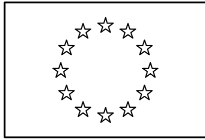

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Public finances in EMU – 2005

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Public finances in EMU – 2005.

This Communication draws the main policy messages from the Public Finances in EMU-2005 report prepared by the Commission services.[1] The report is published yearly since 2000. It presents an overview of recent budgetary developments in the EU, tracks the evolution in EU fiscal surveillance, and carries out analysis on fiscal policy issues of relevance for the EU-wide policy debate.

Large budgetary imbalances persist in some countries…

After deteriorating for three consecutive years, reflecting to a large extent the economic slowdown, the euro-area general government deficit improved marginally in 2004 (from 2.8 % of GDP in 2003 to 2.7 % in 2004). The deficit of the EU-25 aggregate also fell (from 2.9 to 2.6 % of GDP), largely as a consequence of the considerable improvement of deficits in a number of recently acceded Member States. According to the Spring 2005 Commission forecasts, the euro-area and EU deficits will remain roughly stable in 2005 and 2006, based on the assumption of unchanged policy. Conversely, debt ratios are projected to grow both for the euro-area and the EU aggregate, reaching, respectively, 71.9 and 64.2 % of GDP in 2006. Aggregate deficit figures mask noteworthy differences between countries. In 2004, six EU countries, including three euro-area countries, exhibited budget positions in balance or in surplus. In contrast, in four euro-area Member States (Greece, Germany, France, Italy) and seven non-euro-area countries (Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia and the UK) deficits were above the 3% of GDP reference value. While the deficit is projected to be reduced in 2005 or 2006 in a number of countries that are currently subject to the excessive deficit procedure (Germany, France, Cyprus, Malta), Italy and Portugal are expected to have deficits above the 3 % of GDP ceiling in 2005 on the basis of their current policies.

…and further action under the excessive deficit procedures has been necessary

Since the summer of 2004, ten EU countries have been subject to the excessive deficit procedure (EDP). In December 2004, the Commission and the Council clarified their position regarding the EDP for Germany and France, following the Court of Justice ruling of July 2004. Since both countries had taken measures which could plausibly result in the excessive deficit being corrected in 2005, it was decided that at that stage no further action under the EDP was necessary. In the case of the EDP for the Netherlands, the Council concluded in October 2004 that effective action was being taken by the Dutch government. Following the March 2005 fiscal notifications indicating that the deficit of the Netherlands fell to 2.5% of GDP in 2004, the Commission proposed on 18 May 2005 to abrogate the decision on the existence of the excessive deficit. In the case of the Czech Republic, Cyprus, Hengary, Malta,

[1] Available on: http://europa.eu.int/comm/economy_finance/publications/publicfinance_en.htm

Poland and Slovakia, after their accession to the EU, the Council decided that an excessive deficit existed in each of them, and consequently decided to issue recommendations under Article 104(7) of the Treaty. A further recommendation under the same article of the Treaty was addressed in February 2005 to Hungary which, unlike the other five new Member States, had failed to take effective action in response to the first recommendation.

For the first time, on February 2005, the Council decided to issue a notice under Article 104(9), the last step before sanctions. This notice was addressed to Greece and contained a deadline for correcting the excessive deficit postponed by one year, i.e. until 2006, as a result of substantial revisions in deficit figures. At the occasion of the fiscal notifications of September 2004 and March 2005, the fiscal data of Greece underwent a revision of unprecedented large magnitude: deficit ratios dating back to 1997 were revised upward and the 2003 and 2004 deficits jumped, respectively, to 5.2% and 6.1% of GDP.

The exceptionally large revision in the Greek government accounts came at a time when increasing emphasis was being put on improving statistical governance in the budgetary field. The Council called on the Commission to improve the monitoring of the quality of reported fiscal data and to make proposals designed to strengthen EU statistical governance. In its December 2004 Communication "Towards a European governance strategy for fiscal statistics", the Commission outlined three lines of action to this end: (i) building up the legislative framework, (ii) developing the operational capacity of the Commission, and (iii) defining European standards on the independence of statistical institutes. The Commission also took initiatives for the implementation of these lines of action. On 2 March 2005, it adopted a proposal for the amendment of Council Regulation 3605/93, which governs the reporting of fiscal data, with the purpose of improving the quality of statistical data used in the EDP. Moreover, the Commission adopted on 25 May 2005 a Communication including a recommendation to Member States on EU-wide standards on statistical institutes including principles on, inter-alia, professional independence, confidentiality, reliability and timeliness of data, and adequacy of resources of statistical institutes.

A good fiscal framework, but which needed to be improved: the 2005 Stability and Growth Pact reform

The EU fiscal framework delivered over the last decade important achievements, with the very high deficits of the beginning of the 1990s brought under control, and comfortable surpluses attained by a number of Member States. However, over time the need emerged for reconsidering some of its elements in order to strengthen its effectiveness.

The review process leading to the 2005 Stability and Growth Pact (SGP) reform was launched by the Commission with its Communication "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact".[2] In response to the Commission Communication, the Eurogroup, the ECOFIN Council and the Commission engaged in several rounds of intense discussions in order to reach consensus, discussions which benefited from technical input from the Commission and Member States. The negotiations revealed differing views among Member States on how much room for discretion was necessary to properly take account of economic developments in the assessment of budgetary performance. The need for some margin for judgement was weighed against the objectives of preserving simple, transparent rules and ensuring equal treatment.

[2] COM (2004) 581 of 3 September 2004.

At the extraordinary ECOFIN meeting of 20 March 2005, the Council adopted the report "Improving the implementation of the Stability and Growth Pact" with a view to improving the EU fiscal framework. The report, subsequently endorsed by the European Council of 22/23 March 2005, updates and complements the existing legal framework of the SGP. The agreement encapsulated in the ECOFIN report entails changes to both the preventive and corrective arms of the Pact and contains recommendations for improving fiscal and statistical governance at both the EU and the national level.

The *preventive arm of the Pact* has been strengthened by ensuring that due attention is given to the fundamentals of fiscal sustainability when setting medium-term budgetary objectives. It is further underpinned by the Member States' commitment to actively consolidating public finances when they are experiencing favourable economic conditions and the possibility for the Commission to act by directly addressing policy advice to a Member State if it fails to do so. The new agreement also includes incentives for Member States to carry out structural reforms, with a view to making the fiscal framework more consistent with the renewed Lisbon strategy.[3] In particular, the implications of major structural reforms that have a verifiable positive impact on fiscal sustainability over the long-term will be taken into account in the assessment of budgetary policies.

The main modifications to the *corrective arm of the Pact* concern the definition of "excessive deficits" and the modalities for their correction, which now permit a more comprehensive economic assessment of budgetary developments in the implementation of the EDP. In particular, the new rules allow the one-year deadline for the correction of an excessive deficit to be extended by an additional year (on economic grounds) and certain steps in the EDP to be repeated (if unexpected adverse economic events occur and provided that effective action has been taken by the Member State concerned in full compliance with recommendations). The new agreement specifies a set of "relevant factors" that the Commission and the Council can take into account when taking decisions on the EDP. These factors include, inter alia, developments in potential growth and prevailing cyclical conditions, but also considerations with respect to debt sustainability and the implementation of policies geared towards meeting the objectives of the Lisbon agenda. Budgetary discipline and the prompt correction of excessive deficits are ensured. Countries with deficits above 3% of GDP that are not close to the reference value or that are not temporary would be considered in an excessive deficit position. Furthermore, Member States in EDP are requested to undertake a minimum fiscal effort. Finally, when assessing whether the excessive deficit has been corrected, the Council shall carefully consider an excess of the reference value which reflects the implementation of pension reforms implying a mandatory partial or total shift from pay-as-you go to funding.

In order to fully restore the Pact's credibility and strengthen the enforcement of budgetary discipline, the ECOFIN report contains *complementary elements to improve fiscal governance*. First, with a view to strengthening peer support, the Council and the Commission commit to publicly explaining their positions at the relevant stages of EU fiscal surveillance. Second, it is suggested that national-level rules and institutions could play a more prominent role in domestic budgetary surveillance, thereby underpinning and complementing the surveillance procedures at the EU level. Third, with due respect to the national prerogative in this area, the report calls for a greater involvement of national parliaments in the EU fiscal surveillance process, including by discussing stability and convergence programmes or action

[3] Commission Communication to the European Council "Working together for growth and jobs. A new start for the Lisbon Strategy", COM (2005) 24, 2 February 2005.

taken in response to EDP recommendations. Finally, the agreement underpins the work under way towards strengthening the governance of fiscal statistics.

The European Council of 22/23 March 2005 invited the Commission to put forward legislative proposals to adapt the existing regulations in line with the new agreement. On 20 April, the Commission adopted proposals for amending Council Regulations 1466/97 and 1467/97.[4] These proposals need to be adopted by the Council after due involvement of the European Parliament and the European Central Bank.[5]

Overall, the way ahead with the implementation of SGP will be characterized by more room for economic judgement in the fiscal surveillance procedure and in the assessment of individual country cases. This allows for a more constructive and transparent policy dialogue between the Commission and the Council and among Member States and will help to restore a sense of national ownership of the rules. The agreement will be tested in the months and years ahead. The greater room for judgement stresses the importance of ensuring both equal treatment and effective enforcement in the implementation of the new system, thereby putting a greater responsibility on both the Commission as it assesses budgetary developments and the Council as it decides on what steps to take in the surveillance procedure.

Developments in EU budgetary surveillance

The Public Finances in EMU report regularly provides analytical work aimed at improving the understanding of public finance issues in the EU and upgrading budgetary surveillance. This year the report presents, among other topics, analysis on the discrepancy between budgetary plans presented in stability and convergence programmes and results, on the determinants of debt dynamics, and on the long-term sustainability of public finances.

Achieving an effective budgetary planning and its surveillance

The process of fiscal surveillance has provided a wealth of data on budgetary plans, outcomes and assessments, which has been used with a view to comparing actual budgetary developments relative to plans and to evaluate how the Commission assessment of stability and convergence programmes evolved over the years. On the first aspect, the data show that slippages between budgetary plans and outcomes have been frequent and sizeable in some years, even controlling for growth surprises. Such slippages seem mainly associated with differences between planned and realised expenditure/GDP ratios, discrepancies in revenue ratios having played a minor role. Such analysis highlights the importance of finding ways to avoid spending slippages and better plan expenditure patterns in a manner which increases their quality - also to better match the new Lisbon priorities - and ensures their sustainability. The Commission has responded to the discrepancy between budgetary plans and outcomes by increasingly focusing its assessment on the credibility of the adjustment path described in the stability and convergence programmes, and by assessing Member States' fiscal policies more comprehensively over time, thereby taking into greater account also aspects relating to the sustainability and quality of public finances.

Understanding the determinants of debt dynamics

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[4] COM(2005) 154 and COM(2005) 155 of 20 April 2005.

[5] The Treaty foresees the cooperation procedure for Council Regulation 1466/97 and the consultation procedure for Council Regulation 1467/97.

In EU fiscal surveillance, increased focus is put on debt developments. The dynamics of the debt-to-GDP ratio depend on the realised budget balance, nominal growth, and the so called "stock-flow adjustment", capturing the residual discrepancy between the change in the outstanding debt stock and the general government deficit, as defined in the Protocol to the Maastricht Treaty. The usual analysis focuses on deficits and nominal growth, while much less attention has been given to the stock-flow adjustment. However, this component conveys relevant information about the evolution of government assets and liabilities (e.g., as a result of privatisation operations) and the discrepancy between cash and accrual deficits. The Public Finances in EMU report aims to fill this gap by analysing the determinants of the stock-flow adjustment for EU Member States. It shows that the stock-flow adjustment in past years has, on average, been positive (consequently adding to the build-up of debt) and that in some countries the stock-flow adjustment is partly associated with cash deficits being systematically higher than "Maastricht deficits". This evidence further supports the importance of paying attention to debt dynamics in budgetary surveillance.

Increasing focus on the long-term sustainability of public finances

The looming budgetary implications of ageing populations and the need to finance in a sustainable way the European social model are broadening the focus of public finance management and budgetary surveillance in the EU to encompass considerations of long-term sustainability. In line with the renewed Lisbon strategy and the Integrated Guidelines for Growth and Jobs[6], many countries have implemented important reforms with a view to strengthening sustainability. The impact of such reforms on sustainability, however, is not easily quantifiable, nor easily comparable across countries.

At the EU level, sustainability analysis is carried out by the Commission services since 2001 in the context of the assessment of the stability and convergence programmes, on the basis of data provided therein and estimates of age-related expenditures up to 2050. The Public Finance in EMU-2005 report indicates that without a medium-term budgetary consolidation a sustainable position will not be reached for most Member States. Sustainability risks are identified in ten Member States (Belgium, Czech Republic, Germany, Greece, France, Italy, Cyprus, Hungary, Malta and Slovenia). The report also describes the current Commission approach to carrying out sustainability analysis, discusses the robustness of debt projections and sustainability indicators with respect to the major assumptions underlying the analysis, and outlines suggestions for possible improvements.

In light of the 2005 SGP reform package, long-term considerations will be given greater prominence in EU budgetary surveillance. In this respect, increased information exchange among Member States and with the Commission on national age-related expenditure projections would increase transparency and lead to a better assessment of the long-term sustainability of public finances and of their implications for the setting of medium-term objectives.[7]

Structural reforms and budgetary objectives

The Commission mid-term review of the Lisbon strategy and the Integrated Guidelines for Growth and Jobs drew greater attention to economic reforms which increase growth and employment through action at the macro, micro and employment level. Part III of the Public Finances in EMU report reviews and discusses the link between the implementation of

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[6] COM (2005) 141, 12 April 2005.

[7] The Commission will report by the end of 2006 on the progress achieved on this front.

structural reforms and budgets in implementing the EU framework for fiscal policy, an under-researched issue that is expected to become more relevant in EU budgetary surveillance.

Reforms can substantially improve government accounts in the medium to long term. For example, reforms directly aimed at containing the growth of certain types of government expenditures (for instance, pension reforms or efficiency improvements in the health care sector, allowing a more effective response to ageing-related pressures) can have an impact on the future path of government budgets and debt.[8] Reforms that improve potential output and growth (including, for instance, labour and product market reforms) may also have indirect positive effects. It is often claimed that numerical rules to limit deficits may discourage structural reforms. A first reason for why there could be a trade-off between reforms and budgetary objectives is the presence of short-term direct budgetary costs of reforms (e.g., pension reforms introducing a funded pillar outside the government sector or public investment in education and training which bring long-term benefits that may more than compensate the initial costs). A second reason is related to the fact that reforms can be costly to particular groups in the society, so that tax cuts or government transfers may be needed to overcome resistance to their introduction.

The analysis contained in the Public Finances in EMU report considers labour and product market and pension reforms (without contemplating growth-enhancing projects with up-front budgetary costs such as the development of physical infrastructure, education and training, or R&D) and focuses on two issues. First, which impact do reforms have on budgets in the short term? Second, is there evidence that fiscal consolidations prevent reforms? In spite of limitations related to the quality and availability of data on structural reforms, the analysis provides interesting results. The expectation that reforms are less frequent in years where a budgetary consolidation takes place does not seem to be strongly supported by the data. However, in the aftermath of reforms there is in general a slight deterioration in budget balances. Results differ depending on the type of reforms considered and on how reforms are designed. The analysis gives some indications that the reform of the SGP has gone in the right direction, but also that caution should be taken on the way structural reforms are to be considered in the implementation of the SGP. In light of the high variance of results, a mechanistic, one-size-fits-all approach where all reforms, or all reforms belonging to some broad categories, are considered the same way should be avoided. This means that careful judgement is needed on a case-by-case basis and considering the relevant features of the specific reforms at stake.

The 2005 SGP reform package includes provisions aimed at ensuring that the budgetary objectives of the EU fiscal framework do not clash with structural reforms that may contribute to sound public finances and increased growth in the medium to long run. Applying them along the lines above could support an efficient contribution of public finances to a sustainable Lisbon strategy.

Fiscal challenges during convergence in the recently acceded Member States

By acceding in 2004, ten Member States have achieved an important step in the process of integration to the EU. Economic integration however is expected to continue through catching up of their income levels and the prospective adoption of the euro as their currency. Fiscal policy can make a key contribution in this process of these countries through efficient and sustainable tax and expenditure policies and by supporting a stable development of the

[8] Efficiency gains are a key factor for a positive long-term impact of structural reforms on public finances. Improved public procurement practices could contribute to the realization of such gains.

economy. Over the long run, these two roles are complementary. Strong growth enhances the economy's financing capacity, while stability is crucial for private investment and sustainable catching up. In the short run, though, some of the new Member States may need to make choices: higher spending on infrastructure, training or R&D can make it harder to contain budget deficits, and tax and pension reforms introducing funded pillars recorded outside the government sector may also involve up-front budgetary costs. Part IV of the Public Finance in EMU – 2005 report discusses the main challenges for the conduct of fiscal policy the new Member States may face in the coming years.

The new Member States have certain advantages that allow them to finance part of their needs: high potential growth and, in some cases, low public debt. However, they may continue to experience a degree of volatility in their public finances, reflecting transformations under way in the real economy and, for the Baltic region and Central Europe, in the financial sector. Moreover, the stock of contingent liabilities is relatively high in many recently acceded Member States, and this creates the risk of sudden upward jumps in debt levels as factors triggering government payments related to explicit or implicit guarantees materialize.

Experience in other Member States highlights the importance of using periods of strong growth to achieve budgetary improvements and thus to ensure adequate headroom to stabilise the economy during a downturn. This lesson is of the highest relevance for the Member States of recent accession. In light of the possible emergence of credit and asset price booms in these countries, it will be important that in setting targets for fiscal policy there is no over-estimation of potential growth and that transitory elements are properly identified in assessing the dynamics of tax revenues. In the run-up to euro adoption, moreover, the credibility of budgetary plans and a balanced policy mix are particularly important. These factors call for prudence in setting medium-term fiscal goals. Meanwhile, in countries that retain national currencies for an extended period, care is needed concerning the build-up of balance sheet vulnerabilities associated with unhedged borrowing in foreign currencies.

While acknowledging the differences among them, there is some scope for policy-makers in the new Member States to achieve synergies in pursuing growth and stability objectives. First, there is room to restructure existing expenditure programmes and enhance tax bases in ways that both strengthen their public finances and improve the incentives for growth, possibly already in the short term. Second, fiscal institutions could be improved upon, including through enhanced transparency of budgetary procedures and effective frameworks for multi-annual budgetary planning and expenditure control. Third, well-conceived supervisory policies would improve risk management in the private sector, thereby containing government contingent liabilities, and well-designed monetary policies would steer market expectations towards stability.

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Overall, the analysis carried out indicates that while the framework for economic and budgetary surveillance in EMU has provided positive results - in terms of budgetary achievements and reforms already undertaken by most Member States - more needs to be done to deliver the expected results. The reform of the Stability and Growth Pact, in parallel with the re-launch of the Lisbon strategy, have reinforced the correspondence of the rules and governance processes with the economic reality and needs of Europe and its Member States. The synergies between macroeconomic stability and the creation of growth and employment through important reforms of the economy should now be exploited. As in the case of the

renewed Lisbon strategy, the reformed Stability and Growth Pact will be tested in the months and years ahead: the way the new framework will be implemented from the start will be crucial for its credibility and the overall success of the ambitious approach which Europe has decided to embrace. All Member States of the EU are strongly encouraged to pursue this strategy by enhancing the quality and ensuring the sustainability of their public finances.