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Public finances in EMU
2004

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Abbreviations and symbols used

Member States

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EUR-12	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AU, PT, FI), i.e. countries participating in economic and monetary union without a derogation
EUR-11	EUR-12 excluding LU
EU-25	European Union, 25 Member States
EU-15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU-14	EU-15 excluding LU
EU-10	European Union, 10 Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LV, LT, HU, MT, PL, SI, SK)

Currencies

EUR	euro
ECU	European currency unit
DKK	Danish krone
GBP	Pound sterling
SEK	Swedish krona
CAD	Canadian dollar
CHF	Swiss franc
JPY	Japanese yen
SUR	Russian rouble
USD	US dollar

Other abbreviations

bn, billion	1 000 million
CEECs	Central and east European countries
CPI	consumer price index
EC	European Commission
ECB	European Central Bank
ECSC	European Coal and Steel Community
EDF	European Development Fund
EIB	European Investment Bank
EMCF	European Monetary Cooperation Fund
EMS	European monetary system
EMU	economic and monetary union
ERM	exchange rate mechanism
Euratom	European Atomic Energy Community
Eurostat	Statistical Office of the European Communities
FDI	foreign direct investment
GDP (GNP)	gross domestic (national) product
GFCF	gross fixed capital formation
HICP	harmonised index of consumer prices
ILO	International Labour Organisation
IMF	International Monetary Fund
LDCs	less developed countries
Mio	million
Mrd	1 000 million
NCI	New Community Instrument
NMS	new Member State
OCTs	overseas countries and territories
OECD	Organisation for Economic Cooperation and Development
OPEC	Organisation of Petroleum Exporting Countries
PEP	pre-accession economic programmes
PPS	purchasing power standard
SCP	stability and convergence programmes
SGP	Stability and Growth Pact
qoq	quarter-on-quarter percentage change
SMEs	small and medium-sized enterprises
VAT	value added tax
yoy	year-on-year percentage change
:	not available
–	none

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Summary and main conclusions ⁽¹⁾

An increasing variety of budgetary positions, with challenging overall developments

Actual deficits continued to increase in 2003 throughout the EU, reflecting the protracted slowdown in growth and the working of automatic stabilisers. In the euro area, the deficit rose from 2.3 % of GDP in 2002 to 2.7 % of GDP in 2003. If all 25 countries which are members of the EU as of 1 May 2004 are taken into account, the deficit has increased from 2.1 to 2.7 % of GDP. Cyclically adjusted developments have started to evolve more favourably, improving from 2.4 % of GDP in 2002 to 2.1 % in 2003. However, this reflects sizeable one-off measures in several countries.

With 8 countries in surplus and 11 with deficits above 3 % in 2003, the EU by enlarging to 25 members sees the variety of budgetary performances across Member States increase. The most significant deficits are those of Germany and France, given the size of both of the countries themselves and of their deficits, which heavily affect the overall outcome of the euro area. The situation in Italy, where the deficit stayed below 3 % only by dint of sizeable one-off measures, is also a matter of concern given its high government debt-to-GDP ratios. Outside the euro area, actual balances deteriorated in a number of countries, including the UK and Poland. In contrast with these developments, Spain, Belgium, Ireland, Finland and Luxembourg (in the euro area) and Sweden, Denmark and Estonia in EU-25 recorded surpluses which were maintained throughout the slowdown, attesting to the soundness of their budgetary positions. Reflecting the budgetary and growth developments in large countries, the government debt-to-GDP ratio increased in 2003 to reach 70.4 % in the euro area and 63.1 % in EU-25. Here too, situations are quite diverse, with Italy, Greece and Belgium having a government debt-to-GDP

ratio above 100 % and 14 countries with debt levels well below 60 % of GDP.

Sound public finances will not be achieved in the near future in some countries

In spite of an improving growth outlook, budgetary prospects for 2004 and 2005 are not very promising. Both the actual and cyclically adjusted budget balances of the euro area, according to the Commission spring 2004 forecasts, are projected to be broadly unchanged in 2004 and, on an unchanged policy basis, in 2005. At EU-25 level, the actual balance is projected to improve marginally to 2.5 % of GDP in 2005. The public debt-to-GDP ratio is projected to increase slightly in 2004 to 70.9 % of GDP in the euro area and to 63.4 % in EU-25, and to remain at the same level in both areas in 2005. At country level, the deficit is projected by the Commission to remain above 3 % of GDP in 2004 in both France and Germany. The two Member States are committed to bring the deficit below 3 % in 2005. The deficit is also expected to be above 3 % in 2004 in Greece, the Netherlands, and, if the expiry of one-offs is not compensated by corrective measures, also in Portugal and Italy. The budgetary situation in most new Member States is expected to improve over the next two years.

The latest updates of the stability and convergence programmes show that a close-to-balance position in cyclically adjusted terms will not be reached in several countries by 2007 (–0.7 % of GDP for the euro area). Germany, France, Portugal and the UK in particular will still be far from a balanced budget at that point. This means that there will be an inadequate safety margin to prevent a breach of the 3 %-of-GDP reference value in the event of adverse economic conditions. In addition, the medium-term objectives of some euro-area Member States are based on growth assumptions which appear to

⁽¹⁾ The summary and main conclusions of this report have been adopted by the College of Commissioners in the form of a communication from the Commission to the Council and the European Parliament, COM(2004) 425, adopted on 24 June 2004.

be overly optimistic. Even if the growth rates expected in the updates were realised, the budgetary targets seem difficult to reach. The new Member States foresee in their convergence programmes an ambitious consolidation of their public finances.

Considering that the implementation record of the programmes has, in several cases, been poor — which has led to a repeated postponement of the achievement of the close-to-balance objective — it is clear that there is no reason for complacency. It is vital for Member States to reach budget positions which ensure that the automatic stabilisers work freely, and decrease the risk of unsustainable public finances in the light of ageing populations, and if the composition of the adjustment is right, would contribute to achieving over the next few years the Lisbon objectives of high growth and employment rates. Past experience shows that significant efforts to improve the underlying budget positions should be undertaken as economic conditions improve: the difficulties experienced in respecting the Treaty requirements in 2002 and 2003 reflect also the fact that countries did not make enough fiscal adjustment during the good times in 1999 and 2000.

Increasing activation of the procedures for budgetary surveillance

By mid-2003, the number of countries placed in an excessive deficit position increased to three, with France joining Portugal and Germany. In spite of the measures taken by France and Germany, it soon became evident that deficits in these two countries, in contrast to Portugal, would remain high in 2003, and that the probability of bringing them below 3 % of GDP by the deadline of 2004 was very low in the light of the draft budgets submitted in autumn 2003. The Commission therefore moved forward with the excessive deficit procedure with the aim of urging France and Germany to take more decisive measures in order to correct their deficits at least by 2005. In spring 2004, following the notification of budgetary data concerning 2003, the Commission started the procedures for Greece, the Netherlands and the United Kingdom, which registered deficits above 3 % of GDP in 2003. At the same time, given that the deficit remained below 3 % of GDP in 2003, the Commission proposed to repeal the decisions placing Portugal in a position of excessive deficit. On the basis of its forecasts, it recommended that an ‘early warning’ be addressed to Italy, given the substantial risk of breaching the 3 %-of-GDP reference value in 2004. The Commission started the excessive deficit procedure for several new Member

States following their accession to the EU. Recommendations will be made to these countries to help pursue a credible multi-annual adjustment path.

Tensions in the implementation of the fiscal framework led to uncertainty

While the procedures foreseen by the Treaty were used smoothly in the run-up to EMU, since the birth of the euro their implementation has become more difficult. In February 2002, the Commission recommended that the Council adopt an ‘early warning’ addressed to Germany and Portugal. On that occasion, the Council did not follow the Commission’s proposals, on account of commitments made by these countries. Similarly, but at a more advanced stage in the procedures, the Council at the end of November of 2003 did not endorse the Commission’s recommendations concerning France and Germany, which extended by one year the deadline for correcting the situation of excessive deficit and implied advancing with the procedures.

The tensions which have arisen in the implementation of the procedures of the Treaty and the Stability and Growth Pact (SGP), and the diverging interpretation of the latter by the Community institutions, have created uncertainty as to how budgetary surveillance should be conducted. They have also shown that certain elements of the framework should be reconsidered in order to increase both its effectiveness and its credibility.

In response to the difficulties in implementing the fiscal framework, the Commission announced a strategy aimed at seeking legal clarity on the provisions of the Treaty and the SGP, continuing budgetary surveillance, and considering what steps are needed to strengthen economic governance. Accordingly, at the end of January 2004 the Commission asked the European Court of Justice to annul the decisions taken by the Council and the conclusions adopted at its November meeting. The Court has decided to handle the case in an accelerated procedure.

Meanwhile, in line with its strategy, the Commission continued to conduct budgetary surveillance in accordance with the provisions of the Treaty and the SGP. This involved assessing the 2003 updates of the stability and convergence programmes and preparing draft opinions for the Council. The Commission also updated the broad economic policy guidelines (BEPGs) including new country-specific budgetary recommendations for seven countries. It also moved ahead with the procedures for

countries not running sound budgetary policies, and also pursued its efforts to improve the quality of surveillance. At the same time, it started to reflect on how the framework could be rejuvenated in order to tackle the shortcomings which have manifested themselves in the first years of EMU.

Analytical improvements made within the framework for EU budgetary surveillance

The report on ‘Public finances in EMU — 2004’ highlights four areas where progress has been made in the analysis of budgetary developments, including on (i) the role of one-off measures for the assessment of budgetary positions, (ii) the use of cyclically adjusted balances for the assessment of the efforts countries have made, (iii) the assessment of the long-term sustainability of public finances, and (iv) the surveillance of contingent liabilities.

The increased focus of multilateral surveillance on more structural factors calls for temporary changes in budgetary positions to be clearly identified, particularly when they are due either to the implementation of budgetary measures with only temporary effects or to the economic cycle.

(i) Among the sources of temporary changes in budgets, ‘one-off’ measures taken by governments warrant particular attention because they are becoming a frequent and sizeable feature in EU countries. It is therefore important to take account of such measures and the reasons behind them in the surveillance process. This calls for greater transparency of budget measures and a clearer reporting of these measures by Member States, including in the stability and convergence programmes.

(ii) A common methodology which provides figures for the cyclically adjusted budget balances (CABs) is used at EU level to disentangle changes in the budget which reflect the economic cycle from those which do not, the latter reflecting measures decided by policy-makers. The CABs have proved to be a very useful instrument for assessing the Member States’ budgetary policies. However, the CABs may not reflect discretionary fiscal adjustment efforts entirely correctly. Unexpected changes in potential output can also have an impact on the results. The solution proposed is a simple correction of CAB figures, excluding the small component of the change attributable to unexpected changes in potential growth.

(iii) In 2004, for the third year in a row, the EU budgetary surveillance includes an assessment of the long-term sustainability of public finances on the basis of the updated stability and convergence programmes. This year greater attention has been devoted to increase the qualitative analysis supporting the interpretation of the results obtained, which has significantly contributed to giving the assessment a higher information value. Overall, the analysis shows that risks to long-term sustainability are still present in nine countries. In five of them (Belgium, Greece, Italy, Germany and France) the difficulties are more serious, while the others face some risks due either to medium-term budgetary developments (Netherlands and the UK) or to the uncertainties over the long-term projections of pension expenditures (Spain and Portugal). Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem relatively well placed to meet the cost of an ageing society on the basis of current policies.

(iv) To get a comprehensive picture of the sustainability of public finances, liabilities other than those included in the Maastricht definition of gross debt should be considered. Among them are the so-called ‘contingent liabilities’, which correspond to government obligations that materialise only when particular events occur. The importance of this issue in EU budgetary surveillance has increased over the last years and in particular after enlargement. The stock of contingent liabilities is in fact relatively high in new Member States. Given the various situations and trends in the EU, increasing disclosure and monitoring of contingent liabilities would be a useful step towards strengthening budgetary surveillance in the EU.

Budgetary discipline and increased growth potential are consistent objectives

The EU budgetary rules aim at promoting medium- and long-term budgetary discipline so as to ensure sound budgetary positions. However, the EU framework has been criticised for focusing too much on disciplinary aspects, thereby not being growth-friendly. Against this background, the report on ‘Public finances in EMU — 2004’ looks at the questions of how fiscal discipline and the quality of public finances contribute to growth.

The benefits of fiscal discipline

During the tense debate which took place last year about the implementation of the EU framework for fiscal surveillance, many critics stressed that it imposes an exces-

sive focus on fiscal discipline and that this has been detrimental to growth. However, these criticisms are ill-founded. Without the progress towards fiscal discipline accomplished in the past decade thanks to the rules-based framework, the European economy would probably have an even more disappointing growth performance. The report on 'Public finances in EMU — 2004' shows that, rather than being at the expense of growth, fiscal discipline and sound public finances contribute to a macroeconomic environment that fosters potential growth. A fiscal framework, by preventing protracted fiscal deficits, avoids the negative impact which such deficits have on future income.

The mechanism at work is quite straightforward. When deficits are protracted, a reduction in national savings will follow. In turn, this translates either into a reduction in private investment, or into a worsening of the current account, or both. The extent of private investment crowding-out will depend upon the sensitivity of national savings to interest rates and the degree of international capital mobility, while the behaviour of government investment will mainly depend upon the allocation of total expenditure and the extent to which deficits are used to finance current or capital expenditure. The real issue, then, is not whether a loss of fiscal discipline will translate over the medium term into lower future incomes but by how much and through which channels.

Protracted budget deficits primarily reduce capital accumulation and income prospects, mainly via higher interest rates. The report on 'Public finances in EMU — 2004' shows, in line with empirical evidence, that an additional deficit of 1 percentage point of GDP in euro-area countries is on average associated with an increase in the spread in the interest rate between long and short-term government bonds of 15–20 basis points. Although small, this increase is likely to have negative effects on investment, which is influenced by long-term interest rates, among other factors.

In addition, the analysis suggests that protracted large budget imbalances in countries with high current account deficits may be a cause of delay in the external adjustment. This concern is of special importance for new Member States, most of which have in recent years been recording relatively large budget deficits coupled with external imbalances. Though the latter may be explained by catching-up dynamics, keeping budget deficits under control will be essential in order to maintain

stable currencies within ERM II as a necessary step towards joining EMU.

In the debate about the EU fiscal framework, little analysis has been conducted on the quantitative impact that the presence of the framework has exerted on budget balances in EU countries. Simulations with the European Commission QUEST II model indicate that, in the absence of the EU fiscal framework, primary budget deficits for the euro area would have been higher by almost 0.9 GDP points per year over the 1994–2003 period. This suggests that the EU fiscal framework has contributed to avoiding a sizeable build-up of euro-area government debt, which in 2003 would have been about 8 GDP percentage points higher than now. Furthermore, the simulations suggest that higher deficits in the euro area would have initially increased the income level by at most half a percentage point of GDP, but this small effect would have faded away quickly. However, taking into account the impact of debt on risk premia, results indicate that the gains from an absence of fiscal discipline would have been even smaller in the short run and negative in the medium term.

Overall, the analysis suggests that the budgetary adjustment in the 1990s induced by the EU fiscal framework implied a reduction in growth of limited magnitude and duration but laid the foundations for better growth prospects. In the absence of the framework, higher deficits would have crowded out private investment and further reduced potential growth compared with current figures.

Improving the quality of public finances

In view of the importance attached by the Lisbon strategy to the quality of public finances, reflected in the broad economic policy guidelines as well as in other processes such as the employment guidelines and the open method of coordination, the report on 'Public finances in EMU — 2004' endeavours to clarify the role of the quality of public finances within the EU framework for economic policy coordination and investigate possibilities for improving the quality of public finances in practice.

Generally accepted definitions of quality are not available. The report uses a broad concept, whereby quality of public finances concerns the allocation of resources and the efficient and effective use of those resources in relation to identified strategic priorities. Regarding the latter, for instance the EU Lisbon strategy identifies sustainable

growth, full employment, social cohesion and competitiveness as strategic priorities. A full discussion addressing the quality of public finances with respect to all these aims is beyond the scope of the report. Therefore, as a starting point for further and more complete analyses and while recognising the partial nature of such an exercise, it mainly focuses on the link between fiscal policy and long-term growth. Accordingly, the report starts by reviewing the recent literature on the link between the composition of expenditure and revenue and long-term growth. The findings of existing studies confirm the importance of taking into account both the costs (i.e. higher taxation) and benefits (i.e. reaching policy objectives) of public spending. The major difficulties that empirical studies have encountered concern the distinction between ‘productive’ and ‘unproductive’ expenditure. Although there is a certain degree of agreement that a few categories of public expenditure can quite safely be included among ‘productive’ public expenditures because they are directly aimed at productivity improvements (e.g. R & D, education and infrastructure investment) there is no consensus among researchers concerning the impact of most expenditure items on long-term growth and its timing. This lack of consensus is reflected by the fact that available estimates of ‘productive’ expenditure in the EU range between 5 and 44 % of total public expenditure.

In the light of these difficulties, the analysis of the composition of public expenditure across EU countries focuses on what the changes in the compositions have been and what factors drive these changes. Generally, over the last decade social protection and healthcare expenditure increased their share in total expenditure, while the latter expressed as a share of GDP has gone down. This suggests that the main drivers of expenditure recomposition over the medium-/long-term are related to underlying upward pressures such as those resulting from ageing and that any framework for the definition of strategic expenditure priorities must take such long-term trends into account.

In recent years, several Member States have introduced medium-term frameworks for expenditure control and reforms to the budgetary process that aim at achieving priorities in the most efficient and effective way by linking public expenditure to policy outcomes (performance-budgeting). The analysis shows that, in countries with more effective control of public expenditure, fiscal consolidation in the run-up to EMU has been mainly based on containing expenditure, rather than on raising

revenues, thereby contributing to a better long-run growth performance.

Overall, this analysis implies that the allocation of resources and the monitoring of action undertaken to pursue identified priorities should have a greater role in the analysis and conduct of fiscal policy. To this end, the BEPGs should contribute more effectively, as well as other EU processes, to improve the quality of public finances.

Progress should include, first, the exchange of information on how strategic priorities have been fixed with respect to national budgets and what the experiences with implementing them have been. Secondly, further improvements in data availability are needed — in particular regarding the functional classification of government expenditure — since this is a necessary condition for an appropriate analysis of the contribution of public finances to agreed priorities. Thirdly, a proper design and implementation of medium-term expenditure frameworks and progress in cost-benefit analysis and performance budgeting would help to improve both the control and allocation of existing funds.

Finally, a contribution to the quality of public finances can be given by the Union’s initiative for growth, through which the European Council has established a roadmap for increased investment at EU level in physical and human capital to complement structural reform. Serious engagement by the EU institutions and Member States is required in order to ensure that financially and economically viable projects of major relevance are undertaken in a sustained and timely way.

Strengthening the EU framework for economic governance

In 2003, the need for further and more decisive progress in the EU framework for economic governance was highlighted by the difficulties in maintaining budgetary discipline and by the persistently low growth. In spite of important advances made in budgetary surveillance, further efforts are needed to improve the quality of public finances and ensure fiscal discipline. In particular, a number of issues that have arisen with the implementation of the EU framework for economic coordination and fiscal surveillance deserve further attention as dealing with them may strengthen the contribution of public finances to growth and employment.

Firstly, the processes underlying the coordination of economic policies in the EU have proven ineffective at times and the EU coordination framework for economic policy has been perceived as focusing almost exclusively on achieving and maintaining balanced budgets. This may be due to the weak link between the guidelines provided on economic policies and those on fiscal policy (i.e. the links between the BEPGs and the Pact) and to the different levels of stringency of the two processes. This weak link between the two processes makes it more difficult to look at fiscal policy in terms simultaneously of fiscal discipline (budgetary balances) and of the contribution of fiscal policy to growth and employment (composition of the budget). In addition, it often appears that the policy guidelines have a limited influence on national budgets or on the priorities for the EU budget.

Secondly, the procedural and numerical rules which aim at ensuring fiscal discipline as an instrument for higher growth and stability have shown shortcomings. The framework lacks both incentives for prudent behaviour in good times and rewards for countries with sound underlying budgetary positions. In some cases, the framework has not been stringent enough. As a consequence, some countries have not reduced their debt level as fast as expected at the start of EMU, while others have moved back to deficit levels above those required for adopting the euro. The strict timetable and conditions spelled out by the SGP concerning the excessive deficit procedure have proven to be complex to implement.

These developments showed that both the framework which applies to the conduct of national fiscal policies and the processes underlying the coordination of economic policies in the EU need to be reassessed. Making the EMU macroeconomic framework more effective would contribute to progress towards the objective of higher growth. In this endeavour, the right balance has to be found between the need to keep the economic governance framework stable and predictable and to improve the system on the basis of past experience.

Various parts of the report on 'Public finances in EMU — 2004' deal with these issues, without being either conclusive or exhaustive.

Firstly, the economic arguments presented above show that, by fostering discipline and quality in public finances, the Treaty — with its numerical and procedural rules — does make an important contribution to growth

while allowing room for a proper implementation of the Lisbon strategy.

Secondly, as the Commission has put forward in its communication on financial perspectives, the BEPGs could assume a more prominent role in economic policy coordination by providing better fiscal guidance to Member States, therefore supporting the conduct of national policies and the definition of budgets. One possibility could be to bring the national budgetary policy coordination calendars more into line with the general policy coordination cycle, for example by having an EU six-month period in which policy guidance would be formulated and issued followed by a national six-month period during which Member States would follow up. This would also make it possible to set fiscal policy in the broader context of increasing growth potential and addressing the quality and sustainability of public finances.

Thirdly, in its communication of November 2002, the Commission already expressed the importance of improving the interpretation of the fiscal rules, in order to take debt developments and country-specific circumstances more into account. The report on 'Public finances in EMU — 2004' examines several options such as: taking more account of growth developments, in particular of protracted slowdowns, in the implementation of the procedures, including in the application of the deficit criterion and in setting the deadlines for correcting the excessive deficit; and increasing the focus on debt in the surveillance of budgetary developments. The report also elaborates on the concept, put forward in the 'Public finances report 2001', of reworking the definition of the medium-term objective for fiscal policy, to cater for other (country-specific) circumstances and consider debt levels and the overall sustainability of public finances while ensuring that deficits remain below 3 % of GDP in normal circumstances. It reviews other options to improve the functioning of the SGP such as strengthening the incentives to conduct prudent and symmetric-over-the-cycle policies and achieve surpluses in good times, or ensuring early action to correct inadequate developments. The report indicates that improving the knowledge of government budgetary positions — through the analysis of all elements which underlie borrowing requirements and balance sheets and through a reinforcement of the statistical framework — also appears to be important. For the credibility and smooth operation of the fiscal framework, the reliability of fiscal statistics is crucial. To this end, it highlights the importance of strong monitoring of the quality of reported fis-

cal data and of consistency between the status and prerogatives of national statistical authorities and their task of ensuring the reliability and timeliness of statistics. To this end the Council conclusions of 2 June 2004 lay down minimum European standards for the institutional set-up of statistical authorities. Full transparency will allow the financial markets to better assess the creditworthiness of the different Member States.

Finally, the report addresses issues of enforcement at both Community and national level. At Community level, it recalls the advantages of clarifying the authority and the instruments entrusted respectively to the Commission and to the Council. The Commission's role in assessing developments and determining policy recommendations contributes to efficiency. A better articulation and differentiation of roles in the application of the SGP resulting from changes agreed in the European Constitution (such as the capacity of the Commission to issue a formal 'early warning' directly and to adopt pro-

posals for the Council decisions launching the excessive deficit procedure) is an important first step. The report recalls the merits of the Community's, and in particular the Commission's, power to effectively monitor the application of the fiscal rules by Member States, especially concerning the preventive element of the framework. At national level, it underlines the importance that Member States ensure that institutions are appropriate to the task of ensuring sustainable public finances. This involves both improving budgetary procedures and favouring the dialogue among all actors concerned. In this context the role played in some Member States by national counterparts for the monitoring function fulfilled by the Commission at EU level appears relevant.

The Commission will build on the analysis presented in this report and proceed with consultations, with the objective to moving towards specific formal proposals for rejuvenating the SGP and strengthening economic governance.

Part I

Current developments and prospects

Summary

In 2003, the fiscal deficit for the euro area continued to increase for a third consecutive year, mainly reflecting lower growth than previously expected. The nominal deficit rose from 2.3 % of GDP in 2002 to 2.7 % of GDP in 2003 and is, according to the latest Commission forecasts, projected to be roughly unchanged in 2004 and 2005. However, this aggregate outcome results from diverse budgetary performances across Member States. In 2003, five euro-area countries had budget positions in balance or in surplus, both in nominal and cyclically adjusted terms. In contrast, in four euro-area Member States actual deficits were equal to or above 3 % of GDP in 2003.

In Germany, despite significant consolidation efforts, the general government deficit continued to deteriorate. The actual deficit increased from 3.5 % of GDP in 2002 to 3.9 % of GDP in 2003. The deficit is projected to remain above 3 % of GDP in 2004 and drop slightly below 3 % in 2005. The actual deficit continued to deteriorate rapidly also in France, where it reached 4.1 % of GDP in 2003. According to the latest Commission forecasts, the actual deficit should remain well above the 3 % of GDP reference value also in 2004 and 2005. Portugal managed to reduce the actual deficit below 3 % of GDP in 2003 (to 2.8 % of GDP), as requested in the recommendations made by the Council. The Portuguese authorities continued, however, to rely on sizeable one-off measures and on the basis of the current policies, Portugal is projected to breach the threshold again in 2004. The deficit remained high in Italy, at 2.4 % of GDP in 2003, in spite of sizeable one-off measures. The deficit is projected to breach the 3 % of GDP reference value by 2004 and to approach 4 % of GDP in 2005. In the Netherlands, the nominal deficit in 2003 amounted to 3.2 % of GDP. Recent forecasts show an even higher deficit for 2004 at 3.5 % of GDP, which should decline to 3.3 % of GDP in 2005. The nominal deficit has worsened sharply in Greece, reaching 3.2 % of GDP in 2003 and, after breaching the reference value in 2004, it is expected to

decline slightly below the reference value in 2005. Outside the euro area, nominal deficits breached the reference value in the UK (3.2 % of GDP in 2003), Cyprus (6.3 %), the Czech Republic (12.9 %), Hungary (5.9 %), Malta (9.7 %), Poland (4.1 %) and Slovakia (3.6 %). On a more positive note, compared to the previous year the nominal budget balances in 2003 in the euro area improved in Belgium (improvement of 0.1 percentage points (p.p.)), Spain (0.3 p.p.) and Ireland (0.4 p.p.). Outside the euro area, similar developments can be mentioned for Estonia (0.8 p.p.), Latvia (0.9 p.p.), Hungary (3.4 p.p.), Slovenia (0.1 p.p.), Slovakia (2.1 p.p.) and Sweden (0.7 p.p.).

In cyclically adjusted terms, the deficit in the euro area decreased slightly in 2003 but remained high at 2.2 % of GDP. In particular, it remained high in Germany and France, while it deteriorated in Greece, Austria and the UK. According to the latest Commission forecasts, the cyclically adjusted balances (CABs) in the euro area and EU-15 are projected to be roughly unchanged in 2004 and 2005. The budgetary consolidation process seems therefore to have stalled. Past experience shows, however, that efforts to improve the underlying budget positions should be made as economic conditions recover in order to ensure sufficient room for the automatic stabilisers to operate when necessary.

After several years of moderate decline followed by a stabilisation in 2002, the euro-area government debt/GDP ratio increased to 70.4 % in 2003 and in EU-15 to 64.0 %. According to the Commission's spring 2004 forecasts, the debt ratio is projected to increase slightly in 2004 to 70.9 % of GDP and remain at the same level in 2005. The aggregate average debt ratio in the new Member States is lower than in the euro area. The ratio is nevertheless projected to increase somewhat and reach 45.2 % of GDP in 2005. Among them, improvement is expected only in Estonia and Hungary.

In the medium term, the euro area would, according to the latest updates of the stability and convergence programme, improve its CAB by slightly less than the required 0.5 p.p. of GDP per year in the coming years. Thus, a close-to-balance position in cyclically adjusted terms would almost be reached by 2007 (– 0.7 % of GDP). However, in the case of some Member States, the projected budgetary adjustment is insufficient to ensure that a close-to-balance budgetary position would be achieved and that a sufficient safety margin to prevent a breach of the 3 % of GDP reference value would be reached before 2007. It should also be noted that the medium-term objectives of some Member States are based on growth assumptions which, in light of the Commission's spring forecast, appear to be overly optimistic. Moreover, the implementation record of the programmes has, in several cases, been below expectations, leading to a repeated postponement of the achievement of the close-to-balance objective. Budgetary targets set in the updates seem, in some cases, to be too optimistic, even with growth rates as expected in the updates. It is vital for Member States to reach the SGP's medium-term target in order to ensure that the automatic stabilisers work freely and to decrease the risk of unsustainable public finances in light of ageing populations.

As far as the medium-term plans of the new Member States are concerned, all the May 2004 convergence programmes foresee favourable growth prospects to be continued over the entire programme horizon. According to the countries' own estimates reported in the convergence programmes, the expected development in the projection period indicates a substantial consolidation of public finances for all of them. Thus, by 2007, only the Czech Republic and Hungary foresee general government deficits still above the 3 % of GDP reference value. Particularly strong deficit reductions are expected in the countries with initially high deficits, such as Cyprus, Malta and Hungary. Following a different path, Estonia plans to move from the 2003 government surplus down to balance in 2005. In contrast, Poland's consolidation

endeavour looks backloaded as the government is still pursuing an expansionary fiscal policy in 2004, hence generating further deficit increases in the early years of the programme, compensated by a consolidation between 2005 and 2007. According to the convergence programmes, all the new Member States except Latvia and Lithuania are expected to improve their structural balances by 2007. Nevertheless, in Slovakia, Hungary and the Czech Republic, the structural deficits are forecast to stand at or above 3 % of GDP in 2007.

For the third year in a row, the EU budgetary surveillance includes an assessment of the sustainability of public finances on the basis of the updated stability and convergence programmes submitted by EU-15 in late 2003. This year's assessment confirms the track record of continuous improvements in the way the sustainability is assessed. For the quantitative indicators, the cyclical component of the budget has been netted out in the first year of the projection, so the long-term projections are only affected by the more structural components of the budget. Also, greater attention has been devoted this year to qualitative features when making the assessment, which has alleviated the mechanistic interpretation of the results obtained and given the assessment a significantly higher information value. Overall, the analysis shows that risks to long-term sustainability are still present in nine countries, in five of which (Belgium, Greece, Italy, Germany and France) the difficulties are more serious, while the other four (Portugal, Spain, the Netherlands and the UK) face some risks from medium-term budgetary developments or from uncertainties over the long-term projections of pension expenditures (Spain and Portugal). Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem relatively well placed to meet the cost of an ageing society, but nevertheless face budgetary challenges as a result of ageing populations.

1. Budgetary developments in the euro area and EU Member States

1.1. Short-term developments and prospects for the budget balance and public debt

In 2003, the budgetary position in the euro area deteriorated for the third year in a row (see Table I.1). Compared to 2002, the nominal deficit increased by 0.4 percentage points and reached 2.7 % of GDP. This development is largely explained by the functioning of the automatic stabilisers in a macroeconomic environment which was considerably less favourable than previously expected. The aggregate nominal deficit also worsened in the case of the new Member States (NMS) by 0.8 percentage points and reached 5.7 % of GDP in 2003 (see Table I.2). Accordingly, the aggregate deficit for EU-25 as a whole amounted to 2.7 % of GDP.

The aggregate outcome for the euro area as a whole results from diverse budgetary performances across Member States. In the case of Germany, France, Italy and Portugal the budgetary positions in 2003 remained weak with nominal deficits ranging from 2.4 % of GDP in Italy to 4.1 % of GDP in France. As a result of the developments in the course of 2002, Germany and France have remained in excessive deficit positions, while in Portugal, the deficit has been kept just under the 3 % of GDP reference value despite a shrinking economy (see Part II.2.3 of this report). In 2003, the nominal deficit has also sharply deteriorated in the Netherlands and Greece, and outside the euro area, in the UK, reaching 3.2 % of GDP. Nevertheless, in spite of a protracted period of low growth, seven EU-15 Member States, of which five are euro-area countries, had nominal budget positions in balance or in surplus. Overall, the nominal budget balances in 2003 did not worsen (or did so only marginally) compared to the previous year in the case of Belgium, Denmark, Spain, Ireland, Sweden, Italy and as already mentioned, in Portugal, although for the latter

two this is mainly due to sizeable one-off measures amounting to around 2 % of GDP in each country.

The budgetary performance also differed across the NMS. Nominal budget balances in 2003 varied from a deficit of 12.9 % of GDP in the Czech Republic to a surplus of 2.6 % of GDP in Estonia. In the case of Cyprus, the Czech Republic, Hungary, Malta, Poland and Slovakia, the nominal deficit in 2003 was above the reference value of 3 % of GDP, and only Estonia had a surplus budgetary position. Relative to 2002, the budget position remained roughly unchanged or improved in four countries, while it deteriorated in Cyprus, the Czech Republic, Lithuania, Malta and Poland. The improvement was particularly important in Hungary and Slovakia.

Looking ahead to 2004 and 2005, the Commission's spring 2004 forecasts project that economic growth in the euro area as a whole will return to potential by the end of 2004. The nominal budget balance is expected to remain roughly unchanged in 2004 as well as 2005. In light of an improvement of the economic situation coupled with budgetary consolidation, the aggregate nominal deficit for the NMS is foreseen to decline to 5.0 % of GDP in 2004 and 4.2 % of GDP in 2005. As a result, the aggregate budget position for the EU as a whole would slightly improve during the forecast period and reach 2.5 % of GDP in 2005.

At the Member State level, the budgetary positions in the case of Belgium and Ireland are expected to deteriorate into deficit positions in 2004. Under a no-policy-change assumption, the deficits in both countries would continue to worsen in 2005. In contrast, Spain, Finland, Denmark and Sweden are expected to maintain their budgetary positions in surplus throughout the forecast period. Among the NMS, this is also the case for Estonia.

On the basis of current policies, the Commission forecasts project that the nominal deficits in Germany, Greece,

France, Italy, the Netherlands and Portugal will be exceeding the 3 % of GDP reference value in 2004 and, except Germany and Greece, also in 2005. In Germany, the nominal deficit is projected to remain above 3 % of GDP in 2004 and move slightly below the reference value in 2005. Similarly, in Greece, the nominal deficit is expected to breach the 3 % of GDP in 2004 and decline slightly below the reference value in 2005. The period of weak budgetary situation in France is being prolonged, since the nominal deficit is expected to remain well above the 3 % of GDP threshold also in 2005. Although Portugal appears to have complied with the terms of the excessive deficit recommendation addressed to it in 2002, the nominal deficit is foreseen to exceed 3 % of GDP again, in both 2004 and 2005. In Italy and the Netherlands, the nominal deficits are expected to breach the reference value in 2004 and, in the case of Italy, to deteriorate further in 2005.

The nominal deficit is projected to be high also in other Member States. In the UK, it is foreseen to remain well above 2 % of GDP during the forecast period and in Austria, the nominal deficit would be around 2 % of GDP. In the NMS, the nominal deficit is expected to decline or remain unchanged in five countries. In the case of Latvia, Lithuania, Poland and Slovakia it is, however, projected to deteriorate in 2004 and would stabilise or decrease only by 2005.

In cyclically adjusted terms, the deficit in the euro area decreased slightly in 2003, but remained high at 2.2 % of GDP. According to the Commission's spring 2004 forecasts, the cyclically adjusted budget balance is projected to remain stable in 2004 and 2005. The budgetary consolidation process seems thereby to have stalled. At the Member State level, eight EU-15 countries, of which seven are in the euro area, are foreseen to have cyclically adjusted deficits above 0.5 % of GDP by 2005. Among the countries with higher cyclically adjusted deficits, deterioration is expected in Greece, Italy, Austria and Portugal, while improvements are foreseen in Germany, France, the Netherlands and the UK. In the cases of France and Greece, it is still projected to be above 3 % of GDP in 2005.

After several years of moderate decline followed by a stabilisation in 2002, the euro-area government debt/GDP ratio increased to 70.4 % in 2003 (see Table I.3 and Part II.5 in this report). The debt ratio is, according to the Commission's spring 2004 forecasts, projected to increase slightly in 2004 to 70.9 % of GDP and remain at the same level in 2005. The primary surplus would not offset the combined negative contribution from interest payments and growth. The aggregate average debt ratio in the NMS is on average lower in comparison to the euro area. However, the ratio is projected to increase somewhat and

Table I.1

General government budgetary position — euro area, 2000–05

(% of GDP)

	2000 ⁽¹⁾	2001 ⁽¹⁾	2002 ⁽¹⁾	2003	2004	2005
Total receipts (1)	47.3	46.6	46.1	46.3	45.8	45.5
Total expenditure (2)	47.1	48.2	48.4	49.0	48.6	48.1
Actual balance (3) = (1) – (2)	0.1	– 1.6	– 2.3	– 2.7	– 2.7	– 2.6
Interest (4)	4.1	4.0	3.6	3.5	3.4	3.4
Primary balance (5) = (3) + (4)	4.2	2.3	1.4	0.8	0.7	0.8
UTMS proceeds	1.1	1.1	0.0	0.0		
Cyclically adjusted balance (6)	– 1.9	– 2.4	– 2.5	– 2.2	– 2.2	– 2.2
Cyclically adjusted primary balance = (6) + (4)	2.2	1.6	1.2	1.3	1.2	1.2
Change in actual balance	1.5	– 1.8	– 0.6	– 0.4	0.0	0.1
Due to: — cycle	0.5	– 0.2	– 0.5	– 0.7	– 0.1	0.1
— UMTS	1.1	– 1.1	0.0	0.0		
— interest	0.2	0.1	0.3	0.2	0.1	0.0
— cyclically adjusted primary balance	– 0.4	– 0.6	– 0.5	0.1	0.0	0.1

⁽¹⁾ Including UMTS receipts. UMTS receipts as a % of GDP would be equal in 2000 to 2.5 for DE, 0.1 for ES, 1.2 for IT, 0.7 for NL, 0.4 for AT, 0.3 for PT, 2.4 for UK, 1.1 for the euro area and 1.2 for EU-15. In 2001 they would be equal to 0.2 for BE, 0.2 for DK, 0.5 for EL, 0.1 for FR, and 0 for the euro area and EU-15. In 2002 they would be equal to 0 for FR, 0.2 for IE and 0 for the euro area and EU-15.

NB: differences are due to rounding.

Source: Commission's spring 2004 forecasts. For a number of countries, the calculated CABs differ marginally from those of the spring forecast due to data revisions.

Table I.2

Budget balances in EU Member States, 2002–05

(% of GDP)

	Budget balance				Cyclically adjusted budget balance				Cyclically adjusted primary balance			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
BE	0.1	0.2	-0.5	-0.7	0.1	0.7	0.0	-0.5	6.2	6.3	5.1	4.3
DE	-3.5	-3.9	-3.6	-2.8	-3.5	-3.2	-2.9	-2.3	-0.4	0.0	0.1	0.7
EL ⁽¹⁾	-1.4	-3.2*	-3.2	-2.8	-1.7	-3.6	-4.1	-3.8	4.4	2.1	1.5	1.7
ES	0.0	0.3	0.4	0.6	-0.2	0.4	0.6	0.7	2.6	2.9	2.9	3.0
FR	-3.2	-4.1	-3.7	-3.6	-3.8	-3.9	-3.4	-3.3	-0.7	-0.8	-0.3	-0.3
IE	-0.2	0.2	-0.8	-1.0	-1.9	0.1	-0.3	-0.2	-0.5	1.5	1.1	1.2
IT	-2.3	-2.4	-3.2	-4.0	-2.2	-1.9	-2.6	-3.6	3.5	3.4	2.4	1.6
LU	2.7	-0.1	-2.0	-2.3	2.7	1.3	0.6	1.2	2.9	1.5	0.8	1.3
NL	-1.9	-3.2	-3.5	-3.3	-2.6	-2.0	-1.7	-1.3	0.4	0.9	1.1	1.7
AT	-0.2	-1.1	-1.1	-1.9	-0.3	-0.9	-0.9	-1.8	3.1	2.2	2.3	1.2
PT	-2.7	-2.8	-3.4	-3.8	-2.7	-1.8	-2.1	-2.6	0.3	1.1	0.8	0.5
FI	4.3	2.3	2.0	2.1	3.7	2.3	2.1	2.2	5.9	4.2	3.9	3.9
EUR-12	-2.3	-2.7	-2.7	-2.6	-2.5	-2.2	-2.2	-2.2	1.2	1.3	1.2	1.2
CZ	-6.4	-12.9	-5.9	-5.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
DK	1.7	1.5	1.1	1.5	1.0	2.1	1.4	1.5	3.8	4.7	3.9	3.7
EE	1.8	2.6	0.7	0.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
CY	-4.6	-6.3	-4.6	-4.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
LV	-2.7	-1.8	-2.2	-2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
LT	-1.4	-1.7	-2.8	-2.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
HU	-9.3	-5.9	-4.9	-4.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
MT	-5.7	-9.7	-5.9	-4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
PL	-3.6	-4.1	-6.0	-4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SI	-1.9	-1.8	-1.7	-1.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SK	-5.7	-3.6	-4.1	-3.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SE	0.0	0.7	0.2	0.7	-0.5	0.7	0.3	0.8	2.4	2.9	2.6	3.2
UK	-1.6	-3.2	-2.8	-2.6	-1.5	-2.9	-2.6	-2.3	0.6	-0.9	-0.5	-0.2
EU-25	-2.1	-2.7	-2.7	-2.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
p.m. EU-15	-2.0	-2.6	-2.6	-2.4	-2.2	-2.2	-2.1	-2.1	1.1	1.0	1.0	1.0
p.m. NMS	-4.9	-5.7	-5.0	-4.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

(¹) For Greece, a revision of the data on general government balance was done in April 2004.

NB: Excluding UMTS receipts for Ireland in 2002.

Cyclically adjusted figures are computed with the production function method, except for Germany, Spain and Austria, where the HP filter method has been used. For a number of countries, the calculated CABs differ marginally from those of the spring forecast due to data revisions.

Source: Commission's spring 2004 forecasts.

reach 45.2 % of GDP in 2005. The large negative contribution from the primary balance and interest payments/growth would only partly be compensated by stock-flow operations. In 2005, the debt ratio for EU-25 is hence expected to amount to 63.4 % of GDP.

Aggregate figures tend to hide different pictures across countries. In 2003, Belgium, Greece and Italy continued to have debt ratios above 100 % of GDP and this would still be the case for the latter two by

2005. In addition to these three countries, six EU-25 Member States are projected to have debt ratios above 60 % of GDP in 2005. Poor growth performance is expected to significantly affect the budgetary situation in Germany and Austria, as well as in France, Portugal and Malta, where in addition, large primary deficits are projected. In Cyprus, the combined positive contribution from interest payments and growth is more than offset by a high primary deficit and stock-flow operations.

Table I.3

Composition of changes in government debt ratio in EU Member States, 2002–05

(% of GDP)

	Government debt				Change in government debt 2003–05	Change in 2003–05 due to:		
	2002	2003	2004	2005		Primary balance	Interest and growth contribution	Stock-flow adjustment
BE	105.8	100.5	97.4	94.3	-6.2	-8.7	2.5	0.1
DE	60.8	64.2	65.6	66.1	1.9	0.1	2.9	-1.1
EL	104.7	103.0	102.8	101.7	-1.3	-5.1	-2.7	6.6
ES	54.6	50.8	48.0	45.1	-5.7	-5.6	-1.5	1.4
FR	58.6	63.7 ⁽¹⁾	64.6	65.6	2.6	1.2	1.5	0.0
IE	32.3	32.0	32.4	32.6	0.6	-0.9	-1.1	2.7
IT	108.0	106.2	106.0	106.0	-0.2	-3.0	2.3	0.5
LU	5.7	4.9	4.5	3.8	-1.1	4.1	-0.2	-5.0
NL	52.6	54.8	56.3	58.6	3.8	1.0	3.6	-0.8
AT	66.6	65.0	65.5	65.3	0.3	-3.1	1.8	1.7
PT	58.1	59.4	60.7	62.0	2.6	1.3	1.7	-0.3
FI	42.6	45.3	44.5	44.3	-0.9	-7.6	0.5	6.2
EUR-12	69.2	70.4	70.9	70.9	0.5	-1.5	1.7	0.2
CZ	28.9	37.6	40.6	42.4	4.7	8.4	-2.1	-1.6
DK	47.2	45.0	42.3	40.0	-5.0	-7.4	1.2	1.1
EE	5.7	5.8	5.4	5.3	-0.5	-1.2	-0.5	1.2
CY	67.1	72.2	74.6	76.9	4.7	n.a.	n.a.	4.6
LV	15.5	15.6	16.0	16.1	0.5	2.6	-0.8	-1.2
LT	22.8	21.9	22.8	23.2	1.3	2.8	-0.9	-0.5
HU	57.1	59.0	58.7	58.0	-1.0	1.4	-1.0	-1.4
MT	61.7	72.0	73.9	75.9	3.8	3.6	2.9	-4.3
PL	41.2	45.4	49.1	50.3	4.9	4.1	0.2	0.7
SI	27.8	27.1	28.3	28.2	1.1	0.2	-0.2	1.1
SK	43.3	42.8	45.1	46.1	3.3	2.4	-1.0	1.9
SE	52.6	51.9	51.8	50.5	-1.3	-5.6	0.3	4.0
UK	38.5	39.9	40.1	40.6	0.7	1.2	-0.1	-0.4
EU-25	61.5	63.1	63.4	63.4	0.3	-1.0	1.3	0.1
p.m. EU-15	62.5	64.0	64.2	64.2	0.2	-1.2	1.2	0.2
p.m. EU-10	39.4	42.2	44.4	45.2	3.0	3.9	1.9	-2.9

⁽¹⁾ For France, this figure was notified by France after the official EDP notification of 1 March 2004.

NB: Aggregates EU-25 and EU-10 for changes in government debt due to primary balances, interest and growth contribution and stock-flow adjustment do not include Cyprus.

Source: Commission's spring 2004 economic forecasts.

1.2. Government revenue and expenditure

The developments in the euro-area budgetary position are derived from changes in expenditure and revenue ratios. On the spending side, the euro-area expenditure-to-GDP ratio increased in 2003, both in nominal and cyclically adjusted terms, compared to the previous year (see Table I.4), which is mainly due to a rise in public expenditures on social transfers. According to the Commission's spring 2004 forecasts,

the expenditure ratio is projected to decline during the forecast period. However, interest payments are, after several years of decline, foreseen to remain broadly neutral. On the revenue side, the revenue/GDP ratio slightly increased in 2003, both in nominal and cyclically adjusted terms, but is expected to decline in the coming years.

At Member State level, the patterns are generally similar to that of the euro area (see Table I.5). Only in Ireland

and Luxembourg and outside the euro area, in Lithuania and Poland, are expenditure ratios projected to increase over the 2003–05 period. In contrast, large decreases are expected in Belgium, Germany, the Czech Republic and Estonia over the same period. Revenue ratios are set to increase slightly over 2003–05 in the case of Spain and outside the euro area, in Lithuania and Poland, whereas important reductions are foreseen in Belgium, Italy, Austria and Estonia ⁽¹⁾.

In the euro area, the projected decrease in tax revenues on income and wealth, social contributions and other resources, is being offset by an expected decline in expenditure on collective consumption, interests, subsidies. Such a development respects lessons from the past showing that tax measures resulting in a decline of tax revenues should be accompanied by expenditure cuts to avoid the worsening of the general government balances. Nevertheless, the composition of expenditure adjustment should not constrain growth-enhancing spending items such as public investment, education and R & D. In previous years, the reduction in interest payments has particu-

larly contributed to a better allocation of available resources. While these seem to stay at a stable level in the forecasting period, additional savings are expected from collective consumption, social transfers and other expenditures.

1.3. The fiscal stance and policy-mix

1.3.1. The fiscal stance and policy-mix in the euro area

An appropriate policy-mix can be defined as a combination of monetary and fiscal policies that ensures price stability and keeps economic activity close to its potential level. In the euro area, given that monetary policy is centralised and fiscal policies decentralised, it is of a particular importance to assess both the aggregate fiscal stance at the euro-area level and national fiscal stances. Namely, the aggregate fiscal stance affects the policy-mix at the euro-area level, and is, therefore, one of the elements to be considered by the ECB when setting the monetary policy. Analogously, the policy-mix for the euro area will have an impact on the national policy-mix via the common interest rates with repercussions on economic developments and prospects at national level.

⁽¹⁾ The decreasing expenditure and revenue ratios in the case of Slovakia are based on non-consolidated figures.

Table I.4

Euro-area government revenues and expenditures, 2001–05

(% of GDP)

	2001	2002	2003	2004	2005
Total revenues	46.6	46.1	46.3	45.8	45.5
— cyclically adjusted	46.0	46.0	46.7	46.2	45.8
Taxes on imports and production	13.3	13.4	13.4	13.5	13.6
Current taxes on income and wealth	12.6	12.2	11.8	11.6	11.5
Social contributions	16.0	16.0	16.2	16.1	15.9
of which actual social contributions	14.9	14.9	15.0	15.0	14.8
Other resources	4.6	4.6	4.9	4.6	4.5
Total expenditure	48.2	48.4	49.0	48.6	48.1
— cyclically adjusted	48.4	48.5	49.0	48.5	48.0
Collective consumption	8.2	8.3	8.4	8.3	8.2
Social benefits in kind	11.9	12.1	12.3	12.3	12.1
Social benefits other than in kind	16.6	16.9	17.2	17.1	16.9
Interest	4.0	3.6	3.5	3.4	3.4
Subsidies	1.4	1.3	1.3	1.2	1.2
Gross fixed capital formation	2.5	2.4	2.6	2.5	2.6
Other expenditures	3.6	3.7	3.7	3.7	3.7

NB: Including UMTS receipts, see footnote to General government budgetary position — euro area, 2000–05.

Source: Commission's spring 2004 forecasts.

Table I.5

Total revenue and expenditure in EU Member States, 2002–05

(% of GDP)

	Revenue				Expenditure			
	2002	2003	2004	2005	2002	2003	2004	2005
BE	50.5	51.7	49.4	48.6	50.5	51.5	49.9	49.4
DE	45.0	45.0	44.5	44.3	48.5	48.9	48.0	47.1
EL	45.3	44.2	44.0	44.1	46.7	47.1	47.2	46.9
ES	39.9	39.9	40.0	40.1	39.9	39.5	39.6	39.5
FR	50.2	50.6	50.7	50.5	53.5	54.7	54.4	54.1
IE	33.1	34.6	34.3	33.7	33.3	34.3	35.1	34.7
IT	45.6	46.5	45.4	44.7	47.9	48.9	48.7	48.7
LU	47.0	47.1	46.8	46.8	44.3	47.3	48.8	49.1
NL	45.9	45.6	45.1	44.8	47.8	48.8	48.6	48.1
AT	51.0	49.9	49.5	47.7	51.2	51.0	50.7	49.7
PT	43.4	44.6	43.2	43.0	46.1	47.5	46.6	46.9
FI	54.4	52.7	52.6	52.2	50.1	50.5	50.7	50.1
EUR-12	46.1	46.3	45.8	45.5	48.4	49.0	48.6	48.1
CZ	45.6	45.0	45.0	44.1	52.0	57.9	50.9	49.2
DK	57.3	57.5	56.9	56.2	54.9	55.4	55.8	54.7
EE	39.6	41.2	43.4	42.2	37.9	38.6	42.8	42.2
CY	n.a.	n.a.	37.5	37.6	n.a.	n.a.	42.1	41.7
LV	41.9	41.5	39.6	38.4	44.6	43.3	41.8	40.4
LT	33.8	33.9	34.7	34.7	35.2	35.6	37.4	37.3
HU	45.0	44.8	47.1	46.8	n.a.	n.a.	n.a.	n.a.
MT	n.a.	n.a.	40.2	40.4	n.a.	n.a.	45.3	44.0
PL	41.3	41.0	40.8	41.2	44.9	45.1	46.8	45.7
SI	n.a.	n.a.	42.3	42.3	n.a.	n.a.	44.0	44.0
SK	45.2	49.1	42.0	43.1	50.9	52.7	46.1	47.0
SE	58.1	59.5	59.1	58.9	58.1	58.8	58.9	58.3
UK	39.5	39.6	39.1	39.2	41.1	42.8	41.8	41.8
EU-25	n.a.	n.a.	45.1	44.9	n.a.	n.a.	n.a.	n.a.
p.m. EU-15	45.5	45.8	45.2	45.0	47.5	48.4	47.8	47.4
p.m. EU-10	n.a.	n.a.	42.5	42.5	n.a.	n.a.	n.a.	n.a.

NB: Including UMTS receipts, see footnote to Table I.1.

Source: Commission's spring 2004 forecasts.

Graph I.1 examines the fiscal stance (approximated by the changes in the cyclically adjusted primary balance, CAPB) in relation to cyclical conditions (approximated by the size of the output gap) ⁽¹⁾. In this graph, fiscal behaviour in accordance with the SGP would be represented by movements along the horizontal axis. In other

words, countries would achieve and maintain broadly balanced budgets over the economic cycle. Thus, changes in the output gap would not imply movements in the CAPB. However, as long as a Member State has not yet reached the medium-term target of the SGP, a restrictive fiscal stance — that is a positive change in CAPB — would be needed for a number of years.

⁽¹⁾ In line with the Council agreement, the output gap in this section is computed with the production function method. It should be noted, however, that changes in the output gap are equally relevant for the judgement of the stance in relation to cyclical conditions. The changes in the gap can be inferred in Graph I.1 by looking at the horizontal distance between years.

According to the Commission's spring 2004 forecasts, the euro-area fiscal stance was broadly neutral in 2003 even though the output gap deteriorated sharply. This

development follows after three years of fiscal loosening in a context of a large positive output gap in 2000 that worsened in 2001 and 2002. Looking ahead to 2004 and 2005, the euro-area fiscal stance is projected to continue to be broadly neutral ⁽¹⁾. Lessons from the past show, however, that efforts to improve the underlying budget positions should be made as economic conditions improve, in order to ensure sufficient room for the automatic stabilisers to operate in the next downturn.

Graph I.2 illustrates the euro-area policy-mix, by plotting the fiscal stance on the vertical axis and the monetary stance (approximated by the change in the short-term real interest rates) on the horizontal axis. Against the background of a protracted slowdown in economic activity, the monetary stance continued to loosen in 2003, although less than the year before. Overall, in 2003, the euro-area fiscal stance could be seen as neutral, coupled with the growth-supportive monetary stance thus contributing to a recovery of economic activity and closing of the output gap. The policy-mix in the early years of EMU has therefore been broadly appropriate to

support growth-enhancing economic conditions and macroeconomic stability.

1.3.2. The fiscal stance and policy-mix at the national level

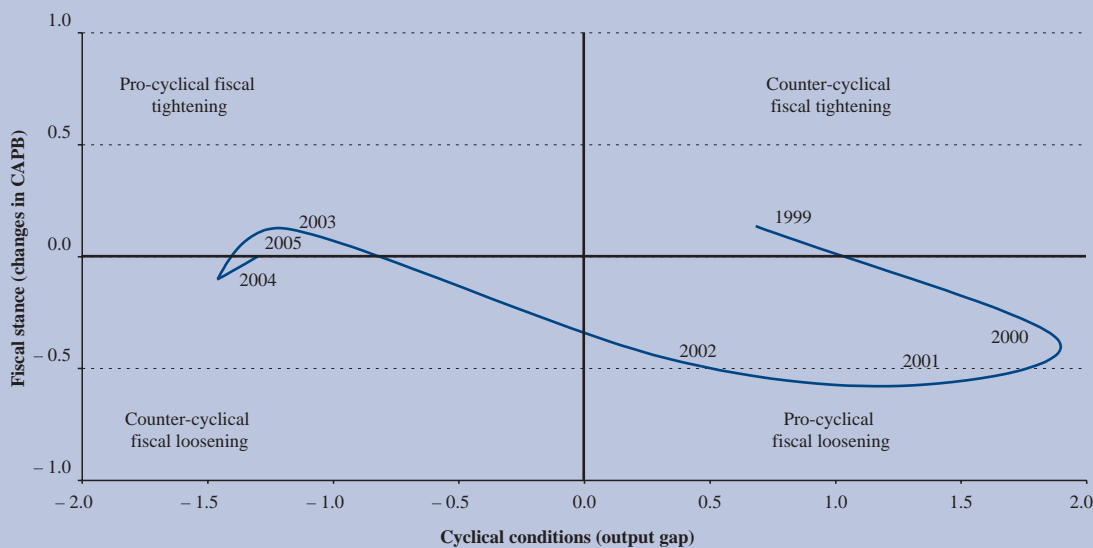
The aggregate fiscal stance for the euro-area results from quite diverse fiscal stances across Member States, despite fairly similar cyclical developments. Graph I.3 shows that most EU countries recorded a negative output gap in 2003, with the exception of Greece, Ireland (where it sharply deteriorated) and Sweden.

In 2003, several EU countries ran moderately counter-cyclical or broadly neutral fiscal policies in a context of negative output gaps. Policies were, however, clearly counter-cyclical in the case of Luxembourg, Austria and the UK. It is worth mentioning that the nominal budget balances in these countries markedly worsened in the course of 2003. Finland, which was benefiting from past consolidation efforts and therefore had a large safety margin, was also easing the fiscal stance.

⁽¹⁾ The forecasted potential growth rate in the euro area for 2004 is 2 % (the Commission's spring 2004 forecast).

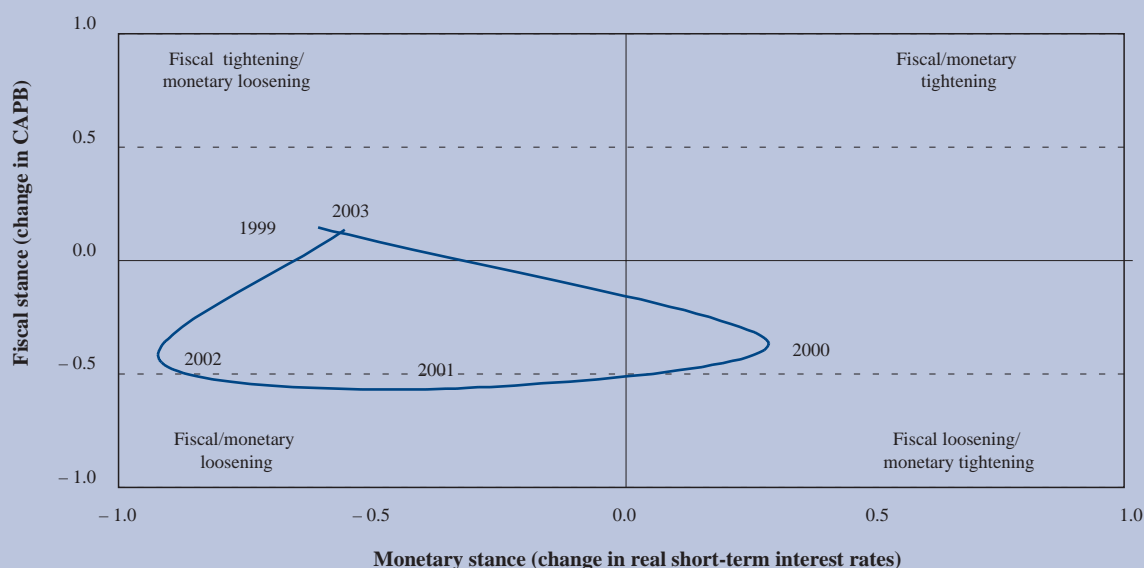
The Netherlands and Portugal ran somewhat pro-cyclical policies in 2003, reflecting consolidation efforts in

Graph I.1: Euro-area fiscal stance and cyclical conditions, 1999–2005



Source: Commission's spring 2004 forecasts.

Graph I.2: Euro-area policy-mix, 1999–2003



Source: Commission's spring 2004 forecasts.

order to keep the nominal deficits below the 3 % of GDP reference value. Denmark and Ireland tightened their fiscal stance, while the output gap quickly deteriorated. Greece stands out for loosening the fiscal stance in spite of a large positive output gap.

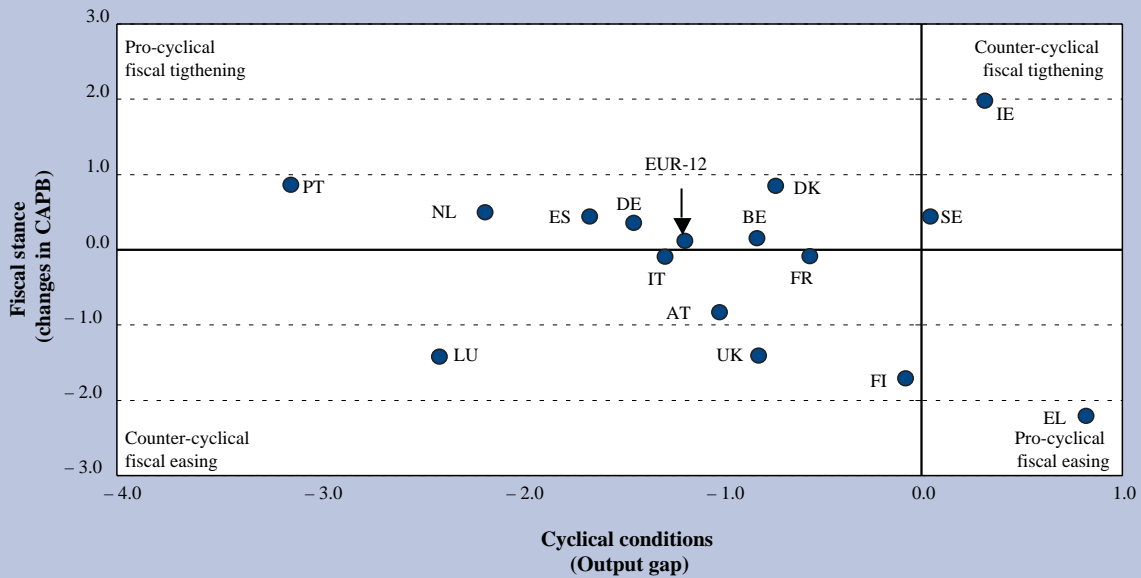
As pointed out above, the overall policy-mix in the euro area has been slightly accommodative in 2003 with most Member States experiencing a broadly neutral fiscal stance accompanied by declining real interest rates (see Graph I.4). The real interest rates fell in all countries, with the exception of Finland.

While Graph I.4 refers to the changes in the real short-term interest rates, its level is equally important when assessing the policy-mix. After the reductions in the nominal interest rate decided by the ECB in the course of 2003, the real interest rate for the euro area (i.e. the short-

term interest rate corrected by private consumption inflation) amounted to 0.4 % in 2003. However, this aggregate figure for the euro area conceals significant differences across Member States due to disparities in inflation rates across countries. The real interest rates in Germany and Austria were around 1 %, whereas in a number of countries (Greece, Spain, Ireland, Italy, the Netherlands and Portugal) the interest rates were negative.

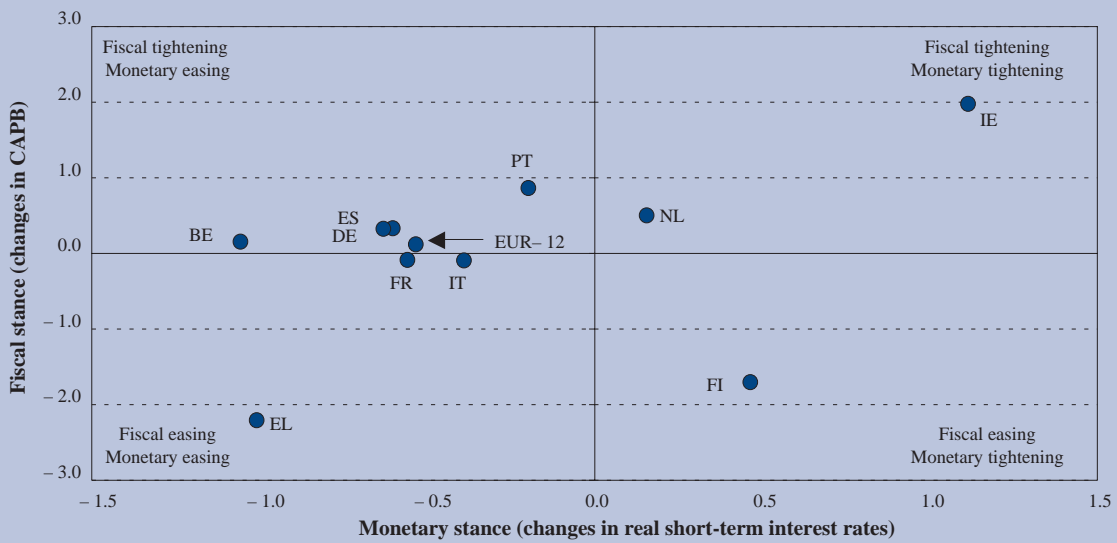
Regarding 2004, the fiscal stance is expected to be broadly neutral in most Member States (see Graph I.5). Belgium, Italy, Luxembourg and Denmark are, however, projected to loosen their fiscal stance, in the case of Italy, as a result of the expiry of the one-off measures. Greece is projected to continue the loosening of its fiscal stance also in 2004, even though the output gap is expected to be positive.

Graph I.3: Fiscal stance and cyclical conditions in EU Member States, 2003



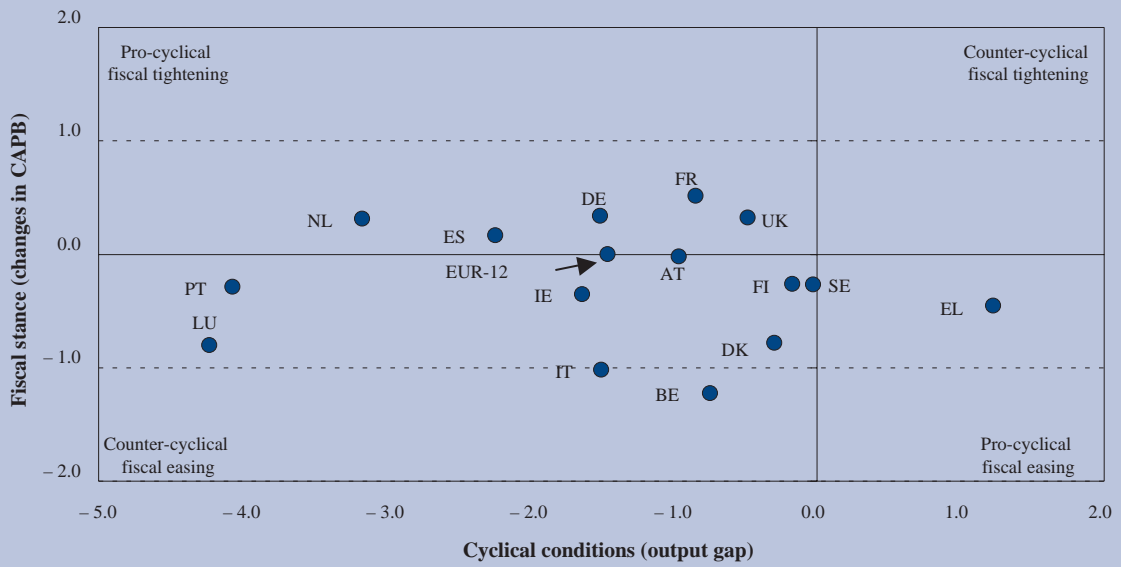
Source: Commission's spring 2004 forecasts.

Graph I.4: Policy-mix in EU Member States, 2003



Source: Commission's spring 2004 forecasts.

Graph I.5: Fiscal stance and cyclical conditions in EU Member States, 2004



Source: Commission's spring 2004 forecasts.

2. Overview of the 2003 updates of the stability and convergence programmes

2.1. The medium-term budgetary targets

The examination of the fifth round of updates of stability and convergence programmes, covering the period up to 2007, was completed by March 2004.

In order to make an assessment of the budgetary targets set by Member States in the 2003 updates of the programmes, it is necessary to examine the growth assumptions upon which the budgetary commitments are made. Economic growth is, according to the updates, projected to recover gradually over the coming years. The average GDP growth in the euro area is expected to pick up to 2.0 % in 2004 and to reach around 2.5 % in 2005 and the following years (see Table I.6).

In comparison with the 2002 updates of the programmes, growth projections have been revised downwards (see the lower half of Table I.6 and Table I.7).

The negative revisions concern the whole period, but in particular 2003. Nevertheless, growth projections are still more favourable than the Commission's autumn 2003 forecasts, by on average 0.2 percentage points per year between 2003 and 2005. This has been the case for the previous updates as well ⁽¹⁾. The growth projections also seem to be optimistic in comparison to the Commission's spring 2004 forecasts (see last row of Table I.6).

The aggregate potential GDP growth in the euro area is projected to be stable, around 2.1 %, throughout the programme period. Accordingly, the euro-area output gap would be -1.1 percentage points of potential GDP in 2003, widen further in 2004 to -1.2 % and thereafter decrease in 2005 and onwards (see Graph I.6). In compar-

ison to the 2002 updates, the slowdown is projected to be protracted with a more sizeable negative output gap that does not fully disappear within the programme period.

Based on these growth assumptions, the nominal deficit in the euro area would, according to the updated programmes, amount to 2.7 % of GDP in 2003, which is almost 1 percentage point of GDP higher compared to the previous updates (see Table I.8). The nominal deficit is, however, projected to be gradually reduced to below 1 % of GDP by 2007. The overall improvement relies strongly on the budgetary consolidation projected in the large Member States, such as Germany (2.5 percentage points of GDP over the next four years), France (2.5 percentage points) and Italy (2.5 percentage points). The excessive deficits in Germany and France are foreseen to be corrected by 2005 in the respective stability programme. Also Greece, the Netherlands, and outside the euro area, Sweden and the UK foresee important improvements in the budget balance. Ireland and Luxembourg are the only Member States that project a budgetary deterioration between 2003 and the end of the programme period.

A comparison between the projections provided by the Member States (the left panel of Table I.8) and the Commission's autumn 2003 and spring 2004 forecasts (right panels) shows that most updates are more optimistic about budgetary developments in 2004 and 2005 than the Commission forecasts, in particular those of Greece, Italy, the Netherlands and Portugal. The only countries projecting less favourable budgetary developments are Spain, Ireland and Finland reflecting among other things more cautious growth assumptions.

The differences in budget balance projections between the updates and the Commission forecasts are particularly relevant for 2005. One obvious explanation for this is that the budgetary projections in several programmes are based on more optimistic growth assumptions. More-

⁽¹⁾ The difference in the real GDP growth for the euro area between the 2001, 2002 and 2003 updates of the stability programmes and the Commission's autumn forecasts has for each period been on average 0.2 percentage points of GDP.

Table I.6

Euro area: Growth projections and macroeconomic developments in the 2003 updates (percentage change on preceding year) and comparison with the 2002 updates and the Commission forecasts

(% of GDP)

Macroeconomic developments	2002	2003	2004	2005	2006	2007
2003 updates of the stability programmes						
Real GDP growth	0.9	0.6	2.0	2.5	2.6	2.5
GDP deflator	2.4	2.1	1.7	1.6	1.6	1.5
HICP change	2.3	2.1	1.7	1.6	1.6	1.5
employment growth	0.3	0.0	0.6	1.1	1.2	1.1
labour productivity growth	0.5	0.8	1.7			
2002 updates of the stability programmes						
Real GDP growth	1.0	2.1	2.6	2.6	2.6	
Difference with the 2003 updates (1)	-0.1	-1.5	-0.6	-0.1	-0.1	
Commission's autumn 2002 forecast						
Real GDP growth	0.9	0.4	1.8	2.3		
Difference with the 2003 updates (1)	0.0	0.2	0.2	0.2		
Commission's spring 2004 forecast						
Real GDP growth	0.9	0.4	1.7	2.3		
Difference with the 2003 updates (1)	0.0	0.2	0.3	0.2		

(1) A positive value implies a higher growth forecast in the 2003 updates.

NB: Commission calculations. Discrepancies are due to rounding. The growth rates used for France are based on the cautious scenario. Since figures for the HICP were not available in the German programme, the Commission forecasts have been used in order to obtain a representative aggregate. In the case of Greece (for 2004-06) and Spain the private consumption deflator was used instead of the HICP.

Source: Commission services.

over, in some cases Member States incorporate in their projections intended policy measures, whereas the Commission forecasts for 2005 are on a no-policy-change basis.

All countries, except Spain, provided figures for the CABs in the updates of the programmes (see left panel of Table I.9). The central panel of Table I.9 shows the CAB derived by the Commission, on the basis of the figures provided by Member States in the updates.

According to these figures, the cyclically adjusted deficit for the euro area, which amounted to 2.1 % of GDP in 2003, is projected to improve by on average 0.4 percentage points of GDP annually in the coming years. This is clearly more optimistic than the Commission forecasts.

According to the Commission calculations, of the eight euro-area countries showing a cyclically adjusted deficit in 2003, Ireland, Italy, the Netherlands and Austria are projecting to be in a close-to-balance position by 2007. Some deficit countries plan to achieve an annual adjustment in cyclically adjusted terms of 0.5 percentage

points of GDP over the coming years. However, the projected budgetary adjustment is in some cases insufficient to ensure that a budgetary position close-to-balance is achieved within the programme period and that a sufficient safety margin to prevent a breach of the 3 % of GDP reference value is reached before 2007.

Particular attention should be paid to the planned adjustments in Member States in excessive deficits positions. At the Ecofin Council of 25 November 2003, Germany and France committed to reducing the cyclically adjusted budget deficit by specified amounts. Respectively, for 2004 and 2005, the adjustment in Germany should be of at least 0.6 and 0.5 percentage points of GDP, while in France of at least 0.8 and 0.6 percentage points of GDP. According to the Commission calculations, Germany projects an improvement in the CAB by 0.7 and 0.4 percentage points of GDP in 2004 and 2005, respectively. Concerning France, the Commission calculations indicate improvements in the CAB of 0.6 percentage points of GDP for both 2004 and 2005. In Portugal the projected improvement in the CAB is, according to the Commission calculations, slightly lower than the

Table I.7

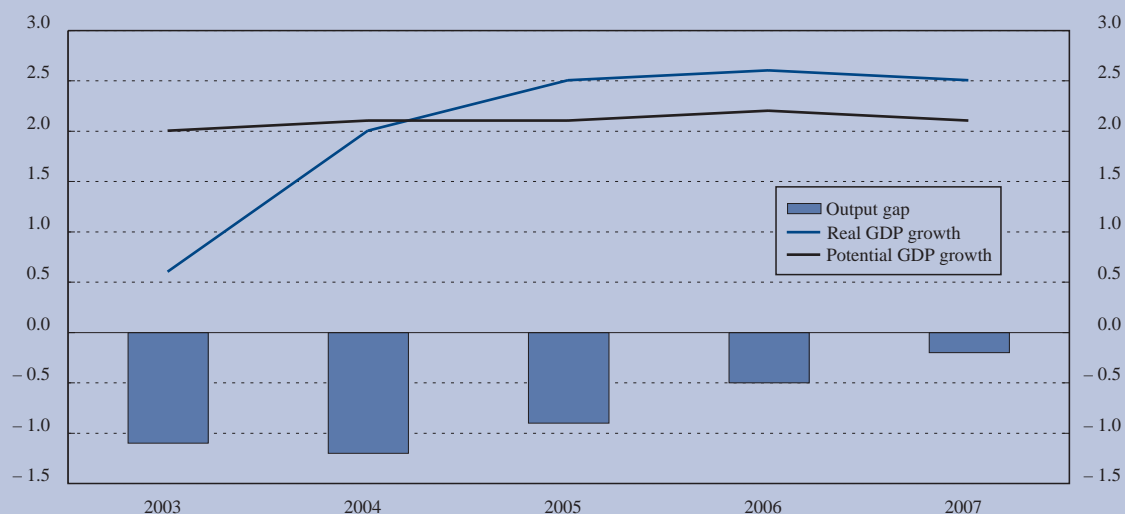
GDP growth projections in the 2003 updates

	2002	2003	2004	2005	2006	2007	Revision ⁽¹⁾
BE	0.7	0.9	1.8	2.8	2.5	2.1	- 0.5
DE	0.2	- 0.1	1.7	2.25	2.25	2.25	- 0.7
EL	3.8	4.0	4.2	4.0	3.8		0.2
ES	2.0	2.3	3.0	3.0	3.0	3.0	- 0.2
FR	1.2	0.5	1.7	2.5	2.5	2.5	- 0.9
IE	6.9	2.2	3.3	4.7	5.2		- 0.8
IT	0.4	0.5	1.9	2.2	2.5	2.6	- 1.2
LU	1.3	1.2	2.0	3.0	3.8		- 0.2
NL	0.2	0.0	1.0	2.5	2.5	2.5	- 0.9
AT	1.4	0.9	1.9	2.5	2.5	2.4	- 0.2
PT	0.4	- 0.8	1.0	2.5	2.8	3.0	- 1.5
FI	2.2	1.4	2.7	2.5	2.4	2.4	- 0.4
EUR-12	0.9	0.6	2.0	2.5	2.6	2.5	- 0.8
DK	2.1	1.4	2.3	2.2	1.9	1.7	0.1
SE	1.9	1.4	2.0	2.6	2.5		- 0.4
UK ⁽²⁾	1.75	2.0	3.25	3.25	2.75		- 0.2
EU-15	1.1	0.9	2.2	2.6	2.6	2.5	- 0.6

⁽¹⁾ Difference with respect to the 2002 updates in average growth over 2003–05.

⁽²⁾ Mid-point of the range provided in the programme.

Graph I.6: Real and potential GDP growth and the output gap for the euro area derived from the 2003 updates, 2003–07



NB: Potential GDP growth and output gap calculated by the Commission on the basis of the data provided in the updates.

Table I.8

Actual budget balances in the 2003 updates and in the Commission forecasts

(% of GDP)

	2003 updates of stability and convergence programmes						Commission's autumn 2003 forecasts ⁽¹⁾			Commission's spring 2004 forecasts		
	2002	2003	2004	2005	2006	2007	2003	2004	2005	2003	2004	2005
BE	0.1	0.2	0.0	0.0	0.0	0.3	0.2	-0.4	-0.4	0.2	-0.5	-0.7
DE	-3.5	-4.0	-3	-2	-2.0	-1	-4.2	-3.9	-3.4	-3.9	-3.6	-2.8
EL	-1.2	-1.4	-1.2	-0.5	0.0		-1.7	-2.4	-2.3	-3.0	-3.2	-2.8
ES	0.1	0.5	0.0	0.1	0.2	0.3	0.0	0.1	0.2	0.3	0.4	0.6
FR	-3.1	-4.0	-3.6	-2.9	-2.2	-1.5	-4.2	-3.8	-3.6	-4.1	-3.7	-3.6
IE ⁽²⁾	-0.2	-0.4	-1.1	-1.4	-1.1		-0.9	-1.2	-1.1	0.2	-0.8	-1.0
IT	-2.3	-2.5	-2.2	-1.5	-0.7	0.0	-2.6	-2.8	-3.5	-2.4	-3.2	-4.0
LU	2.4	-0.6	-1.8	-2.3	-1.5		-0.6	-2.1	-2.5	-0.1	-2.0	-2.3
NL	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6	-2.6	-2.7	-2.4	-3.2	-3.5	-3.3
AT	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4	-1.0	-0.6	-0.2	-1.1	-1.1	-1.9
PT	-2.7	-2.9	-2.8	-2.2	-1.6	-1.1	-2.9	-3.3	-3.9	-2.8	-3.4	-3.8
FI	4.2	2.3	1.7	2.1	2.1	2.2	2.4	1.7	1.9	2.3	2.0	2.1
EUR-12	-2.2	-2.7	-2.3	-1.8	-1.2	-0.7	-2.8	-2.7	-2.7	-2.7	-2.7	-2.6
DK ⁽³⁾	1.7	1.4	1.5	2.0	2.0	2.3	0.9	1.3	1.9	1.5	1.1	1.5
SE	1.1	0.2	0.4	1.2	1.6		0.2	0.5	1.0	0.7	0.2	0.7
UK ⁽⁴⁾	-2.1	-3.3	-2.6	-2.4	-2.1	-2.0	-2.8	-2.7	-2.4	-3.2	-2.8	-2.6
EU-15	-2.1	-2.6	-2.2	-1.7	-1.2	-0.9	-2.7	-2.6	-2.4	-2.6	-2.6	-2.4

⁽¹⁾ Based on pre-budget figures for Ireland and the UK. For 2005, on the assumption of unchanged policies.

⁽²⁾ Including UMTS receipts of 0.2 % of GDP in 2002.

⁽³⁾ Data relative to 2010 have been used for 2007 in the convergence programme.

⁽⁴⁾ Financial years ending the following March for data in the convergence programme.

required minimum of 0.5 percentage points of GDP per year. However, a close-to-balance position in cyclically adjusted terms is almost reached by the end of the period.

The development in the general government balance can be decomposed by sectors of government (see Table I.10) ⁽¹⁾. For the euro area as a whole, the budget deficit of the general government is mainly the result of a large deficit for the central government, with a far smaller deficit for the local governments. The social security sector is estimated to record a small surplus, in particular in the case of Luxembourg, Finland and, outside the euro area, Sweden. France is the only Member State expecting a deficit in the social security sector.

The government debt/GDP ratio in the euro area is, after the increase recorded in 2003, projected to gradually

decline to just below 68 % of GDP by 2007 (see Table I.11). The adjustment path is, however, slower in comparison to the 2002 updates due to smaller primary surpluses and lower nominal GDP growth.

Table I.11 shows also that the estimated stock-flow component on average increases the debt ratio over the programme period. *Inter alia*, this could stem from plans to build up financial assets in some countries (for example public pension reserve funds which are invested in non-governmental assets) ⁽²⁾.

Table I.12 shows that six Member States expect the debt level to be above the 60 % of GDP ceiling in 2006 (Belgium, Germany, Greece, France, Italy and Austria). With the notable exception of Germany,

⁽¹⁾ To simplify the presentation, Table I.10 presents the two sectors of State and local government in one single row, given that the State government sector is relevant only for four Member States.

⁽²⁾ As in the previous updates, large contributions of the stock-flow over the programme period are identified in Finland (with a yearly average around 4 % of GDP), Greece (around 3 %), Sweden (around 1.5 %) and Ireland (around 1 %).

Table I.9

Cyclically adjusted balances in the 2003 updates and in the Commission forecasts on the basis of the production function method

(% of GDP)

	2003 updates of the programmes ⁽¹⁾					Commission calculations based on the 2003 updates ⁽²⁾					COM autumn 2003 forecasts ⁽²⁾			COM spring 2004 forecasts ⁽²⁾ ⁽⁴⁾		
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007	2003	2004	2005	2003	2004	2005
BE	0.8	0.6	0.1	-0.1	0.2	0.8	0.6	0.2	0.0	0.3	0.8	0.1	-0.2	0.7	0.0	-0.5
DE	-3.1	-2.5	-2.0	-1.5	-1.0	-3.2	-2.5	-2.1	-1.6	-1.4	-3.5	-3.3	-3.0	-3.2	-3.0	-2.5
EL	-2.0	-1.8	-1.1	-0.5		-1.7	-1.7	-1.2	-0.9		-2.2	-3.1	-3.2	-3.6	-4.1	-3.8
ES						0.6	0.1	0.1	0.2	0.3	0.1	0.3	0.3	0.4	0.6	0.7
FR	-2.8	-2.0	-1.4	-0.8	-0.2	-3.8	-3.2	-2.6	-1.9	-1.3	-3.9	-3.3	-3.2	-3.9	-3.4	-3.3
IE	-0.8	-0.5	-0.4	-0.1		-0.5	-0.7	-0.8	-0.5		-1.0	-0.6	-0.2	0.1	-0.3	-0.2
IT	-1.9	-1.6	-1.1	-0.5	0.1	-1.8	-1.6	-1.0	-0.4	0.1	-2.1	-2.3	-3.2	-1.9	-2.6	-3.6
LU	2.4	1.0	0.6	1.2		1.1	0.9	1.0	2.2		1.8	1.4	1.7	1.3	0.6	1.2
NL	-1.3	-0.7	-0.5	-0.3	-0.5	-1.3	-0.7	-0.5	-0.3	-0.5	-1.3	-0.7	-0.6	-2.0	-1.7	-1.3
AT	-1.0	-0.4	-1.3	-1.1	-0.5	-1.0	-0.4	-1.4	-1.1	-0.5	-0.7	-0.3	-0.1	-0.9	-0.9	-1.8
PT	-1.7	-1.1	-0.6	-0.1	0.4	-2.1	-1.7	-1.3	-0.9	-0.7	-2.0	-2.1	-2.6	-1.8	-2.1	-2.6
FI	3.0	2.4	2.4	2.3	2.2	2.7	2.0	2.4	2.3	2.2	2.8	2.1	2.0	2.3	2.1	2.2
EUR-12	-1.9	-1.5	-1.2	-0.7	-0.4	-2.1	-1.8	-1.4	-1.1	-0.7	-2.3	-2.2	-2.2	-2.2	-2.2	-2.2
DK ⁽³⁾	1.9	1.7	2.1	2.0	2.3	1.3	1.3	1.7	1.8	2.4	1.0	1.4	1.9	2.1	1.4	1.5
SE	1.2	1.3	1.8	2.0		0.5	1.0	1.8	2.3		0.4	0.9	1.5	0.7	0.3	0.8
UK	-2.4	-2.0	-2.2	-2.1	-2.0	-2.8	-2.4	-2.4	-2.2	-2.0	-2.4	-2.3	-2.1	-2.9	-2.6	-2.3
EU-15	-1.8	-1.4	-1.2	-0.8	-0.6	-2.1	-1.7	-1.4	-1.0	-0.8	-2.2	-2.0	-2.0	-2.2	-2.1	-2.1

⁽¹⁾ Since figures for the CAB were not available in the Spanish stability programme, the Commission calculations have been used to have a representative aggregate for EUR-12 and EU-15.

⁽²⁾ On the basis of the PF method, except in the case of Germany, Spain and Austria, where the HP filter method has been used.

⁽³⁾ The structural budget balance (i.e. net of special items) in Denmark is, according to the programme, expected to be: 2.0 % of GDP in 2003, 1.7 % in 2004, 1.8 % in 2005, 1.9 % in 2006 and 2.1 % in 2010.

⁽⁴⁾ For a number of countries, the calculated CABs differ marginally from those of the spring forecast due to data revisions.

NB: Footnotes to Table I.8 apply here.

Source: Commission services.

Table I.10

Euro area: Net lending by subsectors in the 2003 updates

% of GDP	2003	2004	2005	2006	2007
General government	-2.7	-2.3	-1.8	-1.2	-0.7
Central government	-2.1	-2.1	-1.8	-1.5	-1.3
State plus local governments	-0.6	-0.5	-0.5	-0.3	-0.2
Social security funds	0.0	0.2	0.2	0.3	0.4

NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes.

France, Ireland and the UK, all Member States project a lower debt level in 2006–07 compared to 2003. In EU-15, the debt level is expected to be below 50 % of GDP in seven Member States, namely Luxembourg, Denmark, Ireland, the UK, Spain, Finland and Sweden, of which the former three will have debt ratios below 40 % of GDP.

2.2. Composition of the budgetary adjustment

The updates of the programmes show that both revenue and expenditure ratios are expected to decline over the programme period (see Table I.13). In the

Table I.11

Euro area: Government debt level and changes in the 2003 updates

(% of GDP)

	2002	2003	2004	2005	2006	2007
Government debt level	69.1	70.1	70.0	69.4	68.4	67.6
Change in government debt	- 0.1	1.0	0.0	- 0.6	- 1.0	- 1.2
Previous updates of the programmes	69.7	68.7	67.0	65.7	63.7	
Difference	- 0.6	1.4	3.0	3.7	4.6	
Contributions to change in government debt:						
Primary balance	- 1.4	- 0.8	- 1.0	- 1.5	- 2.1	- 2.5
Interest payments	3.6	3.5	3.4	3.4	3.4	3.4
Nominal GDP growth	- 2.1	- 1.8	- 2.4	- 2.7	- 2.7	- 2.6
Other factors influencing the debt ratio ⁽¹⁾	- 0.1	0.2	0.1	0.4	0.6	0.7

(1) The programmes do not always contain enough information to identify directly the contribution from different factors to the development of the euro-area debt ratio. Therefore, it has been necessary in some cases to identify the contribution from nominal GDP growth (GDP deflator plus real GDP growth multiplied by the debt ratio). In this way, the stock-flow adjustment is derived as a residual.

NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes.

Table I.12

Debt levels in the 2003 updates

(% of GDP)

	2002	2003	2004	2005	2006	2007
BE	106.1	102.3	97.6	93.6	90.1	87.0
DE	60.8	64.0	65.0	65.5	65.5	65.0
EL	104.7	101.7	98.5	94.6	90.5	
ES	54.5	51.8	49.6	47.7	45.7	43.8
FR	59.0	61.4	62.8	63.2	62.8	61.8
IE	32.4	33.1	33.3	33.5	33.3	
IT	106.7	106.0	105.0	103.0	100.9	98.6
LU	5.7	4.9	5.2	5.0	4.4	
NL	52.4	54.0	54.5	53.7	53.0	52.2
AT	66.7	66.4	65.8	64.1	62.3	59.9
PT	58.1	59.5	60.0	59.7	58.6	57.0
FI	42.7	45.1	44.7	44.9	45.0	44.6
EUR-12	69.1	70.1	70.0	69.4	68.4	67.6
DK ⁽¹⁾	45.5	42.7	41.2	38.7	36.4	27.5
SE	52.7	51.7	51.5	50.0	48.3	
UK ⁽²⁾	37.9	39.3	40.2	40.8	41.1	41.4
EU-15	62.6	63.8	63.8	63.3	62.5	61.9

(1) Data relative to 2010 have been used for 2007 in the convergence programme.

(2) Financial years ending in the following March.

euro area, total receipts are expected to fall by 1 percentage point of GDP between 2003 and 2006 to around 45 % of GDP in 2006. This is more than compensated by reductions in the expenditure ratio which, over the same period, are expected to amount to 2.1 percentage points. Revenue ratios are projected to decline in all Member States with the exception of Spain and France, where they will remain unchanged and outside the euro area in the UK, where it is set to increase. Strong reductions in revenue ratios are projected in Belgium, Luxembourg and Austria. In the case of France, Finland, Denmark and Sweden revenue ratios are still expected to exceed 50 % of GDP. Almost all Member States are set to decrease the expenditure ratio, with the exception of Spain, Finland and the UK. Strong reductions are planned by Germany, Austria and Portugal.

Although the information in the updates of the programmes on the budget components is not always

complete ⁽¹⁾, it would seem that the reduction in taxes which has taken place in earlier years in most euro-area countries is not expected to continue. The tax-to-GDP ratio is projected to remain constant at around 27 % over the programme period (see Table I.14). Important reductions are expected in Luxembourg (in 2004 and 2005), Austria (in 2005) and Finland (in 2004), while the UK plans to increase the tax ratio. Social contributions in the euro area are projected to be reduced as a share of GDP in the medium term, in particular in Germany and the Netherlands. Other revenues as a share of GDP are expected to decrease slightly over the period.

As to the components of public expenditures, very limited data are provided for collective consumption.

⁽¹⁾ No information was given in the French programme and only partial information was given by Spain.

Table I.13

Expenditure and revenue ratios in the 2003 updates

	Total revenues			Total expenditures		
	2003	2006 ⁽¹⁾	2003–06 ⁽²⁾	2003	2006 ⁽¹⁾	2003–06 ⁽²⁾
BE	50.5	48.4	- 2.1	50.2	48.4	- 1.8
DE	45.0	43.5	- 1.5	49.0	45.5	- 3.5
EL	43.7	43.5	- 0.2	45.2	43.5	- 1.7
ES	40.0	40.0	0.0	39.6	39.8	0.2
FR	50.3	50.3	0.0	54.3	52.4	- 1.9
IE	34.1	32.5	- 1.6	34.6	33.6	- 1.0
IT	45.8	44.4	- 1.4	48.4	47.0	- 1.4
LU	47.1	44.9	- 2.2	47.7	46.6	- 1.1
NL	45.5	44.8	- 0.7	47.6	45.9	- 1.7
AT	50.6	48.3	- 2.3	51.9	49.4	- 2.5
PT	44.1	42.9	- 1.2	47.0	44.5	- 3.5
FI	51.0	50.8	- 0.2	48.7	48.8	0.1
EUR-12	46.0	45.1	- 1.0	48.7	46.6	- 2.1
DK	55.2	54.2	- 1.0	54.0	52.3	- 1.7
SE	56.4	56.0	- 0.4	56.3	54.3	- 2.0
UK ⁽³⁾	37.7	39.2	1.5	40.2	40.7	0.5
EU-15	45.1	44.7	- 0.4	47.6	46.5	- 1.1

⁽¹⁾ Concerns 2005–06 for the UK and 2005 for the EU.

⁽²⁾ Concerns the period between 2003–04 and 2005–06 for the UK and between 2003 and 2005 for the EU.

⁽³⁾ Financial years ending in the following March. Concerns total current revenue.

NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes. Therefore, the net lending implied by this table may be different from the one in other tables.

According to the updates, social transfers in the euro area are projected to decrease by on average 0.3 percentage points of GDP annually, mainly reflecting decreases in Germany. Gross capital formation in the euro area is projected to remain constant around 2.4 % of GDP across the programme period. For the countries with high deficits, the budgetary consolidation strategy, based on expenditure restraint, should not be achieved at the expenses of the most 'productive' components of public spending (such as public investment, education and research expenditures). However, the composition of expenditure adjustment in the case of Portugal suggests that about a quarter of it falls on investment expenditures. Public investment is also expected to decline somewhat in Luxembourg and Finland, while a relatively important increase is foreseen in the UK.

Graph I.7 presents the contribution to the change in the budget balances from four budget components, namely primary current expenditures, interest payments, gross fixed capital formation and total revenues. A number of remarks can be made.

Firstly, Germany, France, Italy, the Netherlands and Portugal, which had large deficits in 2003, project to improve budget balances substantially via cuts in primary current expenditures. However, excluding France, further cuts on the revenue side are also foreseen. In the case of Portugal the budgetary adjustment involves a decline in public investments. In contrast, the UK plans to increase the expenditure ratio (notably public investments). This is financed by an increase in the revenue ratio, which should help reduce the deficit to closer to balance. Secondly, deterioration in the budget balance over the period is expected in Ireland and Luxembourg. The reduction in revenues is partially compensated by cuts in primary current expenditures as well as public investments. Thirdly, several Member States with budgets close-to-balance or in surplus in 2003 (Belgium, Denmark, Austria and Sweden) foresee cuts in primary current expenditures as well as in taxes, thereby reducing the size of the public sector while maintaining sound budgetary positions.

Table I.14

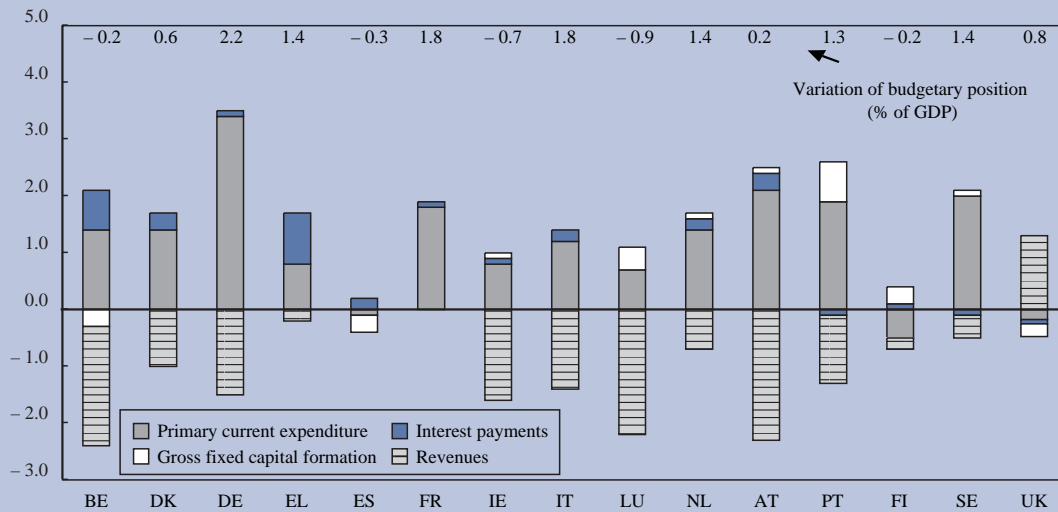
Euro area: Budget developments for the general government

% of GDP	2002	2003	2004	2005	2006	2007
Components of revenues						
Taxes	27.1	26.8	26.8	26.8	26.8	26.9
Social contributions	15.4	15.4	15.4	15.1	14.9	15.1
Interest income						
Other	4.1	4.5	4.0	3.7	3.7	3.5
Total receipts	46.1	46.0	45.7	45.3	45.0	45.1
Components of expenditures						
Collective consumption						
Social transfers in kind	14.7	14.0	13.6	13.5	13.3	13.7
Social transfers other than in kind	17.4	17.6	17.4	17.0	16.7	16.6
Interest payments	3.7	3.5	3.4	3.4	3.4	3.4
Subsidies	1.4	1.3	1.4	1.3	1.1	1.1
Gross fixed capital formation	2.2	2.4	2.3	2.4	2.4	2.3
Other	3.1	3.2	3.1	3.2	2.9	2.9
Total expenditures	47.6	48.7	47.9	47.3	46.6	46.3

NB: Totals might not correspond to the sum of the components: while for totals information is available for all countries, several countries are not included in the aggregation concerning budgetary components, which affects the ratio of the components.

Source: 2003 updates of the stability and convergence programmes.

Graph I.7: Contributions to change in budgetary position, 2003–06 (% of GDP)



NB: A positive value indicates a positive contribution to the change in the budgetary position. A positive value in total variation of the budgetary position (value is presented on top of columns) implies an improvement of the balance. For UK data refer to 2003–05. For France values of primary current expenditures refer to primary expenditure. Net lending for Italy includes unspecified measures totalling 1.8 percentage points of GDP in 2006.
Source: 2003 updates of the stability and convergence programmes.

3. Overview of the 2003 updates of the pre-accession economic programmes and the 2004 convergence programmes

3.1. Introduction

The third set of pre-accession economic programmes (PEPs) covering the period 2002–06 was submitted by acceding countries in August 2003. Their assessment was completed by the Commission in November 2003. All documents followed the guidelines and principles set up by the document ‘2003 pre-accession economic programme: consolidated outline and external assumptions’, ensuring cross-country consistency and comparability. The programmes presented data according to ESA 95 methodology.

The PEPs outlined the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. In doing so, the programmes strengthen the institutional and analytical capacity necessary to participate in EMU with a derogation from the adoption of the euro upon accession, particularly in the areas of multilateral surveillance and coordination of economic policies. All programmes foresee an improvement in the economic climate in the period covered by the plans. The areas of structural reforms to be undertaken are well defined, although their cost is not always quantified. As a result, the impact of these reforms on the presented budgetary framework cannot be fully assessed.

In mid-May 2004, the first set of convergence programmes covering in most Member States the period 2004–07 was submitted. The programmes present the medium-term framework for fiscal adjustment. In some countries, the aim is to obtain a budgetary position of close to balance or in surplus to allow them to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 % of GDP.

A brief comparison with the 2003 updates of the pre-accession economic programmes on growth assumptions, budgetary targets and structural deficits as well as debt levels is offered in the last section of this chapter.

3.2. 2003 updates of the pre-accession economic programmes

3.2.1. Medium-term budgetary developments

According to the PEPs, average growth in the NMS in the 2003–06 period is expected to be the same as in the period 1998–2002, which is overall somewhat more confident than the growth prospects outlined in the 2002 programmes, although there are country differences. Latvia, Lithuania and Poland revised the economic growth projections for the period 2003–06 upwards, while Cyprus, the Czech Republic, Hungary, Malta and Slovenia revised them downwards. In the period 2002–06, the level of inflation is expected to decline in all the countries, except in Lithuania and Latvia. In Lithuania, deflation will be replaced with moderate inflation. The current account balance is to remain negative in all the NMS, according to the PEPs, except in Slovenia, where a continuous surplus is foreseen over the entire programme period (see Table I.15).

In 2002, all the countries, with the exception of Estonia (1.3 % of GDP surplus), were running general government deficits (see Table I.16), in the one digit range, varying from the lowest deficit of Lithuania (1.4 % of GDP) to the highest of Hungary and Slovakia (9.2 and 5.7 % of GDP, respectively).

The expected developments in the PEPs period indicate for all the NMS a substantial consolidation of their pub-

lic finances. Thus, by 2006, only the Czech Republic, Malta and Poland foresaw general government deficits above the 3 % of GDP reference value. Hungary is estimated to deploy the strongest consolidation effort to reduce its fiscal imbalance by 6.7 percentage points to 2.5 % of GDP by 2006, followed by Slovakia, expecting to shrink its deficit in the same period by 4.3 percentage points. Displaying a different path, Estonia plans to bring the 2002 government surplus down to balance by 2006, while Poland's consolidation endeavour looks weak as the government is still engaged in expansionary fiscal policy leading to further deficit increases in 2003 and 2004.

Contrary to such a general improvement, comparing the latest data available with the Commission's spring 2004 forecast, the adjustment path projected in the 2003 PEPs may prove too optimistic. The spring 2004 fiscal notification presented by the Czech authorities reported the registration of one single imputed State guarantee of about 6.3 % of GDP, which brought the general government deficit to 12.9 % of GDP in 2003. In Malta, the general government deficit went up to 9.7 % of GDP in 2003 due to a one-off outlay of 3.2 % of GDP related to the restructuring operation of the shipyards. Similarly, taking 2005 for comparison for most countries (e.g. not

the Czech Republic) deficit projections were lower in the 2004 PEPs than in the Commission's spring 2004 forecast.

In 2002, Hungary and the Czech Republic ran the highest primary deficit (5.5 and 5 % of GDP, respectively), while Estonia and Cyprus reached a primary surplus (1.6 and 1.4 % of GDP, respectively). Although Estonia and Lithuania presented projections for a deterioration in their respective primary balance at the end of the period, their overall fiscal position is to remain relatively strong. All other countries are expected to improve their primary balance, albeit the Czech Republic, Latvia, Lithuania, Poland and Slovakia will keep primary deficits.

When comparing the budgetary objectives between the PEPs of 2002 and 2003, Estonia and Slovenia are the only countries to revise their fiscal balance upwards, whilst all other countries made downward revisions, thus implying larger deficits. These modifications were particularly significant in Slovakia and Cyprus. In some countries, the upward revision of the deficit is partially related to the downward revision of growth, but in others, such as Poland, the projected deterioration of the fiscal balance reflects an easing of the budgetary stance.

Table I.15

Macroeconomics projections in the 2003 PEPs

	Real GDP growth			Consumer price inflation		Current account balance	
	(Annual percentage change)			(Annual percentage change)		(% of GDP)	
	1998–2002 ⁽¹⁾	2003–06 ⁽²⁾	Revision ⁽³⁾	2002	2006	2002	2006
CZ	1.5	3.0	-0.7	4.7	3.4	-6.5	-6.2
EE	4.7	5.5	0.0	5.8	3.5	-12.3	-9.0
CY	4.2	3.8	-0.4	2.0	2.0	-5.3	-1.4
LV	4.4	6.2	0.7	2.5	3.0	-7.8	-7.6
LT	5.8	6.4	1.1	1.3	4.1	-5.3	-5.6
HU	4.3	4.0	-0.6	9.2	3.0	-4.0	-5.0
MT	2.8	2.7	-0.8	2.9	2.4	-4.7	-4.4
PL	5.4	4.7	1.1	5.5	3.1	-3.5	-5.1
SI	2.8	3.9	-0.6	8.4	4.6	1.7	1.1
SK	4.2	4.3	0.0	7.1	4.5	-8.2	-3.3
EU-10	4.3	4.3	0.3	5.8	3.3	-4.4	-4.9

⁽¹⁾ Annual average over the period 1998–2002.

⁽²⁾ Annual average over the period 2003–06.

⁽³⁾ Difference between the average rate of growth over the period 2003–05 in the 2002 and 2003 PEPs.

Source: 2002 and 2003 PEPs, Commission services.

Table I.16

General government balances in the 2003 PEPs

(% of GDP)

	Nominal balance				Primary balance			Cyclically adjusted balance ⁽²⁾		
	2002	2006	Change	Revision ⁽¹⁾	2002	2006	Change	2002	2006	Change
CZ	-6.7	-4.0	2.7	-0.1	-5.0	-2.4	2.6	-6.5	-4.1	2.4
EE	1.3	0.0	-1.3	0.3	1.6	0.3	-1.3	n.a.	n.a.	n.a.
CY	-3.5	-2.2	1.3	-1.8	1.4	2.5	1.1	-2.5	-2.2	0.3
LV	-3.0	-2.0	1.0	-0.8	-2.6	-1.3	1.3	-3.1	-2.3	0.8
LT	-1.4	-1.8	-0.1	-0.2	-0.2	-0.5	-0.3	-1.7	-1.6	0.1
HU	-9.2	-2.5	6.7	-0.7	-5.5	0.4	5.9	-9.1	-2.4	6.7
MT	-6.2	-3.4	2.8	-0.6	-1.4	1.5	2.9	n.a.	n.a.	n.a.
PL	-3.8	-3.4	0.4	-0.7	-1.0	-0.8	0.2	-3.4	-3.8	-0.4
SI	-2.4	-1.3	1.1	2.2	-0.2	0.0	0.2	-2.2	-1.1	1.1
SK	-5.7	-2.9	4.3	-3.0	-3.5	-0.6	2.9	-7.2	-3.7	3.5
EU-10	-5.1	-3.1	2.1	-0.6	-2.4	-0.7	1.7	-4.8	-3.2	1.6

⁽¹⁾ Difference between the average nominal balances over the period 2003–05 in the 2002 and 2003 PEPs.

⁽²⁾ Countries' own estimates as presented in the 2003 PEPs.

NB: Nominal balances for Lithuania and Slovakia for 2002 were revised subsequently.

Source: 2003 PEPs and Commission services.

The estimations presented for CABs over the 2002–06 period (not submitted by Malta and Estonia) suggest that the Czech Republic, Hungary and Slovenia foresee substantial general government deficit reductions as a result of the implementation of policy changes. On the other side, Cyprus and Poland seem to rely on the effect of the cycle for their respective fiscal position, while Slovakia anticipates a narrowing of its budget deficit due to both fiscal consolidation and upbeat economic developments. Save for Poland, all the countries expect improved structural balances by 2006 as compared to 2002. In Slovakia, Poland and the Czech Republic the cyclically adjusted deficits are forecast to stand above 3.5 % of GDP in 2006. Overall, the NMS seem to be making some effort for structural changes in the budget's revenue and expenditure to reach the targets set in the 2003 PEPs, and the favourable economic conditions are also expected to contribute to the planned adjustment

3.2.2. Government debt

The general government debt position widely contrasts among the NMS. Most of them hold low levels of foreign debt and some programmes show a preference for a steady reduction in external financing in order to lower exchange risk exposure, widen domestic capital markets and decrease the issuing costs. Thus, Estonia and Latvia

post very low levels of debt, in absolute and relative terms (5.8 and 14.6 % of GDP, respectively), and their debt is mainly owned by foreign creditors. On the other side, the latest data available for 2003 ⁽¹⁾ showed Cyprus government debt running at 72.2 % of GDP and Malta's government debt attained 72 % of GDP, clearly exceeding the 2003 PEP estimates and the 60 % of GDP threshold. In addition, the level of government debt in Hungary (56.3 % of GDP) is slightly below the Maastricht reference value.

Six countries anticipated in their PEPs a worsening of their debt levels over the period. The Czech Republic's PEP reported a further deterioration of 12.4 percentage points of GDP between 2003 and 2006, this projection being worse than the one made in last year's programme. The reasons for this are the upward revision of the deficit and the imputation of a State guarantee in 2003. Poland's government debt is forecast to increase by 7.3 percentage points up to 2005 and stabilise in 2006. This mainly results from financing the high deficit of the State budget, leading not only to debt increase in a given year but also, due to debt servicing costs and refinancing, to

⁽¹⁾ Fiscal notification presented in March 2004.

Table I.17

General government debt in the 2003 PEPs

(% of GDP)

	2002	2006	Change
CZ	26.9	39.4	12.4
EE	5.8	4.6	-1.2
CY	59.7	56.1	-3.6
LV	14.6	17.4	2.8
LT	22.7	23.3	0.6
HU	56.3	54.0	-2.3
MT	66.6	68.4	1.8
PL	41.8	49.1	7.3
SI	27.8	25.9	-1.9
SK	44.3	48.5	4.2
EU-10	39.8	45.1	5.3

Source: 2003 PEPs and Commission services.

an increase in future debt levels. Despite gradually lower deficits, Slovakia estimates an increase in its debt level by 2006. Malta, already running a debt/GDP ratio well above 60 % of GDP, expects after an initial deterioration, the debt/GDP ratio to come down to 68.4 % of GDP by 2006. This estimation seems somewhat optimistic in light of the above mentioned one-off increase which occurred in 2003.

Cyprus, Estonia, Hungary and Slovenia expect a gradual improvement of their debt ratios in accordance with their fiscal consolidation path.

3.2.3. Composition of the adjustment

Unlike in the 2002 PEPs, where most countries proposed to reduce the general government revenue in terms of GDP, the programmes presented in 2003 indicate that only Hungary, Malta and Slovakia are planning to shrink public revenue. Slovakia reports the highest decline by 3.5 percentage points between 2002 and 2006, stemming from a sizeable reduction in direct tax collection brought about by tax reform. The most important increase takes place in Cyprus, where revenues are expected to rise by 2.2 percentage points during the programme period, due to a renewed effort by the current government to carry out fiscal consolidation, improving tax administration and collection and higher fees and royalties levied by the government. Lithuania also plans to boost revenues by 1.8 percentage points by 2006, as the key points of a tax reform are to be implemented by the end of 2004 and the EU grants will contribute to the increase. Estonia esti-

mates an increase in revenues of 1 percentage point by 2006, as the revenue item — other receipts — compensates for diminishing of both income tax revenues and social contributions. Lithuania, Slovakia and Cyprus will have budgetary revenues below 40 % of GDP, with Lithuania the lowest, at 35.6 % of GDP in 2006. Other countries' revenues will exceed 40 % of GDP, Hungary having the highest share (43.6 % of GDP), while still below the EU-15 average (46.4 % of GDP in 2002).

On the expenditure side, Cyprus, Estonia and Lithuania foresee higher spending in terms of GDP in 2006, reflecting comparatively favourable starting conditions for the relative weight of expenditure. The three countries had expenditure-to-GDP ratios below 40 % of GDP in 2002 (the EU-15 average being 47.2 % of GDP), however, only Lithuania foresees to stay below this level by 2006. At 46.8 % of GDP, the Czech Republic is expected to post the highest level of expenditure by 2006, stemming from the cost of industrial and financial restructuring and from the burden of mandatory and quasi-mandatory expenditures. The biggest reductions in the period are listed by Slovakia, Hungary and Malta. Downward adjustments in expenditure in the period come from reductions in social transfers in Slovakia (- 3.2 percentage points) and Poland (- 2.8 percentage points), in gross fixed capital formation in Hungary (- 2.1 percentage points) and collective consumption in Cyprus (- 1.6 percentage points). Poland and Lithuania project to increase capital formation by 1.8 and 1.7 percentage points, respectively, and Cyprus reports an increase in interest payments of 2.3 percentage points over the period 2003–06.

3.2.4. Risk considerations

Most PEPs have submitted a budgetary risk analysis over the period with consideration of explicit and implicit contingent liabilities. Also, the programmes contained an analysis of the long-term sustainability of public finances in the light of the envisaged trends in pension and healthcare expenditures, although the extension and detail of the assessment varies among the countries.

The main source of risk is the existence of State guarantees extended to semi-government institutions. Their amount, composition and assessment of the actual risk level are unevenly appraised among the acceding countries. The guarantees seem to be relatively high in Malta (22 % of GDP) and somewhat more bearable in Cyprus and the Czech Republic (around 10 and 12.2 % of GDP, respectively), Slovenia (6.6 % of GDP) and Hungary

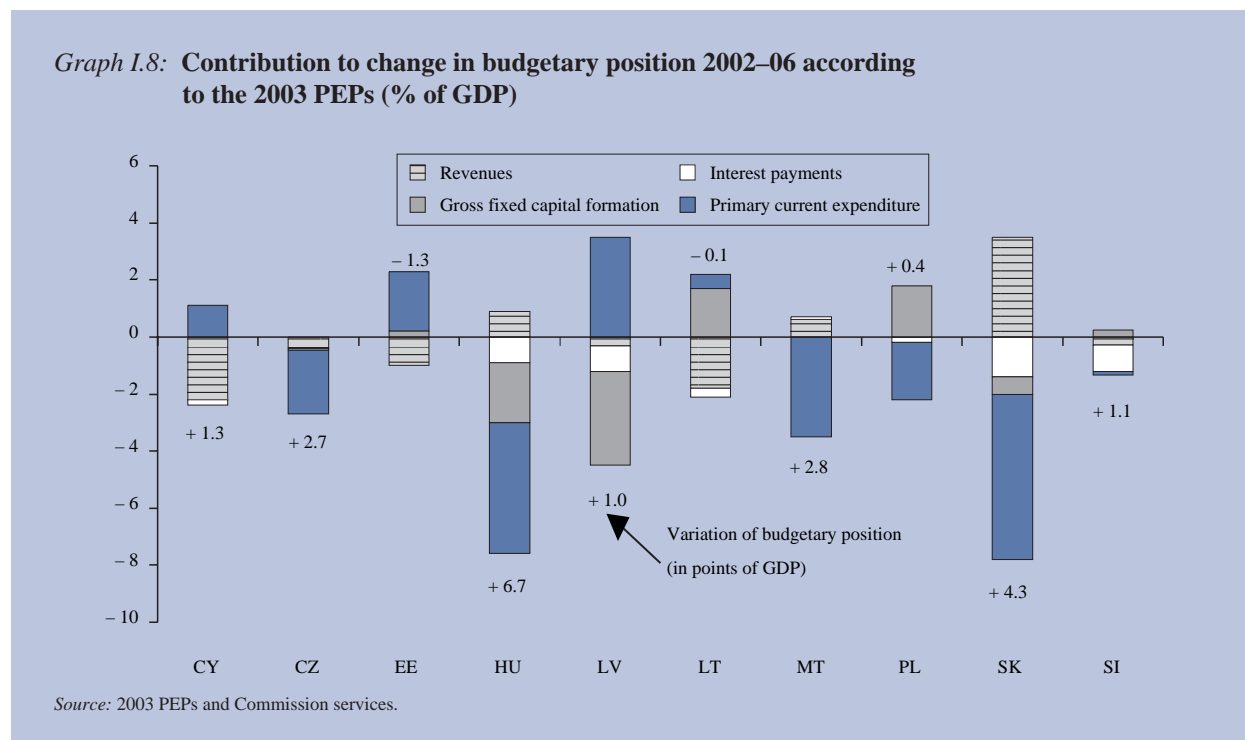


Table I.18

General government revenue and expenditure in the 2003 PEPs

(% of GDP)

	Revenue			Expenditure		
	2002	2006	Change	2002	2006	Change
CZ	42.4	42.7	0.4	49.1	46.8	-2.3
EE	39.7	40.7	1.0	38.4	40.7	2.3
CY	36.3	38.5	2.2	39.8	40.7	0.9
LV	41.9	42.2	0.3	44.9	44.2	-0.7
LT	33.8	35.6	1.8	35.6	37.4	1.8
HU	44.5	43.6	-0.9	53.7	46.1	-7.6
MT	43.8	43.2	-0.6	50.0	46.6	-3.4
PL	42.1	42.1	0.0	45.9	45.5	-0.4
SI	41.5	41.7	0.3	43.9	43.0	-0.8
SK	41.8	38.3	-3.5	49.0	41.2	-7.8
EU-10	42.0	41.9	-0.1	47.2	45.0	-2.2

Source: 2003 PEPs and Commission services.

(5.4 % of GDP). In the case of Lithuania, other sources of fiscal risk are related to deposit insurance, restitution of real State ownership rights, debt of State-owned enterprises to banks and privatisation of State-owned assets. In the Czech Republic, legal disputes potentially involv-

ing large compensation payments by the State are also considered as a possible risk to the budget. In Poland, a relatively prominent share of foreign debt, high risk of servicing the domestic debt due its short-term average maturity and the compensations to former real estate

Table I.19

Composition of general government expenditure in the 2003 PEPs

(% of GDP)

	Collective consumption			Social transfers			Subsidies			Gross fixed capital formation			Others, including interest		
	2002	2006	Change	2002	2006	Change	2002	2006	Change	2002	2006	Change	2002	2006	Change
CZ	9.4	9.1	-0.4	25.0	24.4	-0.7	3.5	3.2	-0.3	4.6	4.5	-0.1	6.5	5.6	-0.9
EE	7.2	7.3	0.1	14.4	15.0	0.6	1.1	1.3	0.2	4.3	4.5	0.2	11.4	12.6	1.2
CY	10.6	9.0	-1.6	15.4	16.0	0.6	1.0	0.6	-0.4	3.7	3.7	0.0	9.1	11.4	2.3
LV	9.3	-	-	23.1	-	-	0.8	-	-	3.3	-	-	8.4	-	-
LT	8.0	7.9	-0.1	22.0	22.2	0.2	0.7	1.1	0.4	2.5	4.2	1.7	2.5	2.0	-0.5
HU	7.5	7.4	-0.1	23.7	23.3	-0.4	2.5	2.7	0.2	6.2	4.1	-2.1	13.8	8.6	-5.2
MT	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.0	2.6	-0.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
PL	10.4	9.9	-0.5	25.4	22.6	-2.8	0.3	0.2	-0.1	2.9	4.7	1.8	7.0	8.1	1.1
SI	8.1	7.6	-0.5	n.a.	n.a.	n.a.	1.1	1.4	0.3	2.5	2.7	0.2	n.a.	n.a.	n.a.
SK	11.0	9.5	-1.5	21.1	17.9	-3.2	1.6	1.5	-0.1	2.4	1.8	-0.6	12.9	10.5	-2.4
EU-10	9.5	8.9	-0.7	22.9	20.8	-2.1	2.6	2.4	-0.2	3.7	4.2	0.5	7.9	7.2	-0.7

Source: 2003 PEPs and Commission services.

owners expropriated in the years 1944–62 contribute to an important fiscal risk as well.

3.2.5. Social security reform

Almost all the countries indicated their awareness of the negative impact of population ageing on the financing of their social security, notably pension and healthcare systems. Through increases in pension and healthcare expenditures, population ageing is expected to have a negative impact on the medium and long-term fiscal sustainability. This is one of the major fiscal risks as pension and healthcare spending are in many countries the biggest single items among all budget expenditures.

When facing this problem, most countries have been adapting their statutory pay-as-you-go (PAYG) pension pillars with the primary objective of securing the future financial balance of these schemes frequently through linking pension benefits closer to pension contributions. The measures include cuts in pension benefits, increases in the retirement age, increases in pension contributions in varying combinations. There are, however, some exceptions to this general trend: in order to improve the social situation of pensioners, the first pillar old-age pensions are being improved in Hungary by introducing a 13th monthly pension payment gradually over four years. Latvia plans to improve the indexation of pensions.

In addition to these changes to the PAYG schemes, several of the new Member States from central and eastern Europe introduced mandatory funded pillars managed by the private sector and created the legislative framework for voluntary funded provision. In the 2003 PEP, Lithuania and Slovakia presented plans to move towards such a ‘multi-pillar’ pension system (in 2004 and 2005, respectively). The introduction of the second (obligatory-funded) pillar requires a high degree of administrative preparation in order to avoid implementation problems. For instance in Poland, the transfers of social insurance contributions from the Social Insurance Institution (ZUS) to private pension funds were affected by serious delays. In addition, the channelling of part of the contribution revenue into privately managed funded schemes reduces government revenues and increases deficits. ESA 95 methodology places these schemes outside the general government sector.

Major motives behind reform steps in healthcare are to increase the quality of healthcare services and to cut healthcare costs that are likely to further increase in the process of population ageing. Many countries mention improvements in the healthcare sector as being important for human capital development. Another motive for healthcare reforms is to contribute to sound general government finances. Radical reform measures are in progress in Slovakia, including private co-financing. Cyprus plans to introduce a general health insurance scheme.

Table I.20

Main measures in the PEPs concerning pension reform

	Funded pillar — developed	Planned reforms
CZ	X	First pillar: parametric reforms within fiscal consolidation, notional defined contribution reform foreseen for 2010. No plans for a compulsory funded pillar.
EE	✓	
CY	✓	Parametric reforms in the first pillar.
LV	✓	More generous indexation rule in the NDC pillar.
LT	✓	Introduction of a voluntarily pillar as of 2004.
HU	✓	Gradual introduction of the 13th month pension. Increase contribution rate to mandatory-funded pillar.
MT	X	Reform of the first pillar planned. No plans for the compulsory funded pillar.
PL	✓	
SI	X	Parametric reforms in the first pillar.
SK	✓	Introduction of a compulsory funded-pillar planned for 2005.

Source: 2003 PEPs and Commission services.

3.3. 2004 convergence programmes

3.3.1. Growth projections

According to the programme projections, the average GDP growth of the new Member States in 2004 is expected to improve for a second consecutive year. Compared to the average GDP growth rate in 2003 (3.6 %), an important acceleration is expected in the course of 2004, to reach the average growth rate of 4.2 % (see Table I.21). Further increases are expected in the future as the average growth rate is estimated to reach 4.4 % in 2005 and 4.8 % in subsequent years.

Of the six new Member States for which an increase in growth rates is expected in 2004, the acceleration is particularly important in Malta (2.8 percentage points), Cyprus (1.5 percentage points), Slovenia and Poland (both 1.3 percentage points). Deceleration of growth in the same period is expected in four new Member States, although marginally in the Czech Republic and Slovakia. In Latvia and Lithuania, despite the expected cooling off, the economic growth is expected to remain very buoyant. According to the convergence programmes, favourable growth prospects are to be continued over the entire programme horizon. In sum, the new Member States with the lowest per capita GDP are expected to grow at the fastest pace, accelerating the catching-up process with higher-income Member States.

In comparison with the 2003 updates of the PEPs, growth projections over the medium-term period have been revised downwards in most new Member States (see Table I.21). While downward revisions for the entire period 2004–06 were made in five countries (Estonia, Cyprus, Hungary, Malta and Slovenia), the Czech Republic and Slovakia marginally lowered their expected growth prospects for 2005 and the former also for 2006. The growth projections presented in the convergence programmes by the Member States are largely in line with the Commission's spring 2004 forecast although somewhat higher in the cases of Latvia, Lithuania, Poland and Slovenia, and lower in the case of Malta.

3.3.2. Budgetary developments and targets

The expected budgetary developments according to the convergence programmes indicate a substantial consolidation of public finances in all new Member States with budgetary deficits. In aggregate terms, the deficit is expected to decrease from its current level, estimated at 5.8 % of GDP in 2003, to 2.1 % of GDP in 2007. Both in 2004 and 2005, the aggregate budget deficit is expected to decrease by 1 percentage point. The overall improvement over the programme period relies strongly on the expected budgetary consolidation in six new Member States for which the excessive deficit procedure was started in May 2004. Among these, particularly strong reductions are expected in the countries with initially high deficits, such as Cyprus (4.7 percentage points over

the period 2003–07), Malta (3.8 percentage points over the period 2004–07) and Hungary (2.8 percentage points over the period 2003–07). It has to be noted that the 2003 deficits in the Czech Republic and Malta were high due to one-off measures (an imputed State guarantee in the Czech Republic and a one-off outlay related to the shipyards restructuring operation and the appropriate accounting treatment of associated debt assumed by the general government sector in Malta). On the other hand, in Poland and Slovakia, following an expected increase in their deficits in 2004, the programmes foresee considerable consolidation efforts for the rest of the programme period (respectively, 4.2 percentage points and 2.0 percentage points).

Of the countries with budgetary deficits below the 3 % of GDP reference value, Slovenia and Lithuania are expected to reduce their deficits over the programme period, however, in the latter, only after a substantial worsening in 2004. Displaying a different path, the budgetary deficit in Latvia is expected to fall only marginally, while Estonia plans to move from the 2003 government surplus to a balanced budget in 2005.

A comparison between the budgetary projections provided by the new Member States in their convergence programmes and the 2003 PEPs (see Table I.22) shows that nominal budgetary balances tend to be similar in the

medium term (by 2006). Only Hungary and Malta present significant revisions compared to their PEPs. Hungary reports higher deficits in the convergence programme than in the 2003 PEP, while Malta foresees lower deficits in its convergence programme. Slovenia and Slovakia present slightly higher deficits in their programmes than in their PEPs by 2006.

All the countries provided figures for cyclically adjusted budget balances (CAB) in the programmes. They are presented in the left panel of Table I.23. The right panel of the table shows the CABs submitted in the 2003 update of the PEPs. According to the programme figures, the aggregate CAB of the new Member States, amounted to – 5.5 % of GDP in 2003 and is projected to reach – 2.3 % of GDP in 2007.

This reflects the expected decline in the CABs from the 2003 levels in all new Member States, apart from Lithuania and Latvia, where a modest increase is expected, and Estonia, where the surplus in cyclically adjusted terms (2.3 % of GDP) is forecast to decline and converge to balance.

On the whole, despite the general plans for adjustment in cyclically adjusted terms over the period 2003–07, only Malta and Estonia are projecting to balance their budgets by 2007, while in the Czech Republic, Hun-

Table I.21

Growth projections in the May 2004 convergence programmes and differences with the 2003 PEPs ⁽¹⁾

(% of GDP)

	2003		2004		2005		2006		2007
	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP
CZ	2.9	0.5	2.8	0.0	3.1	- 0.1	3.3	- 0.3	3.5
EE	4.7	0.2	5.3	- 0.3	5.8	- 0.2	5.6	- 0.4	5.9
CY	2.0	0.0	3.5	- 0.5	4.3	- 0.3	4.4	- 0.2	4.5
LV	7.5	1.0	6.7	0.6	6.7	0.7	6.5	0.5	6.5
LT	9.0	2.2	7.0	0.8	7.3	0.8	6.6	0.6	6.3
HU	2.9	- 0.6	3.3	- 0.2	3.6	- 0.4	4.0	- 0.5	4.3
MT	- 1.7	- 3.0	1.1	- 1.4	1.7	- 1.5	2.1	- 1.5	2.1
PL	3.7	0.7	5.0	0.0	5.0	0.0	5.6	0.0	5.6
SI	2.3	- 0.8	3.6	- 0.3	3.7	- 0.3	3.8	- 0.6	3.9
SK	4.2	0.2	4.1	0.0	4.3	- 0.1	5.0	0.2	4.7
EU-10	3.6	0.3	4.2	0.0	4.4	- 0.1	4.8	- 0.2	4.8

(1) A positive value implies higher growth forecasts in the May 2004 convergence programme.

Source: Commission services.

Table I.22

Budget balances in the May 2004 convergence programmes and differences with the 2003 PEPs ⁽¹⁾

(% of GDP)

	2003		2004		2005		2006		2007
	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP
CZ	-12.9	-5.3	-5.3	0.6	-4.7	0.1	-3.8	0.2	-3.3
EE	2.6	2.2	0.7	0.7	0.0	0.0	0.0	0.0	0.0
CY	-6.3	-0.9	-5.2	-1.5	-2.9	-0.1	-2.2	0.0	-1.6
LV	-1.8	1.1	-2.1	0.3	-2.2	0.0	-2.0	0.0	-2.0
LT	-1.7	0.7	-2.7	0.2	-2.5	0.0	-1.7	0.1	-1.5
HU	-5.9	-1.1	-4.6	-0.8	-4.1	-1.3	-3.6	-1.1	-3.1
MT	-9.7	-2.3	-5.2	0.6	-3.7	0.4	-2.3	1.1	-1.4
PL ⁽²⁾	-4.1	0.0	-5.7	-0.7	-4.2	-0.2	-3.3	0.1	-1.5
SI	-1.8	0.2	-1.9	-0.3	-1.8	-0.2	-1.5	-0.2	-0.9
SK ⁽³⁾	-3.6	1.4	-4.0	-0.1	-3.4	0.0	-3.0	-0.1	-2.0
EU-10	-5.8		-4.8		-3.9		-3.2		-2.1

⁽¹⁾ A positive value implies lower deficits in the May 2004 convergence programme.

⁽²⁾ The deficit figures will have to be adjusted upwards if the open pension funds are excluded from the general government sector following the Eurostat decision on the classification of funded pension schemes.

⁽³⁾ The figures are net of the effect of the introduction of a funded pension pillar in 2005. The programme estimates this revenue-decreasing and hence, ceteris paribus, deficit-increasing effect at 0.5 % of GDP in 2005, 0.9 % of GDP in 2006 and 1 % of GDP in 2007.

Source: Commission services.

Table I.23

Cyclically adjusted budget balances in the May 2004 convergence programmes and the 2003 PEPs ⁽¹⁾

(% of GDP)

	2004 convergence programmes					PEPs 2003			
	2003	2004	2005	2006	2007	2003	2004	2005	2006
CZ ⁽²⁾	-12.9	-5.3	-4.6	-3.8	-3.4	-7.5	-5.8	-4.8	-4.1
EE	2.3	0.6	0.0	0.1	0.1	n.a.	n.a.	n.a.	n.a.
CY	-4.0	-4.7	-2.8	-2.4	-1.9	-4.3	-3.5	-2.8	-2.2
LV	-1.7	-2.0	-2.2	-2.0	-2.0	-2.9	-2.5	-2.4	-2.3
LT	-1.5	-2.7	-2.6	-2.0	-1.8	-2.6	-3.0	-2.5	-1.6
HU	-5.9	-4.5	-3.9	-3.5	-3.0	n.a.	n.a.	n.a.	n.a.
MT	-8.6	-3.6	-2.1	-0.9	-0.2	n.a.	n.a.	n.a.	n.a.
PL	-3.7	-5.5	-4.1	-3.4	-1.7	-3.6	-4.7	-4.0	-3.8
SI	-1.3	-1.4	-1.3	-1.1	-0.7	-1.4	-1.1	-1.1	-1.1
SK	-3.5	-4.0	-3.9	-4.1	-3.1	-5.1	-4.1	-4.2	-3.7
EU-10	-5.5	-4.7	-3.8	-3.2	-2.3	-4.4	-4.5	-3.8	-3.5

⁽¹⁾ Countries' own estimates as presented in the May 2004 convergence programmes and the 2003 PEPs.

⁽²⁾ Due to the 2004 revision of the statistical methodology regarding the calculation of GDP, the CABs from the two sources are not fully comparable.

Source: Commission services.

gary and Slovakia, the cyclically adjusted deficits are forecast to stand at or above 3 % of GDP in 2007. Moreover, of the countries forecasting an improvement in the CAB over the programme period, Slovakia is the only one projecting an improvement after 2006.

3.3.3. Debt levels

In general, government debt is low in the new Member States and is expected to increase steadily over the programme period from 44.3 % of GDP in 2003 to 47.8 %

of GDP in 2006 before declining in 2007 (see Table I.24). Overall, apart from the Czech Republic, Latvia, Poland and Slovakia, new Member States are expected to have lower debt levels in 2007 than in 2003. In Cyprus and Malta, government debt is expected to stay above the 60 % of GDP reference value over the entire programme period, while although remaining below the reference value, a relatively rapid increase in debt levels is projected in the Czech Republic and Poland. Finally, in four countries, namely, Estonia, Latvia, Lithuania and Slovenia, debt levels are expected to be kept below 30 % of GDP.

Table I.24

Debt levels in the May 2004 convergence programmes

(% of GDP)

	2003	2004	2005	2006	2007
CZ	37.6	38.4	39.7	41.0	41.7
EE	5.8	5.4	5.1	4.7	3.4
CY	72.6	75.2	74.8	71.5	68.4
LV	15.3	16.2	16.8	17.3	17.7
LT	21.5	22.4	22.2	21.4	21.0
HU	59.1	59.4	57.9	56.8	55.6
MT	72.0	72.1	72.4	70.5	70.4
PL ⁽¹⁾	45.3	49.0	51.9	52.7	52.3
SI	28.6	29.1	29.5	29.4	28.4
SK	42.8	45.1	46.4	46.1	45.5
EU-10	44.3	46.2	47.5	47.8	47.3

⁽¹⁾ The debt figures will have to be adjusted upwards if the open pension funds are excluded from the general government sector following the Eurostat decision on the classification of funded pension schemes.

Source: Commission services.

4. The sustainability of public finances based on the 2003 updates of stability and convergence programmes

4.1. Introduction

Due to the growing concerns regarding the impact of ageing populations, ensuring the long-term sustainability of public finances is a key objective in the EU. Since the launch of the euro, in 1999, the Commission has sought to integrate an examination of the sustainability of public finances into the existing EU framework for the surveillance of Member States' economic and budgetary policies, in line with the conclusions of the Stockholm (March 2001) and Barcelona (March 2002) European Council meetings and the March 2003 Ecofin Council.

The Commission therefore regularly produces the assessment of long-term sustainability of public finances in the context of the Stability and Growth Pact. This chapter presents an overview of the assessment of the long-term sustainability of the public finances based on the 2003 updates of stability and convergence programmes carried out by the Commission for the third year in the row.

The assessment of long-term sustainability of public finances is a multi-faceted issue and there is no unique indicator which gives a clear response on whether a country's public finances are sustainable in the long run. Thus, on the basis of the EPC 2003 report ⁽¹⁾, the Commission assessed long-term sustainability of public finances using both quantitative indicators and qualitative information. Although the approach followed was broadly similar to the one used in previous assessments (see European Commission, 2002a and 2003a for a

review of the first two assessments), it is important to note a number of improvements undertaken in order to enhance the quality of the assessment.

For what concerns the quantitative indicators, the cyclical component of the budget has been netted out in the first year of the projection, so the long-term projections are only affected by the more structural components of the budget. In practice, the tax to GDP ratio in the last year of the programme has been corrected by the cyclical component of the budget ⁽²⁾.

Also, a greater attention has been devoted to qualitative features when making the assessment, which alleviated the mechanistic interpretation of the results obtained. The main qualitative features shaped into the assessment are (i) current debt/GDP ratio; (ii) how the use of one-off measures or contribution to pension reserve funds affect the budget balance; (iii) the current level of tax ratios; and (iv) the robustness of the long-term budgetary projections.

4.2. How the sustainability of public finances was assessed

4.2.1. The quantitative indicators

Table I.25 summarises the data included in the 2003 updates of stability and convergence programmes that were used to run the sustainability indicators. The priority has been given to the national projections reported in the programmes, complemented if necessary with the commonly agreed EPC projections.

⁽¹⁾ See the report 'The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme' (October 2003), available at: http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf.

⁽²⁾ This makes this year's results of the quantitative indicators not fully comparable with last year.

Table I.25

Data used to run the sustainability indicators

	Age-related expenditure						Others		Total non-age-related exp.	Total revenue	
	Pensions		Healthcare		Education					const.	2008
	2008	2050	2008	2050	2008	2050	2008	2050	2008		2050
BE	8.8	12.6	7.1	9.9	4.1	3.7	6.7	5.0	16.5	48.1	48.1
DK	5.5	6.9	8.0	10.4	8.7	8.4	9.3	11.2	18.1	53.1	55.6
DE	11.0	14.9	5.9	7.1	5.3	5.5	0.9	0.7	18.3	43.4	44.3
EL	12.3	22.6	5.1	6.6	3.3	3.2	0.4	0.2	17.2	43.0	43.0
ES	8.0	13.0	5.7	7.2	4.0	3.7	0.6	0.4	19.0	40.0	40.0
FR	12.7	14.5	6.4	7.4	5.9	5.5	1.0	0.7	22.8	51.6	51.6
IE	4.0	7.7	6.1	7.8	4.0	3.2	1.0	1.0	17.0	33.5	33.5
IT	14.0	14.1	6.4	8.1	4.6	4.2	0.4	0.3	13.4	44.1	44.1
LU	7.4	9.3	n.a.	n.a.	n.a.	n.a.	0.3	0.2	38.9	48.0	48.0
NL	5.2	8.7	7.5	10.5	5.0	4.9	6.6	6.9	18.4	44.7	47.6
AT	14.6	15.0	5.2	6.4	5.6	5.0	1.5	2.0	18.3	47.9	47.9
PT	11.3	12.1	5.3	6.1	5.4	5.1	0.5	0.5	18.1	43.9	43.9
FI	11.6	14.5	4.8	5.8	5.8	5.4	3.3	4.8	21.3	51.0	51.0
SE	9.0	9.9	11.0	13.4	8.2	8.7	6.8	9.7	16.8	56.3	56.7
UK	5.1	5.3	7.7	9.7	5.4	5.4	1.4	1.5	20.4	40.0	40.0

NB: Data refer to the first year of projections, 2008, unless specified differently. In all the countries, other age-related expenditure includes unemployment benefits; where relevant, additional items are specified below. Total revenues refer only to the programme scenario. BE: Other expenditures include family allowances, unemployment and early retirement transfers, work-related accidents and sickness and residual regimes. DK: The starting data refer to 2011. Other expenditure items are childcare and old-age care. Concerning the change in tax revenues, the net tax on net pension payments is projected to increase by 2.5 percentage points of GDP by 2050. Also, pension assets are projected to increase from 124 % of GDP in 2005 to 217 % of GDP in 2050. DE: Pension projections were made by the BMGS (Statutory Pension Insurance and Public Service Workers Pension). Tax revenues only concern taxation of future pension payments to private households made by the German Institute for Economic Research. EL: The starting data refer to 2007. Healthcare only concerns acute healthcare. FR: Pension expenditures are calculated from last year's programme, including the impact of the pension reform as reported by the national authorities. IE: The starting data refer to 2007. LU: The starting data refer to 2007. No projections on healthcare and education expenditures were reported. Equally, the EPC projections for Luxembourg do not include information on these two items. NL: Projections on age-related items from a report of CPB Netherlands, 'Ageing in Netherlands', 2003. Other age-related expenditure includes disability benefits. Net old-age-related direct tax revenues are projected to increase by 2.8 percentage points between 2010 and 2050. AT: Other age-related expenditure includes care expenditure. PT: The pension expenditure projections were reported in the national strategy report on the future of pension schemes. FI: Long-term care expenditure is included in other age-related expenditures. Pension system assets are projected to increase from 67.3 % of GDP in 2006 to 78.4 % of GDP in 2050. SE: The starting data refer to 2007. Healthcare expenditure includes ill health and medical care expenditure. Other age-related expenditures also includes labour market training grants and wage guarantee, childcare and care of elderly. The net old-age-related tax revenues are projected to increase by 0.4 percentage points between 2010 and 2050. Pension system assets are projected to increase from 28.4 % of GDP in 2006 to 29.6 % of GDP in 2050. UK: The starting data refer to 2009. Long-term care expenditure is included in other age-related expenditures. The non-age-related expenditures are expected to decline by 0.9 percentage points between 2009 and 2050.

Source: EPC and national updated stability and convergence programmes (2003).

This year, the EPC projections on unemployment benefits and education, carried out for the first time in 2003, were added to the age-related expenditures for all countries that did not provide such information in the programme ⁽¹⁾. Thus, at least four different age-related expenditure items — pensions, healthcare, education and unemployment benefits were included in the calculations of all the Mem-

ber States which contributed to increased comprehensiveness of the quantitative assessment.

On the revenue side, the level of revenue-to-GDP ratio was kept constant at the (cyclically adjusted) level reached in the last year of the programme period for most countries ⁽²⁾.

⁽¹⁾ For a detailed analysis of long-term education expenditure see EPC (2003) and Montanino, Przywara and Young (forthcoming, 2004).

⁽²⁾ Changes in the tax ratio were included for four Member States (Denmark, Germany, the Netherlands and Sweden) as these can largely be attributed to the deferred tax revenues from contributions to funded pension systems as well as accumulated earnings prior to disbursement.

Table I.26

Projected changes in the expenditure and revenues between the first year of projections and 2050

	Age-related expenditure				Total	Tax revenues	Net change
	Pension	Healthcare	Education	Other age-related expenditure			
BE	3.8	2.8	-0.4	-1.7	4.5	0.0	4.5
DK ⁽¹⁾	1.4	2.4	-0.3	1.9	5.4	2.5	2.9
DE	3.9	1.2	0.2	-0.2	5.1	0.9	4.2
EL ⁽²⁾	10.3	1.5	-0.1	-0.2	11.5	0.0	11.5
ES	5.0	1.5	-0.3	-0.2	6.0	0.0	6.0
FR	1.8	1.0	-0.4	-0.3	2.1	0.0	2.1
IE ⁽²⁾	3.7	1.7	-0.8	-0.1	4.5	0.0	4.5
IT	0.1	1.7	-0.4	-0.1	1.3	0.0	1.3
LU ⁽²⁾	1.9	0.0	0.0	-0.1	1.8	0.0	1.8
NL	3.5	3.0	-0.1	0.3	6.7	2.9	3.8
AT	0.4	1.2	-0.6	0.5	1.5	0.0	1.5
PT	0.8	0.8	-0.3	0.0	1.3	0.0	1.3
FI	2.9	1.0	-0.4	1.5	5.0	0.0	5.0
SE ⁽²⁾	0.9	2.4	0.5	2.9	6.7	0.4	6.3
UK ⁽³⁾	0.2	2.0	0.0	0.1	2.3	0.0	1.4

(¹) 2011 replaces 2008 for Denmark.

(²) 2007 replaces 2008 for Greece, Ireland, Luxembourg and Sweden.

(³) 2009 replaces 2008 for the United Kingdom.

Source: EPC and national updated stability and convergence programmes (2003).

Table I.26 presents projected changes in the expenditure and revenues between the first year of projections and 2050. As expected, the projections of age-related expenditures show that the pension and healthcare-related expenditures are of the highest concern for the long-term sustainability of public finances. In Denmark, Italy, Austria, Sweden and the UK, healthcare spending is projected to grow faster than pension spending. In turn, other age-related expenditures — one of which is education — are projected to decline in the majority of countries, although insufficiently to offset the increase in pension and healthcare expenditures.

Table I.27 and Table I.28 present, respectively, the extrapolation of debt/GDP ratio and the sustainability gaps under two scenarios. Under a so-called 'programme' scenario, the starting position in terms of the cyclically-adjusted budget balance, the level of the debt/GDP ratio, the primary spending and the tax revenues are the figures reported by the Member State for the final year of their 2003 updated stability or convergence programme; for most Member States this is 2007.

The extrapolation of the debt/GDP ratio relies on several assumptions:

- The tax burden remains constant as a share of GDP unless there are foreseen increases of revenues due to the design of the pension system. Thus, future additional pension income resulting from the accumulation of non-taxable contributions is included while changes in revenues due to assumptions on future trends in private consumptions or due to special sources are not considered.
- Age-related expenditures evolve in line with the available projections.
- Non-age-related primary expenditures remain constant as a share of GDP at the 2007 level over the projection period (¹). These include mainly public investment, other social expenditure apart from education, health and pensions, purchases of goods and services not due to age-related expenditures, com-

(¹) Only in the case of the UK did the Commission take into account the decline in non-age-related expenditures, namely, the dynamics reflect the current set of legislation in place. In addition, most non-pension social benefits will rise in line with prices after 2007–08, reducing their share of GDP.

pensation of employees (excluding the staff in education and healthcare sectors).

- The GDP deflator is fixed at 2 % for the whole projection period.
- The GDP real growth rate is country-specific and relies on agreed EPC assumptions ⁽¹⁾. It results from both assumptions on employment trends and labour productivity trends. However, labour productivity growth is assumed to converge towards an annual rate level of 1.75 % by 2030, although some leeway for higher rates is provided for catching-up countries.
- The nominal interest rate converges towards an EU average level of around 5–6 % in 2015. It is calculated as the sum of the EU average real growth rate plus the ECB inflation target (2 %) plus an interest rate growth differential of 2. To avoid a discrete jump in the debt projections, it is assumed that the implicit interest rate on debt in the final year of the stability/convergence programme converges towards the common nominal interest rate in a linear fashion within 10 years.

The ‘programme’ scenario assumes that Member States actually achieve the budget targets set down in their programmes. However, such an outcome is by no means assured. In order to assess the relevance of the consolidation processes in the medium term to achieve long-term sustainability, a ‘2003 position’ scenario was run in the same way as the ‘programme’ scenario, excepting that the starting budget position is different since it is based on budgetary data for 2003. Debt levels are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2008 remains the same as the 2003 level and no stock-flow operations take place.

It is important to recall that the purpose of the debt extrapolation is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face

⁽¹⁾ See EPC (2001).

Table I.27

Results of the sustainability gap indicators

	Programme scenario		2003 budget scenario	
	S1	S2	S1	S2
BE	-0.3	0.3	-5.1	-1.0
DK	-0.6	-0.6	-2.0	-1.3
DE	2.2	2.6	4.4	4.4
EL	1.9	3.3	2.3	3.8
ES	0.4	1.3	-0.3	0.6
FR	0.7	0.8	3.6	3.5
IE	1.6	2.2	2.2	2.5
IT	-0.7	-0.7	1.1	1.3
LU	0.0	-0.1	-1.2	-1.1
NL	2.0	2.2	2.6	2.7
AT	0.1	0.3	0.2	0.5
PT	-0.8	-0.4	1.6	1.8
FI	0.2	-1.8	-1.1	-2.8
SE	0.6	0.2	1.4	1.0
UK	2.2	2.4	2.8	3.1

NB: S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualised flow of revenues and expenses over an infinite horizon.

Source: Commission services.

value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of ‘no policy change’.

Findings from the results of the quantitative assessment can be summarised as follows.

Firstly, even assuming that all Member States achieve their medium-term budgetary targets (programme scenario) there is a risk of unsustainable public finances (measured against the 60 % of GDP reference value) emerging in at least one third of the EU-15 Member States.

Secondly, debt developments for most EU-15 Member States follow a U-shaped pattern. In the coming 20 or 25 years, debt levels are projected to decrease due to the effect of maintaining balanced budget positions: however,

this trend would start to reverse once the budgetary impact of ageing starts to take hold, with the largest increase in most countries expected between 2030 and 2050 (see Table I.29 for the EU-15 aggregate).

Given the projected increase of debt levels, it is important to use this window of opportunity and to contain the emerging risks of increasing age-related expenditures and debt levels.

Thirdly, the risk of unsustainable public finances increases considerably if the Member States do not achieve the SGP goal of budget positions of 'close to balance or in surplus'. An indication of this can be seen by comparing the projected debt levels under the 'programme scenario' with the '2003 budgetary position' scenario. This issue is especially relevant for the six euro-area countries with highest underlying cyclically adjusted deficits in 2003, i.e. Germany, Greece, France, Italy, the Netherlands and Portugal.

Fourthly, the sustainability gap indicators provide some order of magnitude to the budgetary adjustment needed to ensure sustainable public finances. The sustainability

gap under the 'programme scenario' indicates that an additional permanent budgetary adjustment of between 1.5 and 2.5 percentage points of GDP is needed in Member States where the sustainability of public finances is a concern (see Table I.27). The scale of budgetary adjustment efforts could be even greater if account is taken of the stated budgetary objectives of some Member States such as a reduction in the tax ratio.

4.2.2. The qualitative considerations

The 2003 updated programmes contain useful information to better qualify the long-term sustainability of public finances. The level of government debt/GDP ratio in 2003 is a source of concern in at least three countries, namely Italy, Greece and Belgium. In order to run it down towards 60 % before the impact of ageing takes place, these countries have to run sustained primary surplus (above 4 %) over the next 10 to 15 years. Such a requirement is subject to risk even if it cannot be excluded a priori: pressures to reduce the tax burden or to increase some expenditure items can arise in the near future, putting at risk long-term sustainability.

Table I.28

Projected evolution of debt levels up to 2050 ⁽¹⁾

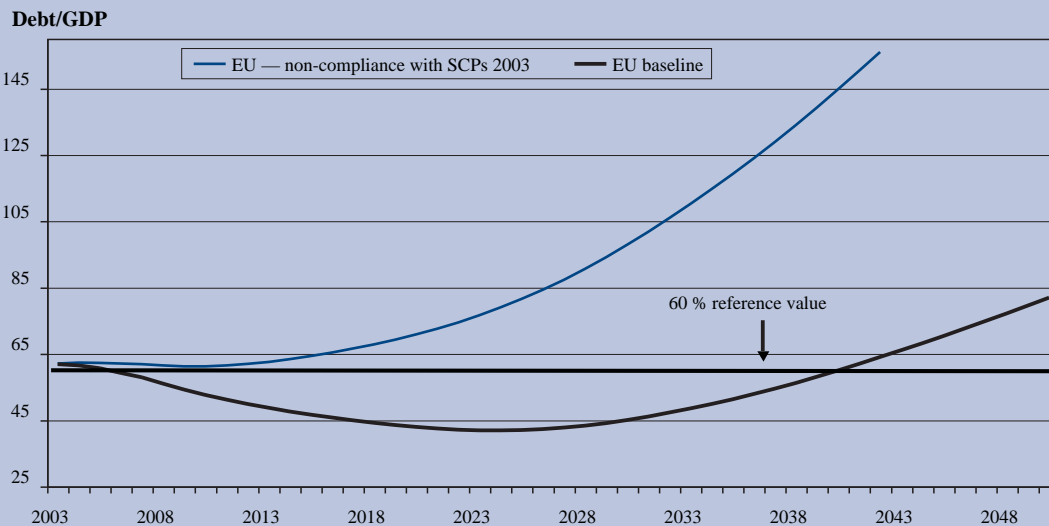
	2003	Programme scenario			2003 budget scenario		
		2010	2030	2050	2010	2030	2050
BE	102.3	74.8	11.5	- 5.0	67.2	- 35.7	- 114.0
DK	42.7	24.6	- 19.5	- 34.8	6.9	- 65.5	- 131.9
DE	64.0	62.2	86.5	175.7	74.3	156.5	336.6
EL	101.7	75.1	42.2	151.0	72.2	52.4	181.0
ES	51.8	36.3	- 1.6	36.6	31.6	- 21.4	- 12.4
FR	61.4	56.0	52.2	72.0	71.8	142.1	288.0
IE	33.1	26.7	36.4	105.0	27.0	50.1	138.4
IT	106.0	86.6	28.9	- 27.8	92.0	82.7	107.8
LU	4.9	- 0.9	- 9.4	1.2	- 3.9	- 35.7	- 47.8
NL	54.0	49.1	67.6	140.0	53.8	88.7	185.9
AT	66.4	53.9	24.4	15.9	55.1	26.1	18.4
PT	59.5	48.0	5.3	- 42.4	60.9	72.1	127.6
FI ⁽²⁾	- 4.6	- 33.4	- 30.1	6.0	- 52.8	- 79.5	- 88.6
SE ⁽²⁾	33.0	16.4	- 0.4	46.7	15.2	19.8	97.6
UK	39.3	42.5	71.6	138.7	45.3	89.5	177.5

(1) The Commission took on board information on financial assets (other than government bonds) in designated pension funds, which are available for future debt reduction. This is because these financial assets are either earmarked for financing future pension payments or debt reduction, and the amounts involved are sizeable and thus have a material impact on the assessment of the sustainability of public finances. It was assumed that the yield on assets is the same as on debt.

(2) Adjusted government debt.

Source: Commission services.

Graph I.9: Projection of future development in EU-15 (weighted average)



Source: Commission services.

The medium-term dynamic of the debt/GDP ratio is affected, in particular in Italy and Greece, by stock-flow operations. In the case of Greece, these financial operations are expected to run down the debt slower than projected from the pure development of the budget balance. Should these operations continue in the future, imbalances in the long-term will be amplified.

The current debt level puts several countries in a safer position than what the purely quantitative indicators could show. Ireland, the UK, Finland, Luxembourg, Denmark and Spain have a relatively low level of debt/GDP ratio. This gives some room to tackle the problem if future imbalances arise. For other countries (namely Germany, France and Portugal) a source of concern is not the very high level of debt/GDP ratio but rather its recent upward trend. The budgetary deterioration pushed debt up since 2001 (2000 in Portugal) and it has quickly reached levels close to or above the reference value of the Maastricht Treaty ⁽¹⁾.

Another important issue to consider when assessing sustainability is the role accumulated assets held by the public sector can play to cope with future pension liabilities. Several countries are accumulating liquid financial

assets for these specific purposes. In some cases (such as Denmark, Sweden and Finland) the value of these assets is particularly large (around or above 50 % of GDP). Clearly, having prepared in time the impact of an ageing population puts these countries on safer ground, regardless of the future trend of government debt. Other countries such as Spain and Ireland are also accumulating funds. Their amount is still relatively limited but increasing.

These assets are not netted out in the calculation of the quantitative indicators because they are based on the Maastricht definition of government debt ⁽²⁾. In principle, the most appropriate measure would be the government net worth but in practice most of the information is not easily available, and more importantly difficult to project into the future. A different solution could be to consider the government debt development net of those assets that are fully liquid (and therefore immediately disposable) and locked up for future pension payments. However, in practice it is difficult to project future flows to these funds over the very long term because assuming a no-policy change scenario can lead to an implausible high level of assets. How the indicators of long-term sustainability of

⁽¹⁾ In particular in Germany the debt/GDP ratio has been on an increasing path since the beginning of the 1990s.

⁽²⁾ Exceptions are Finland and Sweden.

public finances can incorporate the impact of pension funds on debt sustainability needs to be explored.

Budget balance trends in the medium term are affected not only by the accumulation of reserve funds but also by one-off measures with a temporary impact on the budgetary positions. A great recourse to one-off measures helps in containing current imbalances but does not improve significantly long-term sustainability. Indeed, if one-off measures are put in place instead of structural measures, the long-term sustainability of public finances can even worsen. The cases of Italy and Portugal raise particular concern due to the large recourse to one-off measures in recent years. Since what counts for the long-term trends of the debt/GDP ratio is the underlying budget balance, i.e. net of all transitory effects on the budget, the projected debt trend for these two countries could be partially affected by the impact of these transitory measures. In running the quantitative indicators, the cyclically adjusted tax-to-GDP ratio at the end of the programme period is kept constant, as are the non-age-related expenditures. If at least one of these two components of the budget is affected by one-off measures, the application of the debt dynamic equation can lead to a faster debt reduction than would be observed on the basis of the underlying budget balance.

Another factor to be considered as a potential risk is whether debt projections rely on a very high tax burden compared with EU average or other industrialised countries. This is the case in Denmark and Sweden where the tax burden is around 50 % of GDP. Even if each Member State can decide over its optimal level of taxation, pressures to reduce the tax burden cannot be excluded in the future. In addition, there is less room to increase taxes should imbalances appear in the future.

A final qualitative feature identified as critical in making the assessment of long-term sustainability is the robustness of projections. While uncertainty surrounds any projection in the long term, there are cases where this is a greater source of concern. In Spain, the projected pension expenditure by Spanish authorities is much lower than what is projected by the EPC in its common exercise (the difference is around 2.8 percentage points in 2050). These differences rely on a more favourable demographic scenario regarding the future flows of immigrants in active age and the assumption that average pensions will increase at only half the projected increase of labour productivity (while the EPC assumes an increase in the average pension equal to labour pro-

ductivity) ⁽¹⁾. Given the uncertainties related to these two assumptions, the possibility of having an even larger increase in pension expenditure over the projected period cannot be ruled out.

The projected increase of pension expenditure in France and Portugal also warrants consideration. In both cases, national authorities provided a set of projections up to 2050 which include the impact of the recent pension reforms. This impact accounts for around 1 % of GDP. For Portugal, it is not sufficiently clear if the pension reforms already introduced will actually curb future pension expenditure. The calculation reported in the programme update seems not to have taken into consideration the impact of some measures which have already been taken or are planned, notably the changes to the civil servants' pension regime ratified at the beginning of 2004, the phased convergence of the lowest pensions towards fractions of the minimum wage, and the planned capping of social security contributions. Therefore it is doubtful that the pension reforms already introduced will actually suffice to curb future growth in pension expenditure.

Thanks to the recent pension reform, France is in a considerably better position to meet the budgetary costs of an ageing population. The reform will indeed not only increase the average retirement age and thus reduce pension expenditures but it will also probably lead to an increase in participation rates among the elderly with positive effects on potential growth. However, it is too early to draw firm conclusions on the related savings and the implementation of the reform should be monitored.

Concerns on the robustness of the projections regard also those included in the UK updated programme, and in particular the scenario for the next 10 years (age-related expenditures are expected to have only a slight impact on public finances). Healthcare and education expenditure are expected to increase by more than 2 percentage points of GDP in the next 10 years. This is compensated by an increase of revenues of 1.8 percentage points of GDP during the same period. The increase in revenue takes place in a no-policy change scenario and it is mainly due to fiscal drag, i.e. the increase of revenues (as a share of GDP) resulting from a higher median income. While spending plans are hard to change once approved, the revenue gains are instead only hypothetical. In addition, implicit nominal interest rates are assumed to

⁽¹⁾ This is a common assumption in the EPC projections.

decrease substantially within the programme period. They move from 5.1 to 4.6 % despite the increase, during the same period, of the GDP deflator which would be expected to push up the nominal interest rates.

4.3. Policy conclusions per Member State

Despite the fact that each country faces country-specific problems, for the purpose of summarising the main results it is possible to group countries according to the main source of potential budget imbalances and the seriousness of the risk as follows.

Very high-debt countries (Belgium, Italy). The source of risks for these countries is mainly the level of debt/GDP ratio. At first sight, the quantitative indicators suggest that these countries appear to be relatively well placed to meet the costs of ageing populations. This is because they are currently running high primary surpluses in order to meet their Treaty and SGP commitments: hence there is more scope to reduce interest payments in the future and thus offset future expected increases in spending due to ageing populations. However, this result needs to be interpreted with caution, as the assumption of a constant tax ratio introduces a degree of fiscal illusion based on an implicit assumption that very high-debt countries are able to sustain large primary surpluses over several (15–20) years. This will imply running actual budget surpluses, which inevitably leads to the challenge of competing budgetary pressures for tax cuts and/or increased public expenditures.

High-deficit countries (France, Portugal and Germany). These countries recently passed a number of pension reforms which aim at better controlling expenditure in the long run and the projections run by the Commission fully included the savings estimated by Member States. However, there are uncertainties regarding the budgetary impact of the pension reforms. In addition, a comprehensive strategy to ensure long-term sustainability must include budgetary consolidation in the medium term. Otherwise, any effort to control age-related expenditures will be offset by raising interest payments and debt/GDP ratio is likely to show explosive paths.

Countries with risks due to pension developments (Greece and Spain). These two countries face a similar pattern in age-related expenditure in the long term. In particular, pension expenditure is foreseen to increase at a faster pace than any other EU country. This means that in addition to a policy of running down debt (where

Spain is performing particularly well) measures to better control future trends of pension expenditure should be envisaged. Risks rely also on the uncertainties surrounding pension projections. A number of factors contribute to put Spain in a safe position but there are large differences between the EPC projections and the Spanish projections on future pension expenditures.

Countries with some risks due to the uncertainties over the medium term (UK, Netherlands). These countries face risks mainly linked to the medium-term budgetary developments. Both the UK and the Netherlands appear relatively well placed to meet the cost of an ageing population. However, the increasing deficit in the medium term raises concern and the current safe position can easily become less stable. Also, projections in the medium term rely on several assumptions. In the case of the Netherlands, the assumption that current policies will lead to sustainability over the long run relies upon the costs of the pension reform that temporally increases the actual deficit. Since these transitional additional costs are protracted beyond the programme period, there is some element of uncertainty on when the costs will be fully contained. For the UK, the medium-term projections foresee a shift from a slight primary deficit in 2003 to a primary surplus (of less than 1 %) in 2012 despite a high increase of healthcare and education spending implied by the spending review during the same period and no policy changes on the revenue side.

Countries with limited or no risk (Finland, Sweden, Luxembourg, Austria, Ireland and Denmark). They share a number of common characteristics, including sound budget positions, and reforms of their pension systems that have strengthened the link between contributions and entitlements, increased the share of pensions that are financed on a funded basis, and increased the capacity of pension systems to cope with demographic developments such as changes in life expectancy. For some of these countries the development of government debt does not reflect properly the soundness of their budgetary position due to the accumulation of liquid financial assets to cope with future challenges. This is particularly relevant for Ireland.

The following table summarises the main conclusions reached by the Ecofin Council in its opinion on the stability/convergence programmes on the basis of the Commission assessment. It shows how, for a number of countries, the long-term budgetary position improved thanks to structural reforms or the increased focus on long-term challenges.

Table I.29

Policy conclusions on the sustainability of public finances

	Are public finances sustainable?	What are the sources of concern?	Do policy conclusions differ from last year?
BE	It still presents some risks of long-term unbalances, linked to the consequences of ageing.	The outstanding level of debt requires attention and maintaining high primary surpluses in the next 10 to 15 years as planned is necessary to keep Belgium on a sustainable path.	Policy conclusions do not differ so much and rely on the fact that a high debt/GDP ratio will entail budgetary challenges for still some time before considering Belgium in a safe position. This year's assessment puts more emphasis on healthcare expenditure trends, which warrant consideration since they are increasing at a faster pace than expected.
DK	Denmark is in a good position to handle the impact of the ageing population.	The large net assets projected for both the government and pension funds put Denmark in a safe position.	No.
DE	Risks of imbalances in the long term cannot be ruled out.	Germany made progress in the reform of the public pension system and to a smaller extent in reforming the health sector. Although such reform steps are welcomed, the expected effects may not suffice to offset the long-term demographic impact on pension and healthcare expenditures. Also, the high deficit and the rising debt are sources of concern.	This year's policy conclusions are very similar. The budgetary strategy outlined in the programme is only partially compatible with improving the sustainability of public finances.
EL	There is a serious risk of severe budgetary imbalances emerging in Greece in the future due to an ageing population.	Taking also into account the high debt ratio, the budgetary challenges posed by an ageing population should be tackled through a comprehensive strategy that includes further reform of the pension system.	The assessment is in line with last year's conclusions, i.e. that a deficit adjustment towards close to balance is not sufficient.
ES	Spain seems relatively well placed to cope with the budgetary costs of ageing populations but several uncertainties surround the future budgetary trends.	Given the risks surrounding long-term projections and the large increase of pension expenditure projected in the very long term, current policies need to be supplemented by measures to prevent the emergence of unsustainable trends, in particular a comprehensive reform of the pension system.	This year's policy conclusions are rather different. The Commission concluded that Spain is placed relatively well to meet the budgetary costs of an ageing population. Differences are mainly due to an even better medium-term budgetary scenario than last year, the accumulation of reserve funds to meet future budgetary challenges, the regular review by the Permanent Commission of the Toledo Pact on progress in the pension system towards financial sustainability, the development of supplementary private pension schemes and the new system for setting medicine prices should improve healthcare expenditure controls and help contain expenditures.
FR	Risks of imbalances in the long term cannot be ruled out.	While France is in a considerably better position than before the reform to meet the budgetary costs of an ageing population, securing an adequate primary surplus will be essential to ensure that the public finances are on a sustainable footing. This should be complemented, particularly in the context of the reform of the health insurance system to be designed and implemented in the course of 2004, by measures aimed at controlling the evolution of age-related spending.	Not very different. Despite improvements due to the pension reform, France still presents risks of imbalances due to the high deficit.
IE	There is a risk of budgetary imbalances emerging in the future due to an ageing population but it has to be noted that the Irish debt ratio is currently quite low and that assets are being built up at a rate of 1 % of GNP annually in the National Pensions Reserve Fund.	Securing an adequate primary surplus is essential to ensure that the public finances are on a sustainable footing.	This year's policy conclusions are the same. While some risks cannot be excluded, the low level of taxation gives enough room to cover possible financing gap. As with last year, they suggest pursuing a policy of budget balance.
IT	There is a risk of budgetary imbalances emerging in the future due to an ageing population.	Securing an adequate primary surplus is essential if the debt reduction is to make a noticeable contribution towards meeting the costs of ageing. This should be complemented by measures to raise employment rates, especially among older workers and women, and control the evolution of age-related spending. The plans to reform the pension system unveiled in late 2003, if implemented, would contribute to achieve these objectives.	This year's policy conclusions are very similar, pointing out risks of imbalances. Among others, the actual level of debt/GDP ratio, the recent trends of healthcare expenditures, the outstanding projected increase in female participation rates are the main factors behind the risks.

(Continued on the next page)

Table I.29 (continued)

	Are public finances sustainable?	What are the sources of concern?	Do policy conclusions differ from last year?
LU	No risks of unsustainable public finances in the long term.	The total net asset position is favourable in view of the substantial financial assets accumulated over past years with fiscal surpluses.	No.
NL	The risk of budgetary imbalances emerging in the future cannot be ruled out.	Securing an adequate improvement in the primary surplus before ageing reaches its peak, together with the necessary measures to stem the long-term increase in expenditure, is essential to ensure that the public finances are kept on a sustainable footing.	This year's policy conclusions stress higher risks of imbalances and are somewhat different from last year. The higher deficit foreseen in the programme for the period (2003–05) and the failure to reach a budgetary position of 'close to balance or in surplus' by the end of the programme period raises concern, deteriorating the long-term trend of the debt/GDP ratio.
AT	Austria appears to be in a considerably better position than before to meet the budgetary costs of an ageing population.	The improved outlook after the 2003 pension reform needs to be confirmed by actual developments. Firstly, projections assume a reform-induced strong increase in participation rates. Secondly, the 10 % cap on benefit losses compared with the <i>status quo ante</i> renders long-term budgetary effects rather uncertain. Moreover, exonerating effects on government finances are unnecessarily delayed due to a disproportionately long transition period for abolishing early retirement until 2017.	This year's policy conclusions welcome the improvements due to the pension reform.
PT	Risks of imbalances in the long term cannot be completely ruled out.	The high deficit and the rising debt/GDP ratio may undermine the sustainability of public finances in the longer term, hence the timely achievement of a budgetary position close to balance is imperative. Moreover, an early assessment of the effects of the 2001 reform of the general social security pension regime seems to suggest that its long-term sustainability has not been improved.	Very similar, even if the efforts to complete the process of pension reform and to make the healthcare sector more efficient are recognised.
SE	Sweden should be able to meet the projected budgetary costs of an ageing population.	The increase of healthcare expenditure, including expenditure related to ill health, foreseen in the projections needs to be addressed as the update notes that further measures are necessary in order to achieve the target of half the number of sick days. Moreover, the medium-term target has to be reached; failure to do so can cause some budgetary imbalances in the very long term.	No.
FI	Public finances appear to be on a sustainable footing to meet the budgetary costs of ageing populations.	Public finances benefit from the sustained running of budget surpluses and a reformed pension system that is to a large extent pre-funded.	No.
UK	There are still, in the light of the current and projected deficits, some risks of imbalances in the long term.	A prudent budgetary position kept in the medium term would help avoid a risk of emerging budget imbalances in the context of ageing populations.	This year's policy conclusions put more emphasis on strength concerns expressed last year since the medium-term scenario worsened.

Source: Based on the Commission's assessment of the 2003 updates to stability and convergence programmes and the respective opinions of the Council.

4.3.1. Comparison with the last year's results

The historical record of the quantitative assessments contributes to the understanding of the developments related to the long-term sustainability of public finances. In making the comparison with last year's results, the two main changes in the input data should be borne in mind: (i) other age-related expenditures than pension and healthcare were included in the exercise for all EU-15 countries; (ii) budgetary positions at the end of the programme have been adjusted to net out the cyclical component (see above).

Both factors tend to reduce the impact of ageing. As shown in Table I.26, projected education and other age-

related expenditures show a decline over the period and at least partly counter the projected increase in pension and healthcare expenditures. In addition, most countries forecast a positive output gap at the end of the programme period so that the cyclically adjusted balance is better than actual figures.

Table I.30 presents why this year's results of the quantitative indicators differ from last year's ones. It analyses reasons for such development, based on pure comparison of the projections used in the two years for the 'programme' scenario.

4.4. Conclusion

This year's assessment of the long-term sustainability of public finances confirms the track record of continuous improvements in the way the sustainability is assessed. Thus, besides the inclusion of additional age-related expenditure items and of cyclically adjusted revenues, a more systematic analysis of qualitative features significantly contributed to a higher information value of the assessment.

Overall, the results show that risks to long-term sustainability are still present in nine countries of which in five (Belgium, Greece, Italy, Germany and France) the difficulties are more serious, while another four (Portugal, Spain, the Netherlands and the UK) face some risks due to the medium-term budgetary development or, as is the case for Spain and Portugal, due to the uncertainties over the long-term projections of pension expenditures. Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem relatively well placed to meet the cost of an ageing society.

Table I.30

The 2003 projections on long-term age-related expenditures compared to the 2002 projections

	Results as compared to the last year	What are the differences between this and last year's projections?
BE	Slightly worse	<ul style="list-style-type: none"> Higher pension expenditures (1.2 p.p. higher at the end of the period). Lower total revenues.
DK	Similar	<ul style="list-style-type: none"> Higher primary expenditure and higher increase in healthcare expenditures (1.1 p.p. at the end of the period). Higher total revenues (0.4 p.p. over the period). Higher initial debt level.
DE	Slightly improved	<ul style="list-style-type: none"> Lower growth of pension expenditures due to the effect of the pension reform (- 1.9 p.p. at the end of the projection period). Higher initial debt level.
EL	Similar	<ul style="list-style-type: none"> Lower increase in total primary expenditures. Lower total revenues (according to the programme and cyclical adjustment) Slightly lower initial debt level.
ES	Improved	<ul style="list-style-type: none"> Higher total revenues. Lower initial debt level.
FR	Improved	<ul style="list-style-type: none"> Gains from the pension reform (app. 1 p.p. per year). Significantly higher total revenues.
IE	Improved	<ul style="list-style-type: none"> Lower increase in age-related spending. Higher total revenues (0.6 p.p. over the period). Lower initial debt.
IT	Similar	<ul style="list-style-type: none"> Lower primary expenditures due to favourable trends in age-related expenditures. Lower total revenues. Higher initial debt level.
LU	Improved	<ul style="list-style-type: none"> Significantly higher total revenues.
NL	Slightly worse	<ul style="list-style-type: none"> Lower tax revenues. Higher initial debt level.
AT	Improved	<ul style="list-style-type: none"> Lower pension expenditures from the expected impact of the pension reform (1.5 p.p. lower at the end of the projection period). Slightly lower total revenues. Lower initial debt level.
PT	Improved	<ul style="list-style-type: none"> Lower pension expenditures from the expected impact of the pension reform (at least 1 p.p. lower between 2020 and the end of the projection period). Significantly higher total revenues (by 0.9 p.p. over the entire period).
SE	Slightly worse	<ul style="list-style-type: none"> Higher total primary expenditure due to higher increases in pension and healthcare expenditures. Higher total revenues (0.9 at the start and 1.8 p.p. at the end of the period).
FI	Improved	<ul style="list-style-type: none"> Higher total revenues (2.1 p.p. over the projection period).
UK	Slightly worse	<ul style="list-style-type: none"> Significantly higher increase in age-related expenditures. Lower total revenues (0.8 p.p. lower at the end of the period). Higher initial debt level.

Source: Commission services.

Part II

Evolving budgetary surveillance

Summary

After five years of experience with the euro area, an overall positive judgement can be given on how economic governance has worked in EMU, as the results achieved are well within the expectations at the beginning of the process of monetary unification. The budgetary framework provided by the Maastricht Treaty and the SGP has helped to deliver macroeconomic stability and budgetary positions under control and at prudent levels in most EU countries. Even if several countries have deficits approaching or exceeding the 3 %-of-GDP ceiling, and therefore need to correct them — the multilateral surveillance has played a decisive role in maintaining such deficit levels well below those witnessed in previous economic slowdowns, which would seem to explain the muted reaction from markets to the latest developments. Economic coordination at EU level has also helped to improve the sustainability of public finances and enhance their contribution to growth and employment. While the EU fiscal framework has broadly delivered, it is natural to strive for further progress. To deal with the tensions that have accumulated over time under this framework, the Commission already made proposals to this end in November 2002.

In spite of these steps, during 2003 the need for further and more decisive progress was clearly exposed by testing developments in the implementation of the SGP. These showed that a reassessment should be made both of the framework which applies to the conduct of national fiscal policies to ensure that they are run on a prudent basis and of the processes underlying the coordination of economic policies in the EU.

By the second half of 2003, the number of countries in an excessive deficit position increased to three, with France joining Portugal and Germany in this group. Like the latter two countries, France received recommendations from the Council in June as to the measures to be taken to correct the deficit. In autumn, given that the measures taken by France and Germany in response to the Council recommendations were proving ineffective, the Commission

moved forward with the excessive deficit procedures in order to ask them to take more decisive measures in order to correct the deficit as soon as possible. In doing so, however, the Commission considered that the changed economic conditions required an additional year to be granted to the two countries in order to correct the excessive deficit situation. The Council, however, could not reach a consensus to endorse the Commission recommendations, and instead adopted conclusions which suspended the application of the Treaty procedure, while extending by one year the deadline set for Germany and France to correct the excessive deficit. In practice, this amounted to weakening the provisions of the SGP intended to have a deterrent effect on those countries which did not take adequate measures in compliance with the Treaty and the recommendations of the Council itself.

Following these controversial events, the Commission announced a three-pronged strategy based on the continuation of budgetary surveillance, the need to seek legal clarity on the implementation of the provisions of the Treaty, and the need to make substantial steps in order to strengthen economic governance. Accordingly, at the beginning of the year, the Commission asked the European Court of Justice to annul the decisions taken by the Council and the conclusions adopted on the same occasions. The case has been assigned to an accelerated procedure by the Court.

At the same time, the Commission continued to conduct budgetary surveillance, by assessing the stability and convergence programmes submitted by the Member States and prepared the related opinions for the Council. Subsequently, following the notification of budgetary data concerning 2003, the Commission proposed to repeal the decisions taken in 2002 which placed Portugal in a position of excessive deficit. At the same time it started the procedures concerning the Netherlands and the United Kingdom, which registered deficits over 3 % for the first time in 2003. On the basis of the latest Commission forecasts, which indicated that there was a substantial risk of breaching the 3 % of GDP ceiling, the

Commission also recommended that the Council address an 'early warning' to Italy, asking it to take measures to avoid the occurrence of an excessive deficit.

Finally, the developments and decisions over the last few months suggest that, in order to capitalise further on the advantages brought about by the euro, there is a need for more ambition in addressing a number of issues which have arisen with the implementation of the framework for economic governance. In particular, this requires that efforts be pursued to continuously improve the analytical expertise necessary for the conduct of multilateral surveillance and that the functioning of the framework be reconsidered in order to identify those elements which may be reworked in order to improve its effectiveness.

Improving and widening the knowledge of budgetary developments is crucial in addressing the budgetary challenges and avoiding unsound or wrong policy conclusions in the EU context. During the last few years, multilateral surveillance has increased the attention given to more structural factors. This calls for temporary changes in budgetary positions to be clearly identified, in particular when due to either the implementation of budgetary measures with only temporary effects or to the economic cycle. Chapter 3 looks at both these issues. The use of temporary measures is becoming a regular feature in EU countries. Changes in the budgetary profile due to measures with temporary effects make the assessment of budgetary developments more difficult as they blur the picture of the 'underlying' budget trend. But assessing whether and when budgetary measures have only temporary effects is difficult. To illustrate the use and budgetary impact of non-cyclical temporary budget effects, the amount and type of one-off measures taken by EU-15 countries during the last few years is presented. Overall, it appears that temporary measures do have an impact on national budgets. It is therefore important to consider such measures in the surveillance process. This calls for more transparent budget measures and a clearer reporting of these measures by Member States, including in the stability and convergence programmes.

Economic growth and cyclical developments significantly affect budgetary developments. In order to better explain the impact of economic growth on budgets and clarify the role of the cyclically adjusted budgets (CABs) for budgetary surveillance under the SGP, this part of the report reviews the Commission methodology for calculating CAB figures and its use for monitoring compliance with adjustment requirements specified in cycli-

cally adjusted terms. In particular, one issue is addressed: it appears that changes in the CABs may not reflect the effects of discretionary fiscal policy alone, but also (unexpected) changes in potential growth. The rules of the SGP are not explicit about whether compliance with the adjustment requirement is to be intended conditional upon *ex ante* expectations on growth or unconditional. If compliance is to be interpreted conditionally, then the change in CABs should be corrected to take into account the component of the change attributable to the difference between actual and expected potential growth. In the chapter, a methodology to operate such correction is developed and discussed.

Available data about government liabilities is normally centred on government debt figures, collected in accordance with the Maastricht definition. However, other liabilities not included in this definition of debt also warrant surveillance. Chapter 4 is devoted to the role of the so-called contingent liabilities in budgetary surveillance. The term 'contingent liabilities' refers to those liabilities that correspond to government obligations which will materialise only in case of the occurrence of particular events. Being highly uncertain, contingent liabilities are not part of the definition of government debt used in EU budgetary surveillance. However, the broad tendency for governments to step back from providing direct support to economic agents and towards playing a more active role in guaranteeing outcomes means that there needs to be an increased focus on contingent liabilities. The importance of this issue in EU budgetary surveillance has increased with enlargement. The stock of contingent liabilities is in fact relatively high in new Member States. On a positive note, it should be noted that these countries, rather differently from most other Member States, have been disclosing information on contingent liabilities in their pre-accession economic programmes (PEPs) and the Commission has taken developments in fiscal risks and contingent liabilities into account in assessing the PEPs. After presenting basic definitions and a widely used taxonomy for government liabilities, Chapter 4 illustrates the broad trends in budgetary risks and surveys the main economic arguments for why such increased risks can be very relevant for government public finances. Finally, it reviews practices for increasing disclosure and for monitoring contingent liabilities and discusses the implications for EU budgetary surveillance. The definition of standards concerning the collection and the reporting of information on contingent liabilities would be a positive step towards increasing the knowledge of such liabilities and would facilitate their surveillance.

Making the EMU macroeconomic framework more effective would contribute to progress towards the objective of higher growth. In this endeavour, the right balance has to be found between the need to keep the economic governance framework stable and predictable and to improve the system on the basis of experience. How the rules and processes — upon which budgetary surveillance at EU level is based — can be improved is the subject of Chapters 5 and 6. Chapter 5 explores the issue of how the rules could be interpreted in order to attach greater weight to government debt ratios in the budgetary surveillance process, as the Commission proposed in November 2002. The ‘2003 report on public finances in EMU’ already addressed the issue of what could constitute a satisfactory pace of debt reduction for high-debt countries. This year, Chapter 5 highlights the importance of focusing on debt developments in order to ensure sound policies over time, reduce high debt ratios and create margins of flexibility for countries which run prudent policies. Firstly, it considers why a prudent debt position should be pursued, concluding that the Treaty ceiling of 60 % for the debt/GDP ratio is an important cornerstone for conducting prudent policies. Secondly, it identifies current developments in EU countries and the implications over the medium term. Thirdly, it discusses how fiscal rules can contribute to the achievement of prudent debt levels and increase flexibility in fiscal policy. Finally, it explores how objectives for the budget balance could be defined in a way which considers debt developments and, is therefore more country-specific. Clearly, further refinements are necessary on this subject and a consensus must be found among the institutions involved in the surveillance of budgetary policies on how they can take better account of sustainability in the monitoring and assessment of budgetary policies.

Chapter 6 explores how economic coordination in EMU must balance common interest with national sovereignty. An intense debate has provided a number of ideas on how to improve the functioning of the processes affecting economic coordination and budgetary surveillance. While some proposals go beyond any realistic changes to the current framework, some ideas could be usefully developed. The chapter explores in some detail the issues of how to improve the budgetary process by adjusting the budgetary calendar at EU level and by stimulating better procedures at national level.

Chapter 7 concludes this extensive part with a wide-ranging contribution to the debate on how the EU framework for budgetary surveillance could evolve. In particular, it includes a number of principles which could usefully be followed in order to further strengthen the EU fiscal framework. The chapter focuses on three main avenues: rendering the BEPGs a more effective instrument for economic coordination; rejuvenating the Pact through a number of elements which should help tackle the issues arising from its implementation, in particular in the definition of fiscal policies and in the respect of policy requirements; rendering enforcement more effective, by strengthening the Community power to monitor national fiscal policies, and putting in place institutions at national level appropriate to the task of ensuring sustainable public finances. These principles are presented with a view to strengthening the governance of economic policies in EMU: the anticipated evolution must remain within the provisions of the Treaty which have demonstrated their validity and usefulness over time.

1. Moving towards a clearer and more effective framework

1.1. A sound framework which needs strengthening

When the project of EMU was launched in the early 1990s ⁽¹⁾ it was clear that, for the successful functioning of EMU, Member States would be responsible for managing national budget deficits at low levels consistent with a high standard of monetary stability and that an effective economic policy coordination function was required. This would have conciliated the need for a common standard of discipline over deficits and debt with that for flexible response at the national level to country-specific shocks. The need for fiscal autonomy and flexibility was seen to arise from the loss of the monetary and exchange rate instrument for individual countries. The need for fiscal discipline was seen as vital to avoid threats to the overall monetary stability.

The Maastricht Treaty and the SGP have defined the budgetary framework for the functioning of EMU along these considerations. The Treaty sets the policy assignment in EMU for fiscal policy to achieve and maintain sound and sustainable public finances. While this is to be achieved through the coordination of fiscal policies, implying a great degree of autonomy at Member State level, it foresees a strict procedure for the correction of policies when 'gross errors' may have undesirable implications for EMU.

The economic governance framework built on the SGP and the Treaty has helped to deliver macroeconomic stability in EMU. Budgetary positions are under control and at prudent levels in most EU countries. Even if several countries have deficits approaching the 3 % of GDP ceiling, or are beyond it — and therefore need to correct them promptly — the multilateral surveillance has played a

decisive role in maintaining such deficit levels well below those witnessed in previous economic slowdowns.

The EMU framework has also contributed to improving the sustainability of public finances and enhancing their contribution to growth and employment. A number of reforms in the public sector, a renewed attention to efficient allocation of resources and a progressive decrease in the debt burden in the majority of Member States indicate that the fiscal policy framework is delivering substantial results overall, even if some countries are falling behind.

After five years of experience with the SGP and with the system of economic governance in the euro area, an overall positive judgement can be given on how economic governance has worked in EMU, as the results achieved are well within the expectations at the beginning of the process of monetary unification. While the EU fiscal framework has broadly delivered, further enhancement is needed. Attention is required for those countries where improvement has been more limited. Progress is required to deal with the tensions that have accumulated over time under this framework. In particular, the developments and decisions at the end of 2003 suggest that in order to capitalise further on the advantages brought about by the euro there is a need for stronger economic governance: a number of issues with the implementation of the economic governance framework have arisen and need to be addressed.

Firstly, the processes underlying the coordination of economic policies in the EU have exhibited certain flaws. As a consequence, the EU coordination framework for economic policy has been perceived as almost only focusing on fiscal policy, and in particular on budgetary balances and fiscal discipline. This reflects the weak link between the orientations provided on economic policies and on fiscal policy (in particular in the BEPGs and the Pact, but also in other processes). Such a weak link between the two processes makes it more difficult to look at fiscal policy

⁽¹⁾ See European Commission (1990).

both in terms of fiscal discipline (budgetary balances) and of the contribution of fiscal policy to growth and employment (composition of the budget) and to show the benefits of coordination. In addition, it often appears that the policy guidelines have a limited influence on national budgets or on the priorities for the EU budget.

Secondly, the rules which apply to fiscal policy have on some occasions shown shortcomings. It is for example apparent that the framework is lacking incentives for prudent behaviour in good time. In other cases, it was not stringent enough: as a consequence, some countries have not reduced their debt level as fast as expected at the start of EMU, while others have moved back to deficit levels above those required for adopting the euro. Taking this experience into account, the case could be made that the rules could be more articulated in practice so as to be more stringent when necessary, and more flexible when possible, by considering the different elements, such as debt levels, dynamism of the economy, investment requirements or long-term demographic trends.

These difficulties with the functioning of economic governance need to be tackled soon, in order to increase the chances of achieving the objectives the EU set itself in Lisbon. This requires an evolution around the essential elements of the Treaty. The latter defines a clear set-up for economic governance based on clear guiding principles, such as stable prices, sound public finances and monetary conditions and a sustainable balance of payments. It foresees clear obligations for sustainable public finances, in particular to avoid excessive deficits. The coordination of economic policies and the procedure to induce countries committing 'gross errors' to correct their excessive deficits are key elements to ensure the smooth functioning of EMU.

These elements of the framework are clearly valid. Any evolution of the framework should deliver the needed improvement within the principles and provisions of the Treaty.

1.2. Developments in the coordination of budgetary policies

1.2.1. Evolution in the framework for budgetary surveillance ...

As explained above, the EU's framework for fiscal surveillance requires improvements on the basis of the experience with its implementation. While some important steps need to be taken at the current juncture, it should be recalled that

refining the current rules is an ongoing process. As an example, in response to the developments which have taken place over recent years, and in line with a mandate from the Barcelona European Council conclusions, the Commission adopted in November 2002 a communication on strengthening the coordination of budgetary policies ⁽¹⁾. While identifying a number of shortcomings with the implementation of the SGP in the first years of EMU, the communication outlined a number of elements on which progress was crucial and a strategy based on Member States reassuming political ownership of the Pact ⁽²⁾.

Many of the Commission's proposals on strengthening the coordination of budgetary policies were shared by the (Ecofin) Council and endorsed by the spring European Council of March 2003. The Council 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 to increase growth-enhancing expenditures on items such as investment and R & D; in the long run, compliance will help Member States meet the budgetary costs of an ageing population while securing adequate pensions and access for all to high quality healthcare. The Council also 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 government 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.

⁽¹⁾ Communication from the Commission 'Strengthening the coordination of budgetary policies', COM(2002) 668 final of 27 November 2002.

⁽²⁾ See Part II.2 of European Commission (2003a) for a substantive presentation of the communication.

Reflecting such an ongoing process to improve budgetary surveillance, and building on the experience of the first years of EMU, new elements have progressively been introduced in the surveillance. In particular, more attention has been given to economic developments both in assessing budgetary positions and in addressing policy recommendations ⁽¹⁾. Improved knowledge of the procedure deriving from its application has been progressively coupled with increasingly broader considerations.

Reflecting the need to continue in the learning-by-doing process, the Commission has been working with the Council on various issues of particular policy relevance. Chapters 3 and 4 in this part present some of this work, which in particular shows how the evolution of surveillance of public finances requires a continuous effort in order to improve the analysis of budgetary developments in the European countries.

1.2.2. ... accompanied by a mixed implementation

In spite of the progress made in strengthening the coordination of budgetary policies, its implementation has not always been consistent with the ambition and the provisions of the Treaty and the SGP. The policies implemented by countries in excessive deficit positions cast on some occasions doubts about the effective willingness and capacity to ensure the correction of the excessive deficits within the deadlines set. In addition, the Ecofin Council did not implement the provisions of the SGP *vis-à-vis* both France and Germany. Instead of adopting formal recommendations the Council presented its position in the form of 'conclusions' of the meeting (see Box II.1). Acting in this way, the Council aimed at introducing an additional informal step in the procedure, so as to postpone the approaching of the last step (i.e. the sanctions).

A more nuanced assessment of experiences in the first few years of EMU points to more mixed results on the benefits of peer pressure and enforcement mechanisms. Peer pressure did appear to work in several cases. Even in countries that have failed to correct excessive deficit positions, the Treaty and SGP requirement have undoubtedly had an impact on budgetary consolidation.

⁽¹⁾ As an example, and as Chapter 2 illustrates more in detail, contrary to the first recommendation addressed to Portugal, the recommendation under Article 104(7) to Germany and the successive recommendations under Article 104(9) to both Germany and France took economic developments more into account: the adjustment has been defined taking into account growth prospects, and the effort has been quantified on the basis of the economic perspective at the moment of finalising the recommendations.

Countries have been forced to address deteriorating budgetary problems sooner than they otherwise would have, preventing deficits from reaching even higher levels. Still, the robustness of the framework was tested during a period of slow growth in large Member States. Heightened tensions in the system call for action to re-establish a consensus on the surveillance and coordination of fiscal policies. The events of 2003 have highlighted not only a different interpretation of the budgetary provisions of the Treaty and the SGP between the Commission and the Council, but also have singled out different views among Member States as to what are the consequences of participating in a single currency for countries with unsound budgetary positions.

1.3. The strategy pursued after the events of 25 November

Following the difficulties in the implementation of the SGP provisions concerning France and Germany, the Commission announced a three-pronged strategy based on the continuation of budgetary surveillance, the need to seek legal clarity on the implementation of the provisions of the Treaty, and on the need to make substantial steps in order to strengthen economic governance ⁽²⁾. The three prongs of this strategy are outlined below.

Continuing surveillance

The Commission made it clear that, in spite of the uncertainty on how to implement the procedures arisen after the November 2003 Ecofin decisions the Commission manifested its intention to continue to exercise fully its role in budgetary surveillance in the framework of the SGP. At the beginning of 2004, therefore, the Commission carried out the assessment of the latest updates of the stability and convergence programmes and adopted recommendations for opinions on these programmes. The assessments were completed by early March. For the first time, the Commission assessments were published on the day of adoption in order to steer public debate and enhance transparency. Moreover, the Commission services' technical documents supporting the assessments have also been published within a few days of the adoption of the assessments by the College.

⁽²⁾ See press release of 13.1.2004: 'Commission sets out strategy for economic policy coordination and surveillance', available at: http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.gettxt=gt&doc=IP/04/3510|RAPID&lg=EN&display=

Following the March 2004 notifications on 2003 budgetary outcomes, the Commission recommended to the Council to abrogate the excessive deficit position for Portugal, and launched new procedures *vis-à-vis* Greece, the Netherlands and the United Kingdom.

Re-establish legal certainty for the future

The second element in the Commission strategy was to re-establish legal certainty for the future. From the point of view of the legal and institutional framework, the Ecofin Council conclusions of 25 November posed problems. These concerned not only the modalities to be followed in the implementation of the procedures, where an unconventional step had been created by the Council, but in a wider context the fact that the Council could implement the Treaty as it wished, rather than following specific provisions contained therein. The Commission had already stated in the minutes of the Council meeting that in its opinion these conclusions were outside the spirit and the letter of the Treaty and the Stability and Growth Pact. The Commission subsequently decided to challenge in the European Court of Justice the legal status

and validity of certain elements of the Council conclusions, on the basis of the following considerations.

According to the Commission, the Council conclusions of 25 November constitute a violation of the control mechanism laid down in Article 104 EC, Regulation (EC) No 1467/97 and the Stability and Growth Pact resolution. This mechanism represents a series of successive steps and stringent deadlines and is designed to guide the Council in addressing recommendations to the Member State in order to correct the excessive deficit.

The Council had the possibility to reject the Commission recommendations. Within the provisions of the Treaty and the SGP, it can do so in the light of its own evaluation of the objective economic factors, which form the basis of the decisions to be taken. In that case, it had to set out clearly and unambiguously why, in the light of such objective economic factors, there was no need to adopt the decisions based on the Commission recommendations. This would have required the Council to

Box II.1: The Council vote on the Commission recommendations concerning France and Germany

In the context of the excessive deficit procedure, draft recommendations concerning France and Germany were submitted by the Commission to the Ecofin Council for adoption. The first two draft recommendations under Article 104(8) of the Treaty aimed at establishing that France had taken no effective action in response to the Council recommendation under Article 104(7), or, in the case of Germany, that the action taken was proving inadequate. The second two draft recommendations, made under Article 104(9) of the Treaty, outlined the measures that France and Germany would need to take in order to remedy the excessive deficit situation while giving an additional year for completing the correction.

The Ecofin decisions were prepared by the meeting of the Eurogroup which preceded the Ecofin on the basis of a compromise identified by the Italian Presidency. The draft conclusions agreed in the Eurogroup were adopted the following day by the Ecofin, after a formal vote which did not endorse the Commission recommendations. The votes expressed in the Council, which were made public in accordance with the provisions of the SGP, showed that there were quite divergent views on how to advance with the procedure. In spite of being the numerical majority, countries in favour of endorsing the Commission recommendations did not manage to achieve the qualified majority (of two thirds of the votes) required by the Treaty in this field. The voting on 25 November took place as follows.

The Council first took a vote on the two Commission recommendations for Council decisions under Article 104(8) of the Treaty concerning France and Germany, respectively. With Belgium, Denmark, Greece, Spain, the Netherlands, Austria, Finland and Sweden voting in favour, the Presidency concluded that there was not a qualified majority for adopting the decisions. The Council then took a vote on the two Commission recommendations for Council decisions under Article 104(9) of the Treaty addressed to France and Germany, respectively. The same countries as above voted in favour (with the exception of Denmark and Sweden, which were excluded from the vote, together with the UK, as only countries which have adopted the euro can vote on decisions under Article 104(9) of the Treaty), and the Presidency concluded that also in that case there was not a qualified majority for adopting the decisions. Subsequently, the Council, with Belgium, Greece, Ireland, Italy, Luxembourg, Portugal and, alternatively, Germany and France voting in favour, adopted specific conclusions regarding France and Germany, respectively.

ascertain full compliance of the action taken by France and Germany with the recommendations addressed to them under Article 104(7). But in the present case concerning the recommendations for France and Germany, the Council confirmed the Commission's economic analysis ⁽¹⁾. Consequently, the Council recognised that additional measures to address the excessive deficit of the Member States concerned were necessary. In those circumstances the Council would have been expected to adopt a recommendation submitted by the Commission, possibly in an amended version.

The Commission filed its complaint with the Court of Justice at the end of January, asking the Court to deal with this case with an accelerated procedure, given the importance of the matter. The Court accepted the request of the Commission.

Working on new proposals

The effectiveness of economic governance has suffered from the developments in 2003. The 25 November events reinforced the importance of making a further step forward. In this respect, the experience over the last five years since the creation of the euro should serve as guidance for future action. In this endeavour, the right balance has to be found between, on the one hand, the need to keep the economic governance framework stable and predictable and, on the other, to improve the system on the basis of experience.

Building on its communication of November 2002, the Commission started considering ways to improve the framework for economic governance in the Union,

which would build on the existing Treaty and the draft Constitution text (see Box II.7) but could imply changes to the SGP regulations.

In order not to prejudice the work of the future Commission, which will be called to carry through eventual formal proposals, the current Commission, in a first debate held in February, focused on the main orientations to be drawn from the experience with the framework.

This part of the report on public finances in EMU represents a contribution to the debate on how the EU framework for budgetary surveillance could be improved. The Commission will further elaborate on specific proposals for any formal changes in the legal provisions which will deem necessary to strengthen economic governance.

The remainder of this part is structured as follows. Firstly, it recalls the main issues which have arisen in the implementation of the SGP since spring 2003, including an explanation of the SGP provisions which are to be applied when countries are placed in an excessive deficit position, and the experience with countries which have been dealt with within the surveillance mechanisms of the SGP. Secondly, a number of important elements are touched upon which concern the analysis of budgetary positions and liabilities for European countries, including the measurement of underlying budgetary positions, and of risks and contingent liabilities. Thirdly, issues concerning the rules and processes upon which budgetary surveillance at EU level is based are considered. Finally, suggestions for a further evolution of the EU fiscal framework are explored ⁽²⁾.

⁽¹⁾ This was highlighted in its recommendations (points 1 and 4 of the Council conclusions).

⁽²⁾ For an overview of the evolution of the debate the reader can refer to Part II.2 of the previous years' reports.

2. Implementing the Stability and Growth Pact

2.1. Introduction

This chapter describes several aspects related to the implementation of the SGP. Section 2 outlines the steps in the enforcement mechanisms provided for in the Treaty and the SGP regulations which have been activated for the first time and recalls the implementation of the SGP since spring 2003. Section 3 examines the developments concerning the Member States for which action has been taken in the framework of the excessive deficit procedure and other countries which have been the object of recommendations by the Council. Section 4 presents the application of the excessive deficit procedure (EDP) to the 10 new Member States which joined the EU on 1 May 2004.

2.2. The implementation of the EDP for euro-area countries in excessive deficit

Steps foreseen by the Treaty and the Pact after a recommendation under Article 104(7) has been addressed

Member States that are in excessive deficit positions have the obligation to correct it in accordance with the content of the recommendation addressed to them under Article 104(7) of the Treaty.

The adoption of a recommendation under Article 104(7) implies an intensification of the surveillance on the country concerned. Ultimately, this recommendation (and the others related) will be abrogated with a Council decision in accordance with Article 104(12). However, depending on the way the Member State acts, the EDP could also lead to an even closer surveillance and to sanctions imposed in order to spur the necessary budgetary adjustment.

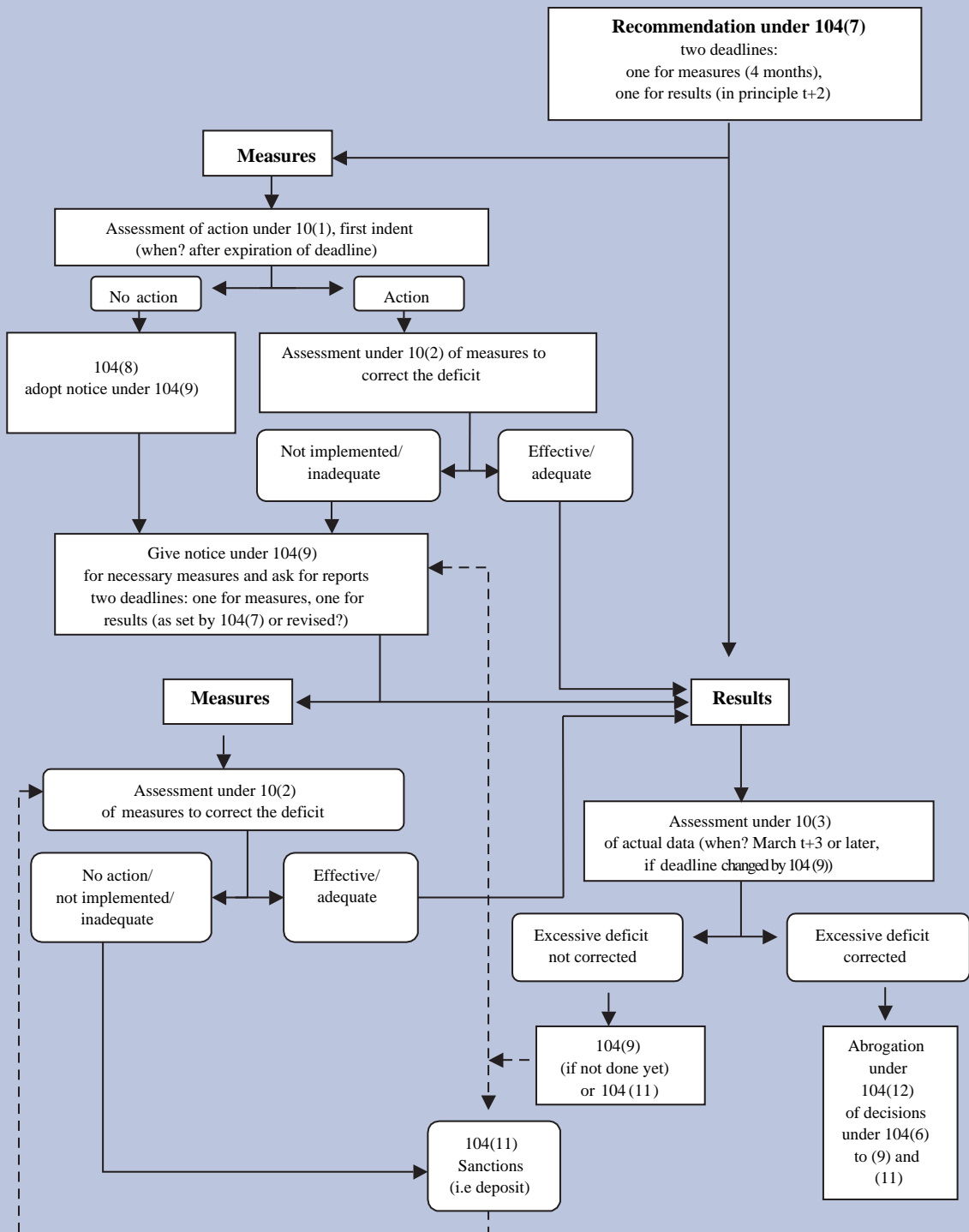
It should be recalled that the recommendations under Article 104(7) of the Treaty included specific deadlines (i) for the adoption of effective action and (ii) for the correction of the excessive deficit. According to Article 3(4) of Council Regulation (EC) No 1467/97, the first deadline for the adoption of effective action has to be within four months at the most from the adoption of the recommendation under Article 104(7). By contrast, the correction of the excessive deficit should be completed in the year following its identification unless there are special circumstances ⁽¹⁾.

After a recommendation under Article 104(7) has been issued, the next steps in the EDP are governed in particular by Article 10 of Council Regulation (EC) No 1467/97 in conjunction with Article 104(9) of the Treaty. These provisions are clearly defined. Graph II.1 gives an overview of how, according to the articles mentioned above, the EDP works in its later stages. It should be noted that while the focus of surveillance is on the delivery of results (i.e. actual deficit back below 3 % of GDP), initially surveillance has to focus on the measures taken by the Member States concerned in response to the recommendations addressed by the Council.

In accordance with these provisions, the Commission has carried out the required surveillance concerning the countries in 'excessive deficit positions'. The next section presents the relevant developments.

⁽¹⁾ The wording 'year following its identification' requires an interpretation of the word 'identification'. The one adopted is that the 'identification' of an excessive deficit takes place in 'the year in which the Council has adopted the decision on the existence of the excessive deficit under Article 104(6) of the Treaty'.

Graph II.1: Steps in the EDP after a Council recommendation has been addressed to a euro-area country in accordance to Article 104(7)



NB: *t* refers to year of occurrence of excessive deficit.

2.3. The surveillance mechanisms since spring 2003

Following developments in 2002 and in the early part of 2003, the Council took action against Portugal, Germany and France ⁽¹⁾. These countries were eventually placed in ‘excessive deficit positions’ and received specific recommendations in order to correct their excessive deficit.

Setting the deadlines as required by the SGP *de facto* implies that Member States can be given a time span of up to two years for completing the correction of the excessive deficit, with respect to the year in which the excessive deficit has occurred. As has been shown by events though, such a period has proven not to be sufficient in the case of Germany and France to achieve the required correction.

In addition to these countries, during the first half of 2004 a number of other countries have been faced with procedures aiming at warning against the risk of an excessive deficit, or at dealing with their situations showing deficits above 3 % of GDP. Below is a presentation of the ongoing procedures concerning the various countries.

Portugal

On 5 November 2002, the Council decided ⁽²⁾ that an excessive deficit exists in Portugal and recommended to bring the situation to an end. As required, two deadlines were set down in this recommendation: (i) a deadline of 31 December 2002 was set for the Portuguese authorities to take measures to correct the excessive deficit position; (ii) a deadline for the correction of the excessive deficit position, which should be completed in the year following its identification; this is understood as being the end of 2003.

The response of the Portuguese authorities began before the Council had decided upon the existence of an excessive deficit position. Eventually, the deficit in 2002 fell to 2.7 % of GDP, an outcome which relied heavily on one-off measures, especially a tax amnesty.

In spite of this result, against the background of slow growth and the termination of one-off measures, Portugal faced a considerable challenge in keeping the nominal deficit below the 3 % of GDP reference value also in 2003.

Indeed, during 2003, the impact of the cyclical downturn in the European economy on Portugal has been sizeable and accentuated by the ongoing adjustment between domestic and foreign demand components. In view of the shrinkage of economic activity, and the revealed high tax elasticities, a massive shortfall in tax revenue developed in 2003, while government expenditure, for its part, grew broadly in line with budgeted targets. Consequently, to avoid breaching the reference value for the deficit of 3 % of GDP, the Portuguese Government resorted to two one-off operations, together worth more than 2 % of GDP. Both operations have been cleared by Eurostat.

The figures reported by the government in March 2004, and validated by Eurostat, showed that, in spite of adverse economic circumstances, the deficit was maintained below 3 % of GDP in 2003. Portugal therefore complied with the terms of the excessive deficit recommendation addressed to it in 2002, namely, to secure a deficit below 3 % of GDP in 2002 and 2003. Accordingly, the Commission recommended on 28 April 2004 to the Council to abrogate the decision on the existence of an excessive deficit position in Portugal. Nevertheless, according to Commission forecasts, the nominal deficit would rebound to 3 % of GDP in 2004 in the absence of further measures. Following the release of the forecasts, the Portuguese authorities made public their intention to carry out additional measures so as to keep the deficit below 3 % in 2004.

On 11 May 2004, the Council abrogated its decision taken in 2002 on the existence of an excessive budget, noting that Portugal had complied with the terms of the recommendation adopted by the Council with a view to bringing that deficit situation to an end. In its decision, the Council noted the efforts made by Portugal to meet the terms it set — the general government deficit stood at 2.8 % of GDP in 2003 and was 2.7 % in 2002, compared with 4.4 % in 2001 — whilst highlighting the need for further vigilance in 2004.

France

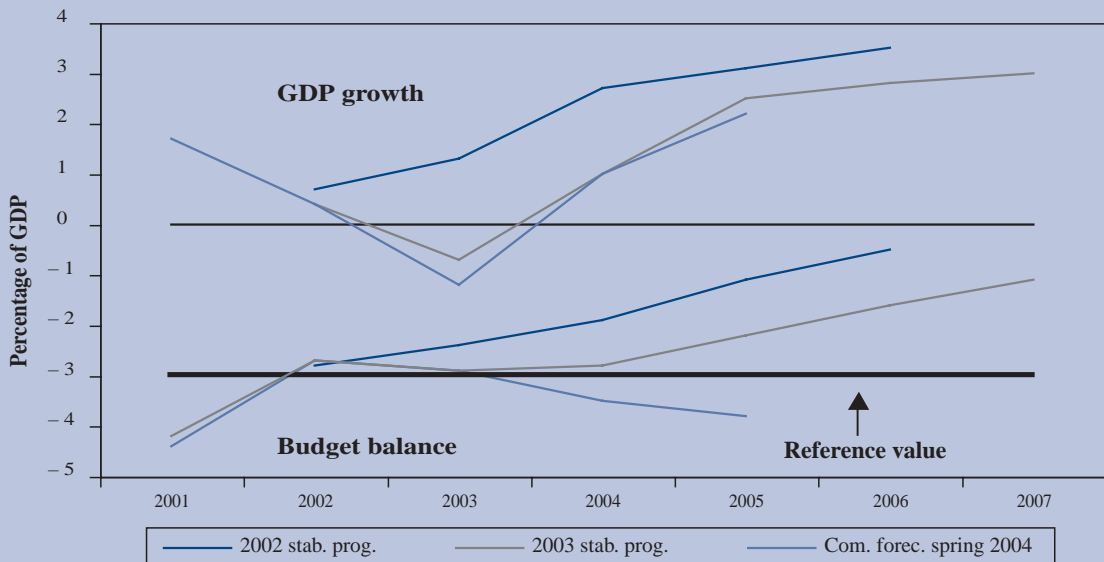
On 21 January 2003, the Council adopted a recommendation giving an early warning to France in order to prevent the occurrence of an excessive deficit in 2003. In the March 2003 reporting of data, however, the French authorities indicated that the deficit was at 3.1 % of GDP already in 2002 ⁽³⁾, above the reference value.

(1) For documents concerning these procedures, see the section on fiscal surveillance on the website of the Economic and Financial Affairs DG: http://europa.eu.int/comm/economy_finance/about/activities/sgp/procedures_en.htm. See also Part II.2 of European Commission (2003a)

(2) Council Decision 2002/923/EC, OJ L 322/30.

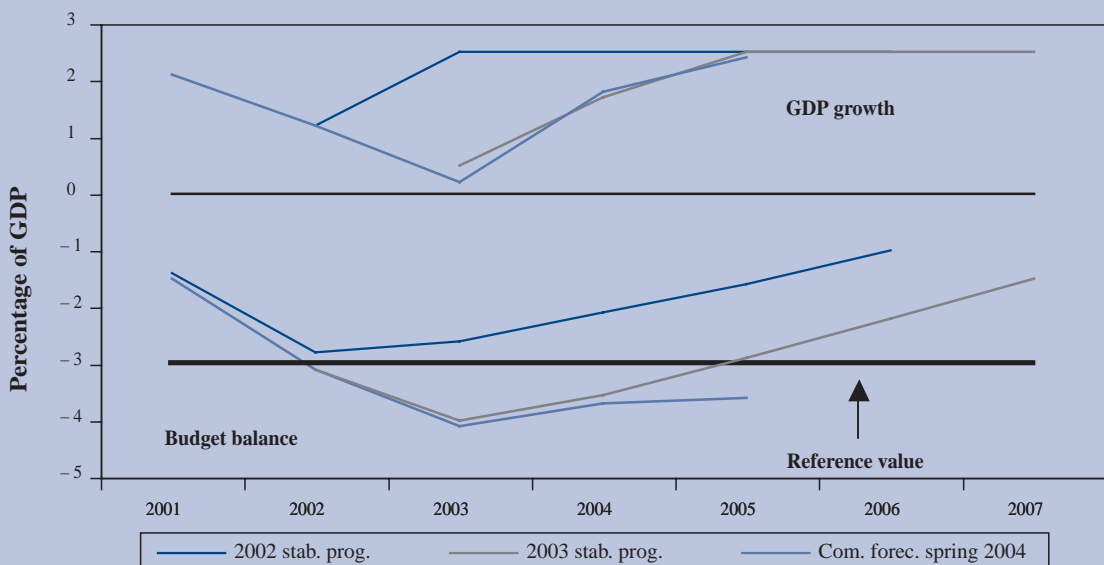
(3) The government deficit for 2002 was revised by Eurostat from 3.0 % of GDP (as notified by the French authorities) to 3.1 % of GDP. See Press Release STAT/03/30 of 17.3.2003.

Graph II.2: Budgetary plans, forecasts and outcomes in Portugal



Source: 2002 and 2003 updates to Portuguese stability programmes and spring 2004 Commission forecasts.

Graph II.3: Budgetary plans, forecasts and outcomes in France



Source: 2002 and 2003 updates to French stability programmes and spring 2004 Commission forecasts.

The overall assessment of the Commission led to the conclusions that although budgetary developments had been adversely affected by continued weakness in economic activity, the excess of the general government deficit over the 3 % of GDP reference value did not result from an unusual event outside the control of the French authorities, nor was it the result of a severe economic downturn. According to Commission calculations, the deterioration in the 2002 budgetary position resulted mainly from a worsening in the cyclically adjusted budgetary position. The breaching of the 3 % of GDP threshold in 2002 was also rooted in the reversal of the budgetary consolidation process which had been taking place since 1999, and was likely not to be temporary. Considering also its forecast for 2003 of a deficit above 3 % of GDP and that the debt ratio would also breach the 60 % of GDP Treaty reference value, the Commission therefore activated the EDP and on 7 May 2003 recommended to the Council to decide on the existence of an excessive deficit in France and to address a recommendation to France to put an end to the present excessive deficit situation as rapidly as possible and by 2004 at the latest.

The Council decided on 3 June 2003 that an excessive deficit existed in France ⁽¹⁾, and recommended the French authorities to put an end to the present excessive deficit situation as rapidly as possible and by 2004 at the latest, establishing the deadline of 3 October 2003 for the French Government to take appropriate measures to this end. The Council also recommended that the French authorities achieve a significantly larger improvement in the cyclically adjusted deficit in 2003 than planned, to limit the increase in the general government debt/GDP ratio in 2003, and to implement measures ensuring that the cyclically adjusted deficit would be reduced in 2004 by 0.5 % of GDP, or by a larger amount, so as to ensure that the cumulative improvement in 2003–04 would be enough to bring the nominal deficit below 3 % in 2004 at the latest.

In response to the Council recommendation, the French authorities took several measures aimed at improving the budgetary results for 2003 ⁽²⁾. However, these measures did not significantly reduce the 2003 cyclically adjusted general government deficit below the level planned by the authorities in June, before the Council addressed its recommendation. In addition, the budgetary plans concerning 2004 were not considered by the Commission sufficient to ensure that the cumulative improvement in the cyclically adjusted balance in 2003–04 would bring

the nominal deficit below 3 % in 2004, as recommended by the Council in June. Indeed, the draft budget projected the general government deficit to decline from 4.0 % of GDP in 2003 to 3.6 % of GDP in 2004. Accordingly, the Commission recommended to the Council to decide that France had taken no effective action in response to the recommendation under Article 104(7).

On this basis, the Commission adopted on 21 October a recommendation for the Council to request France to take new measures to reduce the budget deficit and remedy the situation of excessive deficit, beyond those contained in the draft budget for 2004. On account of a number of elements (see Section 2.3.2), the draft recommendation stipulated that France should:

- achieve in 2004 an improvement in the cyclically adjusted balance of 1 percentage point of GDP ⁽³⁾;
- in 2005, achieve an adjustment in the cyclically adjusted deficit of at least 0.5 percentage points of GDP or by a larger amount so as to ensure that the general government deficit would be brought below 3 % of GDP;
- allocate any higher-than-expected revenue in 2004 to deficit reduction and, should the recovery in economic activity be stronger than expected, the improvement in the underlying budgetary position should be accelerated.

The Commission also included in its recommendation a request for the French authorities to submit a report announcing the measures or reforms to be implemented and the time-horizon for their application, followed by

⁽²⁾ The measures included (i) in September the decision to cancel credits in the State sector worth EUR 1.4 billion (0.1 % of GDP). However, this cancellation was meant to ensure the achievement of the planned expenditure objective in the State sector, and not to secure a better outcome; (ii) in July, the decision to cancel the reimbursement of drugs with 'insufficient medical service'; (iii) in the same month, a decision, taking effect in October, to increase taxes on tobacco; and (iv) on 1 September, a decision to slightly increase social contributions for AGS, 'association pour la gestion du régime d'assurance des créances des salariés' (this is a fund in charge of the payment of wages of workers in companies in bankruptcy). The last three measures were expected to have a marginal impact on the 2003 general government deficit but, for some of them, a larger impact on the 2004 general government deficit was expected. Last but not least, the French authorities successfully implemented an important pension reform which was under discussion at the moment that the Council adopted the recommendation according to Article 104(7).

⁽³⁾ This would have allowed France to catch up in 2004 for the lack of adjustment in 2003 and to set a credible basis for bringing the deficit below 3 % of GDP in 2005. Given its size, and provided that it was of the right composition, the additional adjustment compared to current plans was considered not to be harmful for growth in the short term and, by enhancing the sustainability of public finances, to have favourable effects in the longer run.

⁽¹⁾ Council Decision 2003/487/EC, OJ L 165/29.

four implementation reports over the next two years allowing assessing progress made in correcting the excessive deficit ⁽¹⁾.

As explained in Section 1.1, on 25 November 2003 the Council did not adopt the draft recommendations, but specific Council conclusions on France. Concerning the substance, the conclusions postponed the deadline for bringing the deficit below 3 % of GDP to 2005, as recommended by the Commission, but were less demanding on the adjustment to be done in 2004, only amounting to 0.8 % of GDP. In the light of the recommendations given and the commitments by France to implement all the necessary measures to ensure that the deficit will be below 3 % of GDP in 2005 at the latest, the Council decided to hold the procedure for France in abeyance for the time being and declared that it stood ready to take a decision under Article 104(9), on the basis of the Commission recommendation, should France fail to act in accordance with its commitments. The Council noted that an assessment on the progress made would be based

on a regular reporting by France, in particular in the context of the biannual notifications, and would give due attention to the prevailing economic conditions and to the structural reforms being implemented in France with a view to strengthening growth and ensuring the long-term sustainability of public finances.

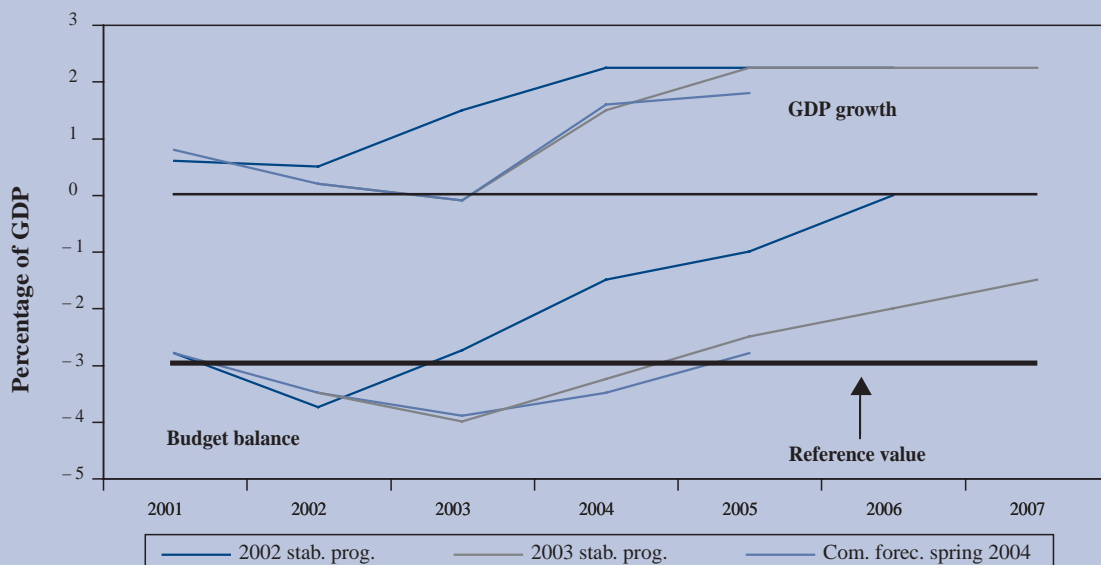
Germany

On 21 January 2003, the Council decided that an excessive deficit existed in Germany ⁽²⁾ and adopted a recommendation with a view to bring the situation to an end. The latter set a deadline of 21 May 2003 to take measures to correct the excessive deficit positions and a deadline for the correction of the excessive deficit position, to be completed in the year following its identification; i.e. the end of 2004. Germany, however, was invited to bring the deficit below 3 % of GDP already in 2003, as planned in the updated stability programme, were the growth conditions projected in the update (GDP growth of 1 %) to materialise. The Council also recommended the German authorities to bring the debt ratio to a halt in 2003 and reverse it thereafter.

⁽¹⁾ France was also invited, when drawing up the measures to be taken in order to comply with these recommendations, to take into account the recommendations issued by the Council in the framework of the 2003–05 broad economic policy guidelines. The need to curb the dynamics of spending in the health sector was explicitly included in the guidelines.

⁽²⁾ Council Decision 2003/89/EC, OJ L 34/16.

Graph II.4: Budgetary plans, forecasts and outcomes in Germany



Source: 2002 and 2003 updates to German stability programmes and spring 2004 Commission forecasts.

Achieving the correction of the excessive deficit situation in 2003 showed very soon to be an unrealistic objective, given the deteriorating growth conditions. It soon proved to be a difficult task also with respect to 2004. In autumn 2003, the Commission forecast showed that the deficit for 2003 would be over 4 % of GDP, implying that, contrary to expectations in spring, neither the nominal nor the cyclically adjusted deficit would be reduced despite the measures taken by Germany ⁽¹⁾. Despite the budgetary consolidation measures taken in 2003, it also appeared that Germany would not be able to comply with the recommendation to bring the deficit below 3 % in 2004. On 18 November 2003 ⁽²⁾, therefore, the Commission adopted two recommendations for the Council in relation to the excessive deficit procedure for Germany. The first, under Article 104(8) established that the action taken by Germany in 2003 was proving inadequate and as a result the excessive deficit would persist also in 2004, in contradiction with what was recommended in January 2003. The second, under Article 104(9), requested Germany to take new measures to reduce the budget deficit, beyond those already planned. On account of a number of elements (see Section 2.3.2), the draft recommendation stipulated that Germany should:

- put an end to the present excessive deficit situation as rapidly as possible and at the latest by 2005;
- achieve in 2004 an annual reduction in the cyclically adjusted balance by 0.8 percentage points of GDP;
- achieve in 2005 a further reduction in the cyclically adjusted deficit by at least 0.5 percentage points of GDP or by a larger amount so as to ensure that the general government deficit is well below 3 % of GDP;
- allocate any higher-than-expected revenue to deficit reduction and, should the recovery in economic activity be stronger than currently expected, accelerate the reduction in the cyclically adjusted deficit.

In addition, and similarly to what had been done for France, the Commission included in its recommendation

a request for the German authorities to submit a report outlining the announced decisions in response to the recommendations, as well as four implementation reports over the next two years, in order to assess progress made by the German Government in correcting the excessive deficit ⁽³⁾.

As said before, the Commission recommendations concerning Germany and France were discussed and voted at the same meeting. Concerning the substance, also in the case of Germany the Council conclusions postponed the deadline for bringing the deficit below 3 % of GDP to 2005, and required a smaller adjustment to be done in 2004 (0.6 % of GDP) than what was indicated by the Commission. Similarly to France, the Council decided not to act in the light of the recommendations and the public commitment by Germany to implement all the necessary measures to ensure that the deficit will be below 3 % of GDP in 2005 at the latest, and agreed to hold the procedure for Germany in abeyance for the time being. The Council declared that it stood ready to take a decision under Article 104(9), on the basis of the Commission recommendation, should Germany fail to act in accordance with its commitments. The regular reporting by Germany, in particular in the context of the biannual notifications would provide the basis for assessing the progress achieved. This assessment, as for France, would give due attention to the prevailing economic conditions and to the structural reforms being implemented in Germany with a view to strengthening growth and ensuring the long-term sustainability of public finances.

Netherlands

On 28 April 2004 the Commission initiated the excessive deficit procedure for the Netherlands with the adoption of the report foreseen in Article 104(3) of the Treaty. According to the latest Commission forecasts, that took into consideration data reported by the Dutch authorities on 31 March 2004, the general government deficit in 2003 reached 3.2 % of GDP in 2003, thus exceeding the 3 % of GDP Treaty reference value, and increased substantially relative to the 2002 deficit (1.9 % of GDP).

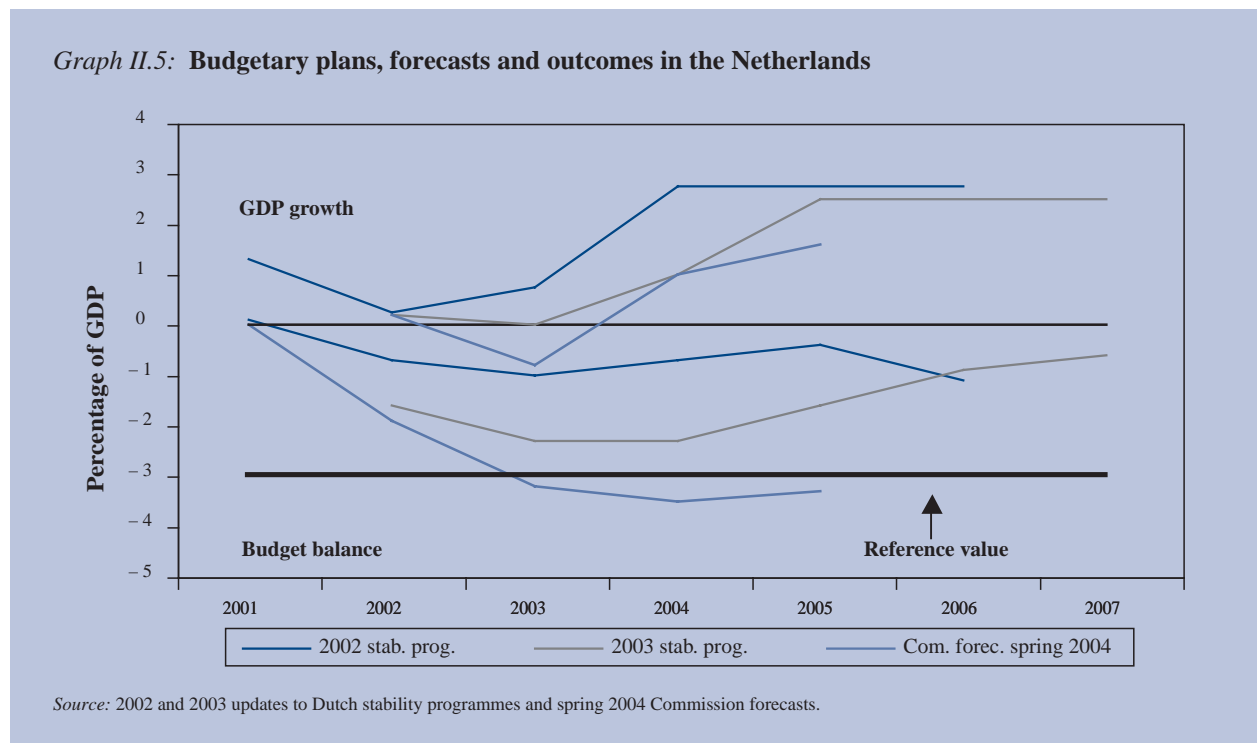
⁽¹⁾ The forecast also confirmed the German authorities' publicly expressed view that the general government deficit was likely to exceed 3 % of GDP also in 2004.

⁽²⁾ See 'Commission proceeds with excessive deficit procedure for Germany', Press Release IP/03/1560.

⁽³⁾ Germany was also invited, when drawing up the measures to be taken in order to comply with the recommendations, to take into account the recommendations issued by the Council in the framework of the 2003–05 broad economic policy guidelines. The latter highlighted the need for structural reforms as the main solution to the growth under-performance of the German economy.

The Commission came to the conclusion that the deficit in 2003 was not the outcome of an unusual event outside the control of the Dutch authorities, nor was it the result of a severe economic downturn, which is defined in the Pact as an annual fall of real GDP of at least 2 %. However, it occurred in a context of strongly negative growth, with real

GDP growth at -0.7 % in 2003, and a negative output gap of around 2 % of GDP emerging. This largely explains the deterioration in the general government balance, which was further aggravated by a greater-than-expected weakening in receipts and higher-than-expected local government deficits while expenditure targets were largely met.



On 16 April 2004, just after the release of the Commission's spring forecasts, the Dutch authorities announced further measures amounting to savings of 0.6 percentage points of GDP, intended to keep the deficit below 3 % of GDP. However, the attainment of this objective depends on the measures yielding the expected results and on not having second round effects. Hence, there is a likelihood that the deficit may exceed 3 % of GDP also in 2004.

On the above considerations on 19 May the Commission adopted an opinion and recommended to the Council to decide on the existence of an excessive deficit in the Netherlands and to make recommendations to the Dutch authorities with a view to bringing this situation to an end. According to the Commission, the Dutch Government should take action regarding corrective measures mainly of a structural nature and amounting to about half a percentage point of GDP. The Commission also invited the Council to urge the Netherlands to ensure that budg-

etary consolidation towards a position close to balance or in surplus is sustained after the excessive deficit has been corrected. To that effect the Dutch authorities should ensure a reduction in the cyclically adjusted deficit by at least 0.5 percentage points of GDP per year.

Greece

On 19 May 2004, following a second revision of fiscal data notified by the Greek authorities concerning the outcome for 2003, which showed a deficit above 3 % of GDP, the Commission adopted a report on the existence of an excessive deficit in Greece.

After an original notification of data at the beginning of March 2004, a revision made by the Greek authorities indicated that the general government deficit in Greece had reached 3.0 % of GDP. However, such figures were not validated by Eurostat. At the beginning of May, fol-

lowing a Eurostat fact-finding mission to Athens, the Greek authorities submitted a new notification, which showed a deficit at 3.2 % of GDP for 2003. Moreover strong indications emerged that there will be significant further, and as regards deficits almost certainly upward, revisions for 2003 and earlier years, when a new notification is made in September 2004.

The deterioration in the general government balance in 2003 from a year earlier was the result of a sharp worsening in the balance of the central government, in spite of a buoyant economy. The general government deficit of 2003 compares with a target deficit of 0.9 % of GDP set in the December 2002 updated stability programme. The significant slippage is attributable, first, to extraordinary factors (expenditure overruns related to the preparation of the Olympic Games and compensation for weather damages), secondly, to higher than planned primary spending (social transfers and public sector wages) and finally to a shortfall of budgetary revenues (VAT and income taxes).

Table II.1

Successive targets for the 2003 general government balance and estimated outcome in Greece

	Real GDP growth (%)	General government balance (% of GDP)
November 2002: draft budget for 2003	3.8	– 0.9
December 2002: 2002 USP ⁽¹⁾	3.8	– 0.9
December 2003: 2003 USP ⁽¹⁾	4.0	– 1.4
April 2004: Commission spring forecasts	4.2	– 3.0
May 2004: Second revised EDP notification		– 3.2

⁽¹⁾ Updated stability programme.

Source: Commission services.

Given the positive and widening output gap in 2003, the sharp rise in the cyclically adjusted deficit from 1.7 % of GDP in 2002 to 3.9 % of GDP in 2003 indicates a pro-cyclical, expansionary fiscal stance. According to the Commission's spring forecasts, based on announced policies, the general government deficit would remain above the 3 % reference value in 2004. Moreover, the

high level of government debt and the slow pace of debt reduction are a cause for concern. The gross government debt is estimated to decline only slightly to 102.8 % of GDP in 2004 from 103.0 % of GDP in 2003, thus remaining widely in excess of the 60 % of GDP Treaty reference value.

Following the Commission report, the adoption of a Commission opinion and of the Council decision on the existence of an excessive deficit and of recommendations to bring this situation to an end are expected before the summer recess.

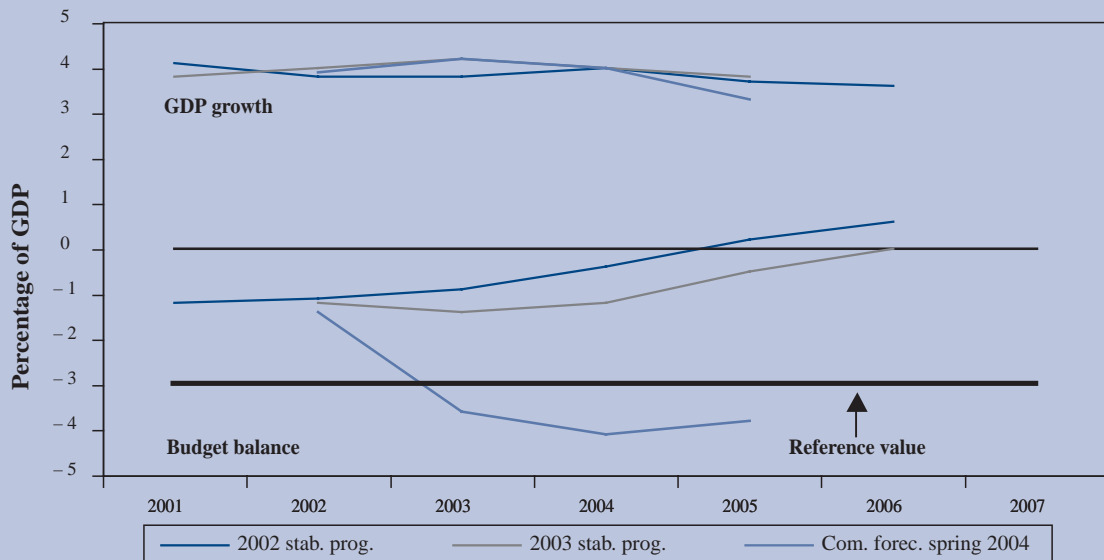
2.3.1. Other procedures

The results of the Commission's spring 2004 forecasts also called for the activation of budgetary surveillance instruments to deal with the occurrence of an excessive deficit or the risk of it in the United Kingdom and Italy.

The **United Kingdom** recorded a general government deficit above 3 % of GDP in the 2003 calendar year and is forecast to record a deficit above 3 % of GDP for the 2003–04 financial year (which is the basis for budgetary surveillance for the UK under the Treaty). On 28 April 2004, the Commission therefore adopted a report on the budgetary situation of the UK under Article 104(3) of the Treaty. The excess over the 3 % of GDP reference value in 2003 did not result from an unusual event outside the control of the United Kingdom authorities, nor from a severe economic downturn in the sense of the Treaty and the Stability and Growth Pact. However, the Commission's spring 2004 forecast projects the UK deficit to return to below the reference value in 2004 and 2005. Hence, the excess over the reference value is likely to be small and temporary, which gave margins to conclude that an excessive deficit would not exist in the sense of the Treaty. The Economic and Financial Committee prepared an opinion on the Commission report confirming the Commission analysis.

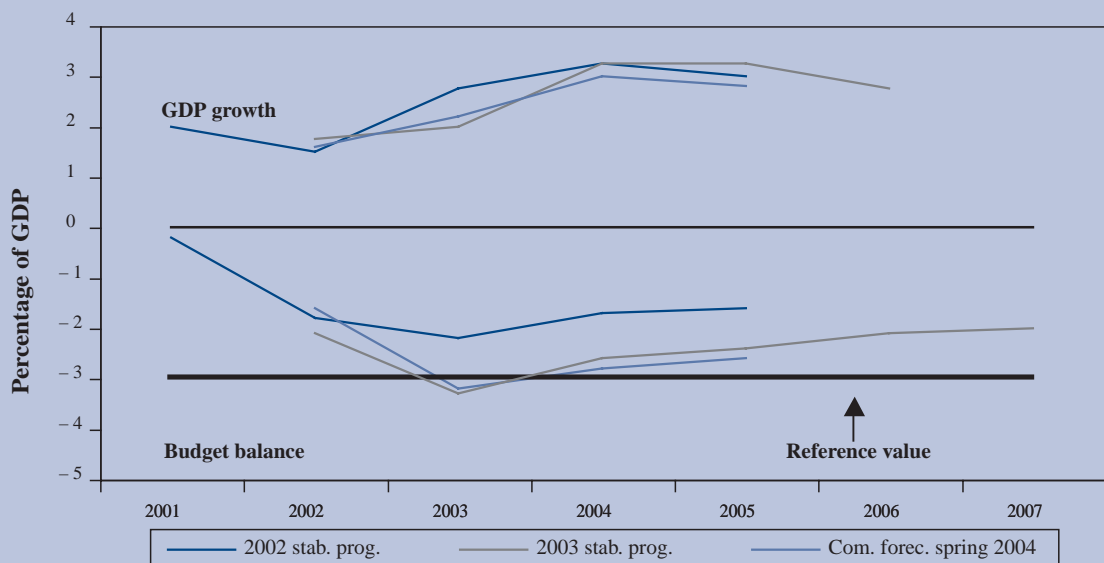
On 28 April 2004, the Commission recommended to the Council that an early warning be issued to Italy to prevent the occurrence of an excessive deficit. Public finance developments in **Italy** have shown a significant divergence from the objectives set in successive stability programmes. The Commission forecasts for 2004 a budget deficit of 3.2 % of GDP compared to a target of 2.2 % of GDP in the 2003 update of the programme and of 0.6 % of GDP in the 2002 update. The divergence from the objectives is almost entirely structural. The cyclically adjusted budget deficit is expected to deteriorate

Graph II.6: Budgetary plans, forecasts and outcomes in Greece



Source: 2002 and 2003 updates to Greek stability programmes and spring 2004 Commission forecasts.

Graph II.7: Budgetary plans, forecasts and outcomes in the United Kingdom



Source: 2002 and 2003 updates to British stability programmes and spring 2004 Commission forecasts.

rate by 0.7 % of GDP in 2004 according to Commission forecasts. The budgetary plans of Italy have been recurrently based on over-optimistic growth assumptions, especially as regards the medium-term growth outlook. The projected interruption of the reduction of the debt, which at 106 % of GDP is the highest in the euro area, is a further source of concern. Without extraordinary operations the debt ratio would have barely decreased in Italy since 2001.

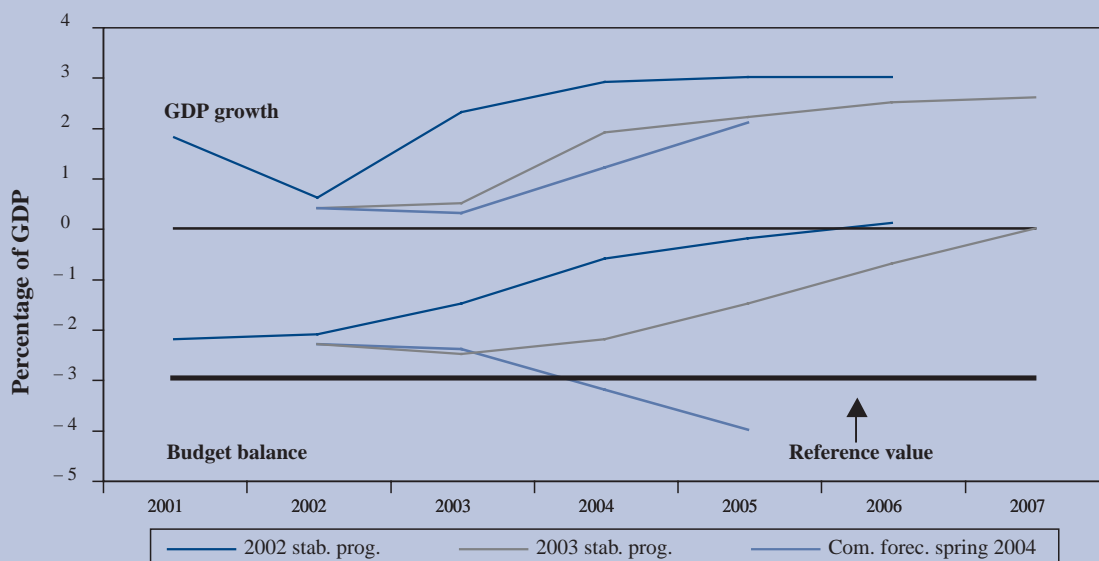
In view of the above, the Commission proposed to the Council to recommend the Italian authorities to take additional measures to ensure that the general government deficit does not breach the 3 % of GDP reference value. A well-devised within-year adjustment, which could give rise to a positive confidence effect, would be centred on a sizeable reduction and re-composition of expenditure, creating room for the intended lowering of the tax burden, and on an acceleration in the reduction of the debt/GDP ratio, which together would enhance potential growth in the long run. Therefore, the Commission considered it appropriate for Italy to implement additional measures of a permanent nature of at least EUR 7 billion (0.5 % of GDP) in 2004 which, based on the Commission's spring 2004 forecast, would stem the deterioration of the cyclically adjusted balance in 2004

and would provide a sufficient margin for bringing the budget below the 3 % of GDP reference value.

At its meeting of 11 May 2004, the Council took note of the Commission recommendation for the Council to issue an early warning. It also took note of the Italian minister's commitment to ensure that Italy's deficit does not exceed 3 % in 2004. It reached a broad consensus in favour of postponing further consideration of this issue until its meeting on 5 July, so as to be able to examine the measures to be announced by the Italian Government.

Following the Council meeting, the Commission took note that the Council had not been able to reach a decision on the recommendation for an early warning to be addressed to Italy. In the view of the Commission the case for an early warning was fully established. The Commission noted that its early-warning initiative already resulted in measures being planned by the Italian Government to cut public expenditure with effect on the current year. However, the final size, their specific impact and the time of their implementation remained undisclosed. The Commission stated that it will continue to monitor the budgetary situation in Italy and will assess measures when they are adopted.

Graph II.8: Budgetary plans, forecasts and outcomes in Italy



Source: 2002 and 2003 updates to Italian stability programmes and spring 2004 Commission forecasts.

2.3.2. Lessons drawn

It is possible to summarise some of the major lessons that can be drawn from the experiences with the EDP in Stage III of EMU.

While monitoring compliance with the Treaty must focus on the respect of nominal budgetary aggregates, the importance of considerations concerning economic developments has increased in the implementation of the EU fiscal framework. In the cases of Portugal, Germany and France the countries faced more difficult economic circumstances than expected when the recommendations were addressed. After the first recommendation issued to Portugal, where no particular reference was made to growth, in the case of the first recommendation to Germany and subsequently of the recommendations prepared last autumn concerning both Germany and France, the budgetary adjustment required has been determined considering past and expected growth. This reflects a prudent and non-mechanical approach: even if budgetary consolidation is not necessarily harmful for growth, it could not be excluded that a too large effort could prove economically costly if undertaken in a single year, in particular given the downward revision in growth prospects.

The assessment of compliance with the recommendations presents a number of difficulties which were not foreseen. Difficulties were encountered in assessing *ex ante* the budgetary impact of the measures taken in response to the Council recommendations. Furthermore, difficulties have materialised in measuring the fiscal effort of EDP countries via changes in cyclically adjusted budget balances between the moment in which the recommendations are addressed and the moment of assessment of compliance. In this respect, an important issue is that of disentangling changes in the CAB due to discretionary budgetary measures and changes associated with modified growth conditions (this latter point is analysed in detail in Section 3.3).

The recent experience with the EDP has shown that attention should be given not only to the size of budgetary adjustment but also to its 'quality'. The case of Portugal illustrates that an excessive reliance on one-off measures for ensuring the correction of the excessive deficit may simply result in postponement of the moment in which permanent measures have to be taken to avoid excessive deficits. The Commission recommendations have generally taken into account the aspect of the quality of the budgetary adjustment, by requiring that

the consolidation measures should secure a lasting improvement in budget balances and that should be geared towards a reinforcement of the growth potential consistent with the BEPGs.

The new steps undertaken in the excessive deficit procedures of the Treaty complemented by the SGP have proven to be quite complex, not always well defined in the legal text, and sometimes difficult to comply with in terms of deadlines. Reflecting this complexity, different interpretations between the Commission and the Council led to undue tensions in the application of the provisions. In addition, the deadlines which the SGP requires concerning the measures to be taken by a country have proved to be quite unrealistic in particular when compared with the usual delays in the national budgetary processes. In sum, it appears that in some cases there is an over-specification of the rules which may usefully be corrected.

Given the relative novelty of the SGP framework, there is room to improve the current practice in the EDP implementation. The emergence of new elements to take into account for a satisfactory implementation of the EDP, as well as unforeseen difficulties in budgetary surveillance and with the application of the rules, raises the necessity of an adaptation of the practice followed by the Commission and the Council within the EDP framework. To be successful the adaptation requires an active dialogue between the Commission and the Council to identify timely the issues at stake and define common ways to tackle them.

The implementation of the EDP has proven more controversial than expected. Part of the problem could be attributed to difficulties in communication. In this sense, a lesson to be drawn is that an over-dramatisation could be counter-productive. Conversely, an effort towards focusing the debate over factual issues and towards increased clarity and transparency may help to limit the risk of misunderstandings.

2.4. The application of the excessive deficit procedure to the 10 new Member States

2.4.1. Introduction

The EU budgetary surveillance framework will apply to the new Member States immediately after accession. This includes, where relevant, the activation of the excessive deficit procedure.

Box II.2: The timing and pecuniary cost of sanctions

The intense debate about the economic and procedural aspects of the SGP seems based on a widespread assumption that imposing a sanction on a Member State in the context of the excessive deficit procedure (EDP) would exacerbate the problems faced by the country concerned, in particular, on the one hand by leading to an increase in the deficit due to the payment of the sanction, and on the other hand, by leading to an additional tightening stance of fiscal policy, which could be unwarranted if the excessive deficit is induced, at least in part, by an economic slowdown. This assumption seems to a large extent unjustified. On the latter aspect, i.e. on the effect of the fiscal stance on the economy, doubts exist whether such additional tightening would weigh negatively on growth (see, for example, Part IV of last year's report). In addition, both elements linked to the timing and real costs of the sanctions suggest that the assumption that the sanction makes the budgetary adjustment more difficult is too strong.

Graph II.1 already explained that the possibility of moving to sanctions is foreseen only in case of a severe lack of cooperation by a Member State, which does not comply with successive recommendations by the Council, or when the actual results for the deficit show that it has not been brought below 3 % of GDP within the deadline set by the Council. Given the framework of the Treaty, and the timetable envisaged by the SGP, under the assumption that a country makes its best to comply with the recommendations but does not manage to deliver a deficit below 3 % of GDP within the set deadline, the imposition of the first form of sanction, i.e. a deposit, is unlikely to be applied before two years after the first year in which the deficit was above 3 % (hereafter 'year t'). However, if the country has been complying with the recommendation under Article 104(7) until that moment, at that stage the Council will only send a notice to the Member State to require further adjustment without imposing any sanction. At the same time, the Council will be assigning an additional year for the correction, as a new 'actual' result must be available, before any decision to abrogate the excessive deficit procedure, or moving to sanctions on the basis of insufficient results. In that case of full 'cooperation by the government' but inability to deliver the result, the deposit would likely only be required three years after 'year t'. If it is assumed that in 'year t' the excessive deficit was partly due to an economic slowdown, it seems likely that in 'year t+3' the economic circumstances will have changed with respect to the 'year t' (from historical evidence, there is a high probability that growth comes back to potential within two or three years of a slowdown).

In addition to the fact that such timing makes any sanction unlikely to exacerbate economic circumstances, another element should be taken into consideration, i.e. that the SGP foresees that the Council should use in the first place the form of a deposit with the Community (Article 11 of CR 1467/97) among the various forms of sanctions listed in Article 104(11) of the Treaty. The amount of such deposit, to be made when a country breaches the deficit criterion, is specified in Article 12 of CR 1467/97: 'the amount of the first deposit shall comprise a fixed component equal to 0.2 % of GDP, and a variable component equal to one 10th of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 % of GDP'. The Council may decide in following years to impose an additional deposit, calculated only on the basis of the variable component expressed above. Any single deposit shall not exceed the upper limit of 0.5 % of GDP.

Given the way the deposit is formulated, the real cost of imposing a sanction in the form of the deposit takes the forms of having to pay the (opportunity) costs of foregone interest on the non-interest-bearing deposit. Given that the deposit should be made only for a limited time, the country could borrow the necessary fund at the short end of the market.

Table II.2 shows that even if Member States in excessive deficit were required to deposit the maximum amount foreseen by the regulation (which would imply deficits at or over 5 % of GDP) the real cost of the deposit in terms of GDP would be very limited: under an interest rate assumption (e.g. at 4 %), it would be equivalent to at most 0.02 % of GDP.

Table II.2

Cost in % of GDP implied by imposing a deposit as a sanction under the EDP

Deposit in % of GDP

Interest rate	0.2	0.25	0.3	0.35	0.4	0.45	0.5
2.0	0.0040	0.0050	0.0060	0.0070	0.0080	0.0090	0.0100
2.5	0.0050	0.0063	0.0075	0.0088	0.0100	0.0113	0.0125
3.0	0.0060	0.0075	0.0090	0.0105	0.0120	0.0135	0.0150
3.5	0.0070	0.0088	0.0105	0.0123	0.0140	0.0158	0.0175
4.0	0.0080	0.0100	0.0120	0.0140	0.0160	0.0180	0.0200

(Continued on the next page)

Box II.2 (continued)

Using assumptions which are closer to current circumstances, i.e. deficit remains below 4 % of GDP and the interest rate paid to raise the funds would be between 2 and 3 % (based on the assumption that countries would issue two-to-four-year bonds to finance the deposit), shows that the costs are likely to be much smaller, i.e. in the range of 0.004 to 0.009 % of GDP. Such an amount, which is almost of a purely reputation nature, seems too small to affect significantly any adjustment in the budget to correct the excessive deficit.

The EDP will be applied to the new Member States by taking into account their status as Member States with a derogation. Compliance with the budgetary objectives will be closely monitored and encouraged through the peer pressure instruments foreseen by the Treaty and the Stability and Growth Pact (SGP), although the sanctions part of the excessive deficit procedure will not apply.

At a High Level Meeting regrouping all Member States, including those entering the EU in 2004, the framework was set on how to integrate the acceding countries into the EU budgetary surveillance framework. The purpose of this section is to clarify how this will be done.

2.4.2. The Athens conclusions

At the High Level Meeting in Athens on 28 May 2003, the following conclusions were agreed with respect to the excessive deficit procedure and the assessment of the convergence programmes.

- The acceding countries agree to observe from 2004 onwards the reporting deadlines (before 1 March and before 1 September) on the bi-annual fiscal notifications of budgetary data. This early submission will allow the Commission to initiate the excessive deficit procedure, where necessary, in May/June 2004.
- The new Member States are invited to submit their first convergence programmes by 15 May 2004, which could be an update of the pre-accession economic programme submitted in August 2003.
- In line with the code of conduct ⁽¹⁾, the new Member States should submit their updates of the convergence programmes shortly after national govern-

⁽¹⁾ Revised opinion of the Economic and Financial Committee on the content and format of stability and convergence programmes, endorsed by the Ecofin Council on 10.7.2001, see Chapter VII.1 of European Commission (2002a).

ments have presented their budget proposals to national parliaments, but not earlier than mid-October and not later than 1 December 2004.

- The code of conduct shall be observed from accession by the new Member States. They are invited to pay more systematic attention to the impact of structural reforms on the medium-term economic scenario and on budgetary implications of structural reforms. Whenever possible, they should provide information on cyclically adjusted budgetary positions. They are also invited to more systematically include information on the long-term sustainability of public finance.

2.4.3. Implications of the status of 'Member State with a derogation' for budgetary surveillance

The new Member States will enter the EU with the status of Member State with a derogation ⁽²⁾. The new Member States will be subject to legislative provisions regarding the EU budgetary surveillance. These stem in particular from Article 99 and/or Article 104 of the Treaty, supplemented by the SGP ⁽³⁾.

The derogation does not exempt the new Member States from the obligation to avoid excessive deficits, which applies to all Member States since the start of the third phase of EMU on 1 January 1999 ⁽⁴⁾. The derogation implies that Article 104 does not apply in its entirety to the new Member States. In particular, according to Article 122(3) of the Treaty, Member States with a derogation, when in a situation of an excessive deficit and fail-

⁽²⁾ Article 4 of the Act concerning the conditions of accession of the 10 new Member States and the adjustments to the Treaties on which the European Union is founded specifies that 'Each of the new Member States shall participate in economic and monetary union from the date of accession as a Member State with a derogation within the meaning of Article 122 of the EC Treaty'.

⁽³⁾ Council Regulations (EC) No 1466/97 and No 1467/97, which together constitute the Stability and Growth Pact.

⁽⁴⁾ Articles 104(1) and 116(3) of the Treaty, with the notable exception of the UK (see protocol on the UK annexed to the Treaty, paragraph 6).

ing to put into practice the Council recommendations under Article 104(7) with a view to bringing that situation to an end, cannot be submitted to the last two steps of the excessive deficit procedure, namely the procedures of Article 104(9) and (11). Therefore, the new Member States cannot be subject to enhanced budgetary surveillance by the Council (Article 104(9)) nor to sanctions (Article 104(11)) ⁽¹⁾.

What are the consequences of this in terms of deadlines and obligations? In case of non-compliance, the overall maximum period of 10 months, from the reporting date of the figures indicating the existence of an excessive deficit until the decision to impose sanctions, evidently does not apply to Member States with a derogation, as the latter stage is not foreseen for these countries ⁽²⁾. However, the first steps of the procedure and the relative deadlines apply to all Member States regardless of their status:

- the Commission prepares the report referred to in Article 104(3);
- the EFC formulates an opinion on the report (Article 104(4)) within two weeks of its adoption by the Commission ⁽³⁾;
- the Council decides on the existence of an excessive deficit (Article 104(6)) within three months of the reporting dates established in Article 4(2) and (3) of Regulation (EC) No 3605/93, and, at the same time, makes recommendations to the Member State concerned with a view to correct the excessive deficit (Article 104(7)) ⁽⁴⁾;
- in its recommendations under Article 104(7), the Council establishes a deadline of four months at the most for effective action to be taken by the Member State concerned ⁽⁵⁾. The effective action requested to the Member State will have to be in line with the adjustment path to correct the deficit defined in the recommendation under Article 104(7).

2.4.4. Initiating the excessive deficit procedure for the new Member States

According to the fiscal notifications of 1 March 2004, 6 of the 10 NMS, namely Cyprus, the Czech Republic, Hungary, Malta, Poland and Slovakia, had a general government deficit above the 3 % of GDP Treaty reference value in 2003, while Cyprus and Malta recorded government debt levels above the 60 % of GDP Treaty reference value. Moreover, on the basis of the Commission's spring 2004 forecasts as well as indicated by the national authorities, the deficits are also expected to continue to exceed the 3 % of GDP reference value in all six countries in 2004. In the two countries which exceeded the debt ratio threshold in 2003 (Cyprus and Malta), the debt ratio is on a rising trend and is therefore projected to remain above 60 % of GDP also in 2004.

On the basis of these notifications and the spring 2004 forecasts and in line with the abovementioned provisions of the EU budgetary surveillance framework, the Commission adopted on 12 May 2004 a report on each of the six countries as required by Article 104(3) of the Treaty. The reports found that the excess of the general government deficit over the 3 % of GDP reference value did not result, in the sense of the Stability and Growth Pact, from an unusual event outside the control of the authorities, nor was it the result of a severe economic downturn. Thereafter, the Commission adopted recommendations within the excessive deficit procedure in time for the Ecofin Council of 5 July ⁽⁶⁾.

2.4.5. The deadline for the correction of the excessive deficit and 'special circumstances'

Article 3(4) of Council Regulation (EC) No 1467/97 states that the Council recommendation under Article 104(7) should establish a deadline for the correction of the excessive deficit and that this correction should be 'completed in the year following its identification unless there are special circumstances.' Without special circumstances, the new Member States found to be in a situation of excessive deficit in 2004 would therefore have to complete the correction in 2005, which may not be appropriate from an economic point of view.

It appears possible that the economic and budgetary situation of the new Member States provides arguments for

⁽¹⁾ In addition, Member States with a derogation have no voting right on decisions provided for under the two paragraphs.

⁽²⁾ Consistently, Council Regulation (EC) No 1467/97 only refers to participating Member States for the application of the overall 10 month deadline.

⁽³⁾ Council Regulation (EC) No 1467/97, Article 3(1).

⁽⁴⁾ Council Regulation (EC) No 1467/97, Article 3(3).

⁽⁵⁾ Council Regulation (EC) No 1467/97, Article 3(4).

⁽⁶⁾ For a complete overview of the country-specific budgetary developments see Part I and Part V.

considering special circumstances. Although the identification of such circumstances will have to be done on a case-by-case basis, some relevant features may be common to several new Member States, on which the assessment of the convergence programmes will shed further light.

For example, an element to consider is the initial level of the government deficit, which will affect the length and the size of the implied necessary adjustment. If the initial deficit level is substantially above the reference value, the new Member State could be allowed to undertake the necessary budgetary adjustment in a period appropriately longer than one year. Naturally, it will be necessary to take into account the reasons behind the excessive deficit, past budgetary developments and the convergence programme, to assess whether the government deficit has been and is expected to be on a sustained decreasing path. Moreover, the level of government debt must also be considered.

If 'special circumstances' are present, the Council may give the Member State concerned a longer period to correct the excessive deficit than the year following its identification.

This multi-annual approach would be consistent with the way the EDP was applied after 1994 to today's members of the euro area ⁽¹⁾. Every year a recommendation under Article 104(7) was issued until the country brought the deficit below 3 % of GDP and the EDP was abrogated.

2.4.6. Monitoring compliance with the recommendations under Article 104(7)

If a new Member State is given a multi-annual period for bringing its deficit to below 3 % of GDP, the period granted for the correction of the excessive deficit would be based on its convergence programme. The assessment by the Commission and the Council should help ensure that the adjustment adopted by the Member State is credible and realistic.

This monitoring of the adjustment will involve comparing the adjustment path with the budgetary outcomes reported in the regular fiscal notifications, taking also into consideration the regular updates of the conver-

gence programmes. The monitoring could include the issuance of further Council recommendations under Article 104(7), which appears to be the only means available to exercise pressure or control. Given the impossibility of moving to the next step in the EDP, namely a recommendation under Article 104(9), on account of the derogation, increased pressure on the Member State concerned would be provided by further Council recommendation under Article 104(7).

In addition to Council recommendations, three other channels may act as complementary disciplinary mechanisms. Firstly, the authorities of most of the new Member States have made their intentions known with respect to ERM II participation and subsequent euro adoption. Before adopting the euro, full compliance with the Maastricht convergence criteria must be achieved. Therefore, non-compliance with the adjustment path for fiscal convergence would delay the abrogation of the decision on the existence of an excessive deficit and consequently the adoption of the single currency.

Secondly, market perceptions of the ability and readiness of policy-makers to live up to the commitments required by participation in a system such as ERM II will play an important role in ensuring the sustainability of the mechanism. In this context, compliance with the budgetary adjustment path as regularly assessed by the Council will be an important indication of the credibility of economic policies. Markets may put the exchange rate under pressure if they detect incompatibilities between a commitment to a central rate within ERM II and budgetary developments in the new Member State concerned.

Thirdly, there is the possibility of suspending Cohesion Fund funding for the new Member States. Article 6 of Council Regulation (EC) No 1264/99 amending Council Regulation (EC) No 1164/94 on establishing the Cohesion Fund states that 'no new projects or, in the event of important projects, no new project stages shall be financed by the Fund in a Member State in the event of the Council, acting by a qualified majority on a recommendation from the Commission, finding that the Member State in the application of this regulation has not implemented the programme referred to in Article 2(4) (i.e. the convergence programme) in such a way as to avoid an excessive government deficit'. This decision is abrogated when the Council finds that 'the Member State concerned has taken measures to implement that programme in such a way as to avoid an excessive government deficit'.

⁽¹⁾ The SGP regulations were not in force at that time and thus the deadline for correcting the deficit was not pre-established as is now the case (see footnote 9).

In conclusion, the convergence programmes of the new Member States should therefore set credible and realistic budgetary targets. Failure to meet these targets could lead to a series of damaging repercussions for economic policies of the new Member States and undermine the planned strategy for the adoption of euro.

2.4.7. New Member States not subject to the excessive deficit procedure in 2004

For those new Member States whose actual or planned deficit is not estimated to exceed the reference value at the time of accession, there is no reason for initiating the excessive deficit procedure. Upon accession their budgetary positions become the subject of normal multilateral surveillance as foreseen by the Treaty (Article 99) and Council Regulation (EC) No 1466/97 ('preventive' arm of the Stability and Growth Pact).

Specifically, the required adjustment toward the objective of a budgetary position of close to balance or in surplus will be monitored in the framework of the examination of the convergence programme, which each Member State with a derogation is obliged to submit and regularly update. In their assessment of convergence programmes, the Commission and the Council can be expected to take into account specific conditions bearing upon the defini-

tion of the appropriate adjustment path much in the same vein as special circumstances will be taken into account in defining the appropriate adjustment path for the correction of excessive deficits, as discussed above.

In line with the provisions of the Pact, in the event of a 'significant divergence' from the adjustment path towards the medium-term objective, the Member State concerned should receive a recommendation in accordance with Article 99(4) 'with a view to giving early warning in order to prevent the occurrence of an excessive deficit' (Article 6(2) of Council Regulation (EC) No 1466/97). In assessing the case for recommending to the Council the activation of the early-warning mechanism, the Commission can be expected to be guided by the general criteria identified by past practice, namely, (i) the size of the budgetary slippage, that is, the extent to which the budget position diverges from targets set down in the stability and convergence programmes; (ii) the reason for the budgetary slippage, that is, whether the budgetary slippage reflects a departure of government policy from the programme or the impact of unforeseen developments in the economy; and (iii) the risk of an excessive deficit, that is, in first approximation, the distance between the projected budgetary outcome and the 3 % of GDP nominal benchmark.

3. Improving the analysis of budgetary developments

3.1. Introduction

A number of elements underlie the effort to strengthen the understanding of budgetary policies. In particular, two main issues are developed in this chapter. Firstly, from the statistical information received, it is important to identify the size and implication of measures which, for their nature, have only a temporary impact on the adjustment of public finance, and therefore, may have to be dealt with separately in view of a proper assessment of the soundness of fiscal positions and policies. Secondly, during the last two years, important advancements have been made in the definition of a common methodology to calculate output gaps, and hence cyclically adjusted balances (CABs). At the same time, the fiscal stance (i.e. changes in CABs) has acquired increased policy relevance, to the point that not only compliance with the medium-term targets is assessed on the basis of such an indicator, but also whether the yearly adjustment towards the target is higher than a given minimum (0.5 % of GDP, as set by the Eurogroup in October 2002). The second section of this chapter highlights the implications of using the common CAB indicator.

3.2. Non-cyclical temporary budgetary effects

3.2.1. Introduction

In the assessment of budgetary positions, the issue of identifying the more permanent budgetary trends from the short-term transitory influences has been increasingly recognised. In the budgetary surveillance it is standard procedure to adjust the budget balance with the estimated temporary impact from the cycle by calculating cyclically adjusted balances. However, to better understand budgetary developments and draw the right policy conclusions it is important to take into account the short-term impact of

other temporary budgetary effects, not directly linked to the cycle, such as different one-off measures.

In this light, the November 2002 Commission communication on ‘strengthening economic policy coordination’ proposed that the ‘close to balance or in surplus’ requirement of the SGP is defined in underlying terms throughout the economic cycle, i.e. net of transitory effects and especially the effects of cyclical fluctuations on budgets.

Beyond cyclical fluctuations, the March 2003 European Council recognised the potential importance of looking at additional temporary influences. It concluded that ‘in making an assessment (of the improvement of the cyclically adjusted budgetary position) one-off measures will be considered on their own merits on a case-by-case basis’.

Also, the recent debate on the Stability and Growth Pact has increased the focus on sustainability and improvements in underlying budgetary positions. To this end it is important to understand how changes in the budget in the short term relate to the underlying budget trends in the longer term.

Indeed, in the EU context there are two main concerns related to the analysis of temporary budget effects.

Firstly, in the general surveillance of budgetary developments, changes in the budgetary profile due to temporary effects make the assessment of the budgetary profile more opaque as they blur the picture of the ‘underlying’ budget trend. This is especially relevant when assessing the fiscal stance and the degree of consolidation.

Secondly, it is important to assess the quality of budgetary consolidation measures taken by governments in the context of the EU budgetary framework.

For countries not yet at close-to-balance or in excessive deficit, the broad aim is to consolidate in such a way that the risk of future budgetary problems is reduced. Hence, it

is important to understand the reasons when active use is being made of one-off operations. On the one hand, one-off impacts can be well justified by a rationalisation of national budgetary procedures, implying an initial temporary change in the timing of specific revenues or outlays. It can also be due to an unusual event that is unlikely to reoccur in the future, or, by a sudden economic slowdown. In the latter case, the use of one-off measures allows keeping the deficit under control while at the same time avoiding a pro-cyclical impact when the slowdown reverses.

Therefore, the recourse to one-off measures is not negative per se ⁽¹⁾, but a persistent use of temporary measures can delay structural adjustment and undermine the transparency and credibility of the budgetary developments over the medium term. What definitively should be highlighted is the recourse to one-off measures to respect the EU fiscal rules. This is because one of the main aims of the EU fiscal rules is to reduce the so-called deficit-bias. The respect of the 3 % rule or of the medium-term target of the SGP can be achieved either through structural adjustments or through temporary measures. While these measures improve the short-term budgetary position and help in respecting the EU targets, they do not improve the longer-term underlying position.

In a numerical rule-based framework, the incentives to aim for ‘accounting friendly solutions’ rather than more difficult substantial measures is well recognised. For example, Eichengreen and Wyplosz (1998) or Kopits and Craig (1998) argue that the existence of a numerical rule induces the use of one-off policy measures. Using one-off measures within the EU rules-based framework allows avoiding reputation sanctions (endorsed in the early-warning procedure or in the first steps of the excessive deficit procedure) or pecuniary sanctions, which can ultimately arise if the excessive deficit is not corrected.

Against this background, below follows a discussion on the nature of temporary budgetary effects coupled with some illustrative indications on their quantitative importance across EU Member States over the last few years.

3.2.2. Temporary budgetary influences

The distinction between temporary and permanent budget impact is complex. There is not a clear categorisation which fits with all national budgetary procedures and

practices. One way to classify broadly different transitory budgetary effects would be to focus on their source.

- A first category would be the cyclical budget impact. Tax revenues increase in good times and decrease in bad times. The reverse is true for unemployment-related expenditures. In the EU surveillance, the temporary budgetary impact from the cycle is assessed by estimating the cyclical component and adjusting the budget accordingly (i.e. the CAB, see Section 3.3).
- A second category is transitory budget effects not linked to the cycle and outside the control of the current government. For example, there could be a court decision with an important one-off impact or alternatively the call of a contingent liability agreed in previous years (see Section 4).
- A third category would be transitory budget effects resulting directly from a policy initiative. This would typically be labelled as a ‘one-off measure’. Examples could be tax amnesties or the sale of real estate (this category will be further discussed below).

Transitory elements of the budget can also be classified according to the nature of their impact on the underlying budget position. For example, some budget measures have a ‘clean’ one-off dimension in that they only have an impact on the nominal budget balance the year they occur. Others may be ‘self-reversing’ in that they basically shift revenues or expenditures over time. In this case higher revenues today would come at the expense of lower revenues or higher expenditures tomorrow. On a similar note, the temporary measure can have, or not have, a permanent effect on the government net worth depending ultimately on whether the one-off measure implies a change of the opposite sign on the government asset side (see Milesi-Ferretti and Moriyama, 2004). For example, the sale of real estate improves the budget balance (sale of a real asset) and the government debt (indirectly to the extent the revenues substitute for additional borrowing) but does not change the net debt of government.

In the end, of course, what is regarded as temporary or not depends on the time frame studied. In the long term everything is temporary and in the very short term everything is permanent. A large and specific investment may be regarded as one-off in the very short term but as normal expenditure if seen in the chain of consecutive investment decisions over time. What features are the

⁽¹⁾ See European Commission (2003a) for a debate on the pros and cons of one-off measures.

most relevant depends on the issue at hand and is ultimately a judgement call for the analyst.

Having the considerations above in mind and focusing on the surveillance in the EU budgetary framework, as a general criterion for the purpose of the analysis below, a measure can be considered as temporary if it implies an improvement/deterioration of the budget balance that does not lead to a reliable improvement/deterioration in the intertemporal budgetary position. To make this definition more operational, a possible approach could be to consider as transitory those measures that have a much greater impact on the budget balance in the short term than in the long term. This approach does not look at the impact on the net worth since the focus is on the role of one-off measures in the current EU framework for budgetary surveillance

A temporary effect will be called a 'one-off measure' only if it is based on a policy action such as a law or any other formal act.

Without the ambition of being fully exhaustive or presenting precise definitions, non-cyclical transitory elements that can be explicitly taken into account are:

On the **expenditure** side:

- large individual sales of real assets such as real estate; the revenues temporarily improve the budget while in the longer term costs for rents etc. could go up depending on the nature and use of the building;
- receipts from auctions of publicly owned licenses (as UMTS receipt). In the accounts, the receipts are recorded as negative investment expenditure at the moment the sale takes place;
- 'unusual events' as short-term emergency costs from flooding or earthquake;
- additional expenditures due to specific court rulings;
- temporary legislative changes in the timing of outlays;
- capital injections not recorded as financial transactions.

On the **revenue** side:

- tax amnesties and tax settlement schemes;
- temporary cuts for social contribution in specific categories;

- exceptional tax revenues from State-owned companies;
- lower revenues due to specific court rulings;
- temporary changes in the timing of revenues, which have an impact on the deficit.

3.2.3. One-off measures in EU-15 countries

With the aim to broadly capture the use and budgetary impact of non-cyclical temporary budget effects, Table II.3 shows figures on the budget impact of different classes of government one-off measures (that is, policy measures taken by government with a temporary impact) across EU-15 Member States from 2000 up to 2004. The figures are estimated within the Financial and Economic Affairs DG, and the different measures taken into account correspond to the list of measures presented above. The figures for 2004 refer to the foreseen impact as planned by national governments ⁽¹⁾. Only those measures identified with an impact on the budget balance of around 0.1 % of GDP or more have been considered

On this basis, the main categories of one-off measures recorded during the last five years in EU countries can be grouped as follows (see Table II.3).

- Sales of real assets. They occur in at least three countries: Portugal in 2002 and 2004, Italy for four years in a row (2001–04), and Denmark in 2000. In Portugal and in Italy they represent a large portion of their budgetary strategy. In Portugal, it is expected the deficit will be reduced in 2004 by 0.7 % of GDP, after a contribution of 0.3 % of GDP in 2002. In Italy, sales of real assets count for 0.9 percentage points of GDP in 2002 and a gain of 0.3 % of GDP in 2004 is still expected. It is worth noting that the sales of real assets, while contributing to ameliorate the actual budget balance, do not modify consistently the net worth since the lower debt is accompanied by a lower amount of public assets.
- Sales of licences. This refers largely to UMTS licences sold mainly in 2000 and 2001 by the majority of Member States. They had a relevant impact on the budgetary position, in particular in Germany (2.5 percentage points of GDP in 2000),

⁽¹⁾ Estimates are either official estimates from national authorities (when available) or made by Commission services.

the UK (2.4 percentage points in 2000) and Italy (1.2 % of GDP in 2000). While they ameliorate the budget balance and the net worth, they do not contribute to improve the underlying budget balance.

- Unusual events. They occurred in Greece and Austria (environmental damages) and the UK, where the ‘foot and mouth disease’ cost around 0.3 % of GDP in 2001. Also the cost of the Iraq War could possibly be classified as an unusual event for the UK, which accounts for about 0.1 % of GDP in 2003 and something close to it is expected for 2004. In most cases these events deteriorate the actual budget balance, leaving unchanged the underlying budget balance.
- Tax amnesties and tax settlements. Such schemes can be identified at least in Greece (2004), Ireland (2000–02), Italy (2002–04) and Portugal (2002). They led to additional revenues of about 1 % of GDP in Portugal, allowing it to bring the deficit-to-GDP ratio below 3 % for that year. In Italy, it amounts to around 1.5 % of GDP in 2003 and it is expected to bring benefits also in 2004. It is questionable to what extent these schemes have a more lasting impact. On the one hand, tax revenues may increase as a result of a larger tax basis emerging after the amnesties. On the other hand, it may also be that they lead to lower future tax revenues if expectations are created for future tax amnesties and agents then decide to avoid paying taxes on a regular basis waiting for the next amnesty.

Table II.3

Main categories of one-off measures recorded during the last five years in EU countries

(% of GDP)

	Sale of licences	Sales of real assets	Tax amnesties/ settlements	Unusual events	Others
BE	0.2 (2001)		0.3 (2004)		1.2 (2003) 0.5 (2004)
DK	0.2 (2001)	0.1 (2004)			
DE	2.5 (2000)		0.2 (2004)	- 0.1 (2003) - 0.2 (2004)	- 0.1 (2001) 0.3 (2003)
EL	0.4 (2001)			- 0.3 (2002) - 0.3 (2003) - 0.3 (2004)	
ES	0.1 (2000)		0.3 (2003)		0.1 (2003)
FR	0.1 (2001)				0.1 (2003)
IE	0.2 (2002)		0.2 (2000) 0.2 (2001) 0.2 (2002)		- 0.2 (2001) - 0.3 (2002) 0.1 (2003) - 0.6 (2004)
IT	1.2 (2000)	0.2 (2001) 0.9 (2002) 0.2 (2003) 0.5 (2004)	0.1 (2002) 1.5 (2003) 0.5 (2004)		0.4 (2001) 0.5 (2002) 0.5 (2003) 0.1 (2004)
LU	2.0 (2001)	0.3 (2004)			- 1.5 (2002) - 1.0 (2003) - 0.5 (2004)
NL	0.7 (2000)				- 0.3 (2001)
AT	0.4 (2000)			- 0.2 (2003)	
PT	0.3 (2000)	0.3 (2002) 0.7 (2004)	1.0 (2002)		0.2 (2002) 2.0 (2003)
FI					0.6 (2004)
SE					0.5 (2000)
UK	2.4 (2000)			- 0.3 (2001) - 0.1 (2003)	

Source: Commission services.

In Table II.4 the impact from one-off measures are aggregated for each year to give the overall impact. The first column of the table shows the cyclically adjusted budget balance (CAB), the second column the aggregate impact of one-off measures and the third column gives the structural budget balance (SBB) here defined as the CAB net of the estimated impact of the one-off measures.

The '**structural budget balance**' reported in Table II.4 in some cases gives a different picture of fiscal developments than looking at the CAB only would do. For example, in 2003, in Portugal and Italy the structural deficit would have been close to 4 % of GDP while the cyclically adjusted budget balance is substantially smaller, at 1.8 and 1.9 % of GDP respectively. In Italy in particular, while the CAB improves between 2002 and 2003, the structural balance deteriorates due to the higher recourse to one-off measures during last year. The same holds for Spain: while the CAB improves from a small deficit to a small surplus between 2002 and 2003, the structural budget does not show the same magnitude of improvement.

Overall, it appears that one-off measures are common and with a non-negligible impact. Temporary effects have been identified in all countries during the last five years, although there are important cross-country differences in the magnitude of the temporary effects and their frequency. In some cases it can be argued that measures have been taken with the specific aim directly to keep the deficit below the 3 % deficit ceiling or in line with the close-to-balance medium-term target. However, it should be noted that one-off measures have been taken also in countries with sound budgetary positions signalling that they are also a normal feature in budgetary policy. In addition, in some cases they have also implied a deterioration of the budget balance in the coming years ⁽¹⁾.

This year's assessment of the stability and convergence programmes increased the focus on one-off measures. Both the Commission's technical assessments and the Council opinions on the programmes refer to one-off measures when relevant for budgetary developments. One-off measures are highlighted in the assessments of six countries: Greece, Belgium, Ireland, Austria, Portugal and Italy. In the former three countries the analysis is

⁽¹⁾ This is, for example, the case with Luxembourg where a temporary change in the timing of revenues (an acceleration in the payment of back taxes by private corporations) led to a deterioration of the budget in the years 2002–04.

mainly factual and it allows to better understand budgetary developments by qualifying the cyclically adjusted figures which are used to assess compliance with the medium-term targets.

In particular, temporary measures improved the budget balance in Ireland for 2003 due to the accounting effects from advancing the date of payments of capital gains tax in 2003. Of course, in 2004 the temporary effect will be the same with the opposite sign. In Greece one-off measures deteriorated the budgetary position for 2003, as a consequence of unusual events (bad weather). Also, additional spending linked to the Olympic Games has a budget impact but here the temporary aspects can be discussed as it mainly relates to investment projects ⁽²⁾.

In Belgium the payment by the telecommunication operator Belgacom to the government in relation to future pensions blurs the picture of the underlying position. The receipt improves the nominal budget balance by 1.9 % of GDP in, while at the same time increasing the implicit pension debt linked to future pension payments ⁽³⁾.

In the Austrian case, taking the one-off spending related to the flood disaster in summer 2002 was relevant. Indeed, in the Commission technical assessment for Austria on the December 2002 update of the programme, the cyclically adjusted balance in 2003 was projected to deteriorate by 0.6 percentage points of GDP, fully explained by the effects of the flood disaster. Therefore, in underlying terms, the budget balance was expected to remain unchanged ⁽⁴⁾.

The recourse to one-off measures in Italy and Portugal is of particular concern. In both cases, one-off measures have been used actively to keep the actual deficit to a GDP ratio below the 3 % threshold. As underlined in the Council opinion on Portugal, the Portuguese authorities relied, for a second year running, on sizeable one-off measures, amounting in 2003 to 2 percentage points of GDP. Part of it, (amounting to around 0.7 % of GDP) results form a lump-sum payment to the government by the Post Office. In exchange, the government assumes

⁽²⁾ This will continue also in 2004.

⁽³⁾ Other one-off operations took place with the opposite sign, leading to an overall improvement of the budget by 1.2 % of GDP.

⁽⁴⁾ However, in the December 2003 update a cyclically adjusted deterioration of 0.8 % of GDP was estimated, that is, 0.3 percentage points higher than what was estimated one year earlier. This was the case despite the fact that there has been a downward revision of the flood-related budgetary impact by some 0.3 percentage points of GDP.

Table II.4

The use of one-off measures in EU countries

(% of GDP)

	2000			2001			2002			2003			2004		
	CAB (¹)	One-off (¹)	Structural	CAB	One-off* ²	Structural	CAB	One-off (¹)	Structural	CAB	One-off (¹)	Structural	CAB	One-off (¹)	Structural
BE (³)	-1.3	0.0	-1.3	-0.1	0.2	-0.3	0.1	0.0	0.1	0.7	1.2	-0.5	0.0	0.8	-0.8
DK	0.8	0.0	0.8	1.7	0.2	1.5	1.0	0.0	1.0	2.1	0.0	2.1	2.4	0.1	2.3
DE	0.6	2.5	-1.9	-3.3	-0.1	-3.2	-3.5	0.0	-3.5	-3.2	0.2	-3.4	-3.2	0.0	-3.2
EL	-1.9	0.0	-1.9	-1.7	0.4	-2.2	-1.7	-0.3	-1.4	-3.6	-0.3	-3.3	-2.9	-0.3	-2.6
ES	-1.6	0.1	-1.7	-1.0	0.0	-1.0	-0.2	0.0	-0.2	0.4	0.4	0.0	0.3	0.0	0.3
FR	-2.3	0.0	-2.3	-2.3	0.1	-2.4	-3.7	0.0	-3.8	-3.9	0.1	-4.0	-3.4	0.0	-3.4
IE	2.3	0.2	2.1	-0.6	0.0	-0.6	-1.7	0.1	-1.8	0.1	0.1	0.0	-1.1	-0.6	-0.5
IT	-1.3	1.2	-2.5	-3.2	0.6	-3.8	-2.2	1.5	-3.7	-1.9	2.2	-4.1	-2.5	1.1	-3.6
LU	2.4	0.0	2.3	4.4	2.0	2.4	2.7	-1.5	4.2	1.3	-1.0	2.3	-1.3	-0.2	-1.1
NL	-0.7	0.7	-1.3	-2.0	-0.3	-1.7	-2.6	0.0	-2.6	-2.0	0.0	-2.0	-1.4	0.0	-1.4
AT	-2.1	0.4	-2.5	0.0	0.0	0.0	-0.3	0.0	-0.3	-0.9	-0.2	-0.7	-0.3	0.0	-0.3
PT	-3.7	0.3	-4.0	-5.0	0.0	-5.0	-2.7	1.5	-4.2	-1.8	2.0	-3.8	-2.6	0.7	-3.3
FI	4.3	0.0	4.3	4.1	0.0	4.1	3.7	0.0	3.7	2.3	0.0	2.3	1.8	0.6	1.1
SE	3.0	0.5	2.5	1.9	0.0	1.9	-0.5	0.0	-0.5	0.7	0.0	0.7	0.6	0.0	0.6
UK	3.2	2.4	0.8	0.3	-0.3	0.6	-1.5	0.0	-1.5	-2.9	-0.1	-2.8	-2.5	0.0	-2.5

(¹) A 'minus' indicates a deterioration of the budget while a 'plus' an improvement.
(²) Including one-off proceeds relative to the allocation of mobile phone licences (UMTS).
(³) Including transfers of the Belgacom pension fund (1.9 % of GDP in 2003).

Source: Commission services.

the responsibility for paying pensions to a group of employees. As in the Belgian case, while ameliorating the current budgetary position the increase of pension liabilities will deteriorate future budget balances.

For Italy the Council expressed its concern both in last year and this year's opinions on the recourse to one-off measures. Also the broad economic policy guidelines for the 2003–05 period recommended Italy to substitute one-off measures with more permanent ones. The Commission assessment raises doubts on the possibility of replacing those measures with structural budgetary adjustments as foreseen in the programme, due to the risk of breaching the 3 % threshold in the future years.

In the case of Portugal, this year's use of one-off measures is partly justified by the economic recession, which did not advocate the recourse to structural fiscal consolidation through pro-cyclical policies. The Italian case is rather different since the growth conditions have been similar to the rest of Europe both in 2002 and 2003 and thus the recourse to one-off measures is less justified by the slowdown.

3.2.4. Conclusions

The discussion above shows that temporary measures can have a relevant impact on the budget and that it can be important to take this into account to better assess the implications of changes in the budget balances. It is difficult to clearly define what is temporary or not. It will by nature depend on the situation and the question at hand. However, such definitional obstacles must not prevent the policy analyst from taking them into account when necessary to avoid drawing the wrong policy conclusions. Additional work will be necessary to analyse these issues more closely which could help to develop a reference framework for how to integrate them better in the standard surveillance 'tool box'.

In the context of the EU budgetary rules it has been a worrying tendency for some Member States to implement measures with only a temporary impact on the budget with the direct aim to shift the demanded budgetary adjustment into the future and postpone necessary efforts and in this way circumvent the basic intentions of the budgetary framework. Indeed, this short-term focus is opposite to the philosophy of the EU fiscal rules, where instead the main aim is to favour policies which will ensure sound public finances in the medium and in the long term. It is therefore important to signal and clearly identify such measures in the surveillance pro-

cess. This calls for more transparency of budget measures and a clearer reporting of these measures in the stability and convergence programmes. This would improve the knowledge of the national budgetary strategies and contribute to making sure that the risk of biased policy conclusions by the Council and the Commission when public finances are scrutinised, is limited.

3.3. The use and interpretation of cyclically adjusted balances

3.3.1. Introduction

The use of the CAB in budgetary surveillance has been expanding over time. Currently, the CAB is used: (i) to build indicators of discretionary fiscal policy; (ii) to assess the risk of breaching a specified nominal deficit threshold; (iii) to gauge the effects of fiscal policy on aggregate demand; (iv) to measure the sustainability of fiscal policy.

A comprehensive analysis commissioned by the OECD at the end of the 1980s thoroughly x-rayed the CAB in connection with its several uses ⁽¹⁾. In spite of the conclusion that the CAB is subject to a series of limitations, especially when applied outside its original function, it has remained a major reference for fiscal policy analysis with all major multilateral institutions as well as national authorities. Like any fiscal indicator, the CAB represents a compromise between simplicity and precision, the alternative being a fully-fledged model-based analysis.

The Commission has been using the CAB for the analysis of budgetary developments for a long time; first as an informal tool, and more recently as an official instrument of budgetary surveillance under the Stability and Growth Pact (SGP).

The present chapter reviews the Commission methodology for calculating the CAB and discusses the role of the CAB for budgetary surveillance under the SGP. It also discusses one controversial issue related to the interpretation of CAB figures that have emerged from recent experience, namely the use of the CAB to monitor compliance with budgetary adjustment requirements specified in cyclically adjusted terms under the SGP. The question relates to the observation that changes in the CAB may not exclusively reflect the effect of discretion-

⁽¹⁾ See Blanchard (1990), Gramlich, (1990) and Chouraqui et al. (1990).

ary fiscal policy, since they also stem from higher or lower than expected potential growth. The rules of the SGP are not explicit about whether compliance with the adjustment requirement is to be intended conditional upon *ex ante* forecasts on potential growth or unconditionally. If compliance is to be interpreted conditionally, then the change in CAB should be corrected to take into account the component of the change attributable to actual potential growth different from expected. In the following sections, a methodology to operate such correction is developed and illustrative figures are produced. A comprehensive annex details the main analytical dimensions of the discussion.

3.3.2. The Commission method for estimating the CAB

The Commission method for estimating the CAB is similar to that adopted by other institutions involved in budgetary surveillance. It has evolved over time, reflecting successive analytical developments and agreement among Member States as to what constitutes best practice. One of the first official references of the Commission's approach of estimating the CAB is in the technical annex to a European Commission (1982) publication and discussed in Heller et al. (1986). The approach was improved later on and outlined in a technical note attached to a European Commission (1995) publication.

The CAB in any given period t is obtained by subtracting the cyclical component c_t from the actual budget balance/GDP ratio, b_t :

$$(1) \quad CAB_t = b_t - c_t = \frac{B_t}{Y_t} - \varepsilon \cdot \frac{Y_t^R - Y_t^{RP}}{Y_t^{RP}}$$

where B_t is the nominal balance and Y_t is nominal GDP. The cyclical component c_t involves two items, firstly, a measure of the link between the budget and the cyclical position of the economy. This measure, denoted by ε , is referred to as a 'budgetary sensitivity' parameter. It measures the level change in the budget associated with a level change in GDP. The second item is a measure of the cyclical position of the economy, the output gap, defined as the percentage difference between actual Y_t^R and potential Y_t^{RP} , both expressed in real terms. A more detailed discussion of expression (1) is in Annex II.1.

As for the budgetary sensitivity ε , it is derived from budgetary elasticities measuring the percentage change in budgetary items associated with a percentage change

in GDP. The elasticities used by the Commission services have been estimated by the OECD ⁽¹⁾.

Concerning the calculation of the output gap, the Commission has recently moved from the purely statistical Hodrick-Prescott filter to a more structural approach, based on a production function model. The new method was developed by the EPC output gap working group (set up in 1999) and adopted by the Ecofin Council of 12 July 2002 ⁽²⁾. A detailed description of the Commission's production function methodology is in Denis, McMorrow and Roeger (2002).

3.3.3. Use of CAB within the framework of the Stability and Growth Pact

The Commission services have been applying the CAB as an instrument for the analysis of budgetary situations for a long time. Initially used as an informal tool, the CAB has been gradually integrated in the official process of budgetary surveillance under the SGP. In 1998 the code of conduct on the 'content and format of stability and convergence programmes' endorsed 'the Commission's services cyclical adjustment method as a useful approach for assessing budgetary developments' ⁽³⁾. The role of the CAB was reiterated in the revised code of conduct in 2001 ⁽⁴⁾. The definitive 'investiture' as a key instrument of budgetary surveillance under the SGP occurred in March 2003, when the Ecofin Council adopted conclusions based on the recommendations contained in the November 2002 Commission communica-

⁽¹⁾ The budget sensitivity ε is given by the difference between the sensitivities of revenues ε_R and of expenditures ε_G : $\varepsilon = \varepsilon_R - \varepsilon_G$. The sensitivities of revenues and expenditures are given in turn as the product of the corresponding elasticities times the share of public revenues and expenditures in GDP:

$$\varepsilon_R = \eta_R \frac{R}{Y}, \varepsilon_G = \eta_G \frac{G}{Y}$$

where η_R and η_G denote, respectively, the elasticities of revenues (R) and expenditures (G) with respect to output produced by the OECD i.e.

$$\eta_R = \frac{\partial R/R}{\partial Y/Y}, \eta_G = \frac{\partial G/G}{\partial Y/Y}$$

The OECD method for estimating η_R and η_G is described in van den Noord (2000) and OECD (2001).

⁽²⁾ Spain, Germany and Austria were granted derogation due to problems related to the quality of data. For these three countries the reference method for calculating potential output was the Hodrick-Prescott filter. Based on further work carried out by the EPC output gap working group and following the draft Council conclusion of 15 March 2004 the production function method will be used as a reference method for Germany and Austria, while in the case of Spain the production function and the Hodrick-Prescott filter will be used in parallel.

⁽³⁾ MC/II/482/98-final of 16 September 1998, endorsed by the Council in October 1998.

⁽⁴⁾ EFC/ECFIN/404/01 — REV1 of June 2001, endorsed by the Council in September 2001.

tion 'Strengthening the coordination of budgetary policies' advocating that the achievement and the progress towards budgetary positions of 'close-to-balance or in-surplus' (CTB) should be assessed in cyclically adjusted terms ⁽¹⁾.

Under current practice within the SGP framework the CAB is used for several purposes, which are discussed in the following paragraphs.

3.3.4. Assessing compliance with the CTB position

The SGP requires Member States to reach and sustain a CTB position which, according to the Council decision of 7 March 2003, is to be assessed in cyclically adjusted terms. The monitoring of the CTB requirement is formally made by the Commission services on the occasion of the assessment of the Member States' stability and convergence programmes followed by an additional review around mid-year taking into account developments observed since the presentation of the convergence and stability programme (see, for instance, 'Budgetary developments in 2003 and prospects for 2004', note to the EFC, ECFIN/279/03). A further appraisal of the budgetary situation is also done in occasion of the Commission's bi-annual forecast exercise.

In the light of the measurement uncertainties involved with the estimation of potential output and the budgetary elasticities, CAB figures are generally interpreted with a sufficient margin of flexibility. As outlined by the European Commission (2001a), a margin of 0.5 % of GDP below balance can be allowed for when assessing compliance with the CTB requirement. Consequently, a CAB estimate showing a deficit of 0.5 % is generally taken to be consistent with the CTB requirement.

A further complication in assessing compliance with the CTB requirement by means of the CAB stems from temporary budgetary components unrelated to the cycle, notably the so-called one-off measures. If not factored-out from the CAB, such components tend to conceal the 'true' underlying budgetary position. The problem does not involve the CAB per se; it is rather the lack of a generally valid definition of what constitutes a one-off measure. While the issue was addressed by the Council decision of 7 March 2003 asking for a case-by-case assessment, more could be done to achieve a more gen-

eral and comprehensive approach especially in view of the increasing recourse to one-off measures.

3.3.5. Gauging the risk of breaching the 3 % Maastricht deficit threshold

In connection with the preventive arm of the SGP, an early warning is given if the Council identifies a significant divergence of the budgetary position from the medium-term objective or the adjustment path towards it ⁽²⁾. Although the SGP does not define the conditions under which an early warning should be launched, the Commission has been applying the following three criteria: (i) the size of the budgetary slippage with respect to the targets set out in stability or convergence programmes; (ii) the reason for the budgetary slippage, (iii) the risk of breaching the 3 % deficit threshold.

The second and the third criteria involve the CAB. As regards the reason for the budgetary slippage the key question is whether it mainly ensues from the working of automatic stabilisers or alternatively, whether it is due to a change in the underlying budgetary position as measured by the CAB. Concerning the risk of breaching the 3 % deficit threshold, the assessment generally includes the comparison of the estimated CAB level with the so-called minimal benchmark ⁽³⁾.

Overall, the experience so far shows that the CAB has been a useful tool in understanding the risk of breach of the 3 % ceiling (see Graph II.9).

3.3.6. Monitoring the budgetary adjustment

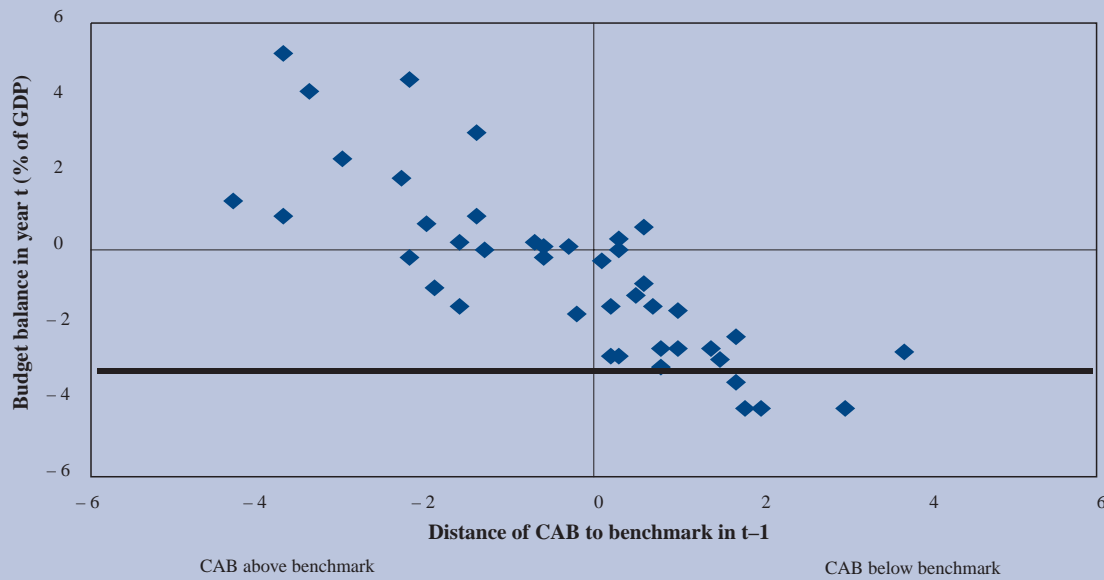
The report adopted by the Ecofin Council in March 2003, states that the budgetary adjustment towards a CTB position is to be measured in cyclically adjusted terms. Concerning the size of the adjustment, the Eurogroup agreed on 7 October 2002 to commit euro-area countries to a minimum annual reduction of 0.5 % of GDP. The same requirement was confirmed in the broad economic policy guidelines for the 2003–05 period. For Member States with an excessive deficit, the Eurogroup agreement requires a correction in cyclically adjusted

⁽¹⁾ COM(2002) 668 final of 27 November 2002.

⁽²⁾ Article 6(2), Council Regulation (EC) No 1466/97 of 7 July 1997 on 'Strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies'.

⁽³⁾ The minimal benchmark is the level of the CAB which, assuming normal cyclical fluctuations, ensures that the nominal deficit stays below 3 % of GDP. See Buti et al. (1998) or European Commission (2002a) for a more detailed discussion of the concept.

Graph II.9: Minimal benchmark and nominal budget balance in EU Member States, 2000–03



Source: European Commission, economic forecasts autumn 2003.

terms of more than 0.5 % of GDP per year, as long as the nominal budget is in excess of the 3 % ceiling.

Compliance with the adjustment requirement is assessed by looking at the observed change in the CAB over time. Although straightforward in theory, the experience of recent years shows that complications arise in practice, with Member States claiming that they adhered to plans, despite a measurable divergence between projected and observed changes in the CAB. This issue will be examined in detail in a separate section below.

3.3.7. Measuring the stance of fiscal policy

The report adopted by the Ecofin Council in March 2003 also underlined that ‘pro-cyclical policies in good times have been one of the major flaws in the implementation of the SGP in the past’. Based on this diagnosis the report concludes that ‘Member States shall avoid pro-cyclical policies, especially when growth conditions are favourable’. Under current practice, the Commission approximates the demand impulse of fis-

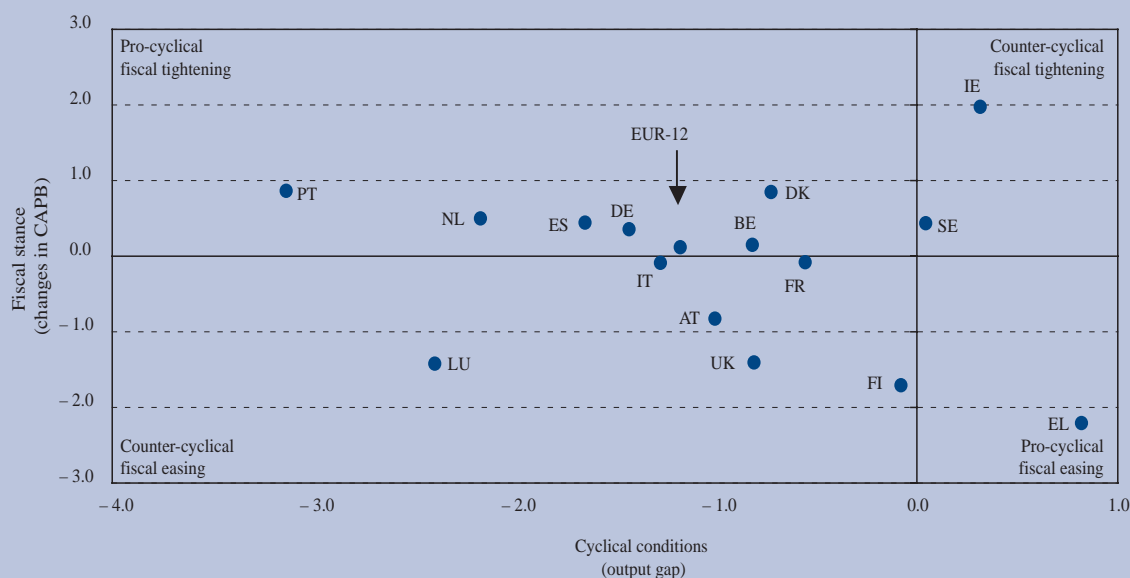
cal policy using the change in the primary CAB. A fall in the primary CAB is interpreted as a sign of expansionary policy, a rise as an indication of a contractionary fiscal policy. Conclusions about the pro or counter-cyclicality of fiscal policy are drawn by relating the observed change in the primary CAB with the output gap, which measure the cyclical condition of the economy. The analysis generally, synthesised in a single graph with changes in the primary CAB plotted against the output gap, is carried out and presented in various areas of the coordination framework of economic policies in the EU, most importantly in the context of the BEPGs and the budgetary surveillance under the SGP.

The main caveats of using the CAB as an indicator of fiscal impulse are well known and documented⁽¹⁾. The basic problem is that changes in the primary CAB may correctly measure neither the impact nor the final effect of fiscal policy on aggregate demand⁽²⁾.

⁽¹⁾ See, for instance, Blanchard (1990) or Mackenzie (1989).

⁽²⁾ The channels through which fiscal policy produces and impacts on aggregate demand and the magnitude of such impacts are subject to debate (see, for example, Part III of this report).

Graph II.10: Fiscal stance and cyclical conditions in EU Member States, 2003



Source: European Commission.

3.3.8. Monitoring budgetary adjustment in cyclically adjusted terms

In principle, monitoring budgetary adjustments defined in cyclically adjusted terms may appear as a purely mechanical exercise. However, on several occasions, the interpretation of the difference between projected and observed changes in the CAB has been debated. Member States argued that they had effectively implemented fiscal measures according to plans, and hence complied with the requirement. The Commission by contrast, took the divergence between planned and observed changes in the CAB as resulting from fiscal policy measures inconsistent with agreed plans.

The basic reason at the root of the difficulties in interpreting changes in the CAB is that the CAB is expressed as a percentage of GDP. Consequently, changes in the CAB can simply result from a difference between expected and realised potential growth. Annex 2 to this chapter presents a detailed analytical discussion of the issue. A simple illustrative example may clarify the issue. Consider a case in which budgetary plans presented in period $t-1$ do not include major discretionary measures for period t , so that tax rates are left unchanged

and expenditure plans broadly follow potential growth. If potential growth turns out to be lower than expected, but expenditure volumes are implemented according to plans at $t-1$, the CAB will fall short off the target. Since revenues are roughly proportional to GDP, the revenue/GDP ratio will probably not change considerably as a result of potential growth lower than expected. Conversely, the expenditure/GDP ratio will rise, thus leading to a lower than expected CAB.

The issue illustrated above became progressively more evident throughout the sustained economic slowdown experienced over the past several years. When faced with negative growth surprises, Member States' fiscal authorities were faced with the requirement to enact additional restrictive measures in order to comply with the targeted correction in the CAB, running this way the risk of implementing a fiscal policy that was perceived as being pro-cyclical or in any case not suitable in the light of weak or negative economic growth. This, coupled with the traditionally long lags in identifying the growth shortfall and the slowness of the decision-making process in fiscal policy put fiscal authorities under strain. As a consequence, and given that SGP and related

rules are not explicit about the issue, a debate started about how the budgetary adjustment in cyclically adjusted terms should actually be interpreted. More specifically, the debate focused on whether the adjustment has to be delivered unconditionally, or, alternatively, whether the adjustment is to be interpreted as conditional upon a growth expectation defined as *ex ante*.

If the requirement of adjusting the budget balance in cyclically adjusted terms was conditional on growth, the fiscal correction would correspond to the obligation of delivering a certain volume of expenditure cuts or revenue increases contingent on a specific assumption about economic growth. The observed change in the CAB would then no longer be the appropriate indicator for monitoring compliance. A correction would be needed.

As an illustration, in the case of the 0.5 percentage point rule set out in the Eurogroup agreement of 7 October 2002 (and included in the 2003–05 BEPGs), the requirement of conditional adjustment can be described as:

$$(2) \quad E_{t-1}\Delta CAB_t = \left(\frac{E_{t-1}\Delta^d R_t^S - E_{t-1}\Delta^d G_t^S}{E_{t-1}Y_t^p} \right) \cdot 100 \geq 0.5$$

where $E_{t-1}\Delta^d R_t^S$ and $E_{t-1}\Delta^d G_t^S$ denote, respectively, the planned discretionary corrections on the level of revenues and expenditures, i.e. the fiscal effort, while $E_{t-1}Y_t^p$ is the expected level of nominal potential output. The fiscal effort needs to amount to at least 5 % of $E_{t-1}Y_t^p$ billions of euro to ensure conditional compliance⁽¹⁾. Note that the adjustment is conditional because the relevant GDP figure is not that effectively realised at time t , but that expected for time t and time $t-1$.

While carrying out the required adjustment measures by Member States is easier when adopting a conditional compliance approach since the size of the fiscal effort is fixed in advance and invariant with respect to unexpected changes in economic growth, the difficulties with conditional compliance are on the monitoring side. The basic problem is that the discretionary measures $\Delta^d R_t^S - \Delta^d G_t^S$ effectively taken are generally not directly observable. Moreover, the fiscal effort cannot be inferred with certainty by looking at the observed change in the CAB, as the latter will be affected by changes in the denominator.

It follows from the above arguments that to assess conditional compliance the observed change in the CAB has to be corrected for the effect of unexpected growth surprises. As shown in Annex 2 a convenient approximation is given by:

$$(3) \quad \Delta CAB_t^{corrected} = \Delta CAB_t + \frac{G_{t-1}^S}{Y_{t-1}^p} (E_{t-1}\omega_t - \omega_t)$$

Equation (3) states that in order to monitor conditional compliance the observed change in the CAB can be adjusted by adding a term equal to the ratio of non-cyclical expenditures over potential output at time $t-1$ times the forecast error of potential output growth ($E_{t-1}\omega_t - \omega_t$).

It should be noted that taking budgetary corrections to be conditional on economic growth may give rise to moral hazard in forecasting GDP since countries may have the incentive to make over-optimistic growth projections *ex ante* in order to blame lower than expected growth *ex post* for any slippage compared to plans⁽²⁾. From equation (3) it is visible that the introduction of a correction in the change in CAB to monitor compliance conditionally may create an incentive for countries to produce a positive and high difference between forecast and actual potential growth: such a difference would translate into a bigger improvement in the corrected CAB. To prevent this risk, the assessment of conditional compliance would have to be anchored to an unbiased forecast of economic growth. In practice, the part of the anchor could be played by the Commission's forecast the accuracy of which is documented in Keereman (1999).

The correction presented in equation (3) might be applied both in the preventive and the dissuasive part of the SGP. To monitor compliance in practice, it would be sufficient to compare the value of the corrected change in the CAB with the required adjustment set out *ex ante*. In the case of the '0.5 rule', conditional compliance at time t requires $\Delta CAB_t^{corrected} \geq 0.5$.

To give an idea of the size of the figures involved, Table II.5 compares the observed change in the CAB of Member States between 2003 and 2002 with the corrected change obtained from applying equation (3). In most of the cases, the correction improves the observed change in the CAB, as growth projections for 2003, on which budgetary plans were built, turned out to be on the high side. The magnitude of the correction depends crucially

⁽¹⁾ See Annex 2 for further details.

⁽²⁾ Larch and Salto (2003) report evidence of an upward bias in the official growth forecasts of large EU countries.

Table II.5

Correcting the change in CAB for the effects of potential growth forecast errors

	<i>Ex post</i> change in CAB between 2002 and 2003 (% GDP)	Ratio of non-cyclical expenditure over potential output in 2002 (%)	Difference between the 2003 estimate for 2003 potential growth and the Commission 2002 autumn forecast (%)	Change in CAB due to potential growth forecast error (% GDP)	Change in CAB between 2002 and 2003 corrected for the potential growth forecast error (% GDP)
	(1)	(2)	(3)	(4) = (2)/100*(3)	(5) = (1)-(4)
BE	0.8	50.5	-0.3	-0.2	1.0
DE	-0.1	48.4	-0.3	-0.1	0.0
EL	-0.7	46.7	0.2	0.1	-0.8
ES	0.3	39.9	0.1	0.0	0.3
FR	-0.2	54.2	-0.3	-0.2	0.0
IE	0.9	35.1	-0.2	-0.1	1.0
IT	0.2	47.5	-0.4	-0.2	0.4
NL	0.8	48.0	-0.6	-0.3	1.1
AT	-0.5	51.1	-0.1	-0.1	-0.4
PT	0.7	46.0	-0.7	-0.3	1.0
FI	-1.0	50.4	-0.5	-0.3	-0.7
DK	-0.1	56.1	-0.2	-0.1	0.0
SE	-0.4	58.6	0.0	-0.0	-0.4
UK	-1.0	41.2	0.1	-0.0	-1.0

Source: Commission forecast.

upon the size of the forecast error on potential output growth, amounting in some cases to 0.3 percentage points of GDP. Consequently, applying the correction to the observed change in the CAB can make a difference. However, Table II.5 suggests that the correction on the observed change in the CAB would generally be quite small. The year 2003 is particularly telling as the difference between forecasts and actual outturns of real GDP growth, and hence potential GDP growth, is estimated to be comparatively large ⁽¹⁾.

Evidently, the proposed correction would be applied symmetrically. It would amplify (compress) any observed increase (decline) in the CAB in the case of negative growth surprises, but compress (amplify) the observed increase (decline) in the CAB when growth

was underestimated. Consequently, when confronted with a positive growth surprise, conditional compliance would be more demanding than the unconditional approach.

3.3.9. Conclusions

The Commission methodology for computing the CAB has evolved over time, incorporating successive analytical developments and the definition of best practices agreed among Member States. In spite of the progress and the overall positive experience, there is still margin for improving the Commission methodology. In particular, the methods for linking output gaps with budgetary figures could be improved.

CAB figures have generally been effective in assessing the underlying budgetary position, in evaluating the achievement of the CTB position as well as in evaluating the risk of breaching the 3 % Maastricht deficit threshold. In this context, it is important to interpret estimated CAB figures with a sufficient margin of flexibility, to account for the inherent uncertainty about potential output.

⁽¹⁾ It has to be stressed that the correction presented in equation (3) and underpinning figures in Table II.5 strictly applies to the assessment of changes in the CAB only. That kind of analysis must not be mixed up with the assessment of planned *vis-à-vis* observed levels of the CAB. In that case the correction is not for the growth surprise, but for the unexpected change in the level of potential output. The size of the two corrections is generally very different, with the correction of CAB levels generally much larger.

Conversely, assessing budgetary adjustment by means of observed changes in the CAB has proved to be problematic, as they can result from both fiscal policy actions and higher or lower than expected growth. The SGP rules do not specify as to whether compliance with budgetary adjustment is defined conditionally upon a given growth forecast or unconditionally. However, whether compliance is to be interpreted unconditionally or conditionally matters both for the implementation of the required adjustment and for its monitoring. Monitoring the adjustment unconditionally is not problematic, but implementing the adjustment package can be, since countries have to adopt additional budgetary corrections whenever economic growth turns out different from expectations, implying the risk of a fiscal stance that is generally perceived as pro-cyclical. Conversely, if compliance is taken to be conditional on a specific growth forecast, monitoring and assessing fiscal policy is difficult, as observed

changes in CAB are blurred by changes in economic growth.

The Commission has recently made suggestions, currently examined by the Economic Financial Committee, on how to monitor conditional compliance with budgetary adjustment requirements. The Commission suggests that, in monitoring compliance, observed changes in the CAB have to be corrected to take into account the impact arising from potential growth which is different than expected. Moreover, to prevent the possibility of 'strategic manipulation', growth forecasts used in defining the required budgetary adjustment should not be provided by the concerned countries but by a third party. The forecasts produced by the Commission services may serve the purpose. Finally, the assessment based on the corrected CAB should also be cross-checked by the assessment of the individual fiscal policy measures effectively taken by Member States.

4. Budgetary risks and contingent liabilities

4.1. Introduction

It is widely recognised that in the academic and policy debate budgetary surveillance in the EU should be increasingly focused on debt (see Chapter 5 in this part of the report). The notion of government debt considered in the EU rules-based fiscal framework is defined in the protocol on the excessive deficit procedure annexed to the Maastricht Treaty in 1992 and further defined in secondary legislation ⁽¹⁾. By ‘Maastricht’ debt it is meant the general government gross debt as: (i) including the consolidated liabilities of the ESA 95 general government sector; (ii) measured at nominal value. It should be noted here that, in spite of capturing a substantial part of government liabilities, the ‘Maastricht’ debt, as do most definitions of government debt used in budgetary surveillance, excludes some categories of government liabilities. Firstly, all kinds of liabilities backed by legal obligations but which may never lead to an actual government payment (e.g. government guarantees) are not included. These are generally named contingent liabilities. Secondly, there is no account of future obligations that are not backed by law but that are very likely to translate into actual government expenditure (e.g. future expenditure on healthcare, pensions, etc.). These are often referred to as implicit liabilities. Although these types of liabilities are not included in government debt, they are regularly taken into account in the long run sustainability assessments of stability and convergence programmes, which include projections for future government expenditures (on pensions, health, education, etc.) not yet grounded in legal commitments (see EPC, 2001).

Focusing budgetary surveillance on government debt is somehow inevitable, since measuring issues would become easily unmanageable and even meaningless if adopting a too comprehensive notion of government lia-

bilities. Moreover, government debt includes liabilities with a strong degree of certainty and enforcement. However, types of government liabilities that are not recognised in national accounting such as contingent and implicit liabilities are receiving increasing attention in the debate among fiscal experts and national accountants ⁽²⁾. There are two major reasons for this rising focus on government liabilities other than debt. Firstly, as a result of ageing populations, government expenditures in pensions and health are likely to increase considerably in the future. Most of these future expenditures are not grounded in legal commitments (hence, are not included in government debt), but result from public expectations based on past patterns of behaviour of government. Secondly, as a consequence of the shrinking role of government in providing direct support and a growing role in guaranteeing outcomes, government finances are becoming increasingly risky. Governments are bearing a growing share of risk of private pension funds, public companies, infrastructure projects through the issuance of guarantees and insurance schemes. Depending on the realisation of particular future events (e.g. failure of private pension schemes) government debt may increase substantially, but present debt is not affected by the piling up of contingent liabilities such as guarantees and insurances.

The aim of this section is that of addressing the issue of contingent liabilities in EU budgetary surveillance. The focus will be on contingent rather than implicit liabilities since the latter type of liabilities are already taken into account in the long run sustainability assessments of stability and convergence programmes. Moreover, the relevance of the issue of contingent liabilities in EU budgetary

⁽¹⁾ Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community.

⁽²⁾ More comprehensive definitions of debt are suggested in international standards and are currently under discussion among fiscal experts and national accountants. In particular, the accounting treatment of liabilities of uncertain amounts (like clearly defined accrued pension obligations) of uncertain nature (like guarantees) and pension-related commitments in general is among the issues that are being discussed with the aim of updating and further modernising the system of national accounts (SNA) and the European system of accounts (ESA).

surveillance has increased after enlargement. The stock of contingent liabilities is in fact relatively high in new Member States. Consistently, these countries have been disclosing information on contingent liabilities in their pre-accession economic programmes (PEPs) and the Commission services have taken into account developments in fiscal risks and contingent liabilities in assessing the PEPs. Although contingent liabilities in EU-15 countries are of a relatively lower quantitative relevance, there are indications that it may increase in the future.

After having presented basic definitions and a widely used taxonomy for government liabilities, broad trends in budgetary risks are surveyed and the main economic arguments for why such increased risk can be very relevant for government public finances presented. Finally, practices for monitoring contingent liabilities are reviewed and implications for EU budgetary surveillance are discussed.

4.2. A taxonomy of government liabilities

According to the definitions used in national accounting, liabilities arise for the government only as a result of obligations backed by law. Moreover, such obligations cannot depend on the occurrence of any specific event. Hence, for instance, loans granted to the government by financial institutions and government bonds issued in financial markets are clearly liabilities. They fulfil all the conditions in the definition of liabilities. The obligation to pay (that is of reimbursing principal and of paying interest) does not depend on any future event and arose from a past event (the issuance of a bond or of the loan).

In contrast, contingent liabilities derive from possible obligations, rather than present obligations⁽¹⁾. Some specific uncertain event must happen before an obligation for the government is generated. For instance, the guarantees granted by governments to the debt of private corporation bonds issued by enterprise are contingent liabilities, since the government obligation to pay depends on the non-ability of the original debtor to honour its own obligations.

The payments that the government has to make as a result of contingent liabilities are necessarily uncertain in their amount. This does not mean, however, that non-

contingent liabilities must necessarily involve payments of a certain magnitude and distributed over time with certainty. In fact, whenever the uncertainty surrounding the obligations of the government concerns the timing and the exact amount of payments and is such that by the use of the law of large numbers reliable expected values can be computed (e.g. in the case of clearly defined accrued pension rights), then these liabilities can be considered as non-contingent liabilities⁽²⁾. This is a subtle but crucial distinction between liabilities and contingent liabilities. The logic is that the uncertainty falling on the underlying obligations can be assimilated with the normal uncertainty characterising economic transactions (related to death, accident, macroeconomic risk, risk of renegotiation, etc.). More specifically, liabilities with uncertain timing and amount are defined as provisions by national accountants. The difficulty with the inclusion of provisions in national accounting systems is not a conceptual one like in the case of contingent liabilities but a practical one, related to the difficulties in obtaining reliable estimates of their expected amount.

A further concept is that of implicit liabilities. The notion of implicit liability refers to all cases in which future government obligations are very likely to arise in spite of the absence of a legal basis. It includes both the cases in which the government has a potential future obligation as a result of legitimate expectations generated by past practice (e.g. paying pensions to the beneficiaries of pay-as-you-go schemes) and the cases in which government obligations are related to the pressure of interest groups (e.g. bailing-out of public or private corporations that are 'too big to fail'). Most implicit liabilities are contingent, i.e. depend upon the occurrence of uncertain future events (e.g. government intervention in the case of natural disaster).

Liabilities of a certain nature and a certain amount are the only type recognised in integrated national accounting systems like the system of national accounts (SNA) and the

(1) According to the definition provided by the International Federation of Accountants (see IFAC, 2002), contingent liabilities are defined as 'possible obligations that arise from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity'.

(2) The IMF government finance manual treats clearly defined accrued unfunded pension schemes operated by employers differently from the SNA and the ESA since they give rise to liabilities recorded in the employers' balance sheets. Hence, government liabilities according to the IMF government finance statistics manual should also include clearly defined accrued pension rights of government employees. Among the most relevant cases of provisions there is the stock of clearly defined accrued pension rights. The logic beyond this treatment is that since the uncertainty for the government surrounds only the exact amount of the payments to be made, but not whether or not payments at all for clearly defined accrued pension rights will be made, these should be considered as provisions and not as contingent liabilities. Moreover, since the degree of contingency is quite limited, clearly defined accrued pension obligations can be recorded as present obligations, i.e. (non-contingent) liabilities.

European system of accounts (ESA). While the issue with the inclusion of provisions in national accounts is rather a practical one related to a reliable estimation of amounts than a logical one, with contingent liabilities and implicit liabilities a logical issue emerges in including them in government balance sheets since actual obligations may never occur. However, the above difficulties do not exclude the usefulness of reporting information on such government obligations in supplementary notes to the budget ⁽¹⁾.

After having exposed the definitions of different types of government liabilities and their treatment in national accounting, it is useful to summarise the different notions of government liabilities encountered by means of a taxonomy that takes into account both the degree of certainty of government obligations and the existence of a legal basis for such obligations. Table II.6 presents a scheme for classifying government liabilities as proposed in Polackova Bixi and Mody (2002) ⁽²⁾. In this scheme, different types of current and future obligations falling on the government are classified according to the certainty of their future existence or the presence of a legal basis. If government obligations arise only when certain specific contingencies are realised, then the corresponding liabilities are contingent liabilities. If government obligations have a legal basis (are backed by law or contracts) then the corresponding liabilities are said to be explicit, if they are instead generated by legitimate expectations in the public related by a past pattern of government behaviour or by pressure by interest groups the corresponding liabilities are said to be implicit. Hence, liabilities may be of four types: non-contingent explicit, non-contingent implicit, contingent explicit, contingent implicit ⁽³⁾.

The use of the taxonomy proposed in Table II.6 is that of providing a simple framework for classifying government liabilities according to their degree of certainty and government commitment. This helps in identifying the risks on the liability side of government balance sheets. The typical categories of liabilities falling under the identified four definitions are reported in the table. The list of liability categories reported in the table aims at being comprehensive but should not be taken as exhaustive and is made for illustrative purposes.

Non-contingent explicit liabilities are those normally entering national accounts and considered in standard fiscal analysis. So, 'Maastricht debt' is among the liabilities included in the first quadrant of Table II.6. Though not included normally in government debt and government balance sheets, provisions also fall in the first quadrant of Table II.6, since the obligations are backed by law and the uncertainty does not concern the existence of an obligation but the amount and timing of payments. Among the most relevant type of provisions there are legally backed obligations of uncertain amount and timing like clearly defined accrued pension rights.

Among the liabilities backed by law (explicit) but contingent, the typical category is that of government guarantees and insurance schemes. Government guarantees serve the purpose of covering risky activities carried out by specific types of agents or for specific types of activities. Common examples of government guarantees are those issued on the debt of specific sub-national levels of government (e.g. municipalities), public corporations or private firms entering relations with the government (including through PPPs for the realisation of public purpose investment projects). Such guarantees are normally issued on an individual basis to the beneficiaries through contracts ⁽⁴⁾. Other guarantees on debt can be 'umbrella' guarantees covering all the eligible entities borrowing for a specific purpose (e.g. housing, education, etc.). A different category of government obligations which depend upon the occurrence of particular contingencies is that of insurance schemes provided directly by the government. In this case, the risk borne by the government is not necessarily related to the liabilities of particular entities (as in the case of guarantees) and may concern a wide set of events. The case of government insurance of private pension schemes is of increasing

⁽¹⁾ The IFAC handbook of international public sector accounting pronouncements defines standards on which information should be provided on contingent liabilities in notes to the government financial statements. Similar recommendations about the disclosure of information on government contingent and implicit liabilities in supplementary notes are contained in the IMF manual on fiscal transparency.

⁽²⁾ This scheme is also known as 'fiscal risk matrix'. In the terminology used in Polackova Bixi and Schick (2002) non-contingent liabilities are referred to as 'direct' liabilities.

⁽³⁾ It is to be remarked that the definitions used in the taxonomy proposed in Table II.6 are not exactly the same as those used in standard national accounting terminology. In particular, since the government liabilities normally taken into account in national accounting are backed by law and independent of the realisation of particular events, there is no further specification in national accounting terminology that these liabilities are non-contingent and explicit. Hence, the government liabilities systematically recorded in integrated systems of national accounts like the SNA and ESA all belong to the first quadrant of Table II.6. Furthermore, Table II.6 does not distinguish between liabilities related to obligations whose amount and timing is certain and those related to provisions, while such a distinction is crucial in national accounting. Hence, all provisions are included in the first quadrant of Table II.6 even if most of them are not recorded as government liabilities in national accounts.

⁽⁴⁾ Public financial support granted to companies may constitute State aid and should be granted in compliance with Articles 87/88 of the Treaty.

quantitative relevance. What the government does with such insurance schemes is to reduce the risk of private pension subscribers concerning the return on their pension contributions.

Among the implicit (non-contingent) liabilities of greater relevance there are those related to welfare provisions by government, e.g. future pension and health-care expenditures. Although there is no legal commitment to provide such services in the future, there are

expectations grounded in past government behaviour that the government will provide such services. Similar considerations apply to government expenditures that occur on a regular basis, such as those for maintenance and refurbishment of the public capital stock. Note that the categories of obligations considered under the heading of implicit and non-contingent should be characterised by a limited degree of uncertainty, concerning at most their timing and magnitude but not their own occurrence in the future.

Table II.6

A taxonomy for government liabilities

	Non-contingent liabilities (the existence of government obligations does not depend upon particular events)	Contingent liabilities (the existence of obligations depends upon the realisation of particular events)
Explicit (government obligations have legal basis)	I <ul style="list-style-type: none"> • government debt • government expenditures as stated in budget law • provisions (e.g. clearly defined accrued pension rights not backed by a fund) 	II <ul style="list-style-type: none"> • government individual guarantees on the debt issued by public and private entities • government umbrella guarantees (e.g. on household mortgages, etc.) • government insurance schemes (on bank deposits, on returns from private pension funds, etc.)
Implicit (government obligations do not have a legal basis and arise as a consequence of expectations created by past practice or pressures by interest groups)	III <ul style="list-style-type: none"> • future welfare payments (pension payments related with pension rights which have not matured yet, future healthcare payments, etc.) • future government expenditures related to recurrent operations (e.g. capital stock refurbishment, etc.) 	IV <ul style="list-style-type: none"> • bail-out of defaulting public sector or private entities (public corporations, banks or other private financial institutions, pension and social security funds, etc.) • disaster relief • environmental damage • military financing

Source: Commission services.

The list of obligations potentially falling under the heading of implicit contingent liabilities is very long and an exhaustive description is beyond the scope of the present treatment. In fact, all possible future obligations triggered by uncertain events and grounded in expectations by the public or pressure by interest groups should be included. Among the most relevant from a quantitative viewpoint are all the cases of government bail-out of public and private corporations. In the recent past, government expenses associated with the bail-out of banks and other financial intermediaries have been particularly relevant in middle income countries, but notable cases have also manifested in advanced economies, including EU countries. Other categories include government expenses related to environmental damage, disaster relief and military financing in the case of war.

A final remark concerns government obligations related to pensions. These are often referred to as implicit liabilities. Although a substantial amount of pension obligations fall in fact in these categories (Quadrant III in Table II.6, i.e. non-contingent, implicit liabilities) especially in the case in which pension systems are of the pay-as-you-go type, pension obligations can be found in all categories (all the quadrants of the matrix in Table II.6). Government obligations corresponding to clearly defined accrued pension rights should be assimilated to provisions (uncertain amount and timing but certain obligation, backed by law) and belong to Quadrant 1, although one should not underestimate the degree to which even pension in payment can be changed through legislation (notably through the indexation of benefits). Explicit guarantees issued to private pension funds or

government pension insurance for private pension schemes are explicit, contingent liabilities. Whenever the bail-out of pension funds does not follow legally backed obligations (as in the case of insurance schemes issued by the government) but is the result of public expectations and pressures on the government, then the related obligations are both implicit and contingent (Quadrant IV). It is worth noting that pension reforms may alter the distribution of government pension obligations across the quadrants in Table II.6. For instance, reforms that reduce the extent of future pay-as-you-go pension obligations and increase the role of mandatory private pension schemes will reduce the size of the pension liability stock in Quadrant III (non-contingent, implicit pay-as-you-go obligations) and most probably increase that found in Quadrants II and IV (since government will explicitly or implicitly guarantee minimum pension benefits to the beneficiaries of mandatory private pension schemes).

4.3. Sources of budgetary risk

4.3.1. Broad trends

Government finances are increasingly exposed to risk in many countries. Increased risk on governments is the result of two separate and simultaneous tendencies.

On the one hand, there is a quite generalised trend for governments to step back from the direct finance and operation of activities (e.g. providing public infrastructure or healthcare) to a more indirect regulatory role (e.g. setting standards for health services, regulating public utilities, etc.). To a certain extent, the changing role of government coincides with a move away from financing services and towards guaranteeing outcomes, with the consequence of containing (other things being equal) the average level of expenditures increasing at the same time their riskiness.

On the other hand, overall economic risk is increasing in many countries as a result of long-term structural tendencies in demography, environment, and technology⁽¹⁾. Ageing populations will increase expenditures related to pensions and health. Rising contingent liabilities are also associated with environment-related concerns. Some of them are quite well documented, because they are linked to legal or contractual obligations. For instance, govern-

ment guarantees are normally issued against the risks associated with the construction and operation of nuclear power plants. Other risks are less documented. Typical examples are risks related to climate change. This is a source of increased risk for government since government finances will be probably called with increasing frequency to compensate the citizen groups hit by natural disasters⁽²⁾. Developments in technology and institutional change are at the basis of possible increased economic risk associated with greater capital mobility ('globalisation'). Advances in information and telecommunication technologies have increased the speed at which financial capital moves in search of the highest returns and made productive capital more footloose, increasing both the magnitude and volatility of FDI flows. Parallel to this tendency, in the past few decades institutional barriers to capital mobility have reduced in most countries, both advanced and emerging economies. Increased capital mobility in the past decade has often coincided with greater volatility of capital flows and with increased risk of speculative attacks, currency crises and sudden current account reversals. Capital flights have coincided with banking crises in most emerging economies and in some instances also in advanced economies⁽³⁾. Once bank failures set in, governments seldom have any other option but bailing out the banks under distress to avoid the failure of bank creditors and the spreading of a confidence crisis.

Ranking the relevance of the different possible sources of budgetary risk is not an easy task due to scarcity of data. Moreover, results are likely to be very country-specific⁽⁴⁾. Available data on the fiscal cost of bailing out the financial sector indicate that such costs could be extremely high, up to a substantial share of GDP⁽⁵⁾. The costs to government to refund banks and bail-out creditors have been highest in Latin America and Asian emerging markets and often occurred in the aftermath of capital flights and currency crises (ranging up to 50 % of GDP in the case of the Indonesian banking crisis of 1997 and 55 % in the banking crisis of Argentina in 1980). Costs, however, have also been severe in some advanced and transition countries (above 10 GDP percentage

⁽¹⁾ See e.g. Heller (2003) for an overview of the factors underlying increasing risks on government finances in various country groups.

⁽²⁾ Of course, the magnitude of such risks will also depend upon the extent to which governments are engaged in environmental prevention policy.

⁽³⁾ For instance, the banking crises of Finland and Sweden in 1991.

⁽⁴⁾ For instance, natural accidents related to global warming have so far been a cause of fiscal distress especially in developing countries found in tropical areas, while risks related to ageing populations are more likely to become relevant in advanced countries.

⁽⁵⁾ See, e.g. Honohan and Klingebiel (2000).

points in the case of Japan, Slovenia, Finland, Bulgaria and the Czech Republic).

4.3.2. Sources of budgetary risks in EU countries

Overall, budgetary risks are probably the highest in emerging countries (Asian and Latin American especially). These countries are indeed structurally more vulnerable to banking crises that are, in quantitative terms, the most relevant source of budgetary risks. However, budgetary risks in EU countries should not be neglected either. In most Member States risks to public finances are likely to increase in the future as a consequence of ageing populations. Increased budgetary risks may also come from the issuance of guarantees to the debt of public corporations (as a form of ‘hidden subsidy’) and to that of corporations involved in the construction, operation, and maintenance on public purpose infrastructures in the framework of public–private partnerships.

Most new Member States are subject to substantial and peculiar budgetary risks. In the early 1990s, CEECs had to face the challenge of transition to a market economy. To that purpose, it was necessary to carry out liberalisation, restructure and privatise the economy, and build the necessary institutions to make effective the working of a market economy. This transition process entailed a significant increase in overall economic risks. Firms previously operating under a regime of regulated prices had to start competing in the market system; formerly State-owned enterprises changed ownership and started being run according to business models; entrepreneurs had to abandon old activities and enter into new businesses. Part of this increase in economic risks was shared by governments in the form of guarantees or other forms of explicit or implicit insurance. A transfer of risk to governments during the transition process was probably necessary to induce private capitals to engage in risky entrepreneurial activities. However, the web of guarantees and implicit insurances issued by governments to corporations, financial institutions and sub-national governments increased without sufficient monitoring in some countries. Quite often, guarantees were not provided by governments directly, but were issued by guarantee funds. Sometimes, the debt issued by these guarantee funds was not consolidated into government debt ⁽¹⁾.

Most of these ‘extra-budgetary’ guarantee funds were set up to deal with the restructuring of State-owned enter-

prises and their privatisation. After privatisation, these guarantee funds often carried over the obligations of the privatised enterprises through the issuance of guarantees (e.g. environmental funds to cover future environmental liabilities of the privatised enterprise). Since the debt assumptions of privatised entities by government do not affect budget balances according to most national accounting systems, privatisation in transition countries often entailed two types of fiscal flows not recorded in budget balances (see Box II.3), on the one hand, privatisation receipts, accruing to governments after the sales of corporate shares, and on the other hand, the payments related to the realisation of events triggering the call of guarantees provided by governments to various stakeholders of privatised entities. While the first type of flow is certain, reduces debt and occurs just after privatisation, the second type of flows are uncertain, distributed in time and increase government debt.

The magnitude and length of the period during which the State has been involved in extra-budgetary fiscal interventions differs across the countries. While in some countries (e.g. the Czech Republic), the fiscal costs of adjustment were postponed through a web of guarantees issued by extra-budgetary funds, others opted for containing the piling-up of contingent liabilities and for adopting a transparent monitoring of such types of liabilities (e.g. Estonia, Latvia and Hungary) ⁽²⁾. In these countries, the operations of guarantee funds were consolidated into government accounts and progress was made to keep track of the magnitude of their contingent liabilities in supplementary budgetary documents.

An indirect way to measure the extra-budgetary costs associated with government contingent liabilities has been proposed by Kharas and Mishra (2001). It simply consists of the difference between budget balances and the change in government debt. Such a difference (named ‘hidden deficits’) is interpreted as an approximation of the fiscal flows associated with government liabilities (some of them contingent) not reported in budgets. Since these ‘hidden deficits’ can be the result of factors different from extra-budgetary activities, Table II.7 reports a decomposition of the change in debt ratios for CEEC Member States between 1999 and 2002 which allows for the better isolation of the component related to extra-budgetary activities. To that purpose, the change in the debt ratio associated with the stock-flow adjustment is further decomposed into a com-

⁽¹⁾ See, for instance, Allan and Parry (2003).

⁽²⁾ See, for instance, Polackova Brix, Schick and Zlaoui (2002).

ponent related to exchange rate movements and another properly consisting in extra-budgetary activities. Since CEEC privatisation proceeds during the investigated period have been a substantial source of extra-budgetary flows, privatisation proceeds are further deducted from the part of stock-flow adjustment associated with extra-budgetary activities. The final figure is quite a close approximation of fiscal flows not reported in budgets and not related to privatisation activities. As argued before, a relevant share of such extra-budgetary flows is likely to be related to the provision of guarantees by government to various stakeholders of privatised entities.

Figures turn out to be quite large. On average, during the investigated period, as a result of extra-budgetary flows other than privatisation receipts, the debt increased by more than 1 and 1.5 GDP percentage points per year, respectively, in Lithuania and Poland, by 2 GDP points in the Czech Republic, and 4 GDP points in Poland ⁽¹⁾. Given the fact that the bulk of privatisation in CEECs has already occurred, extra-budgetary flows related with privatisation proceeds are likely to become of a smaller magnitude in the future. This also means that the stock of contingent liabilities will most probably start growing at a slower rate or will begin to fall in most new Member States. However, the

existing stock of guarantees and implicit insurances issued by CEEC governments will still be a source of extra-budgetary flows and debt increase for years. An appropriate measurement of this stock of implicit guarantees is the only way for evaluating the magnitude and riskiness of the associated future payments.

According to the last round of pre-accession economic programmes (PEPs) submitted by new Member States in 2003, the main source of risk remains to be the existence of a wide range of State guarantees. In some countries, the PEPs report the expected value of the stock of the liabilities associated with guarantees. The amount of guarantees seems to be relatively high in Malta (22 % of GDP) and somewhat lower in Cyprus and the Czech Republic (around 10 and 13 % of GDP, respectively), Slovenia (6.6 % of GDP) and Hungary (5.4 % of GDP).

⁽¹⁾ Such 'top-down' estimates of extra-budgetary fiscal flows related to contingent liabilities seem broadly consistent with existing 'bottom-up' estimates in some CEECs. Polackova Bixi, Schick and Zlaoui (2002) for instance report that the government disbursements related to guarantees in the Czech Republic amounted to 1, 3.1, and 1.5 GDP percentage points in, respectively, 1996, 1997, 1998.

Table II.7

Average annual contribution of various factors to change in debt/output ratio, CEEC new Member States (1999–2002)

	Change in debt ratio	Of which:						
		Snowball effect	Primary deficit	Stock-flow adjustment	Of which:			
					Exchange rate effect	Extra- budgetary flows	Of which:	
							Privatisation revenues	Other extra- budgetary flows
CZ	2.95	0.08	3.9	-1.02	0.03	-1.05	-3.18	2.13
EE	-0.08	-0.2	0.1	0.03	0.28	-0.25	n.a.	n.a.
HU	-2.7	-1.43	-2.03	0.75	2.7	-1.95	n.a.	n.a.
LV	1.13	-0.08	2.2	-1	0.1	-1.1	-0.63	-0.48
LT	1.45	0.75	1.15	-0.46	-0.38	-0.08	-1.1	1.05
PL	0.02	-0.05	-0.35	0.43	0.88	-0.45	-2.03	1.58
SK	3.93	0.35	4.68	-1.1	0.7	-1.8	-5.85	4.02
SI	0.78	-0.7	0.3	1.17	1.3	-0.13	-0.13	-0.03

Source: Commission services.

4.4. Why risk matters for government finances

Government finances are subject to increasing risk in many countries. Although there may be reasons that justify such a tendency, there are also reasons for concern.

Missing markets for insurance justify the provision of explicit or implicit insurance by governments for some type of risks. A typical case is that of natural catastrophes. Such events may entail very high losses coupled with limited possibilities of diversification of individual risks. Under these conditions, actuarially fair insurance premia may be too high to permit the development of an insurance market. The only possible provision of insurance may come from the government, which has the possibility of covering losses through taxation and to spread the burden of natural accidents more. A different case is that of economic ‘systemic’ risk. The typical example is that of bank runs and financial crises. Bank failures may involve considerable externalities since the initial failure of a limited number of banks may induce a ‘domino effect’ whereby a large number of creditors may fail as well and trigger a confidence crisis. The consequence will be a credit crunch and a possibly considerable and persistent reduction in economic activity. Asymmetric information is at the root of the market failures characterising the financial system that justify government intervention as a lender of last resort. A final relevant case to be mentioned is insurance provision by government to the returns of mandatory-funded pension schemes. Government intervention in such a case is justified not only for equity purposes (avoiding excessively diverse outcomes in terms of actual pension income for scheme beneficiaries) but also for efficiency purposes, since a less risky pension income permits a more efficient distribution of disposable income between consumption and savings.

In spite of the existence of a sound rationale for governments providing explicit or implicit insurance to the private sector, social costs may nevertheless be substantial when such an insurance role by government is exercised in the presence of pervasive problems of information asymmetries in markets or when government action is biased towards short-term horizons. Asymmetric information in markets may give rise to a moral hazard problem whereby the provision of government explicit or implicit guarantees leads financial institutions or private firms to undertake excessively risky activities⁽¹⁾. Paradoxically, due to moral hazard, an active role of the government to reduce systemic economic risks through

guarantees may end up raising aggregate economic risks. A second issue with the provision of government guarantees and insurance is related to government action oriented towards short-term goals. By guaranteeing a minimum level of economic returns, governments can provide hidden subsidies to public or private corporations, even when such firms are not viable on the market without the presence of government guarantees. A similar case arises when the government guarantees the debt issued by corporations, since this reduces the effective cost of capital borne by these firms. In such cases, the undertaking of risk by the government reduces economic efficiency since its motivation is that of delaying the inevitable adjustment costs associated with corporations’ failure and restructuring rather than that of addressing market failures. Governments acting over a short-term horizon may also easily understate the amount of risk they are putting on public finances through the use of explicit and implicit guarantees and the future consequences this may have. The main reason is that proper accounting of government guarantees in budget documents is generally missing. In contrast to commercial accounting practices which require firms to include committed uncertain obligations in their balance sheets, relatively few governments disclose enough information on guarantees in their books to make possible a proper assessment of their impact on public finances. This lack of proper information on government contingent liabilities, coupled with short-term incentives for governments to issue implicit and explicit guarantees as a substitute of explicit transfers and subsidies, may lead to the build-up of excessive risks on public finances⁽²⁾. An appropriate monitoring of the budgetary risks associated with the presence of contingent liabilities and a shift of the focus of budgetary surveillance towards a longer term perspective is a key requirement to prevent the possibility that shocks to the economy or the financial sector reverberate in some countries into public finance distress.

(1) For instance, there are documented cases showing that pension funds, once government insurance schemes were introduced, started investing in shares rather than in less risky financial assets like bonds.

(2) Through the issuance of government guarantees, the overall risk in the economy is translated on public finances and magnified. From the viewpoint of their financial characteristics, guarantees can be assimilated to put options issued by governments. In fact, guarantees could be priced as options and sold to financial institutions and corporations. It is well-known from option theory that the price of options tend to vary more than proportionally with variations of the value of the underlying asset (e.g. the value of corporate debt in the case of guarantees issued to private firms’ debt). A wider use of option theory instruments has been recently suggested in public debate as a means to measure the accumulation of government risk (Draghi, Giavazzi and Merton (2004)).

4.5. Monitoring and containing budgetary risks

4.5.1. Monitoring and measuring contingent liabilities

Most national accounting systems do not recognise government contingent liabilities. As a result of government explicit or implicit guarantees and insurances, debts and deficits are affected only at the moment in which the events that trigger actual payments by government are realised. Such payments will increase deficit and, depending on the specific transactions involved, they may also increase debt. Box II.3 describes the accounting treatment of government guarantees to the debt issued by other entities.

Although the mere presence of guarantees does not alter the magnitude of government debt, most national accounting manuals recommend the disclosure of information concerning guarantees and other types of contingent liabilities in supplementary documents to the budget. Supplementary information on contingent liabilities is also recommended by the IMF code on fiscal transparency. Finally, documentation attached to the budget may be requested by national parliaments that have to approve the budgetary law. Disclosed information on contingent liabilities may range from short statements describing the major characteristics of existing government guarantee and insurance schemes to detailed reports possibly including estimates of their economic impact on public finances.

Concerning the evaluation of the impact of contingent liabilities on government finances, a first approach is to assess the expected value of government payments associated with the existing guarantees, insurances, and other programmes of government support. Although the estimation of the expected value of contingent liabilities is only a first approach to measure their economic impact on public finances, computations may nevertheless be quite demanding. What is needed for such an assessment is not only the likely amount that will be paid by government in case of the realisation of uncertain events, but also an estimate of the probability of the occurrence of such events ⁽¹⁾. The estimation of the probability of certain events is quite problematic (e.g. debt default of cor-

porations) and the information reported will be inevitably indicative. However, regular updating estimated probabilities as new information becomes available could improve considerably the quality of the estimation of the expected value of contingent liabilities.

The expected value of contingent liabilities conveys relevant information to assess the extent to which the government is providing 'hidden' subsidies to private or public entities via the issuance of guarantees or the set-up of insurance schemes. Such a measure, however, is of limited use in evaluating the amount of risk borne by the government. What is missing with the use of the expected value is an assessment of the magnitude of the payments that government might have to effectuate in very adverse circumstances. Such an evaluation can be of great use, especially if governments have limited capacity of borrowing. The expected value of, say, guarantees to the financial sector may not be particularly high. However, in case of a very severe banking crisis, the fiscal costs to government may be extremely large, so large to possibly imply a debt crisis.

Ideally, one would like to measure the risk impact of contingent liabilities by computing the whole probability distribution of the monetary value of the obligations triggered by such liabilities. A more practical approach, largely followed in the banking sector and increasingly used also in fiscal analysis is that of evaluating the so-called 'value at risk' of such liabilities. This consists of estimating the highest government cost whose probability of realisation is not lower than a given, pre-determined threshold ⁽²⁾.

Apart from the disclosure of information on contingent liabilities and the assessment of their impact on government finances, a more comprehensive approach to the assessment of fiscal risk is possible. Consistent with the taxonomy presented in Table II.6, a fully-fledged analysis of fiscal risks should consider in fact whole balance sheets of government and the covariance of the items of both the liability and the asset side. Following this approach, the net worth of the government (as measured by the difference between a comprehensive definition of government assets and liabilities, including assets and

⁽¹⁾ For instance, in the case of a guarantee by the government to the debt issues by a particular corporation, the expected cost of such a guarantee is given by the probability of the corporation defaulting on debt times the value of the outstanding debt at the time of default.

⁽²⁾ Even more sophisticated techniques of evaluation for government guarantees come from option theory. The idea behind this approach is that government guarantees play the same economic role as financial put options so that, if appropriately priced by financial markets, their value should be recorded as that of options with corresponding characteristics among government liabilities and among the assets of the beneficiaries of the guarantee.

liabilities that are contingent) depends on a limited set of stochastic variables (e.g. interest rates, exchange rates, real growth rates, etc.) which affect both government assets and liabilities and the way they vary together ⁽¹⁾.

Monitoring contingent liabilities is a necessary first step towards the containment of an excessive accumulation of such types of liabilities. Several precautionary measures can be taken in this respect.

A reduction in the rate of growth of contingent liabilities can be achieved through the imposition of caps to the number of guarantees or to the volume of guaranteed debt issued by government and governmental bodies in the framework of medium-term budgetary plans. This was, for instance, the route followed by Hungary during the years of transition to contain the growth of guarantees associated with privatisation (Polackova Bixi, Schick and Zlaoui, 2002) and by the Czech and the Slovak Republics (Allan and Parry, 2003).

A different approach is that of avoiding the piling up of an excessive stock of government guarantees by making the granting of guarantees conditional upon the payment of fees by the entities benefiting from guarantees ⁽²⁾. The working of this solution crucially depends on the criterion chosen for setting the magnitude of these fees.

As long as the fees reflect the volume of the guaranteed liabilities (e.g. the debt of a corporation, the present value of the pension benefits to be paid by a private pension fund, etc.) and their riskiness, the introduction of mandatory fees entail a trade-off for the beneficiaries between the up-front cost of the fee and the insurance provided by the guarantee against adverse events. Some government counterparts may be willing to pay the fee to be entitled to guarantees, others may not. The result will be a lower amount of contingent liabilities accumulated by government in the medium/long run ⁽³⁾.

Finally, an alternative method to contain the risk associated with government liabilities is that of designing

guarantees in such a way as to limit the risk to government. For instance, in the case of government guarantees provided to the financial sector, conditions could be added specifying the maximum amount of payments that government is ready to make in case of default of financial institutions ⁽⁴⁾.

In this context, the consequent decrease in government contingent liabilities would be not only desirable from the point of view of government finances, but would also be consistent with the reduction of the overall amount of State aid, and the reorientation to horizontal objectives, in accordance with the Lisbon strategy.

4.5.2. Dealing with budgetary risks in the EU fiscal framework

The existing practice of EU Member States concerning the monitoring of contingent liabilities and containing budgetary risks varies widely. Some EU Member States simply disclose information on guarantees and other insurance schemes in supplementary documents to the budget countries. Other countries have instead developed more sophisticated practices to achieve and adequately monitor contingent liabilities. In the Netherlands, for instance, contingent liabilities have been incorporated in the cash-based budgets. In some new Member States, notably in Hungary, detailed information on the expected cost of each guarantee scheme is reported in the documents attached to the budget. Moreover, in Hungary, the Czech Republic and Slovakia the volume of guarantees issued is limited by law. In Sweden, the issuance of guarantees by government is subject to the payment of mandatory fees by the beneficiaries.

⁽¹⁾ Though more comprehensive and rigorous, since such an approach requires collecting and processing a large amount of information which is not always available to governments, its use is so far rather limited. See, e.g. Barnhill and Kopits (2003) for an application to Ecuador.

⁽²⁾ This is the practice followed by the EIB and the European Commission, which issue guarantees conditional upon the payment of fees by the beneficiaries.

⁽³⁾ The presence of mandatory fees does not mean that an effective transfer of risk to government through the issuance of guarantees would not occur. If the cost of the fees reflects the expected value of the guarantees without incorporating any risk premium, the risk of the underlying liabilities will be effectively transferred onto governments. Under these conditions, a form of subsidising will still take place. However, the subsidy will not coincide with the full value of the guarantee as in the absence of mandatory fees, but only to the risk premium that would be required by markets for the issuance of a guarantee of the type provided by the government. Of course, governments may also set guarantee fees in such a way as to exclude any subsidy component. To that purpose, they could set the same fees that would be set by private operators offering contracts with conditions yielding similar financial outcomes (e.g. put options).

⁽⁴⁾ In addition to measures to contain the accumulation of contingent liabilities, government may take action to reduce the overall amount of risk on the finances. One possibility is that of establishing reserves against commitments yielding uncertain outcomes for government finances. An alternative approach to reducing overall risks to government finances is through hedging, for instance via financial derivatives exhibiting a negative correlation with the net resource flows accruing to government.

Box II.3: Accounting for financial guarantees and for debt assumptions in the ESA 95

Many governments give guarantees for liabilities issued by other entities, notably public enterprises or private enterprises involved in some government-related project. Governments may also guarantee liabilities of other governments, for example in relation to projects of common interest. A guarantee will improve the credit rating of the liability and therefore improve borrowing conditions (for example by reducing interest costs). Therefore, from the perspective of the original debtor, the credit guarantees are similar to subsidies for interest relief. However, in some cases, a government guarantee is the only way ailing companies, including non-viable public enterprises, can obtain financing from private capital markets. In the case of companies operating in heavily regulated industries, guarantees are also given to protect companies from major changes in government regulations — for example price controls — which could affect their economic viability. From the government perspective, a guarantee does not lead to any cash payment when it is given — in some cases, the government may even receive some fees or commissions — but might lead to disbursement in future, were the guarantee to be called.

The most typical guarantee involves a legal commitment to take on a liability, paying the debt service and reimbursing the outstanding principal, if the original debtor fails to meet its obligations relating to this or (possibly) other liabilities. However, in some cases, the guarantee can be limited to the interest, to the principal or to a share of the principal. There are many other types of guarantee instruments, for example where the guarantor does not have an obligation to formally take over a debt, but commits to open a credit line to an entity if the latter is unable to meet its financial obligations.

Guarantees are contingent liabilities. This means that they are conditional obligations which will become present obligations if the original debtor was unable to meet its obligations and the government had to take over the debt. As a general rule, contingent liabilities are not recognised in the ESA 95 or SNA systems of national accounts ⁽¹⁾. There are two reasons for this. The first, more pragmatic, reason is that most guarantees are never called. In most cases, the original debtor will be able to satisfactorily meet its obligations without assistance. Therefore, to record a guarantee as government debt, as a conventional liability, would be detrimental to the comparability and meaningfulness of debt statistics. The second reason is more technical. In an integrated accounting system, such as the ESA 95 or SNA, each financial liability has a corresponding financial asset and each liability should be recorded in the accounts of one, and no more than one, unit. If guarantees were recorded as liabilities in the accounts of the guarantor, they would have to be deleted from the original debtor's balance sheet (or an asset would have to be imputed in the balance sheet of the original debtor). This would be detrimental for the usefulness and analytical interest of the accounts of the respective sectors.

Under the ESA 95, the assumption by a government of debts of other units — even when there is no explicit guarantee — is recorded as a capital transfer from government to the defaulting unit. This can be seen as if the government gave a gift to the original debtor to allow the latter to discharge its liabilities. Capital transfers are government expenditure and therefore increase the government deficit. At the same time the assumption of the debt by the government increases its own debt. In principle no actual call of the guarantee is needed to register a capital transfer and the respective increase in the deficit and debt. It is sufficient that there is enough evidence that the primary debtor is unable to fulfil its obligations and the government will have to step in. In practice, given the difficulty in obtaining such evidence, capital transfers are recorded when the government has formally taken over the liability or starts behaving as if it is now the primary debtor, for example by paying coupons or instalments.

There is one major exception to this accounting rule. When debt assumptions take place during a privatisation or a liquidation, the debt assumption is recorded without any direct impact on the government deficit. In these cases, the assumption of liabilities by government leads to an increase in government debt, but no capital transfer is recorded and the deficit does not change. The rationale for these exceptions is that the assumption of liabilities in these contexts will increase the proceeds from privatisation or liquidation. The privatisation and liquidation proceeds are recorded as financial transactions ('below the line'), without any direct impact on the government deficit, and it would not make sense that the operations that are directly linked to privatisation or liquidation — increase the proceeds of privatisation and liquidation — would adversely affect the government deficit ⁽²⁾.

⁽¹⁾ The ESA 95 and SNA record contingent liabilities when these liabilities are tradable and have a market value. State guarantees are very rarely tradable.

⁽²⁾ There is also a second, more technical and rarer, exception, when the unit that is relieved from the liability is a government-owned quasi-corporation. Quasi-corporations are units that do not have the legal status of corporations, but whose economic behaviour is similar to that of corporations. These units often cannot issue liabilities on their own and, when they can, statisticians always impute their net worth — the difference between liabilities and assets — in the accounts of the owner. Therefore, when governments assume debts from one of their quasi-corporations, they are, in fact, already recorded as government debts.

Up to now, the relevance of contingent liabilities in EU budgetary surveillance has been reflected especially in the preparation and assessment of the PEPs. Former acceding countries have been reporting information on the main sources of fiscal risk and in some cases have provided quantitative assessments. A number of countries, in the framework of their PEPs, have quantified, for instance, the expected value of the cost of the outstanding guarantees. Table II.8 provides an overview of the information on State guarantees and other sources of fiscal risks provided in the 2003 PEPs. The Commission services, in assessing the PEPs submitted annually by former acceding countries, have been taking into account the magnitude of fiscal risks in such countries

and the progress made in monitoring and containing such risks.

Given the possible future increase in the amount of government guarantees (for instance in the framework of pension reforms or infrastructure financing) and other sources of fiscal risk among EU countries, a better account of contingent liabilities may become needed in EU budgetary surveillance. In this perspective, given the wide differences in the current practices followed by Member States, a first step will be the definition of standards concerning the collection and reporting of information on various types of contingent liabilities.

Table II.8

Fiscal risks in the new Member States end-2002 as reported in the PEPs of 2003

Fiscal risks	
Cyprus	<ul style="list-style-type: none"> State guarantees (10 % of GDP).
Czech Republic	<ul style="list-style-type: none"> State guarantees (12.2 % of GDP).
Estonia (1)	<ul style="list-style-type: none"> total explicit (0.04 % of GDP): student loans, business bankruptcies, court settlements, guarantees given by Kredex; total implicit (0.01 % of GDP): local government liabilities, environmental and natural damages; total (0.05 % of GDP).
Hungary	<ul style="list-style-type: none"> State guarantees (5.4 % of GDP).
Latvia	<ul style="list-style-type: none"> State guarantees — government guaranteed loans (1.2 % of GDP); planned issuance in 2003: Latvian Mortgage and Land Bank (SME development) student and study crediting and Skulte port reconstruction (total: 0.8 % of GDP).
Lithuania	<ul style="list-style-type: none"> low level of private deposit insurance (total amount of insured deposits — 21.4 %); restitution of real estate ownership rights (2.9 % of GDP); debt of State-owned enterprises to banks (1.4 % of GDP); restitution of rouble savings (4 % of GDP); debt and defaults on loans on-lent by the government to enterprises which will be privatised (once privatised, the State may face the problem of recovery of the on-lent funds — 6.3 % of GDP); decommissioning of the Ignalina nuclear power plant (7 % of GDP); State guarantees and municipal budget arrears (0.3 % of GDP).
Malta	<ul style="list-style-type: none"> State guarantees (22 % of GDP — 90 % of it to public entities); proceeds from privatisation.
Poland	<ul style="list-style-type: none"> State guarantees (total anticipated payments up to 2024; 1.5 % of GDP); reprivatisation (compensation for the real estate appropriations by the State Treasury in years 1944–62 to former owners — potential value 5.6 % of GDP); potential liabilities arising from restructuring of industries (coal mining, railway).
Slovakia	<ul style="list-style-type: none"> State guarantees (12.6 % GDP); legal disputes between the state and the CSOB bank; legal disputes regarding bills of the Slovak gas company SPP; already reported in government debt: debt of Slovenska konsolidacna — 2.6 % of GDP; debt of social insurance funds — 0.3 % of GDP; debts of territorial self-governing units — 1.4 % of GDP, State guarantees — principal of 6.1 % of GDP.
Slovenia	<ul style="list-style-type: none"> State guarantees (6.6 % of GDP); total debt of public sector entities (11.1 % of GDP).

(1) Realisation of contingent liabilities in 2002. Total expected realised contingent liabilities in 2003 and 2004 are estimated at 0.03 % of GDP and 0.02 % of GDP respectively.

NB: Fiscal risks related to ageing populations and the characteristics of government debt (e.g. maturity, currency denomination) are not included in the table.

Source: Commission services.

5. Increasing the focus on debt and economic developments

5.1. Introduction

Government debt matters. Both its level and dynamics are sources of concern, for at least three reasons. Firstly, a high debt level leads to budget inflexibility, and in particular it reduces the room for devoting additional resources to growth-enhancing public expenditures or to reduce employment-unfriendly taxes. Secondly, high and increasing debt positions can lead to rising interest rates in order to allow governments to attract private savings, crowding out private investment⁽¹⁾. Thirdly, a growing debt can ultimately undermine price and/or financial stability. In the context of a monetary union, the abovementioned effects are likely to influence economic developments across the whole area.

To avoid the risks or negative effects arising from high debt levels, there is general agreement that it is important to pursue and achieve prudent policies over time. Within the debate on the implementation and functioning of the Stability and Growth Pact, increasing attention has accordingly been placed during the last two years on better including debt developments in the assessment of budgetary positions. In November 2002, the European Commission put forward a set of proposals to improve the implementation of the SGP⁽²⁾. Among other proposals, the Commission suggested that 'greater weight must be attached to government debt ratios in the budgetary surveillance process. The debt criterion of the excessive deficit procedure, which requires debt levels above 60 % of GDP to approach the reference value at a 'satisfactory pace', should be made operational'. In addition, the Commission proposed that 'a small deviation from the 'close to balance or in surplus requirement of a longer term nature could be envisaged for Member States where

debt levels are well below the 60 % of GDP reference value, and when public finances are on a sustainable footing'.

After several months of debate upon the Commission proposals, the Ecofin Council in March 2003 concluded that 'the pace of decline in government debt plays an important role in budgetary surveillance, especially in highly indebted countries. In conformity with the Treaty provisions, the excessive deficit procedure should contribute to ensuring a satisfactory pace of debt reduction'. The Council recognised the need to increase the focus on debt although did not decide on specific steps on how to operationalise the debt criterion⁽³⁾.

Although the debt requirement of the Maastricht Treaty has never been enforced so far⁽⁴⁾, following the institutional developments indicated above, some progress in considering debt development in the monitoring of public finances has been made. Steps have been taken to upgrade the assessment of long-term sustainability (see Part I of this report) and additional pressure to very high-debt countries to increase the rate of reduction has been exercised. In addition, even if no formal position has been taken by the Council on whether small deviations from the medium-term objective are acceptable in cases of low debt, in practice, the discussions on budgetary positions in the context of the assessment of the last stability and convergence programmes have highlighted that this approach is somehow taken into consideration.

After the problems encountered in the implementation of the SGP in 2003, in particular after the decisions of the Ecofin Council of 25 November 2003, it appeared clear

⁽¹⁾ See Part III for an analysis of the effects of fiscal discipline on growth.
⁽²⁾ European Commission (2002a).

⁽³⁾ For a debate on how the debt criterion can be made operational, see European Commission (2003a).

⁽⁴⁾ As pointed out, for example, by Alesina and Perotti (2004).

that the credibility of the framework had been seriously dented. The proposals made by the Commission in 2002 had been made on an unchanged legislation basis, to avoid any discussion on redesigning the provisions of the SGP which would have affected the credibility of the surveillance process. At the end of 2003, however, it became clear that the moment had arrived for openly accepting the possibility of changing the SGP: this could possibly increase the support for the fiscal framework, as it could lead to improve its functioning, increase its effectiveness in ensuring fiscal discipline, and reinforce its contribution to growth oriented policies within the Lisbon strategy.

The Commission therefore announced its intention to make proposals to strengthen economic governance. Among the building blocks of the ongoing discussion on how the fiscal framework can be reinforced in an enlarged Union, the Commission announced the need for taking debt levels and their developments more into consideration ⁽¹⁾. While there is a growing awareness of the need to tackle the problematic issues, the reasons why it is important to rapidly achieve prudent levels below the 60 % of GDP ceiling set by the Treaty are not extensively discussed. In view of the elements described above, the remainder of this chapter explores the following aspects. Firstly, it considers the reasons why a prudent debt position should be pursued, independently of the Treaty ceiling of 60 % for the debt/GDP ratio, concluding that the latter is a relevant indicator for conducting prudent policies. Secondly, it identifies current developments in EU-15 countries, and the implications over the medium term. Thirdly, it discusses how fiscal rules can contribute to achieve prudent debt levels and increase flexibility in fiscal policy. Finally, it explores how the current rules could be improved to define objectives for the budget balance which consider debt developments and, accordingly, are more country-specific.

5.2. A prudent reference value for the debt

The 60 % reference value of the Maastricht Treaty is often criticised for being an arbitrary number and for being

restrictive as it does not necessarily represent a ‘maximum level of debt’ beyond which countries face difficulties in issuing new debt (Blanchard, 1984). In addition, there is no evidence that it represents the ‘optimal’ debt level which ensures the most growth-enhancing use of resources.

However, it should be recalled that an ‘optimal’ or a ‘maximum’ level of debt cannot be clearly identified. This presupposes precise knowledge of the effects of government debt which is not available ⁽²⁾. In policy terms, even if these levels could be defined, they are likely to change over time reflecting the evolution in the economy. Given that the change in the stock of debt takes time, once reached, the level previously considered ‘optimal’, may no longer be so.

Therefore, it appears that, given the current state of the art, policy action should focus on maintaining ‘prudent’ levels of debt, in order to reduce risks and negative effects arising from high debt levels. However, even the definition of ‘prudent’ levels of debt is an open issue. For example, it is argued that ‘a moderate debt level is desirable, but moderate cannot be precisely pinned down. We simply have to rely on good judgement’ (Wyplosz, 1999).

There are several indications on what can constitute a prudent debt level. In order to assess whether a position is prudent or not, a number of factors can be considered, such as the volatility of the economic conditions and the capacity of the public finances to adapt to mutated circumstance, either through higher taxes or lower expenditure. Below it is argued that these factors are more likely to play a significant role when debt levels are high.

The fact that higher debt levels can lead to risks arising from changes in the economic circumstances can be shown by looking at the simple framework of the so-called ‘sustainability area’. Graph II.11 shows, under different economic conditions, the ‘sustainability area’ (the area above the depicted continuous lines) ⁽³⁾, which indicates those positions where the debt/GDP ratio remains stable or decreases, for a given primary surplus. At this point, it can be already noted that being within the sustainability area in a specific point in time is not a sufficient condition for medium-term sustainability. If the economy moves to a new steady state with less favourable economic conditions, any debt level

⁽¹⁾ In a speech at the European Parliament at the beginning of December 2003, Commissioner Solbes recalled this strategy and the intention to build upon the November 2002 Commission communication and thus to put more emphasis on sustainability and indebtedness. The speech is available at: http://europa.eu.int/8082/rapid/start/cgi/guesten.ksh?p_action=getfile=gf&doc=speech/03/590/0laged&lg=en&type=pdf. The strategy was formalised by the Commission on 13 January 2004, see the press release of the commission available at: http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action=getfile=gf&doc=ip/04/35/0lrapid&lg=en&type=pdf

⁽²⁾ Balassone, Franco and Zotteri (2004) believe that general equilibrium models would be needed to capture all the effects of fiscal policies and public debt.

⁽³⁾ The ‘sustainability area’ is defined by the following inequality: $s \geq (i - y)b$, where s is the primary surplus, i is the interest rate, y is the growth rate and b is government debt as a percentage of GDP.

could become unsustainable. This risk increases with the level of debt: the higher the level of the debt, the higher its vulnerability. This can be seen with an example based on Graph II.11, where two stylised countries have the same primary surplus (2.5 % of GDP), the same interest rate growth differential ⁽²⁾ but two different debt/GDP ratios: country A has a debt/GDP ratio equal to 60 % while country B has a ratio of 100 %. Given these conditions, both economies are into the sustainability area and the debt/GDP ratio decreases. However, a change in the economic conditions is likely to take place, as in practice it is normal that economic conditions fluctuate over time. If for instance, they deteriorate, so that the interest rate growth differential increases up to 3, the relative position of the two countries would change: country A would remain in the sustainability area while country B would find itself in a position which requires a change in the primary surplus. Therefore, without an increase in the primary surplus to 3 % of GDP, country B would see its debt level increasing continuously, and at an increasing speed. Thus, while a given debt level can be considered to be stable at a given point in time, this may not always be the case at all times (in particular if changes in economic circumstances of a permanent nature take place). The risk that such changes in the economic conditions may determine the insurgence of unsustainable developments increases with the level of debt.

This analysis illustrates several aspects linked to the vulnerability of public finances. Firstly, the sustainability area tends to become smaller the higher the interest rate growth differential. Secondly, the risk of becoming unsustainable when the economic environment changes increases with the level of the debt/GDP ratio ⁽¹⁾. In addition, an endogeneity between debt level and the interest rate growth differential cannot be excluded, so that the higher the debt, the higher are interest rates and the lower is real growth. This reinforces the probability that higher debt levels risk putting the country in an unsustainable position.

Clearly, given a specific economic condition, sustainability is guaranteed at any debt/GDP ratio, whenever the primary surplus is high enough. However, the other side of the coin is that the primary surplus required to stabilise the debt level increases with the level of debt, under given economic circumstances. But the capacity of a government to adapt the primary surplus to changed economic conditions

(and/or increasing debt levels) is not without costs ⁽²⁾. In particular in European countries the capacity to increase taxation from current levels or to rapidly and permanently compress public spending, if significant unbalances arise, appears limited. Finally, the analysis assumed that primary surpluses are fully within the control of governments. However, if primary surpluses are volatile, reflecting factors outside government control, this may increase the risk that a country could find itself in an unsustainable position: significant changes in the primary surplus not arising from policy decisions may have to be corrected by the government promptly, and especially at high debt level, to avoid unfavourable developments ⁽³⁾.

The analysis above shows that maintaining low debt levels reduces the vulnerability of public finances to economic developments ⁽⁴⁾. Although arbitrary, the threshold set by the Maastricht Treaty for debt levels below 60 % of GDP seems consistent with sound budgetary policy, as it is well below levels which could be perceived as leading to default for indebted countries. Being below such a threshold would give a reasonable margin for fiscal policy to avoid unsustainable debt development if economic conditions change. By doing so, it reduces the risk of having to implement drastic policy changes, which could be economically costly and politically difficult. The analysis of government response to unfavourable debt developments shows that it is often belated, as the market incentives only appear at a very late stage, when high debts have been accumulated, and therefore it has to be strong in order to place the country back onto a sustainable path ⁽⁵⁾. In addition, as argued in Part I, rapidly moving to and remaining at levels below 60 % of GDP will be a helpful contribution to tackle the budgetary pressures arising from the ageing of populations.

⁽¹⁾ If a country with a high debt moves from a sustainable to an unsustainable position, the transmission effect on its debt is higher than for a low debt country: the impact on interest payments creates a snowball effect on debt/GDP ratios which is more difficult to correct than for a small debt country.

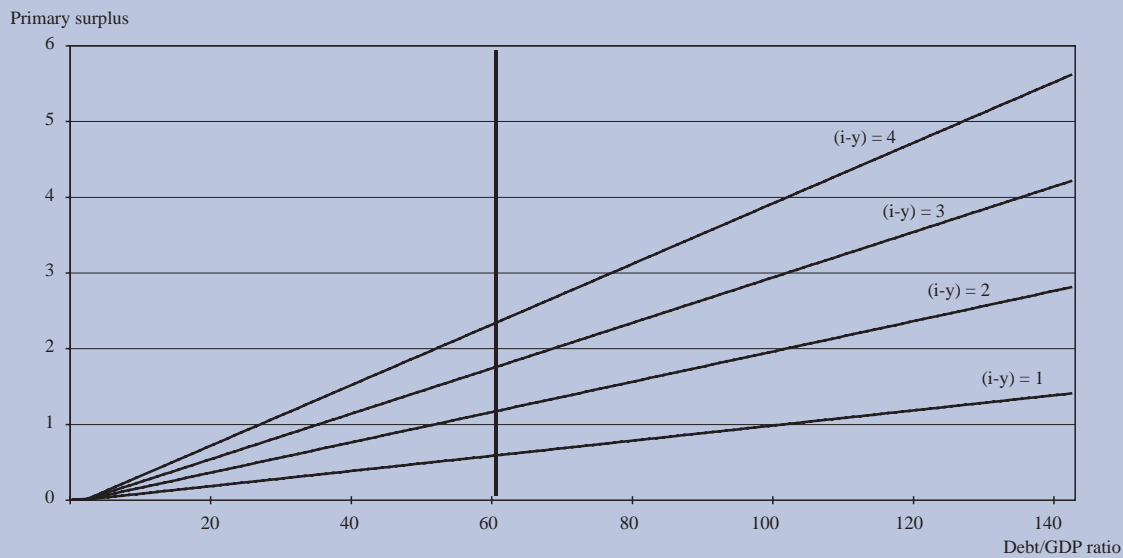
⁽²⁾ As argued by Blanchard (1984), there is an upper limit of the debt/GDP ratio, above which there is not additional political consensus to increase the primary surplus further. Thus, when this upper bound is reached, the government has to run a drastic policy change, which is costly in terms of consensus. As an illustrative example, Mongelli (1996) computed maximum levels of primary surpluses which government of European countries would be able to impose.

⁽³⁾ This may happen, for example, reflecting changes in the price of and/or demand for one particular material or product whose sales produce significant government revenues. This issue, however, is mainly relevant for emerging markets (see IMF (2003)).

⁽⁴⁾ In addition, Part III of this report suggests that prudent fiscal policies can have positive effects on growth.

⁽⁵⁾ The IMF (2003) identifies maximum sustainable debt levels for industrialised countries and shows that their governments on average started a serious response to debt level only when it reached about 80 % of GDP. Other studies, e.g. by Balassone, Franco and Zotteri (2004), highlight the limited and belated role of financial markets and credit ratings in inducing government reactions to unsustainable debt developments.

Graph II.11: The sustainability area



Source: European Commission.

In conclusion, the analysis carried out also highlights two important issues. Firstly, the analysis of debt developments cannot take place over too short a horizon, as current economic circumstances are not necessarily close to a steady-state condition in the short term. Secondly, the analysis over a long-term horizon is affected by the hypothesis made on the future development of economic conditions, which are likely to vary from the current position, and as argued in Part III, may even be influenced significantly by fiscal policy itself.

For these reasons, Blanchard et al. (1990) suggested that sustainability should be assessed over one-, five- and 40-year periods ahead to capture short-, medium- and long-term implications of current deficit and debt positions and their interrelation with economic variables. Along these lines, the European Commission assesses debt developments on a yearly basis (when making forecasts and implementing the EDP), in a medium-term perspective (in the assessment of stability programmes) and over the long term, (when assessing the long-term sustainability of public finances) ⁽¹⁾.

⁽¹⁾ See Part I of this report for the three different types of analysis.

5.3. An assessment of debt developments

Having in mind that achieving prudent debt levels and ensuring the respect of the debt ceiling set by the Treaty is crucial to avoid fiscal risks and increase the contribution of public finances to growth and employment, it is relevant to assess whether the policies run by EU-15 countries are consistent with achieving and maintaining prudent debt positions, given economic conditions. Firstly, this requires having a look at the determinants of past developments in high-debt countries. Secondly, by projecting past debt developments into the future, it is assessed how long it takes for very high-debt countries to reach debt levels below 60 % of GDP. Thirdly, debt prospects for the EU-15 countries are analysed, taking into account the volatility and trends in debt developments over recent years. The analysis is conducted on a medium-term horizon: this reduces the influence of the volatility of economic circumstances on debt developments. It should also allow stock-flow operations to compensate over time, which would make debt developments depending to an almost exclusive extent on deficits and economic conditions.

Table II.9 explores *ex post* the debt dynamic in those EU-15 countries with debt levels in 2003 above 60 % of

GDP (Austria, Belgium, Germany, Greece, France and Italy). It compares them with the targets planned in the stability programmes submitted four years ago, when the year 2003 was covered for the first time. In practice, the table assesses the reasons behind the different outcomes in terms of debt/GDP ratio. The reasons for slippages are grouped into three broad factors: the primary balance, the economic environment (which includes interest payments, GDP deflator and real economic growth) and the stock-flow adjustments.

The first result emerging from Table II.9 is that the debt/GDP ratio is currently higher than planned in all high-debt countries, except Belgium. The difference is particularly remarkable for Greece (more than 10 percentage points of GDP), Germany, Italy (about 6 percentage points) and France ⁽¹⁾.

⁽¹⁾ Slippages from planned trends are greater than what appears for France due to a revision in the debt/GDP ratio figures for the year 1999. This can be read from the difference between the actual debt/GDP ratio for 1999 and the one included in the updated programme (submitted in January 2000, see last line in Table II.9). According to the French 2000 updated programme, the debt/GDP ratio in 1999 should have been 1.8 percentage points of GDP higher than what it has instead been. It means that the difference between the planned debt reduction (in points of GDP) and the actual one is 7.4 percentage points of GDP, resulting from adding up the contribution of stock-flow adjustments, the external environment and the primary balance.

The primary balance in particular has had a strong negative impact on debt development in these four countries. In absence of slippages in the primary balance, the debt/GDP ratio would have been below 60 % in Germany and France, close to 100 % in Italy and well below it in Greece. Conversely, the primary balance has been more favourable than planned in Austria and Belgium, limiting the slippage in debt due to lower real GDP growth.

A second general feature resulting from the decomposition provided in Table II.9 is that real growth turned out to be worse than projected in late 1999, reducing the contribution to debt reduction with respect to plans in all cases. Cumulated over the period, real growth contributed less than expected in particular in Belgium and Italy. However, the debt dynamics are driven by nominal growth, which results from the evolution of both real GDP growth and GDP deflator. If the GDP deflator turns out to be higher than estimated, the impact of (nominal) growth on debt is stronger than planned, for a given real GDP growth. This is particularly the case in Greece, where the GDP deflator contributed by almost 6 percentage points of GDP more than initially expected in ameliorating debt developments. The GDP deflator had a more favourable impact on debt trends also in Italy, where it almost completely offset the worse than expected real growth conditions (cumulative over the

Table II.9

Difference in the 2003 debt/GDP ratio between planned data in the 2000 updated stability programmes and actual data

(% of GDP)

	AT	BE	DE	EL ⁽¹⁾	FR	IT
Debt ratio (actual)	65.0	100.5	64.2	103.0	63.0	106.2
Debt ratio (as planned in USP 1999)	61.2	101.2	58.0	90.5	57.7	100.0
Difference	3.8	-0.7	6.2	12.5	5.3	6.2
Contribution to change:						
Primary balance	-2.7	-1.2	6.2	9.1	4.3	4.3
Economic environment:	0.0	-0.3	3.6	-0.8	1.8	1.6
Interest payments	-0.2	-1.1	-0.6	3.2	0.5	1.2
GDP deflator ⁽²⁾	-1.8	-2.8	1.4	-5.8	-0.6	-4.7
GDP growth (real)	2.1	3.6	2.8	1.8	2.0	5.1
Stock-flow adjustment	3.9	0.8	-3.8	3.6	1.0	-0.5
Difference due to starting position in 1999	2.6	-0.1	0.2	0.6	-1.8	0.8

⁽¹⁾ Figures for Greece concern USP 2001 (December 2000).

⁽²⁾ Figures replaced by the HCPI (harmonised consumer price inflation) for Austria.

NB: A 'minus' indicates a positive contribution (a faster than expected debt reduction), a 'plus' indicates the opposite.

Source: European Commission.

period growth, therefore, nominal GDP growth is responsible for only half a percentage point of GDP to the different-than-planned debt development). Finally, a mixed contribution results from interest payments developments. In general this has been close to what was projected, except for Greece due to the slower debt reduction and probably to higher interest rates on government debt than originally expected. Overall, the economic environment (measured as the sum of the contribution of interest payments, growth and GDP deflator to debt reduction) had a relatively minor impact (although generally negative) on debt developments during the last few years than generally perceived, with the sole exception of Germany, where a combination of lower than expected real growth and inflation led to unfavourable debt developments.

A final factor to be considered in the analysis is the stock-flow adjustments (resulting from privatisation receipts or the impact of exchange rate changes on foreign denominated debt). As shown in Table II.9, stock-flows had a negative cumulative effect on debt dynamics in all countries but Germany and Italy. While in Austria and Greece they have contributed more than planned to increase the debt ratio, in Germany, stock-flows have contributed by almost 4 percentage points of GDP to bring the debt down more than planned in the 2000 updated programme ⁽¹⁾.

On the basis of past developments, Graph II.12 shows the projected debt/GDP ratios in the three very high-debt countries (Belgium, Greece and Italy). This reflects the assumption that the debt reduction in future will continue as in the recent past ⁽²⁾. The graph is a simple projection in the future of average past behaviours and therefore assumes that economic growth, interest rates, inflation remain on average as in past years, while it does not include additional assumptions on age-related expenditure ⁽³⁾.

⁽¹⁾ This shows that the difference between planned figures and actual ones is bigger than in other countries. However, it does not mean that overall stock-flow operations have been higher in Germany than in the other countries. Stock-flows deteriorated debt developments by around 25 percentage points of GDP in Greece between 1999 and 2003.

⁽²⁾ This is based on the average rate of reduction over 1998–2003. The six-year period is likely to cover a whole economic cycle so that it could be considered a ‘structural’ rate of reduction, i.e. the one the country can achieve in normal economic conditions. A six-year average means undue weight is not given to unusual stock-flow operations. Positive and negative adjustments should compensate each other in this length of time, with the sum of these operations resulting in the ‘structural’ impact of stock-flows on the debt dynamic.

⁽³⁾ For the latter analysis, see the assessment of long-term sustainability included in Part I of this report.

Since the rate of reduction has been positive on average during the last six years, convergence towards 60 % results in all three countries, although the speed differs widely across countries. Projecting the current rate of reduction over time implies that Belgium will bring its debt/GDP ratio below 60 % within the next 20 years, Italy would need around 30 years while Greece will not converge to 60 % before the end of the century. This clearly means that in Greece and, partly, in Italy the current average rate of reduction will not bring debt below 60 % of GDP before the impact of ageing fully takes place.

In a wider perspective, it is possible to look at debt prospects in all EU-15 Member States, on the basis of recent developments. Focusing the analysis on overall deficit levels, nominal GDP growth and initial debt levels, current situations in Member States can be presented using the 60 % of GDP ceiling as a benchmark. Four cases can be identified on this basis, where countries have:

- (i) an initial debt/GDP ratio above 60 % and increasing;
- (ii) an initial debt/GDP ratio above 60 % and decreasing;
- (iii) an initial debt/GDP ratio below 60 % and increasing;
- (iv) an initial debt/GDP ratio below 60 % and decreasing.

Graph II.13 places countries in four quadrants, which reflect the four cases depicted above. Accordingly, quadrant (i) shows countries where measures have to be taken rapidly to be consistent with current economic circumstances. A judgement on the four countries in quadrant (ii) depends on the speed of reduction, as that implies how quickly the country will move to below 60 % of GDP. Case (iii) signals that despite a good performance in the past, economic conditions and the current deficit imply increasing debt levels. Quadrant (iv) shows countries pursuing prudent policies given the economic environment ⁽⁴⁾.

Graph II.13 also shows that a large number of EU countries have debt levels below 60 % and reducing.

⁽⁴⁾ The case of Hungary should be considered carefully: although the debt position in 2003 is lower than in 1998, debt is recently on an upward path after the minimum of 53.5 % of GDP reached in 2001. This mainly reflects substantial deficits recorded in 2002 and 2003 and reinforces the importance of looking at both debt and deficit developments when assessing budgetary positions.

Box II.4: Stock-flow adjustments in Greece

The high debt/GDP ratio in Greece is declining albeit at a slow pace, despite the improvement of the primary balance since the second stage of EMU, strong growth and the prevailing low interest rates in particular since adoption of the euro. The slow decline in the debt ratio seems due to large stock-flow adjustments: the residual change in government debt not resulting from the surplus/deficit or the effect on the ratio of the evolution of nominal GDP. In Greece these adjustments have been consistently positive in recent years, i.e. they have had the effect of raising the debt compared with what would have resulted only from the effects of the surplus/deficit and change in nominal GDP. In the case of Greece, the stock-flow adjustment includes: the variation in the valuation of debt denominated in foreign currencies as a result of exchange rate movements; debt assumptions by the State on behalf of third parties; military borrowing; the acquisitions of financial assets, such as capital injections to public enterprises; a number of financial operations related to debt management such as the securitisation of future receipts, privatisation certificates, share-convertible bonds and exchangeable bonds; and privatisation proceeds.

The stock-flow adjustment which peaked at 6.8 % of GDP in 2001 was still high in 2002, standing at 4.2 % of GDP, before being reduced to 3 % of GDP in 2003. These large autonomous increases in the stock of debt, which from 1999 to 2003 amounted to a cumulative 25 % of GDP, reduced the beneficial impact on the debt ratio of the high primary surplus, the snowball effect during periods of low interest rates and strong nominal GDP growth, and of sizeable privatisation receipts.

The very high level of spending on military equipment in Greece is one of the most important components of the stock-flow adjustment. In 2003 military borrowing reached 1.4 % of GDP as compared to 2.3 % in 2002 ⁽¹⁾. Before the introduction of the euro, the relatively high external debt was exposed to the fluctuations of the exchange rate with serious implications in periods of national currency depreciation. Sizeable debt assumptions and capital injections to public enterprises also contributed significantly in increasing the stock of debt. In 2002, Eurostat requested that the securitisation proceeds and the share convertible and exchangeable bonds, until then fully omitted from government accounts, should be included in the stock of debt, resulting in a significant upward revision of the debt ratio to 107 % of GDP in 2001 and to 104.7 % in 2002. Nonetheless, the treatment of debt-creating financial operations according to 2002 Eurostat guidelines led to a reduction in the stock-flow adjustment and improved the transparency and credibility of the government accounts. In addition, in the period 2001–03, privatisation proceeds used to pay-off government debt amounted to a cumulative 6 % of GDP.

In recent years the Greek authorities have taken measures to restructure the debt and to improve its dynamics. Some of these measures might contribute to limit the stock-flow adjustments, which continue to be high.

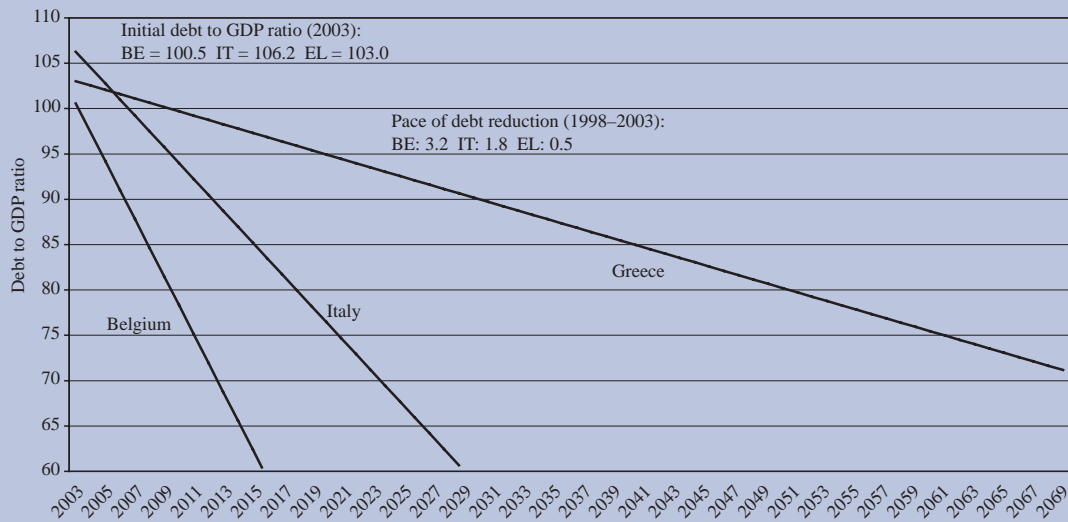
- Following the introduction of the euro and as a result of currency swap operations carried out during the last three years, the share of non-euro currency denominated debt declined from 5.5 % in 2001 to 2.1 % in 2003; the sensitivity of debt to exchange rate movements was thereby reduced significantly.
- The establishment of a liquid market for government securities, through the issuance of large liquid benchmarks traded both in the domestic secondary market and abroad, contributed to a narrowing in the spread of the Greek Government bonds *vis-à-vis* the euro area. In addition, the lengthening of the weighted maturity of debt and the smoothing of its maturity structure contributed to the better management of the government debt.

⁽¹⁾ The stock flow effect of military expenditure in Greece results from the fact that it affects the deficits only once military equipment has been delivered by producers and enters into service. Until that moment the purchase is only recorded in the debt.

If sustained over time, this may lead to very low or even negative debt levels. This aspect has been

remarked by observers (e.g. Bishop, 2003) as a critical aspect of the implementation of the EU fiscal rules, in

Graph II.12: The rate of debt reduction in very high-debt countries



Source: Commission services.

Graph II.13: Debt levels and trends in the EU

Debt level (2003)	> 60 %	(ii) Austria Belgium Greece Italy	(i) Germany France Cyprus Malta
	< 60 %	(iv) Denmark Finland Ireland Luxembourg Netherlands Spain Estonia Hungary Sweden United Kingdom	(iii) Portugal Poland Latvia Lithuania Slovenia Slovakia Czech Republic
		Debt trends (1998–2003)	
		Decreasing	Increasing

particular related to a strict interpretation of the medium-term objective of close to balance or in surplus. Giudice and Montanino (2003) point out that, on the basis of average conditions in 1998–2002, debt would disappear only in Luxembourg, the Scandinavian countries, the UK and Ireland, as the debt/GDP

ratio would be below 15 % of GDP (or even below 0) within 15 years at most ⁽¹⁾.

⁽¹⁾ However, their computations do not take the effects of ageing populations into account.

While Graph II.13 presents average debt developments over recent years, Table II.10 points out that there is volatility in the financial position of the EU-15 countries. It indicates in column (1) the average distance of current deficit from the deficit level which would stabilise the debt ratio ⁽¹⁾, in column (2) the volatility of such a margin and in column (3) how this distance has changed between 2003 and 1998. Column (4) indicates current debt levels.

As shown in the first column of the table, all countries except France, Germany and Portugal have had on average a budget balance which allowed a debt reduction under prevailing economic conditions. However, the distance of the actual balance from a debt stabilising value has changed considerably on a yearly basis, as column (2) shows: the greater the value, the greater its volatility. In some cases the standard deviation is even higher than the average distance of the actual deficit from a stabilising position, showing how a country can easily move from a sustainable to an unsustainable position due to deteriorated economic environment or changes in budget balances.

The third column shows how the margin has changed between 2003 and 1998. It appears that all countries save Spain have smaller margins now which results from either the deterioration of the economic environment or the loosening of budgetary policy.

This analysis shows how medium-term debt sustainability is not only a concern for very high-debt countries. In addition, available information shows a high probability of increasing pressure on the budget in a no-policy change scenario as the result of demographic pressure. Pursuing a policy of debt reduction over the medium term would avoid dramatic policy shifts at a later stage, which could be politically hard to implement and could have an important impact on growth, at least in the short term. Therefore, it seems important to reach once again budget positions which ensure that debt ratios converge rapidly towards prudent values.

⁽¹⁾ The equation $yb - d = 0$, where d is the deficit to GDP ratio, shows that when the sum of budget balance and the nominal growth rate times the debt/GDP ratio is equal to zero, the debt/GDP ratio is stabilised. If it is greater than zero, the country concerned is within the sustainable zone, or 'over sustainable' in the medium term, while for negative values the country is out of the sustainability zone.

Table II.10

Index of medium-term debt stability

	Average 1998–2003 (1)	Standard deviation (2)	Diff. 2003–1998 (3)	Debt level in 2003 (4)
BE	3.8	1.3	-1.2	100.5
DE	-0.8	2.3	-3.4	64.2
EL	6.4	0.7	-0.2	103.0
ES	3.2	0.9	1.9	50.8
FR	-0.3	1.6	-3.0	63.0
IE	6.7	4.2	-10.5	32.0
IT	2.3	1.5	-1.2	106.2
LU	3.9	2.7	-4.2	4.9
NL	2.7	2.9	-4.9	54.8
AT	0.9	0.9	0.0	65.0
PT	0.2	1.1	-3.0	59.4
FI	6.1	2.7	-2.3	45.3
EUR-12	1.1	1.6	-1.8	70.4
CZ	-5.2	4.3	-10.2	37.6
DK	4.0	1.4	-0.9	45.0
EE	0.6	2.0	3.1	5.8
CY	0.5	1.8	-1.2	72.2
LV	-1.1	1.7	-0.6	15.6
LT	-1.5	2.3	0.9	21.9
HU	1.8	2.8	-4.0	59.0
MT	-4.3	1.9	1.1	72.0
PL	0.5	2.8	-6.6	45.4
SI	-3.6	3.0	0.4	27.1
SK	-2.6	2.5	1.3	42.8
SE	4.5	2.4	-3.0	51.9
UK	2.4	2.5	-3.9	39.9
EU-25	1.5	2.4	-3.6	63.2
p.m. EU-15	1.5	2.4	-3.5	64.0

NB: Column (1) indicates the sum of budget balance and nominal growth rate times the level of debt/GDP ratio. A positive value indicates that, under the given economic conditions, on average the actual budget balance has led to declining debt levels.

Source: Commission services.

5.4. Strengthening economic surveillance by jointly assessing deficit and debt developments

The previous analysis has shown that additional focus on debt levels and developments is needed to better qualify medium-term budgetary positions. A given deficit level could be perfectly sustainable for a country, while it could lead to explosive debt developments in others. This reflects the specific economic circumstances of each country, but to a very large extent their level of government debt. In particular, the analysis highlighted that

under normal economic circumstances, high-debt countries need higher primary surpluses to stabilise their debt. It also pointed out that high-debt countries are more vulnerable in their budgetary position: if economic circumstances become unfavourable the sustainability of public finances in those countries risks being jeopardised unless drastic policy changes are taken. At the same time, it appears that for some countries the current combination of budget balances and debt levels implies that prudent debt levels will be easily maintained, even if a small deterioration in the budget balance would occur.

In sum, the analysis shows that current combinations of budget balances and debt positions are very different across EU countries, that debt developments should be more clearly taken into account in the multilateral budgetary assessment, and that this should lead to more country-specific assessments.

In addition, the analysis revealed that considering deficit levels in isolation from other factors affecting debt dynamics can lead to misleading interpretation as to whether current policies imply risks to sustainability. It has been noted in the previous section that the recent evolution of debt levels is to a significant extent explained by other factors than the overall budget balance (or the primary surplus). Ideally, all the other main factors affecting debt dynamics (real growth, interest rates and inflation rates, the so-called economic environment) should be considered in the application of the fiscal framework for economic surveillance. At the same time, the inclusion of more elements in the analysis naturally leads to a wider country diversification. This would be a positive development at this stage of economic surveillance in EMU, where in an EU of 25 Member States it cannot be expected that a common rule leads to uniform consequences on different countries. The common rules should recognise such differences, and accordingly imply different policies.

Although looking at the factors behind the debt dynamics would complicate the framework, it would improve its economic rationale. As argued by Buitier and Grafe (2002), the appropriate operational expression of the concept of sustainable and stabilising policies ought to depend on certain key structural economic features of the economy. Building flexibility and strengthening credibility in the rules seems to require above all an extension of the focus of surveillance. Indeed, the experience of the first years of EMU has shown that surveillance based on monitoring exclusively and the respect of

the nominal deficit ceiling of 3 % is not sufficient to cater for the complexity of the European economies ⁽¹⁾.

In addition, it has been noted that the SGP suffers from the notion that a simple deficit rule could provide a rich enough environment to deal with many of the biases of fiscal policy: it turned out that the reality is much more complex (Fatàs and Mihov, 2003). Accordingly, it appears to some observers that the narrow interpretation of the rules of the SGP, by being too simplistic (in this exclusive focus on deficits) and not fitted to take national differences into consideration, is over-restrictive in some cases while too lenient in others. As a consequence, Buitier and Grafe (2002) ⁽²⁾ think that the strict enforcement of the SGP as it is interpreted now would cause serious problems for EU members whose initial conditions are different from average and whose medium-term growth rates and inflation rates may differ significantly from average.

Among the various characteristics of an optimal numerical rule, credibility and flexibility play a relevant role. However, flexible need not mean opportunistic, while credible need not mean rigid and inflexible. In this context, it cannot be excluded that the EMU fiscal framework, especially since the adoption of the SGP, may have erred to the side of rigidity, without necessarily being more credible. The lack of considerations about debt levels and developments, as well as the strict enforcement of procedures only in relation to deficit positions have led to criticisms concerning the lack of clear economic rationale (see, among others, Melitz, 2002 and Pisany-Ferry, 2002), and the mechanistic approach (HM Treasury, 2004).

One of the features of the SGP is indeed that it defined narrowly the procedures to be applied for not respecting the deficit ceiling set in the Treaty, while barely any reference is made in the SGP to debt developments. In particu-

⁽¹⁾ A deficit below 3 % of GDP is a necessary but not sufficient condition for reducing debt ratios. See European Commission (2003a) and Giudice and Montanino (2003) for an account of recent experiences in EMU and the implications of only focusing on the deficit rule.

⁽²⁾ According to Buitier and Grafe (2002), the Pact is apt to lead to errors of commission as well as to errors of omission, by signalling the need for action when there is no danger, and by omitting alerting for real risks. The authors challenge the medium-term target of close to balance or in surplus as non-economically-based, and criticise it for preventing countries from borrowing when they want to build up public sector capital, for lacking any incentive for fiscal restraints in view of the impact of ageing populations, for preventing essential but temporary expenditures which may help the transition towards the steady state, and for their asymmetric behaviour. Buitier and Grafe also consider that currently in the SGP there is insufficient flexibility but scope for opportunistic, politically motivated manipulation of the framework and the process.

lar, the SGP defines two specific aspects of the procedures by relating them expressly to the deficit-to-GDP ratio: first, among the three 'escape clauses' foreseen in Article 104(2) ⁽¹⁾ the only one which has been developed in detail is the one concerning the deficit-to-GDP ratio (Article 2 of CR 1467/97); secondly, the specification of sanctions mentioned in Article 104(11) has been spelled out in detail only as concerns sanctions to be applied in the case of protracted excessive deficit positions resulting from non-compliance with the criterion relating to the deficit ratio (Article 12 of CR 1467/97). This has led to a short-term bias in the procedure which has somehow left the surveillance of debt developments in a secondary place.

As recalled above, the European Commission (2002a) already expressed the importance of improving the interpretation of the fiscal rules, in order to take debt developments and country-specific circumstances more into account. Since then, the debate concentrates on how numerical rules should be interpreted or even changed for mainly two reasons: firstly, strengthening the pressure on high-debt countries to rapidly reduce their debt towards more prudent levels; secondly, giving more flexibility to low-debt countries to enact policies which could enhance growth in the medium term, or to stabilise the economy during slowdowns. In particular, the debate has focused on:

- how to apply the Maastricht criteria in order to foster debt reduction;
- how to avoid submitting countries to procedures and recommendations, when they do not present risks of unsustainable developments;
- how to set medium-term targets which are ambitious enough to bring debt ratios towards prudent levels without making them over-restrictive;
- how to determine the adjustment path towards prudent budgetary positions, given the consideration expressed above.

⁽¹⁾ The term 'escape clauses' is commonly used to refer to those cases in which, in spite of the reference values of the deficit and debt being exceeded, the criteria for assessing compliance with budgetary discipline are considered satisfied. These cases are respectively, for the deficit/GDP ratio, 'either the ratio has declined substantially and continuously and reached a level that comes close to the reference value, or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value'; for the debt/GDP ratio, if 'the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace'.

For some observers, stronger focus on the analysis of debt developments would imply that in the context of the multilateral budgetary surveillance the only variable to be monitored should be debt levels. However, the analysis of the previous sections clearly suggest that the surveillance on the sustainability of the government financial positions of Member States cannot refrain from taking account of overall deficit positions, as they are an important, generally the main, determinant of debt developments. Therefore, any increase in attention placed on debt developments should not be at the cost of less attention on deficit developments. Deficit levels remain the primary indicator and the only one directly controllable by governments in the short term: therefore they cannot be excluded from the monitoring and surveillance of budgetary policies.

In trying to achieve the objectives presented above, it should thus be stressed that the Treaty approach does not need any change as to how the surveillance should be conducted. In addition, the SGP concept of establishing medium-term objectives seems valid in order to provide directions to Member States on which policies should be pursued, and to the EU institutions on how to conduct surveillance.

Within these boundaries for the current fiscal framework, there are three specific instances where interpretation of the numerical rules may take place to take the elements indicated above into consideration:

- in assessing the respect of the reference values which prompt corrective action;
- in determining the medium-term objective which should reflect the conduct of prudent policies;
- in setting the pace of adjustment, either when the deficit ceiling is breached or in order to achieve the medium-term objective.

Clearly, the three aspects are strictly interrelated. Provided that there is agreement that 'gross errors' in national fiscal policies must be avoided and promptly corrected at EU level, an approach which defines prudent policies cannot be inconsistent with ceilings which allow the identification of 'gross errors'. Ultimately, the speed of adjustment to correct 'gross errors' and achieve the medium-term objectives must be based on the same economic rationale underlying the other two concepts.

5.5. How can debt developments be better considered in the numerical rules?

There are several ways to consider the various budgetary and macroeconomic variables in the assessment of budgetary positions, and to make them consistent with Treaty requirements on debt and deficit. In the course of the last years, the academic and political debate has produced a number of ideas on how the joint assessment of budgetary positions and debt developments could be carried out in practice. Clearly, the thinking on this issue is only beginning, and needs to be pursued further. Therefore, it is stressed here that the ideas reported for illustrative purposes in the next section do not represent in any case specific proposals for strengthening surveillance.

Without formalising the link between debt and deficit, the European Commission (2002a and 2003a) proposed to apply the debt criterion, in addition to the one on the deficit, by setting the satisfactory pace of debt reduction mentioned by the Treaty ⁽¹⁾. Accordingly, by conducting the surveillance jointly on the two criteria, and taking action when one of the two is not respected, a significant degree of country differentiation would be introduced: the higher the debt/GDP ratio, the higher would be the implied debt reduction required to respect the debt criterion. At the same time, flexibility for low-debt countries would be provided. The Commission suggested that the medium-term objective could be somewhat relaxed for countries having debt levels well below 60 % of GDP, and presenting no problems in terms of sustainability. Therefore, the Commission proposals aimed at widening the focus from fiscal deficits to also include debt levels, allowing for a substantial degree of country differentiation.

Other ideas discussed in the literature, also based on the objective of giving sustainability a greater place in the assessment of budgetary positions, rely less on the Treaty framework. Without necessarily providing more economic rationale than the current rules, as the Commission would like to implement them, they either widen the focus from fiscal deficits to include also debt levels, or sometimes shift altogether the surveillance only on debt levels. Below are briefly reviewed some ideas circulated on how the objective of increasing the focus on medium-term sustainability could be made operational. Most of the ideas that have been put forward responded to the only objective of providing more room for low-

debt countries. By contrast, no specific suggestions have been provided on how to make sure that the rules ensure a fast reduction of debt levels in high-debt countries, nor on how the adjustment towards sound budget positions should be done.

Therefore, most proposals address only one of the many concerns, and accordingly they usually tend to raise the deficit ceiling, if debt levels are maintained below 60 %. In practice, this would imply that in some cases a low-debt country raising its deficit above 3 % may not incur into procedures aiming at the prompt correction of such deficit.

For the sake of illustration, hereafter are some examples of ideas which could pursue the limited objective of raising the deficit ceiling for low-debt countries. It should be clear, however, that this is not in conformity with the Treaty and does not represent a viable way ahead. Most of the proposals provide a diversification across countries through deficit ceilings based on debt levels. As a general intuition, the lower the debt/GDP ratio below the 60 % of GDP ceiling, the higher should be the maximum allowed deficit. An advantage in such an approach could be that it could create incentives to run down debt during good times, in order to achieve more room of manoeuvre in bad times.

According to one approach which would group countries in ranges reflecting their debt levels ⁽²⁾, only those countries with a debt/GDP ratio above 55 % should maintain the 3 % ceiling, while other countries would be allowed to run a higher deficit (up to 5 % of GDP for countries with a debt/GDP ratio below 25 %). In applying this approach, under normal economic circumstances a country with a starting debt/GDP ratio equal to 25 % could run excessive deficits (higher than 3 %) for about 15 years before approaching the 60 % reference value for the debt. The deficit ceiling would get closer to 3 % as debt approaches 60 % of GDP. This rule is appealing for its simplicity, but the discretionary groupings may create jumps and lead to incentives to creative accounting for countries at the edge of the groups. Alternatively, deficit ceilings could be defined with a specific formula, linking deficit and debt which would avoid discontinuity ⁽³⁾.

⁽²⁾ See Calmfors and Corsetti (2003).

⁽³⁾ A formula suggested by Fiorito (2002) is $d = 0.03 - x*(b - 0.6)$ where d is the maximum allowed deficit to GDP ratio, b is the current debt/GDP ratio and x is the 'degree of incentive' the rule would put forward in order to create motivation to run down debt. Clearly, the greater x , the greater the spread of country-specific ceilings.

⁽¹⁾ See also Giudice and Montanino (2003).

A different approach would imply disregarding the deficit ceiling altogether, and placing stronger focus on debt levels and long-term sustainability. As, for instance, suggested by Pisani-Ferry (2002), Member States could opt for a 'sustainability pact' and be exempted from the SGP numerical rules if they fulfil the following conditions:

- publish a comprehensive balance sheet of the public sector, that would allow an assessment of the potential future impact of off-balance sheet liabilities;
- maintain the debt ratio (Maastricht definition) below 50 % of GDP;
- set a five-year target for the government debt, taking into account implicit liabilities, which would be the benchmark for assessing their budgetary policies.

Countries choosing to opt for the 'sustainability pact' and complying with these conditions would automatically be exempted from the Treaty procedure for excessive deficits. In practice, those who follow the sustainability pact can run a deficit higher than 3 % of GDP. Besides the fact that the primary variable for controlling budgetary developments would be excluded altogether from the surveillance, compared with the approaches previously presented, the sustainability pact requires a higher degree of judgement, since it would be based on future budgetary and macroeconomic developments ⁽¹⁾.

As argued above, while there is a need to increase the focus of surveillance on debt developments and sustainability, the ideas mentioned above increase the risks of fiscal indiscipline, as they revise substantially or abandon altogether the deficit ceiling. Besides the fact that following such ideas would mean changing the protocol of the Treaty, which is politically highly unlikely, the economic arguments used to support these ideas are considering only part of the complex of needs which must be tackled in the surveillance of 25 countries. In sum, the risks for fiscal indiscipline arising from such a revision of the deficit ceilings seems too high for considering this route further ⁽²⁾.

⁽¹⁾ The higher degree of judgement is in line with proposals in Wyplosz (1999).

⁽²⁾ Besides these proposals aiming at linking debt and deficit levels, by making the admissible deficit function of debt levels, other proposals have been advanced to propose linking admissible deficits (the deficit ceiling) to other elements than the debt. Among them, are the proposals of excluding capital expenditure from the computation of the deficit, which de facto links deficits to public investment. See, for example, Blanchard and Giavazzi, (2002). As argued later in this section, it may be possible to conciliate the needs for increased investment and for fiscal discipline by redefining the medium-term objective.

A more promising avenue seems to be one which considers the Treaty ceilings as reference values for the analysis of fiscal positions, and an accurate judgement is given as to the reasons why the developments in these variables have led to a non-respect of the Treaty values. The focus of the revision of the numerical rules should be elsewhere. While leaving the main provisions unchanged, the various concerns expressed above could be addressed by redefining the medium-term objective enshrined in the SGP: the 'close-to-balance or in surplus' objective in order to consider each country's debt level and developments. Member States whose debt and implicit liabilities are low would be able to run higher deficits ⁽³⁾.

In defining the medium-term objective, a number of possibilities exist. Here too, groupings of countries can be defined according to their debt level: in practice, the medium-term objective would be more stringent (close to zero or in surplus) the higher the debt level. A debt reduction policy would eventually lead to a less stringent medium-term objective but without compromising the 3 % deficit reference value. Such a link could also be expressed with various formulas, although the economic complexity is hard to reflect in a smart rule. If it is assumed that a prudent policy would be running a medium-term deficit of 0.5 % of GDP over the cycle, when the debt/GDP ratio is equal to the reference value of 60 %, variations around such an objective could be allowed according to other levels of debt. For countries with higher (lower) debt levels a more (less) demanding objective could be set, where such a variation would be determined by an 'incentive' ⁽⁴⁾. As an example, Table II.11 shows different medium-term objectives under a range of 'incentives': for a very low-debt country, the medium-term objective could vary between 0.8 % of GDP to 1.7 % of GDP, while a high-debt country could be required to be in balance or run a surplus, depending on how the 'incentive' is set. Clearly, the higher the 'incentive' set, the greater would be the spread across medium-term objectives. Also, over time, the development of debt levels would imply a change in the medium-term objective. In any event, the redefinition of the medium-term objective should imply that the latter would have to remain well below the 3 % reference value. Nevertheless, it seems evident that the possibility that a low-debt coun-

⁽³⁾ For instance, the European Commission (2002a) suggested that for countries with debt ratios well below 60 % of GDP, the medium-term objective may be relaxed for temporary or more permanent deviations.

⁽⁴⁾ The formula used could be similar to the one expressed in footnote 3, p. 117 by replacing the number 0.03 by 0.005 and considering the letter *d* as the medium-term objective and not the deficit ceiling.

try breaches the 3 % threshold during economic downturns increases.

Table II.11

Incentives and medium-term objectives

Degree of incentive	Debt to GDP ratio	Medium-term objective
1 %	30	- 0.8
	60	- 0.5
	100	- 0.5
2 %	30	- 1.1
	60	- 0.5
	100	0.3
3 %	30	- 1.4
	60	- 0.5
	100	0.7
4 %	30	- 1.7
	60	- 0.5
	100	1.1

Source: Commission services.

A few limitations, however, are still not addressed: firstly, the central medium-term objective, i.e. in this example 0.5 % for a country with a debt level of 60 %, is still set arbitrarily; secondly, the main economic factors indicated in the previous sections and which affect debt developments would not be taken into account explicitly. Therefore, over time, the debt ratio may develop unfavourably and the rule may not be sufficient to prevent such evolution. At the same time, the analysis could include other factors which over time may induce a better evolution of the economic factors (for example public investment, assuming that they positively affect growth).

On the latter aspect, the issue of supporting public investment could be addressed through the redefinition of the medium-term objective, for example by allowing countries to target over the medium term a balance or surplus for the deficit excluding net capital expenditure, while the 3 % ceiling could still apply to overall deficits. In this fashion, the difficulties in implementing the rules for the respect of the deficit ceiling would be reduced, as accounting issues would not arise with respect to the 3 % of GDP ceiling ⁽¹⁾. At the same time, excluding net capital expenditure in the assessment of the medium-term

⁽¹⁾ Resulting from the perverse incentive which the rules provide in recording current expenditure under capital accumulation, and in the computation of the 'net' investment, which is not observable.

targets makes economic sense and, not being such a large amount, it should not put fiscal discipline and the respect of the 3 % of GDP ceiling at risk.

Some authors have extended the analysis further, at the cost of adding complexity, by including considerations about the impact of real growth, interest rates and inflation on debt dynamics in a mechanistic approach. Though such formulas do provide a useful analytical tool for the assessment of sound budgetary policy, their complexity limits their practical use.

Reflecting the various elements mentioned so far, Buiters and Grafe (2002) propose a 'permanent balance rule', which takes into account both the structural and temporary situation of an economy ⁽²⁾. According to this 'rule', and given the current nominal GDP growth, a deficit is implied which should be considered the objective to be followed over time. This would in principle maintain the debt ratio stable, but the rule does not specify around which level. Variations of current public spending, of government capital income and of the inflation-and-real-growth-corrected current interest bill from their permanent values should be accepted, so that the deficit ceiling should be adjusted accordingly ⁽³⁾. Implicitly, such a rule has relevance for the use of the Treaty reference value for the deficit, as it does not exclude that, on occasions where temporary deviations from the permanent balance rule would be high, the deficit be left to go well above 3 %.

Among the difficulties with this approach, the most important is certainly its general complexity and difficulty to compute, given that most variables are not observable. In addition, the issues of recognition of whether current deviation are temporary or permanent, and of the irreversibility of spending decisions should not be underestimated. Assuming that a temporary devi-

⁽²⁾ The rule is based on the idea of 'tax smoothing', so that taxes would remain at a constant share of GDP, no lower than the lowest share of GDP which would ensure government solvency now and in future — intended as a non-exploding (net) debt level. This implies that current (and permanent) taxes are no less than permanent public spending, minus permanent government capital income, plus the inflation-and-real-growth-corrected permanent interest cost of the public debt, all expressed as a share of GDP. Permanent public spending can be thought as the average expected future value of the share of public spending to GDP, which given the discounting factor does not necessarily mean this is the steady-state value (see Buiters, 2003).

⁽³⁾ Buiters and Grafe (2002) propose the following formula: $d \leq (n + \pi)b + g - g^p + \kappa^p - \kappa + [(r - r^p) - (n - n^p)]b$ where deficit is represented with d and debt with b . Permanent values are shown with a p superscript, with g meaning current government spending, κ government capital income, r is the real rate of interest, n is the real GDP growth rate, and π is the rate of inflation.

ation from the permanent value is indeed originally conceived to remain temporary, the political economy factor could not exclude the irreversibility of decisions taken. Therefore, if a 'temporary' programme becomes over time 'permanent', a deficit higher than what could have been allowed would have been maintained for a number of years. At that moment, in order to bring the debt down to its initial level, taxes may have to be increased. Therefore, the rule may not be efficient. Finally, no specific position is taken to which should be the debt level which is to be pursued, which does not address aspects of the effects of the debt level on economic factors.

A less ambitious approach could be one setting a deficit on the basis of observed economic variables in the past few years, and of a specified debt target for the long run. Taking into account the Maastricht ceiling as a reasonable value to define sustainable policies, such a debt target implied by current policies should aim at providing comfortable room below the 60 % ceiling ⁽¹⁾. For example a prudent target could be in the range of 40 % of GDP ⁽²⁾. This approach could use past data ⁽³⁾, and by adapting yearly, would progressively indicate which seems the most appropriate deficit in order to achieve over time the debt target. A faster nominal growth rate would imply setting more demanding objectives for countries with high debt levels.

Both this and the previous approach consider inflation in the computation of the appropriate medium-term objective. Indeed, it should be noted that high inflation is a problem which needs to be tackled by countries, both because it creates spillovers in the euro area, and because it reduces the relative competitiveness of the higher-inflation country with respect to its counterparts in the currency area ⁽⁴⁾. While this is a problem which needs to be

tackled in the context of the wider conduct of economic policies (and therefore at EU level should be addressed by the BEPGs), it cannot be denied that in a sustainability perspective it plays a role. The role is particularly relevant in case of very fast disinflation processes, where the reduction in inflation is likely to result in a worse debt development. Requiring an adjustment of fiscal policies to compensate the more unfavourable debt developments may be inappropriate. In particular the last approach, by progressively adapting to the mutated economic condition ⁽⁵⁾, would avoid asking for an immediate but sizeable correction. Rather, it would require a progressive adjustment towards the new steady-state, an adjustment which would become stronger in periods of higher nominal growth.

Finally, a combination of the approaches indicated above could be used to determine the speed of the adjustment to be required from a country when it has either not yet achieved the medium-term objective, or worse, breached the 3 % deficit ceiling. The last approach already includes a self-adjusting mechanism dictating the appropriate speed of correction. Other approaches could be used that determine the adjustment as a function of the debt/GDP ratio, or the current (and expected) economic growth, or a combination of the two. Of course, even more factors could be taken into account, such as the need to build up the infrastructure of the economy. These types of consideration may have to be made when determining the adjustment path of those EU Member States which have just entered in the Union and have a deficit well above 3 % of GDP.

This brief and illustrative presentation on how current rules could be implemented to increase the focus on debt developments is clearly non-exhaustive and should not be seen as revealing a preference by the Commission for any specific reform. Rather, it has been made to illustrate the many possibilities which exist to widen the scope of the surveillance of countries' budgetary positions. It also serves to point out that any choice on the approach to be taken inevitably requires striking a balance between the need for simplicity and the need for economic rationale, which may in turn mean increasing complexity in the implementation of the rules.

As another example of issues which would need to be addressed for determining the country-specific objectives (or the speed of adjustment towards them or to below the 3 % deficit ceiling) is whether it is more

⁽¹⁾ A formula which could be instrumental to achieve such an objective could be the following: $d \leq (n + \pi)b + (n + \pi)\left(\frac{b-x}{b}\right)$, where the medium-

term objective for the deficit should be smaller than the nominal GDP times the debt level, plus an adjustment factor requiring convergence over time of the debt/GDP ratio towards the value x .

⁽²⁾ This is consistent with the notion already used by the European Commission (2002a) that a small deviation of a more permanent nature from a balanced budget could be allowed for countries well below 60 %. It could also be noted that the UK have set a target of 40 % of GDP for their net debt/GDP ratio.

⁽³⁾ Namely, moving averages of observed nominal GDP growth over a number of years (a period of at least five years would allow for smooth cyclical fluctuations), and the last debt/GDP ratio.

⁽⁴⁾ Deroose, Langedijk and Roeger (2004) discuss the existence of long price and wage adjustment cycles with periods of overheating and overcooling and large differences in nominal growth over a sustained period. These cycles have an important impact on the pace of debt reduction and the perception of sustainability.

⁽⁵⁾ It could be noted that this applies also in the case of an economic slowdown, which implies a partial reduction of growth potential.

appropriate to define specific values for each member State, or rather ranges, or make some groupings of countries. Clearly, as country-specificity would require that each country is treated with a common and unique approach, while recognising its structural and even temporary specificities, computational problems would make it inadvisable to define 'point' estimates for the medium-term objective. Establishing ranges for setting medium-term policy seems a more cautious approach. In all cases, care should be taken to avoid too mechanical an approach in the implementation of the rules. The recent experience suggests that, in order to reinforce the credibility of the framework, it will be essential to regain space for judgement which the original interpretation of the pact somewhat hampered.

5.6. Conclusions

This chapter has focused on the analysis of debt levels and developments, which is becoming central in the EU fiscal framework. Low debt levels reduce vulnerability and contribute to a growth-enhancing environment. From a multilateral point of view, it is evident that ensuring budgetary positions which remain sustainable in the long term is essential. The progress made in the last decade is an example of how simple numerical rules with adequate incentives can be instrumental in moving outside dangerous waters and towards prudent positions.

While the rules set in the Treaty for monitoring and ensuring that public finances are sound and sustainable have made, and are making, an important contribution to ensure the proper functioning of the currency union, it is clear that more can be done to tackle those issues which initially appeared of a secondary importance. Now, in particular, it is clear that those countries which have made all the required efforts to pursue sound public finances should be rewarded with more flexibility than initially allowed by the SGP. At the same time, other countries have not persevered with the adjustment carried out with the objective of entering the single currency area. For these reasons, the framework should be improved to rapidly achieve prudent debt positions.

In this context, both the deficit and the debt criteria of the Treaty are complementary and appear prudent indicators which signal the presence of 'gross errors' in the conduct of a Member States' fiscal policy. Accordingly, there seems to be no necessity to reconsider the reference values. Both criteria should be used, as countries which respect the deficit criterion may enjoy economic condi-

tions which do not ensure a rapid convergence of the debt/GDP ratio to below 60 % of GDP. Therefore, the debt criterion should be used to put pressure on those countries to adapt their budgetary positions in order to achieve a satisfactory pace of reduction with respect to the debt ceiling.

At the same time, it is evident that the concept of a medium-term objective for the budgetary balance introduced by the SGP is a central element of the surveillance of the fiscal framework. It helps government to create a clear strategy over the medium and long term and over their electoral mandate, which can set clearly the expectations of agents and be supportive of sometimes difficult but necessary choices. Setting an appropriate objective in view of the medium-to-long-term debt developments is crucial, given that increasingly information is available about very long-term trends, and that current responses through budgetary choices affect only gradually these trends.

While the recent experiences would suggest rebalancing the current fiscal framework, this demands careful examination and in particular a delicate balance between a simple approach and an economically more appropriate but more complicated approach. Several possibilities could be envisaged on how to take the various considerations into account in the definition of the medium-term objective. In the previous section a number of ideas have been mentioned as a contribution to the debate which needs to take place among the institutions of the EU and the Member States on how the rules should be interpreted so as to provide more incentives and stronger pressure in steering the conduct of national budgetary policies. These ideas do not represent any formal proposal by the Commission. Rather, they have been used to illustrate the difficulty of conciliating different needs existing in the complex reality of the EU with the simplest possible rule (or its interpretation). Nevertheless, they indicate that at this stage, more country-specific issues should be taken into account, and any assessment of budgetary positions and developments should reflect a judgement on how they are likely to affect the sustainability of public finances, but also the functioning of the economy and of the single currency area in the short to medium term.

In sum, rejuvenating the interpretation of the numerical rules could at this stage be useful: this would provide the basis for a better assessment of budgetary and economic developments and would help to better deal with the major concerns which the conduct of budgetary and economic policies must tackle in the coming years.

Box II.5: Definitions of debt sustainability

There is no agreed definition on what constitutes a sustainable debt position. Debt sustainability can be a short- to medium-term concept, or used to define a long-term condition. What is long term is however not strictly defined: it could be either a precise number of years or an infinite horizon. In addition debt sustainability is not a synonym of 'optimal' debt. The former refers to a condition which can be afforded by policy-makers while the latter defines a condition in which the debt ratio is growth-maximising. A sustainable debt is also not a synonym of a 'prudent' debt. A 'prudent' position is one where the debt is in general more than sustainable but it allows to avoid shift from sustainable to unsustainable positions when the economic environment changes.

The economic literature considers that if the Ricardian equivalence does not hold, the accumulation of debt can lead to unsustainable position. The Ricardian equivalence suggests that taxation has no impact on the aggregate demand. To finance its spending, a government has two options: raise taxes or borrow funds. Borrowing implies debt servicing. Since any deficit has to be repaid later, taxpayers will increase their savings in prevision of the future tax bill, smoothing the effect of tax over time. Nevertheless, this theoretical view has little empirical corroboration and, for this equivalence to hold, a large number of restrictive requirements have to be fulfilled, and modern economies do not.

When a general government deficit arises, a government can finance it through inflation, monetisation or debt. As debt and the interest rates are measured in nominal terms, generating inflation depreciates the real value of debt and interest payments ⁽¹⁾. Secondly, money creation produces some benefits from seigniorage. Seigniorage refers to the right of printing money which generates revenue as there is a difference between the face value of a banknote and the cost of issuing and distributing it. Moreover, those new issued banknotes can also be used to pay interest. The third option is issuing debt ⁽²⁾ but it does not hold forever and in any event, it depends ultimately whether the level and the trend of debt is sustainable.

Borrowing from A to pay B is known as Ponzi finance. It can be defined as

$$(1) \quad d_{t+1} - d_t \geq id_t$$

where d_{t+1} is the debt level in period $t+1$, d_t is the debt level in period t and i is the real interest rate. The value of the debt carried into the next period ($d_{t+1} - d_t$) is, at least, as large as the value of the cost of servicing the debt carried into the current period (id_t). In practice, Ponzi finance implies that interest payments on debt are financed through additional debt. Blanchard (1984) argues that this can be run for a while but, as debt becomes greater and greater, the risk of debt unsustainability arises. Thus, there is a 'maximum level of debt which the government can sell before repudiating it' (Blanchard, 1984; p. 6).

While there is a general agreement on this principle, so that government cannot always borrow over time to pay the cost of servicing the debt, debt sustainability has been defined in a number of ways. Broadly speaking, the economic theory defines sustainability in two main alternative ways.

The first interpretation of sustainability refers to the 'obligation to achieve budget balance on average over a number of years' (Wyplosz, 2002a). As already known, the implementation of a fiscal policy will generate disturbances in the budget balance but, to be called sustainable, those increases in taxes or reductions in expenditure may not cause social or political upheaval (Collignon and Mundschenk, 1999). Hence, it will be called sustainable a policy stance whose continuation in time does not violate the budget constraint (Frenkel and Razin, 1996).

⁽¹⁾ The interest amount is computed as a certain percentage of the nominal amount of the debt. Thus, if the inflation rate is positive, the real value of the interest amount is lower than the due nominal value of it.

⁽²⁾ Countries of the EMU do not have many options to finance their deficit but to issue more debt.

(Continued on the next page)

Box II.5 (continued)

In other words, it means that the intertemporal budget constraint has to be satisfied ⁽³⁾. Defining R_s as government's revenue and E_s as government's expenditures in year s , r as the real discount rate and D as the initial stock of debt, the intertemporal budget constraint can be formalised as

$$(2) \quad \sum_{t=s}^{\infty} \frac{R_s}{(1+r)^{s+t}} = \sum_{t=s}^{\infty} \frac{E_s}{(1+r)^{s+t}} + D$$

The present discounted value (PDV) of all the government's future revenue must be equal to the PDV of all its future spending and today's outstanding debt. This solvency condition expressed by the intertemporal budget constraint allows the existence of government debt in a sustainable fiscal policy. Moreover, as the PDV of all the government's future revenue is larger than the PDV of all its future spending, debt must not necessarily be ever fully paid off. Nevertheless, the level of government debt has clearly an impact on the sustainability of a fiscal policy, as a higher debt level generates higher servicing costs, increasing government's future spending and requiring higher future revenue to cover this double increase in the right-hand part of the condition. The main problem of this condition is that it is not binding: with an infinite horizon, a government can always anticipate a bright future for its revenue in order to legitimise its outstanding debt and its current spending.

The second interpretation considers debt sustainability as 'a given reduction of the debt/GDP ratio over a given horizon' (Wyplosz, 2002a). In the same way, Blanchard et al. (1990) defines a sustainable fiscal policy as a 'policy such that the ratio of debt/GNP eventually converges back to its initial level'⁽⁴⁾. The Maastricht Treaty also refers to this interpretation of debt sustainability as it declares a budgetary situation unsustainable 'whether the ratio of government debt/GDP exceeds a reference value (60 % of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace' (Article 104). This interpretation of debt sustainability as the convergence of the debt/GDP ratio to a reference value in the long term is the one used within the Commission as in the different parts of the present report.

The main justification to this interpretation is that government with a high debt level will be less flexible to respond to the occurrence of adverse shocks since the costs of servicing that debt restrict its means of intervention through fiscal policy. The following will illustrate this.

Considering a limited period model and defining d_t as the debt/GDP ratio for period t and S_{t+1} as the primary surplus for period $t+1$, i as the real interest rate and y as the real growth rate of the economy, the budget constraint can also be formalised as follows

$$(3) \quad \Delta d_{t+1} \equiv d_{t+1} - d_t = (i - y)d_t - S_{t+1}$$

According to this interpretation of the sustainability concept, the budgetary policy of a government must achieve a reduction of the debt/GDP ratio for a certain period ⁽⁵⁾. Thus, with a stable level of debt, in a no Ponzi scheme ⁽⁶⁾, the primary surplus must be greater than the service of the debt in order to reduce it. This condition can be expressed as

$$(4) \quad S_{t+1} \geq (i - y)d_t$$

⁽³⁾ This condition is known as the government's solvency condition.

⁽⁴⁾ The justification of the initial level of the debt/GNP ratio as the conversion point is discussed in Blanchard et al. (1990).

⁽⁵⁾ For instance, it could be considered that a period corresponds to an elective period for a government.

⁽⁶⁾ The government cannot sell debt to finance its debt-servicing.

(Continued on the next page)

Box 11.5 (continued)

This static condition is known as the weak short-term condition⁽⁷⁾. Obviously, if the real interest rate is larger than the real growth rate of GDP, the government should ensure a positive surplus to guarantee a sufficient diminution of the debt/GDP ratio towards the reference value. It can also be observed that this condition will be hard to hold with high levels of debt/GDP ratio since, politically and socially speaking, it is problematic to extract large primary surplus from the population⁽⁸⁾.

In this weak condition, the interest rate and the economic growth rate are determined exogenously without taking into account the impact of a high debt level on both of them. Moreover, this condition does not provide a clear definition of the appropriate reference value for the debt/GDP ratio above which debt will be declared unsustainable as mentioned in the Maastricht Treaty.

Based on the weak short-term condition, Collignon and Mundschenk (1999) propose a strong sustainability condition. This condition sets endogenously the interest rate as a positive function of debt⁽⁹⁾ and assesses, for a specific economy, the maximum primary surplus extractable from the population and the speed at which fiscal policy responds to a shock⁽¹⁰⁾. Those estimations lead to the evaluation of the maximum level of sustainable debt, which can be defined as the reference value for that economy. However, the strong sustainable condition is specific to each model considered, implying that no general definition of sustainability, applicable to all countries, can be derived.

⁽⁷⁾ A medium-term sustainability index can also be constructed to balance short-term variation over time (see Collignon and Mundschenk, 1999).

⁽⁸⁾ So far, it has been assumed that the real interest rate exceeds the real growth rate of the economy. Without this condition, the sustainability discussion would be very different. Indeed, if $(r-y)$ was negative, the economy would be dynamically inefficient as the government no longer needs to run primary surpluses to achieve sustainability. It is easily seen from equation (4) that surpluses of the primary balance would generate a stable reduction of the debt/GDP ratio, at rate $(r-y)$. According to Blanchard et al. (1990), 'in such a case, a government should (...) probably issue more debt until the pressure on interest rates made them at least equal to the growth rate'.

⁽⁹⁾ High debt level will, other things being equal, generate a loss of confidence in a country fiscal management which will raise the risk premium and thus, the interest rate paid by the government.

⁽¹⁰⁾ Estimates for the EMU countries can be found in Bagnai (2004).

6. Integrating the budgetary processes

6.1. Introduction

The Maastricht Treaty establishes two guiding principles with regard to the conduct of budgetary policies in the EU. Firstly, Member States have recognised budgetary policies (and indeed all economic policies) as a matter of common concern, and agreed to coordinate them with a view to achieving, *inter alia*, sustainable, non-inflationary growth⁽¹⁾. Secondly, by stating that budgetary policies should be coordinated (as opposed to harmonised, federalised, or otherwise centralised) the Treaty preserves Member States' fundamental right to formulate their own expenditure and taxation decisions, providing that excessive budget deficits are avoided⁽²⁾.

By increasing economic interdependence between participating Member States, EMU intensifies the effects that the policies implemented in one country have on economic policies of other countries. Such increased interdependence increases the benefits of coordination of Member States' economic policies.

Coordination in EMU has to be balanced with the basic fact that, by and large, nation States remain the centre of political accountability on economic policies. In addition, the EMU set-up must balance common interest with national sovereignty. Binding checks on national policies are justified when they may create a serious risk for the stability of EMU. In this perspective of shared competences, the role of the EU can be qualified as of a 'supervisor' (Sapir et al., 2003).

From the point of view of sound public finances, this institutional configuration has two important implications. On the one hand, the Treaty preserves Member States' sovereignty in relation to budgetary policy. On the other hand, it means that for coordination to be suc-

cessful, the EU's budgetary goals must be embedded in the machinery of domestic policy-making.

The number of countries that experienced excessive deficit positions in the past few years, and the difficulties in the coordination and surveillance processes, have highlighted the need for improvement on this aspect.

A number of proposals have been made by academics in the last years, regarding possible changes in the budgetary process and monitoring at both EU and national level. Among them can be mentioned proposals such as by Begg et al. (2002) to delegate monitoring of technical issue to an independent body⁽³⁾. Fatas et al. (2003), and von Hagen (2002) name such a body, called to monitor the sustainability of Member States' finances, the 'European Sustainability Council'. Along similar lines, HM Treasury (2004) suggest the establishment of an inter-governmental fiscal surveillance committee to conduct analysis and surveillance of national fiscal policies. At the opposite side of the spectrum are proposals which aim at reinforcing the role of current institutions, in particular of the Commission, in order to increase its ability to monitor and give recommendations on the evolution of Member States' public finances. Other proposals aim at altering the numerical rules in conjunction with changes in the surveillance procedures (e.g. Pisani-Ferry (2002). Wren-Lewis (2003)) suggests that countries should be allowed to establish and follow their own national procedures, which, if they are sufficient to ensure long-term sustainability and are respected, would imply that the countries are exempted from the SGP. More proposals are made concerning the establishment of independent bodies at national level which should increase monitoring and enforcement of sound policies.

While some proposals go beyond any realistic changes to the current framework, similar ideas could be devel-

(1) Article 98 and Article 99(1) TEU.

(2) Article 99 TEU.

(3) The authors mention, for example, the issue of calculating cyclically adjusted budgets, which they suggest could be computed by the ECB.

oped in order to improve the functioning of the processes affecting economic coordination and budgetary surveillance. The issues of improving the budgetary process by revisiting the budgetary calendar at EU level and by stimulating better procedures at national level are explored below in some detail.

6.2. Moving to a proper EU semester

The right balance between the limits to supra-national coordination and the objective of governance in EMU can be found by focusing the fiscal rules on avoiding negative spillovers to protect monetary policy and on ensuring long-term fiscal sustainability, while other EU processes should give guidance on issues where national sovereignty has a large role.

Within this approach, economic coordination and budgetary surveillance in EMU take the form of guidelines (BEPGs), common assessments (i.e. of the stability and convergence programmes) and binding rules (the SGP). The events and experience of recent years suggest that a new balance between these forms of coordination needs to be found. In this context, the recent debate and events suggest that there is a need to shift the focus of coordination to a wider perspective than just fiscal discipline within the Pact. While the SGP focuses on the need to avoid 'gross errors', and therefore looks at developments in the balances, the BEPGs cover quality aspects of the budget.

Increasing the coherence between these processes and integrating them better at the national and European level seems an important step to strengthen economic governance in EMU. In particular it appears that the SGP and the BEPGs, the two key EU instruments for economic policy coordination, could usefully add more value to the conduct of national policies and the definition of budgets.

This objective could be achieved by a better articulation between the stability programmes and the BEPGs, and the national budgetary processes. In particular, a more efficient contribution of the European process to the conduct of national policies could be created by revisiting the European processes to bring them more in line with the national one. While the BEPGs process has been streamlined recently, and has now a more settled timetable, the one concerning the preventive part of the SGP has not fully achieved the purpose for which it has been created.

Indeed, the preventive part of the Pact, based on the submission and analysis of the stability and convergence

programmes, has seen its effectiveness reduced by the *ex post* approach on which the assessment of the programmes is still based. It should be recalled that, when the SGP entered in force, it required the submission of the programmes at the beginning of the year. This implied that the content of the early programmes mainly illustrated the budget just approved, and only loosely reflected the guidelines adopted with the BEPGs almost a year before. More recently, the revision of the timetable established with the code of conduct⁽¹⁾ has advanced the submission to before 1 December of each year. This has made it possible to assess the programmes at an earlier stage. However, the Council opinions on the programmes are currently adopted in the early months of the year, which is evidently too late for the budget just adopted, but also too early for the forthcoming one.

In order to increase the value which both the SGP and the BEPGs can provide to national authorities in setting up their budgets, a possible route ahead could be to transform the stability and convergence programmes into a real *ex ante* process and shift their submission and adoption to just before the summer. This would mainly imply reorganising the timetable for the submission and assessment of the stability and convergence programmes, while the timetable of the BEPGs would not be changed.

The rationale of such a shift would be that it could increase the focus on the medium term by reorienting the content of the programme on strategic planning, ensure an interaction between European and national levels before a draft budget for the following year is prepared, provide the possibility to involve national parliaments at an early stage, and strengthen the assessment of implementation at the end of the year on the budget just approved. In brief, this would increase the Member States' ownership of EU policy coordination, making it easier to factor common orientations into domestic policy-making, by allowing for a proper EU semester in the definition of guidelines and recommendations which can be taken into account by national authorities.

The modalities which could be applied could be the following. The submission of the stability programmes by the Member States could be advanced to before the summer, say as early as (end) May. This would allow governments to take into account the main content of the

⁽¹⁾ Code of conduct on the format and content of the stability and convergence programmes, adopted in July 2001 (see Part VII.1 of European Commission (2002a)).

BEPGs almost finalised when preparing the programme. It would also allow governments to base their medium-term planning on the Commission forecasts released in spring, which would avoid non-marginal problems so far experienced with the degree of optimism of economic assumptions underlying national programmes. Possibly, governments could consult national parliaments before submitting the national stability programmes ⁽¹⁾. In practice, this step could be envisaged as the national transposition into a national perspective of the multiannual guidelines provided in the BEPGs, focused in particular on the budgetary aspects. Clearly, given such a timetable, the programmes (with this new style) would not include detailed information about the forthcoming budget, but would rather be a more strategic document over the medium- to long-term budgetary policy (covering the main aggregates). Subsequently, the Ecofin would deliver its opinion on the programmes by the end of July. In that way, the BEPGs and the opinions on the programmes would provide the framework for the preparation of national budgets by governments and for its final adoption by the parliament.

Finally, the process of assessment of the implementation of the BEPGs could conclude the annual cycle. The (eventually single) reports prepared by Member States by the autumn would include information on the forthcoming budget (currently included in the programmes), and would deal, among the various aspects treated in the BEPGs, also with the budgetary features of the actions addressed in the BEPGs/EGs. The Commission and the Council would take all the elements of the yearly cycle into consideration when assessing the degree of implementation of the BEPGs.

In sum, a coherent cycle could be achieved by reorganising the timetable of the SGP, increasing the effectiveness, democratic legitimacy and national ownership of the process. Clearly this involves administrative changes in the Member States. At the same time, however, it implies a rationalisation of resources, as they could be more efficiently coordinated, used in a more integrated manner, and focused in the respective phases of the year

on the various aspects of the process of defining guidelines, transposing them into budgetary strategies, adopting them into the budget, and assessing their degree of implementation.

6.3. Strengthening the national budgetary surveillance and performance

It has been said above that, for coordination to be successful, the EU's budgetary goals must be embedded in the machinery of domestic policy-making. This point is particularly salient in relation to domestic budgetary institutions. Recent studies in the political economy tradition have found that institutions which shape the formation and implementation of national budgets are a significant determinant of fiscal outcomes, and hence of Member State's capacity for compliance with the EU's budgetary rules ⁽²⁾. The Treaty duly recognises this fact when it calls on Member States to 'ensure that national procedures in the budgetary area enable them to meet their obligations' ⁽³⁾.

The link between domestic budgetary institutions and compliance with the EU's budgetary rules has important implications for ongoing efforts to strengthen budgetary coordination in the EU. It implies, in particular, that whatever steps are taken to improve the transparency, enforceability, flexibility and adequacy of the EU's budgetary rules, it is equally important to ensure that domestic budgetary institutions contribute towards sound public finances. In considering which budgetary institutions have a closer 'fit' to the aims of budgetary coordination, it is convenient to distinguish between the dissuasive and persuasive elements of current arrangements.

The dissuasive elements of budgetary coordination centre on the use of peer pressure as a sanction mechanism. In so far as current arrangements rely to only a limited extent on hard law obligations or the threat of financial penalties, a principal deterrent against non-compliance with the EU's budgetary rules comes in the form of non-binding recommendations for corrective action by the Council of Ministers. Since it is not straightforward to induce Member States to comply with their legal obligations (i.e. to follow the recommendation), peer pressure is also used, in the form of naming, shaming, and blaming to promote awareness about unsound domestic eco-

⁽¹⁾ In European Commission (2001a), Section II.2.3, it is shown that whereas governments interact directly with national parliaments in the annual budgetary process, they operate with a large degree of autonomy when deciding the medium-term targets and commitments in their stability programmes. Amato (2002) suggests that the Italian experience of adopting a DPEF (Documento di Programmazione Economic a e Finanziaria), a multi-annual strategic plan, presented and endorsed by the parliament, and which precedes and constrains the draft financial law, could be usefully extended to the European level.

⁽²⁾ Hallerberg (2004).

⁽³⁾ Article 3, TEC Protocol 20. The excessive deficit procedure.

conomic policies, increasing ‘reputation costs’, and to stimulate appropriate action. The effectiveness of peer pressure will depend on a number of factors ⁽¹⁾. Firstly, the obligation which peer pressure enforces must be well defined so as to minimise the opportunity for counterclaim on the part of errant Member States. Secondly, the Council of Ministers must exercise peer pressure in an impartial and consistent manner so as to eliminate doubts about its credibility. Thirdly, peer pressure must generate a ‘diminution (for the errant Member State) of credibility with peers, and the possibility of censure by political elites, the media and public opinion within the State’ ⁽¹⁾. If the first two elements point towards the need for greater transparency and credibility at the EU level, then the third implies that accountability mechanisms at the Member State level must be strengthened to ensure that Council recommendations reach the right audience.

Recent studies of budgetary coordination have focused on two ways in which domestic institutions might increase the effectiveness of peer pressure. One strand of the literature focuses on the need to create independent agencies to monitor Member States’ budgetary policies. One such suggestion calls for the creation of a Fiscal Policy Committee (FPC), comprised of independent experts appointed on a non-renewable basis, to assess, and publicly comment upon, the sustainability of Member States’ budgetary positions ⁽²⁾. Another strand of the literature focuses on the role of national parliaments in the coordination process. Existing evidence suggests that the interest of national parliaments in budgetary coordination has thus far been fairly muted ⁽³⁾. The implication is that a closer involvement of national parliaments in the coordination process could help to bolster accountability mechanisms at the Member State level and thus increase the effectiveness of peer pressure as a sanction mechanism ⁽⁴⁾.

The persuasive elements of budgetary coordination in the EU attempt to build consensus between Member States over the aims of economic policies. From the point of view of domestic budgetary institutions, successful budgetary coordination will depend not just on the pursuit of agreement at the EU level, but also on whether the agreement is compatible with the process of budgetary formation and implementation at the Member State level. Recent studies have emphasised a number of steps that could be taken to

strengthen the contribution of budgetary institutions in this regard. Firstly, budgetary institutions should be more compatible with the underlying electoral system. Budgetary institutions which delegate powers to a strong finance minister appear better suited to an electoral regime in which single party majority governments are the norm, while budgetary contracts will generally work better in an electoral regime in which coalition governments between ideologically distinct political parties are more common ⁽⁵⁾. Secondly, the more transparent and enforceable domestic budgetary institutions are, the more they will constrain public finances, and hence the more they will boost compliance with the EU’s budgetary rules ⁽⁶⁾. Finally, budgetary institutions which embed fiscal policy in a robust medium-term framework will make it easier for Member States to comply with the EU’s budgetary rules. For example, the deficiency of such mechanisms in Portugal during the first three years of EMU can partially explain why its budgetary estimates proved to be so misleading from the point of view of compliance with the Stability and Growth Pact ⁽⁷⁾.

In conclusion, well-formed budgetary institutions at the Member State level are a complement to budgetary rules at the EU level. It follows that attempts to strengthen budgetary coordination in the EU level will benefit from some degree of reform to national budgetary institutions. The involvement and role of the various institutions vary according to the focus of budgetary coordination. For the dissuasive elements of the EU’s macroeconomic framework, stronger domestic institutions would be beneficial to amplify the resonance of Council recommendations for corrective action addressed to errant Member States. This should have the effect of increasing domestic opposition against profligate fiscal policies, thus reinforcing the effectiveness of peer pressure as a sanction mechanism. With regard to the persuasive elements of budgetary coordination, stronger domestic institutions would ensure that the EU’s budgetary goals are embedded in the formulation and implementation stages of national budgets.

In sum, national budgetary institutions could become more integrated with and beneficial to the overall system of economic coordination and budgetary surveillance in the EU, if they would ensure consistency with their own political structure (i.e. well suited to the underlying electoral regime), transparency and internal enforceability and by focusing better on medium-term planning.

⁽¹⁾ Hodson and Maher (2004).

⁽²⁾ Wyplosz (2002b).

⁽³⁾ European Commission (2001a).

⁽⁴⁾ Meyer (2004).

⁽⁵⁾ Hallerberg (2004).

⁽⁶⁾ European Commission (2003a).

⁽⁷⁾ Hodson (2004).

7. Conclusions

7.1. Orientations on how to strengthen economic governance

The previous chapters of this part of the report highlight the strengths and weaknesses of the current EU fiscal framework and explore ideas for possible improvements. While the framework worked reasonably well in avoiding excessive deficits and not repeating past errors in the conduct of budgetary policies, it encountered difficulties in its implementation, both in its preventive and dissuasive components.

The Commission stressed at the beginning of the year the need to strengthen economic governance. In this endeavour, the right balance has to be found between the need to keep the economic governance framework stable and predictable and to improve the system on the basis of experience. Making the EMU macroeconomic framework more effective would contribute to progress towards the Lisbon objectives of sustainable growth, full employment, social cohesion and competitiveness. It should not, and need not, compromise the degree of stability achieved.

The key elements agreed by the Commission to be addressed in order to strengthen economic governance are: '(i) the need to better combine discipline with economic growth considerations by placing fiscal policy within the broader context of general economic policy surveillance; (ii) the need to focus more on the sustainability of the Member States' public finances; (iii) the need to improve implementation by enhancing the common interest in the area of economic policy' ⁽¹⁾.

This report provides analytical insight on how these three elements can be approached. It reviews ideas and suggestions but it does not reach any firm conclusions at this stage. It has been argued that both better implemen-

tation of the existing tools and specific refinements of the legislative framework can help in strengthening economic governance. This does not mean changes in the Treaty but rather a better application of the Treaty itself through an enhanced coordination of the available policy instruments and an improvement in some specific parts of the Stability and Growth Pact.

7.2. Possible improvements

The analysis in Part IV below shows that there is in particular scope to improve the balance between the broad economic policy guidelines and the Stability and Growth Pact as instruments to coordinate economic policy since both deal with budgetary surveillance. There is also room to combine stricter discipline and enforcement with more flexibility in the conduct of national budgetary policies. The previous chapters and the recent literature on EU fiscal rules stress the importance of, among other things: (i) putting more emphasis on government debt and sustainability; (ii) being particularly strict at the time when the economy is booming and thereby applying more symmetry in budgetary surveillance over the economic cycle; (iii) making more allowance for country-specific differences without putting at risk the equal treatment principle; and (iv) reconsidering how the budgetary adjustment path should be set and enforcement could be enhanced. Increasing awareness about budgetary evolution among institutional actors and the public opinion is likely to enhance the common interest in economic policies.

In developing these reform ideas, one might consider the following.

7.2.1. Improving the available tools

Part II.3 shows how the assessment of yearly budget positions is affected by transitory elements such as the impact of the economic cycle and the recourse to one-off measures. Improvements in the available tools to judge the underlying budgetary position will allow the Com-

⁽¹⁾ See Press Release No IP/04/35 of 13.1.2004.

mission, the Council and ultimately the public opinion to better understand the fiscal strategy put forward by the governments and give appropriate recommendations.

Along the same lines of improvements of existing tools, better information on structural reforms and their impact on long-term growth and public finances, on accumulated assets to afford future pension payments, on implicit liabilities in the field of pensions, healthcare and education, and on contingent liabilities can increase the knowledge on future budgetary trends and enhance the focus on long-term sustainability of public finances.

7.2.2. More effective broad economic policy guidelines

The arrangements concluded in the context of streamlining and the Commission proposals on strengthening economic governance submitted to the Convention and discussed in the IGC (see Box II.7) would go some way in addressing the identified shortcomings. However, further measures could be envisaged. In particular, as addressed in Part II.6, it would be worth exploring how to bring the budgetary policy coordination calendar more into line with the general policy coordination cycle agreed in the context of streamlining. This would fit with the idea of having an EU semester in which policy guidance would be formulated and issued followed by a national semester during which Member States would follow up. This would also allow to place fiscal policy into a broader context than just the disciplinary one through a deeper and more comprehensive analysis of budgetary developments and their relation with inflation, cyclical conditions, long-term sustainability and the overall objective of enhancing the growth potential.

The Commission and the Council have repeatedly underlined the need to focus more on the sustainability of the Member States' public finances and of being particularly strict at the time when the economy is booming and thereby applying more symmetry in budgetary surveillance over the economic cycle. In this respect the idea has been raised of a more active use of recommendations under Article 99(4) should be made to guide fiscal policies in times when the Pact is not constraining, but equally in other policy areas. In November 2002, the Commission also put forward the idea of a better organisation of the information flow from Member States to the Community level and on the need that the BEPGs be better linked with the Community's policy agenda and that more consideration should be given to the contribution of Community policies to the overall economic per-

formance. In particular, the Commission communication on the multiannual financial framework ⁽¹⁾ states that, as a number of the commonly agreed recommendations in the BEPGs have budgetary implications, a closer look is required to the implications for EU or national budgets (or a combination of both).

7.2.3. Rejuvenating the Pact

Based on various possibilities explored by the Commission, input from academics, and the experience of the last years with the implementation of the common fiscal rules which has been summarised in the previous chapters of this part, the objective of increasing flexibility while strengthening prevention and enforcement may require a revision of the Stability and Growth Pact. In this regard, the Treaty provisions, including the protocol continue to provide the necessary strong backbone of the fiscal framework.

Aspects to be considered, some of which have been discussed in the preceding chapters, could be the following:

- **Allowing for country-specific circumstances by redefining the medium-term objectives of 'close to balance or in surplus'.** As discussed in Part II.5, medium-term objectives could be of a small deficit for countries with low debt ratios and/or high potential growth rates. This would approximate the flexibility of a 'golden rule' by focusing on long-term sustainability, while avoiding its major drawbacks. By contrast, for countries with high debt levels, large future pension liabilities and/or low potential growth rates, the medium-term target should be more ambitious, possibly a surplus.
- **Placing more focus on debt and sustainability in the surveillance of budgetary positions.** Both the 3 and 60 % of GDP values would be used for assessing whether a country is in an excessive deficit (see also European Commission, 2003). A Commission report should always be produced in cases of non-compliance with either of the reference values of 60 and 3 % of GDP for respectively the debt and the deficit. The Pact can help in clarifying these concepts and how the two reference values would be assessed in the budgetary surveillance process.

⁽¹⁾ European Commission (2004), 'Building our common future: Policy challenges and budgetary means of the Enlarged Union', COM(2004) 101 final, 10.2.2004.

- **Ensuring earlier action** to correct inadequate developments to foster both a prudent and symmetric-over-the-cycle behaviour and surpluses in good times. Early warnings and recommendations could be issued in case of unsustainable developments, even if the deficit-to-GDP ratio is still well below 3 %.
- **Catering for protracted slowdowns and ensuring consistency with the medium-term objectives** for example by redefining the clause on ‘exceptional circumstances’ concerning the application of the deficit criterion.
- **Allowing for country-specific elements in the enforcement of the correction of excessive deficits.** On the basis of the analysis developed in Part II.5 and the literature reviewed in this part of the report, this could be pursued along two lines:
 - (i) Setting appropriate deadlines for correcting the excessive deficit, taking into account country-specific debt and growth conditions. A slower adjustment may be required from countries with low debt levels and/or experiencing slow growth.
 - (ii) Reconsidering the deadlines for moving within the EDP. The analysis in Part II.3 on monitoring budgetary adjustments as well as the recent experience lead to the consideration of the possibility to revise the deadlines set in the first recommendation for the correction of the excessive deficit. Also the modalities for application of the sanctions and their amount could be revised.

Some of the abovementioned elements may imply changes in the implementation, or a better specification which can be achieved through a revision of the code of conduct. Others may require changes in the Pact regulations.

7.2.4. More effective enforcement

In order to work properly any coordination mechanism needs to be embedded in strong institutions. This is because coordination, however well devised, will always contain a considerable element of judgement.

A more flexible and articulated interpretation of the notions of ‘close to balance’ and a more discretionary

application of the procedure would need to be bolstered by stronger authority of the institutions involved. Otherwise the reform risks becoming a simple watering down of the existing rules.

As argued in Part II.6, economic policy coordination in EMU implies a shared authority between institutions at the Community and the national level. Strengthening economic coordination therefore requires addressing issues at both levels.

At Community level, the authority and the instruments entrusted respectively to the Commission and to the Council need to be clarified and possibly reviewed. The Commission is best placed to assess developments and determine policy recommendations. Authority can be clarified through a better articulation and differentiation of roles in the application of the SGP. As regards instruments, the changes agreed in the European Constitution are a first important step (see Box II.7). Namely, they will allow the Commission to issue ‘early-warning’ recommendations directly to Member States in case of significant deviations from the medium-term budgetary objective, and to address proposals rather than recommendation to launch the EDP.

More in general, however, the Community power to effectively monitor the application of the fiscal rules by Member States needs to be strengthened, especially concerning the preventive element of the framework. This need not involve changes in legislation, but would require significantly greater cooperation on the part of the Member States and increased Commission, including the verification of national budgetary projections.

At national level, it is important that Member States ensure that institutions are appropriate to the task of securing sustainable public finances. Although this mandate is explicitly included in the protocol on the excessive deficit procedure, little consideration has been given so far to its implementation. Improving budgetary procedures and favouring the dialogue among all actors concerned would strengthen the institutions for effective economic policy coordination. As pointed out in Part II.6, a more relevant role could be played by national counterparts for the monitoring function fulfilled by the Commission at EU level.

Box II.6: Other possible approaches for a reform of the SGP

In the debate on the need to reform the EU fiscal rules, several other approaches have been suggested. They have merits and disadvantages and it is beyond the scope of the box to discuss them in detail. Their main features are briefly outlined below.

- **Moving back to the excessive deficit procedure as foreseen by the Treaty.** This would mean abrogating Regulation (EC) No 1467/97, i.e. the dissuasive part of the Pact. This could help to reduce automaticity and time constraints for the correction of an excessive deficit that has been perceived as too restrictive by some. However, this approach would provide too much room for interpretation of the Treaty. It would also reduce excessively the weight of the dissuasive provisions of the Pact, and therefore such an approach would be perceived as a substantial weakening of the rules. It would also require stronger institutions to use their increased discretion in a credible and consistent way. Finally, the preventive part of surveillance, which has shown its limits over the last years, would not be touched.
- **Continue to refine the interpretation of the SGP to mainly strengthen prevention.** Such an approach would redefine some concepts used in the application of the SGP, in particular the specification of the 'close-to-balance or in surplus' requirement, or the role of debt in the EDP. This approach would attempt to (re)interpret the preventive part of the SGP (CR 1466/97) through at most a revision of the 'code of conduct', a text simply endorsed by the Ecofin, which gives an interpretation to a few issues of the SGP. However, such an approach may be perceived as a 'non-change' by observers, in particular when confronted with the Commission communication of November 2002. In addition, it would not solve certain issues set in Regulation (EC) No 1467/97 which have shown their limits, i.e. the 'clause on exceptional circumstances' for not placing a country in an excessive deficit position, the speed of adjustment required in case of excessive deficit, and the working of the latter part of the procedure concerning the enforcement of correction or of sanctions.
- **Changing the nature of the 3 % ceiling to look exclusively at sustainability.** Shifting the focus more from the deficit rule to surveillance of sustainability may imply that the 3 % of GDP value would no longer be the exclusive and hard anchor of the system as has hitherto been the case. This approach would imply that countries with deficit/debt ratios above the reference values would not be placed in an 'excessive deficit position' if such budgetary developments did not threaten sustainability. This may include the case of countries with debt/GDP ratios above 60 % but which are nevertheless reduced at a satisfactory pace, or of deficits which, although being above 3 % of GDP, are considered not dangerous for sustainability. In such circumstances the Commission would not move forward with the procedure after the adoption of its report. Nevertheless, by moving radically away from the current approach, this may be seen as too lax by some, particularly because the discretion in establishing whether ratios above the reference values can be accepted as 'non-excessive' may be used arbitrarily by the Council. In addition, the annual fiscal deficit is the main operational variable for governments and parliaments. Finally, the ECB considers changes in the fiscal stance when deciding a monetary policy action.
- **A golden rule.** A golden rule means excluding capital expenditure from the computation of the deficit. Its rationale is that the cost of public investment should be borne by future generations who will benefit from it. Therefore capital expenditure should be financed through debt and not by taxes paid by the current generation. While its rationale is appealing, there are several shortcomings with the golden rule. Firstly, depending on the specific design of the golden rule, it could entail maintaining high deficit for long periods. Secondly, it may create distortions in the allocative process, where physical infrastructure could be preferred to other forms of capital or current spending which may have also beneficial effects over the long run. In case a wider spectrum of 'productive' expenditures is deducted from the computation of deficits and the application of the golden rule, an issue would arise concerning the choice of which expenditure categories should be granted special budgetary treatment and which not (e.g. public investment and R & D? Public investment and R & D and education? Public investment and R & D and education and health?). Moreover, the rule advocated is based on gross investment, while the relevant variable to be considered when looking at intergenerational equity should be net public investment, which is just a small fraction of the total. Finally, a sudden introduction of the golden rule may lead to contentious accounting problems, as there would be significant incentives to record current expenditure as capital spending. The golden rule becomes less attractive at the EU level, in particular given the diversity of country circumstances and that compliance checks and enforcement would be much harder. In addition, to implement it, it would be necessary to change either the protocol or the system of national accounts (ESA). Conversely, the alternative possibility to maintain small deficits in some countries and in particular circumstances, namely when sustainability is not jeopardised, would mean that some expenditure with economic benefits differed in time may be carried out, in practice catering for the economic rationale of the golden rule without entailing all its risks.

Box II.7: A summary of the changes introduced by the Constitution in the field of economic governance

The draft Constitution prepared by the Convention on the Future of Europe primarily focused on the European Union's powers and competences, its institutional architecture, and the simplification of its legal instruments and decision-making procedures. The existing Treaty provisions relating to the different EU policy areas (e.g. agriculture, transport, environment, etc.) largely remained unchanged. In the area of economic governance, however, the draft Constitution introduced a number of important amendments. The intergovernmental conference (IGC), which was formally opened on 4 October 2003, introduced some further changes to the Convention's draft. On 18 June 2004, it adopted the text of the Constitution, which will need to be ratified by all 25 Member States. A summary of the main changes in the area of economic governance is presented below.

Both the Convention and the IGC took some steps towards reinforcing the decision-making powers of the Member States belonging to the euro area in view of their need for closer policy coordination and in order to allow them to be more fully in charge of their economic destiny. This approach builds on existing practice in the current Treaty, as the representatives of participating Member States in the Council are the only ones to vote on certain matters of relevance to the euro area (cf. Article 104.9 or 122.5 EC). The draft Constitution extends this approach to the adoption of the parts of the broad economic policy guidelines which concern the euro area generally. In addition, the draft Constitution contains a new Article III-88 allowing for the adoption of specific measures to strengthen the coordination of the budgetary discipline of these Member States as well as for its surveillance. Finally, the draft Constitution prepared by the Convention recognises the important role of the (informal) Eurogroup, which is mentioned in Article III-89. A separate protocol has been added describing the tasks and composition of the Eurogroup. The IGC went a considerable step further in reinforcing the decision-making autonomy of the euro-area Member States. It agreed that both the surveillance recommendations (under Article III-71.4 which corresponds to the current Article 99.4 EC) addressed to euro-area Member States (including stability programmes and early warnings) as well as measures related to excessive deficits concerning euro-area countries (under Article III-76, paragraphs 6, 7, 8 and 11, which replace the corresponding provisions of Article 104 EC), will henceforth be decided only by the euro-area representatives in the Ecofin Council. It also decided to amend the procedure for abrogating the derogation concerning Member States not yet participating in the single currency ('pre-in'). While the decision will still be taken by the 'full' Council, it will be conditional upon the adoption (on the basis of a Commission proposal) of a prior recommendation by a majority of the Council's euro-area representatives.

The Convention also sought to strengthen the framework for multilateral economic surveillance, notably by reinforcing the Commission's powers. The Convention allowed the Commission to address a 'direct' warning to a Member State under Article III-71.4 in case its 'economic policies are not consistent with the broad guidelines or that they risk jeopardising the proper functioning of economic and monetary union'. This broadly defined instrument, which allows for rapid and autonomous action by the Commission, not only applies in the context of the BEPGs but also in the area of budgetary surveillance. The possibility for the Council to make a recommendation to the Member State concerned, on a recommendation from the Commission, remains in place. Under the constitutional rules, such Council recommendations will however be adopted without taking into account the vote of the Member State concerned, thereby reducing the latter's capacity to block the adoption of the recommendation. Both changes have been accepted by the IGC.

The Convention moreover introduced a number of changes in the excessive deficit procedure (Article III-76). First of all, the Council's decisions on whether an excessive deficit exists will be based on a proposal (as opposed to a recommendation) from the Commission. The Convention proposed to apply the same procedure to the adoption of the recommendation addressed to the Member State concerned with a view to bringing that situation to an end within a given period, but was not backed up in this by the IGC, which decided to cross out this amendment on the grounds that this change would overly strengthen the Commission's hand in the process. Indeed, any amendment introduced by the Council that appears unacceptable to the Commission would then require unanimous Council approval. The IGC however conceded that its recommendations to the Member State concerned should be adopted 'without undue delay'. As a third new element, the Convention agreed (and the IGC endorsed) that the Council decision on the existence of an excessive deficit will henceforth be taken without taking into account the vote of the representative of the Member State concerned. Finally, the conference decided to adopt a declaration on the Stability and Growth Pact.

Box 11.7 (continued)

The Commission considers that many changes introduced by the Convention and the IGC go in the right direction. It however regrets that some of its key proposals were not taken up. For example, it had proposed to establish a genuine Ecofin Council for the euro area, in which only euro-area ministers would be represented. The substitution of Commission recommendations by genuine proposals, notably for the draft BEPGs and associated surveillance (Article III-71), constitutes another important element which was not incorporated in the Constitution. Finally, the Constitution still fails to ensure the proper external representation of the euro area, despite the fact that all parties involved recognise that the current situation is unsatisfactory.

Annex II.1. The Commission methodology for cyclical adjustment

In Section 3.3.2 the CAB is defined as

$$CAB_t = b_t - c_t = \frac{B_t}{Y_t} - \varepsilon \cdot \frac{Y_t^R - Y_t^{RP}}{Y_t^{RP}}$$

where b_t stands for the nominal budget balance to GDP ratio, ε is the budgetary sensitivity, Y^R is real GDP and Y^{RP} is real potential GDP, and c_t denotes the cyclical component of the budget. In the Commission approach the budgetary sensitivity parameters ε represents a marginal change in the level of the budget balance bb with respect to a change in the level of GDP Y i.e. $\varepsilon = \partial bb / \partial Y$. Consequently, the CAB approximates the budget balance net of cyclical components expressed in percentage points of actual GDP:

$$CAB = \frac{bb}{Y} - \frac{\partial bb}{\partial Y} \cdot OG \cong \frac{bb}{Y} - \frac{\partial bb}{\partial Y} \cdot \frac{(Y^R - Y^{RP})P}{Y^{RP}P} = \frac{bb}{Y} - \frac{\Delta bb}{Y^P}$$

where P^Y is the deflator of GDP, Y^R real GDP, and Y^{RP} real potential GDP ⁽¹⁾.

By contrast, an alternative method for the cyclical adjustment applied by several institutions other than the Commission captures the impact of the cycle on the budget to GDP ratio. Denoting by CAB' such alternative method to carry out the cyclical adjustment in a linearised form, one has $CAB' = \frac{bb - \Delta bb}{Y^P}$. The budgetary sensitivity to be

used when computing CAB' is $\varepsilon' = \eta'_R \frac{R}{Y} - \eta'_G \frac{G}{Y}$, where

$$\eta'_R = \frac{\partial(R/Y)}{\partial Y} \frac{Y}{(R/Y)}, \quad \eta'_G = \frac{\partial(G/Y)}{\partial Y} \frac{Y}{(G/Y)}$$

represent rela-

tive changes in the revenue and expenditure to GDP ratio with respect to a relative change in GDP. In fact, this yields

$$\begin{aligned} CAB' &= \frac{bb}{Y} - \frac{\partial \left(\frac{bb}{Y} \right)}{\partial Y} Y \cdot OG = \frac{bb}{Y} - \frac{\partial \left(\frac{bb}{Y} \right)}{\partial Y} Y \frac{Y^R - Y^{RP} P^Y}{Y^{RP} P^Y} = \\ &= \frac{bb}{Y} - \left(\frac{\partial bb}{\partial Y} - \frac{bb}{Y} \right) \frac{\Delta Y}{Y^P} = \frac{bb}{Y} \left(1 + \frac{\Delta Y}{Y^P} \right) - \frac{\partial bb}{Y^P} = \frac{bb - \Delta bb}{Y^P} \end{aligned}$$

Note that this is the budget to GDP ratio that would prevail if the economy was operating at its potential, i.e. the underlying budgetary position relevant for assessing the compliance with the close to balance or in surplus requirement of the Stability and Growth Pact.

For small output gaps the CAB and CAB' are very close. This can be seen by considering the relation between ε and ε' :

$$\varepsilon' = (\eta_R - 1) \frac{R}{Y} - (\eta_G - 1) \frac{G}{Y} = \varepsilon - \frac{bb}{Y}$$

which reveals that:

(i) As the tax elasticity η'_R is close to zero for most member countries the contribution of revenues to ε' is almost nil, i.e. the revenue-to-GDP ratio hardly changes as GDP changes. Conversely, the expenditure elasticity η'_G is close to $-G/Y$; i.e. the expenditure to GDP ratio falls as GDP rises;

(ii) the difference between ε and ε' increases with the budget balance.

⁽¹⁾ The output gap is derived from actual and potential GDP both expressed in constant prices. Hence, it is implicitly assumed that the GDP deflator is the same for both realisations of GDP.

Annex II.2. Changes in the CAB as a measure of budgetary adjustment

Traditionally, changes in the CAB are used as an indicator of discretionary fiscal policy. This annex shows that this reading needs to be qualified in the presence of higher or lower than expected growth coupled with budgetary inertia or adherence to plans in the execution of the budget.

The budget and the CAB *ex ante*

The budget for the year t is generally drafted in advance in year $t-1$ based on projections for economic growth and price inflation. The following link between budgetary aggregates and economic activity is assumed in the planning phase of the budget:

- Revenues: Any variation in economic growth will automatically translate into a corresponding variation in governments' receipts as, under unchanged fiscal policy, tax bases should bear a stable relationship with the level of economic activity. For the sake of simplicity taxes are assumed to be proportional to GDP.
- Expenditure: Fiscal policy-makers are assumed to increase non-cyclical expenditure in line with projected potential GDP growth ⁽¹⁾.
- Discretionary measures: Fiscal authorities plan discretionary corrections the size of which may depend of fiscal objectives.

⁽¹⁾ In contrast to the revenue side of the budget, there is no evident or stable link between non-cyclical expenditure and the level of economic activity. A wide range of alternative relationships could be used. However, the assumption of proportionality with respect to potential output has a relatively long tradition in the economic literature and is referred to as neutral fiscal policy. It can be found in Heller et al. (1986) and more recently von Halleberg et al. (2001), von Hagen (2002) and Buti and van den Noord (2003). It essentially implies that under unchanged fiscal policy expenditure is set to keep the size of government constant over the cycle.

As a result of the above the planned non-cyclical expenditure to potential output ratio expected for year t is:

$$E_{t-1} \left. \frac{G_t^S}{Y_t^P} \right|_{E_{t-1} Y_t} = \frac{G_{t-1}^S (1 + E_{t-1} \omega_t + E_{t-1} \pi_t) + \Delta^d G_t^S}{E_{t-1} Y_t^P} \Bigg|_{E_{t-1} Y_t}$$

where $\Delta^d G_t^S$ the planned discretionary component in non-cyclical expenditure in period t . $E_{t-1} \omega_t^P$ and $E_{t-1} \pi_t$ are expected potential output growth and expected inflation respectively. The ratio is conditional on the expected level of actual GDP $E_{t-1} Y_t$, as potential output is extracted from observed real GDP. Non-cyclical expenditure is obtained as

$$\frac{G_t^S}{Y_t^P} = \frac{G_t}{Y_t} + \varepsilon_G \cdot OG_t$$

Since the tax system is assumed to be proportional, the tax to GDP ratio will remain constant except for discretionary measures ⁽²⁾. Thus, the expected change in the CAB in year t with respect to year $t-1$ is

$$\begin{aligned} E_{t-1} \Delta CAB_t &= \frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P} \Bigg|_{E_{t-1} Y_t} \\ &- \frac{G_{t-1}^S}{Y_{t-1}^P} \left(\frac{1 + E_{t-1} \omega_t^P + E_{t-1} \pi_t}{1 + E_{t-1} \omega_t^P + E_{t-1} \pi_t} - 1 \right) \Bigg|_{E_{t-1} Y_t} \\ &= \frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P} \Bigg|_{E_{t-1} Y_t} \end{aligned}$$

⁽²⁾ The assumption of proportionality is made for the sake of simplicity. If the tax system is regressive or progressive economic growth also affects the revenue side of the budget and hence the CAB:

$$E_{t-1} \left. \frac{R_t^S}{Y_t^P} \right|_{E_{t-1} Y_t} = \frac{R_{t-1}^S \phi (1 + E_{t-1} \omega_t^P + E_{t-1} \pi_t)}{Y_{t-1}^P (1 + E_{t-1} \omega_t^P + E_{t-1} \pi_t)} \Bigg|_{E_{t-1} Y_t} \neq \frac{R_{t-1}^S}{Y_{t-1}^P} \Bigg|_{E_{t-1} Y_t}$$

where ϕ is the degree of progressivity or regressivity of the tax system.

implying that the expected change in the CAB will be equal to the discretionary fiscal policy intervention

$$\left. \frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P} \right|_{E_{t-1}Y}$$

The budget and the CAB *ex post*

The ratio of non-cyclical expenditure to potential GDP in year t results from the implementation of expenditure plans, discretionary fiscal policy corrections and actual economic growth. Assuming that expenditure plans are implemented as planned we have

$$\left. \frac{G_t^S}{Y_t^P} \right|_{Y_t} = \left. \frac{G_{t-1}^S(1 + E_{t-1}\omega_t^P + E_{t-1}\pi_t) + \Delta^d G_t^S}{Y_t^P} \right|_{Y_t}$$

The actual ratio is conditional on real GDP in year t . In contrast to the *ex ante* case, it is not expected real GDP but the actual level observed *ex post*. Hence, if actual real GDP in year t differs from the forecast, it will also affect potential output and the output gap compared to what was expected *ex ante*. Both the denominator and the nominator of the ratio are affected.

In addition, lower or higher than expected growth not only affects potential output in year t , it also impacts on potential output of previous years as potential output is either estimated as a kind of moving average of the actual output series or involves a moving average of a component of actual output (the Solow residual in the case of the production function approach used by the Commission). Consequently, assuming again that the tax system is proportional, the observed change in the CAB in year t with respect to year $t-1$ is

$$\Delta CAB_t = \left. \frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P} \right|_{Y_t} - \left. \frac{G_{t-1}^S}{Y_{t-1}^P} \left(\frac{(1 + E_{t-1}\omega_t^P + E_{t-1}\pi_t)}{(1 + \omega_t^P + \pi_t)} - 1 \right) \right|_{Y_t}$$

The observed change in the CAB will exclusively reflect discretionary fiscal policy interventions only if non-cyclical expenditure follows potential output growth. However, given that expenditure plans are fixed in advance based on economic projections, inertia in the budgetary processes or adherence to plans will lead to a departure from the projected change in the CAB *ex ante*. This effect may be called passive fiscal policy. In particular, if growth is overestimated $(1 + E_{t-1}\omega_t^P + E_{t-1}\pi_t) > (1 + \omega_t^P + \pi_t)$ a full implementation of expenditure plans results into a deterioration of the CAB, even in the absence of discretionary

fiscal policy measures. There is empirical evidence that forecast errors on potential output are significant in explaining the CAB ⁽¹⁾.

Denoting the degree with which spending plans are adjusted to unexpected changes in potential output by λ we can distinguish between two extreme cases:

- $\lambda = 0$ signals full inertia or adherence to budgetary plans in volume terms,
- $\lambda = 1$ stands for no inertia or full adjustment,

The change in the CAB can be written as

$$\Delta CAB_t \approx \left. \frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P} \right|_{Y_t} - (1 - \lambda) \left. \left(\frac{G_{t-1}^S}{Y_{t-1}^P} ([E_{t-1}\omega_t^P - \omega_t^P] - [E_{t-1}\pi_t - \pi_t]) \right) \right|_{Y_t}$$

The change in the CAB can be taken to be equal to the effect of discretionary fiscal policy only if we assume:

Perfect foresight on the side of fiscal policy-makers, implying that potential output and inflation turn out to be exactly as foreseen when setting the budgetary plan. In such a case, inertia would not even come into play; or

No inertia in the implementation phase of the budget with fiscal policy-makers ‘being on call’ i.e. adjusting non-cyclical expenditure plans with respect to higher or lower than expected economic growth.

Taking into account relatively long recognition lags, the complexity and slowness of budgetary processes and the political economy of political inaction, a viable working hypothesis over the short term, for instance one year, is to assume full inertia or full adherence to spending plans i.e. to assume that spending is not adjusted for unexpected short- or windfalls of growth.

The difference between *ex ante* and *ex post*

The effect of lower than expected growth and passive fiscal policy also plays a role in explaining the difference between plans and actual results. Specifically, planned changes in the CAB and actual outcomes will generally differ even if expenditure plans and discretionary fiscal

⁽¹⁾ Larch and Salto (2003).

policy measures are fully implemented. Simplifying the notation and assuming again that the tax system is roughly proportional, the difference between *ex ante* and *ex post* changes in the CAB can be written as:

$$\left[\frac{\Delta^d B_t^S - G_{t-1}^S (1 + E_{t-1} \omega_t + E_{t-1} \pi_t) + \frac{G_{t-1}^S}{Y_{t-1}^P}}{Y_t^P} \right]_{Y_t} - \left[\frac{\Delta^d B_t^S}{Y_t^P} \right]_{E_{t-1} Y_t} =$$

ex post *ex ante*

where $\frac{\Delta^d B_t^S}{Y_t^P}$ is the discretionary fiscal policy intervention $\frac{\Delta^d R_t^S - \Delta^d G_t^S}{Y_t^P}$. Rearranging the difference between *ex post* and *ex ante* yields.

$$= \frac{\Delta^d B_t^S|_{Y_t} - \Delta^d B_t^S|_{E_{t-1} Y_t} + \left(\frac{\Delta^d B_t^S|_{E_{t-1} Y_t}}{Y_t^P|_{E_{t-1} Y_t}} \right) \frac{Y_t^P|_{E_{t-1} Y_t} - Y_t^P|_{Y_t}}{Y_t^P|_{Y_t}}}{Y_t^P|_{Y_t}} - \frac{G_{t-1}^S}{Y_{t-1}^P|_{Y_t}} \left(\frac{1 + E_{t-1} \omega_t + E_{t-1} \pi_t}{1 + \omega_t + \pi_t} - 1 \right) \approx$$

$$\approx \frac{\Delta^d B_t^S|_{Y_t} - \Delta^d B_t^S|_{E_{t-1} Y_t} + \left(\frac{\Delta^d B_t^S|_{E_{t-1} Y_t}}{Y_t^P|_{E_{t-1} Y_t}} \right) \frac{Y_t^P|_{E_{t-1} Y_t} - Y_t^P|_{Y_t}}{Y_t^P|_{Y_t}}}{Y_t^P|_{Y_t}} - \frac{G_{t-1}^S}{Y_{t-1}^P|_{Y_t}} \left((E_{t-1} \omega_t + E_{t-1} \pi_t) - (\omega_t + \pi_t) \right)$$

Hence, if expenditure plans and discretionary fiscal policy measures are fully implemented in volume terms, the difference between *ex ante* and *ex post* is a function of

- the effect of the revision of growth on the output gap and, in turn, on the discretionary component of the budget (first term). A revision in the output gap entails that budgetary items, which *ex ante* were thought to be cyclical, turn out to be structural or vice versa. Empirically, this term will tend to be fairly negligible;
- the effect of the revision of growth on the level of potential output and, via the assumption of adherence to plans, on the size of the discretionary correction expressed in percent of potential GDP (second term);
- the effect of the revision of growth on the level of potential output and, in turn, on the non-cyclical expenditure to potential GDP ratio (third term). Numerically, this term clearly dominates as the non-cyclical expenditure to potential GDP ratio is generally around 0.4–0.6, whereas discretionary corrections tend to be comparatively small.

Monitoring conditional compliance

Recapitulating, the practical problem of monitoring the budgetary adjustments in cyclically adjusted terms is that the observed difference between the planned and the actual change in the CAB will generally include components not attributable to discretionary fiscal policy. They rather refer to revisions in real GDP which in turn affect the estimates of potential output and the output gap.

To adjust for this overlay of causes one has to gauge the effect of higher or lower than expected growth on the CAB so as to isolate the policy component. A practical approximation of the total growth effect in year *t* given by the equation shown above is

$$-\frac{G_{t-1}^S}{Y_{t-1}^P|_{Y_t}} (E_{t-1} \omega_t - \omega_t)$$

i.e. the ratio of cyclically adjusted expenditure multiplied by the revision in potential output growth. The approximation essentially ignores the first two elements of the total growth effect which, as mentioned above, will tend to be numerically small in practice. To ensure coherence with the cyclical adjustment described in equation (1) the focus is on revisions in real potential output growth. Prices are not to be affected by the revision. In this connection one needs to bear in mind that in some cases inflation projections presented in stability and convergence programmes are target values rather than forecast, serving as a benchmark for expected inflation in the national wage bargaining process.

The above approximation was derived on the assumption that taxes are proportional to GDP. Based on the tax elasticities calculated by the OECD, this assumption would seem to be acceptable for most Member States (see Van den Noord, 2000). However, some countries appear to have a non-negligible element of regressivity in their tax system, notably France, Austria, and Portugal implying that a revision of potential output also affects the CAB through changes in the revenue ratio. In practice, this does not pose a problem. The effect can be captured by adding a term to the above approximation ⁽¹⁾.

⁽¹⁾ The new approximation would be $\left((\eta_R - 1) \frac{R_{t-1}^S}{Y_{t-1}^P|_{Y_t}} - \frac{G_{t-1}^S}{Y_{t-1}^P|_{Y_t}} \right) (E_{t-1} \omega_t - \omega_t)$ where η_R denotes the tax elasticity.

Part III

The benefits of fiscal discipline

Summary

Budget deficits are increasing in major advanced economies. During the past three years, the fiscal surplus in the United States has turned into a deficit and started deteriorating rapidly. In Japan, the already high budget deficit widened further from 2001 onwards. In the EU, the average budgetary position has also deteriorated in the last few years: the almost balanced budgetary position recorded in 2000 turned into a deficit above 2.5 GDP points in 2003.

The recent record on EU budget balances is largely the result of lower than expected growth in the largest Member States. Nevertheless, there are reasons for concern. Is the deterioration in the budgetary position of many EU countries a temporary phenomenon or a sign of permanent loss of fiscal discipline? The question is of the utmost relevance for at least two reasons. The first reason is the current situation of institutional uncertainty. After the Ecofin Council decision of 25 November 2003 not to proceed further with the excessive deficit procedure for France and Germany, uncertainty has increased concerning the future of the EU rules-based framework for fiscal discipline. However, it is crucial that the EU rules-based fiscal framework should function effectively in order to shape market expectations concerning the future behaviour of fiscal authorities. Actual developments in financial markets that in turn affect the cost of capital and growth potential largely depend upon such expectations. The second reason is that the relatively high debt/GDP ratios coupled with rapidly ageing populations that characterise most EU countries could make the postponement of budgetary discipline very costly.

The aim of this part is to reassess the case for fiscal discipline in the EU. The objective is to highlight the main channels through which protracted deficits affect income prospects and to assess empirically the relevance of such channels for EU countries. A counter-factual simulation analysis on the issue is also provided. The following question is raised: what developments in economic activity would have prevailed in EMU in absence of fiscal discipline?

According to prevailing economic theory, budget deficits may stimulate demand in the short run. However, when deficits are protracted, they will reduce future income prospects by reducing national savings. The reduction in public savings associated with budget deficits is in fact likely not to be fully compensated by an increase in private savings (as predicted by the so-called ‘Ricardian equivalence’ theorem). As long as national savings are reduced, either a reduction in private investment follows (investment crowding-out), or a worsening of the current account occurs, or both. Irrespective of whether the reduction in national savings is reflected in lower investment or in worsened current account balances, a reduction in future income is inevitable. Lower investment reduces future potential output; a less positive, or more negative, current account balance, corresponds to a lower stock of net foreign financial assets, and therefore to a lower net stream of interest payments from abroad. The real issue is not so much whether a loss of fiscal discipline will translate into lower future incomes but how much and through which channels. The first chapter of this part of the report highlights all the main channels through which budget deficits may affect income prospects. Apart from reducing national savings, thereby reducing investment and current account balances, protracted deficits may affect potential growth indirectly, via other channels. High and persistent deficits lead to the accumulation of debt and this in turn may raise the pressures by governments on central banks to produce inflation as a short-cut for debt reduction. High-inflation environments, in turn, may discourage investment and be conducive to low growth potential. High debts can also lead to higher interest rates via increased credit risk premia. Therefore, persistently high deficits may depress investment not only directly, by reducing national savings, but also indirectly, via higher risk premia. Credit risk premia reflect expectations of default on debt. Persistent and high deficits may also lower expectations concerning the sustainability of current account imbalances, triggering capital flights and currency crises. Finally, persistent deficits may reduce

growth prospects by making necessary a future increase in the tax burden, which may in turn reduce capital accumulation. The second chapter of this part of the report assesses the effects of protracted budget deficits, focusing on their impact on investment and current account balances.

Budget deficits crowd out private investment via higher interest rates. A good understanding of the impact of fiscal aggregates on interest rates is crucial to assessing this link empirically. Although the issue is quite contentious and there is a relatively wide range of magnitude for the existing estimates, most of the analyses on the subject report significant effects of budget deficits on interest rates. Econometric analysis carried out in this part of the report shows that, on average, in euro-area countries, one additional point of (expected) deficit is associated with an increase in the interest rate spread between long and short-term government bonds of 15–20 basis points. Correlation analysis shows a robust negative relation (current and past) between budget deficits and private investment shares, which is consistent with the finding that deficits raise interest rates.

Concerning the link between budget deficits and current accounts in EU countries, although correlation analysis indicates, as expected, a negative relation on average, this relation is quite weak and influenced by country-specific factors. However, this does not mean that considerations related to the current account balance and the external equilibrium of countries are not relevant for budgetary policy. Current account imbalances within the euro area have been increasing. Protracted large budget deficits in countries with strongly negative current account balances may be a cause of delay in the external adjustment. As for the new Member States, most of them have in recent years been recording relatively large budget deficits coupled with wide current account deficits. Keeping budget deficits under control will be a key condition for maintaining stable currencies within ERMII as a necessary step towards joining EMU.

It is commonly perceived that the EU fiscal framework provided by the Treaty and the SGP has strongly influ-

enced budgetary policies in EU countries, not only in the run-up to EMU, but also after the introduction of the single currency. However, agreement is missing on the quantitative impact of the presence of the EU fiscal framework exerted on budget balances in EU countries. This part of the report proposes a counter-factual analysis of what economic developments would have taken place in the euro area in its absence. To that end, counter-factual budget balances after 1994 (corresponding to Stage II of EMU) in the absence of the EU fiscal framework have been estimated econometrically, and simulations with European Commission QUEST II model have been performed to assess what implications such counterfactual budget balances would have had for growth. The following main points emerge from the analysis:

- in the absence of the EU fiscal framework, primary budget deficits for the euro area would have been higher by almost 0.9 GDP percentage points per year over the 1994–2003 period. This would have led to a sizeable build-up of euro-area government debt, which would have been about 8 GDP percentage points higher by 2003;
- model simulations ignoring the link between increased debt and risk premia on interest rates indicate that the short-run gains from an absence of fiscal discipline would not have exceeded half a percent of GDP and would have faded away quickly;
- simulations taking into account the impact of debt on risk premia suggest that the gains from an absence of fiscal discipline over the last decade would have been even smaller in the short run, and would have become negative in the medium term.

Overall, the analysis suggests that the budgetary convergence in the 1990s implied a reduction in growth of limited magnitude and duration but laid the basis for better growth prospects. In the absence of the fiscal discipline induced by the EU fiscal framework, private investment crowding-out would have further reduced potential growth compared with current figures.

1. Introduction

The aim of this part of the report is that of refocusing the debate on the benefits of fiscal discipline, building on the positive experience of the EU-15 countries that managed to reduce budget deficits and bring government debts under control on the road to EMU. In the European case, the introduction of numerical rules for fiscal discipline was followed by an actual improvement in budget balance in most countries. What would have happened in the absence of such rules? Would the current growth performance of EU economies be more or less satisfactory? Answering the above questions would help to reassess the need and the relevance for an EU-wide framework for fiscal policy.

In Chapter 2 the main channels are reviewed through which budget balances and government debts affect the economic variables on which crucially depends countries' income prospects, like interest rates, current account balances and the structure of taxation and expenditure. The chapter is introduced by an overview on long-term developments and recent trends in budget

balances in advanced economies. Afterwards, the major channels through which permanent deficits affect income prospects are highlighted, referring both to theoretical findings and existing empirical analysis. Particular attention is given to the link between budget deficits and interest rates, given the relevance for channelling crowding-out effects. The methodology employed in existing empirical analysis, exploring this link, is illustrated and the results surveyed.

In Chapter 3 the analysis focuses on the link between budget deficits, investment, current account balances and growth in EU countries. Original analysis concerning the impact of budget deficits on interest rates in euro-area countries is provided. A discussion on the major issues raised by the links between budget deficits and current accounts in euro-area countries and new Member States follows. The chapter ends with simulation analysis aimed at assessing what would have happened to EU growth in the absence of a rules-based fiscal framework introduced with Maastricht and enshrined in the SGP.

2. What do budget deficits do?

2.1. Budget deficits in advanced countries: Long-run developments and recent trends

The past behaviour of deficits and debts in advanced countries shows that persistent departures from the balance between government revenues and expenditures have been rather uncommon. In the past, advanced countries have run persistent deficits and accumulating government debt in correspondence of periods of particular distress in public finances. Consistent with the tax-smoothing principle, high and sustained deficits characterised war periods. The cost of financing war needs have been spread across generations by means of deficit spending, in order to avoid a concentration of the tax burden on the generations having to live with the economic distress of wars. Table III.1 reports average values for deficits and debts over selected historical periods in the United States, Japan and the three major European economies. The data show that deficits in belligerent countries were higher than historical averages during the two world wars. Government debt increased dramatically starting from the First World War, and the stock of debt peaked at the end of the Second World War. After the Second World War, debt was brought down by a concomitance of improved budget balances and high growth in nominal GDP.

Except for the periods in which the economies were engaged in wars, government budgets in the past have been relatively low (the deficit of the central government averaged 0.9 GDP points during the whole 1881–1913 gold standard period and 3.2 GDP points over the 1947–95 post-war period in G7 countries) and debt levels have been stable beyond fairly low levels (47.8 in the gold standard period and 45.2 in the post-war period)⁽¹⁾. The picture changes starting from the 1970s, where sustained deficits were registered in most advanced countries and debts started rising. Such a tendency was not related to exceptional public

finance needs as during war periods, but was a result of an increased role of the government in providing public goods and social security and in redistributing income, coupled with decelerating growth rates in most advanced countries.

The tendency towards increased deficits and debts has been reversed for most advanced countries during the 1990s. Graph III.1 reports budgetary developments in the United States, EU-15 and Japan starting from 1995. The high debt/GDP ratios of the 1980s required a correction, which was brought about by fiscal consolidations episodes in many advanced countries⁽²⁾. Some EU countries started their consolidation already in the 1980s, others undertook budgetary adjustment policies in the mid-1990s, to fulfil the fiscal discipline requirements for adopting the single currency. In this landscape, a notable exception is Japan, which responded to economic depression with a broadly expansionary fiscal stance throughout the 1990s.

The picture changed again after 2001. The fiscal surplus in the United States rapidly transformed into a deficit and started deteriorating rapidly, as a result of reduced growth and actively expansionary fiscal policies. In the EU, the average budgetary position also deteriorated, but less markedly than in the United States and to a lesser extent as a result of an expansionary fiscal stance. In 2002 the budget deficit in Germany and Portugal exceeded the Maastricht 3 % ceiling, followed by France in 2003. After the Ecofin Council decision of 25 November 2003 not to proceed further with the excessive deficit procedure for France and Germany, uncertainty has increased concerning the future of the EU rules-based framework for fiscal discipline.

A question arises. Is the recent deterioration in advanced countries' budgetary position temporary or is it a sign of lost fiscal discipline and the start of a journey into what Ball and Mankiw (1995) refer to as an 'uncharted terri-

⁽¹⁾ Bordo and Jonung (1998).

⁽²⁾ See, e.g. IMF (1996, 2001) and Alesina and Ardagna (1998) for an overview of the fiscal consolidation experiences of advanced countries in the 1980s and 1990s.

Table III.1

**Deficits and debts in advanced countries in historical perspective
(average value of ratios over GDP over selected periods)**

	Gold standard (1881–1913)	First World War (1914–19)	Inter-war (1920–38)	Second World War (1939–46)	Bretton Woods (1947–71)	Floating exchange rate, high inflation (1973–82)	Floating exchange rate, low inflation (1983–95)
Deficit (central government)							
United States	– 0.2	5.1	1.0	15.2	0.6	3.1	5.5
UK	– 0.3	24.1	0.6	20.2	1.8	5.1	3.2
Germany	0.5	23.5	2.7	45.3	1.0	2.0	2.7
France	0.9	33.1	5.4	n.a.	2.8	2.1	3.3
Japan	3.3	1.3	5.0	41.1	1.9	6.4	4.2
G7 mean	0.9	18.1	2.7	27.2	2.0	4.9	5.3
Debt (central government)							
United States	7.6	10.0	29.4	73.6	60.9	33.5	10.2
UK	38.5	72.9	162.2	161.7	125.8	45.1	41.8
Germany	6.8	56.8	16.2	146.3	8.2	13.1	24.9
France	96.6	135.2	118.2	n.a.	25.0	11.2	n.a.
Japan	38.9	44.2	57.4	145.8	16.4	26.1	56.7
G7 mean	47.8	69.1	78.4	122.8	48.7	31.6	52.4

NB: The budget deficit is defined as the change in end-of-year government debt.

Source: Bordo and Jonung (1998).

tory’, where high and persistent deficits and debts materialise in absence of major war shocks?

It is probably too early to judge whether the current deterioration in budget balances taking place across the major advanced economies is a temporary phenomenon or is a sign of an enduring loss of fiscal discipline. Among the elements that can induce optimism, in the late 1990s there has been a broad tendency across advanced economies towards consolidation based on expenditure cuts rather than on tax increases, which are more likely to have durable impact on debt developments⁽¹⁾. This was often accompanied by reforms in public sector management to improve the prioritisation and control of public spending (see Part IV of this report). Other elements may instead induce pessimism. The improvement in budget balances achieved in

the late 1990s in the United States and, to a lesser extent, in the EU, was partly due to higher than expected revenues associated with an exceptionally well-sustained period of economic growth. In the case of a large number of EU countries, the improvements in budget balances were the result of falling costs of debt ensuing from the reduction in risk premia on interest rates that accompanied the process of monetary unification. Similar reductions in interest rates cannot be expected in the future. Analogously, the positive impact on the budget balance of several EU countries due to one-off measures undertaken in the recent past are not likely to be repeated on the same scale in future years. However, the most worrisome tendency for future years is probably the pressure that the fiscal positions of many advanced countries will receive from the increase in ageing-related expenditures like pensions and healthcare.

(¹) Details on these tendencies for advanced countries are reported in IMF (2001). See also European Commission (2002a, 2003) for evidence on EU countries. Among the studies showing that consolidations based on expenditure cuts are more likely to have a durable impact on debt levels than consolidations based on tax increases see, e.g. Alesina and Ardagna (1998).

Understanding whether the recent budgetary deterioration in advanced countries is the beginning of a new phase of protracted deficits or the result of contingent events is of the utmost relevance, especially in the case

of the EU for at least two reasons. The first is the role played by the EU fiscal framework in shaping market expectations concerning the future behaviour of fiscal authorities. Actual development in financial markets and the functioning itself of the monetary union largely depend upon such expectations. The second reason is that the relatively high debt/GDP ratios coupled with rapidly ageing populations that characterise most EU countries could make the postponement of budgetary discipline very costly.

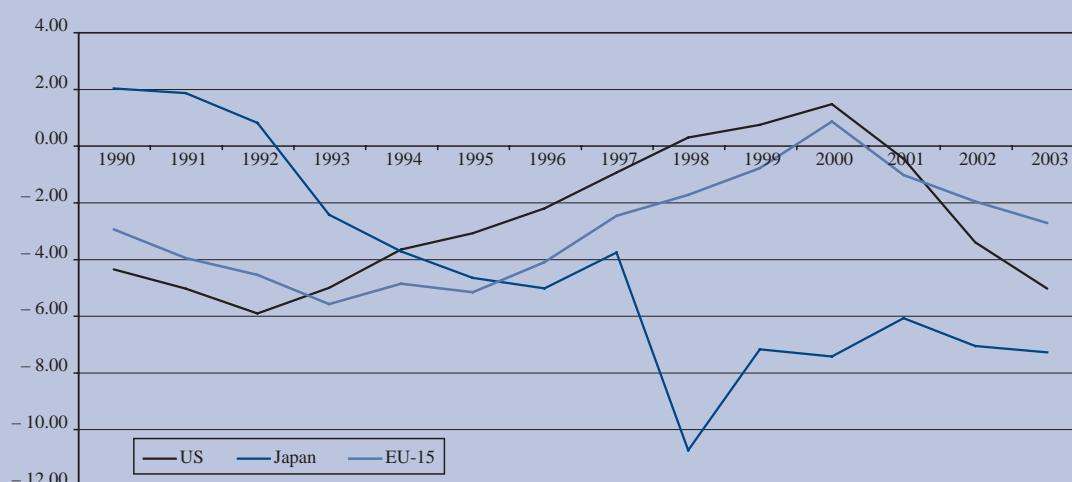
In the light of the developments summarised above, the objective of this part of the report is to reassess the case for budgetary discipline in the EU. What are the implications of protracted deficits for national income? Through which channels can budget deficits affect the growth potential and international income flows? These are the basic questions that this part of the report aims to address. The focus will be on the long-run impact of permanent deficits on national income, abstracting from the effect of deficits on output stabilisation and income distribution. This section illustrates the main channels through which budget deficits may affect income and reviews the main findings from available empirical evidence. The next section explores the empirical relevance of these channels for the case of EU countries.

2.2. The impact of permanent budget deficits: Predictions from alternative views

From a long-run perspective, budget deficits can affect national income prospects (i.e. the income accruing to national production factors) either by having an impact on the level and rate of change of domestic potential output or by affecting income flows between national and foreign citizens. Potential output in turn depends upon the efficiency in resource allocation (e.g. the extent of distortions associated with public intervention) and the accumulation of production factors and knowledge. Other things being equal, higher potential output corresponds to increased national income. Income flows between national and foreign citizens mainly depend on the stock of net foreign assets, i.e. the difference between the stock of assets held abroad by national citizens and the stock of assets owned by foreigners at home. The stock of net foreign assets decreases whenever a country, in a given year, is a net borrower from the rest of the world, i.e. when it exhibits a negative current account balance.

The role of budget deficits in the determination of national income can be understood by looking at national accounting identities. From the equality of the value of aggregate final output supplied and demanded,

Graph III.1: Recent developments in budget deficits in advanced economies (% GDP)



Source: 2002 and 2003 updates to French stability programmes and spring 2004 Commission forecasts.

and given the definition of the components of aggregate demand and that of the determinants and uses of disposable income, it follows that

$$(1) \quad S - BD = I + CA$$

i.e. the sum of aggregate private savings (S) and the budget surplus (i.e. the negative of the budget deficit, BD) must equal the sum of domestic private investment (I) and the current account balance (CA)⁽¹⁾. The above relation is an identity, i.e. it is always verified. It states that aggregate national savings can either finance domestic private investment (I) or investment abroad, increasing net foreign lending (which occurs whenever the current account improves)⁽²⁾. Both private investment, I , and the current account balance, CA , contribute to national income prospects. Identity (1) is silent on which variables adjust to restore the equality after the occurrence of shocks that may perturb it, notably fiscal policy shocks that affect the budget balance. Any deterioration in the budgetary position will necessarily imply either an increase in aggregate private savings, or a reduction in investment, or a reduction in the current account balance, or a combination of all the above effects. Which variable will adjust depends upon assumptions concerning how the economy works, mainly on the consumption and investment behaviour of agents. Different theories have been developed putting emphasis on alternative aspects of consumption and investment and generating alternative predictions concerning the long-run impact of budget deficits.

The Keynesian view

Keynesian macroeconomics is mainly suited for short-term analysis, but implications for the long-run relation between budget deficits and national income can be inferred⁽³⁾. One of the basic tenets of Keynesian

macroeconomics is the idea that (e.g. as a result of liquidity constraints) aggregate consumption is determined by current disposable income. This is sufficient for policies that directly affect aggregate demand (such as budgetary policies) to have additional effects on income via increased consumption spending (multiplier effect). Any policy-induced increase in aggregate income will therefore also be associated with higher private savings since only a fraction of the additional income will be consumed. Budget deficits in Keynesian macroeconomics are therefore expected to have a relevant short-term impact on the level of economic activity and are seen as a relevant tool for macroeconomic stabilisation.

Under the typical assumptions underlying Keynesian models (underemployment of production factors, high aggregate demand multipliers, low sensitivity of investment on interest rates) budget deficits are not expected to affect in a relevant way aggregate investment or the current account. After an increase in budget deficits, the equality in (1) will be restored mainly via increased private savings (so that national savings remain broadly unchanged), which is made possible by an increased level of economic activity. The implication from Keynesian theory is that, in spite of relevant short-run effects of budget deficits, the long-term impact on national income is expected to be small.

The Keynesian view of budget deficits can be appropriate for temporary deficits, not for permanent deficits. When the government runs persistent deficits, the stock of government bonds raises over time. The prediction of Keynesian models is that the additional savings needed to absorb the rising supply of bonds will come from additional aggregate demand. However, this means that aggregate output needs to grow continuously as a result of demand injections irrespective of the determinants of potential output (supply of factors, technology). The major limitation of traditional Keynesian analysis is the neglect of the role of time and expectations, a gap that has been filled by more recent developments in macroeconomic theory.

Ricardian equivalence

The developments in macroeconomic thinking occurred since the late 1970s have put emphasis on the forward-looking behaviour of agents and on the requirement of agents' rationality in forming their expectations⁽⁴⁾. The

⁽¹⁾ The definition of income implicit in (1) is GNP. In EU national accounting it is common to use GDP as a measure of national income. The use of GDP would require substituting the current account with net exports in expression (1), which excludes net returns on national production factors and unilateral transfers. Note also that investment in expression (1) excludes government investment. An alternative way of writing (1) would be to add government investment, I^G to both sides of the identity, obtaining the following expression: $S - CBD = I^G + CA$, where CBD denotes current rather than overall budget deficit.

⁽²⁾ Strictly speaking, national savings are given by $S - CBD$, i.e. private savings net of the current government deficit.

⁽³⁾ While in short-run analysis the actual level of economic activity can differ from the potential (or full-employment) level, in the long run deviations of current output from potential average out. Temporary policy-induced discrepancies between actual and potential output can be rationalised on the ground of incomplete nominal adjustment coupled with real rigidities (in the Keynesian tradition) or imperfect information and surprise policy shocks (in the tradition of new classical economics). See, e.g. Romer (1996).

⁽⁴⁾ See Barro (1974).

basic idea from the 'new classical economics' view of budget deficits is that, since consumers base their decisions on permanent income (i.e. on the whole stream of expected future incomes) how the government decides to finance a given amount of expenditure will be irrelevant for agents' consumption choices and aggregate income⁽¹⁾. It follows from agents' forward-looking behaviour that financing public expenditure through deficits (and the consequent accumulation of debt) or taxes will not affect permanent income and therefore consumption, since all debt will have to be paid in the future by means of higher taxes. Such prediction, briefly discussed by David Ricardo in his 'Principles of political economy', is commonly known as the 'Ricardian equivalence theorem'. It states that the financing policy chosen by the government will not affect consumption, so that any change in public savings will be matched by a change of opposite sign and equivalent magnitude in private savings. Ricardian equivalence has the very strong implication that budget deficits will be neutral on the macroeconomic equilibrium both in the short and the long run. Since national savings are unchanged after a change in budget deficits, there will be no impact either on investment or on the current account. The only impact will be on disposable income, without any effect on the aggregate level of economic activity.

The very strong result on the neutrality of budget balances descending from Ricardian equivalence relies on a set of strong assumptions, that have been criticised on several grounds both theoretically and empirically⁽²⁾. The assumption that agents will fully take into account additional future taxes associated with debt repayment in computing their permanent income requires households to be characterised by a strong bequest motive. Moreover, the hypothesis that households' consumption depends on permanent rather than on current income necessitates a very efficient working of credit markets, since consumption needs may be in excess of current income for some individuals.

The emerging consensus

In a sense, while the basic limitation of Keynesian models is that of referring to a too short time horizon (with agents that base their decisions entirely on current variables), that of models producing Ricardian equivalence is that of evaluating agents' behaviour over an extremely long time horizon. There is growing consensus that the relevant time-frame to evaluate the impact of budget deficits is most probably in between⁽³⁾. From such an intermediate perspective, agents are assumed to take into account expected future events in their consumption and investment decisions, but the weight put on variables distant in the future is much smaller than that given to current variables. Overlapping generations' models with finitely-lived forward-looking agents have been developed exhibiting features that permit to analyse the long-run effects of permanent deficits without relying on extreme assumptions at the basis of Ricardian equivalence⁽⁴⁾. This category of models has sometimes been referred to as 'neoclassical' models for the analysis of budget deficits (e.g. Bernheim, 1987). 'Neo-classical' models are at the basis of most of the applied macroeconomic models used for policy analysis in academia and policy institutions. The basic result which is common to such models is that a permanent increase in budget deficits will not be fully compensated by an equivalent increase in private savings. The ensuing reduction in national savings will necessarily be followed by either a reduction in domestic investment or a reduction in net foreign assets, i.e. worsened national income prospects. The reason why national savings fall as a result of a permanent increase in budget deficits is related with the behaviour of consumption in 'neo-classical' overlapping generations models. Since deficits shift disposable income from the future to the present and since agents put a higher weight on current income in taking consumption decisions, consumption will not remain unchanged as predicted by the Ricardian equivalence theorem but will generally increase⁽⁵⁾. Empirical evidence on advanced economies shows that government

(1) Formally, while in the Keynesian framework $S = Y^d - C(Y^d)$, where $Y^d = Y - T$ denotes disposable income (income net of taxes and transfers, T) and $C(Y^d)$ denotes that consumption is a function of disposable income, according to the expectations view $S = S = Y^p - C(Y^p)$, where Y^p is permanent income. Since deficits leave unchanged permanent income in the Ricardian view, it follows that a change in the budget deficit generated by a change in T will impact on private savings by the same amount as the impact on disposable income, while it will in general affect also C (and then Y) according to the Keynesian view.

(2) For a survey on the debate on Ricardian equivalence see, e.g. Bernheim (1987), Seater (1993) or Ricciuti (2003).

(3) This is the framework considered to be relevant in recent advanced macroeconomics textbooks (e.g. Azariadis (1993), Obstfeld and Rogoff (1998)).

(4) Among the first contributions in this field see, e.g. Diamond (1965). Blanchard (1985) develops an analytical framework where agents are forward looking but characterised by a constant probability of death in which Ricardian equivalence does not hold. See also Tirole (1986) and Weil (1987) for theoretical contributions on the subject.

(5) Recent literature has also considered a 'non-Keynesian' view according to which in the presence of distortionary taxation and high debt levels budget consolidations may actually increase agents' expected disposable income and then provoke an increase in consumption. See, e.g. Giudice, Turrini and in't Veld (2003) for a discussion of non-Keynesian effects of budgetary consolidations in EU countries.

deficits are significantly, yet partially offset by increased private savings ⁽¹⁾.

2.3. The long-term impact of permanent deficits: The channels at work

In the following, the main channels through which budget deficits affect national income prospects are illustrated, taking care of distinguishing between the direct impact of budget deficits on capital accumulation and net factor rewards from the indirect effects arising through induced changes in the perspective stream of revenues and expenditures and on the risk perceived by markets.

2.3.1. Debt, interest rates and private investment crowding-out

The first reason for why persistent budget deficits may affect potential output is the reduction in capital accumulation caused by the building-up of government debt. Potential output depends upon the supply of production factors and technology. How the supply of capital changes over time depends on investment, which in turn depends on savings. Persistent deficits reduce national savings and raise over time the stock of government bonds. Such new issues of debt can be absorbed by the public only if yielding higher real returns. The growth in government bonds' real returns shifts savings away from productive capital (firms' stocks) into financial assets, thus depressing investment. It follows that a permanent increase in budget deficits translates into a lower steady-state per capita capital stock and then into reduced per capita potential output ⁽²⁾.

The magnitude of the effect of deficits on interest rates crucially depends upon two factors: the sensitivity of private savings to interest rates and the degree of international capital mobility. The weaker the response of private savings to changes in interest rates, the higher the increase in the interest rate required to equate the supply and the demand of bonds. Other things being equal, when private savings are relatively insensitive to interest rates, general government deficits will have a strong effect on interest rates and then on productive

investment ⁽³⁾. As for the role of international capital mobility, as capital becomes increasingly mobile across national boundaries, domestic interest rates are increasingly determined by foreign interest rates and by exchange rate expectations. The higher the degree of capital mobility, the lower the impact of budget deficits on interest rates: the increased supply of government bonds associated with the realisation of deficits will mainly be allocated abroad, with no need of a change in interest rate to induce a sufficient increase in domestic private savings.

Concerning the dynamics of adjustment in interest rates to budget deficits, agents' expectations play a crucial role. Since agents participating in financial markets take their decisions from a forward-looking perspective, what is relevant for the relation between budget deficits and interest rates is not the current but rather the future budget deficits expected by markets. At unchanged current deficits, factors that may affect expectations concerning future budget deficits (including the introduction of laws aimed at promoting budgetary discipline) will have an impact on expected interest rates. Via arbitrage, expectations on future interest rates will translate into immediate changes in the terms' structure of interest rates. The emergence of factors that induce expectations of higher deficits in the future will entail an immediate steepening of the yield curve, since the value of long-term interest rates tend to reflect that of average future short-term rates ⁽⁴⁾. If expectations on budget deficits turn out to be correct, interest rates across the whole term structure (both short- and long-term) will rise over time ⁽⁵⁾.

A final remark concerns the impact of budget deficits on economic activity via changed rates of capital accumulation. As stressed by endogenous growth theory, a reduction in the rate of investment may impact not only the level of potential output (and its growth on the transition path) but also its rate of growth at the steady state. The reason is that new capital goods may embody a higher level of technology, being therefore more productive. A higher rate of investment would therefore be associated

⁽¹⁾ See, among others, Bernheim (1987), Seater (1993), Elmendorf and Mankiw (1999).

⁽²⁾ The theoretical result that permanent deficits should lead to reduced capital accumulation is a robust one. The major requirement for its validity is the absence of Ricardian equivalence.

⁽³⁾ The impact of interest rates on consumption (and then on savings) savings is a priori ambiguous, since while substitution effects are negative, income effects are generally positive (being households' net creditors on aggregate). Consistently, empirical evidence shows a relatively small impact of interest rates on savings, both in advanced economies (Bosworth, 1993) and developing countries (Giovannini, 1985).

⁽⁴⁾ Campbell (1995) provides a survey on the theory and the empirics of the expectation view for the term structure of interest rates.

⁽⁵⁾ See, e.g. Blanchard and Fischer (1989), pp. 132–134, for a formal characterisation of the dynamic response of interest rates to budget deficits.

with a lower average age of capital and with a faster rate of growth in total factor productivity ⁽¹⁾.

It follows from the above arguments that the crowding out of productive investment by permanent government deficits can be a sufficient condition for debt unsustainability. On the one hand, deficits reduce the rate of investment, which in turn leads to lower transition or steady-state growth. On the other hand, the increase in real interest rates caused by high permanent deficits raises the cost of government debt ⁽²⁾.

Concerning empirical evidence, a large body of work has been carried out in the past few decades to estimate the impact of budget deficits on interest rates ⁽³⁾. Most of the existing work focuses on the United States, but a number of studies on European countries and other OECD countries are also available. Several different methodologies have been employed to test the impact of deficits on interest rates (see Box III.1). In spite of recognised difficulties in estimating the effect of deficits on interest rates, there is increasing consensus on a causal relationship between governments' fiscal positions and interest rates (see Table III.2). A significant impact of budget balances on interest rates is found especially in those analyses that employ measures of expected rather than actual budget deficits as explanatory variables. Concerning the magnitude of the estimated impact, most of the studies indicate that a 1 GDP point of additional deficit increases long-term nominal interest rates on government bonds by between 20 and 100 basis points and long-term real interest rates by between 15 and 80 basis points.

2.3.2. Current account deficits and decumulation of net foreign assets

Allowing for the economy to be open internationally, the adjustment in response to budget deficits may come from the current account side. Going back to the accounting identity (1), the adjustment may fall on the current account *CA* rather than on investment *I*. When this is the case, the loss in income prospects is not asso-

ciated with a reduction in domestic potential output but rather with an income transfer between national and foreign citizens to pay back foreign debt. A reduction in the current account balance corresponds in fact to a deterioration in the stock of net foreign assets held by residents ⁽⁴⁾.

Under which conditions are deficits more likely to induce a worsening of the current account, rather than a slowdown in capital accumulation? In general, the response of the current account will depend upon the degree of international capital mobility and the exchange rate regime ⁽⁵⁾. With flexible exchange rates, permanent budgetary expansions will normally entail an incipient increase in interest rates, thus triggering capital inflows. The inflow of capital will in turn lead to the appreciation of the currency and then to a deterioration in the current account (*CA* falls) ⁽⁶⁾. Conversely, with fixed exchange rates, crowding-out of fiscal expansions via the current account will be limited, since monetary expansions are required to offset the impact of budgetary policies on interest rates, in order to avoid the currency appreciation. In the long run, however, a deterioration in the current account will occur due to an appreciation of the real exchange rate associated with an increase in the domestic price level and a consequent loss of competitiveness. This form of external adjustment via the real exchange rate following budgetary expansions takes place also in the euro area. Expansionary budget policies will normally raise output temporarily above potential, thereby putting pressure on prices: the associated loss in 'competitiveness' will result in a deterioration in the current account.

As for empirical evidence, it has been shown by Feldstein and Horioka (1980) that there is a very close relation between domestic investment and domestic savings across countries. This finding, known as the

⁽¹⁾ Although permanent effects of investment on growth via 'endogenous growth' channels is much emphasised both in theoretical work and in the policy debate, estimating empirically the magnitude of these effects is subject to major difficulties (see, e.g. Temple, 1999).

⁽²⁾ It is shown in Chalk (2000) that debt unsustainability may arise from investment crowding out generated by primary deficit levels that leads over time to real interest rates in excess of growth.

⁽³⁾ See, e.g. Gale and Orszag (2003) and Brook (2003) for surveys.

⁽⁴⁾ This is easily understood in the case of a current account deficit ($CA < 0$). The excess of the value of imports over exports must be financed by an increase of liabilities (or reduction of assets) with respect to the rest of the world. Foreign residents will then hold in their portfolios a higher stock of domestic assets, i.e. of claims on the returns from the stock of domestic capital and national citizens will hold a lower stock of claims on foreign assets.

⁽⁵⁾ The 'workhorse' model to evaluate the short-run impact of budget deficits in open economies remains the Mundell-Fleming model, eventually re-adapted to account for covered or uncovered interest rate parity (see, e.g. Obstfeld and Rogoff (1998)).

⁽⁶⁾ In the extreme case of 'perfect' capital mobility, crowding-out via the current account will be complete: any changes in the budget balance will be matched by an equivalent change in the current account balance ('twin deficits' case) and there will not be impact on aggregate income.

**Box III.1: Testing empirically the relation between budget deficits and interest rates:
Results and methodological issues**

Estimating the impact of budget deficits on interest rates involves a number of difficulties. A first difficulty is related to the modelling strategy of the relationship between government fiscal positions and interest rates. Of course, budget deficits are not the only factor affecting interest rate developments. How to account for the remaining explanatory factors? One way is that of analysing this relationship by means of simulations via applied, multi-equation macro models. Such models embed a rich amount of relations among macroeconomic variables, and take into account a wide range of interactions and feedback. The resulting estimates of the impact of budget deficits on interest rates depend on the model assumptions (e.g. the modelling of private consumption determination or that of international capital markets) and the values for relevant model parameters (normally based on existing empirical work). Applied macro models are useful in analysing the impact of budget deficits on the whole economy but are less suited to provide an assessment of the particular relation between government fiscal positions and interest rates. The reason is that results can be quite sensitive to the features of the model and to the chosen value for model parameters ⁽¹⁾.

A more direct approach is that of econometric estimation. Following this approach measures of budget balances are used as explanatory factors in regressions (normally time-series regressions for single countries, but also panel regressions comprising several countries) where interest rate dependent variables appear. Also when following this route there is the issue of choosing a theoretical framework of reference for the specification of the empirical model for interest rate determination. Most of the existing analyses in this vein have estimated reduced-form specifications of equilibrium models. In some studies the specification of the equations tested is derived from static equilibrium models in which the interest rate on government bonds adjusts in order to maintain equality between the supply and demand of bonds ('loanable fund models'). This is the approach followed for instance in Thomas and Abderrezak (1988) or Cebula (1998, 1999, 2000). The typical additional explanatory variables employed in such specifications are short-term interest rates (determined by monetary policy and therefore taken as exogenous), inflation or money growth (which increases, *ceteris paribus*, nominal interest rates) and capital inflows (which tend to raise the demand for bonds). Econometric tests have also been provided for alternative specifications grounded on intertemporal models of saving behaviour (e.g. Laubach, 2003).

A second issue in estimating the link between budget deficits and interest rates concerns the detection of causal relationships rather than correlations with alternative possible interpretations. As one can imagine channels through which budget deficits affect interest rates, one can also envisage the possibility of reverse causation, running from interest rates to deficits (explained by increased public expenditure in interest payments). In order to tackle the issue of causality, fully-fledged dynamic specifications have been developed in estimating empirically the link between budget deficits and interest rates (via ECM model estimations, co-integration analysis or VAR estimations). Examples are found in Plosser (1982, 1987), Evans (1987a, 1987b), Orr, Edey and Kennedy (1995), Cheng (1998), Cebula (1999), Ewing and Yanochik (1999).

A further estimation issue concerns the role of expectations. If agents participating in financial markets are forward-looking, what matters for the determination of interest rates are the expected, rather than the current budget deficits. To the extent that agents are rational so they incorporate in their expectations and actions all the information concerning future deficits that is publicly available, what should be relevant to understand changes in interest rates are only those changes in budgetary prospects that are unexpected. The VAR approach (pioneered by Plosser (1982, 1987) and followed subsequently in Evans (1987a, 1987b)) can isolate the impact on interest rates of the unexpected component of changes in fiscal variables. The limitation with the use of VAR is that the estimation of expected fiscal variables are extrapolations from past data and do not account for new available information not included in past observations. To overcome this limitation of VARs in modelling agents' expectations, a number of studies have included official forecasts on budget balances as explanatory factors, with the aim of capturing in this way better measures of agents' expectations. In the US case,

⁽¹⁾ See Gale and Orszag (2003) for a survey on results concerning the relation between budget deficits and interest rates in the United States obtained from applied macro-model simulations. Results tend to vary quite widely across different models.

(Continued on the next page)

Box III.1 (continued)

the medium-term (five years) budget forecasts of the CBO have normally been used. Analogous medium-term budget projections are generally not available for European and other countries. Shorter term forecasts have then been used for countries other than the United States. An alternative approach, followed for instance in Bovenberg (1988) is that of using actual forward values for cyclically adjusted budget balances as proxies of expected deficits.

In order to disentangle expected from unexpected changes in budget figures, a series of papers have analysed the relation between news on the budgets printed in the press or new data announcements by budgetary institutions and the day-to-day change in government bond interest rates (Wachtel and Young, 1987; Thorbecke, 1993; Elmendorf, 1996).

Some recent analyses use measures of expected deficits to measure their impact on expected future interest rates (Laubach, 2003) or the term structure of interest rates (e.g. Reinhart and Sack, 2000; Lindé, 2001; Canzoneri, Cumby and Diba, 2002). The idea beyond using the terms structure of interest rates (i.e. the difference between long- and short-term rates) rather than interest rate levels is that expectations of higher deficits in the future result in higher future interest rates and therefore in an immediate steepening of the yield curve. Using as dependent variable the difference between long- and short-term interest rates permits the capture of this effect without the need of modelling the determinants of interest rate levels.

Finally, it must be mentioned that an indirect assessment on the impact of budget deficits on interest rates comes from the studies that use debt levels as explanatory variable. In interpreting the implications for the effect of deficits arising from these studies it is crucial the extent to which deficits are assumed to be permanent. While the effect of purely temporary deficits would be close to equivalent changes in debt, the effect of permanent deficits on steady-state debt would be considerably stronger.

As for results, a number of regularities seem to merge from existing studies. Firstly, analyses using data up to the early 1980s (e.g. Plosser, 1982, 1997; Evans, 1987a, 1987b) tend to yield (for the US case) insignificant effects of budget deficits on interest rates. The explanation for such evidence may be rooted on a possible non-linear relation between the stock of debt and interest rates as found, for instance in Conway and Orr (2002) or in O'Donovan, Orr and Rae (1996). The stock of US debt was lower in the 1970s and early 1980s, and this may explain a reduced impact of deficits on interest rates for that period. Secondly, the interest rate impact of deficits on interest rates is stronger for the United States than for other countries. This regularity is probably related to the fact that the US is a relatively big economy with a relatively low weight of international capital in deficit financing. Secondly, analyses using short-term interest rates as dependent variables are more likely to report weak or insignificant results. A possible reason is that short-term interest rates are affected in a hardly predictable way by monetary policy considerations. Thirdly, studies employing official budgetary projections or news and announcements on budget data, rather than current deficits or VAR expectations, generally find a significant impact of budgets on interest rates. This can be interpreted as a test of the better empirical performance of models emphasising the forward-looking behaviour of economic agents and a confirmation of the greater informational content of budgetary projections compared with VAR innovations. Finally, the estimated impact of debt on interest rates is in general smaller than that of deficits. This result appears clear in those studies using alternatively deficits and debts as explanatory variables for interest rates (e.g. Laubach, 2003).

'Feldstein-Horioka puzzle' goes against the widespread view that international capital markets are highly integrated. In a fully integrated international capital market, the link between savings and domestic investment would be weak, since residents of each country would hold an internationally diversified portfolio of activities (i.e. would finance not only domestic investment but also investment abroad). Consistently, cross-country evidence on the determinants of the current account is not strongly supportive of the 'twin deficit' view that government budget imbalances will translate into corresponding imbal-

ances in the current account (e.g. Lane and Perotti, 1998; Chinn and Prasad, 2000). Subsequent research (e.g. Feldstein and Bacchetta, 1991) has shown that the strength of the link between domestic savings and domestic investment has somewhat declined in more recent years. Recent evidence reported by Blanchard and Giavazzi (2002) points to a possible gradual disappearance of the Feldstein-Horioka puzzle among EMU countries, which have been exhibiting growing current account imbalances in recent times and a weakening of the link between domestic investment and savings.

Table III.2

The impact of government deficits on interest rates: Survey of existing studies

Study	Data	Interest rate dependent variable ⁽¹⁾	Fiscal position explanatory variable	Results
Actual deficits used as explanatory variable				
Plosser (1982)	US, 1954–78, quarterly	Interest rates on short-term bonds (bills) at various maturities	VAR innovations in government debt holdings by the private sector and the Federal Reserve	Changes in debt holdings do not affect interest rates, while public expenditures increase them
Plosser (1987)	US, 1967–85, monthly	Interest rates for bills and bonds at various maturities	VAR innovations in government debt holdings by the private sector and the Federal Reserve	Insignificant impact of debt growth rates on interest rate variables
Evans (1987a)	US, 1908, 1984, monthly	Nominal and real interest yields for bonds with different maturities	VAR innovations in budget balances are used as proxies for unexpected changes in fiscal policy	Insignificant or negative impact of unexpected changes in budget balances on interest rates.
Evans (1987b)	G7 countries except Italy, 1974–85, annual	Interest rates on short-term bonds	Changes in the budget balance	Insignificant or negative impact of unexpected budget balance changes on interest rates
Elmendorf (1993)	US, 1971–87, quarterly	Change in interest rates for bonds with different maturities	Change in DRI budget balance projections for current and next fiscal years	Significant impact of changes in budget projections on interest rate changes: about 40 basis points per 1 % GDP deficit for long-term bonds and 20 basis points for short-term bonds
Orr, Edey and Kennedy (1995)	17 OECD countries, 1981–94, quarterly	Real interest rate on 10-year bonds	Budget balance	Budget balances have a significant long-run impact on interest rates of 15 basis points per each GDP point of deficit
Knot and de Haan (1995)	DE, FR, IT, NL and UK, 1960–89 annual	Cross-country average interest rate on 10-year bonds	Budget balance and CAB	Significant impact of deficit measures on interest rates. 1 additional GDP point of deficits raises interest rates in the range of 40–60 basis points
Vamvoukas (1997)	Greece, 1950–93, annual	Interest rates on 1-year bonds	Budget balance	Budget deficits have a significant impact on interest rates. The ECM impact multiplier implies that 1 GDP point of additional deficit increases interest rates by about 20 basis points
Cebula (1998)	US, 1963–95, annual	Active and passive interest rates on bank deposits	Budget balance	Budget deficits increase the cost of deposits for banks (between 20 and 60 basis points) but not prime rates on deposits
Cheng (1998)	Japan, 1955–93, annual	Interest rates on short and long-term bonds	Budget balance	Budget balances are not co-integrated with long-term interest rates
Giannaros and Kolluri (1989)	Canada, FR, UK, DE, 1965–85, quarterly	Real interest rate on short-term bonds	Budget balance	Insignificant impact of budget balance on interest rates
Cebula (1999)	UK, 1972–91, quarterly	Interest rates on 20-year bonds	Budget balance	Budget deficits and long-term interest rates are cointegrated
Ewing and Yanochik (1999)	Italy, 1977–91, quarterly	Interest rate spread between long and short-term bonds	Budget balance	Budget balances Granger-cause interest rate spreads but not vice-versa
Cebula (2000)	US, 1973–95, annual	Ex post real interest rates for bonds of various maturities	Budget balance	Significant impact of budget deficits on ex post real interest rates. 1 GDP point of additional deficit increases ex post real interest rates by 86 basis points

(Continued on the next page)

Table III.2 (continued)

Study	Data	Interest rate dependent variable ⁽¹⁾	Fiscal position explanatory variable	Results
Lindé (2001)	Sweden, 1982–96, monthly and quarterly	Spread of domestic over foreign interest rate for both 3-month, 5-year and 10-year bonds	Budget balance	Significant impact of deficits on interest rate spread over foreign bonds. 1 additional GDP point of expected deficit raises spreads on average by 20 basis points
Darrat (2002)	Greece, 1950–93, annual	Interest rates on 1-year bonds	Budget balance	Budget balances do not Granger interest rates but interest rates do cause budget deficits
Cebula (2003)	Germany, 1975–90, quarterly	Interest rates on bonds with maturity higher than 3 years	Budget balance	Budget balances and long-term interest rates are cointegrated
Faini (2004)	11 euro-area countries, 1979–2002	Real interest rates on 10 government bonds	Primary cyclically adjusted budget balances	1 additional GDP point of expected deficit raises the euro-area interest rate level by 35 basis points and the spread between domestic and euro-area interest rates by 5 basis points.

Expected deficits used as explanatory variable

Bovenberg (1988)	US, 1961–85, annual and semi-annual	Interest rates on 10- and 3-year bonds	Proxy for expected deficit: average value of the CAB 5 years ahead	Statistically significant impact of expected deficits long-term interest rates. An additional GDP point of expected deficit raises interest rates by about 100 basis points
Thomas and Abderrezak (1988)	US, 1970–86, quarterly	Interest rates on 10-year government bonds	Two proxies for expected deficits: current CAB, average CAB recorded 3 years ahead	Statistically significant impact of expected deficits on interest rates. 1 additional GDP point of expected deficit raises interest rates by 94 basis points
Reinhart and Sack (2000)	19 OECD, G7 countries; 1981–2000, annual	Interest rate spreads (10-year minus 3-month)	OECD 1 year ahead budget balance projections	Significant impact of expected deficits on the interest spread. For OECD 1 GDP point of additional deficit raises spreads by 9 basis points on average, for G7 by 12 basis points
Canzoneri, Cumby and Diba (2002)	US, 1984–2002, semi-annual	Interest rate spreads (10-year or 5-year minus 3-month) <i>Ex post</i> real interest rate realised after 5 years	Budget balances CBO budget balance projections 5 and 10 years ahead	Significant impact of expected deficits on interest rates. 1 additional GDP point of expected deficit raises on average expected nominal and real interest rates by 40–60 basis points. The impact of actual budget balances is of a similar magnitude 1 GDP point of deficit raises the <i>ex post</i> real interest rate by 45 basis points
Laubach (2003)	US, 1976–2003, annual; 1985–2003, semi-annual	Expected future nominal and real 10-year bond yields	OMB and CBO 5-year ahead projections on budget balances	Significant impact of expected deficits on interest rates. 1 additional GDP point of expected deficit raises on average expected nominal and real interest rates by about 20 basis points

Event studies: news concerning future deficits used as explanatory variable

Watchel and Young (1987)	US, news on deficits and daily data on interest rates in the 1982–86 period	Interest rates on bonds at various maturities	OMB and CBO announcements on deficit projections	Statistically significant impact of news on higher deficits on day-after interest rates. USD 1 billion of additional announced deficit increases on average interest rates by about 0.2–0.3 basis points
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Table III.2 (continued)

Study	Data	Interest rate dependent variable ⁽¹⁾	Fiscal position explanatory variable	Results
Thorbecke (1993)	US, news on deficits and daily data on interest rates in the 1979–89 period	Interest rates on bonds at various maturities	OMB and CBO announcements on deficit projections	Statistically significant impact of news on higher deficits on day-after interest rates, insignificant impact of news on government purchases. USD 1 billion of additional announced deficit increases on average interest rates by about 0.3 basis points. News on higher expected deficit also significantly raise the day-after US dollar exchange rate
Quigley and Porter–Hudak (1994)	US, deficits news appeared between 1979 and 1989, daily data on interest rates	Interest rates on 3-month bills	Deficit projections appeared in the Wall Street Journal	Significant impact of news on deficits on day-after interest rates. On average, a 1 % GDP announced increase in deficit raises short-term interest rates by 0.52 basis points over 1 day
Kitchen (1996)	US, news on deficits and daily data on interest rates in the 1981–94 period	Interest rates on US and UK bonds at various maturities	OMB and CBO announcements on deficit projections	News on 1 additional GDP point of deficit increase day-after US interest rates by about 4 basis points. There is also a statistically significant effect on UK interest rates on long-term bonds
Elmendorf (1996)	US, news on budget laws and data on interest rates in 1985 and 1990	Interest rates on 7-year bonds	News appeared in the New York Times and Wall Street on Gramm-Rudman-Hollings law (1985) and Budget Enforcement Act (1990)	Statistically significant relation between news pointing to stricter budget laws and interest rate reductions
Knot and De Haan (1999)	Germany, deficit announcements between 1987 and 1993, daily data for interest rates	Long- and short-term interest rates	Announcements on budget balance projections from Ministry of Finance, the Bundesbank and the Council of Economic Advisers	Significant impact of deficits news on day-after interest rates on long-term bonds (up to 0.27 basis points per 1 % GDP additional deficit). No significant impact of expenditure news

Debt measures used as explanatory variable

Helbling and Wescott (1995)	Eight advanced economies, 1963–90, annual	Country-level and aggregate measures of real short- and long-term interest rates	World gross government debt	1 additional GDP point of debt raises interest rates by 10–20 basis points
Ford and Laxton (1995)	Nine advanced economies, 1977–93, annual	Country-level and aggregate measures of real interest rates at 1-year maturity	World net government debt	1 additional GDP point of debt raises interest rates by 10–20 basis points at world level, by 15–50 basis points at country level
Chalk and Tanzi (2002)	EUR-11 + UK, 1970–98, annual	Real long-term interest rates	Gross debt	In a panel including EUR-11 countries and the UK, 1 additional GDP point of debt raises real interest rates by 6 basis points over the 1970–98 period and by 1 basis point over the 1980–98 period
Laubach (2003)	US, 1976–2003, annual; 1985–2003, semi-annual	Expected future nominal and real 10-year bond yields	OMB and CBO 5-year ahead projections on net government debt	1 additional GDP point of expected debt raises on average expected nominal and real interest rates by about 5 basis points
Chinn and Frankel (2003)	Seven EU countries, 1988–2002, quarterly	Real interest rate on 10-year government bonds	Net government debt	1 additional GDP point of debt raises EU real interest rates by 7–12 basis points on average per year

⁽¹⁾ Nominal rates if not otherwise indicated.

It is important to stress that the degree of capital mobility is relevant to assess the extent to which reduced national savings due to budget deficits can be compensated by foreign borrowing but is probably not crucial to understand what will be the cost of deficits in terms of foregone future national income. As long as the return on the funds borrowed from abroad does not differ much from the cost of borrowing, the income loss associated with reduced domestic investment (lower I) will not differ much from that associated with higher net foreign debt (lower CA) ⁽¹⁾.

2.3.3. Debt monetisation and inflation

Persistent deficits are a main cause for rising government debt stock. Since the real cost of debt repayment for the government can, at least temporarily, be reduced by means of inflation surprises, in the presence of high debt levels government pressures to create inflation are stronger. A link between deficits, debt and inflation may emerge also when central banks are independent by statute from the government, to the extent that the incentives to reduce the real cost of debt through inflation may translate into pressures of the government on monetary authorities.

In the past decade, economic theory has placed the focus of the analysis of the structural determinants of inflation on the behaviour characterising fiscal and monetary authorities. The idea at the grounds of the ‘fiscal theory of the price level’ is that the level of prices and inflation rates cannot be seen as the result of decisions taken by monetary authorities only and that the behaviour of fiscal authorities necessarily matters as well (see Box III.2). In particular, monetary authorities with a strong anti-inflationary commitment will not be sufficient to prevent structural inflation if fiscal policy is not conducted in such a way to avoid persistent excessive deficits. The reason is that when fiscal authorities are not committed to fiscal discipline, debt will accumulate up to the point in which default occurs or in which debt sustainability is achieved through a reduction in its real value obtained via an increase in the price level. This increase in the price level will not necessarily be caused by expansionary monetary policies but may result from real factors, i.e. increased aggregate demand resulting from government deficits.

⁽¹⁾ See Elmendorf and Mankiw (1999) on this point.

In spite of the fact that the lack of fiscal discipline does not currently seem to be a major cause of inflation in the EU (see Box III.2 for a review of available empirical evidence on the fiscal theory of the price level) it cannot be excluded that inflationary tendencies may show up in the future if debt remains high and the increase in age-related expenditures is not matched by an increase in government revenues or cuts in other types of expenditure.

Concerning the empirical relation between budget deficits and inflation, Fischer, Sahay and Vegh (2002) and Catão and Terrones (2003) show that while for developed countries the relation seems a weak one, it is a significant one for developing countries.

As for the effects of inflation on economies’ growth potential, there is widespread agreement that high and volatile inflation reduces both potential output and growth by weakening price signals, thus worsening resource allocation ⁽²⁾. Cross-country empirical evidence exists showing a negative relation between the level and the volatility of inflation and growth ⁽³⁾.

2.3.4. Deficits, budgetary policies, and resource allocation

Persistent deficits may have also relevant indirect effects on economies’ income prospects, via induced changes in budgetary policies. There are two main arguments which point to a possible negative impact on efficiency and growth through this channel ⁽⁴⁾.

The first argument states that since persistent deficits shift the tax burden to the future, income prospects may be reduced due to a perspective increase in the degree of distortions introduced by taxation in the economy. High deficits cannot be sustained indefinitely: a moment will come when, in order to stabilise and pay back the accumulated debt revenues, taxes will have to rise and expenditures fall. As long as part of the needed consolidation is achieved by means of an increased tax burden, this will aggravate the distortions introduced in resource allocation in product and factor markets. A reduction in the level of

⁽²⁾ See, e.g. Romer (1996) for a review of the arguments pointing to a negative impact of inflation on resource allocation. Among the papers demonstrating a negative effect of inflation on the incentives to accumulate productive capital see Stockman (1981).

⁽³⁾ Grier and Tullock (1989) find that the standard deviation of inflation is negatively related to growth in a cross-country growth regression.

⁽⁴⁾ These arguments are reported as in Elmendorf and Mankiw (1999) and have a long-standing tradition in public finance analysis.

Box III.2: The fiscal theory of the price level

The link between monetary and fiscal policy in determining structural inflation tendencies has been initially emphasised by Sargent and Wallace (1981) in the framework of their ‘unpleasant monetarist arithmetics’. The idea behind the Sargent and Wallace (1981) contribution is that since the respect of the government intertemporal budget constraint must hold as an identity for any possible trajectory of primary budget balances, the way in which this constraint will be respected ultimately depends upon the behaviour of monetary and fiscal authorities.

When the government can sell debt both to the public and to monetary authorities (which correspondingly issue new money base) the respect of the government intertemporal budget constraint requires that the present value of future real primary balances and real money base creation must equal the real value of the outstanding stock of debt. Formally, this means that at any time t the following equality must hold

$$(2) \quad \frac{B_{t-1}}{P_t} = \sum_{i=0}^{\infty} \delta_i \left(\tau_{t+i} + \frac{\Delta M_{t+i}}{P_{t+i}} - g_{t+i} \right)$$

where B_t is the nominal stock of debt, P_t is the level of prices, ΔM_t is the creation of money base, δ_t is the discount rate (which depends upon real interest rates and the growth rate of the economy) and τ_t and g_t are, respectively, real government revenues and primary expenditures.

From expression (2) it can be seen that if monetary authorities can credibly commit towards price stability (i.e. a low rate of money supply growth), then fiscal authorities will anticipate that a persistent imbalance between nominal revenues and expenditures cannot be fully offset by higher money base creation. The main policy implication from the analysis of Sargent and Wallace (1981) is that credible anti-inflationary targets for monetary authorities can be sufficient to induce the perception of a ‘hard budget constraint’ by fiscal authorities, which will need to run a sequence of primary surpluses to pay back the accumulated debt.

The analysis of the links between inflation and the behaviour of fiscal and monetary authorities in the fiscal theory of the price level (developed in Leeper (1991), Sims (1994) and Woodford (1994)) also focuses on the governments’ intertemporal budget constraint but departs from the view of Sargent and Wallace (1981) in a crucial respect. According to the fiscal theory of the price level it is not necessary that (at least) one policy authority behave in such a way to guarantee the respect of the government intertemporal budget constraint. Even when both monetary and fiscal authorities act independently and stick to their own behavioural rules, the respect of the government budget constraint will be guaranteed by an adjustment in the price level induced by market forces. When the behaviour of fiscal authorities is oriented towards fiscal discipline (i.e. when primary balances tend to increase as the stock of debt increases) government solvency will hold for any trajectory of prices consistent with the behavioural rule of monetary authorities. In this case a ‘monetary dominance’ regime will realise. If instead primary balances do not tend to adjust against increasing debt, then government solvency can only apply if the level of prices P_t ‘jumps’ in such a way to reduce the real value of the debt stock (‘fiscal dominance’ regime). Here comes the main difference of the fiscal theory of the price level compared with the unpleasant arithmetics of Sargent and Wallace (1981). The respect of the government budget constraint is not guaranteed by an increase in the rate of money base supply by monetary authorities but by a change in the price level due to increased aggregate demand generated by the deficit policy of fiscal authorities. The policy implication of the fiscal theory of the price level is that the independence of monetary authorities may not be sufficient to guarantee a non-inflationary policy environment: rules that induce sufficient fiscal discipline may also be required.

In recent times there have been several attempts to test empirically the fiscal theory of the price level. Canzoneri, Cumby and Diba (2001) show that in Europe and the United States the need of government solvency is not a significant determinant of the level of prices.

potential output will result. It has also been shown in theory that increased taxation may reduce the incentive to undertake capital investments or investments in human capital and R & D (e.g. Barro, 1990). This would in turn

translate into a reduced per capita capital stock and a lower rate of total factor productivity growth. Easterly and Rebelo (1993) find empirically in a cross-country growth regression including both advanced and developing coun-

tries that higher taxation contributes negatively and significantly to per capita output growth. Similar results are obtained by Kneller, Bleamey and Gemmell (1999) for OECD countries and by Romero de Avila and Strauch (2003) for a sample limited to EU countries ⁽¹⁾.

The second argument states that poor fiscal discipline affects the quality of the budget process. When additional government expenditures need not be matched by increased revenues the higher the probability that inappropriate or poorly conceived expenditure programmes will be approved.

Under these conditions, the incentive of the different departments of the public administration to carry out efficiently their tasks will also be reduced. The lack of fiscal discipline resulting in persistent deficits may therefore be accompanied by a reduction in the level of efficiency of public expenditure. Again, this would translate into lower potential output and possibly into lower rates of total factor productivity growth.

2.3.5. Debt accumulation, credit risk and confidence crises

A final channel through which persistent deficits may affect national income prospects is the increase in the perceived risk on government bonds and the higher vulnerability to a crisis of confidence of international financial markets.

Risk premia on government bonds tend to increase with debt/GDP ratios. As pointed out previously (Section 2.3.1) high debts tend to increase interest rates and to depress growth, thus increasing the probability of divergent debt dynamics. Moreover, when the conditions for explosive debt dynamics are realised, the growth rate of the debt/GDP ratio will be higher the higher the initial debt ratio. It follows that in the presence of high debt ratios the risk of unstable debt dynamics is higher and that a stronger response by fiscal authorities is needed to stabilise the debt/GDP ratio. Once the debt/GDP ratio starts exhibiting divergent dynamics, policy-makers are fundamentally left with two alternatives: carrying out timely and effective fiscal consolidations or defaulting on debt. Since successful fiscal consolidations may be politically costly to implement, markets tend to attach a higher probability of default to government bonds when debt/GDP

ratios are high. Hence, persistent deficits which lead to debt accumulation tend to increase interest rates and then to displace investment not only via reduced national savings as previously described. An additional reason for increased government bond interest rates is related to the necessity of compensating the increased default risk perceived by investors when debt levels become excessively high. Anecdotal evidence, including for the EU countries, suggests that financial markets may evaluate the risk on government bonds also on a forward-looking perspective, giving attention not only to the level of the stock of the accumulated debt but also to the budgetary policies that countries are likely to put in place in the future. Hence, not only the history of past deficits are relevant in determining risk premia on government bonds, but also expectations on future deficits may matter.

A series of studies have attempted to estimate the impact of debt on credit risk premia. Bayoumi, Goldstein, and Woglom (1995) analyse credit risk determinants of US municipal bonds. The measure of credit risk used is the difference between yields on 20-year general obligation bonds of 39 US states and that of New Jersey. Debt ratio differences have a significant, large and non-linear effect on yield spreads. A similar approach has been applied in Bernoth, Von Hagen and Schuknecht (2003) who analyse differences between bond yields on government bonds of different EU countries and comparable bonds issued by Germany in the same currency over the period 1991–2002. Their findings are that an additional GDP point of debt raises yield spreads significantly but by much less than found for the case of US municipal bonds (by a bit more than 1 basis point) ⁽²⁾. In Alesina et al. (1992) the difference between government and private sector bonds denominated in the same currency is used as a proxy of credit risk premia and employed as dependent variable in regression analysis on a panel of 12 OECD countries over the period 1974–89. The study estimates an average impact of 1.6 basis points of each additional GDP point of debt when limiting the sample to high-debt countries ⁽³⁾. The proxy used in Alesina et al. (1992) to measure credit risk has the main limitation of not being able to check for changes in private risk. A further limitation is that differences in liquidity risk are also not taken into account. In subsequent studies this issue has been addressed by measuring as a proxy of credit risk the difference between the

⁽¹⁾ It is to be remarked, however, that the impact of fiscal variables in growth regressions is not always significant. Levine and Renelt (1992) in their robust assessment of explanatory factors of growth, include fiscal variables among the set of non-robust regressors.

⁽²⁾ Balassone, Franco and Zotteri (2004) also find a high and significant impact of changes in the debt/GDP ratio, and overall and primary deficits on interest rate spreads with Germany in a regression across euro-area countries.

⁽³⁾ A similar result is found in Caselli, Giovannini and Lane (1998).

interest rate on government bonds and the returns on swaps (with same maturity and denominated in the same currency). Since there is no principal at risk in swap contracts, such a measure can check for differences in private risk. Adopting such measure for credit risk, Lemmen and Goodhart (1999) estimate an impact of 1.5 basis point for each additional GDP point in a panel of EU countries. Codogno, Favero and Missale (2003) disentangle the credit risk component from the liquidity premia component in interest rate swaps and find that debt ratios are not significant in explaining interest rate swap spreads in most EU countries, with the exception of Spain, Italy and Austria, where debt has been found to be a significant and quantitatively relevant explanatory factor.

A related argument, put forward recently in the debate on deficits in advanced countries, is the possibility that persistent deficits may lead to a crisis of confidence in international financial markets and then to sudden and massive capital outflows⁽¹⁾. Currency crises have accompanied foreign debt crises of several developing countries throughout the 1980s and 1990s. Abrupt and massive capital flights generated by self-fulfilling expectations of exchange rate devaluation were common to the experience of these countries. Currency crises were the result of worsened expectations concerning official foreign reserves and the current account, often triggered by persistent deficits against the background of high risk of default on government debt. The experience of developing countries is an imperfect guide to understanding the consequences of high and persistent deficits and large debts in advanced countries. This is only partly related to the fact that wealthy countries are less likely to default on their debt⁽²⁾. A crucial difference is instead that in the case of default in developing countries, a large share of government debt was held by foreign investors, so that the expectation of defaulting was also justifiable in the presence of debt levels which were not extremely high⁽³⁾. However, what can be inferred from the experi-

ence of the developing countries are the effects that confidence crises may exert on the economy⁽⁴⁾. Anecdotal evidence on international financial crises shows that shifts in investor confidence can be sudden and hard to predict, with the timing driven by the interaction between the occurrence of news on the state of the economy (e.g. concerning growth prospects or policy developments) and the dynamics of self-fulfilling expectations. The massive and abrupt decline in the demand of an economy's financial assets leads to sudden and potentially very strong increases in interest rates, which would in turn aggravate debt sustainability problems. Restrictive fiscal policies would then be required to stabilise debt and restore investor confidence. This would aggravate the negative impact on aggregate demand associated with depressed productive investment. On top of that, there is the risk that a confidence crisis may trigger a widespread financial crisis, with the hike in interest rates causing firms' bankruptcies which would in turn generate distress in the banking system. In sum, the consequences of generalised confidence crises may easily go well beyond a temporary increase in the cost of capital. The economy may have to go through a prolonged period of instability with stagnating demand and reduced investment rates.

The above arguments, when applied to the case of advanced economies like those of the EU countries, are necessarily speculative. At present, the eventuality of a large-scale confidence crisis in EU countries is a remote one. However, this does not mean that this argument in favour of fiscal discipline is to be dismissed altogether⁽⁵⁾. High and persistent budget deficits tend to worsen the current account balance, to the accumulation of foreign liabilities, and to an increased probability of a 'sudden stop', i.e. to abrupt and massive capital outflows which force a fast correction in the current account⁽⁶⁾. Although the argument of fiscal discipline to limit the risk of currency crises does not apply to euro-area countries, it may be of some relevance for new Member States. In spite of current low debt levels and relatively high growth rates, new Member

⁽¹⁾ For instance, Rubin, Orszag and Sinai (2004) argue that a possible consequence of persistent budget deficits in the United States may be an increase in the risk of 'financial disarray'.

⁽²⁾ There have been cases indeed of wealthy States and counties in the United States defaulting or being close to default. Ball and Mankiw (1995), for instance, reports that Orange county in California went through a debt crisis in the 1990s when a proposal for a tax increase to honour the debt was turned down by voters.

⁽³⁾ When government debt is held by foreigners, defaulting on debt does not have direct consequences on national citizens' income, thus making this eventuality less costly in political terms. It must also be added that in the case of developing countries' debt crises interest rate levels (and then the cost of servicing the debt) were in general much higher compared with that registered by most advanced countries in recent times while the possibility of collecting revenues was more limited.

⁽⁴⁾ It should be remembered that EU countries also have experienced currency crises associated with speculative attacks in the past, markedly in 1992 and 1993, when the ERM had to be suspended and revised.

⁽⁵⁾ As pointed out by Ball and Mankiw (1995), 'despite the vagueness of fears about hard landings, these fears may be the most important reason for seeking to reduce budget deficits ... if policy-makers are prudent, they will not take the chance of learning what hard landings in G-7 countries are really like'.

⁽⁶⁾ See Edwards (2004) for recent cross-country evidence on the characteristics and determinants of 'sudden stops' in current account deficits. The paper shows that the probability of a 'sudden stop' increases with the stock of cumulated foreign liabilities and the size of the current account deficit.

States are characterised by much higher shares of debt held by foreigners, 'rigid' public expenditure and more limited possibilities to increase revenue (see, e.g. European Commission, 2002a). If deficit levels for acceding countries

will remain persistently high, this may increase the risk of speculative attacks and currency crises during the period in which their currencies will join ERM II as a necessary step towards the adoption of the single currency.

3. The benefits from fiscal discipline in the EU

3.1. Introduction

After having illustrated the main channels through which persistent budget deficits affect long-term income prospects, in this section the empirical relevance of those channels is addressed with reference to EU countries. The analysis will focus especially on the channel linking budget deficits to income prospects via private investment. Moreover, due to lack of data, the analysis will only partially cover the new Member States. The plan of the analysis is as follows. Correlations of budget deficits with relevant macroeconomic variables both across countries and over time are first computed and commented. Subsequently, the relation between budget balances and interest rates is analysed restricting the focus to euro-area countries. Afterwards, issues concerning the link between countries' fiscal positions and their current account balance are discussed distinguishing separately issues for euro-area countries and the new Member States. Finally, an analysis is provided concerning the size of the economic benefits to euro-area countries generated by the introduction of the EU fiscal framework. To that purpose, an appropriate counterfactual is constructed which allows to assess what level of economic activity would have prevailed in absence of EU-wide rules aimed at guaranteeing fiscal discipline.

3.2. Budget balances, investment, current accounts and growth: A cursory look at EU data

Budget balances may impact on income prospects by having an effect on private investment or on the current account balance. *Prima facie* evidence concerning the link between budget balances and these variables can be gauged by simply looking at time correlations. Table III.3 reports contemporaneous correlation coefficients (relating variables measured at the same point in

time) between budget balances, private investment and the current account balance (all expressed as a share of GDP), separately for each EU country. Due to short time-series, correlations have not been calculated for new Member States. To check for the presence of possible structural breaks in the investigated relations occurred in the past few decades, contemporaneous correlation coefficients have been computed both for the whole period 1970–2003 and restricted to years after 1990. Moreover, to account for the possibility of reverse causation (e.g. investment affecting the budget balance rather than vice versa) correlations have also been computed between budget balances and the average investment and current account balances registered in the subsequent five years. ⁽¹⁾

Results show that budget balances are generally positively correlated with both private investment and the current account as could be expected. As far as the relation between budget balances and private investment is concerned, simultaneous correlations appear to be positive for almost all countries and fairly stable over time. However, this result should not be interpreted as evidence of a causal relationship running from budget balances to private investment shares. Reverse causation (running from investment to budget balances) or comovements associated with the impact of third variables on both budget balances and investment shares are also possible.

⁽¹⁾ Taking a five-year average can better capture relations that may manifest with possibly long and unpredictable lags, like those we are dealing with between budget balances on the one hand and investment and the current account balance on the other. The data span considered for computing correlations between budget balances and five years ahead averages of investment and current account is the whole period 1970–2003. Of course, the most recent budget balance data used to compute correlations are those of 1998, since five years ahead data for private investment and the current account balance are needed.

Table III.3

Budget balances, private investment and the current account — correlation analysis

	Budget balance/private investment			Budget balance/current account		
	Contemporaneous correlation, 1970–2003	Contemporaneous correlation, 1990–2003	Correlation with the average private investment in the subsequent five years, 1970–2003	Contemporaneous correlation, 1970–2003	Contemporaneous correlation, 1990–2003	Correlation with the average current account in the subsequent five years, 1970–2003
BE	0.67	– 0.06	0.77	0.64	0.49	0.18
DK	0.83	0.76	0.41	– 0.16	– 0.10	0.05
DE	0.47	0.33	0.07	0.16	– 0.26	0.24
EL	0.46	0.28	0.83	0.23	0.44	0.32
ES	0.90	0.91	0.71	– 0.34	– 0.26	– 0.19
FR	0.82	0.48	0.86	– 0.22	– 0.06	– 0.46
IE	– 0.22	0.90	0.02	0.78	0.53	0.57
IT	– 0.07	– 0.13	0.43	0.26	0.13	0.05
NL	0.41	0.31	0.08	0.03	0.22	– 0.36
AT	0.69	0.64	0.26	0.18	0.46	0.08
PT	0.21	0.50	0.39	0.15	– 0.42	– 0.04
FI	0.72	0.57	0.69	– 0.37	0.22	0.73
SE	0.62	0.62	0.36	– 0.15	0.12	– 0.57
UK	0.44	0.70	0.09	– 0.20	– 0.45	– 0.34
Simple average	0.49	0.48	0.43	0.07	0.07	0.02

However, reverse causation does not seem to be an issue, since looking at correlations between current budget balances and subsequent investment a positive relation appears in all countries.

Turning to the relation between budget balances and the current account, contemporaneous correlation coefficients also turn out to be positive on average. However, such relation is weak and not present in all countries. Contemporaneous coefficient correlations are also quite fragile with respect to the data sample used. When looking at the correlation between current budget balances and subsequent current account balances, the relation remains weak. A minority of countries exhibits a negative rather than a positive link between deficits and the subsequent current account balance. Overall, this evidence is broadly consistent with the expectation that budget deficits lead to a deterioration in the current account balance. However, additional country-specific factors (which are not accounted for in bivariate analysis like that reported in Table III.3) seem to contribute significantly to shape the relation between budget balances and the current account.

Time correlations as those presented in Table III.3 do not permit to distinguish satisfactorily between short-

term relations and relations of a longer-term nature that occur over the cycle. In particular, it is hard to disentangle to what extent the positive relation between budget balances and investment shares is related to cyclical co-movements and to what extent it is instead the outcome of a longer-term relation linking deficits to debt levels and debt to investment rates. Looking at the cross-country variation in average values over time may help to identify the existence of long-run structural relations. Graph III.2 reports a scatter plot relating average budget balances and debt levels over the 1970–2003 period. The negative relation identified is consistent with the expectation that, other things being equal, protracted budget deficits contribute to the build up of debt. Graph III.3 reports the cross-country scatter plot between debt ratios and the share of private investment. The plot describes a negative relation, broadly confirming the hypothesis that debt crowds out private investment via increased interest rates ⁽¹⁾.

⁽¹⁾ However, such negative relation appears weak, due to the pooling of countries at different stages of development, exhibiting investment rates either much higher (Portugal) or lower (Sweden, UK) than average.

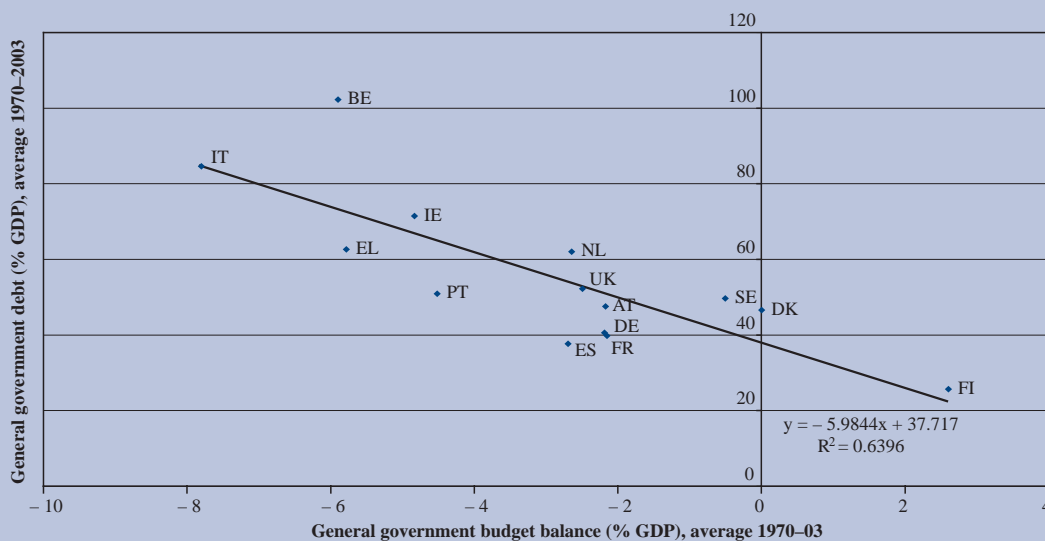
To what extent the possible crowding out of investment caused by budget deficits translated into lower potential growth in EU countries? A first approach to tackle this question is to look at time correlations between budget balances and trend GDP growth. Table III.4 reports contemporaneous correlation coefficients separately for the 1970–2003 and the 1990–2003 periods. It also reports the correlation of budget balances with the average trend GDP growth rate in the subsequent 5 years (1970–2003 period). Moreover, in order to account for the impact of the cycle on countries' fiscal positions, the same correlations are computed using the cyclically adjusted budget balance.

Looking at contemporaneous time correlations between budget balances trend growth a positive relation emerges on average. However, the relation between budget balances and potential growth does not seem to be very robust over time. The average correlation coefficient drops from 0.48 to 0.18 when the sample is restricted to the years after 1990 and the correlation turns from positive to negative for a series of countries. It is also worthwhile recalling that such a positive relation may go in either direction, either from budget balances to trend growth or vice versa. An impact of growth on budget balances may come from the automatic reaction of cyclical budgetary components or from the reaction of fiscal

authorities to cyclical conditions (assuming that they pursue an output stabilisation objective). The positive link identified may also simply be the result of a co-movement of the two variables associated with some third factor.

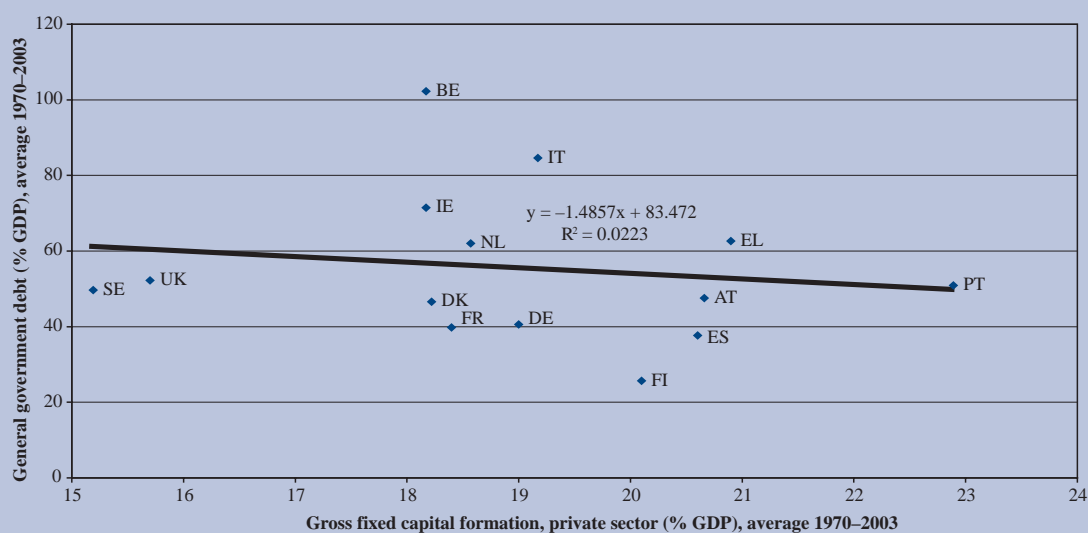
Looking at contemporaneous time correlations between cyclically adjusted budget balances and trend growth can help to understand to what extent the relation between budget balances and growth is driven by movements in cyclical components in the budget. Such correlations are also positive and with a magnitude close to that for the correlations between budget balances and trend growth. This evidence cannot be used to infer causation but broadly supports the view that either (i) fiscal policies have in general been counter-cyclical, or (ii) budget deficits impacted negatively potential growth. A further check on point (ii) of the above statement is obtained by looking at the correlation between budget balances and subsequent potential growth. This permits to exclude reverse causation issues. The data suggest that both budget balances and cyclically adjusted budget balances are negatively correlated with subsequent potential growth and that this positive correlation is quite strong (about 0.4, i.e. each additional point of deficit is associated with a reduction in subsequent growth by 0.4 points) and present in almost all countries.

Graph III.2: Budget balances and debt levels, cross-country correlation



Source: Commission services.

Graph III.3: Debt and private investment, cross-country correlation



Source: Commission services.

Table III.4

Budget balances and trend real GDP growth — correlation analysis

	Budget balance/trend GDP growth			Cyclically adjusted budget balance/trend GDP growth		
	Contemporaneous correlation, 1970-2003	Contemporaneous correlation, 1990-2003	Correlation with the average trend growth in the subsequent five years, 1970-2003	Contemporaneous correlation, 1970-2003	Contemporaneous correlation, 1990-2003	Correlation with the average trend growth in the subsequent five years, 1970-2003
BE	0.22	-0.77	0.45	0.13	-0.79	0.4
DK	0.62	0.58	0.2	0.67	0.4	0.29
DE	0.04	-0.09	0.46	-0.21	-0.49	0.63
EL	0.79	0.96	0.55	0.74	0.96	0.53
ES	0.56	0.9	0.1	0.48	0.87	0.22
FR	0.75	0.94	0.72	0.73	0.82	0.73
IE	0.89	0.79	0.87	0.87	0.91	0.9
IT	-0.13	-0.79	0.38	-0.14	-0.83	0.35
NL	0.36	-0.39	0.02	0.27	-0.32	0.0
AT	0.58	-0.58	0.76	0.53	-0.68	0.78
PT	0.53	-0.73	0.67	0.48	-0.77	0.68
FI	0.54	0.57	0.14	0.59	0.63	0.32
SE	0.43	0.49	-0.25	0.45	0.50	-0.22
UK	0.47	0.67	-0.04	0.44	0.67	0.11
Simple average	0.48	0.18	0.36	0.43	0.13	0.41

Summarising, bivariate correlation analysis shows that budget deficits tend to be associated with lower investment rates, lower current account balances and weaker trend GDP growth. Such relations also hold when excluding reverse causation by using subsequent values for investment, current account, and trend growth. While the positive link between budget balances and current accounts appears to be rather weak and driven to a large extent by country-specific factors, the link between budget balances and private investment shares is fairly strong and robust, as is the link between budget balances and subsequent trend growth. In spite of the fact that such bivariate relations do not account for other possible factors other than budget balances that may have helped to shape developments in private investment, current accounts or trend growth, they are consistent with the expectation that persistent budget deficits may compromise income prospects via investment crowding out.

3.3. Do budget deficits increase interest rates in the euro area?

The previous section has highlighted a quite strong and robust positive correlation between budget balances and private investment. Such positive relations are consistent with the view that budget deficits, by reducing national savings, lead to an increase in interest rates, an increase in the user cost of capital and a consequent reduction in private investment. As illustrated in Section 2.3.1, the relation between deficits and interest rates is crucial to assess a possible causal relation between deficits and investment. Consistently, abundant empirical work has been produced to test the relevance of such a link in advanced economies. The aim of the present section is that of investigating empirically the link between deficits and interest rates in EMU countries. The analysis is limited to EMU countries to restrict the focus on countries characterised by analogous exchange rate arrangements.

Long-term real interest rates are among the major determinants of the cost of capital. In EU countries, the overall level of long-term interest rates depends in turn largely on the rates paid on government bonds, which have a high weight (more than 50 % of the total) on the overall stock of long-term bonds issued⁽¹⁾. The current level of nominal interest rates on 10-year government bonds in euro-area countries is about half the rate for cor-

responding bonds that have been prevailing over the 1970s and the 1980s. Table III.5 reports statistics on annual data on nominal and interest rates on 10 government bonds for euro-area countries over the past decades. Data for the 1990s are reported separately for the different periods corresponding to the different phases of EMU (Stage I, 1990–93; Stage II, 1994–98; Stage III, 1999 on). Distinguishing the evidence for the 1990s between different sub-periods is necessary since that decade was characterised by relevant changes in the institutional and policy environment that explained largely the behaviour of interest rates. Concerning the criterion used to obtain average values across countries, Table III.5 reports data both for simple and GDP-weighted averages. Standard deviations are reported distinguishing between the cross-country component and the variation over time, within each country.

Table III.5 shows that between the 1970s and the 1980s average nominal long-term interest rates have been rising, while they have been falling throughout all the 1990s. Most of the movement in nominal interest rates are explained by developments in the inflation rate. Inflation rose on average during the 1970s, until the second oil shock in the early 1980s. After that, the average inflation rate in the euro area started falling, interrupted by a period of rising inflation in the late 1980s and early 1990s. The disinflation which occurred in euro-area countries starting from Stage II of EMU was partly a result of macroeconomic policies directed at containing inflation differentials to respect the Maastricht inflation criterion, requiring inflation rates not higher than half a point that of the average three best performing countries. As illustrated in Graph III.4, nominal interest rates on long-term government bonds of EMU countries converged over the past decade towards the benchmark German bond rates, and the convergence path was more marked for the rates paid on bonds issued by countries with a past history of higher inflation, like Greece, Italy and Portugal.

Changes in real interest rates were also quite considerable⁽²⁾. During the 1970s, real interest rates on long-term government bonds were very low or even negative in several EMU countries, as a result of high inflation, restrictions on international capital movements and administrative controls imposing the purchase of mini-

⁽¹⁾ For further data and information see, e.g. European Commission (2001b).

⁽²⁾ The measure of real interest rates reported in Table III.5 consists of the difference between nominal rates and the realised yearly inflation rate.

large quantities of bonds to the banking system. Real interest rates rose throughout the second half of the 1970s and all the 1980s as a result of the elimination of most administrative controls on capital and credit markets and a generalised reduction in aggregate savings, aggravated by rising government deficits in most EMU countries.

Throughout the 1990s, average real interest rates have been on average falling. At the end of the decade the average interest rate paid on 10-year government bonds in EMU countries was about half that prevailing at the beginning of the decade. Several factors contributed to this decline in real interest rates and then in the cost of capital. During Stage I of EMU remaining controls on intra-EU capital movements were removed. This translated into a compression of the interest rate spreads with respect to the German benchmark rate (reflected in a falling standard deviation of interest rates across countries, as reported in Table III.5).

Starting with Stage II of EMU falling real interest rates on government bonds are attributable to both falling credit risk and exchange rate risk premia. The fall in credit risk in the mid-1990s corresponded to an upward revision in debt rating by the major rating agencies for several countries (Ireland, Italy, Portugal and Finland, see, e.g. Dhanjine, Giavazzi and Von Thadden (2000))⁽¹⁾. The reduction in exchange rate risk materialised already in the mid-1990s as a result of the credibility of the respect of the

⁽¹⁾ Codogno, Favero and Missale (2003) show that in the second half of the 1990s the reduction in the interest rate spread of 10-year government bonds with respect to the German benchmark rate is explained almost entirely by falling credit risk for Italy and Spain.

Maastricht criteria for inflation and for the exchange rate, requiring currencies to remain within the ERM for two consecutive years before the adoption of the euro. Reduction in exchange risk premia translated into considerable reduction in interest rate spreads especially for countries characterised by a structural tendency towards higher inflation and repeated exchange rate devaluations like Italy. By 1998, all exchange rate risk on EMU countries' government bonds virtually disappeared. After the introduction of the single currency, however, in spite of the absence of exchange rate risk premia, cross-country real interest rate differentials persisted, mainly explained by differences in credit and liquidity risk.

The behaviour of public finances was relevant in several respects in explaining developments in long-term interest rates and therefore in the cost of capital in euro-area countries. A first reason is that, as stressed previously, government deficits contribute to the determination of national savings and then to the determination of prevailing real interest rates. While the 1980s were characterised by rising real interest rates, high deficits and growing government debts, in the 1990s the behaviour of such variables reversed, with real interest rates falling, budget balances improving and debt falling in most euro-area countries. Secondly, public finances mattered also for the dynamics of nominal long-term rates since actual and perspective deficits and debts were key in conveying expectations concerning inflation.

Thirdly, public finances were relevant in the determination of credit and exchange risk. Credit risk was directly

Table III.5

Nominal interest rates on 10-year government bonds, EUR-12

	1970–79	1980–89	1990–93	1994–98	1999–2002
Nominal interest rates					
Simple average	9.5	12.1	10.2	7.7	5.1
GDP weighted average	6.6	8.8	7.6	5.6	3.2
Standard deviation across countries	1.9	3.7	4.5	2.4	0.2
Standard deviation within countries	1.4	2.2	1.2	2	0.3
Real interest rates					
Simple average	– 0.3	4	5.5	4.5	2.5
GDP weighted average	0.4	3.4	3.8	3.8	2
Standard deviation across countries	2.6	2.8	1.7	0.5	1.2
Standard deviation within countries	2.7	2	1.5	1.5	0.8

Source: Commission services.

affected by the shrinking size of government debts and by changed attitudes towards budget balances by fiscal authorities ⁽¹⁾. As for exchange rate risk, the state of public finances was crucial in shaping the expectations concerning the adoption of the single currency by some countries, and the consequent disappearance of exchange rate risk.

The relation between the euro-area (GDP-weighted) average 10-year government bonds and the average budget balance since 1990 is illustrated in Graph III.6. The left-hand axis reports quarterly data for nominal interest rates, the right-hand axis reports annual data for the budget balance as a share of GDP. Interest rates show a falling trend overall in the period; the upward sloping pattern between 1994 and 1995 and 1999 and 2000 is mainly explained by the contractionary stance of the US monetary policy as a response to the over-heating of the cycle. Conversely, the trend in the budget balance over the whole period is broadly increasing. The opposite

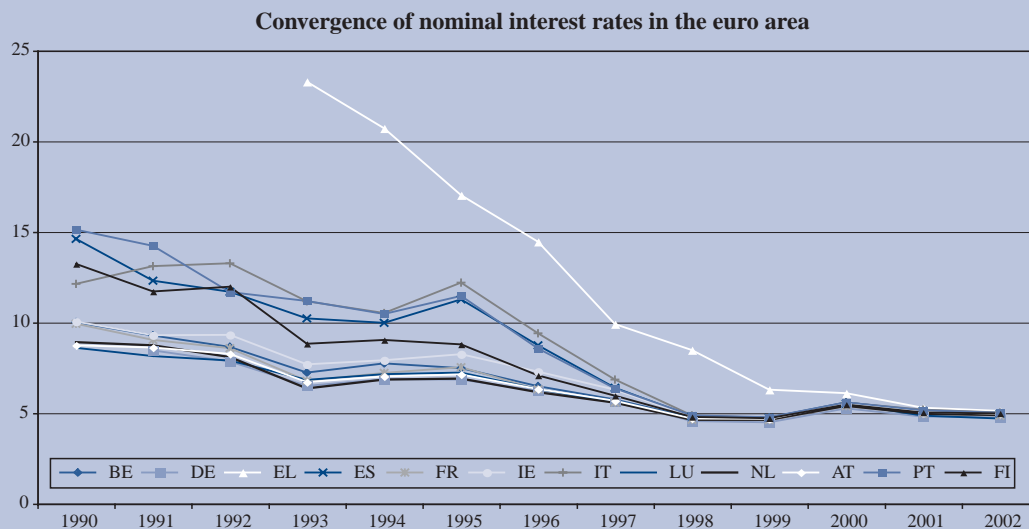
behaviour of interest rates and budget balances is clearly visible during the run-up to Maastricht, i.e. between Stage II and Stage III of EMU. This relation between EMU-wide averages captures tendencies that were present in most countries, although with different intensity. While the opposite pattern in interest rates and budget balances is very clear throughout the whole period in the case of Italy, the evidence is much weaker for Germany.

As illustrated in Section 2.3.1 and in Box III.1, efficient financial markets are likely to react to expected rather than actual deficits. Expectation of higher future deficits will consistently translate into expectations of increasing interest rates. According to the expectation theory, the term structure of interest rates would in turn follow a steepening of the yield curve, i.e. an increase in the spread between the returns on long- and short-term bonds ⁽²⁾.

⁽¹⁾ See, e.g. Dhantine, Giavazzi and Von Thadden (2000), Codogno, Favero and Missale (2003), Balassone, Franco and Zotteri (2004).

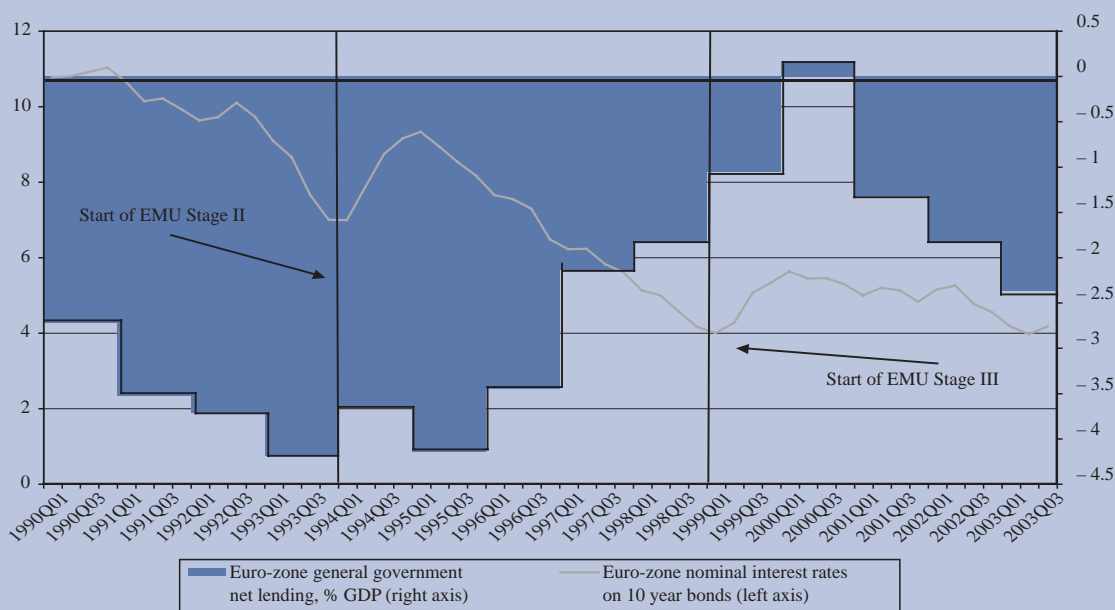
⁽²⁾ On the yield curve and the expectation theory of interest rates see, e.g. Campbell (1995) and Rendu de Lindt and Stolin (2003).

Graph III.4: Convergence of long-term interest rates in the 1990s (10-year government bonds, euro-area countries)



Source: Commission services.

Graph III.5: Long-term interest rates (left-hand axis) and budget balances (right-hand axis), euro-area average



Source: Commission services.

Hence, following the lead of several recent studies (e.g. Canzoneri, Cumby and Diba, 2002), the impact of fiscal discipline on interest rates in EMU is assessed quantitatively by analysing the relation between expected deficits and the term structure of government bond interest rates (see Box III.3).

Alternative measures have been used for expected deficits. The analysis focuses on the impact of these measures of expected deficits on the difference between the interest rates on 10-year government bonds and 3-month bills. The data cover EUR-11 countries for the 1990–2002 period. The empirical analysis shows that expected deficits have a statistically significant impact on interest rates. Moreover, results appear to be fairly robust both with respect to the measure of expected deficit used and the specification of the empirical equation estimated. The analysis shows that one additional GDP point of deficit raises long-term interest rates by about 15–20 basis points. The estimated impact is consistent with that reported in existing recent studies (see Table III.2).

3.4. Budget balances and current accounts in euro-area countries and new Member States

The reduction in national savings resulting from government deficits may translate into current account deficits rather than into reduced investment. The extent to which a reduction in national savings will fall on the current account depends on a number of factors, primarily on the degree of capital mobility. As for the consequences of current account imbalances, they imply a reduction in national income prospects due to the necessity of paying back the accumulated external debt. Additional consequences may arise if large current account imbalances are recorded in countries that keep fixed a parity for their exchange rate with a foreign currency or basket of currencies. If current accounts are perceived as unsustainable by markets, capital outflows and speculative attacks may result, which may force countries to abandon the chosen parity.

Box III.3: Assessing the impact of budget deficits on interest rates in the euro area

To assess the impact of budget deficits on interest rates, econometric analysis is carried out on a panel of euro-area countries. The methodology followed is akin to that in Canzoneri, Cumby and Diba (2002) on the US case. The dependent variable employed is the interest rate spread between long- and short-term bonds (i.e. between 10-year government bonds and 3-month bills). This approach permits the assessment of the impact of expected budget outcomes on financial asset returns without modelling the determinants of interest rate levels. In particular, this approach permits the implementation of empirical analysis on long-term interest rate developments without having to employ measures of long-term expected inflation as explanatory variables, which inevitably imply a degree of arbitrariness.

The hypothesis is that an expectation of higher government deficits in the future induces an expectation of lower aggregate savings and increased interest rates. Arbitrage in bond markets will equate returns on long-term bonds with average expected future returns on short-term bonds. This will translate in turn into a steepening of the yield curve, i.e. an immediate increase in the spread between long- and short-run interest rates.

Several measures of budget balances are used as explanatory factors. A first measure simply consists of the current budget balance (as a share of GDP). Such a measure implicitly assumes static expectations by agents (i.e. that current values of the budget balance satisfactorily proxy future expected values). A more direct measure of agents' expectations employed is the one year ahead budget balance forecast produced by the European Commission ⁽¹⁾. A third measure used, aimed at capturing agents' expectations of budget balances over a longer time frame, is the simple average of the values recorded in the cyclically adjusted budget balance over a time horizon of three years. This is the same approach followed for instance in Bovenberg (1988) and Thomas and Abderrezak (1988) and is used given the absence of regularly produced medium-term budgetary forecasts for EMU countries. The assumption underlying the forward actual value of the cyclically adjusted budget balance is that agents' expectations on the economic cycle over the medium run are unbiased (so that a null output gap is expected), like those on cyclically adjusted budget balances.

The data-set comprises yearly data on all euro-area countries (except Luxembourg) for the 1990–2002 period. The selected time period has been chosen in such a way to restrict the analysis to sufficiently homogenous observations keeping at the same time a sufficiently large sample to carry out statistical inference. Including observations prior to 1990 would have meant analysing in the same panel time periods characterised by controls on international capital movements and heavier internal financial regulations. Excluding observations contained in the selected panel (e.g. data before the introduction of the single currency) would have compromised the statistical significance of results.

In order to account for a possible impact of the different institutional regimes included in the sample on the term structure of interest rates in the sample, two dummy variables have been included. One dummy takes value 1 for all the years following Stage II of EMU (i.e. all years from 1994 on) and the purpose of it is to capture the impact on interest rate expectations associated with the start of the convergence process. The other dummy employed takes value 1 for all the years following Stage III of EMU (i.e. all years from 1998 on) and the reason for its inclusion is to account for the effect of the introduction of the single currency.

Since the expectations on interest rates are to a large extent driven by the perception of economic agents on cyclical developments (see, e.g. Rendu de Lindt and Stolin, 2003), the output gap is also included as a further explanatory factor for the interest spread. To the extent that a low value of the current output gap is associated with expectations of a forthcoming upturn in the cycle, while high output gaps tend to be associated with expectations of downturns, the regression coefficient of the output gap is expected to be negative.

⁽¹⁾ Time-series data on Commission budget forecasts up to 1997 are available in Keereman (1999).

(Continued on the next page)

Box III.3 (continued)

Empirical estimates are produced using within-group panel regressions correcting for (first order) error autocorrelation by means of a Cochrane-Orcutt procedure ⁽¹⁾. Results are shown in Table III.6. Results for six different specifications are reported. Regressions using each of the three alternative measures for expected deficits are performed with and without the inclusion of the output gap as an additional explanatory factor.

Results show that the chosen specifications explain around 40 % of the within-group variance in interest rate spreads. The negative coefficient for the constant term indicates that prior to the start of Stage II of EMU the slope of the yield curve in EMU countries was on average negative, mainly reflecting a contractionary current stance of monetary policy and strong deflationary expectations. The positive sign for the included dummy variables shows that starting from the early 1990s, interest rate spreads over longer maturities turned positive. The output gap has the expected negative relationship with interest rate spreads and is generally significant when included in the regression specifications. A non-significant coefficient is reported in the specification using the current budget balance, possibly as a result of a multi-collinearity problem.

Budget balance measures enter all specifications with the expected sign and are almost always significant. Results show that the impact of expected budget deficits is fairly robust and its magnitude does not depend crucially either on the measure chosen for expected deficits or on the particular specification of the estimated equation. The impact of an additional 1 GDP point of deficit increases the interest spread between long-term and short-term bonds by about 15–20 basis points. Overall, the estimates are in line with those obtained in analogous recent analyses (see Table III.6).

⁽¹⁾ The estimation procedure is the same as in Canzoneri, Cumba and Diba (2002). In their case, the analysis is referred to the US, so that the corresponding panel structure is a degenerate one with a single panel.

Table III.6

The relation between interest rate and government budget balances (EUR-11, 1990–2002)

Specifications Explanatory variables	(1)	(2)	(3)	(4)	(5)	(6)
Budget balance	- 0.21*** (- 3.59)			- 0.16** (- 2.44)		
One year ahead budget balance forecast		- 0.16** (- 2.02)			- 0.1 (- 1.26)	
Three years ahead CAB			- 0.2** (- 2.09)			- 0.19** (- 2.03)
Output gap				- 0.11 (- 1.6)	- 0.165** (- 2.34)	- 0.17*** (- 3.21)
EMU Stage II dummy	2.82*** (8.28)	2.78*** (7.45)	3.23*** (9.54)	2.74*** (7.99)	2.55*** (6.7)	3.02*** (9.12)
EMU Stage III dummy	0.82** (2.76)	0.62** (2.02)	- 0.01 (- 0.06)	0.94*** (3.10)	0.89*** (2.79)	0.5 (1.66)
Constant term	- 1.48*** (- 5.62)	- 1.33*** (- 4.46)	- 1.87*** (- 4.89)	- 1.38*** (- 5.2)	- 1.13*** (- 3.93)	- 1.78*** (- 4.97)
Number of observations	123	121	107	123	121	107
R square within groups	0.42	0.37	0.57	0.43	0.39	0.59
Estimated error auto-regression coefficient	0.38	0.38	0.5	0.39	0.41	0.2
F statistic	26.31	21.51	42	20.39	17	34.25

NB: Dependent variable: difference between yearly average nominal interest rates between 10-year government notes and three-month bills. Estimation method: within-panel regression correcting for error order one serial correlation.
***, **, * denote statistical significance at, respectively, 1, 5, and 10 % level.

This section focuses on aspects of relevance concerning the link between budget balances and the current account separately for EMU countries and for the new Member States.

The overall current account balance for the euro-area aggregate has remained fairly stable and of a relatively low magnitude over the past decades (see Table III.7). However, over time a tendency towards widening imbalances at country level has emerged. This can be gauged by looking at the simple average of the absolute value of the current account imbalance across euro-area countries ⁽¹⁾. As reported in Table III.7, the average balance of the current account in euro-area countries has been increasing over the 1970s and slightly fell during the 1980s. Starting from the early 1990s an increase in the average absolute values for current account balances took place at an accelerated pace. Larger imbalances in the current account registered at country level showed up in an increased cross-country dispersion in current account balances, as measured by the standard deviation of such values.

Widening current account imbalances within the euro area are consistent with increasing capital market integration within the area. The removal of persisting formal barriers to capital movements in 1990, financial deregulation and innovation, and advancements in IT contributed to weaken the link between national savings and domestic investment among EU countries and within the euro area in particular ⁽²⁾. Increasingly, savings are directed towards the investment opportunities yielding the highest returns,

being those domestic or foreign. Increased capital mobility corresponds to better conditions for external borrowing for low per capita income, capital-scarce countries and improved investment opportunities abroad for high per capita income countries. The former will find it convenient to borrow at lower cost from capital-abundant countries; the latter will profit from investment opportunities opening in capital scarce countries, characterised by higher expected growth rates in their catching-up process. In this way, a mutually convenient form of 'inter-temporal' trade takes place, through which low income countries borrow from their future income possibilities. Graph III.6 shows average current account balances across euro-area countries distinguishing different sub-periods: the 1970s, the 1980s, and the different EMU phases in the 1990s. The cross-country pattern is broadly consistent with the expectation that high per capita income countries should exhibit current account surpluses, while low income countries should run deficits. Across the period considered, Greece, Spain, and Portugal have been on average running deficits, while Germany and the Benelux countries have been running surpluses. Over the 1990s, Ireland managed to turn positive the large deficits accumulated in the previous decades, while the balance of the current account turned more negative for Greece and Portugal. The largest imbalances in current accounts are also observed in small Member States. This is not only due to the fact that small countries are relatively more open. The risks of over-heating (or over-cooling) are in fact higher for small members of monetary unions, given that the monetary stance of the union is likely to be rather independent of their cyclical position.

⁽¹⁾ The use of absolute values (so that negative balances are turned into positive) in constructing cross-country averages avoid offsetting large positive current account balances in some countries being offset by large negative balances in some other countries.
⁽²⁾ Blanchard and Giavazzi (2002) reports evidence from panel data analysis pointing to a decline over time in the regression coefficient between domestic investment and national savings. Such a decline is present at OECD level, stronger within the group of EU countries, even stronger among euro-area countries.

The increased size and dispersion in current account imbalances within the euro area is a sign of effective capital market integration. Such developments are likely to bring about the beneficial effects of increased inter-temporal trade. However, large and persistent current account imbalances may pose a problem of adjustment, especially if growth prospects turn out to be weaker than

Table III.7

Current account balances in euro-area countries (EUR-11)

	1970–79	1980–89	1990–93	1994–98	1998–2003
Euro-area aggregate (% of GDP)	0.26	– 0.12	– 0.35	0.63	0.52
Simple average of absolute value of euro-area countries' current account balance (% of GDP)	1.44	2.12	1.76	2.77	3.28
Cross-country standard deviation of current account balances	2.08	2.47	2.19	3.27	4.43

Source: Commission services.

expected. When countries run current account deficits they deplete the stock of their net foreign assets. The repayment of net foreign debt will require running current account surpluses in the future. Depending on the degree of wage and price flexibility, current account surpluses can be obtained in two ways. Under flexible prices, the current account can turn positive by means of a reduction in the domestic price levels to improve export competitiveness (i.e. to induce a depreciation of the real exchange rate). This will entail in turn an improvement in the trade balance ⁽¹⁾. If prices are rigid downward, current account surpluses require a compression in countries' absorption (i.e. the sum of public and private consumption and investment).

Budget balances play a major role in the adjustment process. Avoiding an excessively expansionary fiscal stance is a major requirement to prevent overheating of the economy, contain inflationary pressures and facilitate the adjustment in terms of trade. Moreover, keeping a balanced fiscal stance helps to maintain government deficits low, and this directly contributes to reduce domestic absorption, thus freeing resources to finance current account surpluses.

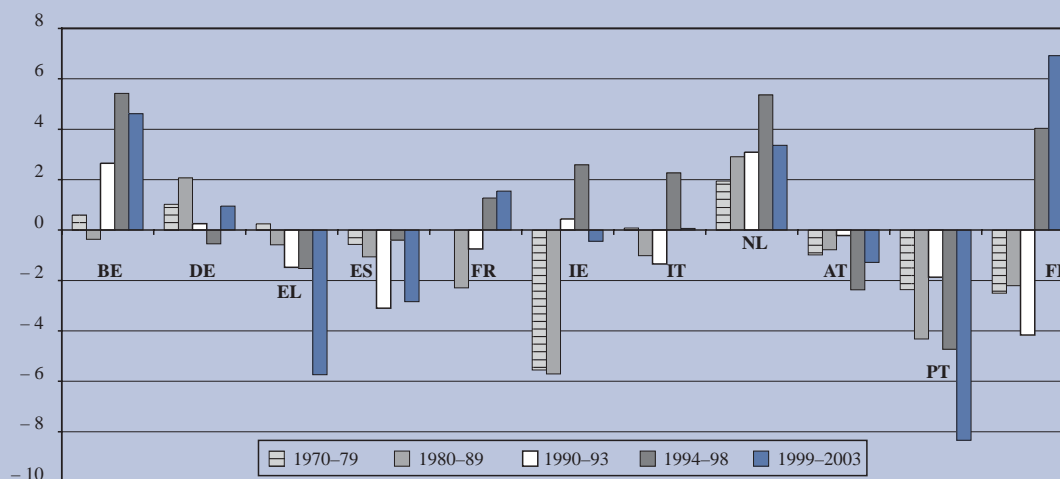
The tendency towards an increasing size and dispersion in current account imbalances within the euro area has implications for the budgetary policy conduct of Member States. An additional warning against the use of discretionary expansionary fiscal policies emerges especially for small countries with structural tendencies towards current account deficit positions. For such countries, avoiding high and persistent budget deficits would be important to prevent the risk of having to incur into strongly contractionary budgetary policies in the future to ease the external adjustment ⁽²⁾.

The current account positions of the new Member States can be a matter of more urgent concern. In recent years, all new Member States have recorded sizeable current account deficits. Graph III.7 reports the average value over the period 1999–2003, computed on the data available in the AMECO database. As remarked in the case of low-income euro-area countries, the current account deficits in new Member States are the result of capital market integration with the rest of the EU. Starting from the mid-1990s, large capital flows moved from overall Europe to the countries of new accession. A substantial share of these capital flows has consisted of foreign

⁽¹⁾ Under this type of adjustment, perspective consumption possibilities will be reduced by the deterioration in the terms of trade which normally accompanies the depreciation of the real exchange rate.

⁽²⁾ See also Deroose, Langedijk and Roeger (2004) for analysis and discussion of the role of budgetary policy in the adjustment process for small euro-area countries.

Graph III.6: Current account balances in euro-area countries, % of GDP, averages over selected periods



Source: Commission services.

direct investment, both greenfield investments and acquisitions of existing, formerly publicly-owned, productive assets. Over the same period, new Member States have been characterised by deficits in government budgets of considerable magnitude, exceeding 5 % of GDP in some cases (Graph III.7).

The link between fiscal positions and current accounts for new Member States should be evaluated differently compared with euro-area countries. At present, the countries of new accession adopt different exchange rate regimes (from free float to currency board) but in perspective, as a requirement for adopting the euro, the currencies of the new Member States will have to participate in ERM II for at least two years ⁽¹⁾. During this period, the stability of the currencies will be a crucial factor to qualify for the subsequent stages of monetary integration. Currency stability will mainly depend upon expectations concerning the sustainability of current accounts and future fiscal behaviour ⁽²⁾. Capital account perspectives are a primary factor for current account sustainability. Capital inflows to new Member States may

continue to be large and even increase on the road to the adoption of the euro.

However, the volatility of the capital account, and with that the risk of sudden capital flights, may increase for several reasons ⁽³⁾.

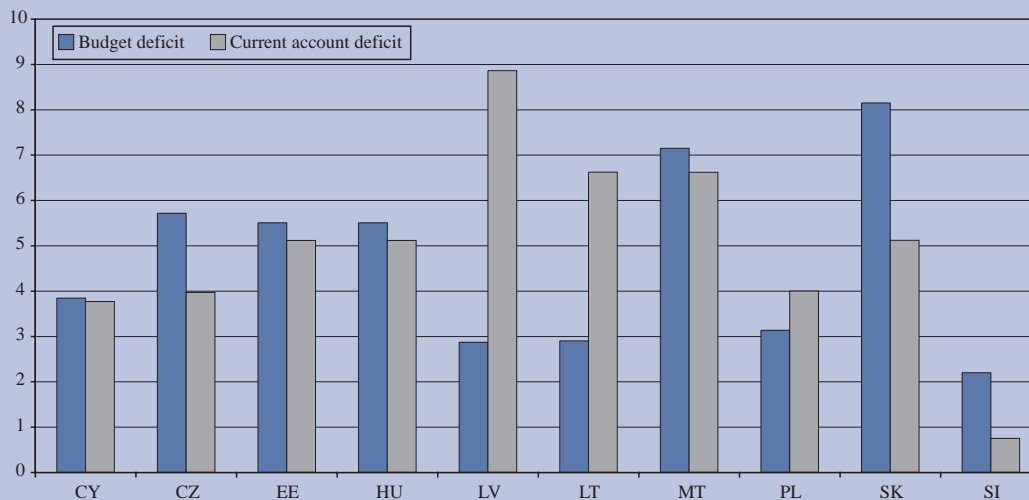
A first reason is that foreign direct investment flows to the new Member States may not remain at the relatively high levels recorded in the recent past. This would imply a re-composition of capital inflows towards more volatile portfolio investments.

A second reason is that capital movements will become more sensitive to changes in expectations concerning the timing of euro adoption. The expected date of adoption will shape the expectations on the returns on investments directed to the new Member States, thereby having an impact on the actual capital flows to these countries. Concerning fiscal behaviour, the budgetary policies that will be adopted by the new Member States in the coming years will contribute to shape market expectations concerning future developments in deficits and debt in

⁽¹⁾ New Member States do not have the possibility of opting-out, i.e. their participation in the Union also implies the adoption of the euro at some stage.
⁽²⁾ On this point see also European Commission (2002a, 2002b).

⁽³⁾ See, e.g. Begg et al. (2003), Kontolemis (2003), and Schadler et al. (2004) for a discussion of the topic.

Graph III.7: Budget balances and current account balances in the new Member States
(% of GDP, average over data available in the AMECO database for the 1999–2003 period)



Source: Commission services.

the new Member States. These expectations will be a relevant factor for the perceived long-term sustainability of current accounts. Moreover, since countries of new accession will have to respect the Maastricht deficit criterion to qualify for the single currency, expectations on the new Member States' fiscal policies will also contribute to determine expectations on the timing of euro adoption. Finally, avoiding an excessively expansionary fiscal stance would help to prevent the possibility of overheating and the emergence of bubbles in housing and equity markets. For the above reasons, prudent budgetary policies will be a key factor for the stability of the currencies of the new Member States within ERM II.

3.5. The economic effects of the EU fiscal framework

The preceding sections have shown evidence consistent with the view that in the past few decades budget deficits in EU countries may have crowded out private investment via debt accumulation and increased interest rates. This section aims at assessing to what extent the EU rules-based fiscal framework for fiscal discipline enshrined in the Maastricht Treaty and the Stability Pact induced public finance consolidations resulting in a contraction in output via Keynesian multipliers and to what extent it instead contributed to growth by limiting the crowding out effect associated with high and persistent deficits. There are two major difficulties with such an analysis. Firstly, there is the necessity of disposing of counterfactual information on what would have been the level of budget balances in the absence of the EU rules for fiscal discipline. In particular, it is necessary to distinguish to what extent the reduction in budget deficits that occurred in the second half of the 1990s in many EU countries was the effect of the requirements of fiscal discipline in the Maastricht Treaty and the SGP and to what extent it was instead a response to high debt levels that would have occurred in any case. Secondly, a general equilibrium analytical setting is required to analyse the impact of such counterfactual budget balances on aggregate demand components, debt and interest rates. Taking into account the above analytical requirements, the strategy performed the analysis as follows. In a first step, 'fiscal rules' are estimated, describing the reaction of fiscal authorities (in terms of chosen levels of budget balances) to major macroeconomic variables, such as the cyclical position (which presupposes that fiscal authorities pursue a cycle stabilisation motive) and the level of debt (debt stabilisation motive). Such fiscal rules are estimated for two different sub-periods: before and after the

start of Stage II of EMU. It is shown that the reaction of fiscal authorities in the two sub-periods changes quite significantly, with a greater weight put on the debt stabilisation motive after the start of Stage II of EMU. The estimated change in the parameters for the fiscal rules (summarising the behaviour of fiscal authorities) is interpreted as resulting from the introduction of the EU fiscal framework. Counterfactual budget balances in absence of the Treaty and SGP provisions are obtained from predictions using the fiscal rules for the period before EMU Stage II. In the second step of the analysis, such counterfactual levels of budget balances are used to simulate by means of the European Commission QUEST II model which would have been the performance in terms of aggregate output in absence of the EU fiscal framework. In order to work on a sample of countries which is sufficiently homogenous from the viewpoint of the working of the major macroeconomic relations (among which are those relating to monetary policies and exchange rates) only euro-area countries are considered for the analysis.

3.5.1. How did the introduction of the EU fiscal framework modify the behaviour of budget balances?

The empirical estimation of fiscal rules summarising the behaviour of fiscal authorities has become common practice in the applied analysis of budgetary policies ⁽¹⁾. The aim is that of identifying a limited set of macroeconomic determinants that explain developments in budget balances. Most of the proposed fiscal rules assume that budget balances depend on the cyclical conditions of the economy and on debt levels. The idea is that fiscal authorities are motivated by an objective of output stabilisation (so that chosen budget balances should respond positively to expected output gaps) and by debt stabilisation motive (so that a positive response of budget balances to the existing stock of debt is expected) ⁽²⁾. As for the budget measures employed in the empirical estimation of fiscal rules, use is generally made of budget balances net of interest payments, given that this budget item is not directly under the control of fiscal authorities. In some analyses (e.g. Gali and Perotti, 2003) the dependent variable employed in estimating fiscal rules is the cyclically adjusted primary balance. Using such a measure of countries' fiscal position presupposes that fiscal authorities decide about the level of the budget anticipating

⁽¹⁾ See, e.g. Von Hagen, Hugues-Hallet and Strauch (2001), Ballabriga and Mongay (2002), Melitz (2002), Gali and Perotti (2003).

⁽²⁾ Formally, most of the fiscal rules estimated in existing work can be derived as the outcome of a problem in which fiscal authorities choose budget balances in such a way to minimise a loss function which increases with the output gap and the distance of the actual debt level from target.

the impact of the cycle on the cyclical components of revenues and expenditures and permits the analysis of the macroeconomic determinants of 'discretionary' fiscal policy. Concerning the explanatory variables that have been included in existing empirical work on fiscal rules, the output gap is generally used as a measure for the cycle, while the lagged debt/GDP ratio is normally used to capture the debt stabilisation motive of fiscal authorities. The lagged dependent variable (e.g. the primary budget balance) is quite often included in the empirical specification to allow for a role of inertia in budgetary policy.

Table III.8 reports the results for panel data estimation of fiscal rules across EUR-11 countries. Annual data for the period 1987–2003 are taken from the AMECO database. The specification chosen follows that in Gali and Perotti (2003). Two alternative dependent variables have been considered: the primary balance and the primary cyclically adjusted budget balance. The explanatory variables included are the output gap, the 1-year lagged debt/GDP ratio and the lagged dependent variable⁽¹⁾. To account for endogeneity issues (i.e. the fact that not only the output gap affects budget variables but also that budgetary policy has an impact on the cycle) the output gap has been instrumented with its own 1-year lag and the US lagged output gap⁽²⁾. The chosen specification has been estimated separately for the sub-sample 1970–93 (before the EU fiscal framework) and the 1994–2003 sub-period (after the introduction of the EU fiscal framework).

Several results of interest emerge from the estimation of fiscal rules. A first finding is that while before the introduction of the EU fiscal framework budget measures (both primary budget balances and primary cyclically adjusted budget balances) were not significantly affected by the output gap, after Stage II of EMU the output gap has a significantly positive impact of primary balances, while the coefficient for the primary cyclically budget balance remains non-significant but turns from negative to positive. This finding disconfirms the view that the introduction of the EU fiscal framework has resulted in

a less counter-cyclical stance for fiscal policy in EU countries⁽³⁾. A second major result is that both primary and primary cyclically adjusted budget balances react positively to debt levels. The regression coefficient for the lagged debt/GDP ratio is positive and significant in both sub-periods irrespective of the budget measure used as dependent variable. This supports the view that fiscal authorities pursue debt stabilisation objectives when deciding about budgetary policy. Moreover, it is worth noting that the magnitude of the coefficient of the debt variable increases after the introduction of the EU fiscal framework, meaning that such a debt stabilisation objective has become more relevant after Stage II of EMU⁽⁴⁾. Finally, results show that the degree of inertia in budget balances has diminished after the introduction of the EU fiscal framework. The regression coefficient for the lagged dependent variable drops from about 0.7 to about 0.45 after Stage II of EMU.

In summary, the estimated fiscal rules indicate that the introduction of the EU fiscal framework resulted in an enhanced debt stabilisation motive for fiscal authorities and a reduced degree of inertia in budgetary policy. As for the reaction of budgets to cyclical conditions, there is no evidence that it became more pro-cyclical. Overall, the results from panel data estimation reported in Table III.8 suggest that the introduction of the EU fiscal framework led to an improvement in budget balances. Primary budget balances (both nominal and cyclically adjusted) became in fact more sensitive to debt levels and easier to adjust over time⁽⁵⁾.

3.5.2. Which impact did the EU fiscal framework have on economic activity?

The estimation of fiscal rules as reported in Table III.8 allows for the construction of counterfactual budget balance values in absence of the EU fiscal framework. In other words, they can obtain an estimation of which

⁽¹⁾ The results reported in Table III.8 refer to output gap data obtained as the percentage difference between actual and trend (HP-filtered) output. Estimates have also been performed using potential output computed through the European Commission production function approach (see, Denis, McMorro and Roeger (2002)) and very similar results have been obtained.

⁽²⁾ More generally, the use of the lagged dependent variable in panel data analysis raises an issue of inconsistency of estimates, generally addressed by relying on GMM estimators. However, given the purpose of the present analysis (understanding how fiscal rules changed after the introduction of the EU fiscal framework) and the relatively small sample used this issue of inconsistency is likely to be of small relevance.

⁽³⁾ The same result is obtained in Gali and Perotti (2003).

⁽⁴⁾ This result does not depend on the chosen year for splitting the sample. Similar estimates are obtained adopting 1992 as the first year of the working of the new regime characterised by the EU fiscal framework (as in Gali and Perotti (2003)). Ballabriga and Martinez-Mongay (2004) analyse the robustness of the coefficient on debt on regression specifications analogous to those reported in Table III.8 and find that for most EU countries the change in the debt coefficient is the highest in the mid-1990s. The choice of the sample length for the period preceding the introduction of the EU fiscal framework may instead affect the result, as indicated by the smaller change in the debt coefficient in Gali and Perotti (2003) who do not include data for the 1970s.

⁽⁵⁾ The reduction in the degree of inertia of budget balances after the introduction of the EU fiscal framework is captured by the reduction in the value of the regression coefficient of the lagged dependent variable.

value for budget balances would have prevailed in absence of the EU fiscal framework but allowing fiscal authorities to follow their output and debt stabilisation motives. Disposing of such counterfactual values for budget balances is a necessary first step to assess the impact of the EU fiscal framework on economic activity. The computation of counterfactual budget balances requires using the fiscal rules estimated before the introduction of the EU fiscal framework to predict values for the budget balances for the following period. Results show that in the 1994–2003 period, primary budget balances for the euro-area aggregate would have been higher by 0.88 GDP points on average in absence of the EU fiscal framework ⁽¹⁾. Though such figures have to be taken cautiously (mainly due to the limited degrees of freedom available for estimating predicted budget balances) they can serve as a benchmark for further quantitative analysis. The computed difference between counterfactual and actual values for primary budget balances for the euro area have been used as shocks to the European Commission QUEST II model to simulate which consequences the absence of the rules for fiscal discipline of the Maastricht Treaty and SGP would have had on euro-area economies ⁽²⁾.

To focus the simulation analysis on the effects of the size budget deficits rather than on those of the composition of budgetary adjustment, such shocks to budget balances have been equally split between revenues and expenditures in the QUEST II model ⁽³⁾.

Three cases are considered. In the first case, the credit risk premium on government bonds is assumed not to react to deficits and debt. In the latter two cases, risk premia are assumed to increase with the level of government debt.

Based on existing empirical work on the relation between debt and interest rates (surveyed in Table III.2) and, more directly, on the relation between debt and risk premia (surveyed in Section 2.3.5), in the second case risk premia are assumed to increase by 1 basis point for each additional GDP point of government debt, while in the third case considered the risk premia are assumed to increase by 2 basis points for each GDP point of debt.

Table III.9 reports simulation results for the case in which risk premia are assumed not to react to debt. The fiscal loosening implied by the shock applied to primary budget balances amounts to an *ex post* increase in the deficit to GDP ratios of about 1 GDP point on average for the euro-area aggregate. The simulated fiscal relaxation leads to a build-up of government debt over time; by 2003 the debt/GDP ratio is almost 8 GDP points higher compared with baseline.

Results indicate that the simulated fiscal loosening boosts output via increased aggregate demand (positive fiscal multipliers). However, the positive output effects of such fiscal expansion are relatively small and tend to vanish over time ⁽⁴⁾. The small value of the fiscal multiplier is associated with forward-looking behaviour by private agents, which tend to save part of the increased disposable income in anticipation of higher future tax liabilities ⁽⁵⁾. The fact that the GDP expansion falls over time is related with the crowding-out of investment.

The simulated persistent increase in budget deficits leads to an accumulation of government debt, to higher long-term interest rates and to a reduction in private investment that becomes stronger over the years ⁽⁶⁾.

⁽¹⁾ Such predictions have been obtained after estimating fiscal rules as in Table III.8 separately for each country. To construct the counterfactual primary budget balance for a given country in the 1994–2003 period ($\hat{b}_{t \in [1994,2003]}$) the vector of the estimated coefficients for the 1970–93 period ($\alpha_{1970-1993}$), the vector of explanatory variables and the estimated regression residuals for the 1994–2003 period (respectively, $X_{t \in [1994,2003]}$ and $\varepsilon_{t \in [1994,2003]}$) has been used as follows: $\hat{b}_{t \in [1994,2003]} = \alpha_{1970-1993} X_{t \in [1994,2003]} + \varepsilon_{t \in [1994,2003]}$, where “ \cdot ” denotes vector transposition.

⁽²⁾ See Roeger and in’t Veld (1997) for a description of the features of the QUEST II model.

⁽³⁾ More precisely, the shock to primary budget balances is equally split between taxes and expenditures. Shocks to taxes are in turn equally divided among three tax rates (labour income tax, corporate profit tax and value added taxes) and expenditures equally divided between transfers to households and government consumption. The shocks are applied to the value of fiscal variables for the period 1994–2010.

⁽⁴⁾ An *ex ante* increase in the deficit of almost 0.9 GDP points leads at most to increased output by 0.3 points. This implies a value of the fiscal multiplier much smaller than predicted by standard Keynesian theory (higher than unity). A further reason for the relatively small GDP impact is related to the crowding-out of the fiscal expansion via the trade balance. The fiscal expansion is accompanied in fact by a jump appreciation of the exchange rate, followed by a gradual depreciation in the following years. The loss in competitiveness leads to a worsening of the trade balance.

⁽⁵⁾ The simulated fiscal shock destabilises debt. However, a solution for the inter-temporal equilibrium in the model requires debt to be stable in the long run, which is achieved by a delayed increase in tax rates. Due to agents’ forward-looking behaviour and rational expectations such future increases in tax liabilities are anticipated.

⁽⁶⁾ Nominal short-term interest rates are determined by a monetary policy rule which targets expected inflation and the output gap and assumes no change in the equilibrium real interest rate. Long-term interest rates are obtained from the arbitrage condition across the term structure. The fiscal expansion simulated here has a small positive effect on inflation and output and interest rates rise.

Table III.8

The EU fiscal framework and budgetary behaviour (EUR-11)

Dependent variable	Primary budget balance		Primary cyclically adjusted budget balance	
	1970–93	1994–2003	1970–93	1994–2003
Output gap	– 0.066 (– 1)	0.363*** (– 3.93)	– 0.086 (– 1.5)	0.097 (1.39)
Lagged debt/GDP ratio	0.027*** (4.5)	0.085*** (5.03)	0.03*** (5.4)	0.067*** (4.04)
Lagged dependent variable	0.74*** (14.9)	0.47*** (6.31)	0.69*** (15.46)	0.45*** (5.78)
Constant term	– 1.37*** (– 4.3)	– 4.85*** (– 3.95)	– 1.5*** (– 5)	– 3.51*** (– 2.99)
Number of observations	238	110	238	110
R square within groups	0.57	0.63	0.62	0.47
Wald Chi square	319.4	875.61	371.76	916.5

NB: Estimation method: instrumental variables fixed effects panel regression. The output gap variable is instrumented using its own lag and the lagged US output gap. All variables are expressed as a percentage of trend output. Z statistics reported in parenthesis. ***, **, * denote statistical significance at, respectively, 1, 5, and 10 % level.

The second set of simulations considered (Table III.9 b) incorporate an additional risk premium effect of 1 basis point per 1 percentage point increase in government debt ⁽¹⁾. This is probably on the low side of the range of estimates found in the literature, so that an alternative scenario with a risk premium of 2 basis points for a 1 percentage point increase in the debt/GDP ratio is also reported (Table III.9 c). Simulation results when risk premia are assumed to react to debt levels are markedly different from those in the case where the risk premium is assumed to be independent of debt. The positive GDP effects of increased deficits are now short-lived and turn negative after a few years of the simulated regime of increased persistent deficits. The main reason is that the impact of debt accumulation on risk premium leads to a bigger increase in interest rates, to a smaller positive impact on consumption and to a stronger degree of crowding out of

private investment ⁽²⁾. When the risk premium is assumed to increase by 2 basis points for a 1 percentage point increase in the debt/GDP (Table III.9 c), rising interest rates offset the direct increase in aggregate demand associated with increased deficits already in the short run.

Summarising, the simulations performed with European Commission QUEST model suggest that the introduction of the EU fiscal framework (modelled as an increase in primary balances by 0.88 GDP points in the euro area) may have had a negative impact on aggregate demand and output for some years. However, such negative impact on aggregate demand is likely to have been quite moderate (entailing a reduction in output by at most half a percentage point). Moreover, current and future growth prospects are rather likely to have benefited from the EU rules-based framework for fiscal discipline. The simulations show that in the absence of such a framework the

⁽¹⁾ In this simulation a risk premium is added to the uncovered interest parity condition in the model, which relates expected exchange rate changes to interest rate differentials. The risk premium is a function of the differences in the debt/GDP ratio from that in the baseline. Note also that the assumed change in the risk premium refers to *ex ante* variables, and that the *ex post* effect on interest rates is determined also by the central bank's response to the output gap and inflation gap.

⁽²⁾ The negative impact of higher interest rates on consumption expenditure is due to stronger discounting to future income flows and the consequent reduction in consumers' permanent income. It should be noted that in such a case the increased risk premium leads to a capital flight, a depreciation rather than an appreciation of the euro-dollar exchange rate and therefore to an improvement rather than a worsening of the trade balance.

Table III.9

Counterfactual simulation of 'no fiscal discipline' (euro-area aggregate)

(a) No impact of deficit and debt on government bond interest rate risk premia											
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2010
GDP (% difference from baseline)	0.26	0.18	0.18	0.17	0.16	0.15	0.11	0.09	0.08	0.06	-0.1
Consumption (% difference from baseline)	0.53	0.51	0.54	0.56	0.58	0.58	0.59	0.59	0.6	0.61	0.62
Investment (% difference from baseline)	-0.9	-1	-1.1	-1.2	-1.3	-1.3	-1.5	-1.6	-1.9	-2	-3.2
Long-term interest rate (absolute difference from baseline, % points)	0.11	0.11	0.11	0.12	0.12	0.12	0.12	0.12	0.12	0.11	-0.2
Deficit/GDP (absolute difference from baseline, % points)	0.89	0.95	0.96	0.96	0.94	0.92	0.98	0.97	0.93	0.9	0.94
Debt/GDP (absolute difference from baseline, % points)	0.25	1.16	2.03	2.88	3.69	4.49	5.26	6.07	6.9	7.61	12.1
(b) Risk premium on government bond interest rate rises by 1 basis point for each GDP point of debt											
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2010
GDP (% difference from baseline)	0.2	0.13	0.09	0.07	0.04	0	-0	-0.1	-0.1	-0.1	-0.3
Consumption (% difference from baseline)	0.36	0.11	0.22	0.22	0.23	0.24	0.25	0.27	0.29	0.3	0.38
Investment (% difference from baseline)	-1.6	-2	-2.2	-2.4	-2.6	-2.7	-2.9	-3.2	-3.4	-3.5	-4.1
Long-term interest rate (absolute difference from baseline, % points)	0.13	0.14	0.16	0.17	0.18	0.19	0.2	0.21	0.21	0.2	-0.1
Deficit/GDP (absolute difference from baseline, % points)	0.92	1	1	1.01	0.98	0.96	1.04	1.02	0.99	0.96	1.01
Debt/GDP (absolute difference from baseline, % points)	0.3	1.25	2.2	3.1	3.94	4.79	5.57	6.4	7.26	7.99	12.6
(c) Risk premium on government bond interest rate rises by 2 basis points for each GDP point of debt											
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2010
GDP (% difference from baseline)	0.15	0.08	0	-0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.3	-0.5
Consumption (% difference from baseline)	0.17	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0	0.13
Investment (% difference from baseline)	-2.5	-3.2	-3.4	-3.8	-4	-4.2	-4.5	-4.8	-5	-5.1	-5.2
Long-term interest rate (absolute difference from baseline, % points)	0.17	0.18	0.2	0.23	0.25	0.27	0.29	0.3	0.3	0.3	0
Deficit/GDP (absolute difference from baseline, % points)	0.96	1.05	1.05	1.05	1.01	0.99	1.1	1.09	1.05	1.02	1.08
Debt/GDP (absolute difference from baseline, % points)	0.36	1.35	2.39	3.33	4.22	5.12	5.9	6.76	7.65	8.4	13.1

NB: Description of shock: the primary budget balance is increased by 0.88 GDP points compared with baseline for the period 1993–2010.

Source: Simulations with the European Commission QUEST II model.

level of government debt in the euro area may have increased by about 8 GDP points over the period 1994–2003. This would have implied upward pressure on interest rates, crowding-out of private investment and reduced long-term growth prospects. The simulations show that what may appear a relatively small impact of increased debt on interest rate risk premia (1 to 2 basis points for each additional percentage point in the debt/GDP ratio, as found in empirical evidence) can instead matter quite considerably for the impact of persistent deficits on growth. When risk premia are assumed to be

affected by debt, simulations show that the absence of fiscal discipline would have had a negative impact on economic activity already in the medium run.

Of course, such results are also suggestive of what a loss of fiscal discipline in the future may imply. Increased permanent deficits may have a positive impact on aggregate demand, but this effect will probably be small and short-lived. Over the medium run, private investment crowding-out will become the major driver, and potential growth will suffer.

Part IV

The quality of public finances:

What role within the EU framework
for economic policy coordination?

Summary

Besides recognising that achieving and maintaining sound budgetary positions is essential for its success, the Lisbon strategy has highlighted the importance of improving the quality of public finances. This part of the report endeavours to clarify the role of the quality of public finances within the EU framework of economic policy coordination and investigates possibilities for improving the quality of public finances in practice.

The analysis proposes a broad definition of the quality of public finances. According to this definition quality concerns the allocation of resources and the most effective and efficient use of those resources in relation to identified strategic priorities. Regarding the priorities, the EU Lisbon strategy includes sustainable growth, full employment, social cohesion and competitiveness. A full discussion of all these aims would go beyond the scope of this report. Therefore, the first part of the chapter focuses on the link between fiscal policy and long-term growth, while recognising the partial nature of such an analysis. It begins with a review of the recent literature on the link between the composition of public expenditure and revenue and long-term growth. The findings of existing studies confirm the importance of taking into account both the costs (i.e. higher taxation) and benefits (i.e. reaching policy objectives) of public spending to undertake a meaningful analysis of such a link. The major difficulties that have been encountered in existing empirical studies concern the question of which expenditures should be considered as 'productive' (i.e. growth-enhancing) and which are instead to be classified as 'unproductive'. Although there is a degree of agreement that a few categories of public expenditure can quite safely be included among 'productive' public expenditures because they are directly aimed at productivity improvements (e.g. R & D, education and infrastructure investment) there is no consensus among researchers concerning the impact of most expenditure items on long-term growth. This lack of consensus is reflected by the fact that available classifications of 'productive' expenditure in the EU range between 5 and

44 % of total public expenditure, depending on which expenditure categories are seen as 'productive'. Macroeconomic data on the composition of public expenditure in fact cannot account for the relevant heterogeneity of expenditure items within a given category concerning their impact on productivity growth. In view of these difficulties, the report also investigates the microeconomic approach to identifying productive expenditure, which is to analyse individual projects on the basis of cost-benefit analysis. On this aspect, the analysis concludes that cost-benefit analysis is theoretically sound, widely used in practice and that the scope for learning from international practices is large given that several countries have undertaken projects to refine the methodology for applying cost-benefit analysis at national level.

A macroeconomic approach has also been adopted to investigate patterns and determinants of the recomposition of public expenditure across EU countries. It focuses on two questions: (i) how did the composition of public expenditure change over time and (ii) what may have been the driving factors of changes in the composition of public expenditure? The outcome for the Member States for which data were available shows that, over the period of 1991–2002, social protection and healthcare expenditure increased their share in total expenditure. This suggests that the main drivers of expenditure composition over the medium/long-term are the underlying upward pressures such as those related to ageing and that the discussion on reallocating funds in line with priorities cannot abstract from such ongoing tendencies.

A microeconomic and institutional perspective is adopted to investigate the second part of the definition of quality, i.e. the effective and efficient use of resources towards identified priorities. It shows that several Member States have introduced reforms to the budgetary process that aim at achieving society's priorities in the most efficient and effective way by linking public expenditure to policy outcomes (performance-budget-

ing). In this respect, the empirical literature arrives at a balanced judgement as to what can be achieved through such reforms, especially given difficulties in identifying appropriate outcome targets, while still concluding that sizeable efficiency gains may be possible through such reforms.

The next sections of the part then continue the institutional analysis by showing how strategies for better controlling public expenditure, reallocating funds to their most 'productive' uses and lasting fiscal consolidation on the expenditure side can contribute to a higher growth potential. Firstly, effective expenditure control is a precondition for performance-budgeting. Secondly, effective medium-term expenditure frameworks can also facilitate the political decision-making process of reallocation funds between broad expenditure categories. Thirdly, the analysis shows that countries with stronger institutional frameworks for expenditure control generally showed expenditure-based fiscal consolidation, while many other countries relied on raising revenues in times of fiscal consolidation. The implementation of such strategies of expenditure-based fiscal consolidation depends not only on the introduction of the appropriate budgetary institutions, however, but also requires the political will to do so. In this respect, the data show that many of the countries that had established a track record of expenditure control — while at the same time strengthening budgetary institutions that aim at using existing funds better — have almost immediately used

the increased room for manoeuvre and slackened the reins in recent years.

Finally, this part of the report stresses that issues related to the composition of the budget are a national competency. In addition, the EU has an important role to play in encouraging public finances that are supportive of the objectives of the Union, in particular those of the Lisbon strategy. Overall, the analysis implies that the allocation of resources and the monitoring of action undertaken to pursue identified priorities should have a greater role in the analysis and conduct of fiscal policy. To this end the broad economic policy guidelines (BEPGs) should contribute more effectively, as well as other EU processes, such as the European employment strategy and the open method of coordination of social protection, to improve the quality of public finances.

Progress should also include, firstly, the exchange of information on how strategic priorities have been fixed with respect to national budgets and what the experiences with implementing them have been. Secondly, further improvements in data availability are needed — in particular regarding the functional classification of government expenditure — since this is a necessary condition for an appropriate analysis of the contribution of public finances to agreed priorities. Thirdly, a proper design and implementation of medium-term expenditure frameworks and progress in cost-benefit analysis and performance-budgeting would help to improve both the control and allocation of existing funds.

1. Introduction

The Lisbon strategy has highlighted the strategic importance of improving both the sustainability of public finances and their quality. However, while the EU fiscal framework lays down the principles and procedures for achieving fiscal sustainability, the principles for improving the quality of public finances have not yet been integrated in a systematic way within the framework of EU policy coordination or within the EU fiscal framework. A consensus seems to have developed that it is important to redirect public expenditure towards ‘productive’ items and to ensure that tax structures strengthen the growth potential ⁽¹⁾, but there is no sufficient understanding yet on the best way of making such an approach operational. The central theme in this part is to discuss the concept of quality in the EU framework of economic policy coordination, with the purpose of facilitating a policy discussion on how the quality of public finances could be improved in practice. Naturally, the question of what could be done at the level of the Member States and what could be done at the level of the EU is an important issue and it will therefore be addressed in Section 2, taking subsidiarity as the guiding principle.

Section 2 starts with conceptual issues. It proposes a broad definition of the concept of quality and shows how quality fits with the existing objectives of the EU framework for economic policy coordination. Sections 3 and 4 then view the topic of quality from different perspectives in order to identify possible policy instruments. As a starting point of the analysis, Section 3 takes a macroeconomic perspective that concentrates on the potential contribution of budgetary aggregates and items (i.e. the

composition of the budget) to long-term growth. It then compares the composition of public expenditure across countries and over time and presents an empirical analysis of the factors that may have influenced changes in individual expenditure categories. It ends with a short review of the possible interaction between the size of the public sector and the long-term growth rate. Next, Section 4 takes a microeconomic perspective that focuses on the tools and institutions that can be helpful for enhancing the quality of public finances in practice. It concentrates on cost-benefit analysis as the principal tool for identifying ‘productive’ investment (which includes all social costs and benefits from government intervention and thereby also addresses issues related to ensuring a sustainable economic development), and on institutional arrangements for linking public expenditure to policy outcomes in order to improve the efficiency and effectiveness of public expenditure. Furthermore, this section also shows how the relevant policy objective from a microeconomic perspective (an efficient allocation of resources) and a central policy objective in the macroeconomic approach (i.e. long-term growth) are related. Section 5 then draws the whole analysis together by focusing on the consistency of fiscal sustainability and quality. It shows how strategies for better controlling public expenditure, fiscal consolidation on the expenditure side and reallocating funds to their best uses can contribute to long-term growth. Finally, it should be noted that the approach throughout the whole of this part is to briefly discuss theory and to concentrate more on empirical comparisons across EU countries ⁽²⁾ where data were available.

⁽¹⁾ See guideline 14 in Council recommendations of 26 June 2003 on the broad guidelines of the economic policies of the Member States and the Community (for the 2003–05 period) (2003/555/EC).

⁽²⁾ The new Member States have always been included in the analysis where data were available.

2. The concept of quality

2.1. The three dimensions of budgeting

The overall objectives of the broad economic policy guidelines (BEPGs) as the overarching instrument for economic policy-making in the EU are defined in the Treaty, Article 98: ‘Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, as defined in Article 2, and in the context of the broad economic guidelines referred to in Article 99(2). The Member States and the Community shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources ...’. Article 2 then provides a list of objectives that includes ‘to promote economic and social progress and a high level of employment and to achieve balanced and sustainable development ...’.

Within this general framework, the coordination of fiscal policies at the level of the EU is geared towards ensuring sound public finances. This includes aggregate fiscal discipline as well as the principle of automatic stabilisation over the economic cycle. However, these are not the only functions of national budgets. Apart from these macroeconomic functions, national budgets also perform the function of the allocation of public resources. More specifically, it is generally accepted that it is possible to examine budgetary policies ‘in three dimensions’ (Atkinson and van den Noord, 2001), to ‘identify budgetary outcomes at three levels’ (World Bank, 1998) or to distinguish ‘three objectives of budgeting’ (Schick, 2002). These three dimensions, levels or objectives of budgeting are:

- aggregate fiscal discipline;
- allocation of resources in accordance with strategic priorities;
- efficient and effective use of resources in the implementation of strategic priorities.

An alternative way of rewriting the three dimensions of budgeting — which aligns them better with the present focus of the EU fiscal framework on macroeconomic aspects — has been proposed by Diamond (2003):

- to ensure fiscal control and fiscal discipline;
- to provide a degree of stabilisation of the economy;
- to promote allocative and technical efficiency in service delivery through procedures that provide incentives for greater productivity.

The first requirement aims at making sure that the total amount of money a government spends will be closely aligned to what is affordable in the medium and long term. This remains particularly important in the euro zone given the need for consistency between national fiscal policies and the single monetary policy as well as in the European Union as a whole given the need to cater for the costs of ageing. The second requirement, to provide for a degree of stabilisation of the economy, also remains particularly important given that the single monetary policy can only be geared towards the euro zone as a whole so that national fiscal policies need to be able to react flexibly to asymmetric economic developments. Therefore, with respect to fiscal policy, analysis at the level of the EU has concentrated on the role and effectiveness of the automatic stabilisers (e.g. European Commission, 2002a) while stressing the importance of allowing the automatic stabilisers to operate symmetrically over the cycle. In sum, at the level of the EU, in light of the creation of the single currency the most urgent task has been to achieve enhanced coordination of the macroeconomic function of national budgets. It has also been pointed out in the literature (e.g. Diamond, 2003) that once budget systems are able to fulfil the requirements of aggregate discipline and a degree of (automatic) stabilisation, it will be possible to devote more attention to allocative and technical efficiency. Such a development is much in line with the way attention in the EU fiscal

framework widened along mutually reinforcing dimensions of sustainability, automatic stabilisation and quality. In fact, by taking the three dimensions of budgeting of fiscal sustainability, automatic stabilisation and quality as a starting point, it becomes possible to propose a definition of the concept of quality, **where the quality of public finances concerns the allocation of resources and the efficient and effective use of those resources in relation to identified strategic priorities** ⁽¹⁾. The advantage of using this definition would be that it focuses on the link between public expenditure and policy objectives, while it does not specify the policy objectives *ex ante*. Put differently, it is the role of the political process to prioritise the objectives, and the role of budgeting to achieve these objectives in the best way. In this respect, the Lisbon process has specified priorities such as sustainable growth, full employment, social cohesion and competitiveness.

A relevant question is whether there are trade-offs between the three dimensions of budgeting or whether they are mutually consistent. In this respect, previous work of the European Commission (e.g. European Commission, 2002a) has highlighted the consistency of fiscal sustainability and automatic stabilisation: a budgetary position of ‘close to balance or in surplus’ creates room for manoeuvre for the automatic stabilisers to operate symmetrically over the economic cycle. In addition, this part will illustrate the consistency of sustainability and quality. Firstly, lowering the debt level — especially in high-debt countries — decreases the flow of interest payments and creates room for increasing ‘productive’ expenditure (Section 3.4). Secondly, a fixed budget constraint fosters the use and development of budgetary techniques and institutions that aim at increasing the effectiveness and the efficiency of the use of public resources (Sections 4.2 and 4.3). Finally, quality can also be seen as consistent with sustainability given that a higher potential growth rate will facilitate maintaining a sustainable fiscal position. Thus, this part argues that the three dimensions of sustainability, automatic stabilisation and quality are mutually reinforcing if they are applied properly.

(1) There would be other possibilities as well, however, for defining the concept of quality, since one could also take the traditional ‘Musgravian’ functions of the State (efficient allocation of resources, redistribution and stabilisation) as a starting point and define quality as the best way of performing these functions.

2.2. Quality: What role within the EU framework for economic policy coordination?

This section discusses how the broad economic policy guidelines (BEPGs) could contribute to improve the quality of public finances. Over the last few years, the role of the BEPGs has evolved towards the central policy document at the level of the EU for identifying guidelines on how to attain strategic priorities, while at the same time attention has also shifted towards monitoring the implementation of the recommendations through implementation reports. In addition, it seems appropriate to address the topic of quality in the BEPGs given the objective of the BEPGs as specified in the EU Treaty of ‘an efficient allocation of resources’. Furthermore, it is also consistent with the fact that the allocation of resources through the budget, including the composition of public expenditure and revenues, is at the heart of the national political decision-making process. The BEPGs fully respect national competencies in this respect, as is reflected in the relevant Treaty provisions (‘Member States shall conduct their economic policies in the context of the BEPGs’). At the same time, this Treaty provision spells out the obligation for Member States to conduct their economic policies within the context of the priorities as set out in the BEPGs, so that policy discussions at the level of the EU could be useful with respect to the exchange of information; for learning from international experiences; for identifying best practices and for peer pressure to improve policy outcomes in line with strategic priorities. In addition, a contribution to the quality of public finances can be given by the Union’s initiative for growth, through which the European Council has established a roadmap for increased investment in physical and human capital to complement structural reforms. Furthermore, other policy processes such as the European employment strategy and the open method of coordination on social protection can also contribute to relevant aspects of the quality of public finances. However, in what follows, only the role of the BEPGs will be discussed.

In order to clarify the role of the quality of public finances in the BEPGs further, the remainder of this part will examine to what extent a macroeconomic perspective on quality may help in identifying guidelines with respect to the growth-enhancing role of public finances. Thereafter, a microeconomic perspective on quality would serve to investigate possibilities for a more effective and efficient use of resources for reaching strategic priorities, whether defined at national or at EU level.

3. A macroeconomic perspective on quality

3.1. Introduction

A full discussion on quality of public finances would consider all possible policy objectives (sustainable growth, social cohesion, etc.) and investigate what fiscal policy can do to achieve them in the most effective and efficient way and whether or not there would be trade-offs between different policy objectives. However, such an extended analysis would go beyond the scope of this part. Instead, as a starting point for further analysis of the contribution of fiscal policy to the objectives of the Lisbon strategy, it concentrates on the link between fiscal policy and long-term growth only. Hence, any findings following from this partial analysis should be seen as preliminary.

The focus on the link between fiscal policy and long-term growth does not imply that fiscal policy is the only variable that may influence growth. Levine and Renelt (1992) have identified more than 50 variables that are significantly correlated to growth in at least some studies. When conducting a systematic sensitivity analysis of a number of these partial growth correlations, they find that most of the correlations are fragile, as it is nearly always possible to find alternative explanatory variables that cause the partial correlation as identified previously to disappear. This finding also applies to a wide array of fiscal variables, including capital formation, education and defence. In response, Sala-i-Martin (1997) uses a different concept of 'robustness' and finds that 22 out of 59 variables are strongly related to growth. However, still no measure of government spending (including investment) appears to affect growth in a significant way. Focusing more directly on fiscal policy, Easterly and Rebelo (1993) make a similar point: the link between most fiscal variables and growth turns out to be statistically fragile since it depends heavily on what other control variables are included in the regression ⁽¹⁾. Hence, it should be admitted from the start that the uncertainty surrounding the partial correlations between fiscal policy variables and growth remains large and that

our understanding of which variables cause economic growth is very limited. This is particularly the case in the fiscal area where the causality often might run from growth to fiscal variables. In sum, from a policy point of view, a broad perspective is needed to identify policies that could raise low structural growth rates within the EU. Such an approach is taken in the Sapir report (2003), which identifies a six-point agenda for improving the growth potential of the EU economy ⁽²⁾. The perspective of this section is narrower and concentrates on the link between fiscal policy and long-term growth only.

3.2. Fiscal policy and long-term growth

Virtually all studies on the link between fiscal policy and long-term growth start from Solow's neoclassical growth model that implies that in the long run steady-state growth rate is constant and driven by exogenous factors of population growth and technological change. Fiscal policy can only affect the level of output in the steady state and the adjustment path through its impact on savings. For example, lower taxes on capital can lead to increased savings and to a higher growth rate until a new steady state has been reached.

The transitional dynamics cannot be ignored, however, given that it may take a long time for the economy to adjust to a new steady state ⁽³⁾. One of the criticisms of the neoclassical growth model points out that it is difficult to find reasons in these models why the government

⁽¹⁾ Nevertheless, the share of public investment in transport and communication and the government's budget surplus are consistently correlated with growth in their cross-section of countries. Furthermore, government revenue/GDP rises with per capita income (Wagner's law) in both the cross-section and the historical data sets.

⁽²⁾ The six-point agenda calls on the EU and its members: (1) to make the single market more dynamic; (2) to boost investment in knowledge; (3) to improve the macroeconomic policy framework for EMU; (4) to redesign policies for convergence and restructuring; (5) to achieve more effectiveness in decision-taking and regulation; and (6) to refocus the EU budget.

⁽³⁾ See Barro and Sala-i-Martin (1995): 'Convergence speeds that are consistent with the empirical evidence imply that the time required for substantial convergence is typically in the order of several generations'.

Table IV.1

Fiscal policy aggregates and long-term economic growth

Budgetary aggregates	Classification	Theory: Effect on growth	Possible examples
Expenditure	Productive	Positive effect on marginal productivity of capital and labour	Investment in transport and communication, education, R & D, healthcare
	Unproductive	Effect on marginal productivity zero or negative	Expenditure on economic services, recreation
Taxation	Distortionary	Distorting supply or demand of capital and labour	Taxation on income and profit
	Non-distortionary	No distortion of supply or demand of capital and labour	Proportional tax on consumption

Source: Adapted on the basis of Gemmell and Kneller (2003) and Gerson (1998).

might intervene at all. Endogenous growth models therefore allow the possibility of government intervention for correcting market failures when there are externalities. This leads to the conclusion that investment in human and physical capital may affect the steady-state growth rate. This point can be illustrated on the basis of the following production function (see Gerson, 1998, for an extensive description ⁽¹⁾):

$$(1) \quad Y_t = f[A_t K_t^\alpha B_t^{1-\alpha} L_t]$$

Where t is time, Y is output, K and L are capital and labour and A_t and B_t represent the quality of the stock of labour and capital. This equation states that total output at any moment in time depends on the volume and productivity of capital and labour.

In the neoclassical model, the production function inhibits decreasing returns to both capital and labour and A_t and B_t are exogenous. Consequently, the economy will tend to a constant capital/labour ratio, where the return from additional investment equals its cost. When, by contrast, endogenously determined increases in A_t and B_t ensure that the marginal product of physical capital does not tend to zero when the amount of capital per worker increases, policies that affect the incentives to invest in either physical or human capital can have permanent effects on the long-run growth rate.

The basic message for fiscal policy is summarised in Table IV.1 where ‘productive’ expenditure is defined as

expenditure with a positive effect on the marginal productivity of capital and/or labour (A_t and B_t in equation (1)), while distortionary taxes are taxes that distort the decision to invest in capital or labour and — hence — might have negative growth effects.

The empirical literature on ‘productive’ government expenditure has been summarised in European Commission (2002a). In sum, there seems to be a tendency towards the conclusion that public infrastructure investment ⁽²⁾, education and R & D investment are positively correlated to long-term growth, even if the magnitude of the impact is questionable and the effects may not be linear. However, it should be borne in mind that the positive effects of fiscal policy on long-term growth ultimately depend on the extent to which it is able to address externalities and not on the specific category of expenditure ⁽³⁾. For example, spending on social security will also be ‘productive’ if it delivers insurance that the market is not able to deliver due to market failures and informational problems.

On the whole, the empirical evidence in support of endogenous growth through fiscal policy remains mixed. Jones (1995) presents evidence against the endogenous growth hypothesis on the basis of time-series data for the United States that indicate a lack of persistent change in growth rates. By contrast, several recent empirical studies have also attempted to estimate the combined impact

⁽¹⁾ The literature on endogenous-growth models starts with Romer (1986).

⁽²⁾ In this respect, the European initiative for growth targets public and private investment in networks and knowledge. See also the communication from the Commission on a European initiative for growth (2003b).

⁽³⁾ Section 4.2 on cost-benefit analysis will develop this point further.

of 'productive' expenditure and distortionary taxation (as well as several 'control' variables in some cases) on growth (Kocherlakoty and Yi, 1997; Kneller et al., 1999 and 2001; Romero de Avila and Strauch, 2003). The basic argument is that both sides of the budget (revenues and expenditures) should be taken into account in estimating the effects of fiscal policy on long-run growth. Indeed, these studies typically find that results are not statistically significant when only the revenue or expenditure side is included in the growth regression given that positive effects of 'productive' spending and negative effects of distortionary taxation could be offsetting. Results become statistically significant, however, and coefficients have the theoretically predicted sign when both the expenditure and revenue side are included in the regression. These results support the notion that the composition of expenditure and revenues matter for long-term growth and that policies to improve the composition of both expenditure and revenue could have positive effects on long-term growth. As noted, from a policy perspective one should also know the degree of uncertainty surrounding different estimates. This, of course, applies to the robustness of the coefficients to alternative specifications and to the confidence intervals around the estimated coefficients (¹), but also to a key question: which part of total expenditure could be considered to be 'productive' and which part of total taxation could be considered to be distortionary?

3.3. From theory to practice: Comparing composite indicators

From a policy perspective, it is highly relevant to know which expenditure categories might be 'productive' or 'unproductive' and which classes of taxes may be more distortionary than others. Therefore, Table IV.2 compares different measures of 'productive' public expenditure and distortionary taxation as used in the empirical literature. Obviously, choices for a particular measure are often driven by considerations of data availability. For example, it is widely recognised that public investment ('gross fixed capital formation') is not a particular good measure of 'productive' expenditure (see, e.g. European Commission, 2003, Part III, where one of the

arguments is that a narrow focus on physical capital ignores the importance of human capital). However, the advantage of using this measure is that long time-series are available which facilitates the use of advanced econometric techniques. Alternatively, R & D and investment in transport and communication would be obvious candidates of any measure of 'productive' expenditure, but for these categories data availability remains a serious problem. The main message from Table IV.2 is that differences in macroeconomic estimates of 'productive' expenditure as a share of total expenditure can be enormous. At one side of the spectrum is the study by Kneller, Bleaney and Gemmell (1999, 2001). In their main analysis, 'productive' expenditure consists of general public services, defence, education, health, housing, transport and communication. On the basis of data for 2001 this would imply that 44 % of total expenditure would be 'productive' for both the euro zone and EU-15. At the other end of the extreme is the study by Romero de Avila and Strauch (2003) that uses public investment as a proxy for 'productive' public expenditure. This reduces the amount of 'productive' public expenditure to only 5 % of total expenditure for both the euro zone and EU-15. A middle position is taken by the recent work of Thöne (2003) that identifies 'productive' expenditure in Germany and calculates that in 2002, the federal budget on 'Public expenditure for growth and sustainable development' (PEGS) amounted to 21 % of federal expenditure. But also in this case, results are highly sensitive to change in the classification since this study draws attention to the fact that the exclusion of the category of 'children's allowance' (as part of the category of 'family policy' in Table IV.2) reduces the PEGS from 21 to 10 % of total federal expenditure in 2002. Similar arguments also apply to the revenue side of the budget, where results for distortionary taxes can change from about 30 to 60 % of total revenues depending on the question of whether or not social security contributions are classified as distortionary.

These large differences in empirical estimates point out a fundamental problem that empirical macroeconomic studies face: data that correspond to the theoretical classification into 'productive' and 'unproductive' expenditure or distortionary and non-distortionary taxation are not available at the macroeconomic level. Instead, data available in national accounts have to be used, either on the basis of the economic or on the basis of the functional classification, while assuming that all expenditure in a particular category is either 'productive' or 'unproductive'. For example, there are good reasons to believe that

⁽¹⁾ Gemmell and Kneller (2003) use the coefficients as calculated in Kneller, Bleaney and Gemmell (2001) to estimate confidence intervals of the possible growth effects of changes in the composition of revenues and expenditures for EU countries over the 1990s. Results suggest a net effect on the structural growth rate that typically ranges from + 0.3 to - 0.3 percentage points. One should keep in mind, however, that these results are based on a regression involving OECD countries and not EU countries separately.

better and more effective and efficient education will improve human capital and therefore will contribute to raising the growth potential. But this does not mean that all expenditure labelled as education is always good for growth (for example, a school with no teachers would not contribute much to improving the growth potential). Similarly, on the revenue side, the question of whether or not to label social security contributions as distortionary would depend on the specifics of its design such as the question of whether there are close links between benefits and entitlements. Thus, the macroeconomic

approach may be useful to identify budgetary categories that are on average more ‘productive’ or distortionary than others, but in the end all government intervention has to be investigated individually with respect to its design and the question of whether or not its benefits outweighs its costs. Such an approach will be followed as part of the microeconomic perspective in Section 4.2 on cost-benefit analysis.

During the last few years, attempts have also been made to arrive at composite indicators, in order to relate the

Table IV.2

Comparing classifications of ‘productive’ expenditure items and distortionary taxation

Study on ‘productive’ expenditure	Fölster and Henrekson (1998)	Kneller, Bleaney and Gemmell (1999, 2001)	Kneller, Bleaney and Gemmell (2001): measure used in sensitivity analysis	Romero de Avila and Strauch (2003)	Thöne (2003): Public expenditure for growth and sustainable development
Expenditure items classified as ‘productive’	— subsidies to R & D — education — transport and communication	— general public services — defence — housing — transport and communication — education — health	— general public services — defence — housing — transport and communication	— public investment	— schools and nursery schools — colleges, universities and other education — science and R & D outside universities — family policy — active labour market policies — public health service — environmental and nature protection — promotion of renewable energies
Total (% of total expenditure)	<i>Typically less than 20 % in OECD countries in 1985</i>	<i>44 % for both the euro zone and EU-15 in 2001 ⁽¹⁾</i>	<i>20 % for both the euro zone and EU-15 in 2001 ⁽¹⁾</i>	<i>5 % for both the euro zone and EU-15 in 2001</i>	<i>21 % of German federal expenditure in 2002</i>
Taxation items classified as distortionary	Not addressed	— taxation on income and profit — social security contributions — taxation on payroll and manpower — taxation on property	Not addressed	— direct taxation on property and income	Not addressed
Total (% of total revenues)		<i>64 % for the euro zone and 63 % for EU-15 in 2001 ⁽²⁾</i>		<i>29 % for the euro zone and 33 % for EU-15 in 2001 ⁽²⁾</i>	

⁽¹⁾ The total for ‘productive’ expenditure as calculated is an approximation given that transport and communication expenditure are left out of the calculation since no data were available for these subcategories of economic affairs.

⁽²⁾ Approximation on the basis of ESA 95 categories of D4 (property income), D5 (current taxes on income and wealth) and D61 (social contributions). The figure for total distortionary taxation as calculated on the basis of Romero de Avila and Strauch (2003) include D4 and D5.

NB: The totals for Kneller, Bleaney and Gemmell (1999, 2001) and Romero de Avila and Strauch (2003) are based on own calculations on the basis of the Ameco and NewCronos databases.

composition of expenditure of a particular country to the achievement of strategic goals of government intervention. The use of such composite indicators could be especially relevant from the perspective of the EU if it allows meaningful comparison across countries. Therefore, it may be useful to summarise the methodology and the outcomes of different indicators. It should be noted from the start, however, that the indicators discussed below (i.e. European Commission, 2002a, and Afonso et al., 2003) aim at measuring different concepts so that the outcomes should not be compared.

Table IV.3 summarises the methodology as used for the two indicators. The indicator in European Commission (2002a) aims at measuring the contribution of public expenditure in different countries to long-term growth. On the basis of a literature review of the link between expenditure items and long-term growth, it derives an assumed impact of different expenditure categories (inputs) on long-term growth (outcome). The impact does not need to be linear as it can be negative (as with interest payments); positive provided that expenditure is kept within certain limits (e.g. social expenditure, indicated by +/- in Table IV.3) or positive for a larger range of values (for example R & D). Finally, the indicator is calculated as an index in which all expenditure items receive the same weight. A noticeable aspect is that the ranking as produced by this indicator is positively correlated with the size of the public sector (a correlation coefficient of 0.49). This results from the methodology employed since expenditure items with an assumed positive correlation to growth outweigh the items with an assumed negative correlation to growth.

The indicator as used in Afonso et al. (2003) aims at measuring the efficiency of the public sector in reaching a range of objectives of government intervention. These include performance indicators with respect to the traditional 'Musgravian' functions of government (i.e. allocative efficiency, stabilisation and the distribution of income) and public performance indicators in the field of public administration (e.g. reducing corruption), education (e.g. secondary school enrolment), health (e.g. life expectancy) and public infrastructure. The final efficiency indicator is calculated as the ratio of performance indicators (outcomes) by a measure of public expenditure related to that indicator (input), based on the assumption that this amount of money is used to achieve that outcome. Finally, in calculating public sector efficiency for each country, all performance indicators receive the same weight. The ranking as produced by this

indicator is negatively correlated to the size of the public sector (correlation coefficient of -0.69), as a result of the methodology in which performance indicators are divided by a measure of 'relevant' expenditure for each indicator, so that higher expenditure lowers efficiency.

To summarise, it seems clear that the different indicators serve different purposes, use a different methodology and thus also produce different rankings. The main advantage of the use of such indicators would be that they allow an aggregate comparison across countries and thus can give generalised policy messages. The main weakness of aggregate indicators is that strong assumptions have to be made in order to calculate such a synthetic indicator. In this respect, both studies as referred to in this section indicate that calculations are for illustrative purposes only, given that devising and calculating any indicator involves a number of arbitrary choices. In addition, the microeconomic approach as it will be discussed in Section 4 will stress the importance of individual project appraisal in order to guide decision-making in practice.

3.4. The composition of public expenditure

The conclusions of the previous sections on the impact of fiscal policy on long-term growth refer to the relevance of shifting expenditure towards 'productive' items and making taxation less distortionary. At the same time, the previous sections also highlighted that the available data at the macroeconomic level do not necessarily correspond entirely to the theoretical classification of 'productive' or distortionary. Therefore, the analysis of the composition of the budget in this section does not investigate whether the 'productive' part of expenditure has increased or decreased. Instead, it focuses on more preliminary questions: what are the differences in the composition of public expenditure across countries, how did the composition change over time and what may have been driving factors of changes in the composition?

In this respect, previous studies (e.g. European Commission, 2002a, and Atkinson and van den Noord, 2001) have analysed changes in the composition on the basis of the national accounts classification according to transactions. However, the functional classification of government expenditure can also be useful for making inter-country comparisons of the extent to which governments are involved in economic and social functions and thus be particularly suitable to analyse issues related to quality. These data are available for all EU-15 countries for

Table IV.3

Comparing the methodology of composite indicators

	Expenditure items (inputs)	Outcomes	Calculation methodology	Ranking of EU countries resulting from indicator
Composition of public expenditure, EC (2002)	Education (+)	Assumed effects of inputs on long-term economic growth on the basis of literature review (as indicated by + or – for every expenditure item)	Index whereby all expenditure items receive same weight	FR
	R & D (+)			DE
	Gross fixed capital formation (+)			FI
	Healthcare (+)			SE
	Active labour market policies (+)			AT
	Compensation of employees (+/-)			NL
	Collective consumption (+/-)			ES
	Old age and survivor (+/-)			IE
	Unemployment benefits (+/-)			PT
	Other social expenditures (+/-)			BE
Interest payments (-)	DK			
				UK
				EL
				IT
Public sector efficiency, Afonso et al. (2003)	<i>Expenditure categories related to outcome indicators</i>	<i>'Opportunity' indicators representing</i>	Index of performance indicators divided by 'relevant' expenditure for each indicator	UK, ES, EL
	Goods and services	Administration		IE
	Education	Education		PT
	Health	Health		AT
	Social transfers	Public infrastructure		FI
	Public investment			NL
	Total expenditure	<i>'Musgravian' indicators representing</i>		DE
		Distribution		DK
		Stability		BE
		Economic performance		FR
		SE		
		IT		

Source: Adapted from European Commission (2002a) and Afonso et al. (2003).

three years only while no data are available for the new Member States (see Box IV.1). Therefore, improving the availability of data remains a key priority. In the meantime, this section already anticipates a full analysis on the basis of the functional classification by analysing developments over time on the basis of a subset of countries for which longer time-series were available.

3.4.1. Comparing the composition of public expenditure across countries

The main conclusions from the analysis of the trends in public expenditure in European Commission (2002a) are that a large part of the growth in public expenditure until the first half of the 1990s can be attributed to the rise in expenditure on social protection and that differences in expenditure on social protection also explain to a large extent the differences in size of the public sector between Member States, reflecting — at least partly — differences in preferences.

The data on the functional classification of public expenditure in EU countries in Table 4 show that social protection is by far the largest category of government spending (see also Revelin, 2003). This category mainly covers benefits for subcategories such as sickness and disability, old age, family and children, unemployment and other forms of social benefits (¹). Differences between countries range from 7 % of GDP in Ireland to 24 % of GDP in Sweden and Denmark. The second largest category is that of general public services that includes expenses related to executive and legislative organs, financial and fiscal affairs, external affairs, foreign economic aid, general services, research and development, interest payments and other expenses related to debt. However, it excludes expenditure on items specifically related to one of the other functions such as R & D

(¹) For a complete overview of the contents of the COFOG classification, see the link to COFOG on <http://unstats.un.org/unsd/cr/registry>.

Table IV.4

Government expenditure by function, 2001

(% of GDP)

	Social protection	General public services	Health	Education	Economic affairs	Others	Total expenditure
BE	17.2	10.2	6.6	6.2	4.4	4.9	49.5
DK	24.0	8.6	5.4	8.3	3.8	5.2	55.3
DE	21.8	6.3	6.4	4.2	4.4	5.3	48.3
EL	19.4	10.9	3.7	3.1	5.1	5.6	47.8
ES	13.4	5.5	5.3	4.3	4.3	6.4	39.4
FR	20.4	6.4	7.9	6.0	5.2	6.5	52.5
IE	7.2	3.7	6.3	4.3	5.0	7.1	33.6
IT	17.8	9.6	6.4	5.0	4.0	5.7	48.5
LU	17.1	4.7	4.9	4.7	2.8	5.0	39.1
NL	17.5	8.2	4.1	4.8	5.6	6.5	46.6
AT	21.5	8.5	6.1	5.7	5.2	4.8	51.8
PT	13.6	6.6	6.8	7.0	5.5	6.6	46.2
FI	20.6	6.5	6.0	6.5	4.7	4.9	49.2
SE	23.9	8.5	6.6	7.7	4.4	6.1	57.2
UK	15.7	4.4	6.2	4.6	2.6	5.8	39.2
Euro zone	19.1	7.2	6.4	5.0	4.6	5.8	48.1
EU-15	18.7	6.8	6.4	5.1	4.2	5.8	46.9

Source: Commission services.

expenditure ⁽¹⁾. Spending on general public services is the highest in the high-debt countries Italy, Belgium and Greece. Spending on health and education generally amounts to around 5 to 6 % of GDP each in most Member States, with highs of 8 % GDP on health in France and 8.3 % on education in Denmark. In most countries, the category of economic affairs adds up to 5 to 6 % of GDP. It covers items such as support programmes and subsidies to mining, manufacturing, agriculture, energy and service industries. It also includes public spending on infrastructure such as transport and communications. Finally, the category of others generally amounts to around 6 % of GDP in most Member States. This category covers defence; public order and safety; environment protection; housing and community amenities and recreation, culture and religion.

3.4.2. Changes in the composition of public expenditure over time

Graphs IV.1 and IV.2 show the development of the composition of the budget over time. Data on the functional classification are available since 1991 for eight countries (BE, DK, DE, EL, IT, LU, PT, UK). Therefore, the graphs

show the aggregate developments for these countries only. Changes in the composition are shown as a percentage of GDP and as a percentage of total expenditure. Over the period as a whole, total expenditure rose to above 50 % of GDP in 1995, then decreased in the run-up to EMU to 46 % of GDP and was still at this level in 2002. Regarding the changes in the composition, the biggest increase was recorded in social protection (+ 1.7 percentage points (p.p.) of GDP and + 6 p.p. in total expenditure), followed by healthcare (+ 0.5 p.p. of GDP and +1.9 p.p. in total expenditure). Expenditure on education remained stable at 4.8 % of GDP and thus increased its share in total expenditure (+ 0.6 p.p.). The biggest decrease in expenditure was recorded for the category of general public services (– 2.4 p.p. of GDP and – 4.1 p.p. in total expenditure), followed by economic affairs (– 1.3 p.p. of GDP and – 2.4 p.p. in total expenditure). Overall, at the aggregate level, these data show that the composition of public expenditure has shifted mainly from general public services and economic affairs towards social protection and health over the period 1991–2002.

3.4.3. Explaining changes in the composition of public expenditure

From a policy perspective, an important question is what could have been the driving factors of changes in the composition as registered. In order to investigate this

⁽¹⁾ Figures for subcategories are not available in the Eurostat database. Therefore R & D expenditure is not shown as a separate category.

Box IV.1: Data availability for assessing the composition of government expenditure

A breakdown of total general government expenditure of EU Member States, on the basis of the data as reported to Eurostat by the statistical authorities of the Member States, can be made according to ESA 95 main aggregates and according to the functional classification of general government expenditure.

In the main aggregates of general government, expenditure is classified according to transactions on the basis of the following main ESA 95 categories:

- collective consumption;
- social benefits in kind;
- social transfers other than in kind;
- interests;
- subsidies;
- gross fixed capital formation;
- other.

This classification is the one used in the annual assessment of budgetary positions according to the code of conduct on the content and format of the stability and convergence programmes. With a delay of three months, data are reported through the data transmission programme under ESA 95. While it is a useful tool to assess the broad development of public expenditures, with some useful breakdowns between current and capital expenditures, it does not give details on which kind of goods and services are provided by the general government.

Data availability: For annual accounts, data are available from 1991 until 2002 for all 15 Member States. For new Member States, data are missing for Cyprus, Malta and Slovenia and are incomplete for a number of other countries.

In the classification of general government expenditure by function (COFOG), total general government expenditure is divided into 10 functional categories:

- general public services;
- defence;
- public order and safety;
- economic affairs;
- environment protection;
- housing and community amenities;
- health;
- recreation, culture and religion;
- education;
- social protection.

This classification gives deeper insight into the composition of public expenditures, and broadly allows identifying the main functions of the State. It allows for the examination of trends in government outlays on particular functions over time, without distortions from organisational changes in government. For every individual function, expenditure can be divided

(Continued on the next page)

Box IV.1 (continued)

further into sub-functions. For example, the category of social protection contains subcategories such as sickness and disability, old age, survivors and unemployment. In addition R & D is included as a subcategory of general public services, but R & D specifically related to one of the other functions is included as a subcategory for these other categories. Data are collected through the data transmission programme under ESA 95, with 12 months of delay.

Data availability: Data under the COFOG classification are available from 1990 until 2002, but the data are far from complete. Data are available only for the 10 main categories but not for subcategories. For France, Ireland, the Netherlands, Austria, Finland and Sweden data are only available after 1995. From 1995 until 2001 data are complete for EU-15, with the exception of Spain for which data are available only since 1999. No data are available for the new Member States. According to Regulation (EC) No 1267/2003 of the European Parliament and of the Council of 16 June 2003 amending Council Regulation (EC) No 2223/96 with respect to the time limit for transmission of the main aggregates of national accounts, several countries have a derogation up to 2005 to provide the information under the COFOG classification. In particular, Austria, Luxembourg, Greece and Portugal do not have to recalculate backwards some data, while Spain and Sweden can submit data with a longer delay (21 and 16 months, respectively).

In sum, the most complete and updated breakdown of total expenditure is the classification according to ESA 95 transactions. However, this classification does not provide information on the functions that are carried out by the government, such as education, healthcare and pensions. These data are available in the functional classification of government expenditure. Data availability has improved during recent years, but the coverage is still far from complete, both across countries (since data for the new Member States are not yet available) and over time (EU aggregates are available for three years only). In addition, no data are available for the subcategories, so that it is not possible to assess changes in the composition of total expenditure with respect to important subcategories such as transport, primary, secondary and tertiary education, unemployment and pensions. Thus, an improvement in the analysis of changes in the composition of public expenditure hinges on the availability of longer time-series for the functional classification and its subcategories for all Member States. At the same time, the costs of additional data collection — such as an increased reporting burden for the Member States — should also be taken into account and weighed against the benefits of additional analysis on the composition of public expenditure.

question, a regression analysis was carried out using panel data for all Member States. As explanatory variables were included economic variables, demographic variables and political variables (see Box IV.2 for the details). Results indicate that, taken together, these variables do reasonably well in explaining variation in expenditure on relatively homogeneous categories such as social protection, health and education, but that it is more difficult to explain developments in heterogeneous categories such as general public services and economic affairs. With respect to underlying upward pressures, the results already confirm a statistically significant upward effect of ageing on healthcare expenditure, despite the short period over which regressions were estimated and despite the fact that the biggest impact from ageing is still to come (in the EU, the population with age above 65 rose by 6.6 million people during 1991–99, while it is projected to rise by 42 million people over the next decades). Regarding temporary effects, falling unemployment levels may have had a favourable impact during the second half of the 1990s (4.5 million people less in the EU between 1994 and 2001, while increasing again by 1.3 million people between 2001 and 2003), while a tem-

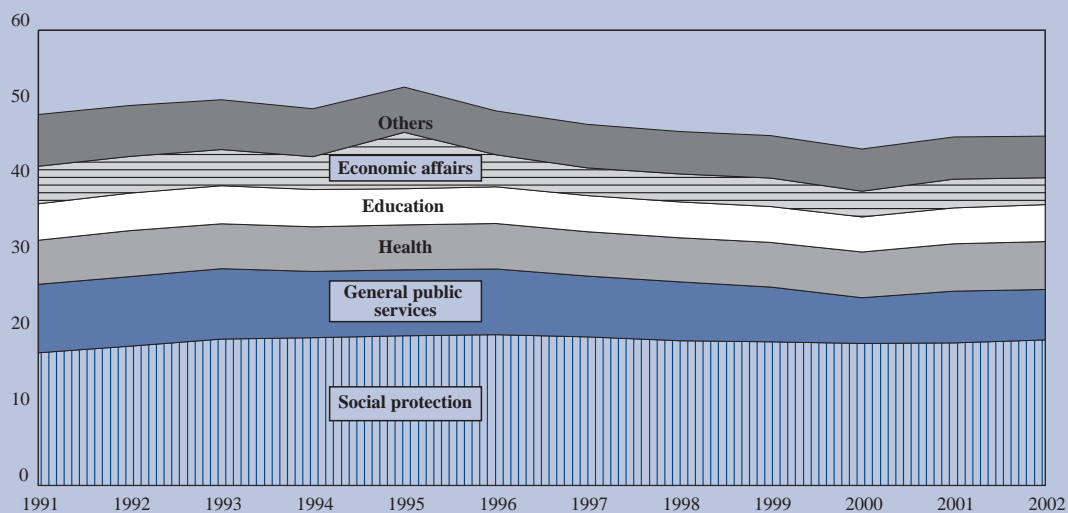
porary effect related to EMU qualification is close to being statistically significant for the category of economic affairs. Furthermore, results also confirm the positive role lower debt levels may play in freeing up resources for expenditure on ‘productive’ items and that expenditure on health and education increases with potential GDP (as a proxy for welfare).

Overall, the analysis in this section suggests that underlying upward pressures such as those related to ageing already exert upward pressures on several expenditure categories. The implication is that any framework for the definition of strategic expenditure priorities and the reallocation of expenditure towards the priorities cannot abstract from such ongoing tendencies. These results are much in line with the findings of a recent study by the OECD that summarises trends in expenditure on the basis of detailed expenditure surveys for 21 OECD countries (Joumard et al., 2004) and concludes that: ‘the spending pressures stemming from the continued expansion of social programmes have been partly compensated by transient or one-off factors’. The long-term projections for age-

related expenditure (see Part I of this report) show that upward pressures on public spending can be expected to intensify further, while at the same time there would be little scope for strategies of raising additional revenues given the already high ratios of total revenues to

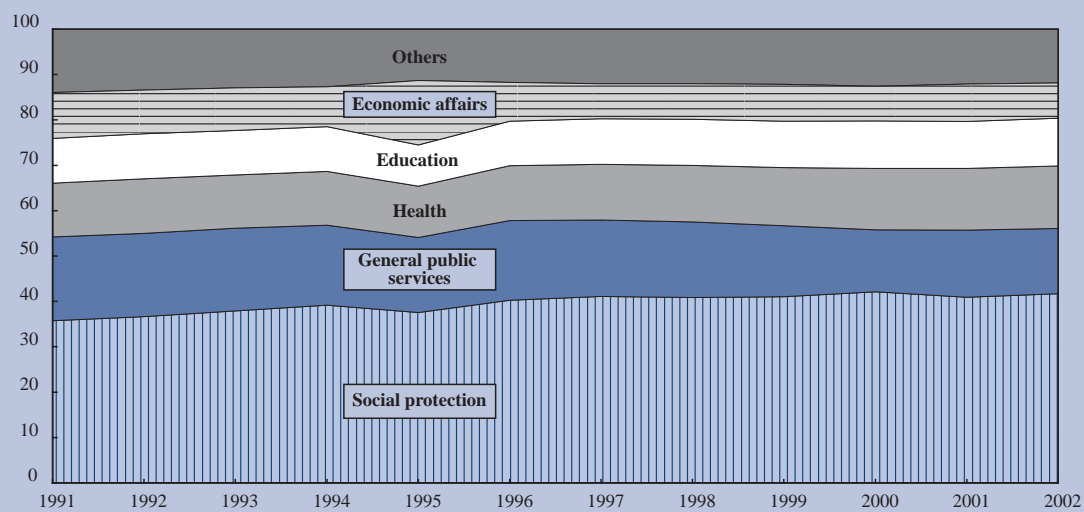
GDP. This increases the importance of a clear focus on spending priorities — which includes being selective as to what can or should be achieved through government intervention — and an efficient and effective use of public resources in reaching them.

Graph IV.1: The composition of expenditure as a % of GDP



Source: Commission services. Countries included are BE, DK, DE, EL, IT, LU, PT, UK.

Graph IV.2: The composition of expenditure as a % of total expenditure



Source: Commission services. Countries included are BE, DK, DE, EL, IT, LU, PT, UK.

Box IV.2: An empirical analysis of changes in the components of public expenditure

In order to investigate the driving factors of changes in the composition, regressions were run using panel data for all EU Member States. The basic approach is to regress individual expenditure items on economic variables, demographic variables and political variables. In vector notation:

$$\Delta ex.item_{i,t} = c_i + \Delta ec'_{i,t}\alpha + \Delta dem'_{i,t}\beta + pol'_{i,t}\gamma + \varepsilon_{i,t}$$

Much of the literature that regresses budgetary variables has used the economic classification of expenditure (e.g. Mulas Granados, 2003) in order to take advantage of long time-series that are available. However, in order to study issues of quality, the functional classification of government expenditure may be more relevant. The drawback is that the longest period over which these data are available is the period of 1990–2002, so one should keep in mind that the period may be too short to properly capture structural trends.

For the economic variables, potential GDP, the output gap and the level of debt are included for all expenditure items. Potential GDP is included since expenditure on a specific item may increase with welfare. The output gap is included in order to capture the effect of the cycle. The debt level is included given that, other things being equal, the larger the stock of accumulated debt, the higher the flow of interest payments to be paid by governments (which may crowd out other expenditure). The debt level may also capture a possible sustainability effect and the need for budgetary consolidation. In addition, the regression for spending on social protection was also run with an alternative specification that includes unemployment instead of the output gap, given that the automatic stabilisers mainly operate on the expenditure side through expenditure on unemployment benefits so that the changes in the level of unemployment may better capture this effect (since unemployment usually reacts with a lag on the cycle).

For the demographic variables, changes in the population aged 24 or younger are included for the category of education. Changes in the population from the age of 65 have been included for social protection (since it includes old age as a sub-category) and health. A priori it would be questionable whether the estimation period of 1990–2002 is long enough for the demographic variables to show a significant effect. Finally, the political variables under consideration contain a dummy for the year preceding the decision on membership of EMU (i.e. 1999 for Greece and 1997 for all other euro-zone countries) given that some countries undertook some special consolidation efforts in this year. Furthermore, an election dummy was included given that several papers have found empirical evidence of an electoral budget cycle (e.g. Buti and van den Noord, 2003). However, the results for this variable were not significant and therefore this variable has not been included in the regressions for which results are reported. A possible explanation for the non-significance of the election dummy might be that Buti and van den Noord concentrate on the role of elections on discretionary expenditure (i.e. corrected for the role of the cycle), while the focus here is on total expenditure which included the effects of the cycle and discretionary changes.

All items have been estimated in first differences, except for debt (in order to better capture a possible 'sustainability effect'). Debt is lagged one period to overcome endogeneity (reverse causation) problems, given that higher spending may lead to a higher deficit and thus higher debt. Moreover, individual expenditure categories are assumed to be too small to have a direct effect on short-term output and any positive effect of 'productive' expenditure (e.g. health, education) on long-term growth will take time to materialise. Therefore, no instrumental variable approach has been used for potential GDP and the output gap. The estimation method is fixed effects panel data, allowing for robust standard errors with respect to autocorrelation and heteroscedasticity.

Table IV.5 contains the result for the estimated equations, with standard errors in parentheses and *,** and *** indicating significance at 10, 5 and 1 % confidence. All expenditure categories are specified in billion EUR in constant market prices, so that the coefficients represent the change in real spending in billion EUR as a result in changes in the explanatory variables. Generally, coefficients have the expected sign. The positive effect of potential GDP (as a proxy of higher welfare) on spending is significant for health and education. Not surprisingly, results also confirm the effect of unemployment on

(Continued on the next page)

Box IV.2 (continued)

expenditure on social protection. Furthermore, results show a statistically significant procyclical pattern of expenditure on health. An explanation might be that sick-report incentives are procyclical: in a downturn, with unemployment rising, people might be less tempted to report sick if absenteeism increases the risk of job loss (Arai and Thoursie, 2001). The negative effect of debt is also significant for several categories, which confirms the link between fiscal discipline and quality given that a lower debt level reduces interest expenditure and thereby creates room for 'productive' expenditure. Regarding demographics, despite the short period covered by the regression and the fact that the biggest impact of ageing is still to come, the data already confirm a significant effect of ageing on health expenditure. For the political variables, the EMU dummy is not statistically significant for any of the individual expenditure categories, although it is close to significant for the category of economic affairs. In addition, it should be noted that the regressions do much better in explaining variation in spending on homogeneous categories such as social protection, health and education than in explaining composite categories such as general public services and economic affairs (see differences in R-squared in Table IV.5).

Table IV.5

Changes in expenditure categories: Explanatory variables

	Potential GDP	Output gap	Unemployment	Lagged debt level	Pop. 65+	Pop. – 24	Dummy EMU	No obs.	R ²
Social protection	– 0.05 (0.16)	– 0.06 (0.06)		– 0.025*** (0.008)	6.95 (25.5)		– 0.16 (1.01)	110	0.70
Social protection	0.11 (0.14)		0.93* (0.51)	– 0.017* (0.01)	11.96 (25.2)		– 0.48 (1.04)	110	0.73
General public services	– 0.19 (0.35)	– 0.23 (0.22)		– 0.003 (0.021)			– 1.76 (1.94)	120	0.11
Health	0.23*** (0.08)	0.083* (0.04)		– 0.006* (0.003)	11.97* (6.61)		0.12 (0.42)	110	0.53
Education	0.095** (0.04)	0.008 (0.02)		– 0.003 (0.002)		0.007 (0.016)	– 0.06 (0.17)	110	0.43
Economic affairs	0.16 (0.13)	0.030 (0.045)		– 0.0089 (0.0060)			– 0.06 (0.40)	110	0.14
Other	0.045 (0.070)	0.027 (0.031)		0.0012 (0.003)			– 0.06 (0.40)	124	0.11
Total expenditure	0.44 (0.33)	– 0.26 (0.15)		– 0.017*** (0.006)			– 3.58** (1.85)	251	0.94

In order to verify the robustness of the results, the regressions were also run in an alternative specification where all variables were scaled. Expenditure variables were defined in per capita terms and as explanatory variables were included income per capita, the dependency ratio (i.e. population 65+ years of age as a percentage of the population 15 to 64 years of age), unemployment (percentage of civilian labour force), debt as a percentage of GDP and the EMU dummy (results not reported). Again, the coefficients generally showed the expected sign. As in the original specification, the dependency ratio was statistically significant for health but not for social protection. A noticeable difference is that the EMU dummy was statistically significant for general public services in the alternative specification.

3.5. The size of the public sector

The possible correlation between the size of the public sector and long-term economic growth, and the robustness of this correlation, is subject to a lively debate in the literature. On the one hand Fatàs et al. (2003) show a negative association between total revenues and the trend growth rate for EU countries. They link this result to the debate on the quality of public finances and rec-

ommend reducing the burden of taxes and social contributions on factor incomes (along with shifting public spending to 'productive' uses). On the other hand, Levine and Renelt (1992), Easterly and Rebelo (1993) and Agell, Lindh and Ohlsson (1997) all show for different cross-sections of countries that the partial correlation between the size of the public sector and growth (i.e. without checking for other variables that are correlated to long-term growth) is not robust to the inclusion of

other explanatory variables of long-term economic growth. In particular, it becomes statistically insignificant already after checking for only one alternative explanatory variable, initial income. This variable is considered since many growth models imply the existence of a catching-up effect: economies which initially have a relatively low GDP level have a tendency to grow faster than richer countries, which are closer to their steady state. But then Fölster and Henrekson (1998) find a tendency towards a more robust negative growth effect of the size of the public sector (i.e. including initial income) for a panel of rich countries after correcting for various econometric problems ⁽¹⁾.

A full econometric discussion in the context of the EU is not possible due to the low number of cross-country observations (academic studies typically use large cross-sections of countries) ⁽²⁾. This section therefore only aims to position EU Member States with respect to several possible interpretations of the link between the size of the public sector and the long-term growth rate and to discuss whether such interpretations are supported by empirical data ⁽³⁾. In particular, the following hypotheses are investigated:

Catching up: countries with a lower initial GDP per capita might show higher trend growth rates

Graph IV.3 shows the effect of catching up. It confirms a negative correlation between initial income (GDP per capita) and the long-term growth rate. On average, new Member States grow faster than the existing Member States, which had a higher initial income.

Wagner's law: the demand for government services and hence the size of the public sector might increase with the level of income

According to Wagner's law, one might expect that the demand for government services will grow as countries become richer. Thus, countries that already have a higher GDP per capita would be expected to have a larger public sector. However, Graph IV.4 does not completely confirm this pattern. It shows that many

EU countries with similar levels of GDP per capita (measured relatively to EU-15) show large differences in the size of their public sector. For example, GDP per head relative to that of EU-15 is 106 in Sweden and 105 in the UK, but the size of the public sector amounts to 55 % of GDP in Sweden, while it is 37 % of GDP in the UK. In this respect, Fölster and Henrekson (1998) draw attention to the fact that Wagner's law may operate especially at low levels of income and that the relationship may break down at the highest levels of income. Furthermore, Tanzi and Schuknecht (2000) argue that public spending is not a natural development that accompanies the growth of per capita income, but rather results from explicit policy decisions. An important element in this regard is also the organisation of social protection. If it is mainly provided through the public sector, this will increase the share of the public sector in GDP. Stronger reliance on private social protection arrangements will, by contrast, result in a smaller public sector.

Differences in preferences across countries: countries with a stronger preference for income equality have a larger public sector and a lower degree of income inequality

Graph IV.5 investigates the role of differences in preferences across countries, assuming that the size of the public sector is a proxy for public policies to reduce inequality ⁽⁴⁾. It confirms a negative correlation between the size of the public sector and the degree of income inequality. It shows that differences in the size of the public sector between Member States can — at least partly — be explained by differences in preferences for income redistribution.

Distortionary taxation: after a certain point, the negative effects of taxation outweigh the positive effects of 'productive' spending on trend growth

Graph IV.6 shows the correlation between total revenues and average five-yearly growth rates. The negative correlation as found in Fatàs et al. (2003) is confirmed. Hence, the data confirm that — on average — countries with a smaller public sector have recorded higher growth rates in recent years. At the same time, the data also confirm that — on average — countries with a smaller public sector had a lower initial GDP. As

⁽¹⁾ In particular simultaneity and heteroscedasticity.

⁽²⁾ Graphs 3 to 6 only show the partial correlations for a cross-section of all EU countries without making statistical inferences about causality or about the significance of the coefficients given that this would give rise to problems of omitted variable bias and reverse causation.

⁽³⁾ In line with the literature, figures as reported are five-yearly averages. In principle, cyclically adjusted data could also be used, but these are not yet available for all new Member States.

⁽⁴⁾ These data on the equality of the income distribution were not available for the new Member States.

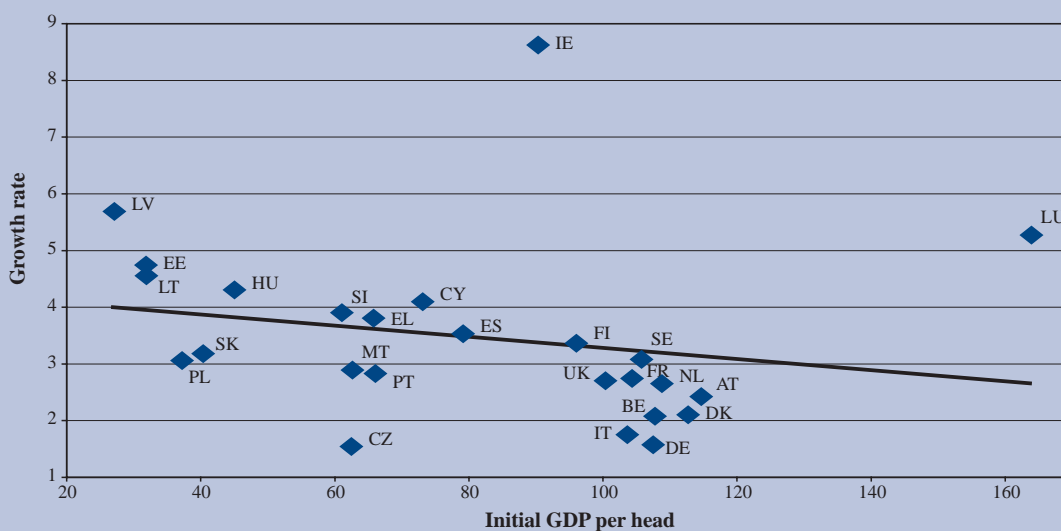
a result, it is (indeed) difficult to disentangle the effects of distortionary taxation and catching up on long-term growth in this small dataset. Finally, differences in preferences regarding the income distribution (equity) also play a role in explaining differences in size.

Simulations with macroeconomic models can provide additional insights into the correlation between the size of the public sector and long-term growth, as they provide the opportunity to keep ‘other’ variables such as initial income constant. European Commission (2003) presents an overview of the effects of fiscal consolidation on growth on the basis of the QUEST model. In this model, short-run Keynesian effects and the medium- to long-term effects of distortionary taxation interact when the size of the public sector is changed. It turns out that all simulations of budgetary consolidation through higher taxes show negative growth effects in the medium run, since the tax rises increase the distortions in the economy and lower output. Fiscal adjustment based on expenditure cuts, on

the other hand, lead to negative GDP effects in the short run, but these are reversed in the medium to long run. Moreover, empirical evidence in European Commission (2003) on expansionary consolidation suggests that fiscal adjustments based on expenditure cuts are more likely to coincide with higher growth rates than consolidation periods based on tax increases. In terms of policy recommendations, emphasis has therefore been put on growing evidence that successful and lasting consolidation appears to occur when the bulk of the adjustment takes place on the expenditure side, both in terms of sustaining an improved budget balance and achieving a positive growth effect ⁽¹⁾. Section 5.1 will continue this analysis by investigating the interaction between budgetary institutions that foster expenditure control and fiscal consolidation on the expenditure side of the budget.

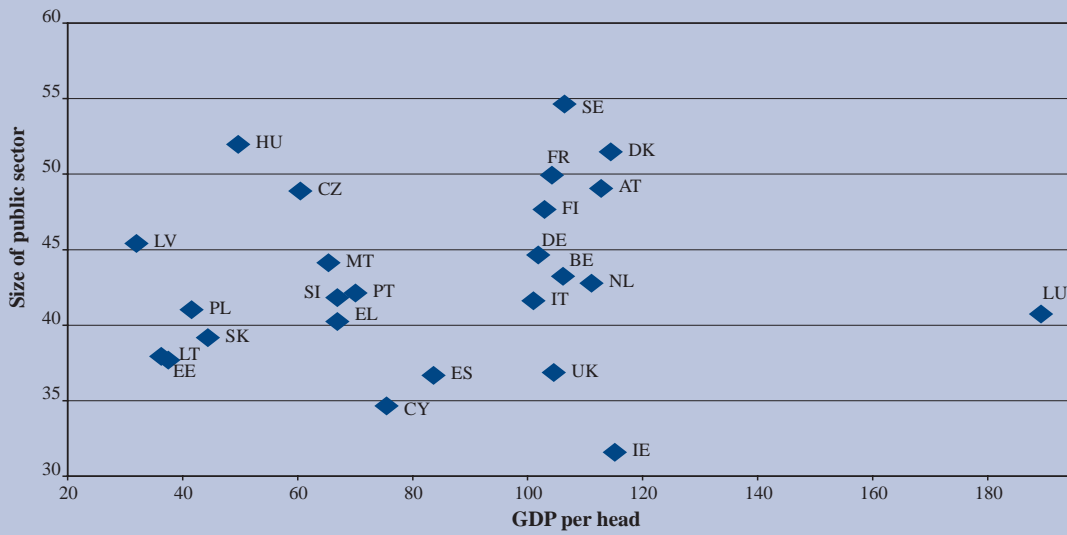
⁽¹⁾ See also European Commission (2000a) on the factors determining the success of a budgetary adjustment.

Graph IV.3: Catching up: Initial income and growth rates



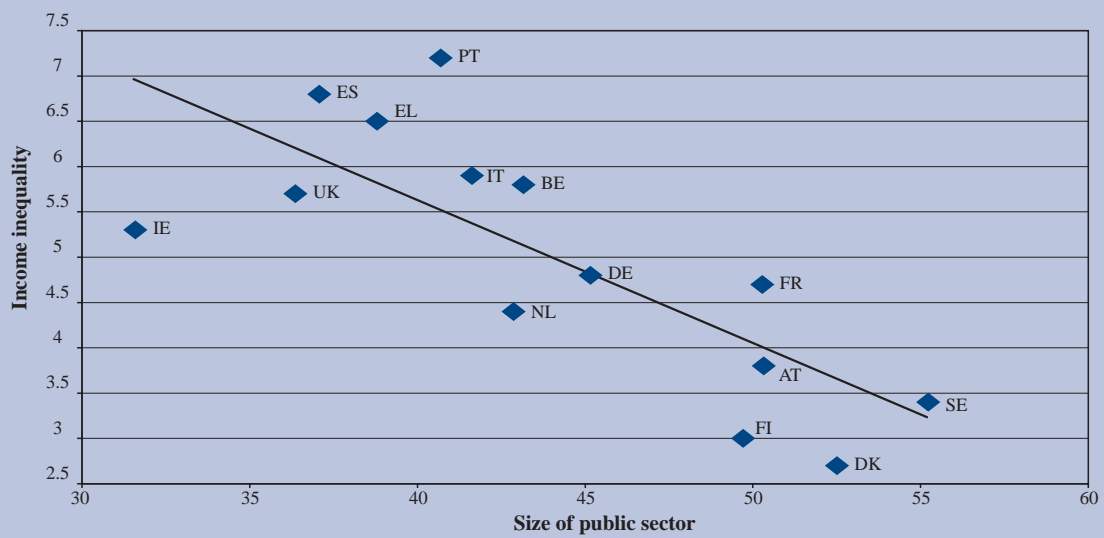
NB: Real growth as an average of 1998–2002 and initial GDP per head is measured in PPS (EU-15 = 100) as an average over 1993–97.
Source: Commission services.

Graph IV.4: Wagner's law: Income per capita and size of the public sector



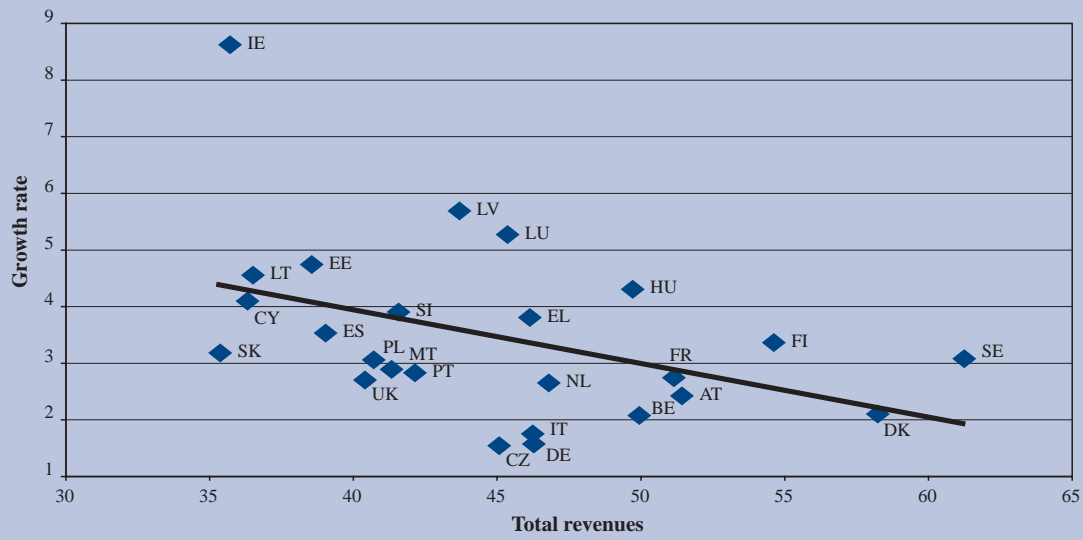
NB: Size is measured as primary expenditure as a percentage of GDP. GDP per head in PPS (EU-15 = 100). Figures shown are averages 1998–2002.
Source: Commission services.

Graph IV.5: Preferences: Size of the public sector and inequality of income distribution



NB: Figures are for 1998. Inequality of income distribution is measured as the ratio between the top (highest income) 20% of a Member State's population and the bottom (poorest) 20% of the Member State's population. Size is measured as cyclically adjusted primary expenditure in 1998.
Source: Commission services.

Graph IV.6: Distortionary taxation: Total revenues and growth rates



NB: Total revenues as a percentage of GDP and real growth rate are averages 1998–2002.
Source: Commission services.

4. A microeconomic perspective on quality

4.1. Institutionalising quality within the budget process

The ‘top-down’ macroeconomic perspective on quality helps to underpin the strategic importance of redirecting public expenditure towards ‘productive’ uses and reducing distortionary taxation in order to raise the growth potential of the EU economy. At the same time, it can only provide for broad generalisations on the question of separating ‘productive’ from ‘unproductive’ expenditure in practice. This is exactly where the ‘bottom-up’ approach of the microeconomic perspective becomes useful as it provides the tools needed to support decision-making in practice. This entails a shift in focus from cross-country differences in fiscal aggregates towards the techniques and institutions that can be used to improve the quality of public finances, i.e. the effective and efficient use of resources in reaching strategic priorities. In particular, it will be shown in this section that the technique of cost-benefit analysis (CBA) provides for the essential criterion for distinguishing between ‘productive’ and ‘non-productive’ public investment in practice. Furthermore, the fiscal institutions for performance-budgeting help to focus on strategic objectives and the most efficient use of resources in reaching them, irrespective of the specific topic they are applied to. In fact, full CBA is especially relevant for large investment projects with a long time horizon, while performance-budgeting offers the opportunity of extending the use of cost-benefit comparisons to all or to a large part of government expenditure, by systematically relating the benefits of government intervention (what is the objective?) to its costs (i.e. public expenditure to reach a particular policy outcome).

Developing such mechanisms for balancing costs and benefits at national level is especially relevant for the ministries of finance given that budgeting is subject to a common pool problem. From the perspective of an individual spending ministry or from the perspective of a local government, the benefits of extra spending can usu-

ally be readily identified while at the same time the costs will be less visible given that they are spread out over the public at large. The consequence is that individual ministries or local governments may fail to internalise the full costs when making their spending bids and may thereby create a continuous pressure for increasing the size of the public sector. With limited resources available and pressures on the expenditure side likely to increase further, a strong role for the ministry of finance to internalise the costs of all extra spending and to increase the efficiency of government intervention becomes more important, and with it the development of mechanisms that institutionalise the process of doing so. In this respect, fiscal rules that ensure overall fiscal sustainability need to be complemented with institutions that ensure the effective and efficient use of funds within overall budget constraints. The national fiscal rules for controlling public expenditure in a medium-term framework have already been discussed in European Commission (2003), so that the analysis in this part can concentrate on the ‘quality’ side of the matter.

4.2. Cost-benefit analysis

4.2.1. Micro versus macro

As an introduction to CBA, it may be useful to clarify how the macroeconomic and the microeconomic perspective on quality are related. According to economic theory, what matters in the end is an allocation of resources that maximises social welfare. This allocation, in turn, depends on the social welfare function, which itself reflects the preferences of individuals (hence, the social welfare function can contain ‘traditional’ economic variables such as the level and distribution of income but also ‘broader’ aspects of the quality of life including employment conditions, a clean environment and security). However, the problem with applying this approach in practice is that one cannot measure interpersonal utility directly in a way that allows a comparison across different individuals. As a result, it is also not possible to measure social welfare in a direct way.

Macroeconomic and the microeconomic approaches offer different ways to solve this problem. Macroeconomic studies concentrate on the contribution of fiscal policy to long-term growth and thereby to social welfare by assuming that growth is an intermediate objective that increases welfare. Applied microeconomic studies, on the other hand, solve the problem that the social welfare function is non-discernable in another way and judge the contribution of individual projects to social welfare relative to the base case, i.e. what would have happened in the absence of the project. Hence, the macroeconomic and the microeconomic approaches take a different route towards the same ultimate objective of maximising social welfare.

In this respect, it should also be noted that the philosophy underlying both approaches is very similar. Firstly, in the macroeconomic approach the ability of fiscal policy to have an impact on long-term growth depends on the presence of externalities, which provide the reason why government intervention might be ‘productive’. In the same vein, in cost-benefit analysis the key issue in determining whether public investment is ‘productive’ is to take social costs and benefits into account, including externalities. Secondly, the sections on the macroeconomic approach have stressed the importance of taking both the benefits of public expenditure and their financing costs into account in determining the overall impact of government intervention. CBA does the same and applies the principle not to the economy as a whole but to individual projects instead.

4.2.2. Identifying ‘productive’ public investment

Microeconomic theory provides for a rather nuanced answer to the question of what is ‘productive’ government intervention given that — at the margin — a ‘productive’ project is a project for which the social benefits exceed the social costs (i.e. it creates a ‘social surplus’). For each individual project, CBA examines whether this criterion has been met in calculating its net present value by discounting future social costs and benefits. Put differently, the basic technique and the economic principles of CBA are the same whether applied to, for example, industrial estates and technology parks (with positive social benefits such as the diffusion of entrepreneurial knowledge and the birth of new productive companies and possible negative environmental costs such as noise and pollution), health infrastructure (with positive social benefits such as avoided lost working days due to ill health), infrastructure networks (with positive social benefits such as time saved or increases in local earnings

due to the setting-up of new enterprises and negative externalities such as those related to environmental impact).

A comprehensive theoretical description of the use of CBA is outside the scope of this report ⁽¹⁾. Several issues are worth mentioning, however, before concentrating on an empirical discussion of the use of CBA across EU countries in Section 4.2.3.

Firstly, the difference between CBA and cost-effectiveness analysis. In cost-benefit analysis, the identification of different project alternatives is essential: the method aims at valuing net costs or benefits of different projects to society and then selecting the best option. Cost-effectiveness, on the other hand, is a method of evaluation that compares the costs of alternative ways of producing the same output. Thus, cost-effectiveness analysis does not include the first step of selecting the best projects and starts with the step of producing the output at the lowest costs. Therefore, CBA is the appropriate method for an economic analysis of different options of reaching a particular objective of government intervention, while cost-effectiveness analysis could be used when benefits cannot be valued.

Secondly, the valuation of non-market costs and benefits. The aim of CBA is to value all costs and benefits of a particular project in order to calculate the net social surplus. Obviously, the process of valuation could be based on market prices where available. However, the common rationale for government intervention is to provide services that are not provided efficiently by the market, so how to value costs and benefits for which no market prices are available? This question goes to heart of the economic rationale of CBA. In essence, the available techniques aim at simulating a market and inferring a value either by using revealed preference techniques or stated preferences. Revealed preferences are based on existing markets and observed prices. From this, implicit prices for non-market aspects are inferred, for example by studying the effect of noise on housing prices. Stated preferences are based on the response to questionnaires, either on the basis of questions that ask for direct valuation or asking preferences and then inferring a value. Naturally, each method has its pros and cons. The scientific basis of revealed preferences is stronger than that for stated preferences, and its results are less easy to

⁽¹⁾ For a theoretical discussion, see Drèze and Stern (1987).

manipulate, but the information required to apply it may not always be available. In practice, the application of these techniques is the topic of specialised research in different sectors (e.g. valuing health benefits, environmental impacts and time saved as a result of infrastructure investment). A recurrent theme in the empirical applications is that the uncertainty margins in various estimates may be large. Obviously, this complicates to some extent the use of CBA in practice and highlights the importance of carrying out sensitivity analysis as a part of CBA ⁽¹⁾.

Thirdly, the inclusion in CBA of considerations related to the distribution of income. The standard (normative) criterion underlying CBA is whether or not the project creates a social surplus. A policy creates a social surplus if it leads to a potential Pareto improvement which implies that the ‘winners’ of a project or policy could in principle compensate the ‘losers’ so that the ‘losers’ are at least as well off as in the base case and the winners are better off. In the standard approach, the change in the social surplus simply adds up costs and benefits without considering the distribution of those costs and benefits. However, the effects of different projects on social welfare may depend also on the distribution of the costs and the benefits, given that the marginal utility of extra income may depend on the income of an individual. As a general rule, it is often assumed that as income is doubled, the marginal utility of consumption to individuals falls by half (HM Treasury, 2003; European Commission, 2002). Thus, the traditional criterion in CBA of simply maximising aggregated income has come under criticism given that distributive effects should also be taken into account. There are two ways to do so. The first is to adjust the weighing of costs and benefits for different income groups so that costs and benefits to low-income groups would receive a higher weight. In this way, effects on the distribution of income are taken into account within CBA. The second is to continue to use base CBA on the criterion of maximising aggregate income, to evaluate the redistributive effects of the project separately and then to combine all information in the final decision-making process.

Fourthly, the role of CBA in the decision-making process. CBA can be useful in all stages of the decision-

making process. During the first phase of identifying the options, a full CBA may not be feasible for each option, given the large amount of information that is required to make a complete CBA. A pre-feasibility study may help to concentrate on the most promising alternatives. A full CBA should subsequently be prepared in order to allow a well-informed final decision. However, in practice not all costs and benefits can always be valued and the decision-maker may want to consider additional objectives to the one used in CBA of maximising generalised income (for example the distribution of income if it has not been reflected already in the CBA). These effects have to be reported separately as they cannot be included in the CBA. A common technique for including additional objectives in the decision-making process is through multi-criteria analysis. This involves the identification of additional objectives, weighing them and then ranking different projects in terms of their impact on the weighed objectives. However, the process of introducing additional objectives and weighing them inevitably increases subjectivity in the decision-making process. It should reflect political priorities, therefore, and cannot be made by technical experts carrying out CBA.

4.2.3. Cost-benefit analysis: Learning from international experiences

In principle, the use of CBA allows for the comparison across projects in their contribution to social welfare. In practice, however, methodological differences in the application often complicate such comparisons. Therefore, at the national level, many countries have undertaken efforts during the last years to harmonise the methodology used for project appraisal. For example, in the Netherlands a large-scale research project was undertaken on the use of CBA in analysing large infrastructure projects with the aim of improving the scientific basis for decision-making. The project resulted in a broad consensus on the importance of cost-benefit analysis in the evaluation of major infrastructure projects and on the outlines of the way in which such analysis needs to be made (Centraal Planbureau, 2000). In the United Kingdom, the new edition of the ‘Green book, appraisal and evaluation in central government’ (HM Treasury, 2003) incorporates revised guidance to encourage a more thorough, long-term and analytically robust approach to appraisal and evaluation. It is relevant to all appraisals and evaluations and states that the relevant costs and benefits to government and society of all options should be valued, and the net benefits or costs calculated. Furthermore, at the level of the EU, CBA of investment projects is explicitly required for larger projects concern-

⁽¹⁾ In addition, the pooling of knowledge in overview studies can also be useful for improving the estimates (an example is in the transport sector, ECMT, 1998), although it should always be kept in mind that estimated values depend on the context in which they were estimated.

ing the Structural Funds, the Cohesion Fund and the instrument for pre-accession countries. While Member States are responsible for the prior appraisal, the Commission has to evaluate the quality of this appraisal in order to admit the project proposal to co-financing and to determine the co-financing rate. In this context, the Regional Policy DG has recently updated its guide for CBA of investment projects (European Commission, 2002b). It indicates that, despite differences of procedures and methods among the different funds, the economic logic of analysis and the methodology should be homogeneous.

In sum, both at the national level and also within the European Commission efforts have been undertaken to improve the use of CBA as a decision-making tool for identifying 'productive' projects. At the same time, comparative cross-country research on the use of CBA is hard to find. A rare example is Florio (2003), which compares differences in the financial and economic rate of return of investment projects sponsored by the European Union, the EBRD and the World Bank. Its main finding is that cost-benefit analysis generates larger variability of rates of return than financial analysis. The suggested interpretation is that while for financial analysis the techniques are fairly standard across sectors, techniques in cost-benefit analysis (and valuing externalities in particular) are less uniform. The authors therefore call for international comparative research into the methods used across countries, sectors and institutions.

A rare example of such a comparison across EU countries is the study by Dings et al. (2000). It contains a comparison of differences and similarities of the use of CBA for large infrastructure projects in Germany, France, the United Kingdom, Denmark and the European Commission. It finds that in all cases the use of CBA is standard practice or prescribed by law. There is an increasing acceptance of CBA as a decision-making tool and in most individual projects studied CBA played an important role in the political decision-making process. Furthermore, it also finds that the EU fiscal framework, in setting out the rules for fiscal discipline, has played an important role in increasing the acceptance of CBA. It has enhanced the awareness of the importance of fiscal discipline and thus of the need of a well-structured decision-making process. In all countries, projects have been undertaken that aim at refining the methodology. More recent revisions of CBA have increased the degree to which externalities are being valued. However, in line with Florio (2003), the results suggest that the largest part of the uncertainties in the cal-

ulation is still due to difficulties and variations in the valuation of externalities.

Another line of research concentrates on the inputs into CBA and compares estimated costs with actual costs. Flyvbjerg et al. (2002) built a database of 258 infrastructure projects and found that costs are underestimated for almost 9 of out 10 projects. For the sample as a whole, actual costs are on average 28 % higher than estimated costs, while for the 181 projects located in Europe, the average cost escalation is 26 %. Cost underestimation appears to be a global phenomenon and has not decreased over the past 70 years. The implication of such systematic misrepresentation at the time of decision-making is a decrease in the quality of public finances, since non-viable projects might go ahead, while alternative viable projects might not go ahead. Thus, the consequences are a less efficient allocation of resources and a decrease in social welfare. In explaining the phenomenon, the authors point out that the incentive structures for large projects may be geared towards underestimation of costs. When a project goes forward, the groups that benefit can be readily identified (engineers, contractors, bankers, landowners, construction workers, lawyers, developers), while a large part of the costs would be spread out over the public at large. In fact, this is an example of the 'common pool' problem as referred to in Section 4.1 ⁽¹⁾. Thus, it would seem that ministries of finance have a key interest in improving the incentive structure in the decision-making process, by improving checks and balances and by involving independent specialists in carrying out the projections underlying CBA ⁽²⁾.

Overall, an appropriate conclusion therefore seems to be that many efforts have been undertaken at national level to improve the consistency and scope of available techniques to better distinguish between 'productive' and 'unproductive' projects, thereby improving the quality of public finances and contributing to a more efficient allocation of resources. At the same time, the evidence suggests that further improvements can be made, in particular with respect to the valuation (in monetary terms) of social costs and benefits in different sectors and the incentives in the decision-making process that lead to a systematic optimism bias. This suggests that there may

⁽¹⁾ The theory of the common pool problem has also been applied to the relationship between the Ministry of Finance and individual spending ministries in Hallerberg (2004) and to the interaction between the central government and local governments in Rodden et al. (2003).

⁽²⁾ In this respect, HM Treasury (2003) requires that optimism bias should be accounted for explicitly in all appraisals.

be scope for learning from international experiences by involving national experts that have been involved in projects of improving the consistency in the methodology of CBA and its application to improve the decision-making process in practice.

4.3. Performance-budgeting

4.3.1. Budgetary institutions: Inputs, outputs or outcomes?

As indicated, CBA is used especially for large investment projects with a long time horizon. The concept of quality does not only apply to public investment, however, as it requires that all public expenditure is used to achieve the priorities of society (such as a sustainable development) in the most efficient and effective way. A starting point of the analysis could be the observation that a government that aims at maximising the social welfare of its citizens needs to be constantly informed about the preferences of its citizens and needs to respond to changes in preferences. This is particularly relevant in a context where preferences change over time due to changes in technology, demographics and social structures. It is also relevant in a context where resources are scarce so that their best uses have to be found within a fixed budget constraint. The application of traditional budgeting sometimes created problems in this context. Firstly, a focus on inputs in the budget provides no visibility on how successful a programme is in achieving its objectives. Secondly, it does not allow consideration of alternative and possibly more efficient ways to achieve the same objective. Hence, in response, several countries have explored ways in recent years to shift attention outwards and to increase the responsiveness of the delivery of goods and services in line with changing preferences. A prominent development has been a (renewed) interest for structural reforms to the budget process that aim at strengthening the link between the allocation of resources and performance in reaching stated objectives. A central idea has been that a clearer focus on outputs or policy outcomes⁽¹⁾ may improve the efficiency and effectiveness of the use of scarce resources so that savings can be achieved while at the same time performance in achieving policy objectives would be maintained or even improved.

The question, of course, is whether these reforms have indeed produced the desired effects. The discussion on this question can be summarised on the basis of the three main elements of performance-budgeting as identified by the OECD (2003):

1. A clear ex ante specification of the performance (outcomes/outputs) expected for each programme or agency

The relevant question is whether and how policies contribute to the objectives of government intervention (i.e. outcomes). In practice, however, it may not always be possible to describe policy outcomes in a measurable and specific way. In some cases outcomes can only be achieved over many years, or can only be described in a general way (for example, improving human capital). Furthermore, policy outcomes may be affected by a range of factors outside the direct control of a particular government agency. In this respect, outputs may be more easy to control and specify (for example, years of education or use of R & D funds), but at the same time a focus on outputs might distract attention from the original reason for government intervention. In addition, it has been pointed out that there may be a danger of a certain degree of over-emphasis on objectives that can be quantified at the expense of objectives that cannot be so easily quantified (Smith, 1995). However, applications of performance-budgeting in practice recognise that formulating measurable outcomes may not always be possible and therefore do not establish direct causal links between performance and budget appropriations.

2. Devolution of decision-making authority and freedom to reallocate funds towards 'productive' items

The philosophy in performance-budgeting is to shift attention from control *ex ante* on budgetary inputs to accountability *ex post* on the basis of results. A relaxation of input controls can give managers and agencies more freedom to use their expertise in finding and designing the best programmes. In return they will be held more accountable for the achieved results (Schick, 2003). Furthermore, there are two preconditions for an approach of relaxing input controls (Diamond, 2003). Firstly, every agency should face a tight overall budget constraint within which it can operate, since increased flexibility requires certainty over the funds that are available to reach the stated targets. Therefore, steps towards performance-budgeting have usually been taken in parallel with introducing or strengthening medium-term expenditure frameworks. Secondly, it also requires the

⁽¹⁾ Outcomes refer to policy impact, while outputs measure production or services delivered.

capacity in the central budget office to monitor developments and to intervene if necessary.

3. A link between performance and budget appropriations

The crucial issue is how to link performance and the allocation of resources. In this respect, Schick (2003) distinguishes two definitions of performance-budgeting. Broadly defined, a performance budget is any budget that presents what agencies have done or expect to do with the money provided to them. Strictly defined, a performance budget is only a budget that explicitly links each increment in resources to an increment in outputs or other results.

In practice many countries that measure performance have avoided a direct link between performance and budget appropriations. Canada, Denmark, Finland and Sweden have all introduced initiatives to promote performance without explicitly tying performance to budgeting (Diamond, 2003) ⁽¹⁾. In the same vein, on the basis of evidence for the states in the United States, Moynihan (2003) ⁽²⁾ reports that the links between performance measures and resource allocations are weak. While 47 of 50 states claim to use some form of performance-budgeting, there is no evidence that any state relies on a strict performance system. One reason might be that, if performance cannot be precisely defined, it would be difficult to link funding and performance. In addition, it has been pointed out that even if a programme performs badly, it may continue to be funded if it concerns an essential government function, while a well-performing programme may not receive additional funding if it is considered to be a marginal function of government.

To summarise, much of the literature on performance-budgeting stresses the importance of moving ‘beyond rhetoric’ and to give a balanced assessment of what can and has been achieved. In this respect, Moynihan (2003) points out that performance information is most widely used by managers seeking to improve the operational efficiency of their programmes. Furthermore, performance-budgeting can enrich policy debates and help to identify and prioritise desired outcomes, especially when

embedded in a broader strategy of managing for results. In the same spirit, and on the basis of an early assessment of reform in Australia, France, New Zealand, Sweden and the UK, the OECD (1997) points out that there are strong reasons to believe that ‘restructuring public management’ has brought sizeable efficiency gains, while there is no reason to believe that outcomes have either improved or deteriorated.

4.3.2. Performance-budgeting by EU Member States: An empirical discussion

Table IV.6 shows an overview of current practices in EU Member States with respect to performance-budgeting on the basis of the OECD/World Bank budgeting practices and procedures database. It is based on answers provided by national authorities to the OECD/World Bank survey of budget practices and procedures that was launched in February 2003. In interpreting the data, it should be kept in mind that the OECD and the World Bank are working to improve the questionnaire and the reliability of the answers. Furthermore, answers may give an overview of institutional arrangements in place, but do not give an indication of the extent to which a culture of performance is embedded in national organisations. Institutional reform is not a sufficient condition for improving performance, and it cannot be concluded on the basis of institutional characteristics alone whether one country performs better than the other.

The survey was set up in a way to obtain information on the extent to which countries measure performance and also on the use of the data in the decision-making process. The first three columns in Table IV.6 summarise the extent to which Member States measure performance (i.e. as reported by the countries themselves). When looking at the degree to which performance data are routinely included in budget documentation, and the extent to which this includes performance targets, it turns out that Spain, the Netherlands, Finland, Denmark, Sweden include performance data for a large majority of programmes, while the UK could also be expected to be in this category ⁽³⁾ (although answers given for the UK are incomplete in this respect). The degree to which the performance data include performance targets differs from all programmes in Spain to around 25 % of programmes in Denmark and Sweden. No performance data are included in the budget data in Ireland, Italy, Austria, Por-

⁽¹⁾ In addition, New Zealand and the UK have attempted to employ formal contractual agreements between the government and chief executive offices (New Zealand) or for all main departments covering 130 targets in key areas of government (UK, 2002 spending review) to ensure performance.

⁽²⁾ Based on the findings of research conducted by the government performance project, see www.maxwell.syr.edu/gpp/

⁽³⁾ See UK Treasury website on 2002 spending review and public service agreements: http://www.hm-treasury.gov.uk/spending_review/spend_sr02/psa/

tugal and Hungary, while results for other Member States vary from less than 25 % of programmes in Belgium to more than 50 % in France. The fourth column investigates the question of whether expenditures are specifically linked to output or outcome targets. A large majority of Member States links expenditure to 'some' or 'a few' targets, while Spain and the Netherlands link expenditure to all output or outcome targets. In sum, the whole range of possibilities is observed in practice, from the inclusion of performance data for all programmes to the use of no performance data in budget documentation at all.

The last three columns summarise the use of performance data in the decision-making process. In a majority of countries, performance data are used in determining budget appropriations, but there is no evidence that appropriations are related to results in a direct manner. This is confirmed by answers in the last column, where only three countries indicate that the size of the budget is affected when performance targets are not met. Therefore, among the EU countries that use performance-budgeting, almost all of them seem to use the broad form of performance-budgeting. Results also indicate that politicians generally use performance measures in the decision-making process, although it is not clear how the information is used, and whether this may have affected

the decisions taken. As regards the use of sanctions when performance data are not met (which relates to the question of making managers manage), results generally show that sanctions are absent, or show that compliance with the targets is related to the pay of the persons that are responsible for reaching the targets.

To conclude, the results indicate widely diverging budgetary practices with respect to performance-budgeting among EU Member States. Results range from practices quite close to the strict form of performance-budgeting in Spain, to more broad forms in the Netherlands and the Nordic countries, a middle group of countries which use performance data but not for all programmes and several countries that do not use performance data at all. The wide range of practices would seem to indicate that the scope for learning from international experiences — on the basis of the expertise as concentrated within the OECD — might be large and thereby also the scope for improving the quality of public finances with respect to the identification of key objectives of government intervention and bringing about efficiency savings in reaching them. In particular, this includes the pros and cons of measuring performance for some, most or all programmes and the use of performance data in order to improve the decision-making process.

Table IV.6

Performance-budgeting in EU Member States: An overview

Member State	Are non-financial performance data routinely included in budget documentation?	Do the performance data include performance targets?	Is actual performance against targets reported?	Are expenditures specifically linked to each output of outcome target?	Is there evidence that performance results are used in determining budget allocations?	Is it common that politicians use performance measures in decision-making?	Are rewards and/or sanctions applied if performance targets are met or are not met?
BE	Yes, for less than 25 % of programmes	Yes, for less than 25 % of programmes	Yes, occasional reports for some programmes	Yes, for some targets	Yes, within government organisation/programmes	Yes, the responsible minister	There are no rewards or sanctions
DE	Yes, for less than 25 % of programmes	Yes, for more than 25 % of programmes	Yes, occasional reports for some programmes	Yes, for a few targets	Yes, within ministries; by the Ministry of Finance to decide funding between programmes	Yes, the responsible minister	There are no rewards or sanctions
EL	Yes, for less than 25 % of programmes	Yes, for less than 25 % of programmes	Yes, occasional reports for some programmes	Yes, for some targets	Yes, by the Ministry of Finance to decide funding between programmes	No	n.a.
ES	Yes, for all programmes	Yes, for all programmes	Yes, systematic annual report for most programmes	Yes, for all targets	Yes, by the Ministry of Finance to decide funding between programmes	Yes, the responsible minister; politicians in the budget committee in the legislature; politicians in the committee overseeing the ministry/entity which is supposed to deliver on the performance target	It is reflected in the size of the budget for the department or government organisation/agency
FR	Yes, for more than 50 % of programmes	Yes, for less than 25 % of programmes	n.a.	n.a.	n.a.	n.a.	n.a.
IE	No	No	No	No	No	No	There are no rewards or sanctions
IT	No	No	No	Yes, for all targets	No	Yes, the responsible minister; the Head of Government; the Cabinet	It is reflected in the pay of the heads of ministries/entities with responsibility for delivering the target

(Continued on the next page)

Table IV.6 (continued)

Member State	Are non-financial performance data routinely included in budget documentation?	Do the performance data include performance targets?	Is actual performance against targets reported?	Are expenditures specifically linked to each output of outcome target?	Is there evidence that performance results are used in determining budget allocations?	Is it common that politicians use performance measures in decision-making?	Are rewards and/or sanctions applied if performance targets are met or are not met?
NL	Yes, for all programmes	Yes, for more than 75 % of programmes	Yes, systematic annual report for most programmes	Yes, for all targets	Yes, within government organisation/programmes; within ministries; by the Ministry of Finance to decide funding between programmes	Yes, the responsible minister; the Cabinet	It is reflected in the pay of the heads of ministries/entities with responsibility for delivering the target
AT	No	No	No	No	No	Yes, the responsible minister	
PT	No	No	n.a.	Yes, for a few targets	Yes, within government organisation/programmes	Yes, the responsible minister	It is reflected in the size of the budget for the department or government organisation/agency
FI	Yes, for more than 75 % of programmes	Yes, for more than 75 % of programmes	Yes, systematic annual report for some programmes	Yes, for some targets	Yes, within ministries	No	There are no rewards or sanctions
DK	Yes, for all programmes	Yes, for more than 25 % of programmes	Yes, systematic annual report for most programmes	Yes, for some targets	Yes, within government organisation/programmes; Yes by the Ministry of Finance to decide funding between programmes	Yes, the responsible minister	It is reflected in the pay of the heads of ministries/entities with responsibility for delivering the target
SE	Yes, for all programmes	Yes, for less than 25 % of programmes	Yes, systematic annual report for most programmes	Yes, for some targets	No	Yes, the responsible minister; politicians in the committee overseeing the ministry/entity which is supposed to deliver on the performance target	There are no rewards or sanctions

(Continued on the next page)

Table IV.6 (continued)

Member State	Are non-financial performance data routinely included in budget documentation?	Do the performance data include performance targets?	Is actual performance against targets reported?	Are expenditures specifically linked to each output of outcome target?	Is there evidence that performance results are used in determining budget allocations?	Is it common that politicians use performance measures in decision-making?	Are rewards and/or sanctions applied if performance targets are met or are not met?
UK	n.a.	n.a.	Yes, systematic annual report for most programmes	No	Yes, by the Ministry of Finance to decide funding between programmes	Yes, the responsible minister	Other
CZ	Yes, for less than 25 % of programmes	Yes, for less than 25 % of programmes	Yes, systematic report for some programmes	Yes, for some targets	Yes, within ministries	Yes, the responsible minister	It is reflected in the size of the budget for the department or government organisation/agency
HU	No	No	Yes, occasional reports for some programmes	Yes, for a few targets	No	No	There are no rewards or sanctions
SI	Yes, for more than 50 % of programmes	Yes, for less than 25 % of programmes	Yes, systematic annual report for most programmes	Yes, for some targets	No	No	There are no rewards or sanctions

Source: OECD/World Bank 2003 budgeting practices and procedures database.

5. Expenditure control, reallocation and fiscal consolidation

5.1. Expenditure control, reallocation and fiscal consolidation: Formulating hypotheses

5.1.1. Expenditure control and reallocation

Improving the quality of public finances requires that resources are (re)allocated in line with strategic priorities. In this respect, Section 3.4.3 highlighted that existing trends in public expenditure such as those related to ageing cannot be ignored in the discussion on reallocating funds towards the priorities. In addition, this section investigates the topic of reallocation further. The purpose is to investigate whether and how budgetary institutions can facilitate the process of reallocation. This section formulates hypotheses that will be confronted with available empirical evidence in Section 5.2.

In this context, the previous section already discussed that effective medium-term expenditure frameworks are a precondition for increased managerial flexibility to reallocate funds to their most ‘productive’ uses within broad expenditure classes. In addition, Schick (2002) argues that medium-term expenditure frameworks can also be used to facilitate reallocation between broad expenditure categories. In this case, reallocation should take place not at the level of spending departments, but within the Cabinet when the envelopes for each sector are set, by permitting some sectors increases above the baseline projections while others should produce decreases.

These two aspects of the link between expenditure control and reallocation have been summarised in the two boxes on the left of Graph IV.7. The hypothesis that follows is that only countries with effective control of broad categories of expenditure will be able to pursue a successful strategy of giving managers the freedom to reallocate resources within broad expenditure catego-

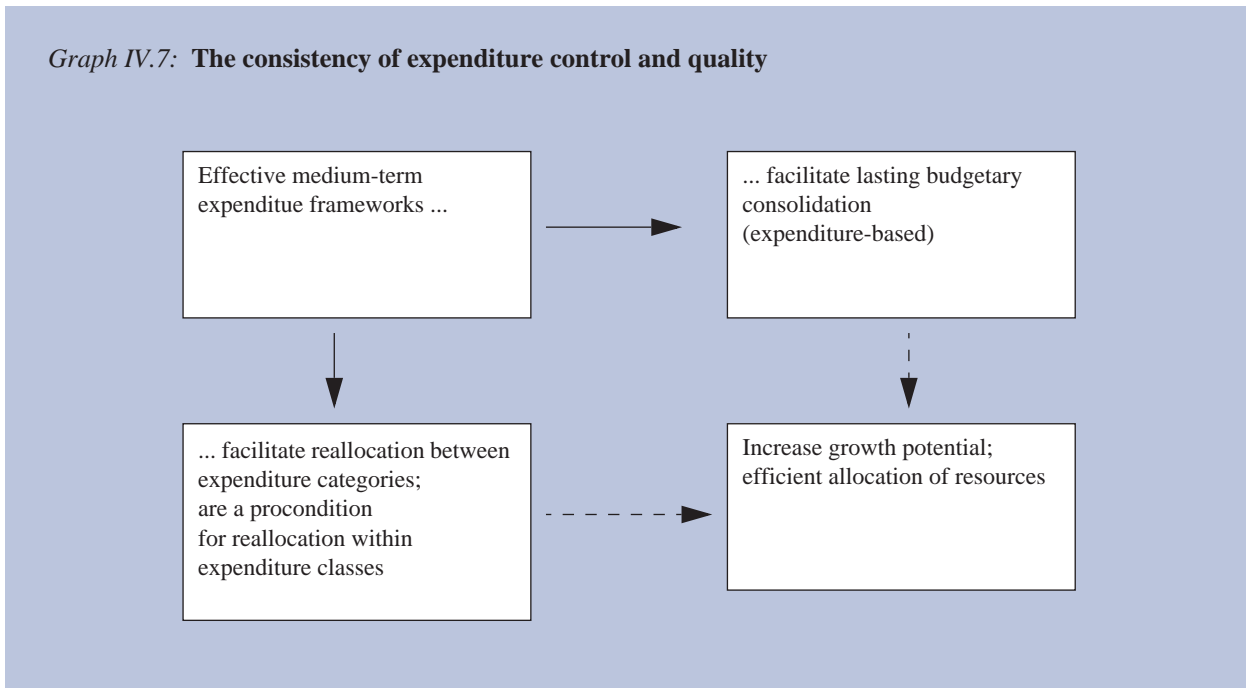
ries. This hypothesis is relevant given that managing and budgeting for performance — if implemented through proper sequencing — may possibly lead to sizeable efficiency gains (Section 4.3.1). In addition, it also contains the hypothesis that the use of these medium-term expenditure limits for each spending sector or major spending department may facilitate reallocation between broad expenditure categories. In essence, these hypotheses focus on ways to better spend (allocate) a given amount of public money (resources), whereby reallocation towards ‘productive’ items can be one element of a strategy for increasing the growth potential.

5.1.2. Expenditure control and fiscal consolidation

Apart from the recommendation to reallocate funds towards identified priorities, previous policy recommendations have also focused on the topic of ‘high quality’ fiscal consolidation. As indicated also in Section 3.5, the available evidence seems to suggest that fiscal adjustments based on expenditure cuts are more likely to coincide with higher growth rates than consolidation periods based on tax increases. Furthermore, Alesina and Ardagna (1998) point out that fiscal consolidation efforts based on expenditure cuts, especially where they focus on reducing transfers and government wages, are more likely to have a lasting effect on budget deficits than consolidations based on higher revenues. If, in turn, such a lasting reduction in budget deficits translates into a permanent reduction in budget deficits, then it should lead to increased capital accumulation and translate into a higher per capita potential output (see Part III of this report).

A previously unaddressed question is whether and how budgetary institutions might facilitate expenditure-based fiscal consolidation. An obvious starting point would be to ask whether a stronger institutional setting for controlling expenditure facilitates expenditure-based fiscal con-

Graph IV.7: The consistency of expenditure control and quality



consolidation. Thus, the top two boxes of Graph IV.7 contain the hypothesis that countries with more effective medium-term expenditure frameworks might be able to better control public expenditure and thus might be more likely to show fiscal consolidation on the expenditure side of the budget than countries with less effective institutions for controlling public expenditure.

As is shown in Graph IV.7, the combination of these hypotheses indicates how effective control of public expenditure through properly designed medium-term expenditure frameworks might foster not only fiscal discipline (see also European Commission, 2003) ⁽¹⁾ but also the quality of public finances by facilitating the reallocation of existing funds as well as lasting expenditure-based fiscal consolidation.

5.2. Expenditure control, reallocation and fiscal consolidation: Empirical discussion

Table IV.7 confronts the hypotheses of Graph IV.7 with available empirical data. The first column is taken from

the survey into national medium-term expenditure rules in European Commission (2003a). It summarises the experience with expenditure rules in EU countries. As can be seen in Table IV.7, in the Netherlands, Austria, Finland, Sweden, and the UK there was a general perception ⁽²⁾ that the expenditure rules had contributed to expenditure control. Overall, these countries were characterised by expenditure rules that were more binding and more ambitious than in other countries.

The second and third columns refer to the question whether fiscal consolidation efforts were balanced towards the expenditure or the revenue side of the budget and whether the consolidations were lasting. A practical question is which definitions to use for consolidation periods and lasting effects. As argued in European Commission (2003a) the definition of fiscal consolidation can be based either on the size of the fiscal consolidation or on the persistence of the fiscal consolidation. The second column uses a definition based on the size of fiscal consolidation, in line with definitions used in the literature ⁽³⁾. In this way, the table focuses on large consolidation efforts in a single

⁽¹⁾ European Commission (2003a) also addresses the consistency between expenditure rules and automatic stabilisation, by allowing the automatic stabilisers to operate on the expenditure side.

⁽²⁾ Given the difficulty of isolating the impact of expenditure rules on expenditure trends from other relevant factors, the survey asked for a summary statement on the experience with the expenditure rules.

⁽³⁾ See notes under Table IV.7 for the exact definitions.

Table IV.7

Expenditure control, fiscal consolidation and performance-budgeting

Member State	Experience with expenditure rule: Contribution to expenditure control? ⁽¹⁾	Fiscal consolidation expenditure or revenue based? ⁽²⁾	Fiscal consolidation expenditure or revenue based? (alternative definition) ⁽³⁾	Index of performance-budgeting ⁽⁴⁾
BE	Difficult to assess given non-binding status	R (1993)	R (1993–98)	2.25
DK	Difficult to assess given specification of average target over several years		E (1996–99)	4.25
DE	No		R (1993–94) R (1996–99)	2.125
EL	Difficult to assess	E (1994)	R (1993–94) R (1996–98)	1.75
ES	Too early to assess		E (1996–97) R (2001–03)	5.5
FR	No		R (1994–97)	n.a
IE	Rule abandoned		R (2003)	0
IT	Too early to assess	R (1997)	R (1993) R (1997)	2
NL	Yes	R (1993)	R (1993) E (1996)	5.25
AT	Yes		E (1995–97) E (2000–01)	0.5
PT	Too early to assess	R (2002)	R (2002–03)	1.75
FI	Yes	E (2000)	E (1998–2000)	3.25
SE	Yes	E (1996)	E (1994–98)	3.125
UK	Yes	E (1997–98)	E (1994–99)	n.a.

⁽¹⁾ European Commission (2003a), Table V.3.

⁽²⁾ Definition of fiscal consolidation: the primary cyclically adjusted budget balance improves by at least 2 percentage points of GDP at time *t* or by at least 1.5 points in two consecutive years.

⁽³⁾ Definition of fiscal consolidation: any period in which the primary cyclically adjusted budget balance shows a cumulative improvement of at least 1.5 percentage points and in which the budget balance does not deteriorate in a single year.

⁽⁴⁾ Index as calculated on the basis of Table 7, where scoring for the first four columns/questions in Table 7 is based on the percentage of programmes (e.g. 0.5 points if performance data are included for more than 50 % of programmes) and scoring is based on answer of 'yes' or 'no' in last three columns (i.e. 0.5 points for yes and 0 points for no).

Source: Commission services.

year or in two consecutive years. The outcome shows that, where countries with stronger expenditure control consolidated, the efforts were indeed balanced towards the expenditure side (i.e. in Finland, Sweden and the UK). An exception is the Netherlands that showed a consolidation on the revenue side in 1993, which can be explained by the fact that this was one year before the introduction of its expenditure rules in 1994. However, a problem with the definition on the basis of the size of the consolidation is that only a few observations are available since expenditure rules were introduced in most Member States in the 1990s. Therefore,

the third column uses an alternative definition that significantly reduces the size of the consolidation in a single year and stresses the persistence of the fiscal consolidation over consecutive years. The justification for using this definition could be that if fiscal institutions would have an impact on the composition of fiscal consolidation, one might expect a gradual, structural and lasting impact, while any large fiscal consolidation in a particular year might be expected to be due more to political factors. The outcome in the fourth column of Table IV.7 now shows that in all countries with stronger expenditure control periods of fiscal consoli-

dation were expenditure-based, including the Netherlands that switched to expenditure-based consolidation after the introduction of its expenditure rule in 1994. In almost all other countries, periods of fiscal consolidation were balanced towards the revenue side. In interpreting these results one should keep in mind, however, that the causality may not necessarily run from expenditure frameworks to expenditure-based consolidation, since it might also be that countries with stronger preferences for expenditure-based consolidation have introduced more effective expenditure frameworks to implement such strategies.

In addition, if the control of broad classes of expenditure is indeed a precondition for the devolution of managerial power within these classes, as part of a strategy of managing and budgeting for performance, the Netherlands, Austria, Finland, Sweden, and the UK would be candidates for pursuing such strategies. Furthermore, other candidates could be Spain, which introduced expenditure ceilings for the first time in 2003 so that its contribution to expenditure control could not yet be assessed and Denmark, which used an ambitious expenditure target but formulated it over a number of years and also changed it during those years so that it became difficult to assess its effectiveness.

In this respect, Section 4.3.2 concludes that apart from Austria ⁽¹⁾ all these countries are using strategies of performance-budgeting. This conclusion is repeated in the third column of Table IV.7 on the basis of a simple index of performance-budgeting. The crucial question, of course, is whether these institutional reforms have led to efficiency savings and a more effective use of resources. As indicated already, available studies point to the importance of moving ‘beyond rhetoric’ while still indicating that efficiency gains can be sizeable. Unfortunately, the hypothesis that expenditure control facilitates reallocation between broad categories could not be tested due to a lack of available data.

Taken together, these results indicate that controlling public expenditure may be an important precondition for improving the quality of public finances. Establishing fixed budget constraints for broad classes of

expenditure may support a better use of expenditure within these fixed constraints. When needed, it may also facilitate the political decision-making process for reallocation expenditure between these categories in line with changing priorities and support a strategy of expenditure-based fiscal consolidation.

5.3. The return of politically motivated fiscal expansions?

In interpreting the results of the previous paragraph, it should be kept in mind that the introduction of institutional arrangements is not a sufficient condition for strengthening either expenditure control or performance, since institutions can be effective only when they are supported by political will and by a culture of budgeting for discipline and performance. In order to illustrate this point, Table IV.8 shows developments in cyclically adjusted primary public expenditure in recent years. It appears that many of the countries with positive experiences with expenditure rules have slackened the reins in recent years, since the UK, Sweden and the Netherlands and to a lesser extent Finland and Denmark all show a recent substantial

Table IV.8

Cyclically adjusted primary expenditure

(% of GDP)

	2000	2003
BE	42.9	45.7
DK	51.1	52.7
DE	44.9	45.7
EL	42.0	41.5
ES	36.8	36.9
FR	49.8	51.8
IE	30.6	33.4
IT	41.6	43.6
NL	43.2	45.3
AT	49.0	47.8
PT	42.3	44.9
FI	46.9	48.6
SE	53.7	56.7
UK	36.7	40.7

Source: Source: Commission services.

(1) In this respect it should be pointed out that Austria did not use a rule that aimed at controlling broad classes of expenditure. Instead, it used a rule that focused on administrative expenditure at the central level of government (i.e. planned cuts in personnel). See European Commission (2003a), Table V.3.

upward movement in public expenditure ⁽¹⁾. In other words, countries that have created room for manoeuvre through prudent behaviour in the past seem to have used at least part of it in recent years. The reasons for the expansionary periods may be different — such as an expansion in expenditure after years of high growth and in the face of elections in the Netherlands or decisions to follow an expansionary policy as

in the UK — but results are similar: a weakening of fiscal discipline so that two of these countries are now close to or above that 3 % limit of the EU fiscal rules and may have (had) to prepare themselves again for new rounds of fiscal consolidation. More generally, the erosion of political ownership of the discipline rules has also been analysed in political-economy terms in Buti and Giudice (2002) and Buti and van den Noord (2003), where it is stated that short-term gains at the national level of higher deficits may have outweighed the systematic costs in violating the rules.

⁽¹⁾ In addition, Ireland, Belgium, Portugal, France and Italy also show substantial increases on the expenditure side in recent years.

6. Conclusion

According to the definition as proposed in this part, enhancing the quality of public finances requires the allocation of budgetary resources and the effective and efficient use of those resources towards identified strategic priorities. With respect to the priorities, the analysis in this part concentrates on the link between fiscal policy and long-term growth. Overall, it confirms the relevance of reallocating public expenditure towards ‘productive’ uses and lowering the burden of distortionary taxation in a context where priority is given to raising the growth potential of the EU economy. At the same time, it stresses the importance of microeconomic analysis on the question of separating what is ‘productive’ from what is not.

If priority is given to stepping up the debate on the quality of public finances at the level of the EU, it

seems necessary to start with the exchange of information with respect to national priorities regarding the composition of the budget, as well as the development of the budgetary tools and institutions that support decision-making in practice. The aim of this part has been to contribute to such a debate by analysing not only broad trends regarding the composition of public expenditure at macroeconomic level, but also the role of cost-benefit analysis in identifying ‘productive’ investment, the contribution of budgetary institutions to better using existing funds and the role of effective medium-term expenditure frameworks as a precondition for reallocation of expenditure within broad categories, while at the same time facilitating the political decision-making process on reallocation of expenditure between broad categories.

Part V

Member State developments

1. Belgium

In the 2002 update of the stability programme, the target for the general government accounts was a balanced budget. This target was based on much stronger economic growth than actually took place. Still, the budget recorded a small surplus. The budget benefited from a decrease in interest payments and a strict control of expenditures but also from sizeable one-off measures. Without these measures the budget deficit would have stood at about 1 % of GDP. The debt target for 2003 in

the 2002 update of the stability programme was 102.3 % of GDP. The actual debt was even lower at 100.5 % of GDP due to the abovementioned one-off measures, as well as due to some financial operations ⁽¹⁾.

⁽¹⁾ These include the sale of financial assets of Credibe (formerly the Central Mortgage Credit Office) and the reimbursement of loans granted by Fadels (Fund for the Repayment of Social Housing Debt).

Table V.1

Budgetary developments 2002–07, Belgium

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	0.1	0.2	-0.5	-0.7		
— Total revenue	50.5	51.7	49.4	48.6		
Of which: — current taxes	30.6	30.2	29.9	29.3		
— social contributions	16.7	16.4	16.2	16.0		
— Total expenditure	50.5	51.5	49.9	49.4		
Of which: — collective consumption	8.2	8.3	8.3	8.2		
— social transfers ⁽⁴⁾	30.1	30.9	30.8	30.3		
— interest expenditure	6.1	5.6	5.1	4.8		
— gross fixed capital formation	1.6	1.6	1.6	1.7		
Primary balance	6.1	5.8	4.7	4.1		
Pm Tax burden	46.6	45.9	45.4	44.5		
Government debt	105.8	100.5	97.4	94.3		
Pm Cyclically adjusted balance	0.1	0.7	0.0	-0.5		
Pm Cyclically adjusted primary balance	6.2	6.3	5.1	4.3		
Pm Real GDP ⁽³⁾	0.7	1.1	2.0	2.5		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	0.1	0.2	0.0	0.0	0.0	0.3
Primary balance	6.1	5.6	5.1	4.8	4.7	4.8
Government debt	106.1	102.3	97.6	93.6	90.1	87.0
Pm Real GDP ⁽³⁾	0.7	0.9	1.8	2.8	2.5	2.1

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in November 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Belgium.

Fiscal policy as reflected in the 2004 budget and in the most recent updated stability programme is focused on employment promoting measures, notably through the reduction in social contributions. However, the budgetary outcome is also influenced to a large extent by the temporary tax regulation (*déclaration libératoire unique*), the income tax reform and the anticipation of subsidies and transfers to SNCB (railway company). Another important measure is the decision to increase health expenditure by 4.5 % annually in real terms. Further details are given in the accompanying table.

Following weak economic development in 2003, the target for the 2004 budget was revised in the most recent update of the stability programme, which targets a balanced budget, compared to a surplus of 0.3 % of GDP in the previous update. The Commission's spring 2004 forecast projects a deficit of 0.5 % of GDP. The difference between the target in the updated programme and the spring 2004 forecast is not only due to the fact that the Commission only takes into account measures already announced and approved but also a more cau-

tious approach by the Commission. The spring 2004 forecast assumes that no additional revenue is expected from the temporary tax regulation. In addition, it assumes that employment growth is less favourable than expected in the updated programme. According to the forecast, the cyclically adjusted budget moves from a surplus of 0.7 % of GDP to balance in 2004. However, the deterioration disappears if one-off measures are excluded.

The updated stability programme targets a balanced budget in 2005. The spring 2004 forecast on the other hand projects a further deterioration of the budget deficit by 0.2 percentage points, to 0.7 % of GDP, based on the usual no-policy change assumption. This means that the improvement in the business cycle is not enough to offset the loss of revenue from one-off measures.

The debt level is particularly high in Belgium but it is also declining rapidly. A fall by more than 6 percentage points to about 94 % of GDP is projected in the spring 2004 forecast over the period 2003–05.

Table V.2

Main measures in the budget for 2004, Belgium

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Déclaration libératoire unique (0.3 % of GDP) • Income tax reform (-0.2 % of GDP) • Reductions in social contributions (-0.2 % of GDP) • Increase in 2004 in income taxes withheld in 2004 at the expense of 2005 (0.1 % of GDP) 	<ul style="list-style-type: none"> • Bringing forward subsidies and transfers to SNCB from 2004 to 2003 (0.4 % of GDP) ⁽¹⁾

⁽¹⁾ This measure was taken after the budget but it has been included in the forecast.

Source: Commission services and Ministry of Finance and Ministry of Budget.

2. Czech Republic

The general government balance recorded a deficit of 12.9 % of GDP in 2003. This compares with a targeted deficit of 7.3 % set in the 2003 pre-accession economic programme (PEP). The very large deviation from target was mainly due to a one-off imputation of State guarantees to the general government deficit (about 6–7 % of GDP). Without this one-off operation the deficit would be actually lower than planned in the PEP owing to a higher than projected growth and a revised base level for GDP. Government debt was 37.6 % of GDP in 2003.

The State budget for 2004 was approved on 3 December 2004. It reflected the fiscal measures as presented in the 2003 PEP. The three major expenditure-side measures are a cut in the wage bill of the central government

administration, reductions in discretionary spending of individual ministries, and reductions in sickness benefits. These three measures together constitute more than three quarters of all expenditure cuts. On the revenue side, a shift is foreseen in the structure of budget revenues — a reduction in corporate income tax should be more than offset by an increase in VAT and in excise duties. Further details are given in the accompanying table.

The target for the general government deficit in 2004 in the 2003 PEP is 5.9 % of GDP. In the Commission's spring 2004 forecast, the projected outcome in nominal values is slightly worse than the one targeted by the government, but because of the upward revision of GDP, the

Table V.3

Budgetary developments 2002–05, Czech Republic

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance ⁽²⁾	- 6.4	- 12.9	- 5.9	- 5.1
— Total revenue	45.6	45.0	45.0	44.1
Of which: — current taxes	20.7	21.1	21.0	20.7
— social contributions	15.1	15.0	14.8	14.6
— Total expenditure ⁽³⁾	52.0	57.9	50.9	49.2
Of which: — collective consumption	10.9	10.0	9.8	9.6
— social transfers ⁽⁴⁾	23.9	23.1	22.9	22.7
— interest expenditure	1.5	1.3	1.3	1.3
— gross fixed capital formation	4.4	4.2	4.2	4.2
Primary balance ⁽³⁾	- 5.0	- 11.7	- 4.6	- 3.8
<i>Pm</i> Tax burden	35.8	36.2	35.9	35.3
Government debt	28.9	37.6	40.6	42.4
<i>Pm</i> Real GDP ⁽²⁾	2.0	2.9	2.9	3.4

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Annual % change.

⁽³⁾ Including UMTS receipts of 0.09 % of GDP in 2001, 0.02 % of GDP in 2002 and 2003, and 0.16 % of GDP in 2004.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services.

deficit/GDP ratio is the same (5.9 % of GDP). The deviation reflects a less optimistic view on the final outcome of cuts in government consumption. It also takes into account the risk of imputation of a part of remaining State guarantees.

The debt ratio is rather low, at around one third of GDP, but its dynamics is worrying. It jumped from 28.9 % in 2002 to 37.6 % of GDP in 2003. In 2004 and 2005, government debt is expected to further increase from 40.6 % of GDP in 2004 to 42.4 % of GDP in 2005.

Table V.4

Main measures in the budget for 2004, Czech Republic

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Broadening the VAT base • Transferring of some goods and services from the reduced VAT rate (5 %) towards the standard one (22 %) • Increase of the excise duty on spirits and tobacco • Reduction of the corporate income tax rate (from 31 % in 2003 to 24 % in 2006) • Increase of social security contribution base of self-employed persons (to 50 % of the difference between revenues and costs, instead of the previous 35 %) 	<ul style="list-style-type: none"> • Cuts in the wage bill of the public sector (2 % of public sector jobs are to be lost annually over the period 2004–06) • Reduction in sickness benefits • Cuts in discretionary spending of individual ministries (mainly cuts in military expenditures, in the State subsidy for housing savings programmes, in subsidies to businesses, and in the operating costs of ministries) • Parametric changes in the PAYG pension pillar • Cuts in social assistance and social care benefits

Source: Commission services.

3. Denmark

The general government balance in 2003 is estimated to be a surplus of 1.5 % of GDP. This is below the 2.2 % of GDP target in the 2002 update of the convergence programme. The main reason for the lower outturn is GDP growth, which is estimated to have been 0.4 % in 2003 ⁽¹⁾,

compared to the 2.2 % assumed in the convergence programme update. This comparatively robust surplus is due to the fact that tax revenues remained strong. In particular corporate tax revenues were high. Moreover, as private consumption grew by more than 1 %, revenues from indirect taxes held up relatively well.

⁽¹⁾ GDP growth in 2003 was revised from 0.0 to 0.4 % subsequent to the publication of the Commission's spring 2004 forecast. Table V.5 is based on the Commission's spring forecast, and therefore does not take account of this revision.

The debt/GDP ratio in 2003 was 45 %, compared to the target of 42 % in the update of the convergence programme. The deviation is due to lower than foreseen sur-

Table V.5

Budgetary developments 2002–07, Denmark

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	1.7	1.5	1.1	1.5		
— Total revenue	57.3	57.5	56.9	56.2		
Of which: — current taxes	46.9	47.3	46.8	46.5		
— social contributions	2.7	2.7	2.7	2.6		
— Total expenditure	54.9	55.4	55.8	54.7		
Of which: — collective consumption	7.6	7.6	7.6	7.5		
— social transfers ⁽⁴⁾	36.3	37.1	37.1	36.4		
— interest expenditure ⁽⁴⁾	2.8	2.6	2.5	2.3		
— gross fixed capital formation	1.8	1.6	1.7	1.7		
Primary balance	4.5	4.0	3.6	3.8		
<i>Pm</i> Tax burden	48.9	49.4	49.0	48.5		
Government debt	47.2	45.0	42.3	40.0		
<i>Pm</i> Cyclically adjusted balance	1.0	2.1	1.4	1.5		
<i>Pm</i> Cyclically adjusted primary balance	3.8	4.7	3.9	3.7		
<i>Pm</i> Real GDP ⁽³⁾	1.0	0.0	2.1	2.2		
Convergence programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	1.6	1.2	1.3	1.8	1.9	2.1
Primary balance	2.9	2.3	2.3	2.7	2.6	2.3
Government debt	45.5	42.7	41.2	38.7	36.4	27.5
<i>Pm</i> Real GDP ⁽³⁾	2.1	1.4	2.3	2.2	1.9	1.7

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in November 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and convergence programme of Denmark.

pluses, but also to an upward revision of historical data for consolidated government debt.

The agreement on the budget for 2004 was concluded on 8 November 2003. On the expenditure side, it includes measures to improve transport infrastructure. In line with the agreement with local governments earlier in 2003, the growth in real public consumption is to be limited to 0.7 % in 2004. On the revenue side, the budget incorporated the largest part of the income tax cuts of the tax reform (see Table V.6).

On 23 March 2004, an agreement in the parliament was reached based on the fiscal package presented by the government earlier in the month. The new measures include the full implementation of the tax reform in 2004 (originally planned for 2004–07); the suspension of contributions to a mandatory savings scheme (1 % of gross income) in 2004 and 2005; public investment and social and health spending earmarked for 2005 is brought forward to 2004; increased labour market expenditure on training of unemployed. The direct impact on public finances of the larger tax cuts is, however, to a large extent offset by the fact that the contributions to the mandatory savings are tax deductible, implying that tax revenues will rise when the contributions to the savings scheme are not paid.

The target for general government balance in the year 2004 in the 2003 update of the convergence programme is a surplus of 1.3 % of GDP.

This target has been revised down from 2.2 % in the previous programme update, *inter alia*, due to expected lower revenues as a consequence of tax reductions. The

Commission's spring 2004 forecast foresees a general government surplus of 1.1 % of GDP.

The difference from the target of the 2003 update of the convergence programme is due to the fact that the Commission foresees higher unemployment and incorporates the effects of the March 2004 fiscal package. The fiscal stance in 2004 as measured by the change in the cyclically adjusted balance is a considerable easing relative to 2003. However, it should be kept in mind that the increase in the cyclically adjusted balance in 2003 was not due to tight fiscal policy ⁽¹⁾.

The Commission's spring forecast foresees a rise in the surplus to 1.5 % of GDP in 2005. The forecast is based on a no-policy change assumption, but incorporates the changes brought about by the March 2004 fiscal package, where expenditure and revenue changes are brought forward to 2004. The target for 2005 in the 2003 update of the convergence programme is a general government surplus of 1.8 % of GDP. The difference *vis-à-vis* the Commission forecast is due to effects of the recent fiscal measures and higher labour market expenditure.

Due to the successive general government surpluses, the government debt ratio continues to decline. In the Commission's spring forecast it is projected to fall to 42 % of GDP in 2004 and to 40 % in 2005. This is slightly above the path for the debt ratio foreseen in the last updated Danish convergence programme.

⁽¹⁾ Revenues from corporate taxes and the pension fund yield tax, in particular, tend to be volatile in Denmark and at times weakly correlated to the business cycle, and can thus distort the cyclically adjusted budget balances. The Danish authorities therefore exclude these and certain other revenue items in their calculations of cyclically adjusted balances.

Table V.6

Main budgetary measures for 2004, Denmark

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Full implementation in 2004 of the tax cuts of the tax reform: the level for middle-bracket income tax is raised; an earned-income tax credit is introduced (2/3 % of GDP) • Temporary suspension of (tax deductible) contributions to mandatory saving raises revenues (1/4 % of GDP) • Lower excise duties on alcohol, tobacco, soft drinks 	<ul style="list-style-type: none"> • Bringing forward public investments and health spending • Increased expenditure on training of unemployed • Growth of real public consumption limited to 0.7 %

Source: Commission services, Danish Ministry of Finance.

4. Germany

The general government budget deficit rose from 3.5 % of GDP in 2002 to an estimated 3.9 % of GDP in 2003, thus breaching the 3 % reference value for the second consecutive year. In its update of the stability programme of December 2002, the German authorities had foreseen a deficit of 2 % of GDP for 2003. This was based on expected real GDP growth at 1 % of GDP. In fact, Germany recorded -0.1 % real growth in 2003, which led to considerable tax revenue shortfalls and

higher social spending. Government debt amounted to 64.2 % of GDP, also breaching the 60 % reference value for the second consecutive year.

The budget for 2004 is shaped by four major developments. Firstly, a large reduction in income tax rates as a consequence of tax relief laws passed in 2000 will be implemented. Secondly, structural measures in the public pension and health systems with budgetary

Table V.7

Budgetary developments 2002–07, Germany

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	-3.5	-3.9	-3.6	-2.8		
— Total revenue	45.0	45.0	44.5	44.3		
Of which: — current taxes	22.6	22.7	22.4	22.3		
— social contributions	18.4	18.6	18.5	18.2		
— Total expenditure	48.5	48.9	48.0	47.1		
Of which: — collective consumption	7.9	7.9	7.8	7.6		
— social transfers ⁽⁴⁾	30.6	31.1	30.5	29.9		
— interest expenditure	3.1	3.1	3.1	3.1		
— gross fixed capital formation	1.6	1.5	1.4	1.3		
Primary balance	-0.4	-0.7	-0.4	0.3		
<i>Pm</i> Tax burden	40.6	40.7	40.4	40.1		
Government debt	60.8	64.2	65.6	66.1		
<i>Pm</i> Cyclically adjusted balance	-3.5	-3.2	-3.0	-2.5		
<i>Pm</i> Cyclically adjusted primary balance	-0.4	0.0	0.1	0.7		
<i>Pm</i> Real GDP ⁽³⁾	0.2	-0.1	1.5	1.8		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	-3.5	-4.0	-3 ¹ / ₄	-2 ¹ / ₂	-2	-1 ¹ / ₂
Primary balance	-0.4	-0.9	- ¹ / ₄	¹ / ₂	1	1 ¹ / ₂
Government debt	60.8	64	65	65 ¹ / ₂	65 ¹ / ₂	65
<i>Pm</i> Real GDP ⁽³⁾	0.2	-0.1	1.7	2 ¹ / ₄	2 ¹ / ₄	2 ¹ / ₄

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in December 2003 (with addendum in January 2004), projections are rounded.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and addendum to the 2003 update of the stability programme of Germany.

consolidation effects have been enacted. Thirdly, the government expects large revenues from a tax amnesty on undeclared interest earned abroad. Fourthly, a number of small consolidation measures (reductions in tax allowances and subsidies) have been passed into law.

The budget for 2004 was finalised in late December 2003. As a result, the German authorities provided an addendum to the update of the stability programme in January 2004, which projects a general government deficit of 3 % of GDP as the target for 2004. In the Commission services' spring 2004 forecast, the outcome is projected at 3.6 % of GDP. The difference is mainly due to budgetary developments not foreseen in the update, in particular a low Bundesbank profit in 2003 (which is relevant for the 2004 budget) and the postponement of the road toll to 2005. In addition, the Commission made a cautious assumption on the expected revenue from the tax amnesty. The spring forecast projects the cyclically adjusted deficit at 3.0 % of GDP in 2004, showing an improvement by 0.2 percentage points compared to 2003. This falls short of the reduction projected in the update of the stability programme. The difference can be mainly explained by the subsequent downward revision of

0.2 percentage points of the 2003 deficit and the one-time budgetary effects for 2004 described above.

For 2005, the Commission services project a general government deficit of 2.8 % of GDP, with growth of real GDP at 1.8 %. This is above the German Government projection of a 2 % deficit contained in the updated stability programme, which was based on a growth projection higher by about a percentage point. Under its no-policy-change assumption, the Commission projection incorporates those structural measures for 2005 that were passed into law in 2003. In line with recent developments, it also assumes continuing restraint in the remuneration of public sector employees. This explains the projection of a falling government expenditure share in 2004 and 2005. If growth in 2005 turns out lower than projected or if the structural measures do not show the expected consolidation effect, Germany clearly risks breaching the 3 % reference value in 2005 for the fourth consecutive time.

The Commission's spring 2004 forecast projects the debt ratio at 65.6 and 66.1 % of GDP in 2004 and 2005, respectively. This increase reflects the high deficits and results in the debt ratio remaining above the 60 % reference value both in 2004 and 2005.

Table V.8

Main measures in the budget for 2004, Germany

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Second and part of third stage of income tax rate reduction (– 0.7 % of GDP) • Tax amnesty (+ 0.2 % of GDP) • Basket of reductions in tax allowances • Increase in tobacco tax 	<ul style="list-style-type: none"> • Reduced coverage of public health insurance (– 0.2 % of GDP) • Adjustments in public pension system (– 0.2 % of GDP) • Numerous small cuts in other transfers and subsidies

Source: Commission services, Ministry of Finance of Germany.

5. Estonia

The general government posted a surprise surplus of 2.6 % of GDP in 2003. This compares with a targeted surplus of 0.4 % of GDP in the August 2003 update of the pre-accession economic programme. This positive result was achieved mainly through strong growth of 4.7 %, but also through improved tax collection, despite additional election-induced spending in 2003, and considerable deficits of some local governments (notably Tallinn). This outcome of the general government confirms once again a healthy tendency towards conservative budget forecasts. Government debt represented a mere 5.8 % of GDP in 2003, according to the reporting of government deficit and debt levels submitted in March 2004, and as confirmed by the first Estonian convergence programme of 13 May 2004.

For 2004, the government originally had targeted a balanced general government budget, on the assumption that a strong adjustment phase of domestic demand would set in. The convergence programme, however, suggests that the unexpectedly high level of revenues in 2003 will have a strong carry-over effect on the 2004 budget. Indeed, budget execution figures for the first few months of 2004 suggest once again strong revenue performance. As a result, the general government budget target was revised upwards to a 0.7 % of GDP surplus in the convergence programme.

Tax cuts that are being implemented starting in 2004, along with increased social benefits, and the EU accession-related expenditure requirements are expected to

Table V.9

Budgetary developments 2002–05, Estonia

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance ⁽²⁾	1.8	2.6	0.7	0.0
— Total revenue	39.6	41.2	43.4	42.2
Of which: — current taxes	22.1	23.3	23.7	23.4
— social contributions	12.3	12.3	11.8	11.4
— Total expenditure ⁽³⁾	37.9	38.6	42.8	42.2
Of which: — collective consumption	8.6	9	9.5	8.4
— social transfers ⁽³⁾ ⁽⁴⁾	13.0	13.8	14.6	14.3
— interest expenditure	0.3	0.3	0.3	0.3
— gross fixed capital formation	4.9	4.7	4.5	4.3
Primary balance ⁽³⁾	2.1	2.9	1.0	0.3
<i>Pm</i> Tax burden	34.4	36.1	36.5	35.8
Government debt	5.7	5.8	5.4	5.3
<i>Pm</i> Real GDP ⁽³⁾ ⁽⁴⁾	6.0	4.7	5.4	5.9

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Annual % change.

⁽³⁾ In kind and other than in kind.

⁽⁴⁾ GDP was revised upwards on 18 May 2004, to 7.2 % (from 6 %) in 2002, and to 5.1 % (from 4.7 %) for 2003, following the introduction of new national accounts rules, definitions and classifications fully compatible with ESA 95.

Source: Commission services, Estonian Ministry of Finance.

put some pressure on public finances in both 2004 and 2005. On the other hand, projected higher tax revenues, the introduction or increase of VAT rates and excise duties upon EU accession (implementing requirements of the EU *acquis*), and strict expenditure control are expected to offset part of the budgetary deterioration (see table for details). On the whole, for 2004 a reduced surplus of around 0.7 % of GDP is projected, whereas for 2005 a balanced budget is forecast. Overall, a period of quite significant fiscal easing is envisaged for the early years of EU membership. Estonia is earmarking 11 % of central government expenditure in the 2004 budget for EU-related funding purposes. Following the positive outturn in 2002/03 together with a cautious forecasting strategy, Estonia should for the foreseeable future be in a position to run budgets close to balance or in surplus.

The medium-term fiscal strategy has been presented within the framework of the country's first conver-

gence programme 2004 in May 2004, very much along the lines of the 2003 PEP. Estonia's plans to proceed with the ongoing tax reform are quite ambitious, but cautiously implemented in a sequenced way. They are based on the principles of a simple taxation with a broad tax basis, low tax rates and a low and declining overall tax burden. A proportional personal income tax equals the corporate flat tax rate, whereby for the latter, generous tax exemptions for re-invested earnings are granted, in order to stimulate investment.

Government debt in Estonia is expected to further decrease, from 5.8 % of GDP in 2003 to 5.4 % of GDP in 2004 and 5.3 % of GDP in 2005. Government debt is backed up by a 'national stabilisation' reserve fund of the central government, which amounts to around 3.8 % of GDP. This fund has been built up since 1997 through privatisation receipts and budget surpluses.

Table V.10

Main measures in the budget for 2004, Estonia

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Personal income tax: increase in tax-free thresholds for low income tax bracket (- 1.2 % of GDP) • Increases in excise duties on tobacco, alcohol and fuel (+ 0.6 % of GDP) ⁽¹⁾ • Introduction of heavy vehicle tax (+ 0.05 % of GDP) • VAT: abolition of tax-free trading in shipping and aviation within EU (+ 0.25 % of GDP) ⁽¹⁾ • VAT: introduction of VAT for pre-ordered periodical papers and magazines subscription (+ 0.01 % of GDP) ⁽¹⁾ • VAT: electricity generated by wind and hydro-power lose their VAT-free status, introduction of a 18 % VAT rate (+ 0.002 % of GDP) ⁽¹⁾ • VAT: abolition of VAT incentives for foreign aid and foreign aid loans (+ 0.3 % of GDP) ⁽¹⁾ • VAT: refund to travellers from third countries (- 0.01 % of GDP) ⁽¹⁾ • VAT: change of VAT regime for finance lease (+ 0.3 % of GDP) ⁽¹⁾ • Deferment of moment of VAT taxation, by introduction of VAT clearing system among EU Member States (- 0.55 % of GDP, with one-off accruals effect in 2004) ⁽¹⁾ 	<ul style="list-style-type: none"> • Introduction of parent-benefit scheme (+ 0.4 % of GDP) • Increase in teachers' salaries (+ 0.001 % of GDP) • One-off increase in pensions, in addition to normal indexation (- 0.05 % of GDP) • Introduction of new spending category: Estonian payment to EU budget (+ 0.8 % of GDP) ⁽¹⁾ • EU co-financing, under assumption of full absorption of funds, estimated at 11 % of total government expenditure (+ 3.4 % of GDP) ⁽¹⁾

⁽¹⁾ Introduced upon EU accession, these measures become effective only from 1 May 2004.

Source: Commission services, Estonian Ministry of Finance, Estonian pre-accession economic programme 2003.

6. Greece

According to the second revised EDP notification communicated by the Greek authorities on 4 May 2004 and validated by Eurostat, the general government balance recorded a deficit in 2003, of 3.2 % of GDP, despite strong economic growth of 4.2 % achieved during the year. The debt ratio reached 103 %. In the light of this evidence the Commission has decided to initiate the excessive deficit procedure (EDP) for Greece.

During a mission by Eurostat and the Economic and Financial Affairs DG to Athens late in April 2004, it became clear that there will be significant further, and as regards deficits almost certainly upward revisions for 2003 and earlier years, when the customary EDP notification is made in September 2004. The recently notified deficit compares with a deficit of 1.7 % of GDP according to a first notification sent early March 2004, which was modified at the end of the same month, providing a figure of

Table V.11

Budgetary developments 2002–07, Greece

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	- 1.4	- 3.2	- 3.2	- 2.8		
— Total revenue	45.3	44.2	44.0	44.1		
Of which: — current taxes	24.1	23.4	22.9	22.8		
— social contributions	14.1	14.6	14.8	15.0		
— Total expenditure	46.7	47.1	47.2	46.9		
Of which: — collective consumption	9.4	9.4	9.5	9.2		
— social transfers ⁽⁴⁾	22.7	23.4	23.7	23.8		
— interest expenditure	6.2	5.7	5.6	5.5		
— gross fixed capital formation	3.8	4.2	4.2	4.2		
Primary balance	4.7	2.7	2.4	2.7		
Pm Tax burden	36.3	36.7	36.4	36.3		
Government debt	104.7	103.0	102.8	101.7		
Pm Cyclically adjusted balance	- 1.7	- 3.6	- 4.1	- 3.8		
Pm Cyclically adjusted primary balance	4.4	2.1	1.5	1.7		
Pm Real GDP	3.9	4.2	4.0	3.3		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	- 1.2	- 1.4	- 1.2	- 0.5	0.0	n.a.
Primary balance	n.a.	4.7	4.7	5.1	5.3	n.a.
Government debt	104.7	101.7	98.5	94.6	90.5	n.a.
Pm Real GDP ⁽³⁾	3.8	4.0	4.2	4.0	3.8	n.a.

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure. For 2003, a revision of the data on general government balance was done in April 2004.

⁽²⁾ Submitted in December 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Greece.

2.95 % of GDP. It also compares with a targeted deficit of 0.9 % of GDP set in the December 2002 update of the stability programme. This significant slippage is attributable first to extraordinary factors (expenditure overruns related to the preparation of the Olympic Games and compensation for weather damages), secondly, to a lack of control over primary spending (social transfers and public sector wages) and finally to revenue shortfalls (VAT, income taxes and property income). With a positive output gap of 1.5 % in 2003, up from 0.8 % in 2002, the sharp deterior-

ation of the government balance cannot be attributed to cyclical factors. The estimated cyclically adjusted deficit rose from 1.7 % of GDP in 2002 to 3.9 % of GDP in 2003, and the primary surplus fell from 4.7 to 2.5 % respectively. At the end of 2003, the debt ratio was reported at 103.0 % of GDP as compared with 100.2 % of GDP set in the December 2002 update of the stability programme. The difference of the 2.8 percentage points is due partly to the higher general government deficit and partly to the stock-flow adjustments.

Table V.12

Main measures in the budget for 2004, Greece

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Tax incentives for investment • Introduction of an objective tax payment control • Tax reductions for cars and bicycles 	<ul style="list-style-type: none"> • Support to farmers and to low incomes • Public wages and pensions • Grants to social security funds and medical care

Source: Commission services.

The target for the general government deficit in 2004 set in the December 2003 updated stability programme is 1.2 %. In the Commission's spring 2004 forecast, the projected outcome for 2004 is significantly worse than this target, with the general government deficit forecast at 3.2 % of GDP. This is due firstly, to the significant base-year effect from the higher deficit in 2003 (notice that Commission 2004 spring forecasts were based on the then available first revised notification of 30 March which indicated a lower 2003 deficit than that of the second revised 4 May notification); secondly, to the impact of the 2003 social package, which seems to have been understated in the expenditure projections; and finally, to the lower than officially projected growth in tax revenues, given the recent tax reform.

The overall budgetary cost of the package of new measures approved by the parliament in December 2003, is estimated at EUR 2.36 billion (or 1.4 % of GDP), mostly in 2004. On the revenue side, a new tax policy will be introduced, the main characteristics of which are: tax incentives for investment and employment, the introduction of an objective tax payment control system and tax reductions on car registrations. On the expenditure side, the social package provides for: an increase in public sector wages and pensions and in grants to social security funds and medical care agencies; and measures to support farmers and low incomes. Based on the adjusted wage law that implements the outcome of the collective bargaining process between the government and the

unions of the public sector employees, the budget will implement an increase in wages and pensions of 7.7 %.

The projected worsening of the general government balance as compared to 2003 in combination with an expected positive output gap, reflects the pro-cyclical, expansionary nature of fiscal policies in Greece. According to the forecast, the cyclically adjusted budget position and the cyclically adjusted primary balance in 2004 will both deteriorate by 0.2 percentage points, and 0.5 percentage points respectively, indicating a move further away from a budgetary position of close to balance or in surplus.

Under the usual assumption of unchanged policy, a marginal improvement is expected to take place in 2005, assuming that some primary expenditure related to the preparation of the Olympic Games will not be recurring in 2005. The general government deficit is forecast at 2.8 % of GDP as against the target of 0.5 % of GDP set in the December 2003 update of the stability programme.

According to the spring forecast, the debt ratio is projected to decline in the period 2004–05, albeit at a slow pace, given still high stock-flow adjustments and debt-increasing financial transactions. Debt is projected at 102.8 % of GDP at the end of 2004 and at 101.7 % of GDP at the end of 2005, as compared with 98.5 % of GDP and 94.6 % of GDP, respectively, in the December 2003 update of the stability programme.

7. Spain

Despite the effects of a reform of personal income tax and slower than expected growth (3 against 2.4 % finally registered), the initial fiscal targets for 2003 were overachieved. Compared with the balanced budget objective of the 2003 budget law and the 2002 updated stability programme, the outturns were a surplus of 0.3 % of GDP. This result can be explained by several factors, including the strong domestic demand and the resilience of job creation. In particular, the social security subsec-

tor recorded a surplus of 1.0 % of GDP, while the State and territorial governments registered deficits of 0.4 and 0.3 % of GDP, respectively. The debt ratio continued to decrease to 50.8 % of GDP, lower than the previously envisaged 53.1 % in the 2002 updated stability programme.

The 2004 budget law approved in December 2003 included a balanced budget target for the general govern-

Table V.13

Budgetary developments 2002–07, Spain

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	-0.0	0.3	0.4	0.6		
— Total revenue	39.9	39.9	40.0	40.1		
Of which: — current taxes	22.6	22.5	22.6	22.7		
— social contributions	13.6	13.6	13.7	13.7		
— Total expenditure	39.9	39.5	39.6	39.5		
Of which: — collective consumption	7.6	7.7	7.7	7.8		
— social transfers ⁽⁴⁾	22.5	22.5	22.5	22.4		
— interest expenditure	2.8	2.5	2.4	2.3		
— gross fixed capital formation	3.4	3.5	3.5	3.6		
Primary balance	2.8	2.9	2.8	2.9		
<i>Pm</i> Tax burden	36.2	36.2	36.3	36.4		
Government debt	54.6	50.8	48.0	45.1		
<i>Pm</i> Cyclically adjusted balance	-0.2	0.4	0.6	0.7		
<i>Pm</i> Cyclically adjusted primary balance	2.6	2.9	2.9	3.0		
<i>Pm</i> Real GDP ⁽³⁾	2.0	2.4	2.8	3.3		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	0.1	0.5	0.0	0.1	0.2	0.3
Primary balance	2.8	3.0	2.6	2.5	2.6	2.6
Government debt	54.5	51.8	49.6	47.7	45.7	43.8
<i>Pm</i> Real GDP ⁽³⁾	2.0	2.3	3.0	3.0	3.0	3.0

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted on 12 January 2004.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Spain.

ment sector in 2004. However, given the fiscal decentralisation in Spain, this budget only refers to the central government and its autonomous bodies and the social security subsector. The main expenditure priorities in the budget were active labour market policies, the justice system and civilian security and pensions. On the revenue side, further social security contribution rebates are planned so as to promote employment on a permanent basis. On the expenditure side, the lowest and widowhood pensions were set to increase while the pension reserve fund was planned to reach 1.6 % of GDP. Further details are given in the accompanying table.

The 2003 updated stability programme retains the balanced budget target for 2004 previously set in the budget law. The Commission's spring 2004 forecast, in contrast, envisages a surplus of 0.4 % of GDP, partially based on the better than expected outturn registered in 2003. In addition, within a context of economic recovery, indirect taxes and social security contributions are expected to remain buoyant, supported by strong job cre-

ation, whereas direct tax receipts should regain some strength as the effects of the 2003 personal income tax reform fade away. According to the Commission forecast, the cyclically adjusted budget position in 2004 is set to improve slightly, while the cyclically adjusted primary balance is expected to remain unchanged.

In 2005, based on a no-policy change assumption, the government budget balance is foreseen to show a surplus of 0.6 % of GDP, compared with a small surplus of 0.1 % of GDP envisaged in the 2003 updated stability programme. However, this forecast is clearly subject to policy changes that could be announced by the new government that gained office in April 2004.

According to the Commission's spring 2004 forecast, the debt/GDP ratio is expected to continue to decline during the forecasting period, falling to around 45 % of GDP by end-2005. This compares with the more conservative forecast in the 2003 updated stability programme, which projects a debt/GDP ratio of 47.7 % in 2005.

Table V.14

Main measures in the budget for 2004, Spain

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Social security rebates to promote employment on a permanent basis (- 0.3 % of GDP) • Freeze of income tax brackets (0.1 % of GDP) 	<ul style="list-style-type: none"> • Lowest and widowhood pension increases (0.1 % of GDP) • Justice system and civilian security (less than 0.1 % of GDP) • Increase in the reserve fund for pensions (0.4 % of GDP, financial operation that does not affect the general government balance)

Source: Commission services.

8. France

The general government deficit is estimated to have increased from 3.2 % of GDP in 2002 to 4.1 % of GDP in 2004. This compares with a targeted deficit of 2.6 % of GDP in the 2002 update of the stability programme. The deviation from target can be mainly attributed to a deterioration in cyclical conditions: real GDP growth was only 0.2 % in 2003, as against 2.5 % expected in the 2002 updated stability programme. However, about one third of the slippage is

directly linked to a significant overspending. General government expenditures in real terms increased by about 2.0 % in 2003, compared to the 1.2 % rise planned in the 2002 update of the stability programme. The largest part of the expenditures overrun can be attributed to slippages in categories of expenditures which are not directly influenced by cyclical developments, namely health expenditures and local authorities' expenditures.

Table V.15

Budgetary developments 2002–07, France

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	- 3.2	- 4.1	- 3.7	- 3.6		
— Total revenue	50.2	50.6	50.7	50.5		
Of which: — current taxes	26.6	26.3	26.3	26.4		
— social contributions	18.2	18.5	18.5	18.2		
— Total expenditure	53.5	54.7	54.4	54.1		
Of which: — collective consumption	9.3	9.6	9.4	9.4		
— social transfers ⁽⁴⁾	32.5	33.3	33.1	33.0		
— interest expenditure	3.0	3.0	3.0	3.0		
— gross fixed capital formation	3.0	3.2	3.2	3.2		
Primary balance	- 0.2	- 1.0	- 0.6	- 0.5		
<i>Pm</i> Tax burden	43.7	43.7	43.7	43.5		
Government debt	58.6	63.7*	64.6	65.6		
<i>Pm</i> Cyclically adjusted balance	- 3.8	- 3.9	- 3.4	- 3.3		
<i>Pm</i> Cyclically adjusted primary balance	- 0.7	- 0.8	- 0.3	- 0.3		
<i>Pm</i> Real GDP ⁽³⁾	1.2	0.2	1.7	2.4		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	- 3.1	- 4.0	- 3.6	- 2.9	- 2.2	- 1.5
Primary balance	0.1	- 0.9	- 0.6	0.1	0.9	1.6
Government debt	59.0	61.4	62.8	63.2	62.8	61.8
<i>Pm</i> Real GDP ⁽³⁾	1.2	0.5	1.7	2.5	2.5	2.5

⁽¹⁾ Commission services' spring 2004 economic forecasts for the years 2004 and 2005. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted on 11 December 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

* Notified by France after the official EDP notification of 1 March 2004.

Source: Commission services and stability programme of France.

Due to the increase in the deficit, but also to low nominal GDP growth and debt-increasing stock-flow adjustments amounting to 1.3 percentage points of GDP ⁽¹⁾, the debt/GDP ratio rose by 4.4 percentage points in 2003 to 63.7 % of GDP.

The budget for 2004 plans a marked slowdown in public spending. After increasing by 3.8 % in 2002 and about 2 % in 2003, real general government expenditures are projected to increase by 1.1 % in 2004. This target is planned to be achieved through (i) a stabilisation of State expenditures in real terms; (ii) a sharp deceleration in health expenditures; (iii) a tightening of eligibility conditions to unemployment benefits; (iv) a slowdown in local authorities expenditures. On the revenue side, discretionary measures are planned to trigger an increase in the tax burden by 0.1 percentage points of GDP: increases in excise duties and in local taxes will more than offset targeted cuts in social contributions and in the income tax (see table for details). Finally, non-fiscal revenues are planned to increase by 0.1 percentage points of GDP, due to sales of real estate properties and payments from State-owned companies.

The French authorities confirmed in March 2004 the target set in the finance law of a 2004 government deficit at 3.6 % of GDP. The Commission services, in their spring 2004 forecast, projected the 2004 deficit at 3.7 % of GDP. In this forecast, it is assumed that expenditures plans included in the budget will be respected, except for a slippage in the health sector. Based on the method

⁽¹⁾ The stock-flow operations consist mainly of the recapitalisation of the public company France Telecom in spring 2003 (0.6 % of GDP) and a large decrease in deposits (0.7 % of GDP) resulting from a financial transaction with the Pension Reserve Fund.

agreed by the Council, the macroeconomic and budgetary projections of the spring 2004 Commission forecast are consistent with a reduction in the cyclically adjusted deficit by % of GDP. This is 0.15 percentage points less than the adjustment included in the 2003 update of the stability programme. The difference stems notably from (i) the slippage in expenditures incorporated in the Commission forecast and (ii) the fact that the potential growth estimate resulting from the Commission forecast is slightly lower than that implicit in the 2003 update of the stability programme.

According to the latest forecasts of the French authorities, the general government deficit will be reduced from 3.6 % of GDP in 2004 to 2.9 % of GDP in 2005. Most of the adjustment would be achieved through a further decline in the expenditure-to-GDP ratio, warranted by a freeze in State expenditures in real terms and the savings generated by the implementation of the reform of the health insurance system that is currently being designed. The Commission projects the general government deficit to decline only marginally to 3.6 % of GDP in 2005. Based on the assumption of unchanged policy, real general government expenditures are projected to increase by 2.2 % in real terms in 2005, in line with the trend observed in the last five years. The Commission forecast incorporates tax cuts for a total amount of 0.15 % of GDP (mostly cuts in social contributions).

The Commission projects the debt/GDP ratio to increase further in 2004–05. This ratio would reach 65.6 % in 2005, more than three times the level of 1980 (20.7 % of GDP). Developments in the debt are projected to reflect those of the deficit and nominal GDP, since no significant stock-flow operations are incorporated in the forecast.

Table V.16

Main measures in the budget for 2004, France

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Cut in the income tax (0.1 % of GDP) • Increase in the income tax credit (0.05 % of GDP) • Increases in excise duties (tobacco, energy) (0.15 % of GDP) • Increase in local taxes 	<ul style="list-style-type: none"> • Stabilisation of State expenditure in real terms • Tightening of eligibility conditions to unemployment benefits • Specific measures aimed at curbing the rapid growth of healthcare spending (reimbursement of medicine, increase in the <i>forfait hospitalier</i>)

Source: Commission services, Ministry of Finance of France.

9. Ireland

The general government balance is estimated to have recorded a small surplus in 2003, of 0.2 % of GDP. This compares with a targeted deficit of 0.7 % of GDP set in the December 2002 update of the stability programme. The deviation from the target in 2003 owes to a tax overshooting driven by capital taxes and savings on expenditure, especially on interest payments and discretionary

capital spending. Government debt represented one third of GDP in 2003.

The budget for 2004 was unveiled on 3 December 2003 together with the updated stability programme for the period 2004–06. On the expenditure side, it implements a further reduction in the growth rate of current discre-

Table V.17

Budgetary developments 2002–06, Ireland

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005	
General government balance ⁽⁴⁾	- 0.2	0.2	- 0.8	- 1.0	
— Total revenue	33.1	34.6	34.3	33.7	
Of which: — taxes	23.7	24.9	24.9	24.6	
— social contributions	5.7	5.8	5.9	5.8	
— Total expenditure ⁽⁴⁾	33.3	34.3	35.1	34.7	
Of which: — collective consumption	5.5	5.7	5.9	5.8	
— social transfers ⁽⁵⁾	18.0	19.1	19.6	19.4	
— interest expenditure	1.4	1.4	1.4	1.4	
— gross fixed capital formation	4.3	3.8	3.8	3.8	
Primary balance ⁽⁴⁾	1.2	1.6	0.6	0.3	
Pm Tax burden	28.6	30.0	29.9	29.6	
Government debt	32.3	32.0	32.4	32.6	
Pm Cyclically adjusted balance	- 1.9	0.1	- 0.3	- 0.2	
Pm Cyclically adjusted primary balance	- 0.5	1.5	1.1	1.2	
Pm Real GDP ⁽³⁾	6.9	1.2	3.7	4.6	
Stability programme ⁽²⁾	2002	2003	2004	2005	2006
General government balance ⁽⁴⁾	- 0.2	- 0.4	- 1.1	- 1.4	- 1.1
Primary balance ⁽⁴⁾	1.2	1.0	0.3	0.1	0.3
Government debt	32.4	33.1	33.3	33.5	33.3
Pm Real GDP ⁽³⁾	6.9	2.2	3.3	4.7	5.2

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in December 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ Including UMTS receipts of 0.2 % of GDP in 2002.

⁽⁵⁾ In kind and other than in kind.

Source: Commission services and stability programme of Ireland.

tionary spending ⁽¹⁾ (to 7.5 from 9.5 % in 2003) and a return to positive growth in discretionary capital spending after the cut in 2003. On the revenue side, there was a more modest hike in indirect taxes than in recent budgets, while the personal income tax system was only partially adjusted for inflation. Further details are given in the accompanying table.

The target for the general government deficit in 2004 in the updated stability programme is 1.1 % of GDP ⁽²⁾. In the Commission's spring 2004 forecast, the projected outcome in 2004 is slightly better than targeted (deficit of 0.8 % of GDP) mainly reflecting base effects. The spring forecast projects the cyclically adjusted deficit to widen by % of GDP. Given that the 2003 outcome incorporates a one-off yield of some 0.4 % of GDP from advancing the date of payment of capital gains tax, this points to a broadly neutral fiscal stance in 2004. However, it is subject to the caveat that calculations of the cyclically adjusted balances are surrounded by a high

degree of uncertainty that is linked especially to the difficulty of estimating the output gap in Ireland.

Given the non-indexed nature of Irish tax and social benefit systems, the no-policy change assumption for 2005 in the spring 2004 forecast is made operational, in the absence of previously announced measures, by freezing average tax rates and adjusting social transfer payments by the forecast CPI inflation rate (with a small top-up). On these assumptions, the spring forecast projects the deficit to widen to 1.0 % of GDP, again somewhat better than the target in the updated stability programme (deficit of 1.4 % of GDP). This target includes a technical provision for unspecified future budget measures (at a full-year cost of % of GDP, which is subject to review in light of emerging economic conditions) as well as a contingency provision (against unforeseen developments) of 0.4 % of GDP.

The debt ratio is projected to remain broadly stable in 2004–05, at around one third of GDP and non-general government assets are continuing to be built up in the National Pensions Reserve Fund (NPRF) ⁽³⁾.

⁽¹⁾ The term 'discretionary' refers, in this context, to the concept of 'voted' current spending, for which annual approval by Parliament is required. It excludes, *inter alia*, the service of the national debt and the contribution to the EU budget.

⁽²⁾ This was confirmed in the March 2004 reporting of government deficits and debt levels in spite of a much better outcome for 2003, namely a deficit of 0.4 % of GDP in the stability programme compared to a surplus of 0.2 % of GDP in the March 2004 reporting.

⁽³⁾ Around 1 % of GNP annually is set to be aside for the pre-funding of the pension liabilities. At the end of 2003, it was worth 7 % of GDP.

Table V.18

Main measures in the budget for 2004, Ireland

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Increases in excise duties (tobacco, auto diesel and petrol); 0.2 % of GDP • Increase in the 'employee credit' (- 0.2 % of GDP) • No other changes in the parameters of the personal income tax system 	<ul style="list-style-type: none"> • Increase in social welfare benefit rates by between 6 and 8 % (0.4 % of GDP) • Further implementation of benchmarking ⁽¹⁾ • Further implementation of the national development plan 2000–06

⁽¹⁾ The benchmarking process was initiated in mid-2000 to adjust pay rates in the public sector by reference to rates in the private sector for comparable jobs. The benchmarking body's report of mid-2002 recommended pay increases differentiated by grade, leading to an 8.9 % rise in public sector pay costs. The national agreement foresees a gradual implementation of the benchmarking awards, with a first tranche (25 %) paid retrospectively to December 2001 in the course of 2003, a second tranche (50 %) in early 2004 and the final tranche (25 %) by mid-2005; payment of the final two tranches is conditional on further progress on flexibility and modernisation and on maintenance of the industrial peace.

Source: Commission services and Department of Finance (2004 budget).

10. Italy

In 2003, the general government deficit was 2.4 % of GDP, compared with a targeted deficit of 1.5 % of GDP set in the 2002 updated stability programme. At first sight, the divergence of the budgetary outturn in 2003 from the original target would appear to result exclusively from an overestimation of economic growth. Upon closer examination, however, the figures show that much higher than initially planned temporary receipts from one-off measures on the revenue side (a generalised amnesty for under-declaration of past tax liabilities

and a compulsory levy on tax collectors) compensated a shortfall in revenues for the given growth assumptions. On the expenditure side, lower than officially expected interest expenditure partly compensated higher current and capital expenditure (also a result of much lower than planned sales of real assets). Overall, the improvement brought about by temporary measures in 2003 is estimated to have been in excess of 2 percentage points of GDP. Despite this, the erosion of the primary surplus continued, with the balance declining by more than half

Table V.19

Budgetary developments 2002–07, Italy

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	- 2.3	- 2.4	- 3.2	- 4.0		
— Total revenue	45.6	46.5	45.4	44.7		
Of which: — current taxes	29.0	28.2	28.2	28.0		
— social contributions	12.8	13.1	13.2	13.2		
— Total expenditure	47.9	48.9	48.7	48.7		
Of which: — collective consumption	7.2	7.5	7.5	7.4		
— social transfers ⁽⁴⁾	28.8	29.2	29.5	29.2		
— interest expenditure	5.8	5.3	5.0	5.2		
— gross fixed capital formation	1.9	2.6	2.5	2.8		
Primary balance	3.5	2.9	1.8	1.2		
<i>Pm</i> Tax burden	42.1	42.9	41.6	41.3		
Government debt	108.0	106.2	106.0	106.0		
<i>Pm</i> Cyclically adjusted balance	- 2.2	- 1.9	- 2.6	- 3.6		
<i>Pm</i> Cyclically adjusted primary balance	3.5	3.4	2.4	1.6		
<i>Pm</i> Real GDP ⁽³⁾	0.4	0.3	1.2	2.1		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	- 2.3	- 2.5	- 2.2	- 1.5	- 0.7	0.0
Primary balance	3.4	2.8	2.9	3.5	4.4	5.1
Government debt	106.7	106.0	105.0	103.0	100.9	98.6
<i>Pm</i> Real GDP ⁽³⁾	0.4	0.5	1.9	2.2	2.5	2.6

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted on 1 December 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and updated stability programme of Italy.

a percentage point to 2.9 % of GDP. Following a large revision of government debt data, the debt ratio fell to 106.2 % of GDP from 108.0 % in 2002, thanks to privatisation operations carried out at the end of the year in conjunction with the transformation of ‘Cassa Depositi e Prestiti’, the formerly public deposits and loans bank, into a joint-stock company.

The 2004 budget and related legislation were adopted by parliament at the end of December 2003. The legislation includes tax breaks for R & D investment and additional funding for renewals of contracts for public sector employees. Corrective measures comprise further securitisation and sales of publicly-owned real assets, a tax amnesty for urban zoning regulation violations and an extension of the terms of the tax amnesty introduced in 2003. In addition, small savings in expenditure are to be achieved as a result of the privatisation of the ‘Cassa Depositi e Prestiti’.

In the 2003 updated stability programme (USP2003) the general government deficit in 2004 was targeted at 2.2 % of GDP (incorporating the measures set out in the budget), built on an economic growth forecast of 1.9 %. In the Commission 2004 spring (COM2004) forecast the projected budgetary outturn is a deficit of 3.2 % of GDP in spite of sizeable one-off measures amounting to around 1 percentage point of GDP (slightly less than in the official forecast). Real GDP growth in 2004 is forecast at 1.2 %. On 7 May 2004 the government released new objectives for this year which largely mirror the COM2004 forecast. With real GDP growth projected at 1.2 %, the nominal deficit is targeted at 2.9 % of GDP. The difference compared to the COM2004 forecast of 3.2 % of GDP is largely due to a classification issue. As in the USP2003, the new official target incorporates the saving from classifying ANAS, the agency charged with investment in and maintenance of the State road network, outside the general government sector. The budgetary impact in 2004 is around 0.2 % of GDP. According to the COM2004 fore-

cast the cyclically adjusted deficit in 2004 would widen by over a percentage point of GDP and the cyclically adjusted primary surplus would deteriorate even more. In the USP2003 the cyclically adjusted deficit showed a marginal improvement; the cyclically adjusted primary surplus was projected to remain unchanged.

The COM2004 forecast for 2005 is based on legislation currently in force, an approach which underestimates some expenditure items, namely compensation of public sector employees and government investment. In the absence of budgetary correction, the deficit would reach 4 % of GDP, reflecting the expiry of one-off measures (no tax amnesties and considerably lower sales of real assets compared to the previous year). Interest expenditure is expected to increase as a percentage of GDP, reversing a trend established over the previous eight years and signalling that the margins for gains from refinancing older higher-rate bonds with new issues at lower rates are almost exhausted. A sizeable budgetary correction would be needed to achieve the official target of a deficit of 1.5 % of GDP set in the USP2003.

In the COM2004 forecast the debt ratio is projected to remain broadly stable at 106.0 % of GDP in 2004 and 2005. In the new official forecast the debt/GDP ratio in 2004 is projected at 105.9 %, up from 105.0 % in the USP2003. The upward revision also reflects the impact of debt-increasing transactions, confirming the persisting and even increasing divergence between the *fabbisogno* — a deficit measure based on cash flows and including transactions with financial assets but excluding proceeds from privatisation — and the EDP deficit. In 2004, the *fabbisogno* is now officially estimated at 5.3 % of GDP, 2.3 percentage points above the EDP deficit.

The planned marginal decline in debt/GDP ratio in 2004 would be achieved only thanks to privatisations and disposals of other financial assets, the proceeds of which are estimated at EUR 21 billion, around 1.6 % of GDP.

Table V.20

Main measures in the budget for 2004, Italy

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Tax amnesty for zoning regulation violations (0.2 % of GDP) • Extension of the terms of the tax amnesty introduced in 2003 (0.1 % of GDP) • Tax settlement scheme (0.3 % of GDP) 	<ul style="list-style-type: none"> • Renewals of contracts for public sector employees (0.1 % of GDP) • Securitisation and sales of publicly-owned real assets (0.4 % of GDP on top of 0.3 % of GDP already established) • Savings in expenditure because of privatisation of the Cassa Depositi e Prestiti and SACE (0.1 % of GDP)

Source: Ministry for Economy and Finances.

11. Cyprus

For 2003 the general government budget deficit rose to 6.3 % of GDP, compared to a targeted deficit of 1.9 % as provided in the 2002 pre-accession economic programme (PEP) and 5.4 % in the 2003 PEP. Similarly to the slippage in 2002, the above-target deficit can partly be ascribed to continued modest growth of the European economy, reverberating repercussions of 11 September 2001 and other terrorist attacks, the Iraq War and SARS, all of which contributed to diminishing external tourism demand feeding into lower than expected GDP growth (2.0 % compared with 2.8 % in the 2002 PEP). Furthermore, another factor adversely affecting public finances was higher than originally planned defence outlays, and a discretionary increase in expenditures partly to offset the economic downturn. At the same time, the tax reform that started in July 2002 (with a shift from direct taxes to VAT and excise duties) aimed at a neutral impact

on public finances. However, this reform was not applied as originally planned since compensatory measures were introduced to secure broad political support. With these developments, the government debt ratio increased from 67.1 % of GDP in 2002 to 72.2 % of GDP in 2003.

The fiscal consolidation programme introduced in the 2003 PEP of September last year — after the previous one was effectively abandoned in the course of the year — no longer targets a budget balance over the medium term, while in the meantime the PEP deficit targets for 2004 and 2005 have again been revised upwards. The budget for 2004 focuses on further implementation of tax reform and on current expenditure restraint through, *inter alia*, a ceiling on defence expenses (investment is not targeted for cutback). Further details are given in the accompanying table.

Table V.21

Budgetary developments 2002–05, Cyprus

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	- 4.6	- 6.3	- 4.6	- 4.1
— Total revenue	37.2	40.2	37.5	37.6
Of which: — current taxes	25.4	27.3	n.a.	n.a.
— social contributions	7.0	6.9	n.a.	n.a.
— Total expenditure	41.7	46.4	42.1	41.7
Of which: — collective consumption	10.4	11.1	n.a.	n.a.
— social transfers	19.1	19.3	n.a.	n.a.
— interest expenditure	3.2	3.3	n.a.	n.a.
— gross fixed capital formation	3.1	3.8	n.a.	n.a.
Primary balance	- 1.3	- 3.0	n.a.	n.a.
P _m Tax burden	32.4	34.3	n.a.	n.a.
Government debt	67.1	72.2	74.6	76.9
P _m Real GDP ⁽²⁾	2.0	2.0	3.4	4.1

(¹) Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definition used in the excessive deficit procedure.

(²) Annual % change.

Source: Commission services.

The general government budget deficit target as set out in the March 2004 reporting of deficit and debt levels is 4.3 % of GDP, up from 3.7 % of GDP still targeted in the 2003 PEP. The Commission's spring 2004 forecast is largely in line with this target but, given the mixed historical record of fiscal consolidation and upward deficit revisions by the government, it assumes that objectives will not be completely met. Hence, the deficit is projected at 4.6 % of GDP.

For 2005, the spring 2004 forecast projects a modest deficit decline to 4.1 % of GDP, above the 2003 PEP government target of 2.8 %. Here again the forecast assumes that revenue and expenditure targets will not be fully met, for similar reasons as in 2004.

Given these deficit developments, the debt ratio in 2004–05 is projected to rise to nearly 77 % of GDP at the end of the period.

Table V.22

Main measures in the budget for 2004, Cyprus

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Increase of public service fees • Measures to improve tax administration and compliance 	<ul style="list-style-type: none"> • Containment of defence outlays • Reduction of agricultural subsidies • Slower pace of civil service employment growth • Other expenditure containing measures

Source: Commission services.

12. Latvia

In 2003, the general government deficit is estimated to be 1.8 % of GDP ⁽¹⁾. This is about 1 percentage point lower than the targeted deficit of 2.9 % set in the 2003 pre-accession economic programme. The deviation was mainly due to better-than-expected tax revenues, itself representing improvements in tax collection as well as higher-than-expected growth (7.4 % compared to 6.5 % respectively), and close monitoring of expenditure by the government. In fact, total government expenditure did not reach the initially allocated amount. The reduction of the general government budget deficit was also due to an improvement in the balance of both the local

government and the social security sectors. The 2004 budget was adopted by the parliament on 13 November 2003. On the revenue side, a shift is foreseen in the structure — decreases in corporate income tax and social security contributions should be offset by an increase in VAT and excise duties. On the expenditure side, the budget includes provisions for ongoing public administration and pension reforms. Further details are given in the accompanying table.

The target for the general government deficit in 2004 is 2.1 % of GDP.

This is in line with the commitment of the Latvian authorities to pursue a gradual reduction of the general government deficit and to keep the deficit below 3 % of GDP as stipulated in the document 'Statement

⁽¹⁾ The general government debt and deficit figures should be treated with caution, since the data submitted for the excessive deficit procedure were not yet validated by Eurostat. The current methodology used by the Latvian authorities is not fully consistent with ESA 95 accounting standards and suffers from low source data reliability.

Table V.23

Budgetary developments 2002–05, Latvia

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	-2.7	-1.8	-2.2	-2.0
— Total revenue	41.9	41.5	39.6	38.4
Of which: — current taxes	21.6	21.2	21.5	22.3
— social contributions	10.1	9.7	9.3	8.9
— Total expenditure	44.6	43.3	41.8	40.4
Of which: — collective consumption	9.6	9.2	9.1	9.0
— social transfers ⁽³⁾	21.7	21.1	20.3	19.5
— interest expenditure	0.9	0.9	0.8	0.7
— gross fixed capital formation	3.3	2.4	2.3	2.1
Primary balance	-1.8	-1.0	-1.4	-1.2
Pm Tax burden	31.9	31.6	30.7	30.4
Government debt	15.5	15.6	16.0	16.1
Pm Real GDP ⁽²⁾	6.1	7.5	6.2	6.2

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Annual % change.

⁽³⁾ In kind and other than in kind.

Source: Commission services.

on macroeconomic development and fiscal policy in 2004–08’.

In the Commission services’ spring 2004 forecast, the projected outcome is slightly higher than targeted (a deficit of 2.2 % of GDP) mainly reflecting more cautious growth expectations (a 6.2 % annual growth rate rather than 6.7 %). Also contributing are different estimates on by how much revenues are set to decrease following the lowering of the corporate income tax rate and the change in the VAT legislation.

Based on a no-policy change assumption, the Commission services’ spring 2004 forecast projects the general

government deficit to decrease slightly to 2.0 % of GDP in 2005. The projected outcome is slightly more optimistic than the one targeted by the government (2.2 % of GDP) ⁽¹⁾. The difference is mainly due to the Commission’s slightly higher estimate of tax revenues.

The government debt/GDP ratio is expected to increase modestly from 15.6 % at end-2003 to 16.0 % of GDP by the end of 2004 and 16.1 % in 2005.

⁽¹⁾ The convergence programme of the Republic of Latvia 2004–07 projects a general government budget deficit of 2.2 % of GDP.

Table V.24

Main measures in the budget for 2004, Latvia

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Alignment of the VAT legislation leading to an increase of the rate on various products to 18 % (base rate) or 9 % (reduced rate) • Broadening the VAT base • Increase of the excise duty on spirits and tobacco and fuel • Reduction of the corporate income tax rate (from 22 % in 2003 to 15 % in 2004) • Reduction of social insurance payments base rate from 35.09 to 33.09 % 	<ul style="list-style-type: none"> • Some parametric changes in the PAYG pension pillar • Wage increases in public sector • Increased expenditure for training of unemployed

Source: Commission services.

13. Lithuania

The general government deficit is estimated to have increased slightly from 1.4 % of GDP in 2002 to 1.7 % in 2003. This compares with a targeted deficit of 2.4 % set in the budget for 2003. The deviation from the target was due to a tax overshoot induced by significantly higher than anticipated output growth. Against the background of higher revenue collection than expected in the first half of 2003, the government decided to allocate additional expenditure by means of a supplementary budget in July 2003, which prevented a reduction of the deficit in 2003 compared to 2002. The government debt accounted for 21.9 % of GDP in 2003.

The budget for 2004 was approved by the parliament in December 2003. On the expenditure side, the budget implements a marked acceleration in capital expenditure growth, largely related to new investment projects co-financed by

the EU. The growth rate of current expenditure is also planned to accelerate, although more moderately, mainly driven by salary increases for public sector workers, higher subsidies to farmers and higher social welfare benefits (e.g. pensions and child benefits). The revenue side is expected to be positively influenced by increases in excise duties for tobacco and petrol and higher VAT rates for heating of residential buildings implemented upon EU accession. The transition costs of the pension reform (i.e. introduction of a second pillar pension scheme) are expected to be significant in 2004, although the voluntary option of participation in the second pillar for all age groups makes it difficult to quantify its impact on the budget.

The general government deficit target published in the budget for 2004 was 2.95 % of GDP, but the government recently revised the target down to 2.7 % of GDP. In the

Table V.25

Budgetary developments 2002–05, Lithuania

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	- 1.4	- 1.7	- 2.8	- 2.6
— Total revenue	33.8	33.9	34.7	34.7
Of which: — current taxes	20.4	22.1	22.2	22.2
— social contributions	8.9	8.8	8.6	8.2
— Total expenditure	35.2	35.6	37.4	37.3
Of which: — collective consumption	7.8	7.6	7.7	7.8
— social transfers ⁽²⁾	21.8	22.2	22.6	22.5
— interest expenditure	1.6	1.3	1.4	1.3
— gross fixed capital formation	2.9	2.9	3.2	3.2
Primary balance	0.1	- 0.4	- 1.4	- 1.3
<i>Pm</i> Tax burden	29.3	30.9	30.8	30.4
Government debt	22.8	21.9	22.8	23.2
<i>Pm</i> Real GDP ⁽²⁾	6.8	9.0	6.9	6.6

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Annual % change.

⁽³⁾ In kind and other than in kind.

Source: Commission services.

Commission services' spring 2004 forecast, the projected outcome is slightly worse than the present target (deficit of 2.8 % of GDP), mainly explained by higher estimated current expenditure.

The Commission's spring 2004 forecast foresees a deficit of 2.6 % of GDP in 2005. The forecast is based on the

no-policy change assumption but present deliberations about tax changes could materialise into policy actions that would likely lead to revised projections.

The debt ratio is projected to increase slightly from 21.9 % of GDP in 2003 to about 23.2 % by 2005, to a large extent reflecting higher general government deficits.

Table V.26

Main measures in the budget for 2004, Lithuania

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Increases in excise duties (tobacco and petrol) • Alignment of VAT rates with EU leading to higher rates for heating of residential buildings 	<ul style="list-style-type: none"> • Salary increases for public sector workers (mainly within health and education sectors) • Significant increase in subsidies to farmers • Increases in social welfare benefits (e.g. pensions, child benefits) • Further implementation of the restitution for losses of rouble savings • Pension reform (introduction of a second-pillar scheme) ⁽¹⁾

⁽¹⁾ The immediate impact of the creation of the second pillar is accounted for as higher expenditure because the pension contributions assigned to the second pillar are still collected by the government and transferred to the new pillar.

Source: Commission services.

14. Luxembourg

The general government balance in 2003 is estimated to have reached a small deficit of 0.1 % of GDP, which is a slightly better outcome than the target deficit of 0.3 % of GDP projected in the 2002 update of the stability programme. Some special factors account for this outcome, such as a speed-up in the collection of back taxes, higher-than-expected social security contributions, and additional indirect tax revenues due to the start of operations of a few large multinational companies in the

Grand Duchy in the course of last year. Some expenditure overruns were compensated by lower interest payments. Luxembourg has the lowest debt ratio among EU Member States and this ratio declined somewhat in 2003, by 0.8 % of GDP, to 4.9 % of GDP, partly reflecting changes in net financial assets.

The amended budget for 2004 was unveiled on 3 December 2003 and voted in the Chamber of Deputies on

Table V.27

Budgetary developments 2002–07, Luxembourg

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	2.7	-0.1	-2.0	-2.3		
— Total revenue	47.0	47.1	46.8	46.8		
Of which: — current taxes	30.3	30.0	29.0	28.3		
— social contributions	12.4	13.0	13.0	12.8		
— Total expenditure	44.3	47.3	48.8	49.1		
Of which: — collective consumption	7.4	8.0	8.2	8.1		
— social transfers ⁽⁴⁾	26.2	28.0	28.2	28.0		
— interest expenditure	0.2	0.2	0.2	0.1		
— gross fixed capital formation	4.8	4.9	4.9	4.8		
Primary balance	3.0	0.1	-1.9	-2.2		
<i>Pm</i> Tax burden	41.5	41.8	40.7	39.7		
Government debt	5.7	4.9	4.5	3.8		
<i>Pm</i> Cyclically adjusted balance	2.7	1.3	0.6	1.2		
<i>Pm</i> Cyclically adjusted primary balance	2.9	1.5	0.8	1.3		
<i>Pm</i> Real GDP ⁽³⁾	1.3	1.8	2.4	3.1		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	2.4	-0.6	-1.8	-2.3	-1.5	n.a.
Primary balance	2.7	-0.4	-1.6	-2.1	-1.5	n.a.
Government debt	5.7	4.9	5.2	5.0	4.4	n.a.
<i>Pm</i> Real GDP ⁽³⁾	1.3	1.2	2.0	3.0	3.8	n.a.

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in November 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Luxembourg.

16 December. Tax revenue is estimated to be rather weak, as the lagged effect of the economic downturn still would take its toll on business taxes in particular. On the expenditure side, total current expenditure is expected to grow at a high rate of around 9 %, similar to 2003. Spending on healthcare and social transfers would continue to increase rapidly. The government has announced a freeze in hiring in most of the public sector to curb expenditure growth. Public investment is planned to remain buoyant at around 3 % of GDP. However, a large part of this investment expenditure is planned to be financed out of the reserves of so-called special funds, which were built up during past years with high surpluses. Further details are given in the accompanying table.

The target for the general government balance in 2004 is a deficit of 1.8 % of GDP according to the 2003 update of the stability programme. For 2004, the Commission services' spring 2004 forecast projects a slightly larger widening of the deficit, to 2.0 % of GDP, mainly reflecting base effects. The continued strong growth of expenditure despite sluggish revenue is the main reason for the projected substantial widening of the deficit. Weak revenue is driven both by the tax reforms implemented in

2001 and 2002, and by cyclical factors. The spring forecast projects the cyclically adjusted deficit to remain broadly stable at a surplus of around 1 % of GDP. However, this figure should be treated with caution in view of the large margins of uncertainty surrounding estimates of potential growth in Luxembourg.

Under a no-policy change assumption the Commission's spring forecast projects the deficit to increase somewhat further in 2005, to 2.3 % of GDP, in line with the target in the 2003 stability programme update. The deterioration in the balance would take place in spite of an expected pick up in tax receipts. This is due to the fact that the positive impact of the economic upturn on tax revenue would feed through only with a substantial delay. Thus, the planned deceleration in current expenditure growth to slightly below 4 % would not be sufficient to prevent the deficit from rising.

According to the Commission's spring forecast, the debt ratio would decrease somewhat further, from 4.9 % of GDP in 2003 to 3.8 % of GDP in 2005. While the debt of central government is being largely repaid, this would be partly offset by a rise in the debt of local government.

Table V.28

Main measures in the budget for 2004, Luxembourg

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Deceleration in the collection of back business taxes (continuing impact of operation started in 2003) • Increase in excise duties on petrol (0.25 % of GDP) and tobacco (0.1 % of GDP) • Sale of real estate (0.3 % of GDP) 	<ul style="list-style-type: none"> • Larger part of public investment in multi-annual capital spending plan financed out of assets accumulated in special funds • Increase of international development aid from 0.82 % of GDP to 0.84 % of GDP • No recruitment of additional civil servants in central government, except in education and police (0.1 % of GDP) • Increase in doctors' and dentists' fees and indexation of fees on prices

Source: Commission services.

15. Hungary

In 2003 the general government deficit turned out to be 5.9 % of GDP. The initial target of a deficit of 4.5 % of GDP for 2003, as set in the budget for 2003, as well as the later revised higher target, was significantly overshoot. Higher than expected spending occurred in a number of areas, such as on subsidies, on housing loans and on prescribed drugs (0.35 % of GDP), interest expenditure (0.2 % of GDP) and unforeseen pay-outs due to a legal ruling regarding eligibility for a supplement to childcare fees (0.15 % of GDP). Weaker tax revenues were mostly due to lower than envisaged personal income and corporate taxes. The debt ratio in 2003 almost reached the 60 % of GDP reference value, with 59.0 % of GDP, up from 57.1 % in 2002.

The budget for 2004 was adopted by parliament in December 2003. On the revenue side major changes in

the tax system are being implemented. A rise in indirect tax rates (VAT and excise taxes) is expected to lead to higher revenue. Direct tax rates (both personal income tax and corporate taxes) were lowered, while numerous tax allowances and credits were eliminated. This should contribute to a decline in corporate tax revenues, while personal income tax revenues are expected to remain broadly stable.

On the expenditure side a reduction in the growth rate of discretionary spending is foreseen. A real wage freeze in the public sector, and the ongoing reduction of the number of public employees should contribute to the reduction of the high growth rate in the nominal wage bill observed over the last three years. The substantial tightening of housing subsidies and the recent freezing of subsidised pharmaceutical products' prices should help prevent the

Table V.29

Budgetary developments 2002–05, Hungary

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	- 9.3	- 5.9	- 4.9	- 4.3
— Total revenue	44.5	44.5	n.a.	n.a.
Of which: — current taxes	n.a.	26.6	n.a.	n.a.
— social contributions	n.a.	12.6	n.a.	n.a.
— Total expenditure	53.7	50.4	n.a.	n.a.
Of which: — collective consumption	n.a.	7.9	n.a.	n.a.
— social transfers	n.a.	24.7	n.a.	n.a.
— interest expenditure	4.1	4.4	4.0	3.9
— gross fixed capital formation	4.9	4.0	4.5	4.6
Primary balance	- 5.1	- 2.0	- 0.9	- 0.5
<i>Pm</i> Tax burden	n.a.	n.a.	n.a.	n.a.
Government debt	57.1	59.0	58.7	58.0
<i>Pm</i> Real GDP ⁽²⁾	3.5	2.9	3.2	3.4

(1) Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

(2) Annual % change.

Source: Commission services.

overspending on subsidies, as seen in 2003. Further details are given in the accompanying table.

In January, the initial budget deficit target for 2004 of 3.8 % was revised to 4.6 % of GDP. In addition, a series of expenditure cuts equivalent to around 1 % of GDP were announced, in order to meet the revised target. Additional correction measures have been announced in case the revised target might be in danger of being missed. However, while the measures adopted so far should provide a basis for a significant narrowing of the budget deficit, the revenue shortfall and the overspending of 2003 indicate that the achievement of the revised target for 2004 is subject to risks. The spring 2004 fore-

cast projects a deficit of 4.9 % of GDP in 2004, somewhat above the revised target.

In 2005, expenditure linked to the co-financing of EU-related investment projects, and the realisation of other postponed investment projects might limit the scope for a deficit reduction. On the basis of a no-policy change assumption, the spring 2004 forecast projects a narrowing of the deficit to 4.3 % of GDP.

The government debt ratio is expected to decrease moderately to 58.7 % in 2004 and further to 58.0 % of GDP in 2005.

Table V.30

Main measures in the budget for 2004, Hungary

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Increase of VAT rates due to EU harmonisation, while maintaining the high top rate of 25 %. Increase of excise tax rates • Increase in social security contribution rates • Cuts in rates and extension of brackets in personal income tax, while elimination of numerous tax allowances and credits (on balance, income should remain as in 2003 in real terms) • Decrease of corporate tax rate from 18 to 16 % 	<ul style="list-style-type: none"> • Reduction of public employment (approximately 10 % for central government and 6 % in other public areas) • Reduction of transfers to the wage bill of local government, which are supposed to induce reduction of local-government employees • Adoption of two correction packages (to the tune of about 1 % of GDP) • Reduction of housing loan subsidies • Freezing of subsidised drug prices

Source: Commission services.

16. Malta

The general government deficit recorded a substantial increase to 9.7 % of GDP in 2003 from 5.7 % in 2002. This figure compares negatively to the target of 4.5 % of GDP set in the 2002 pre-accession economic programme. The principal reasons for this deviation are lower tax collection due to weak GDP growth and in the restructuring of Maltese shipyards and the accounting of the associated debt assumed by the general government sector. The latter brought about an increase in public liabilities of 3.2 % of GDP. Principally, as a result of the high deficit, the debt/GDP ratio attained 72.0 % of GDP, from 61.7 % of GDP in 2002.

The 2004 budget was presented in November 2003. On the revenue side, receipts are expected to increase by MTL 102 million or 5.3 percentage points of GDP, 50 % of this amount being due to inflows under the Italian financial

protocol (a cooperation treaty between Malta and Italy) and from EU funds. Other revenue increases stem from stronger enforcement in tax collection, mainly in the real estate sector, and VAT rate and excise increases. On the expenditure side, recurrent payments are forecast to increase by 3.6 % of GDP, linked to increases in social benefits and debt interest. Capital expenditures will rise to 6.6 % of GDP, with the increase largely attributable to a major hospital construction project.

Both the 2003 PEP and the latest reporting of deficit and debt level point to a general government deficit in the range of 5.3–5.4 % of GDP. The Commission's 2004 spring forecast raises this figure to 5.9 % of GDP based on economic growth developments in 2004 somewhat lower than projected in the PEP (1.4 % compared with 2.5 % respectively).

Table V.31

Budgetary developments 2002–05, Malta

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	- 5.7	- 9.7	- 5.9	- 4.5
— Total revenue	n.a.	n.a.	40.2	40.4
Of which: — current taxes	n.a.	n.a.	n.a.	n.a.
— social contributions	n.a.	n.a.	n.a.	n.a.
— Total expenditure	n.a.	n.a.	45.3	44.0
Of which: — collective consumption	n.a.	n.a.	n.a.	n.a.
— social transfers	n.a.	n.a.	n.a.	n.a.
— interest expenditure	3.7	3.6	2.6	2.5
— gross fixed capital formation	n.a.	n.a.	n.a.	n.a.
Primary balance	- 2.0	- 6.1	- 3.3	- 2.0
P _m Tax burden	n.a.	n.a.	n.a.	n.a.
Government debt	61.7	72.0	73.9	75.9
P _m Real GDP ⁽²⁾	1.7	0.4	1.4	2.0

(¹) Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

(²) Annual % change.

Source: Commission services.

On a no-policy change assumption, the spring forecast projects a general government deficit of 4.5 % of GDP in 2005, whilst the 2003 PEP target is a deficit of 4.1 % of GDP and the current budget target is 4.3 % of GDP.

The debt/GDP ratio is expected to further increase to 73.9 % of GDP and to 75.9 % of GDP in 2004 and 2005, respectively.

Table V.32

Main measures in the budget for 2004, Malta

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • VAT rate increase (from 15 to 18 %). Additional receipts (MTL 21 million or 1.1 % of GDP) will be credited to the health account. Increase in excises on tobacco • Actions against tax evasion, namely on property sales • Italian financial protocol and EU funds (MTL 48 million or 2.5 of GDP) 	<ul style="list-style-type: none"> • Strengthen transparency and control over expenditure • Creation of sub-accounts in strategic sectors to enhance expenditure scrutiny

Source: Commission services.

17. Netherlands

According to provisional data for 2003, the general government deficit increased to 3.2 % of GDP, from 1.9 % of GDP in 2002. This compares with a targeted deficit of 1.6 % of GDP deficit in the 2002 stability programme update. The deficit increased despite substantial consolidation efforts equivalent to around 1.2 % of GDP, largely in the form of structural reductions in expenditure. The weakening of central government revenues in response to the economic slowdown was the main reason

for the deterioration in the government balance but a larger-than-foreseen deficit of local authorities also played a role. The debt ratio increased from 52.6 % of GDP in 2002 to 54.8 % of GDP in 2003 mainly due to the combination of an increasing deficit and weak nominal GDP growth.

The budget for 2004 was presented to parliament on 16 September 2003. The 2004 budget included a further

Table V.33

Budgetary developments 2002–07, Netherlands

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	- 1.9	- 3.2	- 3.5	- 3.3		
— Total revenue	45.9	45.6	45.1	44.8		
Of which: — current taxes	24.6	24.0	23.7	24.0		
— social contributions	14.9	15.5	15.6	14.9		
— Total expenditure	47.8	48.8	48.6	48.1		
Of which: — collective consumption	11.4	11.6	11.6	11.3		
— social transfers	24.9	26.1	26.4	26.0		
— interest expenditure	3.1	2.9	2.9	3.0		
— gross fixed capital formation	3.3	3.5	3.4	3.3		
Primary balance	1.2	- 0.3	- 0.7	- 0.3		
<i>Pm</i> Tax burden	39.5	39.4	39.2	38.9		
Government debt	52.6	54.8	56.3	58.6		
<i>Pm</i> Cyclically adjusted balance	- 2.6	- 2.0	- 1.7	- 1.3		
<i>Pm</i> Cyclically adjusted primary balance	0.4	0.9	1.1	1.7		
<i>Pm</i> Real GDP ⁽³⁾	0.2	- 0.8	1.0	1.6		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	- 1.6	- 2.3	- 2.3	- 1.6	- 0.9	- 0.6
Primary balance	1.7	0.6	0.6	1.2	1.8	2.1
Government debt	52.4	54.0	54.5	53.7	53.0	52.2
<i>Pm</i> Real GDP ⁽³⁾	0.2	0.0	1.0	2.5	2.5	2.5

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in October 2003.

⁽³⁾ Annual % change.

Source: Commission services and stability programme of October 2003.

package of substantial savings, equivalent to around 1.2 % of GDP. The measures in the budget consist to a large extent of expenditure cuts on social security, healthcare public wages and subsidies, but also incorporate some tax-revenue-raising measures. In response to a projected further worsening of public finances since the submission of the 2004 budget, the government decided on 16 April 2004 on additional savings measures equivalent to 0.6 % of GDP. This additional package of measures intends to achieve a deficit of below 3 % of GDP from 2004 onwards, and consists mainly of further cost reductions in healthcare, and of a series of smaller measures (some of them of a one-off nature) to increase revenue in 2004. Further details are given in the accompanying table.

The medium-term projections in the budget are the same as in the 2003 stability programme update. Despite the consolidation efforts, the deficit was projected to reach 2.3 % of GDP in 2004 according to the budget, the same estimated figure as for 2003. However, the most recent data show that the deficit reached 3.2 % of GDP in 2003. Under the assumption of no changes in fiscal policy, the Commission's spring 2004 forecast projected the deficit to rise further to 3.5 % of GDP in 2004. The deviation from the target in the budget mainly stems from the upward revision of the 2003 deficit and from the impact of weaker-than-expected economic activity on tax revenue. In addition, higher tax deduction of mortgage interest and pension premiums in the wake of rises in house prices and falls in global asset prices also play a role. The

spring forecast, published on 7 April 2004, did not yet incorporate the additional package of measures decided on by the government on 16 April. It projects the cyclically adjusted balance to improve from – 2.0 % of GDP in 2003 to – 1.7 % in 2004 in response to fiscal tightening. This is an improvement of the same order of magnitude as foreseen in the 2002 updated stability programme.

As public finances respond with a lag to the cycle and fiscal tightening, the deficit is projected to decrease only somewhat in 2005, to 3.3 % of GDP, according to the Commission's spring forecast. This is a less favourable projection than the 0.9 % of GDP deficit expected in the 2003 updated stability programme and reflects the substantial downward revisions to economic growth and upward adjustments to the deficit data and projections that occurred in the mean time. In view of the severity of the economic downturn, the cyclically adjusted balance is expected to develop more favourably, reaching a deficit of 1.3 % of GDP in 2005 according to the Commission's spring forecast. Also for 2004 the spring forecast neither took into account the impact of the measures for 2004 decided by the Dutch authorities on 16 April 2004 nor the package of roughly equal size announced for 2005 but not yet specified.

In the spring forecast, the debt ratio is expected to rise further in 2005, to around 58 % of GDP in response to the projected rise in the deficit and still weak GDP growth.

Table V.34

Main measures in the budget for 2004 and additional package, Netherlands

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Higher contributions for healthcare • Broadening of the tax base by limiting tax-deductibility of mortgage interest payments • Termination of subsidies to employ low-skilled workers 	<ul style="list-style-type: none"> • Freeze in public sector wage increases • Reductions in social security expenditure by tightening eligibility for unemployment and invalidity benefits • Reduction in healthcare expenditure • Reduction in subsidies • Delay of planned expenditures on public consumption and investment

Source: Commission services.

18. Austria

In 2003, the budgetary position weakened markedly. The deficit widened by more than a full percentage point from 0.2 % of GDP in 2002 to 1.3 %, in line with the target set out in the November 2003 update of the stability programme. Expenditure exceeded the budget, reflecting a sharper-than-expected rise in unemployment and additional discretionary spending such as an increase in social transfers, an extra pay-rise for public sector employees, additional labour market expenditure foreseen in the fiscal

stimulus package, topped by deferred flood-related spending. Tax revenues, by contrast, developed more favourably than budgeted. Helped by a considerably lower interest burden, the debt/GDP ratio developed more favourably than expected. Interest expenditure amounted to 3.3 % of GDP, some 0.3 percentage points below the projection of the updated stability programme. Government debt stood at 65 % of GDP at the end of 2003 compared with a target of 66.4 %, helped by higher growth of nominal GDP.

Table V.35

Budgetary developments 2002–07, Austria

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	-0.2	-1.1	-1.1	-1.9		
— Total revenue	51.0	49.9	49.5	47.7		
Of which: — current taxes	28.9	28.7	28.6	27.4		
— social contributions	16.6	16.5	16.3	16.2		
— Total expenditure	51.2	51.0	50.7	49.7		
Of which: — collective consumption	7.0	7.0	6.8	6.6		
— social transfers ⁽⁴⁾	30.2	30.8	30.6	30.4		
— interest expenditure	3.4	3.1	3.1	3.1		
— gross fixed capital formation	1.3	1.2	1.2	1.1		
Primary balance	3.1	2.0	2.0	1.2		
Pm Tax burden	44.2	43.9	43.6	42.4		
Government debt	66.6	65.0	65.5	65.3		
Pm Cyclically adjusted balance	-0.3	-0.9	-0.9	-1.8		
Pm Cyclically adjusted primary balance	3.1	2.2	2.3	1.2		
Pm Real GDP ⁽³⁾	1.4	0.7	1.8	2.5		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4
Primary balance	3.5	2.4	2.8	1.9	2.2	2.8
Government debt	66.7	66.4	65.8	64.1	62.3	59.9
Pm Real GDP ⁽³⁾	1.4	0.9	1.9	2.5	2.5	2.4

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in November 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Austria.

In January 2004, the first step of an income tax break took effect, including certain family-related tax relief measures, which were originally planned for 2005. In total, the budgetary impact amounts to some EUR 0.75 billion or almost 0.4 % of GDP. Taxes for low and middle incomes were lowered through higher tax allowances and preferential taxation for retained profits will be introduced. Moreover, non-wage labour costs, in particular for older workers, were reduced, a measure that had been repeatedly postponed. Already in 2003, the 13th monthly VAT prepayment was abolished. By contrast, social contributions increased and energy and mineral oil taxes were raised as of 2004, with a view to aligning energy taxation to the EU average. Last but not least, the two economic stimulus packages and a 'growth' package, passed since December 2002, continue to burden budgetary spending (see Table V.36).

On balance, the tax measures and the rise in social contributions largely offset each other and therefore the impact on the general government budget should be neutral. As regards deficit-decreasing effects, expected savings from the pension reform for private and federal employees are considerable, largely outpacing the increase in discretionary spending. However, several factors prevent a narrowing of the deficit. Firstly, certain tax relief measures, originally planned for 2005 and worth some 0.1 percentage points of GDP, were brought forward. Secondly, the finance ministry revised downwards the expected surpluses of the sub-federal government levels by 0.2 percentage points to 0.5 % of GDP. Last but not least, central bank profits (in 2003 but affecting the 2004 budget) turned out considerably lower

due to low interest rates and the depreciation of the US dollar. As a result, and despite the expected acceleration in domestic demand, the general government deficit is estimated to remain in the same order of magnitude as in 2003, which is percentage point above the target set in the updated stability programme. With real GDP growth expected to resume its trend rate, the deficit in cyclically adjusted terms is expected to remain unchanged. In 2005, the second step of the tax reform consisting of a sizeable income tax relief for both households and enterprises will take effect. The Austrian parliament passed the respective bill in the beginning of May. The wage and income tax relief and tax cuts for enterprises will amount to some 0.5 % of GDP each. In addition, excise duties with negligible revenue impact ('*Bagatellsteuern*') will be abolished. In total, the tax cuts planned for 2005 are worth some 1.0 % of GDP. To some, albeit small, extent these revenue shortfalls will be offset by continued structural savings from the pension and administrative reforms. Despite the projected strengthening of domestic demand and the closing of the output gap, the general government deficit is projected to widen some 2 % of GDP, which is percentage point above the target set in the November 2003 stability programme update.

Reflecting the expected deficit developments but helped by rather favourable interest rate developments, government debt will decline only slowly. According to the Commission's spring 2004 forecast, and taking into account more recent data, the debt/GDP ratio is expected to fall to some 65 % by 2005.

Table V.36

Main measures in the budget for 2004, Austria

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • First phase of income tax relief (some 0.3 % of GDP) • Family-related tax measures (new tax deductions for single income earner families with children, 0.1 % of GDP) • Increase in energy taxes • Rise in social contributions • Reduction in non-wage labour costs 	<ul style="list-style-type: none"> • Reform of public administration (staff reduction, current cost cuts) • Pension reform — private (ASVG) and federal employees • Wage increases 2004 for civil servants • Increase in discretionary expenditure (R & D, universities, agriculture, sport and culture, ODA) • Continued impact of increase in family allowances

Source: Commission services, Ministry of Finance of Austria.

19. Poland

In 2003, the general government deficit estimated at 4.1 % of GDP was slightly lower than expected. This is mainly due to a higher than initially foreseen growth rate. As the Eurostat decision on the classification of funded pension schemes ⁽¹⁾ is of a generic nature with the individual cases to be assessed in time for the reporting due by 1 September 2004, this figure still considers the open pension funds as part of the government sector ⁽²⁾. The debt ratio in 2003 stands at 45.4 % of GDP as compared to 41.2 % of GDP in 2002, a level 0.6 percentage points higher than expected at the begin-

ning of the year. This difference is mainly due to lower privatisation receipts.

The budget for 2004, voted by the Parliament on 19 December 2003, unveiled an important increase of the financing needs of the government and a significant widening of the deficit despite the acceleration of growth. It is based on (over)optimistic macroeconomic assumptions. The stock of government debt, measured according to the Polish methodology, would approach the second prudence threshold of 55 % of GDP ⁽³⁾. The 2004 budget is

⁽¹⁾ Eurostat news release 30/2004, 'Classification of funded pension schemes in case of government responsibility or guarantee', 2 March 2004.

⁽²⁾ This figure might increase to 5.7 % if the open pension funds are classified outside the general government sector.

⁽³⁾ The Polish Constitution and the Public Finance Act require guarantees to be included in the calculations of the public debt. The Public Finance Act provides for a series of prudence procedures when the public debt ratio breaks the levels of 50, 55 and 60 % of GDP. If the public debt exceeds 55 % of GDP in year *t*, in year *t+2* the State Treasury debt/GDP ratio assumed in the budget made in year *t+1* cannot exceed the ratio observed in year *t*.

Table V.37

Budgetary developments 2002–05, Poland

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	- 3.6	- 4.1	- 6.0	- 4.5
— Total revenue	41.3	41.0	40.8	41.2
Of which: — current taxes	21.6	22.0	21.5	21.1
— social contributions	15.0	14.7	14.3	14.4
— Total expenditure	44.9	45.1	46.8	45.7
Of which: — collective consumption	9.1	9.2	9.0	8.8
— social transfers ⁽³⁾	26.3	25.8	25.4	25.4
— interest expenditure	2.9	3.1	3.2	3.3
— gross fixed capital formation	3.5	3.5	3.5	3.7
Primary balance	- 0.7	- 1.0	- 2.8	- 1.2
<i>Pm</i> Tax burden	n.a.	n.a.	n.a.	n.a.
Government debt	41.2	45.4	49.1	50.3
<i>Pm</i> Real GDP ⁽²⁾	1.4	3.7	4.6	4.8

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Annual % change.

⁽³⁾ In kind and other than in kind.

Source: Commission services.

built upon a set of measures on the revenue side (see Table V.38 below). No major measures are foreseen on the expenditure side, except for the ones resulting from the reform of local governments. A 'medium-term fiscal strategy', which indicates the way forward without, however, showing the precise measures, has been unveiled shortly after the presentation of the budget draft by the government (October 2003). The 'programme of public spending rationalisation and reduction' ('Hausner plan') assumes in turn a reduction of social and administrative spending over the period 2004–07. The 2004 budget has not been amended to incorporate the savings foreseen for 2004 by the 'Hausner plan'. In the Commission's spring 2004 forecast, the general government balance is projected to increase substantially to 6 % of GDP notwithstanding the strengthening of economic growth. The projected outcome is more pessimistic than the one targeted by the government in its first convergence programme (5.7 % of GDP) ⁽¹⁾. Eventual savings, announced in the 'Hausner plan', will be offset by additional expenditures resulting from higher indexation of old-age and disability pensions

and the unforeseen magnitude of the zloty depreciation in 2003 inducing an increased contribution to the EU budget. The rise in indirect taxation is not expected to neutralise the decline in the revenues from the corporate tax. It is projected that the deficit will fall in 2005 to 4.5 % of GDP. The fiscal adjustment would be mainly cyclical with a positive role played by positive net inflows from the EU budget. The forecast takes into account eventual savings reflected in the bills voted in parliament (mainly changes in the indexation of pension schemes, in the allocation of the pre-retirement benefits and in the rural pension system) in March 2004.

The government debt ratio is expected to be slightly above 49 % of GDP by the end of 2004 and to exceed 50 % in 2005 ⁽²⁾ mainly because of delays in the privatisation process and the depreciation of the zloty against the euro in 2003, boosting the domestic currency value of the Polish government debt denominated in foreign exchange.

⁽¹⁾ The 2003 PEP (August 2003) targeted a general government deficit of 5 % for 2004.

⁽²⁾ If the open pension funds are classified outside of the government sector, these figures might increase by approximately 4.5 percentage points.

Table V.38

Main measures in the budget for 2004, Poland

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Reduction of the corporate income tax rate from 27 to 19 % • Introduction of the possibility to pay the corporate income tax rate of 19 % for small companies (self-employed), which paid so far taxes according to the personal income tax thresholds, if they renounce all tax exemptions and rebates • Alignment of the VAT legislation leading to an increase of the rate on various products to 22 % (e.g. construction materials) and an increase in excise taxes • Introduction of a flat tax of 19 % on capital income (e.g. dividends) 	<ul style="list-style-type: none"> • Local governments' reform: gradual transfer of personal and corporate income tax revenues from the central budget to local authorities (self-governments) and a simultaneous reduction of subsidies • No other major measure is included in the 2004 budget law despite savings foreseen in the 'Hausner plan'

Source: Commission services.

20. Portugal

The general government deficit for 2003 is estimated at 2.8 % of GDP. This compares with a targeted deficit of 2.4 % of GDP set in the January 2003 update of the stability programme. The deviation from target is due to a massive tax shortfall (excluding the sale of tax and social security contributions arrears), resulting from the unanticipated decline of GDP in 2003 by an estimated 1.3 %. On the expenditure side, by contrast, the government has been broadly successful in securing the planned restraint.

Together, these revenue and expenditure developments would have led to a government deficit clearly above 3 % of GDP in 2003. In order to prevent this, the Portuguese authorities relied on two one-off measures, worth in total 2.1 % of GDP. The government debt/GDP ratio continued to rise in 2003, approaching the 60 % benchmark.

The budget for 2004 was presented to parliament in October 2003, then approved and ratified by the end of

Table V.39

Budgetary developments 2002–07, Portugal

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	-2.7	-2.8	-3.4	-3.8		
— Total revenue	43.4	44.6	43.2	43.0		
Of which: — current taxes	24.7	24.7	23.5	23.4		
— social contributions	12.2	12.6	12.7	12.7		
— Total expenditure	46.1	47.5	46.6	46.9		
Of which: — collective consumption	8.5	8.5	8.3	8.1		
— social transfers ⁽⁴⁾	25.6	26.5	26.5	26.3		
— interest expenditure	3.0	2.9	2.9	3.1		
— gross fixed capital formation	3.4	3.9	3.1	3.7		
Primary balance	0.3	0.1	-0.5	-0.8		
<i>Pm</i> Tax burden	36.9	37.2	36.0	35.9		
Government debt	58.1	59.4	60.7	62.0		
<i>Pm</i> Cyclically adjusted balance	-2.7	-1.8	-2.1	-2.6		
<i>Pm</i> Cyclically adjusted primary balance	0.3	1.1	0.8	0.5		
<i>Pm</i> Real GDP ⁽³⁾	0.4	-1.3	0.8	2.2		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	-2.7	-2.9	-2.8	-2.2	-1.6	-1.1
Primary balance	0.3	-0.1	0.1	0.9	1.5	2.0
Government debt	58.0	59.5	60.0	59.7	58.6	57.0
<i>Pm</i> Real GDP ⁽³⁾	0.4	-0.8	1.0	2.5	2.8	3.0

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in December 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Portugal.

2003. On the revenue side, it implements the first of a two-stage reduction in the corporate tax rate, introduces significant rises in the prices of marketed government services and plans sales of real estate amounting to 0.7 % of GDP. On the expenditure side, it implements for a second year running a quasi-freeze of employment and wage scales in the central government. Further details are given in the accompanying table.

The Commission services' 2004 spring forecast projects a general government deficit of 3.4 % of GDP for 2004, thereby significantly above the official target of a deficit of 2.8 % of GDP ⁽¹⁾. The difference can basically be accounted for by three elements: (i) projected growth of

GDP is percentage point lower in the Commission forecast; (ii) base effects due to the significant amount of one-off measures adopted in 2003, mainly affecting the revenue side; and (iii) the partial substitution of the one-off measures taken in 2003, i.e. from 2.1 % of GDP to a so far planned value of 0.7 % of GDP. Excluding one-off measures, the spring forecast projects a marked narrowing of the cyclically adjusted deficit in 2004 by 1 percentage point of GDP.

⁽¹⁾ This was confirmed in the March 2004 reporting of government deficits and debt levels (in accordance with Council Regulation (EC) No 3605/93, as amended by Council Regulation (EC) No 475/2000).

Table V.40

Main measures in the budget for 2004, Portugal

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Reduction in the corporate tax rate from 30 to 25 % (0.1–0.2 % of GDP) • Reform of the real estate tax system • Rises in the prices of marketed government services • Planned sales of real estate worth a total of EUR 1 billion (0.7 % of GDP) 	<ul style="list-style-type: none"> • A 10 % cut in working expenditure in the central government • A quasi-freeze of employment and wage scales in the central government

Source: Commission services.

21. Slovenia

In 2003, the general government deficit came to 1.8 % of GDP — slightly better than projected in the 2003 pre-accession economic programme (1.95 %), thanks to a determined fiscal policy, and against the background of faltering growth. On the revenue side, taxes on profits and capital gains increased markedly, while substantial savings on interest payments materialised due to lower than anticipated inflation. After unexpected shortfalls leading to failures in achieving the targets and frequent revisions of budgets in previous years, fiscal consolidation seemed to be on track in 2003. Government debt declined to 27.1 % of GDP in 2003.

In December 2003, the Parliament adopted a supplementary budget for 2004. The budget implementation bill stipulates a novel measure: in case of a revenue shortfall due to an economic downturn the government has the discretion to reduce expenditure proportionally — up to SIT

15 billion (0.25 % of GDP) in the course of the year, without having to propose the budget to be amended. If unfavourable macroeconomic conditions persist, an up to SIT 10 billion (0.17 % of GDP) budget deficit overrun will nevertheless be accepted at the end of the year. Moreover, the agreement on public sector wages for 2004–05, which introduced forward-looking indexation — with anticipated rather than actual domestic inflation and also taking into account EU inflation and the euro/tolar exchange rate — is expected to contain budget expenditure as wages constitute an important part of general government spending. Furthermore, indexation of some social benefits has also been weakened (see Table V.42 for details on the public finance measures in 2004).

According to the March 2004 fiscal notification, the target for the general government deficit in 2004 is 1.6 % of GDP. At 1.7 %, the Commission services project a

Table V.41

Budgetary developments 2002–05, Slovenia

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	- 1.9	- 1.8	- 1.7	- 1.8
— Total revenue	41.5	41.6	42.3	42.3
Of which: — current taxes	n.a.	n.a.	n.a.	n.a.
— social contributions	n.a.	n.a.	n.a.	n.a.
— Total expenditure	43.9	43.6	44.0	44.0
Of which: — collective consumption	n.a.	n.a.	n.a.	n.a.
— social transfers	n.a.	n.a.	n.a.	n.a.
— interest expenditure	2.1	1.9	1.7	1.6
— gross fixed capital formation	n.a.	n.a.	n.a.	n.a.
Primary balance	- 0.3	- 0.1	- 0.1	- 0.1
P _m Tax burden	n.a.	n.a.	n.a.	n.a.
Government debt	27.8	27.1	28.3	28.2
P _m Real GDP ⁽²⁾	2.9	2.3	3.2	3.6

(¹) Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

(²) Annual % change.

Source: Commission services.

slightly worse outcome since a tendency towards accommodating government consumption in an election year was assumed ⁽¹⁾.

Despite the planned measures in revenue policy — reforming the direct taxes as well as improving the tax administration — and expenditure limits, the general government budget deficit is projected to increase marginally to 1.8 % of GDP in 2005.

On the one hand, the introduction of the real estate tax, which will replace the current local tax, is expected to have a neutral fiscal effect.

⁽¹⁾ The European Parliament elections took place in June while national parliamentary elections are due in November.

On the other hand, the corporate income tax will increase the general government revenues by broadening the tax base and eliminating loopholes in the legislation while the new personal income tax regime, designed to disburden the lowest income classes from 2005, will adversely affect the revenues. On the expenditure side, the measures enhancing cost-effectiveness and flexibility will result in savings, which will be partly offset by additional spending commitments related to EU accession (Schengen border).

The debt ratio is relatively low and will remain so in the future. In the Commission's spring 2004 forecast, the government debt is projected to increase from 27.1 % of GDP in 2003 to 28.3 % this year and then stabilise around that level.

Table V.42

Main measures in the budget for 2004, Slovenia

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Further harmonisation of excise duties on spirits and tobacco with the <i>acquis</i> 	<ul style="list-style-type: none"> • Containing the rise in public wages and social benefits through weakened indexation mechanisms • Increasing cost effectiveness of the public administration (cuts in discretionary spending of individual ministries mainly through rationalisation of material costs) • Further restructuring (reallocation of expenditure items favouring investment in education and research and promoting regional cohesion)

Source: Commission services.

22. Slovakia

After the 2002 election year, the newly formed Slovak government initiated a fiscal turn-around. The budget for 2003 targeted a general government deficit of 5.0 % of GDP (down from 5.7 % of GDP in 2002). During the budget execution, the government took additional measures against emerging risks, which occurred in particular in the form of underperforming VAT revenues, for instance by advancing excise tax increases from the beginning of 2004 to August 2003. In the end, the general government deficit turned out to be much lower than planned and amounted to 3.6 % of GDP — partly due to spending postponements. The budget for 2004 reflects the major part of the public finance reform agenda of the current government. At the beginning of 2004, far-reaching tax reforms took effect, consisting mainly of the introduction of a flat income tax and a unified value added tax, both at a rate of 19 %. The tax reform package

leads to a shift from direct to indirect taxation and is likely to strengthen incentives and growth. On the expenditure side, the 2004 budget incorporates notably a multitude of incentive-enhancing measures in the area of social transfers. Table V.44 lists major measures. In addition, the budget for 2004 is, for the first time, affected by the contributions to and transfers from the EU associated with Slovakia's membership as of 1 May 2004.

The budget passed by parliament last December is in line with a general government deficit target of 4.0 % of GDP for 2004. The Commission's spring 2004 forecast projects that the government will basically meet this target. These estimates are subject to the caveat that budget forecasts are relatively uncertain in the present wide-ranging reform environment.

Table V.43

Budgetary developments 2002–05, Slovakia

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005
General government balance	-5.7	-3.6	-4.1	-3.9
— Total revenue ⁽⁴⁾	45.2	49.1	42.0	43.1
Of which: — current taxes	19.5	18.3	17.5	17.6
— social contributions	13.6	14.0	13.2	13.6
— Total expenditure ⁽⁴⁾	50.9	52.7	46.1	47.0
Of which: — collective consumption	11.3	11.2	10.9	10.7
— social transfers ⁽³⁾	20.6	20.3	19.7	19.2
— interest expenditure	3.6	2.4	2.7	2.9
— gross fixed capital formation	3.3	3.0	2.7	2.5
Primary balance	-2.1	-1.2	-1.4	-1.0
<i>Pm</i> Tax burden	33.0	32.3	30.7	31.2
Government debt	43.3	42.8	45.1	46.1
<i>Pm</i> Real GDP ⁽²⁾	4.4	4.2	4.0	4.1

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Annual % change.

⁽³⁾ In kind and other than in kind.

⁽⁴⁾ Revenue and expenditure ratios are not consolidated.

Source: Commission services.

For 2005, the Commission's spring 2004 forecast predicts a general government deficit of 3.9 % of GDP. As in 2004, the forecast is based on already passed reform measures on the revenue and expenditure side — with the notable exception of some specified health reform measures. The forecast includes the effect of the introduction of a mandatory funded pension pillar

in 2005. So far, the government has not indicated any additional measures to compensate for the associated increase of the general government deficit of some 0.7 % of GDP.

The debt/GDP ratio is likely to hover between 45 and 46 % of GDP in 2004/05.

Table V.44

Main measures in the budget for 2004, Slovakia

Revenue measures	Expenditure measures
<p>The tax reform package leads to a considerable shift from direct to indirect taxation, increases the transparency of the tax system and is likely to strengthen incentives and growth. Elements of the package are:</p> <ul style="list-style-type: none"> • introduction of a flat tax rate of 19 % for both individual and corporate income taxation, coupled with the removal of tax exemptions; • introduction of a unified VAT tax rate of 19 %; • abolition of some less significant taxes (inheritance tax, gift tax) and amendments to some others (real estate tax, vehicle tax). <p>In addition, the health and social insurance contribution rates payable by employers and employees have been reduced, albeit to a less significant extent, i.e. to a still relatively high total level of roughly 48 % of gross wages.</p>	<p>The reforms on the expenditure side effect in particular the area of social transfers. <i>Inter alia</i>, the following incentive-enhancing measures have been implemented:</p> <ul style="list-style-type: none"> • changes in key parameters of the pay-as-you-go pillar of the pension system (e.g. benefit formula, indexation, retirement age) — while a funded pension pillar will be instituted in 2005; • various changes in other components of the social insurance system (e.g. sickness benefits), of social assistance and of social benefits (e.g. child benefits); • changes in the healthcare system (e.g. full impact of introduction of co-payments).

Source: Commission services.

23. Finland

In 2003, the general government balance continued to be in surplus, at 2.3 % of GDP. This was in line with the target set in the November 2003 update of the stability programme. The overall budgetary outturn was in line with expectations, although central government finances posted a surplus 0.3 % of GDP compared with a projected deficit of 0.1 %. This derived from higher indirect tax revenues and also from savings in subsidies and transfer payments and lower interest expenditure. How-

ever, the social security surplus was slightly lower than anticipated, whereas the local government deficit was close to target. The debt ratio in 2003 was 45.3 % of GDP, while the target in the updated stability programme was 45.1 %. The 2.7 percentage points rise in the debt ratio from 42.6 % of GDP in 2002 follows mainly from a technical change in the classification of central government debt as the repo portfolio was removed from the State Treasury's balance sheet.

Table V.45

Budgetary developments 2002–07, Finland

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	4.3	2.3	2.0	2.1		
— Total revenue	54.4	52.7	52.6	52.2		
Of which: — current taxes	33.1	32.1	31.6	31.3		
— social contributions	12.4	12.1	12.3	12.4		
— Total expenditure	50.1	50.5	50.7	50.1		
Of which: — collective consumption	7.6	7.7	7.8	7.8		
— social transfers ⁽⁴⁾	30.9	31.3	31.5	31.4		
— interest expenditure	2.2	1.9	1.9	1.7		
— gross fixed capital formation	2.9	3.0	2.8	2.7		
Primary balance	6.5	4.1	3.8	3.8		
<i>Pm</i> Tax burden	46.1	44.8	44.5	44.4		
Government debt	42.6	45.3	44.5	44.3		
<i>Pm</i> Cyclically adjusted balance	3.7	2.3	2.1	2.2		
<i>Pm</i> Cyclically adjusted primary balance	5.9	4.2	3.9	3.9		
<i>Pm</i> Real GDP ⁽³⁾	2.3	1.9	2.6	2.7		
Stability programme ⁽²⁾	2002	2003	2004	2005	2006	2007
General government balance	4.2	2.3	1.7	2.1	2.1	2.2
Primary balance	4.4	2.4	1.6	1.8	1.8	1.8
Government debt	42.7	45.1	44.7	44.9	45.0	44.6
<i>Pm</i> Real GDP ⁽³⁾	2.2	1.4	2.7	2.5	2.4	2.4

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in November 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ In kind and other than in kind.

Source: Commission services and stability programme of Finland.

The State budget for 2004 was approved by parliament on 19 December. Expenditures will go up by 4 % in real terms from 2003. Half of the increase derives from appropriation increases forced by current legislation and decisions made by the previous government, and the other half from the spending increases included in the new government's programme and compensations payable to other government levels due to income tax cuts. Revenues are set to grow by over 1 %, even though the government has cut taxes on income and alcohol.

The target for the general government surplus in 2004 in the semi-annual economic survey of the Ministry of Finance is 1.9 % of GDP (1.7 % in the November 2003 update of the stability programme) ⁽¹⁾. The Commission's spring 2004 forecast of the general government

surplus is 2.0 % of GDP ⁽²⁾ for 2004. It implies that the cyclically adjusted surplus will remain virtually unchanged at some 2 % of GDP during 2004–05. In 2004, the cyclically adjusted surplus will decrease by some 0.3 percentage points from 2003, indicating a slightly expansionary stance in fiscal policy.

Given the no-policy change assumption in the forecast for 2005, the general government finances are foreseen to record a surplus of 2.1 % of GDP, which is in line with the surplus target presented in the November 2003 update of the stability programme.

According to the spring 2004 forecast, the debt ratio is seen to decrease slightly from 44.5 % of GDP to 44.3 % during 2004–05. The economic survey from the Ministry of Finance sees debt ratio ease to 44.7 % of GDP in 2004.

⁽¹⁾ Starting from 2003, the national accounts definition and the EDP definition of the general government balance will differ due to swap-interest payments. The difference in 2003 was 0.2 percentage points, the EDP definition of general government surplus being at 2.3 % of GDP and the national accounts definition at 2.1 %.

⁽²⁾ EDP definition, Ministry of Finance will continue to use the national account definition.

Table V.46

Main measures in the budget for 2004, Finland

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Decrease in earned income taxation (0.5 % of GDP) • Decrease in excise duty on alcohol by an average of 33 % (0.2 % of GDP) 	<ul style="list-style-type: none"> • Increase in active labour market policy measures (0.1 % of GDP) • Increase in central government transfers to local government (0.3 % of GDP)

Source: Ministry of Finance (budget for 2004).

24. Sweden

The general government balance is estimated to have recorded a surplus in 2003, of 0.7 % of GDP. This compares with a targeted surplus of 1.5 % of GDP set in the November 2002 update of the convergence programme. The deviation from the projection is due to higher-than-projected primary expenditures, in particular transfer pay-

ments. This was however partially offset by lower-than-projected interest expenditure. Moreover, the tax hikes in the local government sector offset weaker-than-expected tax revenue for central government linked to weaker-than-forecast economic growth. The government debt/GDP ratio continued to fall and was 51.9 % of GDP in 2003.

Table V.47

Budgetary developments 2002–06, Sweden

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005	
General government balance	0.0	0.7	0.2	0.7	
— Total revenue	58.1	59.5	59.1	58.9	
Of which: — taxes	35.2	36.3	36.2	36.2	
— social contributions	15.0	14.7	14.5	14.4	
— Total expenditure ⁽⁴⁾	58.1	58.8	58.9	58.3	
Of which: — collective consumption	8.5	8.6	8.6	8.6	
— social transfers ⁽⁵⁾	37.9	38.8	38.8	38.4	
— interest expenditure	2.9	2.1	2.3	2.4	
— gross fixed capital formation	3.3	3.1	3.0	2.9	
Primary balance ⁽⁴⁾	2.9	2.9	2.5	3.1	
Pm Tax burden	50.4	51.0	50.7	50.6	
Government debt	52.6	51.9	51.8	50.5	
Pm Cyclically adjusted balance	- 0.5	0.7	0.3	0.8	
Pm Cyclically adjusted primary balance	2.4	2.9	2.6	3.2	
Pm Real GDP ⁽³⁾	2.1	1.6	2.3	2.6	
Convergence programme ⁽²⁾	2002	2003	2004	2005	2006
General government balance ⁽⁴⁾	0.2	0.4	0.6	1.4	1.9
Primary balance ⁽⁴⁾	3.4	3.0	3.2	4.1	4.6
Government debt	52.7	51.7	51.5	50.0	48.3
Pm Real GDP ⁽³⁾	1.9	1.4	2.0	2.6	2.5

(1) Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definition used in the excessive deficit procedure.

(2) Submitted in December 2003. In the 2004 spring Fiscal Policy Bill released on 15 April, the following projections were made: GDP growth: 2.5 % in 2004, 2.6 % in 2005 and 2.5 % in 2006. General government budget balance (% of GDP): 0.3 % in 2004; 0.6 % in 2005; 1.1 % in 2006. Government debt (% of GDP): 52.1 % in 2004, 51.5 % in 2005, and 50.6 % in 2006.

(3) Annual % change.

(4) This figure corresponds to the updated convergence programme's concept of 'net lending with accruals taxes', which best reflects Statistics Sweden's revised methodology to report tax receipts.

(5) In kind and other than in kind.

Source: Commission services and convergence programme of Sweden.

The budget for 2004 was unveiled on 22 September 2003. The updated convergence programme for the period 2003–06, drawing fully on the budget, was submitted to the Commission on 1 December 2003. Expenditure in relation to GDP is expected to fall in 2004. New expenditure-increasing measures adopted in the budget were very small in size and offset by cost-cutting measures, though some additional measures have been announced since the release of the budget, described in the accompanying table. This reflects to a large degree the virtually non-existing budgetary margin included under the expenditure ceiling at the central government level in 2004. Therefore, the previously announced expenditure ceiling for 2004 may be considered to have been binding for the government when preparing the budget. Revenues by contrast are expected to remain unchanged in 2004, influenced also by the announced tax hikes at the local government level.

The updated convergence programme projects a general government surplus in 2004 of 0.6 % of GDP ⁽¹⁾. In the Commission services' spring 2004 forecast, the 2004 outcome is somewhat worse than projected by the Swedish authorities (surplus of 0.2 % of GDP) reflecting to a large part the Commission's worse outlook for the labour market and also some additional factors. Subject to the caveat that calculations of the output gap are surrounded by a large degree of uncertainty in Sweden, the spring forecast projects the cyclically adjusted surplus to narrow by % of GDP and the cyclically adjusted primary surplus to narrow less. This suggests a slightly expansionary fiscal stance in 2004. By contrast, the calculations in the Commission's assessment of the updated programme suggested a somewhat restrictive fiscal stance. This differ-

ence is due both to additional expenditure measures and a smaller effect of the cycle in the spring forecast.

On current policies the spring forecast projects an increase in the surplus to 0.7 % of GDP in 2005, which is below the projection in the updated convergence programme of a surplus of 1.4 % of GDP ⁽²⁾. Half of the difference is due to the new measures announced by the government in December 2003 (the 'three-party negotiations package' together with the Left and the Green parties). The other half is mainly due to higher transfer payments to households, in particular as a result of a weaker labour market performance foreseen in the Commission's spring forecast.

In the spring Fiscal Policy Bill released on 15 April, the expenditure ceilings set in the September 2003 budget were confirmed though the 2004–06 budgetary margins were narrowed further. Gradually higher surpluses in the government finances were projected though considerably lower than the projections in the September 2003 budget. In 2004, a surplus of 0.3 % of GDP is projected, followed by 0.6 and 1.1 % of GDP in 2005 and 2006, respectively. The bill's estimate of the structural budget balance in 2004 is almost unchanged compared with the September 2003 budget, reflecting an estimate of a more negative output gap in this bill (going forward to 2006). The fiscal stance in 2005–06 is assessed to be restrictive, but less so than in the September 2003 budget.

General government debt, which mainly lies in central government, is projected to rise as the central government is expected to remain in deficit until 2005. This rise is however slower than nominal GDP growth and the debt ratio is therefore projected to continue to decline in 2004–05, to slightly above 50 % of GDP.

⁽¹⁾ This figure corresponds to the updated convergence programme's concept of 'net lending with accrual taxes', which best reflects Statistics Sweden's revised methodology to report tax receipts. According to the previous methodology, the surplus projection in the 2003 update was 0.4 % of GDP.

⁽²⁾ See previous footnote. For 2005, the surplus projection according to the previous methodology was 1.2 % of GDP.

Table V.48

Main measures in the budget for 2004, Sweden

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Green tax swap (increase of energy taxes and a reduction of labour taxes) and a reduction of wealth and inheritance taxes (- 0.1 % of GDP) ⁽¹⁾ 	<ul style="list-style-type: none"> • Additional resources to the Swedish National Labour Market Administration for labour market programmes and also for life-long learning activities (0.2 % of GDP) ⁽²⁾

⁽¹⁾ At the same time, the 2003 updated convergence programme estimated tax rises at the local government level of 0.1 % of GDP.

⁽²⁾ These measures were introduced with the December 2003 'three-party negotiations package'

Source: Commission services, Swedish Ministry of Finance (budget for 2004).

25. United Kingdom

The outturn for the general government balance is estimated (in budget 2004) to be a deficit of 3.2 % of GDP in financial year 2003/04 — compared with a deficit of 2.4 % projected in budget 2003. This result, worse than expected, appears to be mostly due to differences in the composition of GDP, with lower-than-expected growth in wages implying lower receipts from income tax and social security contributions. Corporation tax receipts

were lower than expected, while higher discretionary expenditure related to the Iraq War also contributed. General government debt is estimated to be 39.8 % of GDP at the end of 2003/04, higher than the 39 % that had been projected in the 2003 budget.

The latest budget was released on 17 March 2004, setting out a number of discretionary policy changes, which over-

Table V.49

Budgetary developments 2002–07, United Kingdom

(% of GDP)

Outturn and forecast ⁽¹⁾	2002	2003	2004	2005		
General government balance	- 1.6	- 3.2	- 2.8	- 2.6		
— Total revenue	39.5	39.6	39.5	39.6		
Of which: — taxes	29.1	28.7	28.6	28.7		
— social contributions	7.4	7.8	8.0	8.0		
— Total expenditure	41.1	42.8	42.3	42.2		
Of which: — collective consumption	7.7	7.7	7.7	7.7		
— social transfers ⁽²⁾	25.9	27.0	26.6	26.4		
— interest expenditure	2.0	2.0	2.0	2.1		
— gross fixed capital formation	1.3	1.5	1.8	2.0		
Primary balance	0.4	- 1.2	- 0.7	- 0.5		
Pm Tax burden	36.5	36.7	36.7	36.8		
Government debt	38.5	39.9	40.1	40.6		
Pm Cyclically adjusted balance	- 1.5	- 2.9	- 2.6	- 2.3		
Pm Cyclically adjusted primary balance	0.6	- 0.9	- 0.5	- 0.2		
Pm Real GDP ⁽³⁾	1.6	2.2	3.0	2.8		
Convergence programme ⁽²⁾	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
General government balance ⁽⁴⁾	- 2.1	- 3.3	- 2.6	- 2.4	- 2.1	- 2.0
Primary balance ⁽⁴⁾	- 0.5	- 1.7	- 0.9	- 0.7	- 0.4	- 0.3
Government debt	37.9	39.3	40.2	40.8	41.1	41.4
Pm Real GDP ⁽³⁾	1 1/4	2 1/4	3 1/4	2 3/4	2 1/2	2 1/4

⁽¹⁾ Commission services' spring 2004 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

⁽²⁾ Submitted in December 2003.

⁽³⁾ Annual % change.

⁽⁴⁾ Figures include UMTS receipts of 0.1 % of GDP in each year.

⁽⁵⁾ In kind and other than in kind.

Source: Commission services, convergence programme of the United Kingdom and 2003 pre-budget report.

all, have only a minor impact on the UK's fiscal position. Measures with the largest fiscal impact included a new package aimed at increasing compliance with direct taxes, a one-off transfer to the over-70s to assist with living expenses, and, in line with usual practice, a rebuilding of the precautionary margin against overspend in annually managed government spending. Further details are given below in the accompanying table.

The 2004 budget also set out new estimates and projections for the public finances, updating those set out in the December 2003 convergence programme update. The general government balance is expected to improve over the course of 2004, to show a deficit of 2.6 % for 2004/05. In the Commission's spring 2004 forecast, the projected outcome for calendar year 2004 is slightly less optimistic, at 2.8 % of GDP, largely reflecting a more conservative estimate of the recovery in revenues — despite forecasts for GDP growth broadly similar to the 'cautious' forecasts used by the government to forecast the public finances. While estimates of the output gap inherently involve a degree of uncertainty, the cyclically adjusted deficit is projected to narrow by 0.3 percentage

points, reflecting to a large extent the falling-away of expenditures associated with the Iraq War.

In 2005, under a no-policy change assumption, the spring 2004 forecast projects a further improvement in the general government balance, to a deficit of 2.6 % of GDP. Again, the deficit is projected to remain slightly higher than official projections of 2.4 % in the 2005/06 financial year. As well as differences in view over revenue growth, the difference also reflects a more optimistic growth projection used by the UK authorities. In particular, the 'cautious' growth rate for GDP used by the government to project the public finances (3.0 % in 2005/06) is above the Commission forecast of 2.8 % for the 2005 calendar year.

According to the Commission forecast, the general government debt/GDP ratio, is expected to rise modestly over the forecast period, from 39.9 % of GDP in 2003 to reach 40.6 % in 2005. Nonetheless, government debt remains at a prudent level well below the 60 % reference value.

Table V.50

Main measures in the budget for 2004, United Kingdom

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Direct taxes compliance package (+ 0.1 % of GDP by 2006/07) • Minimum rate of tax, distributed profits (+ 0.04 % of GDP by 2006/07) 	<ul style="list-style-type: none"> • GBP 100 payment to the over-70s (– 0.04 % of GDP in 2004/05 only) • Resetting of the margin against overspend in annually managed expenditure (– 0.1 % of GDP in 2004/05, – 0.2 % of GDP in 2005/06) • Scheme to allow local government to retain a proportion of growth in local non-domestic rates revenue (– 0.02 % of GDP by 2006/07)

Source: Source: HM Treasury, budget 2004.

Part VI

Resources

1. Glossary

Accession countries Countries that will become members of the EU in May 2004 and include Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

Automatic stabilisers Various features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance tends to improve in years of high growth, and deteriorate during economic slowdowns.

Broad economic policy guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (Ecofin).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government aggregates*. See also *structural budget balance*, *primary budget balance* and *primary structural balance*.

Budgetary rules Rules and procedures through which policy-makers decide on the size and the allocation of public expenditure as well as on its financing through taxation and borrowing.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Candidate countries Countries that wish to accede to the EU. Besides the *accession countries*, they include Bulgaria, Romania and Turkey.

Close-to-balance requirement A requirement contained in the *Stability and Growth Pact*, according to

which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus.

Code of conduct on the format and content of the stability and convergence programmes Policy document endorsed by the Ecofin Council in July 2001 setting down the information requirements and key definitions to be followed by Member States in preparing their stability or convergence programmes.

Convergence programmes Medium-term budgetary and monetary strategies presented by each of those Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. Prior to the third phase of EMU, convergence programmes were issued on a voluntary basis and used by the Commission in its assessment of the progress made in preparing for the euro. See also *stability programmes*.

Crowding-out effects Offsetting effects on output due to changes in interest rates and exchange rates triggered by a loosening or tightening of fiscal policy.

Cyclical component of budget balance That part of the change in the *budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *output gap*. See *automatic stabilisers*, *tax smoothing* and *structural budget balance*.

Cyclically adjusted budget balance See *structural budget balance*.

Demand and supply shocks Disturbances that affect the economy on the demand side (e.g. changes in private consumption or exports) or on the supply side (e.g. changes in commodity prices or technological innovations). They can impact on the economy either on a temporary or permanent basis.

Dependency ratio A measure of the ratio of people who receive government transfers, especially pensions, relative to those who are available to provide the revenue to pay for those transfers.

Direct taxes Taxes that are levied directly on personal or corporate incomes and property.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government aiming at stabilising the economy. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*. See also *fiscal stance*.

Early-warning mechanism Part of the preventive elements of the SGP, activated when there is significant divergence from the budgetary targets set down in a stability or convergence programme.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, renamed the Economic and Financial Committee as of January 1999. Its main task is to prepare and discuss (Ecofin) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior officials whose main task is to prepare discussions of the (Ecofin) Council on structural policies. It plays a large role in the preparation of the BEPGs, and it is active on policies related to labour markets, methods to calculate cyclically adjusted budget balances and ageing populations.

Effective tax rate The ratio of broad categories of tax revenue (labour income, capital income, consumption) to their respective tax bases.

ESA 95/ESA 79 European accounting standards for the reporting of economic data by the Member States to the EU. As of 2000, ESA 95 has replaced the earlier ESA 79 standard with regard to the comparison and analysis of national public finance data.

Excessive deficit procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See

also *stability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Fiscal consolidation A continuous improvement in the *budget balance*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal decentralisation The transfer of authority and responsibility for public functions from the central government to intermediate and local governments or to the market.

Fiscal federalism A subfield of public finance that investigates the fiscal relations across levels of government.

Fiscal impulse The estimated effect of fiscal policy on GDP. It is not a model-free measure and it is usually calculated by simulating an econometric model. The estimates presented in the present report are obtained by using the Commission services' model *QUEST*.

Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also *budgetary rule*, *expenditure rules*.

Fiscal stance A measure of the discretionary fiscal policy component. In this report, it is defined as the change in the *primary structural budget balance* relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU budget.

Government budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, government borrowing, or changes in the monetary base. In the context of EMU, the ability of govern-

ments to finance spending through money issuance is prohibited. See also *stock-flow adjustment, sustainability*.

Government contingent liabilities Obligations for the government that are subject to the realisation of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depends on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e. depend upon the occurrence of uncertain future events.

Hodrick-Prescott (HP) filter A statistical technique used to calculate trend GDP and *output gaps* by filtering actual GDP.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Interest burden *General government* interest payments on public debt as a share of GDP.

Maastricht reference values for public debt and deficits Respectively, a 60 % *general government* debt/GDP ratio and a 3 % *general government* deficit/GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *excessive deficit procedure*.

Maturity structure of public debt The profile of total debt in terms of when it is due to be paid back. Interest rate changes affect the budget balance directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *public debt*.

Minimal benchmarks Values indicating a budgetary position that would provide a cyclical safety margin for the *automatic stabilisers* to operate freely during economic slowdowns without leading to excessive deficits. The minimal benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks and should not be confused with the '*close-to-balance or in surplus*' medium-term requirement of the Pact.

Monetary conditions index (MCI) An indicator combining the change in real short-term interest rate and in the real effective exchange rate to gauge the degree of easing or tightening of monetary policy.

Mundell-Fleming model Macroeconomic model of an open economy which embodies the main Keynesian hypotheses (price rigidity, liquidity preference). In spite of its shortcomings, it remains useful in short-term economic policy analysis.

NAIRU Non-accelerating inflation rate of unemployment.

Non-Keynesian effects Supply-side and expectations effects which reverse the sign of traditional Keynesian multipliers. Hence, if non-Keynesian effects dominate, fiscal consolidation would be expansionary.

Old-age dependency ratio Population aged over 65 as a percentage of working age population (usually defined as persons aged between 15 and 64).

One-off measure Transitory budget effects resulting directly from a policy initiative. A temporary measure implies an improvement/deterioration of the budget that does not lead to a reliable improvement/deterioration in the intertemporal budgetary position.

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *cyclical component of budget balance*.

Pay-as-you-go pension system (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees.

Pre-accession economic programmes (PEPs) Annual programmes submitted by candidate countries which set the framework for economic policies. The PEPs consist

of a review of recent economic developments, a detailed macroeconomic framework, a discussion of public finance issues and an outline of the structural reform agenda.

Pre-accession fiscal surveillance framework (PFSF) Provides the framework for budgetary surveillance of candidate countries in the run up to accession. It closely approximates the policy coordination and surveillance mechanisms at EU level.

Policy-mix The overall stance of fiscal and monetary policy. The policy-mix may consist of various combinations of expansionary and restrictive policies, with a given *fiscal stance* being either supported or offset by monetary policy.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural (or cyclically adjusted) budget balance* net of interest payments.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. It can be contrasted with (discretionary) counter-cyclical policy that has the opposite effects. A neutral fiscal policy keeps the *cyclically adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work. See also *tax-smoothing*.

Production function approach A means to estimate the potential level of output of an economy on taking inputs on labour and capital as well as trend factor productivity into account. This is used to estimate the *output gap* that is a key input in the estimation of cyclical budget component.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public goods Those goods and services that are consumed jointly by several economic agents and for which there is no effective pricing mechanism that would allow private provision through the market.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Public-private partnerships (PPP) Agreements that transfer to the private sector investment projects that traditionally have been executed or financed by the public sector. To qualify as a PPP, the project should concern a public function, involve the general government as the principal purchaser, be financed from non-public sources and engage a corporation outside the general government as the principal operator that provides significant inputs in the design and conception of the project and bears a relevant amount of the risk.

Quality of public finances The part of the EU fiscal framework that relates to the allocation of resources and the efficient and effective use of those resources in relation to identified strategic priorities.

Quasi-fiscal activities Activities promoting public policy goals carried out by non-government units.

QUEST The Economic and Financial Affairs DG's macroeconomic model of the EU Member States plus the United States and Japan.

Ricardian equivalence Under fairly restrictive theoretical assumptions on the consumer's behaviour (*inter alia* infinite horizon for decision-making), the impact of fiscal policy does not depend on whether it is financed by tax increases or by a widening deficit. The basic reasoning behind this statement dates back to Ricardo and was revisited by Robert Barro in the 1970s.

Securitisation Borrowing (issuing of bonds) with the intention of paying interest and capital out of the proceeds derived from assets (use or sale of) or from future revenue flows.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection, given various changes in the underlying assumptions.

Significant divergence A sizeable excess of budget balance over the targets in the stability or convergence programmes, that triggers the *early warning mechanism* of the *SGP*.

‘Snowball’ effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy. See also *government budget constraint*.

Social security contributions (SSC) Mandatory contributions paid by employers and employees to a social insurance scheme to cover for pension, healthcare and other welfare provisions.

Stability and Growth Pact (SGP) Approved in 1997, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council regulations setting out legally binding provisions to be followed by the European institutions and the Member States and two resolutions of the European Council in Amsterdam (June 1997). See also *excessive deficit procedure*.

Stability programmes Medium-term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments.

Structural budget balance The actual *budget balance* adjusted for its *cyclical component*. The structural bal-

ance gives a measure of the underlying trend in the budget balance, when taking into account the automatic effect on the budget of the economic cycle. It is referred to also as the *cyclically adjusted budget balance*. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax gaps Measure used in the assessment of the *sustainability* of public finances. They measure the difference between the current tax ratio and the constant tax ratio over a given projection period to achieve a predetermined level of debt at the end of that projection period.

Tax smoothing The idea that tax rates should be kept stable in order to minimise the distortionary effects of taxation, while leaving it for the *automatic stabilisers* to smooth the economic cycle. It is also referred to as neutral *discretionary fiscal policy*. See also *cyclical component of fiscal policy*.

UMTS Third generation of technical support for mobile phone communications. Sale of UMTS licences gave rise to sizeable one-off receipts in 2001.

Wagner’s law Theory according to which public spending — since it comprises ‘luxury goods’ with high elasticity to income — would tend to rise as a share of GDP as per capita income increases.

Welfare state Range of policies designed to provide insurance against unemployment, sickness and risks associated with old age.

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3. Useful Internet links

European Union

European Commission	europa.eu.int/comm
Directorate-General for Economic and Financial Affairs	europa.eu.int/comm/dgs/economy_finance/index_en.htm
European Council	ue.eu.int/
European Parliament	www.europarl.eu.int/

Economics and Finance Ministries

Belgium	treasury.fgov.be/interthes	Ministère des Finances/Ministerie van Financien
Denmark	www.fm.dk	Ministry of Finance
Germany	www.bundesfinanzministerium.de	Bundesministerium der Finanzen
Spain	www.mineco.es/	Ministerio de Economía y Hacienda
France	www.finances.gouv.fr	Ministère Économie, Finances et l'Industrie
Ireland	www.irlgov.ie/finance	Department of Finance
Italy	www.tesoro.it	Ministero dell'Economia e delle Finanze
Luxembourg	www.etat.lu/FI	Ministère des Finances
Netherlands	www.minfin.nl	Ministerie van Financiën
Austria	www.bmf.gv.at	Bundesministerium für Finanzen
Portugal	www.min-financas.pt	Ministério das Finanças
Finland	www.vn.fi/vm	Ministry of Finance
Sweden	finans.regeringen.se	Finansdepartementet
United Kingdom	www.hm-treasury.gov.uk	Her Majesty's Treasury
Bulgaria	www.minfin.bg	Ministry of Finance
Cyprus	www.mof.gov.cy	Ministry of Finance
Czech Republic	www.mfcr.cz	Ministry of Finance
Estonia	www.fin.ee	Ministry of Finance
Hungary	www.p-m.hu	Ministry of Finance
Latvia	www.fm.gov.lv	Ministry of Finance
Lithuania	www.finmin.lt	Ministry of Finance
Malta	mfea.gov.mt	Ministry of Finance and Economic Affairs
Poland	www.mofnet.gov.pl	Ministry of Finance
Romania	www.mfinante.ro	Ministry of Finance
Slovakia	www.finance.gov.sk	Ministry of Finance
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