural reforms can be implemented in the Member States and, by way of a reduction in the cyclically-adjusted deficit, the automatic stabilisers brought into play in the event of a downturn; stresses that this can be promoted by systematically consolidating the internal market;

5. points out that the Member States must apply the agreements reached within the Council; considers that the debate on improving the SGP does not justify failure to implement it; believes that applying the agreements will have a positive effect on the public perception of the European Community and will minimise the negative effects which the excessively uneven budget policies of the Member States have on the economies within the Eurozone;

6. calls on the Commission and the Member States, because of the unchanged economic situation, to implement a responsible financial policy to support a long-term sustainable and continuous upturn as well as to continue to promote a knowledge-based and competitive economy with the objective of full employment and social cohesion;

7. minds the Member States to take the appropriate steps to tackle the consequences of the ageing population; supports therefore the systematic assessment of the sustainability of public finances in the light of ageing populations;

8. recognises that new prospects for growth in the euro zone lead us to open a debate about the nature of the finance and economic policies which Member States should follow; recalls in this context**,** that economic policy lies fundamentally within the area of Member-State competence, that Member States nevertheless agreed, following Article 99 of the EC-Treaty, to consider their economic policies as an area of common interest and to coordinate them; supports, in that connection, the stepping-up of efforts to accelerate implementation of the targets of the Lisbon strategy covering growth and job incentives, investment, research, regional development, training and labour markets;

9. congratulates the Commission on the improvements of the framework for budgetary surveillance with the revised code of conduct, the development of information and economic analysis concerning the euro area, the improvements of the system of statistics used, the clarification of the principles common to fiscal and structural policies and increasing efficiency of the decision-making system,

10. notes however, that there are needs for more and better work on statistical reqirements and for more universal understanding of what constitute good economic and public finance policies in order to achieve better economic convergence and increased transparency; calls in particular to achieve a common understanding of qualitative follow-up of public spending towards positive contribution to the goals of the Lisbon strategy;

11. requests furthermore a clear method with a definition of "high quality public expenditure" for quantifying public budgetary positions and their contribution to growth and investment, so that fluctuations in the economic cycle can be accurately quantified and qualified;

12. welcomes the fact that the framework for budgetary surveillance and in particular the SGP has worked well in ensuring stability by keeping fiscal policies broadly neutral and has, moreover, provided those Member States that have not overstretched their budgets with the necessary margin of manoeuvre for measures to be applied in crisis periods;

13. points out that achieving the stability objective is contributory to higher growth; warns against any attempt, in calculating the deficit, to avoid taking certain expenditure items into account; considers that any such action would represent an insuperable task in principle, as well as appearing well-nigh incomprehensible to market observers, with an adverse impact on the interest-rate level and on the internal and external stability of the common currency;

14. welcomes the priority to avoid pro-cyclical budget policies in good times and proposes to extend the political goal to generally avoid pro-cyclical budget policies at any time,

15. underlines again the need to promote public and private investment in order to make Europe the most competitive and dynamic knowledge-based economy in the world, including economic growth with better jobs, full employment, sustainable development and greater social cohesion in the first decade of the 21st century; calls especially for a reorientation of public expenditure towards physical and human capital accumulation and the creation of public-private partnerships operating in such areas as education and training, life-long learning, research, information and frontier technologies, telecommunication and transportation networks etc.;

16. finally, underlines the major policy challenge to implement upon accession the EU framework for budgetary surveillance taking into account the specific needs and circumstances of the candidate countries; supports the view that candidate countries should be required to comply with the Copenhagen criteria in order to achieve medium-term macroeconomic stability and growth**,** which must include a minimum of economic convergence; recommends to accession countries that they should even now begin to prepare themselves for compliance with the Maastricht criteria required for eurozone membership;

17. instructs its President to forward this resolution to the Council and Commission and the parliaments of the Member States and applicant countries as well as to the Social partners.

EXPLANATORY STATEMENT

On October 21, the president of the Commission, Romano Prodi, expressed in his intervention in the European Parliament his concerns facing the downturn in the economic cycle, criticised an inflexible and dogmatic enforcement of the Stability and Growth Pact regardless of changing circumstances as "stupid" and called for adjustments and the introduction of more sophisticated criteria for applying the Pact.

<u>Economic background:</u>

The optimistic economic forecasts in the Commission report "Public Finance in EMU 2002", had to be revised downwards. Economic recovery is much slower than anticipated and the average growth rate is estimated to be 0,8% of GDP in 2002 and is forecast at only 1,8% in 2003.

Therefore the economic background for budgetary surveillance under EMU is much less favourable than expected previously leading to repercussions on budgetary plans. In 2001 the budget deficit for the Euro area reached 1.3% of GDP, up from 0.7% in 2000 and are expected to widen to 2,3% of GDP in 2002 in the Euro zone. Four countries show significant deficits, where the risk of breaching the 3% of GDP “excessive deficit” threshold is large, or has already materialised.

<u>The early-warning system</u>

In January 2002, the European Commission recommended that an early warning be sent to Germany and Portugal under the SGP. Both countries were at risk that their deficits approached the 3% of GDP reference value.

In the case of *Portugal*, the excessive deficit procedure was launched in late July when the deficit reported for 2001, was revised from 2.2% to 4.1% of GDP. On November 5, 2002, the ECOFIN Council has decided on the existence of an excessive deficit in Portugal and adopted a recommendation of necessary measures to combat the deficit.

In *Germany* the deficit for 2002 might reach up to 3,8% of GDP threshold. The Commission is about to launch the first step of the excessive deficit procedure.

For *France*, the Commission forecasts this year’s deficit at 2.7% of GDP. The Commission is about to recommend that an early warning be sent to France under the SGP.

In *Italy*, the deficit reaches 2,4% in 2002 and even 2,9% in 2004. The Italian debt ratio rising close to 110% of GDP also gives reason for concern.

However, the deterioration in the government accounts is also due to expenditure overruns and unfunded tax changes. The Commission strongly criticises the fact that some deficit countries failed to advance the consolidation towards the medium-term objective of close-to-balance or in surplus during periods of strong expansion. Prodi criticised that the Pact had not prevented Members States from adopting fiscal policies, which are incompatible with the objective of stability. If the Commission acted in an inflexible way, it would have to force countries with big deficits to stick to budgetary targets regardless of changes in the economy and regardless of the danger to jeopardise the economic prospects not only of the countries concerned but also of the whole of Europe. The four Member States which are having increasing difficulties to respect the targets and commitments within the SGP represent 75% of the Euro zone. Sticking to the rules in a dogmatic way in the present economic situation would endanger economic recovery, growth - the second pillar of the Pact - and jobs in all of Europe.

The framework for budgetary surveillance

In the report on Public Finance in EMU in 2002, the Commission underlines that the framework for budgetary surveillance and in particular the Stability and Growth Pact has worked well in responding to the cyclical slowdown. Countries have had scope to allow the automatic stabilisers to operate and to cushion the effects of the downturn and did not embark on expansionary policies.

Thus the Commission showed much satisfaction in the fact that despite of the economic slowdown, fiscal policies remained broadly neutral and monetary conditions eased markedly. Predicting a turnaround in the European economy, the European Commission judged that "the recent downturn was neither particularly severe or prolonged" and concluded that thus expansionary measures may ex post have turned out to be pro-cyclical. The Commission proposed in its report to discuss the desirability and effectiveness of discretionary fiscal policy in general and to lay down some rules limiting expansionary fiscal measures in the future.

Considering that the turnaround in the European economy is still not in sight, the rapporteur sees strong grounds to challenge these proposals. More expansionary policies might have given the economy the necessary boost to recover. The monetarist approach has failed to give sufficient economic stimulus. With an independent monetary policy, further limiting economic instruments does in no way seem to be the right strategy to take into account in particular being confronted with the troubles the European Union is facing in manoeuvring in an economic slowdown within the rigid corset set by the Stability and Growth Pact.

While the framework has worked well to bring down inflation expectations to historic lows, the other part of the Stability and Growth Pact, the growth part gives a much less gloomy outlook to the pact.

Need for adjustments and more sophisticated criteria

The rapporteur welcomes the declaration of the president of the Commission Romano Prodi expressing his commitment to the idea and the spirit of the Stability and Growth Pact but stressing the need "for adjustments and introducing more sophisticated criteria for applying the Pact so that it becomes an ever more valuable instrument in promoting stability and growth." The rapporteur supports the introduction of more sophisticated criteria taking into account inflation, employment, public debts, financial burdens arising from ageing of the population, public investment requirements and quality of expenditures;

Public and Private Investment

Considering the importance of public investment for growth, the fact that the stability and growth pact led to a policy in which deficits were reduced by cutting spending on public investment reveals the urgent necessity to adjust the rules. There is an imminent danger of reducing growth potential by neglecting public investments.

In recent years the ratio of public investment to GDP has decreased constantly. Also, private investment did not substitute public investment but rather followed along the same downward trend. Gross fixed capital formation contracted by 2.9% in 2002 Q2, down for the fifth quarter in a row. There is an urgent need to encourage both private and public investment and one possibility could be to exclude investment spending from deficit calculations. The rapporteur wishes to point out that also the US exempts investment spending from deficit calculations.

One major issue to identify is how to limit and define the investments that ought to be excluded. The rapporteur suggests linking the possibility of exemption of public investments to the definition of "high quality" expenditure of the Commission in its report on Public Finance in EMU 2002: "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."

In this way the Stability and Growth Pact will "finally become an instrument that is fully in tune with the growth and jobs strategy adopted by the European Council at Lisbon" as Prodi said and include the strategy for sustainable development as agreed in Goteborg.

<u>Cyclically-adjusted budgets</u>

As an answer to the economic downturn, the Commission introduced more room for manoeuvre by paying attention to the cyclically adjusted budget balances when examining the budgetary positions of Member States.

Regarding budgetary targets, budgetary positions to which the Member States are committed are conditional on an agreed growth path. Therefore, if the economy weakens relative to the agreed scenario, the budgetary position would be corrected for the cyclical deterioration in public finances, in order to focus on the underlying or cyclically adjusted budgetary balance.

<u>Required rate of structural adjustment of 0,5% of GDP annually</u>

The Commission proposed to postpone the deadline for reaching the objective of close-to-balance budgets and a commitment to a strict and enforceable adjustment path including an agreement on in any case a swift return below the 3% threshold, and a minimum required rate of structural adjustment of 0,5% of GDP, with the objective of reaching a close-to-balance or in surplus budget.

<u>The need for an authority and a co-ordination pact for economic policies</u>

In his intervention, the president of the Commission, Roman Prodi, stressed not only the need for an adjustment of the criteria but also made the case for an authority that has the power to give guidance to the system in a way that is both rigorous and intelligent, that can enforce the rules and adjust policies to changing economic circumstances. The rapporteur supports the proposal of Romano Prodi that the Commission is best suited for this steering role, on the basis of the mandate and the rules laid down by the Council and subject to Parliament's control. The rapporteur further supports Jacques Delors proposal to set up a "Co-ordination Pact for economic policies" that covers growth and job incentives, investment, research, regional development, training, labor markets. The convention should take note of the suggestions made by Prodi and Delors and work out an appropriate proposal for the future economic and monetary policy.

Improvements to the process of budgetary surveillance:

The rapporteur welcomes the improvements of the quality and coverage of budgetary surveillance by measures such as the Code of Conduct and the inclusion of sections on the quality and sustainability of public finances in line with the Lisbon conclusions.

Sustainability of Public Finance:

EU budgetary surveillance was extended to the systematic assessment of the sustainability of public finances in the light of ageing populations showing the potential risk for emerging budgetary imbalances in many Member States.

Public spending has risen 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 is 15 percentage points of GDP above that in the US and mainly reflects spending on social protection programmes, this being a typical feature of the European Social Model. 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.

Quality of Public Expenditure:

Greater attention must be paid to how public resources are spent and how taxes are levied. Surveillance of the quality of public finances is still at an early stage. The difficulty in putting in place an effective monitoring of the quality of public spending is due to the conceptual difficulty in defining what ‘quality’ actually means, the lack of timely and comparable data.

The rapporteur welcomes the Commission's definition of high quality public expenditure: "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."

Enlargement:

Since 2001, the Commission has implemented the Pre-accession Fiscal Surveillance Procedure 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.

Conclusion

The rapporteur welcomes Prodi's suggestions for adjustments and the introduction of more sophisticated criteria for applying the Pact, in order for the Stability and Growth Pact to become an even more valuable instrument in promoting both stability and growth.

Economic and Monetary Union has been and remains of the utmost importance and the Stability and Growth Pact is its most important instrument. Romano Prodi's proposals in no way weaken the SGP but rather build on it and improve it to adapt it to better react to economic developments and to devise a more realistic course of action for consolidating deficits. The president of the Commission is right in his assessment that it is most unwise to stick to rigid and inflexible rules in the economic slowdown and thus strangling economic growth potential. It is much more important to assure that an inflexible application of the Stability and Growth Pact does not jeopardise economic growth, jobs and EMU as a whole and that support for the spirit and the idea of the SGP is maintained. An improvement of the SGP has to be seen as a learning process that will make the SGP more in line with the political objectives decided in Lisbon and Gothenburg and give it more credibility and acceptability and is the right response to the economic and political situation.