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Public finances in EMU 2005

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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, AT, PT, FI), i.e. countries participating in economic and monetary union without a derogation
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-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
CYP	Cyprus pound
CZK	Czech koruna
DKK	Danish krone
EEK	Estonian kroon
GBP	pound sterling
HUF	forint
LTL	litas
LVL	lats
MTL	Maltese lira
PLN	zloty

SEK	Swedish krona
SIT	tolar
SKK	Slovak koruna
CAD	Canadian dollar
CHF	Swiss franc
JPY	Japanese yen
SUR	Russian rouble
USD	US dollar

Other abbreviations

EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EDP	excessive deficit procedure
EMU	economic and monetary union
ERM	exchange rate mechanism
Eurostat	statistical office of the European Communities
FDI	foreign direct investment
GDP	gross domestic product
HICP	harmonised index of consumer prices
IMF	International Monetary Fund
NMS	new Member States
OECD	Organisation for Economic Cooperation and Development
SCPs	stability and convergence programmes
SGP	Stability and Growth Pact
PEPs	pre-accession economic programmes
PPP	public–private partnership
VAT	value added tax
:/n.a.	not available
—	none

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Contents

Graphs

Boxes

Summary and main conclusions

This communication draws the main policy messages from the 'Public finances in EMU — 2005' report prepared by the Commission services ([1]). The report has been published yearly since 2000. It presents an overview of recent budgetary developments in the European Union, 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 in 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 budgetary positions in balance or in surplus. In contrast, in four euro-area Member States (Germany, Greece, France and Italy) and seven non-euro-area countries (the 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 and 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, 10 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 of the European Communities 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 had fallen 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, Hungary, Malta, 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 EC 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, in 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 unprec-

([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(2005) 231 final, adopted on 1 June 2005. Available at http://europa.eu.int/comm/economy_finance/publications/publicfinance_en.htm.

edented large magnitude: deficit ratios dating back to 1997 were revised upwards 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; (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 (EC) No 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 has delivered over the last decade important achievements, with the very high deficits at 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' ([1]). In response to the Commission communication, the Eurogroup, the Economic and Financial Affairs (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 judgment was weighed against the objectives of preserving simple, transparent rules and ensuring equal treatment.

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 and 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 levels.

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 ([2]). 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

([1]) COM(2004) 581, 3.9.2004.

([2]) Commission communication to the European Council 'Working together for growth and jobs — A new start for the Lisbon strategy' (COM(2005) 24, 2.2.2005).

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 to be 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 (PAYG) 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 should 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 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 and 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 (EC) No 1466/97 and (EC) No 1467/97 ([1]). These proposals need to be adopted by the Council after due involvement of the European Parliament and the European Central Bank ([2]).

Overall, the way ahead with the implementation of the SGP reform will be characterised by more room for economic judgment 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 judgment 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 effective budgetary planning and its surveillance

The process of fiscal surveillance has provided a wealth of data on budgetary plans, outcomes and assessments, which have been used with a view to comparing actual budgetary developments relative to plans and to evaluate how the Commission's assessment of stability and convergence programmes has 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

([1]) COM(2005) 154 and COM(2005) 155, 20.4.2005.
([2]) The Treaty foresees the cooperation procedure for Council Regulation (EC) No 1466/97 and the consultation procedure for Council Regulation (EC) No 1467/97.

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 also taking into greater account aspects relating to the sustainability and quality of public finances.

Understanding the determinants of debt dynamics

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 ([1]), 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 has been 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 finances 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 10 Member States (Belgium, the 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 ([2]).

Structural reforms and budgetary objectives

The Commission's 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 — 2005' report reviews and discusses the link between the implementation of 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 cer-

([1]) COM(2005) 141, 12.4.2005.

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

tain types of government expenditures (for instance, pension reforms or efficiency improvements in the healthcare sector, allowing a more effective response to ageing-related pressures) can have an impact on the future path of government budgets and debt ([1]). 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 for the initial costs). A second reason is related to the fact that reforms can be costly to particular groups in 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 — 2005' report considers labour and product market and pension reforms (without contemplating growth-enhancing projects with upfront budgetary costs such as the development of physical infrastructure, education and training, and R & D) and focuses on two issues. First, what 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 is required 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 in the same way should be avoided. This means that careful judgment 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, 10 Member States have achieved an important step in the process of integration into the EU. Economic integration, however, is expected to continue through the catching-up of their income levels and the prospective adoption of the euro as their currency. Fiscal policy can make a key contribution to this process of these countries through efficient and sustainable tax and expenditure policies and by supporting a stable development of the 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, however, 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 upfront budgetary costs. Part IV of the 'Public finances in EMU — 2005' report discusses the main challenges for the conduct of fiscal policy which 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 materialise.

([1]) 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 realisation of such gains.

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 recently acceded Member States. 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 overestimation 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, including through enhanced transparency of budgetary procedures and effective frameworks for multiannual 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.

Overall, the analysis carried out indicates that while the framework for economic and budgetary surveillance in economic and monetary union (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 relaunch of the Lisbon strategy, has reinforced the correspondence of the rules and governance processes with the economic reality and needs of the European Union 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.

Part I

Current developments and prospects

Summary

After having deteriorated for three consecutive years, the euro-area general government deficit improved marginally in 2004 to 2.7 % of GDP, from 2.8 % of GDP in 2003. The nominal deficit of the EU fell from 2.9 % of GDP in 2003 to 2.6 % of GDP in 2004. The larger improvement in the EU deficit is due to a significant reduction in deficits in a number of the recently acceded Member States (EU-10). According to the spring 2005 forecasts of the Commission services, the euro-area and EU deficits will remain roughly stable in 2005 and 2006, based on the assumption of unchanged policy. Past and projected developments in the EU and euro-area deficits result from diverse budgetary performances across Member States. In 2004, only three euro-area countries and six EU countries had budgetary positions in balance or in surplus, both in nominal and cyclically adjusted terms. In contrast, in four euro-area Member States (Germany, Greece, France and Italy) and seven non-euro-area countries (the Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia and the UK), deficits reached or breached the 3 % of GDP reference value in 2004. The deficit is projected to be reduced to or below 3 % of GDP in 2005 in France, albeit temporarily, and in the UK and Cyprus. The deficit would be brought below 3 % of GDP in 2006 in Germany and Malta. After having kept their deficit at or just below 3 % of GDP in 2004, Portugal and Italy could breach the 3 % of GDP ceiling significantly in 2005, on the basis of the current policies.

In cyclically adjusted terms, the euro-area deficit remained unchanged in 2004, at 2.4 % of GDP. Across the EU-15, the cyclically adjusted deficit was particularly high in Germany, France, Greece, Italy and the UK. It deteriorated significantly in Greece, Spain and Luxembourg. According to the latest Commission forecasts, the cyclically adjusted balance (CAB) in the euro area and the EU-15 should improve by 0.3 percentage points of GDP in 2005 and slightly worsen again in 2006, despite the projected improvement in the macroeconomic situation. Efforts to improve the underlying budgetary positions should be made as economic conditions recover in order to ensure sufficient room for the automatic stabilisers to operate when necessary.

One of the consequences of the lack of substantial adjustment in the underlying fiscal position is that the debt-to-GDP ratio continues to increase. After having stood at 70.8 % in 2003 and 71.3 % in 2004, the euro-area debt ratio is projected to reach 71.7 % in 2005 and 71.9 % in 2006. In the EU, the debt-to-GDP ratio would increase from 63.8 % in 2004 to 64.2 % in 2006. The debt ratio would remain particularly high in Belgium, Greece and Italy (106.3 % of GDP). In the last, the debt ratio would continue to increase over the projection period. The debt ratio is also projected to increase over the next two years from a relatively high level in Germany, France, Portugal and Malta.

Budgetary developments in 2004 triggered further actions by the Commission and the Council in the context of the implementation of the SGP. Since summer 2004, 10 EU countries have been subject to the excessive deficit procedure: four euro-area Member States and six of the EU-10. For the first time, the Council decided to issue a notice under Article 104(9) of the EC Treaty, the last step before sanctions. This recommendation was addressed to Greece, which has to correct its excessive deficit in 2006. In December 2004, the Commission and, subsequently, the Council clarified their position regarding the excessive deficit procedure for Germany and France, after the events of November 2003 and the ruling of the Court of Justice of the European Communities of 13 July 2004. Considering that these two countries had taken measures that make plausible a correction of the excessive deficit in 2005, the Commission decided that no further actions were necessary in the context of the excessive deficit procedure. Finally, the Commission considered that the Netherlands had taken effective action to correct its excessive deficit. Concerning non-euro-area Member States, the Council decided on 5 July 2004 that an excessive deficit existed in the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia

and at the same time issued recommendations to each country for its correction. Except for Hungary, the Commission considered on 22 December 2004 that all countries had taken effective action in response to the Council recommendation, in particular to respect the 2005 deficit targets set in the May 2004 convergence programmes. Accordingly, the Commission concluded that no further steps were necessary for the Czech Republic, Cyprus, Malta, Poland and Slovakia under the excessive deficit procedure. In March 2005, the Council addressed a new recommendation to Hungary.

In the context of budgetary surveillance, the Commission also assessed the 2004 updates of the stability and convergence programmes submitted by the 25 Member States and proposed Council opinions on these documents. For the euro-area countries, macroeconomic and budgetary projections included in the programmes are consistent with an annual improvement in the CAB of 0.3 to 0.4 percentage points over the coming years. This implies a tightening of the fiscal stance in the euro area compared with the current situation. A close-to-balance position in cyclically adjusted terms would then almost be reached by 2008 (– 0.7 % of GDP). However, for several Member States, the projected budgetary adjustment would remain insufficient to ensure that a sufficient safety margin to prevent a breach of the 3 % of GDP reference value would be reached over the time span covered by the programmes. In addition, the budgetary targets of some Member States are based on growth assumptions and government expenditure projections which appear to be overly optimistic. This is a source of concern since the implementation record of the programmes has, in several cases, been characterised by a repeated postponement of the achievement of the close-to-balance or in surplus objective. Concerning the medium-term plans of the recently acceded Member States, the expected budgetary development in the projection period indicates a substantial consolidation of public finances for all of them. By 2007, only the Czech Republic foresees the general government deficit to be still above the 3 % of GDP reference value. Large deficit reductions are expected in countries with initially high deficits, such as Cyprus, Malta, Poland and Hungary. All the non-euro-area Member States are expected to improve their CABs by the end of the programme period, except for Estonia and Sweden, where they are projected to be broadly unchanged at a sound level.

The increased focus on long-term sustainability in the EU has resulted in reforms in several countries, leading to some further improvement to cope with the budgetary impact of ageing populations. Several countries, including the larger ones, have implemented reforms with a view to strengthening sustainability; for example, Germany and Italy have reformed their pension systems and France has reformed its healthcare system. The EU-10 have been fully included in the analysis for the first time. The situation for these countries is generally positive; a majority have recently implemented major reforms of their pension systems and they generally have a relatively low debt-to-GDP ratio, both of which contribute to a more sustainable position over the long run.

However, the analysis also shows that the planned budgetary consolidation in the medium term is a very important factor in achieving a more sustainable position for most Member States, as was the case in previous years. The results show that there are risks to long-term sustainability in 10 countries (Belgium, the Czech Republic, Germany, Greece, France, Italy, Cyprus, Hungary, Malta and Slovenia). In seven other countries (Spain, Latvia, Lithuania, the Netherlands, Poland, Slovakia and the UK), there could be some risks due to the projected medium-term budgetary developments, the budgetary impact of enacted reforms or, as is the case for Spain and Poland, due to the considerable uncertainties over the long-term age-related expenditure trends. Finally, seven countries (Denmark, Estonia, Ireland, Luxembourg, Austria, Finland and Sweden) at present appear to face only limited risks in view of the budgetary costs of an ageing society.

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 2004, the budgetary position in the euro area improved slightly after having deteriorated for three consecutive years (see Table I.1). Compared with 2003, the nominal deficit fell by 0.1 percentage point and reached 2.7 % of GDP. The aggregate nominal deficit of the entire EU also improved, by 0.3 percentage points, and reached 2.6 % of GDP in 2004 (see Table I.2).

The aggregate outcome for the euro area as a whole results from diverse budgetary performances across Member States. In the case of Germany, Greece, France, Italy, the Netherlands and Portugal, the budgetary positions in 2004 remained weak with nominal deficits ranging from 2.5 % of GDP in the Netherlands to 6.1 % of GDP in Greece. Germany, Greece and France have remained in excessive deficit positions, while, in the Netherlands, the deficit has been under the 3 % of GDP reference value. According to the Commission's spring 2005 forecasts, the budgetary situation remained weak in Italy and Portugal in 2004 as deficits reached respectively 3.0 and 2.9 % of GDP ([1]). In 2004, the nominal deficit also significantly deteriorated in Spain and Luxembourg. Outside the euro area, a large majority of Member States improved their budgetary situation, apart from Estonia, Lithuania and Poland. Given the protracted period of low growth, only Belgium, Ireland and Finland had nominal budgetary positions in balance or in surplus in the euro area. Overall, the nominal budget balances in 2004 did not worsen (or did so only marginally) compared with the previous year in the case of Belgium, Germany, France, Ireland, Italy, the Netherlands, Austria, Portugal and Finland.

Certainly, the budgetary performance also differed across the Member States outside the euro area. Nominal budget balances in 2004 varied from a deficit of 5.2 % of GDP in Malta to a surplus of 2.8 % of GDP in Denmark. In the case of Cyprus, Hungary, Malta, Poland, Slovakia and the UK, the nominal deficit in 2003 was above the reference value of 3 % of GDP, and only Denmark, Estonia and Sweden had a surplus budgetary position. Relative to 2003, the budgetary position remained roughly unchanged or improved in 10 countries, while it deteriorated in Estonia, Lithuania and Poland. The improvement was particularly important in the Czech Republic and Malta.

Looking ahead to 2005 and 2006, the Commission's spring 2005 forecasts project that economic growth in the euro area as a whole will hover around 2 %, decreasing to 1.6 % in 2005 in order to rise to 2.1 % in 2006. The nominal budget balance is expected to improve slightly, to 2.6 % of GDP in 2005 and deteriorate again in 2006 (2.7 % of GDP). In light of the scarcely resilient economic situation coupled with difficulties in pursuing budgetary consolidation in some Member States, the aggregate nominal deficit for the entire EU is foreseen to hold stable at 2.6 % of GDP in 2005 and decline only slightly to 2.5 % of GDP in 2006.

At the Member State level, the surplus budgetary positions in the case of Belgium and Ireland are expected to deteriorate into deficit positions in 2005. Under a no-policy-change assumption, the deficit in Belgium would continue to worsen in 2006, while in Ireland it would hold stable. In contrast, Spain and Finland are expected to maintain their budgetary positions in balance or in surplus throughout the forecast period. Among the Member States outside the euro area, this is also the case of Denmark, Estonia and Sweden.

([1]) Following the Eurostat decision of 23 May 2005, the government deficit of Italy has been provisionally set at 3.1 % of GDP for the year 2003 and at 3.1 % of GDP for the year 2004 (Eurostat: Euroindicators, News Release 65/2005, 23.5.2005).

On the basis of current policies, the Commission forecast projects that the nominal deficits in Germany, Greece, Italy and Portugal will be exceeding the 3 % of GDP reference value in 2005 and, except Germany, also in 2006, when France is expected to breach the reference value again. In Germany, the nominal deficit is projected to remain above 3 % of GDP in 2005 and move slightly below the reference value in 2006. In Greece, the nominal deficit is expected to stay at higher levels than 3 % of GDP in 2005 and slightly improve in 2006. The period of weak budgetary situation in France is being prolonged, since the nominal deficit is expected to remain around the 3 % of GDP threshold also in 2005 and breach the reference value again in 2006. Although the excessive deficit procedure for Portugal was abrogated in 2004, the nominal deficit is foreseen to exceed 3 % of GDP again in both 2005 and 2006. In Italy, although the nominal deficit is expected to hover around the reference value in 2004, it is projected beyond the threshold in 2005 and will deteriorate further in 2006.

The nominal deficit is also projected to be high 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 new Member States, the nominal deficit is expected to decline or remain unchanged in more than half of the countries. In the case of Latvia, a significant deterioration is projected for 2005, while the surplus in Estonia is expected to be reduced over the forecast period.

In cyclically adjusted terms, relative to 2003, the deficit in the euro area remained unchanged in 2004, at 2.4 % of GDP. According to the Commission's spring 2005 forecasts, the cyclically adjusted budget balance is projected to decrease in 2005 and deteriorate again slightly in 2006, reflecting the weak resilience of the budgetary consolidation process which has stalled in the last couple of years. Among the euro-area countries with higher cyclically adjusted deficits, deterioration over the entire projection period is expected in Italy. In Portugal, after a pronounced deterioration expected to occur in 2005, it is projected to slightly improve in 2006. Improvements over the whole period are foreseen in Germany, Greece and the Netherlands, while in France the improvement will fade out in 2006, when the cyclically adjusted deficit is planned to be above 3 % of GDP. Despite the expected improvement in Greece, the cyclically adjusted deficit is projected to remain above 5 % of GDP over the whole period.

Table I.1

General government budgetary position — Euro area, 2001–06

(% of GDP)

	2001 (1)	**2002** (1)	**2003**	**2004**	**2005**	**2006**
Total revenue (1)	46.5	46.1	46.3	45.7	45.6	45.4
Total expenditure (2)	48.3	48.6	49.1	48.5	48.2	48.0
Actual balance (3) = (1) – (2)	– 1.7	– 2.4	– 2.8	– 2.7	– 2.6	– 2.7
Interest (4)	4.0	3.7	3.5	3.3	3.3	3.3
Primary balance (5) = (3) + (4)	2.2	1.2	0.6	0.6	0.6	0.6
UTMS proceeds	0.0	0.0	0.0			
Cyclically adjusted balance (6)	– 2.4	– 2.6	- 2.4	– 2.4	– 2.1	– 2.2
Cyclically adjusted primary balance = (6) + (4)	1.6	1.0	1.0	0.9	1.1	1.0
Change in actual balance	– 1.9	– 0.7	– 0.4	0.1	0.1	– 0.1
Due to: — cycle	– 0.1	– 0.5	– 0.6	0.1	– 0.1	0.0
— UMTS	– 1.1	0	0			
— interest	0.1	0.3	0.2	0.2	0.0	0.0
— cyclically adjusted primary balance	– 0.7	– 0.5	0.0	– 0.1	0.2	– 0.1

(1) Including UMTS receipts. UMTS receipts as a percentage of GDP would be equal in 2001 to 0.2 for Belgium, 0.2 for Denmark, 0.5 for Greece, 0.1 for France, and 0 for the euro area and the EU-15. In 2002, they would be equal to 0.2 for Ireland and 0 for the euro area and the EU-15.
NB: Differences are due to rounding.

Source: Commission's spring 2005 forecasts.

Table I.2

Budget balances in EU Member States, 2003–06

(% of GDP)

	Budget balance				Cyclically adjusted budget balance				Cyclically adjusted primary balance			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
BE	0.4	0.1	– 0.2	– 0.6	1.2	0.6	0.3	– 0.2	6.5	5.3	4.7	4.0
DE	– 3.8	– 3.7	– 3.3	– 2.8	– 3.2	– 3.3	– 2.8	– 2.3	– 0.1	– 0.3	0.3	0.7
EL	– 5.2	– 6.1	– 4.5	– 4.4	– 5.7	– 7.1	– 5.5	– 5.3	0.1	– 1.4	0.0	0.1
ES	0.3	– 0.3	0.0	0.1	0.2	– 0.3	0.0	0.2	2.7	1.8	2.1	2.2
FR	– 4.2	– 3.7	– 3.0	– 3.4	– 4.0	– 3.6	– 2.8	– 3.1	– 1.0	– 0.7	0.2	– 0.1
IE	0.2	1.3	– 0.6	– 0.6	0.2	1.6	– 0.1	0.1	1.5	2.8	1.0	1.1
IT (1)	– 2.9	– 3.0	– 3.6	– 4.6	– 2.6	– 2.4	– 2.9	– 4.0	2.7	2.6	2.0	1.0
LU	0.5	– 1.1	– 1.5	– 1.9	1.3	– 0.3	– 0.6	– 0.6	1.6	– 0.1	– 0.3	– 0.5
NL	– 3.2	– 2.5	– 2.0	– 1.6	– 2.0	– 1.2	– 0.4	0.0	0.9	1.7	2.5	2.8
AT	– 1.1	– 1.3	– 2.0	– 1.7	– 0.8	– 1.1	– 1.9	– 1.6	2.3	1.9	1.1	1.2
PT	– 2.9	– 2.9	– 4.9	– 4.7	– 2.2	– 2.1	– 3.9	– 3.7	0.7	0.8	– 1.0	– 0.7
FI	2.5	2.1	1.7	1.6	3.2	2.4	1.9	1.8	5.2	4.3	3.5	3.4
EUR-12	**– 2.8**	**– 2.7**	**– 2.6**	**– 2.7**	**– 2.4**	**– 2.4**	**– 2.1**	**– 2.2**	**1.0**	**0.9**	**1.1**	**1.0**
CZ	– 11.7	– 3.0	– 4.5	– 4.0								
DK	1.2	2.8	2.1	2.2	2.0	3.4	2.5	2.4	4.5	5.7	4.7	4.4
EE	3.1	1.8	0.9	0.5								
CY	– 6.3	– 4.2	– 2.9	– 1.9								
LV	– 1.5	– 0.8	– 1.6	– 1.5								
LT	– 1.9	– 2.5	– 2.4	– 1.9								
HU	– 6.2	– 4.5	– 3.9	– 4.1								
MT	– 10.5	– 5.2	– 3.9	– 2.8								
PL	– 4.5	– 4.8	– 4.4	– 3.8								
SI	– 2.0	– 1.9	– 2.2	– 2.1								
SK	– 3.7	– 3.3	– 3.8	– 4.0								
SE	0.2	1.4	0.8	0.8	1.3	1.7	0.8	0.7	3.4	3.5	2.9	2.8
UK	– 3.4	– 3.2	– 3.0	– 2.7	– 3.0	– 3.0	– 2.9	– 2.6	– 0.9	– 1.0	– 0.8	– 0.5
EU-25	**– 2.9**	**– 2.6**	**– 2.6**	**– 2.5**								

(1) Following the Eurostat decision of 23 May 2005, the government deficit of Italy has been provisionally set at 3.1 % of GDP for the year 2003 and at 3.1 % of GDP for the year 2004 (Eurostat: Euroindicators, News Release 65/2005, 23.5.2005).

NB: Excluding UMTS receipts for Ireland in 2002. Cyclically adjusted figures are computed with the production function method, except for Spain, where the HP filter method has been used.

Source: Commission's spring 2005 forecasts.

The euro-area government debt-to-GDP ratio increased to 71.3 % in 2004 (see Table I.3 and Part II, Chapter 5, in this report). According to the Commission's spring 2005 forecasts, the debt ratio is projected to increase slightly in 2005, to 71.7 % of GDP and again in 2006, reaching 71.9 % of GDP. Over the period 2004–06, it is expected that the primary surplus would not offset the combined negative contribution from interest expenditure and stock-flow adjustment. The aggregate debt ratio in the EU is lower in comparison with the euro area. Nevertheless, the ratio is projected to increase somewhat and reach 64.1 % of GDP in 2005 and 64.2 % in 2006. As was the case with the euro area, the overall positive contribution from the primary balance will not fully offset negative contribution from the other two elements of debt dynamics — interest expenditure/growth and stock-flow operations.

Aggregate figures tend to hide different pictures across countries. In 2004, Greece and Italy continued to have

debt ratios above 100 % of GDP, and this is expected to still be the case also in 2006 (1). Belgium managed to reduce its debt below this level in 2004 and its debt ratio is expected to be reduced further in the future. In addition to these three countries, six EU Member States are projected to have debt ratios above 60 % of GDP in 2005. The combined effect of poor growth performance and interest expenditure is expected to significantly affect the budgetary situation in Germany, France, Italy and the Netherlands, as well as in Portugal and Malta, where in addition, large primary deficits are projected.

(1) Following the Eurostat decision of 23 May 2005, the government debt of Italy has been provisionally set at 106.5 % of GDP for the year 2003 and at 106.6 % of GDP for the year 2004 (Eurostat: Euroindicators, News Release 65/2005, 23.5.2005).

Table I.3

Composition of changes in government debt ratio in EU Member States, 2003–06

(% of GDP)

	Gross debt				Change in gross debt	Change in 2004–06 due to:		
	2003	2004	2005	2006	2004–06	Primary balance	Interest and growth contribution	Stock-flow adjustment
BE	100.0	95.6	94.9	91.7	– 3.9	– 7.9	0.9	3.1
DE	64.2	66.0	68.0	68.9	2.9	0.1	3.6	– 0.8
EL	109.3	110.5	110.5	108.9	– 1.6	– 2.0	– 2.3	2.7
ES	51.4	48.9	46.5	44.2	– 4.7	– 4.1	– 1.8	1.3
FR	63.9	65.6	66.2	67.1	1.5	0.4	1.1	0.0
IE	32.0	29.9	29.8	29.6	– 0.3	– 1.0	– 2.2	2.9
IT (1)	106.3	105.8	105.6	106.3	0.5	– 1.7	2.4	– 0.2
LU	7.1	7.5	7.8	7.9	0.4	3.0	– 0.6	– 2.0
NL	54.3	55.7	57.6	57.9	2.2	– 2.0	3.0	1.2
AT	65.4	65.2	64.4	64.1	– 1.0	– 2.0	1.1	– 0.2
PT	60.1	61.9	66.2	68.5	6.6	3.6	1.4	1.6
FI	45.3	45.1	44.3	43.7	– 1.4	– 6.4	– 0.3	5.3
EUR-12	**70.8**	**71.3**	**71.7**	**71.9**	**0.6**	**– 1.3**	**1.5**	**0.3**
CZ	38.3	37.4	36.4	37.0	– 0.4	5.8	– 2.6	– 3.6
DK	44.7	42.7	40.5	38.2	– 4.4	– 8.5	1.0	3.0
EE	5.3	4.9	4.3	4.0	– 1.0	– 1.7	– 0.4	1.2
CY	69.8	71.9	69.1	66.6	– 5.3	– 1.8	– 2.2	– 1.3
LV	14.4	14.4	14.0	14.3	– 0.1	1.5	– 1.4	– 0.3
LT	21.4	19.7	21.2	20.9	1.2	2.6	– 1.8	0.5
HU	56.9	57.6	57.8	57.9	0.3	0.7	– 1.9	1.5
MT	71.8	75.0	76.4	77.1	2.2	– 1.9	3.7	0.4
PL	45.4	43.6	46.8	47.6	3.9	3.1	– 0.4	1.2
SI	29.4	29.4	30.2	30.4	1.0	1.0	– 0.6	0.6
SK	42.6	43.6	44.2	44.9	1.3	3.1	– 1.9	0.0
SE	52.0	51.2	50.3	49.2	– 2.0	– 5.8	– 0.4	4.2
UK	39.7	41.6	41.9	42.5	0.9	1.6	0.0	– 0.8
EU-25	**63.3**	**63.8**	**64.1**	**64.2**	**0.4**	**– 0.8**	**1.0**	**0.2**

(1) Following the Eurostat decision of 23 May 2005, the government debt of Italy has been provisionally set at 106.5 % of GDP for the year 2003 and at 106.6 % of GDP for the year 2004 (Eurostat: Euroindicators, News Release 65/2005, 23.5.2005).

Source: Commission's spring 2005 economic forecasts.

1.2. Government revenue and expenditure

The developments in the EU and euro-area budgetary positions are derived from changes in expenditure and revenue ratios. On the expenditure side, the euro-area expenditure-to-GDP ratio decreased in 2004, both in nominal and cyclically adjusted terms, compared with the previous year (see Table I.4). This is due to a combined effect of reductions in social expenditures, collective consumption, interest and other expenditures. According to the Commission's spring 2005 forecasts, the expenditure ratio is projected to decline further during the forecast period, with additional reduction in collective consumption and social transfers other than in kind, while other items are foreseen to remain broadly unchanged. On the revenue side, the revenue-to-GDP ratio also decreased in 2004, both in nominal and cyclically adjusted terms, and is expected to decline further in the coming years.

At the Member State level, the patterns are generally similar (see Table I.5). Only in Ireland, Italy, the Netherlands and Portugal and outside the euro area, in Latvia, Slovakia and the UK, are expenditure ratios projected to increase over the 2004–06 period. In contrast, over the same period, large decreases are expected in Germany, Greece, Austria, Hungary, Malta, Poland and Slovenia. Revenue ratios are set to increase pronouncedly over 2004–06 in the case of the Netherlands and outside the euro area, in Poland and the UK, whereas important reductions are foreseen in Belgium, Ireland, Italy, Austria, Finland, the Czech Republic, Denmark, Estonia and Hungary.

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, social benefits other than in kind, and subsidies. Such a development respects lessons from the past showing that tax measures resulting in a decline in 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 expenditure items such as public investment, education and R & D. The reduction in interest expenditure that has contributed particularly to a better allocation of available resources in past years will not continue as the interest burden will stabilise at 3.3 % of GDP over the projection period.

Table I.4

Euro-area government revenue and expenditure, 2002–06

(% of GDP)

	2002	2003	2004	2005	2006
Total revenue	**46.1**	**46.3**	**45.7**	**45.6**	**45.4**
— Cyclically adjusted	46.0	46.7	46.1	46.1	45.8
Taxes on imports and production	13.4	13.4	13.6	13.6	13.6
Current taxes on income and wealth	12.2	11.8	11.7	11.6	11.5
Social contributions	16.0	16.2	15.9	15.9	15.9
Of which actual social contributions	14.9	15.0	14.9	14.8	14.8
Other revenue	4.6	4.9	4.5	4.5	4.3
Total expenditure	**48.6**	**49.1**	**48.5**	**48.2**	**48.0**
— Cyclically adjusted	48.6	49.0	48.4	48.1	47.9
Collective consumption	8.3	8.4	8.3	8.2	8.1
Social benefits in kind	12.1	12.3	12.2	12.2	12.2
Social benefits other than in kind	16.9	17.2	17.1	17.1	16.9
Interest	3.7	3.5	3.3	3.3	3.3
Subsidies	1.4	1.3	1.3	1.2	1.2
Gross fixed capital formation	2.5	2.6	2.6	2.6	2.7
Other expenditures	3.7	3.8	3.7	3.7	3.7

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

Source: Commission's spring 2005 forecasts.

Table I.5

Total revenue and expenditure in EU Member States, 2003–06

(% of GDP)

	Revenue				Expenditure			
	2003	2004	2005	2006	2003	2004	2005	2006
BE	51.3	49.6	49.1	48.5	50.9	49.5	49.3	49.0
DE	45.0	43.8	43.6	43.4	48.8	47.5	47.0	46.2
EL	43.5	43.9	44.3	44.3	48.0	50.0	48.8	48.7
ES	40.0	40.2	40.4	40.5	39.7	40.5	40.4	40.4
FR	50.4	50.8	51.5	51.1	54.6	54.5	54.5	54.4
IE	34.6	35.7	34.5	34.0	34.4	34.3	35.1	34.6
IT	46.3	45.4	44.6	44.0	49.2	48.4	48.2	48.5
LU	45.5	44.9	44.4	44.2	45.1	46.0	46.0	46.0
NL	45.8	45.5	45.8	47.6	49.0	48.0	47.9	49.2
AT	50.0	49.4	48.1	47.4	51.2	50.7	50.1	49.2
PT	44.8	43.8	42.5	43.1	47.7	46.7	47.4	47.8
FI	53.3	52.5	51.9	51.3	50.8	50.4	50.3	49.8
EUR-12	**46.3**	**45.7**	**45.6**	**45.4**	**49.1**	**48.5**	**48.2**	**48.0**
CZ	41.6	42.7	41.8	41.0	53.3	45.7	46.3	45.1
DK	56.6	57.7	56.5	55.7	55.3	55.0	54.3	53.5
EE	38.9	40.9	40.8	39.2	35.8	39.1	40.0	38.7
CY	39.1	39.4	39.4	38.9	45.4	43.6	42.3	40.7
LV	34.2	35.2	35.4	35.3	35.7	35.9	37.0	36.8
LT	32.3	31.8	32.3	31.6	34.2	34.3	34.8	33.6
HU	44.5	47.5	43.9	43.0	50.8	52.0	47.8	47.1
MT	40.5	49.0	48.8	48.6	50.9	54.1	52.6	51.4
PL	44.3	43.8	44.2	44.2	48.8	48.7	48.6	48.0
SI	46.2	45.8	45.4	45.1	48.2	47.7	47.6	47.2
SK	35.4	35.1	36.1	34.8	39.2	38.5	39.9	38.8
SE	58.6	58.4	57.8	57.4	58.4	57.0	57.0	56.6
UK	40.0	40.4	40.9	41.4	43.4	43.6	44.0	44.1
EU-25	**45.6**	**45.3**	**45.2**	**45.1**	**48.5**	**47.9**	**47.8**	**47.6**
***Pm* EU-15**	**45.7**	**45.4**	**45.4**	**45.2**	**48.5**	**48.0**	**47.9**	**47.7**
***Pm* EU-10**	**42.4**	**43.0**	**42.5**	**42.0**	**48.1**	**46.8**	**46.4**	**45.5**

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

Source: Commission's spring 2005 forecasts.

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 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.

Graph I.1 examines the fiscal stance (approximated by the changes in the cyclically adjusted primary balance, CAPB) in relation to cyclical conditions (approximated

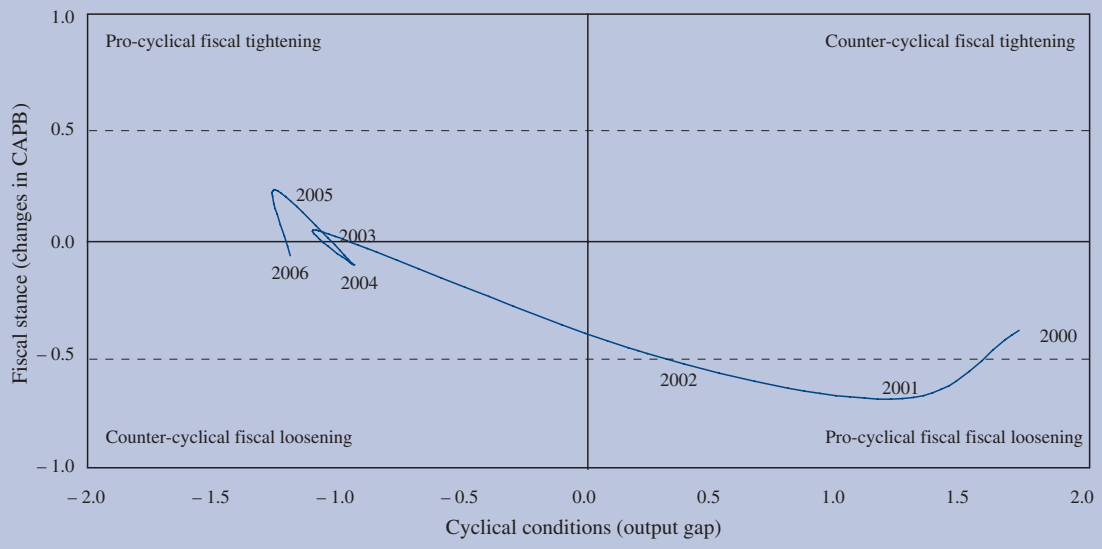
by the size of the output gap) ([1]). In this graph, fiscal behaviour in accordance with the SGP would be represented by movements along the horizontal axis. In other words, countries would achieve and maintain broadly balanced budgets over the economic cycle. Thus, changes in the output gap would not 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 the CAPB — would be needed.

According to the Commission's spring 2005 forecasts, the euro-area fiscal stance in 2004 was slightly on the side of countercyclical fiscal loosening, although still broadly neutral. Looking ahead to 2005 and 2006, the euro-area fiscal stance is projected to remain broadly neutral. Lessons from the past show, however, that efforts to improve the underlying budgetary 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 real short-term interest rates) on the horizontal axis. Against the background of a protracted slowdown in economic activity, the monetary stance tightened somewhat and became more neutral, after three consecutive years of loosening. Overall, in 2004, the euro-area fiscal stance could still be seen as neutral, coupled with a growth-supportive monetary stance, despite tightening with respect to 2003, 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.

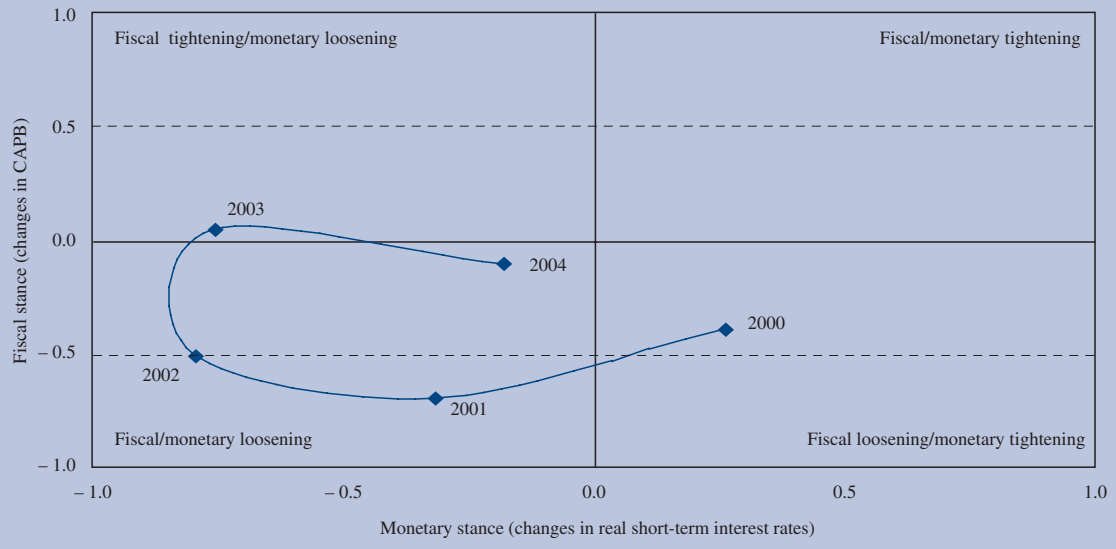
([1]) In line with the Council agreement, the output gap in this section is computed with the production function method. It should be noted, however, that changes in the output gap are equally relevant for the judgment of the stance in relation to cyclical conditions. The changes in the gap can be inferred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

Graph I.1: **Euro-area fiscal stance and cyclical conditions, 2000–06**



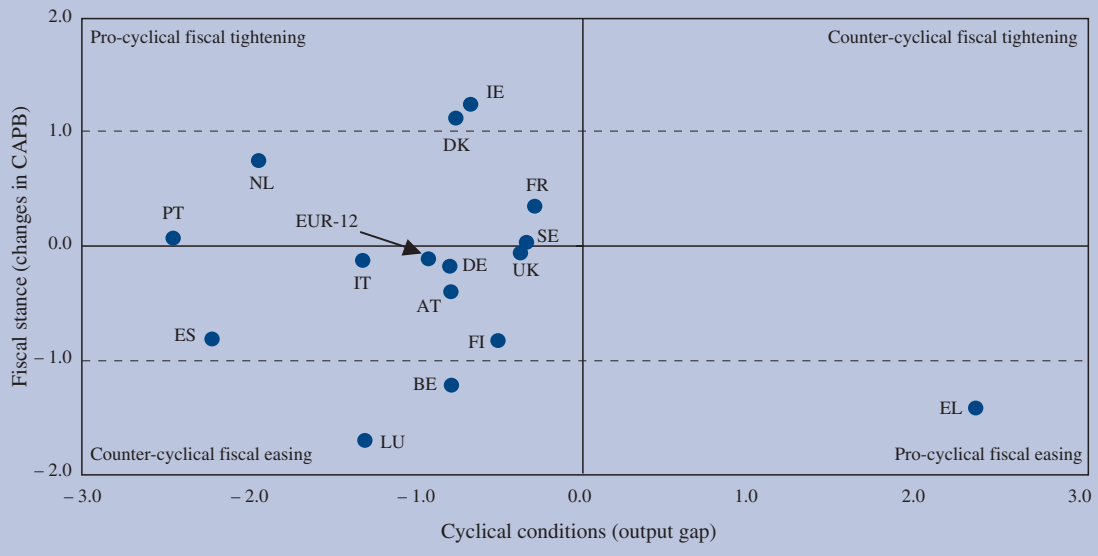
Source: Commission's spring 2005 forecasts.

Graph I.2: **Euro-area policy-mix, 2000–04**



Source: Commission's spring 2005 forecasts.

Graph I.3: **Fiscal stance and cyclical conditions in the EU-15 Member States, 2004**



Source: Commission's spring 2005 forecasts.

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

The aggregate fiscal stance for the euro area results from a variety of diverse fiscal stances across Member States, despite fairly similar cyclical developments.

Graph I.3 shows that most EU-15 countries recorded a negative output gap in 2004, with the exception of Greece.

In 2004, several EU countries ran moderately broadly neutral fiscal policies in a context of negative output gaps. Policies were, however, clearly countercyclical in the case of Luxembourg, Belgium and Spain. It is worth mentioning that the nominal budget balances in these countries markedly worsened in the course of 2004. Finland, which was benefiting from past consolidation efforts and therefore had a large safety margin, was also somewhat loosening the fiscal stance.

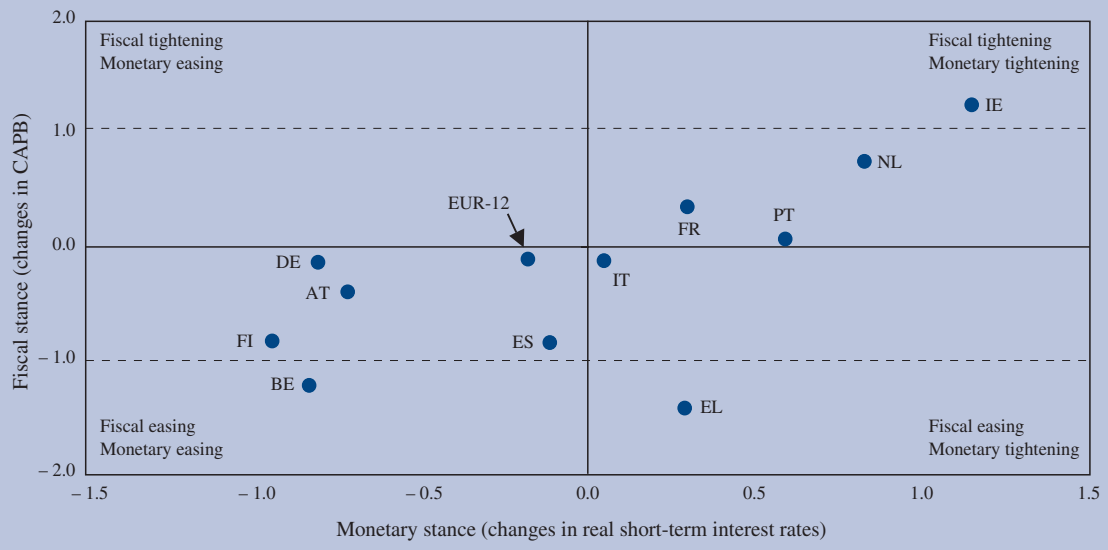
The Netherlands ran procyclical policy in 2004, reflecting consolidation efforts in order to keep the nominal deficits below the 3 % of GDP reference value. At the same time, Denmark and Ireland tightened their fiscal stance, while in the latter the output gap deteriorated quickly. Greece stands out 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 was still accommodative in 2004 with most Member States experiencing a broadly neutral fiscal stance despite increasing real interest rates (see Graph I.4). The real interest rates rose in half of the euro-area Member States, in particular in Ireland, the Netherlands and Portugal.

While Graph I.4 refers to the changes in the real short-term interest rates, their 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 0.2 % in 2004. However, this aggregate figure for the euro area conceals significant differences across Member States due to disparities in inflation rates across countries. The highest real interest rates were in Finland and the Netherlands (1.2 and 0.2 % respectively), whereas in a number of countries (Belgium, Greece, Spain, Ireland, Luxembourg and Portugal), the real interest rates were negative.

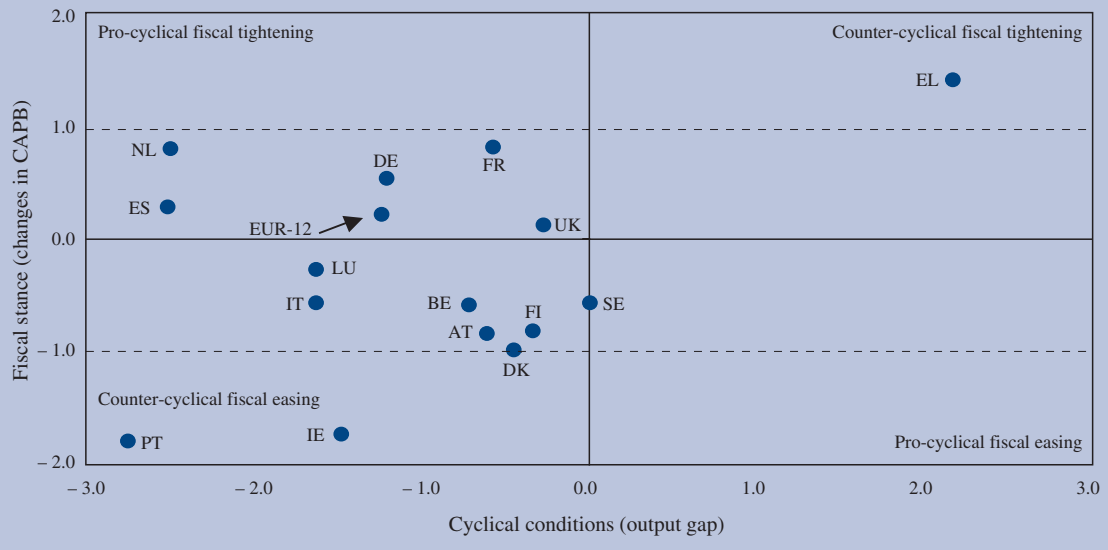
Regarding 2005, the overall fiscal stance of the euro area is expected to be broadly neutral (see Graph I.5), although some procyclical fiscal tightening is expected, particularly in France, Germany and the Netherlands. Greece is projected to considerably tighten its fiscal stance, even though the output gap is expected to be positive. Portugal, Ireland and Austria, on the other hand, are, however, projected to loosen their fiscal stance.

Graph I.4: **Policy-mix in euro-area Member States, 2004**



Source: Commission's spring 2005 forecasts.

Graph I.5: **Fiscal stance and cyclical conditions in the EU-15 Member States, 2005**



Source: Commission's spring 2005 forecasts.

2. Implementing the Stability and Growth Pact

2.1. Introduction

The fiscal framework of EMU aims at ensuring budgetary discipline through two main requirements. These are the Treaty requirement to avoid excessive deficit positions, measured against reference values for deficits and debt of 3 and 60 % of GDP respectively, and the requirement of the Stability and Growth Pact (SGP) to achieve and maintain a budgetary position of 'close to balance or in surplus' over the cycle. Compliance with the 'close-to-balance or in-surplus' requirement secures fiscal discipline and the sustainability of public finances, and thus contributes to maintaining an economic environment in which monetary policy can effectively pursue price stability. It also provides the necessary room for manoeuvre to allow the automatic stabilisers to play freely without breaching the 3 % reference value of the Treaty.

The rules-based framework of the Treaty and SGP consists of both preventive and dissuasive elements, both of which are backed up with enforcement procedures. Section 2.2 gives a short description of these procedures, namely the excessive deficit procedure and the early-warning mechanism. This section is entirely based on the provisions in force, and does not discuss the recent reform proposals agreed in the Council.

During 2004 and the early part of 2005, the deterioration in the budgetary positions has required the Commission and the Council to apply the various enforcement mechanisms of the SGP against several Member States. Section 2.3 reviews the implementation of these mechanisms since spring 2004 in the EU countries. It examines the developments concerning the Member States which have been subject to an excessive deficit procedure and other countries which have been the object of Council recommendations giving early warning.

2.2. The enforcement mechanisms of the Stability and Growth Pact

This section provides a description of the enforcement mechanisms at the disposal of the Commission and the Council to ensure budgetary discipline in the EU. It explains the different steps of the excessive deficit procedure, which are codified in Article 104 of the EC Treaty and Council Regulation (EC) No 1467/97, and when these steps need to be activated. This description puts particular emphasis on the consequences of euro-area membership on the procedure. In a second step, a short description of the early-warning mechanism is provided. This mechanism is codified in Article 99(4) of the Treaty and Articles 6(2) and 10(2) of Council Regulation (EC) No 1466/97.

The excessive deficit procedure

Article 104 of the Treaty states that Member States shall avoid excessive government deficits. In particular, Member States shall comply with budgetary discipline by respecting two criteria: a deficit ratio and a debt ratio not exceeding reference values of respectively 3 and 60 % of GDP. A few exceptions are specified in the Treaty. Article 104 also sets out the procedure to be followed to identify and correct situations of excessive deficit, and voting modalities in the course of the procedure. Regulation (EC) No 1467/97 on the Stability and Growth Pact clarifies the procedure.

The first four steps of the procedure, corresponding to the provisions of paragraphs 3 to 6 of Article 104, concern the identification of situations of excessive deficit. The excessive deficit procedure is triggered if the defi-

cit of a Member State exceeds 3 % of GDP ([1]). In such a situation, the Commission adopts a report, in accordance with Article 104(3), reviewing in detail the economic and budgetary situation of the Member State considered. As foreseen in Article 104(4) and Regulation (EC) No 1467/97, the Economic and Financial Committee formulates an opinion on this report within two weeks. The Commission takes this opinion into account and, if it considers that an excessive deficit exists, addresses an opinion under Article 104(5) to the Council. On the basis of the Commission opinion, the Council itself decides on the existence of an excessive deficit under Article 104(6).

The subsequent steps of the procedure are dedicated to the correction of excessive deficits. When it decides that an excessive deficit exists, the Council addresses a recommendation to the Member State concerned in accordance with Article 104(7). In this recommendation, the Council sets two deadlines: one for the Member State to take effective action to correct the excessive deficit, and one for the correction of the excessive deficit itself ([2]). Regulation (EC) No 1467/97 specifies that the latter deadline shall be the year following the identification of an excessive deficit, unless there are special circumstances.

In the case where action by the Member State concerned leads to the correction of the excessive deficit, the Council shall decide, in accordance with Article 104(12), to abrogate its decisions under the excessive deficit procedure. In other words, the procedure is closed. In the event the Council considers that no effective action has been taken, it may decide, as stated in Article 104(8) of the Treaty, to make public its recommendation according to Article 104(7).

The steps described above apply to all EU countries. The further steps of the procedure depend on whether the Member State is a euro-area Member State.

The excessive deficit procedure applies in full to euro-area Member States. For these countries, Article 104(9) stipulates that, provided the Council adopts a decision under Article 104(8), it may decide to give notice to the Member State concerned to take the necessary measures to reduce the deficit. The recommendations under Article 104(9) of the Treaty shall include a deadline for the correction of the excessive deficit, and Regulation (EC) No 1467/97 specifies that measures for the deficit reduction that the Council judges necessary have to be taken by the Member State concerned within two months at the most from the adoption of the notice under Article 104(9).

This step constitutes a move towards even closer surveillance, and is the ultimate step before the possible imposition of sanctions. If the Member State fails to comply with the recommendations, the Council may decide to impose sanctions no later than two months after notice has been given. In the case of compliance with the recommendations formulated in the notice under Article 104(9), the decisions taken under Article 104(6) to (9) are abrogated with a Council decision in accordance with Article 104(12), and the procedure is closed.

As already mentioned, non-euro-area Member States are not exempt from the obligation to avoid excessive deficits, but the later steps of the EDP do not apply to them. When a Member State outside the euro area in a situation of excessive deficit fails to respect the recommendations addressed under Article 104(7), it cannot be submitted to the last two steps of the excessive deficit procedure, namely the notice foreseen in Article 104(9) and the imposition of sanctions foreseen in Article 104(11) ([3]). Non-compliance with a recommendation under Article 104(7) may lead to a renewed recommendation according to Article 104(7).

Denmark, Sweden, the UK, and the EU-10 are in such a situation. The specific situation of the EU-10, which have the status of 'Member States with a derogation', in the sense of Article 122 of the Treaty, was detailed in the 2004 edition of this report. This report also underlined that, in addition to Council recommendations, other channels may act as complementary discipline mechanisms for these countries.

([1]) Article 104(2) of the Treaty states that a deficit in excess of the 3 % reference value that is only exceptional and temporary may not be considered excessive in the case where the deficit remains close to the reference value. A deficit above 3 % of GDP may also not be considered excessive if it has declined substantially and reached a level that comes close to the reference value. The same article provides an exception for countries having a debt ratio above 60 %, if this ratio diminishes sufficiently and approaches the value of 60 % of GDP at a satisfactory pace.

([2]) Regulation (EC) No 1467/97 stipulates that the deadline for taking measures cannot exceed four months.

([3]) These Member States have no voting right on decisions provided for under the two paragraphs.

The early-warning mechanism

In complement to the excessive deficit procedure, the Treaty foresees in its Article 99(4) the possibility for the Council to make recommendations to Member States in the case where their economic policies 'are not consistent with the broad guidelines … or … risk jeopardising the proper functioning of economic and monetary union'. Based on this article, Regulation (EC) No 1466/97, which constitutes the preventive arm of the SGP, provides the Council with the possibility to issue 'early warnings' to Member States in order to prevent the occurrence of an excessive deficit.

Early warnings are issued by the Council, upon recommendations of the Commission, in the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective of 'close to balance or in surplus', or the adjustment path towards it.

2.3. The surveillance mechanisms since spring 2004

Since summer 2004, 10 EU countries have been subject to an excessive deficit procedure: four euro-area Member States and six of the recently acceded Member States ([1]). In addition, in 2004, the Commission recommended to the Council that an early warning be issued to Italy to prevent the occurrence of an excessive deficit. Below is a presentation of the ongoing procedures concerning the various countries.

2.3.1. The surveillance mechanisms in the euro-area countries

Since spring 2004, the Commission and the Council have taken action or clarified their positions concerning four euro-area Member States in EDP. The Council decided to address an Article 104(9) recommendation, the latest step of the procedure before sanctions, to Greece, which has to correct its excessive deficit in 2006. The Commission clarified its position for the excessive deficit procedure for Germany and France, after the events of November 2003 and the ruling of the Court of Justice of 13 July 2004. Finally, the Commission and the Council considered that the Netherlands had taken effective action to correct its excessive deficit and the Commission proposed on 18 May 2005 to abrogate the EDP.

Greece

On 4 May 2004, the Greek authorities submitted a revised EDP notification showing a 2003 deficit of 3.2 % of GDP. This provided prima facie evidence for the existence of an excessive deficit. The Council decided that an excessive deficit exists in Greece and addressed on 5 July 2004 a recommendation to Greece with a view to bringing the excessive deficit situation to an end by 2005. The Council established the deadline of 5 November 2004 for Greece to take appropriate measures to this end.

Based on its autumn 2004 forecast incorporating the data revisions of September 2004 notification and projecting the 2005 deficit at 3.6 % of GDP, on 22 December 2004 the Commission recommended to the Council to decide under Article 104(8) that no effective action had been taken in response to its Article 104(7) recommendation. The Council decided accordingly on 18 January 2005. On 9 February 2005, the Commission recommended to the Council to give notice to Greece, in accordance with Article 104(9) of the Treaty, to take the necessary measures to remedy its excessive deficit situation.

The Commission recommended extending the deadline for bringing the deficit below the 3 % reference value by one year to 2006. When taking this decision, the Commission took into account the fact that the deficit would likely be substantially higher than expected (the 2003 deficit was revised to 5.2 % in March 2005, up from an estimated 4.6 % of GDP in September 2004 and 1.7 % of GDP in March 2004), due to statistical revisions and to expenditure overruns associated notably with the organisation of the Olympic Games. In addition, the Commission considered that GDP growth prospects for 2005 and 2006 had become less favourable, making the reduction of the deficit more difficult.

On 17 February 2005, the Council adopted a decision giving notice to Greece, in accordance with Article 104(9) of the Treaty, to take measures to remedy the situation of excessive deficit as rapidly as possible and at the latest by 2006 through: (i) a rigorous implementation of the 2005 budget as approved by its Parliament; and (ii) implementing in 2006 adjustment measures of a permanent nature leading to a correction in the deficit of at least 0.6 percent-

([1]) For documents concerning these procedures, see the section on fiscal surveillance on the Economic and Financial Affairs DG's website (http://europa.eu.int/comm/economy_finance/about/activities/sgp/procedures_en.htm).

age points of GDP ([1]). The Council decided that Greece had to submit, by 21 March 2005 at the latest, a report outlining the decisions to respect these recommendations.

([1]) The Council also recommended Greece to pursue further the efforts to identify and control factors other than net borrowing, which contribute to the change in debt levels, with a view to ensuring that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace in line with the correction of the excessive deficit.

In March 2005, Greece submitted a report, which was assessed in the Commission communication of 6 April. The Commission concluded that the Greek government is taking effective action so that no further steps under the EDP seem to be needed at this stage. Greece shall submit other reports by 31 October 2005, 30 April 2006 and 31 October 2006 examining progress made in respecting the recommendations of the notice issued under Article 104(9).

Box I.1: The revision in the Greek deficit and debt ([1])

In 2004, the Greek data on the government deficit and debt underwent a very large revision. The government deficit for 2003, which was initially reported at 1.7 % of GDP, stood at 4.6 % of GDP after the September 2004 notification. Following a further revision in March 2005, it stands at 5.2 % of GDP. The deficit ratios over the period 1997–2003 were also quite significantly revised upwards by up to 2½ % of GDP. A separate revision of the debt data led to increases of between 5 and 8 % of GDP. Moreover, if a revision which had already taken place in autumn 2002 is taken into account, the overall upward revision in the deficit and debt ratios reaches, for some years, 4 and 15 percentage points, respectively. Moreover, in March 2005, Eurostat did not validate the revised Greek data and highlighted inconsistencies in the recording of flows with the EU budget which could lead to further upward revisions in the deficit figures.

The revision in the Greek accounts concerned several topics as summarised Table I.6. The most significant revisions — such as the revision in social security accounts and military expenditure — were in relation to difficulties in the compilation and estimation of basic data. Other revisions — such as debt assumptions, capital injections and interest — concerned an inappropriate application of accounting rules.

Table I.6

Main components of the revision in the Greek data, 1997–2003

(% of GDP)

	1997	1998	1999	2000	2001	2001	2003
Deficit (as of March 2004)	**4.0**	**2.5**	**1.8**	**2.0 ([1])**	**1.4 ([1])**	**1.4**	**1.7**
Military expenditure	0.2	0.1	0.9	1.9	1.2	1.7	0.7
Interest	1.0	0.3	0.1	0.3	0.1	0.1	0.1
Social security accounts	—	—	—	—	1.0	0.4	0.6
Debt assumptions/capital injections	1.0	1.1	0.8	—	—	—	—
Tax revenue	—	—	—	—	—	—	0.9
Other	0.4	0.4	– 0.1	0.0	0.0	0.5	1.1
Deficit (as of March 2005)	**6.6**	**4.3**	**3.4**	**4.1**	**3.6 ([2])**	**4.1 ([2])**	**5.2 ([2])**
Debt (as of March 2004)	**108.2**	**105.8**	**105.2**	**106.1 ([1])**	**106.6 ([1])**	**104.6**	**102.6**
Bonds with capitalised interest	4.9	4.7	4.5	4.5	4.2	3.9	3.4
Social security accounts	1.0	1.9	1.9	3.2	3.9	3.5	2.6
Other	0.0	0.0	0.7	0.1	0.1	0.2	0.1
Debt (as of March 2005)	**114.0**	**112.4**	**112.3**	**114.0**	**114.8 ([2])**	**112.2 ([2])**	**109.3 ([2])**

([1]) Data for 2000 and 2001 had already been significantly revised in autumn 2002.
([2]) Not validated by Eurostat and subject to further upward revision.

Source: Eurostat.

([1]) For more information on the revision of Greek government statistics, see 'Report by Eurostat on the revisions of the Greek government deficit and debt figures (1997–2003)' (SEC(2004) 1539, 22.11.2004).

(Continued on the next page)

Box I.1 (continued)

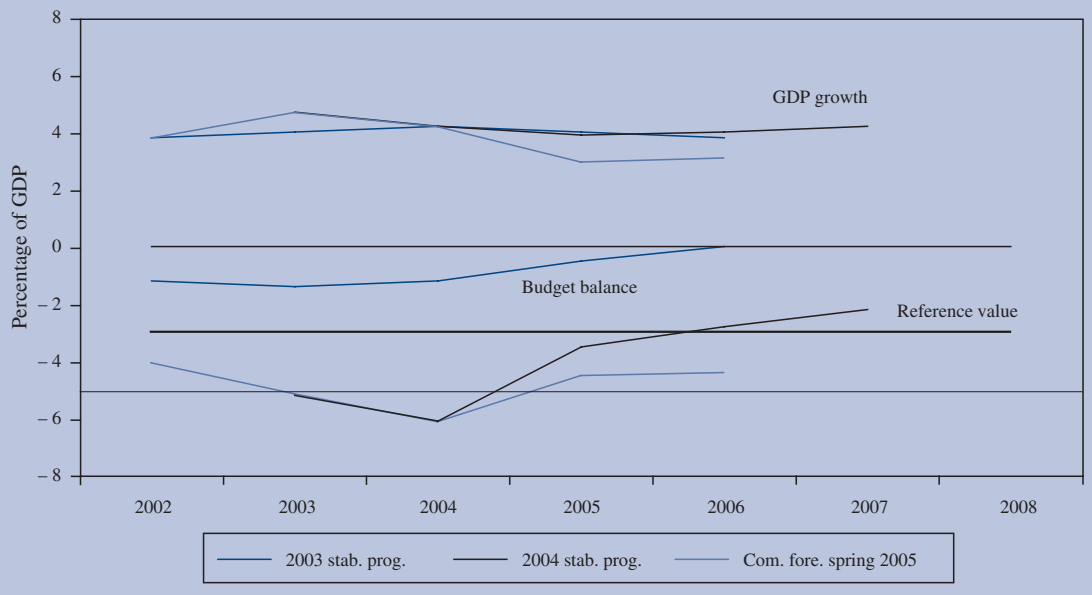
Revisions in statistics, and in particular in the government deficit and debt data, are not unusual. After the publication of the first outcomes in March, data are often revised because new information becomes available or because errors are corrected. However, 'the scope and size of the past revisions in the Greek case are unprecedented and very serious, particularly as regards the overall credibility of the multilateral surveillance framework' ([2]).

The revision in the Greek accounts revealed 'systemic weaknesses' in the statistical authorities of Greece: notably 'lack of expertise' and 'lack of reliable basic data needed to produce public accounts of good quality' ([3]). However, this case also illustrated insufficiencies in the Commission services and of a more general nature. Notwithstanding a permanent dialogue between the national statistical authorities and Eurostat, the latter has neither the resources nor the legal means to countercheck the veracity and reliability of information provided by Member States. Moreover, in spite of the relevance of budgetary statistics for macroeconomic surveillance and for the decision on participation in the monetary union, and the fact that most difficulties in the Greek statistical system had been identified in earlier years, the statistical issues used to be discussed among a restricted circle of statisticians without being brought to public attention and the appropriate political level. In this respect, the Ecofin Council of 7 December 2004 regarded as 'serious cause for concern that … Eurostat validated the critical March 2000 EDP notification data of Greece [immediately before the decision on the participation of Greece in the euro], in spite of significant open issues related to the fiscal data' and that 'the Commission's and the ECB's convergence reports failed to emphasise to the Council potential problems with regard to Greek budgetary statistics'.

The revision in the Greek accounts also brought the issue of professional independence of national statistical authorities to the fore. (See Box II.2 on the strengthening of the governance of budgetary statistics which summarises recent developments and proposals to address these weaknesses.)

([2]) Ecofin Council conclusions of 7 December 2005.
([3]) Commission communication 'Report on the accountability issue related to the revision of Greek budgetary data' (COM(2004) 784, 1.12.2004).

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



Source: Commission services

Germany and France

Summary of past events and consequences of the Court of Justice ruling of 13 July 2004

Following evidence of government deficits above 3 % of GDP in 2002, the Council decided in spring 2003 that excessive deficits existed in Germany and France and adopted recommendations under Article 104(7) with a view to bringing this situation to an end by 2004. In autumn 2003, the Commission assessed the measures taken in both countries and considered that the actions implemented by Germany and France were inadequate to correct their excessive deficits and recommended the Council to decide accordingly. The Commission also recommended the Council to adopt a decision giving notice to these two countries to take measures to remedy the situation. In light of the weaker-than-expected economic situation, the Commission recommended that the deadline for correcting the deficit should be extended by one year to 2005.

On 25 November 2003, the Council voted on the recommended decisions but did not achieve the required majority. Instead, the Council adopted conclusions addressing recommendations to Germany and France for the correction of the excessive deficit by 2005 and stating that, in light of the commitments by the two Member States, the excessive deficit procedure was held in abeyance. The Commission brought the case before the Court of Justice of the European Communities challenging certain elements of the Council conclusions of 25 November 2003. On 13 July 2004, the Court annulled the Council conclusions in so far as they aimed at formally suspending the procedure and modifying the existing recommendations. However, the Court did not elaborate on the implications of its decision for the excessive deficit procedure for Germany and France.

On 14 December 2004, the Commission adopted a communication clarifying the situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgment of the Court of Justice. The Commission considered that, in assessing the position of Germany and France, it is appropriate to take into account the consequences of the Council conclusions until their annulment by the Court, and notably the fact that these conclusions benefited from the presumption of validity that is attached in principle to every Community instrument.

Therefore, while maintaining its view on the inadequacy of the actions taken by Germany and France to correct the excessive deficit by 2004, the Commission recognised that the actions of the two Member States concerned taken in the aftermath of the Council conclusions of 25 November 2003 and up to their annulment by the Court on 13 July 2004 were based on the notion that the deadline for the correction of the deficit had been effectively moved to 2005. In light of these circumstances, the Commission considered that the assessment of the actions taken to correct the excessive deficit situation should refer to 2005 as the relevant deadline. The Council agreed with this position.

As detailed in the following two subsections, the Commission considered in its communication that Germany and France were in a position that makes the correction of the excessive deficit still possible. The Commission noted, however, that, if failures in implementing the envisaged correction measures should emerge at a later stage, it would have to recommend to the Council to enhance the budgetary surveillance and to take the necessary action within the provisions of the Treaty and the Stability and Growth Pact.

Germany

In the autumn 2004 forecasts, the Commission projected real GDP growth at 1.5 % and the general government deficit at 3.4 % of GDP in 2005 based on a no-policy-change scenario with the reference date 18 October 2004. On 4 November, the federal government presented a savings package and, in the Fiscal Planning Council (*Finanzplanungsrat*) meeting of 18 November, the federal, state and local levels of government agreed to reduce the government deficit to 2.9 % of GDP in 2005.

The Commission considered in its communication of 14 December 2004 that measures taken as well as a subsidy repayment by the state banks (*Landesbanken*) would allow the 2005 deficit to be reduced to 2.9 % of GDP. Therefore, the Commission considered that the measures taken by the German authorities were consistent with a correction of the excessive deficit by 2005. Accordingly, the Commission concluded in its communication of 14 December 2004 that no further steps were necessary under the excessive deficit procedure.

The Commission, however, noted that the budgetary situation of Germany remains vulnerable, that none of the additional measures constitutes a structural reform with

long-term benefits, and that the reduction of expenditure to the cash settlement office shifts an implicit liability to the future. In addition, the Commission noted that any unfavourable development on the macroeconomic or on the budgetary side could bring the deficit above 3 % in 2005.

In spring 2005, the Commission services revised their deficit forecast for 2005 up to 3.3 % of GDP, due to economic developments in Germany which were less favourable than expected at the end of 2004. This suggests that additional measures may be needed to bring the deficit below 3 % of GDP in 2005. However, in view of the uncertainties attached to the 2005 deficit outcome at this point in the year, the Commission considered that it would be premature to take further steps under the excessive deficit procedure. The Commission will continue monitoring the budgetary situation, which remains vulnerable, in the coming months.

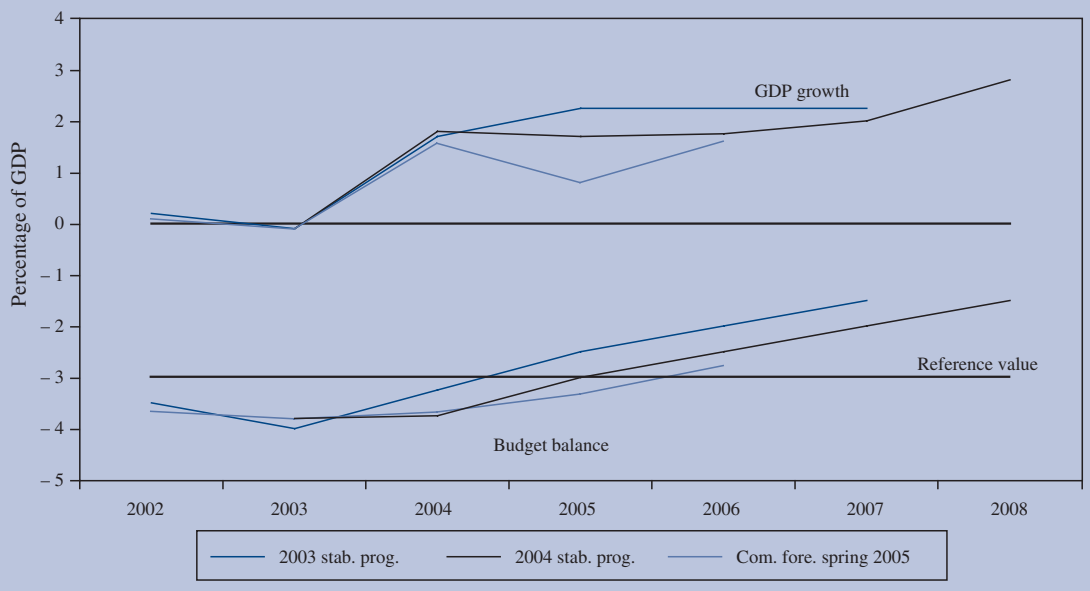
France

The Commission services' autumn 2004 forecasts projected the general government deficit at 3.7 % of GDP in 2004 and 3.0 % of GDP in 2005. The deficit reduction was projected to result from expenditure restraint and a significant increase in revenues, stemming notably from a large one-off payment (0.5 % of GDP) linked to the transfer of the responsibility for the payment of pensions of the employees in public electricity and gas companies to the social security sector ([1]). Based on these forecasts, the Commission considered that actions taken by the French authorities were broadly consistent with a correction of the excessive deficit by 2005. Accordingly, the Commission concluded in its communication of 14 December 2004 that no further steps were necessary under the excessive deficit procedure.

As in the case of Germany, the Commission noted that the budgetary situation of France remained vulnerable. The Commission also noted that any unfavourable development on the macroeconomic or on the budgetary side could compromise the achievement of the objective of correcting the excessive deficit in 2005 at the latest. The Commission also underlined that the deficit reduction in 2005 largely relies on the favourable impact of a

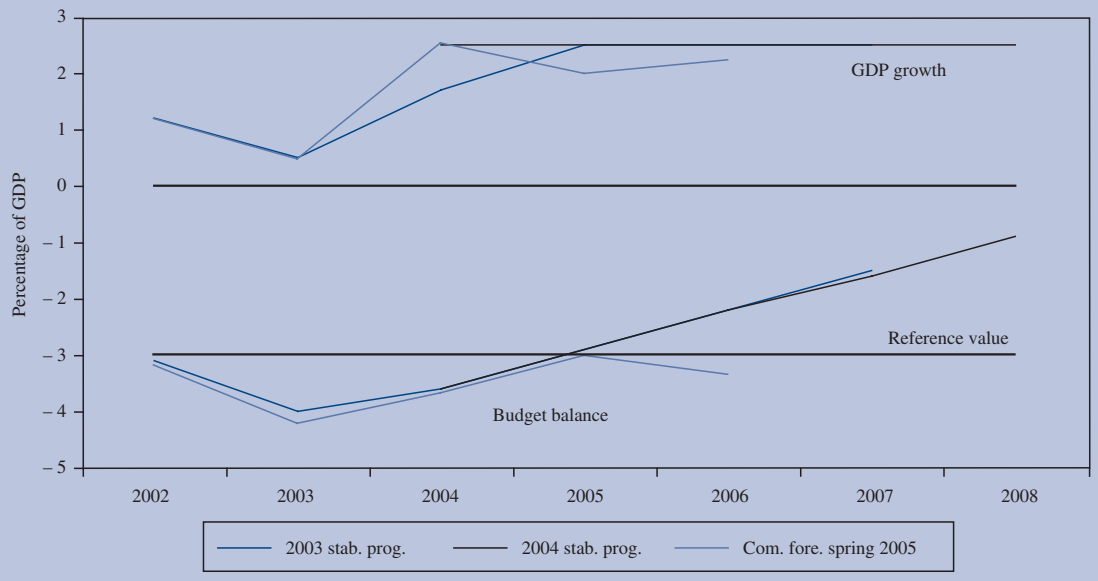
([1]) Expenditure restraint is planned to stem notably from (i) the stabilisation of State expenditures in real terms, and (ii) an expected slowdown in health expenditure following the reform of the health insurance system adopted in summer 2004.

Graph I.7: **Budgetary plans, forecasts and outcomes in Germany**



Source: Commission services.

Graph I.8: **Budgetary plans, forecasts and outcomes in France**



Source: Commission services.

large one-off measure. This was reflected in the autumn 2004 Commission services' deficit forecast, which projected an increase in the deficit to 3.3 % of GDP in 2006 under the assumption of an unchanged policy.

In spring 2005, the Commission services confirmed their forecast of a 2005 deficit of 3.0 % of GDP, on a no-policy-change basis. The deficit forecast for 2006 was revised slightly upwards, to 3.4 % of GDP. Following this forecast, and considering the uncertainties attached to the 2005 deficit outcome, the Commission considered that it would be premature to take further steps under the excessive deficit procedure, and will continue monitoring budgetary developments, which remain vulnerable.

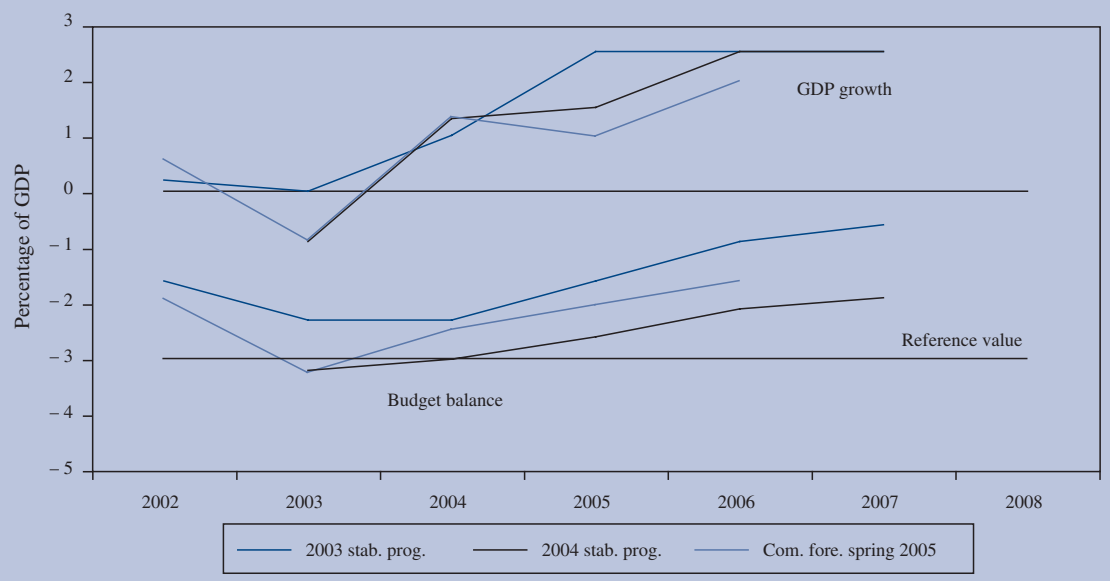
The Netherlands

In light of a reported general government deficit of 3.2 % of GDP in 2003 and considering the risk that the deficit might remain above 3 % of GDP in 2004, the Council placed the Netherlands in excessive deficit on 2 June 2004 and at the same time issued an Article 104(7) recommendation for its correction. The Netherlands government was recommended to put an end by 2005 at the latest to the present excessive deficit. To that end, it was recommended to take action regarding corrective measures in 2005 amounting to at least a ½ percentage point of GDP by the deadline of 2 October 2004.

Following this recommendation, the Dutch authorities implemented an additional savings package for 2004 equivalent to 0.6 percentage points of GDP on top of the savings measures that had already been included in the 2004 budget. The measures involved, in particular, higher premiums for health insurance, lower health expenditure and an end to subsidies on employing low-skilled workers. The budget for 2005 contained further deficit-reducing measures adding up to an adjustment of a ½ % of GDP for 2005. The corrective measures were for the largest part of a structural nature, thus having a deficit-reducing impact also in subsequent years. On 6 October 2004, the Commission considered that the Netherlands had taken effective action to correct the excessive deficit by 2005. The Council concurred with this analysis in its conclusions of 21 October 2004.

On a no-policy-change basis, the Commission services' spring 2005 economic forecast projected the deficit at 2.0 % in 2005, after 2.5 % of GDP in 2004. Following this forecast, the Commission recommended on 18 May to the Council to abrogate its decisions under Article 104(6) and (7) of the Treaty.

Graph I.9: **Budgetary plans, forecasts and outcomes in the Netherlands**



Source: Commission services.

Italy

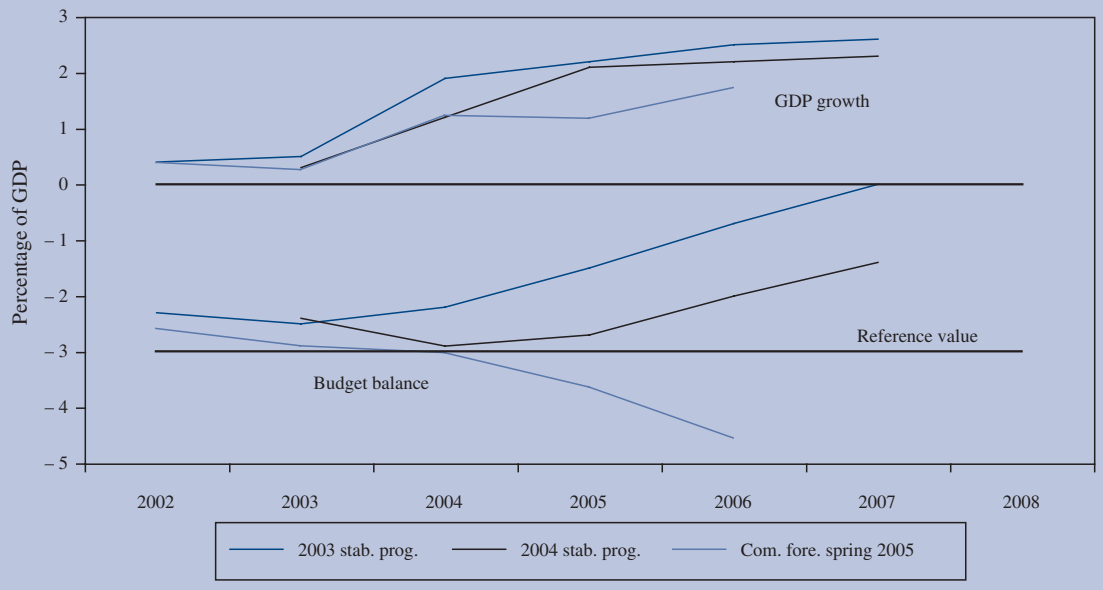
In spring 2004, the Commission projected for 2004 a budget deficit of 3.2 % of GDP compared with a target of 2.2 % of GDP in the 2003 update of the programme and of 0.6 % of GDP in the 2002 update. The Commission, also considering that divergence from the objectives was almost entirely structural and the projected interruption of the reduction of the debt ratio, recommended, on the basis of Article 99(4) of the Treaty and Article 6(2) of Council Regulation (EC) No 1466/97, that an early warning be issued to Italy to prevent the occurrence of an excessive deficit. In July 2004, in view of the announcement of further consolidation measures by the Italian authorities, the Council decided not to put to the vote the Commission recommendation for an early warning to Italy.

In March 2005, the Italian authorities reported a 2004 deficit of 3.0 % of GDP. Eurostat indicated that it was not in a position to validate the figures for Italy in view of pending statistical issues and that 'the clarification of these issues could lead to an upward revision in the government deficit, most notably for 2003 and 2004'. This suggests a clear risk that the 2004 deficit was already above the reference value of 3 % of GDP. On a no-policy-change basis, the spring 2005 forecasts of the Commission services project the 2005 deficit at 3.6 % of GDP, followed by 4.6 % of GDP.

2.3.2. The surveillance mechanisms in the non-euro-area Member States

After the publication of the Commission services' spring 2004 economic forecasts, which took into account data reported in March 2004, the Commission initiated the excessive deficit procedure for six new Member States: Hungary, the Czech Republic, Cyprus, Malta, Poland and Slovakia. The Council decided on 5 July 2004 that an excessive deficit existed in these countries and at the same time issued an Article 104(7) recommendation to each of them for its correction. Different deadlines, from 2005 to 2008, were set for the correction of the excessive deficit, taking into account the deficit level, growth prospects, and the intentions of the authorities regarding the participation in EMU. Except for Hungary, the Commission considered on 22 December 2004 that all countries had taken effective action in response to the Council recommendation, in particular to respect the 2005 deficit target set in the May 2004 convergence programmes. Accordingly, the Commission concluded that no further steps were necessary for the Czech Republic, Cyprus,

Graph I.10: **Budgetary plans, forecasts and outcomes in Italy**



Source: Commission services.

Malta, Poland and Slovakia under the excessive deficit procedure.

Hungary

On 5 July 2004, the Council issued a recommendation to the Hungarian authorities to implement the measures envisaged in the May 2004 convergence programme aiming at a correction of the excessive deficit by 2008. The Hungarian authorities were recommended to stand ready to introduce additional measures, if necessary, with a view to achieving the deficit targets for 2004 and 2005.

On 18 January 2005, the Council considered that Hungary had not taken effective action in response to its recommendation. The Council considered that the measures taken were not sufficient to avoid a sizeable deviation from the 2004 and 2005 deficit targets and from the adjustment path planned in the convergence programme. Having joined the Community on 1 May 2004, Hungary is a Member State with a derogation, which means that it is to avoid excessive deficits but that Article 104(9) and (11) of the Treaty does not apply to it. The Council therefore issued another recommendation based on Article 104(7), taking into account information from Hungary's convergence programme update submitted in December 2004.

This update foresees a decline in the general government deficit from 4.4 % of GDP in 2004 to 2.2 % of GDP in 2007 and 1.6 % of GDP in 2008. These figures benefit from the decision by Eurostat of 23 September 2004 allowing that, for a transitory period, until the March 2007 fiscal notification, second-pillar pension funds can be recorded inside the general government. This lowers the yearly deficit figures by 0.8 to 1 percentage point between 2004 and 2008. Including the impact of the pension reform of 1998, the projected deficit path would show a reduction from 5.3 % of GDP in 2004 to 2.8 % of GDP in 2008.

On 8 March 2005, the Council adopted a new recommendation under Article 104(7) recommending notably the Hungarian authorities to: (i) put an end to the excessive deficit situation as rapidly as possible; (ii) take action in a medium-term framework in order to bring the deficit below 3 % of GDP by 2008 in a credible and sustainable manner; and (iii) take effective action by 8 July 2005 regarding additional measures, as far as possible of a structural nature, in order to achieve the deficit target for 2005 as set in the December convergence

programme. The action taken in response to the new Article 104(7) recommendation will be assessed by the Commission at the expiry of this deadline.

The Commission services' spring 2005 forecast projected a deficit of 3.9 % of GDP in 2005, followed by 4.1 % of GDP in 2006, on a no-policy-change basis. This is to be compared with the 3.6 and 2.9 % of GDP respectively in the December 2004 update of the convergence programme, which constituted the basis for the multiannual adjustment path recommended by the Council in March 2005.

Czech Republic

The Council recommendation under Article 104(7) to the Czech authorities was to correct the excessive deficit by 2008 and to take effective action by 5 November 2004 in order to achieve the 2005 deficit target, set in the May 2004 convergence programme at 4.7 % of GDP.

In summer 2004, the Parliament passed a law on new budgetary rules, which introduced fiscal targeting based on medium-term expenditure ceilings for central government. Although the expenditure ceilings will become legally binding only in 2006, the government had already accepted them as voluntary guidelines for the 2004 and 2005 budgets. The 2005 State budget largely respects the 2005 expenditure ceiling, leading to a sharp decline in the expenditure ratio, and includes revenue cuts worth 0.7 % of GDP.

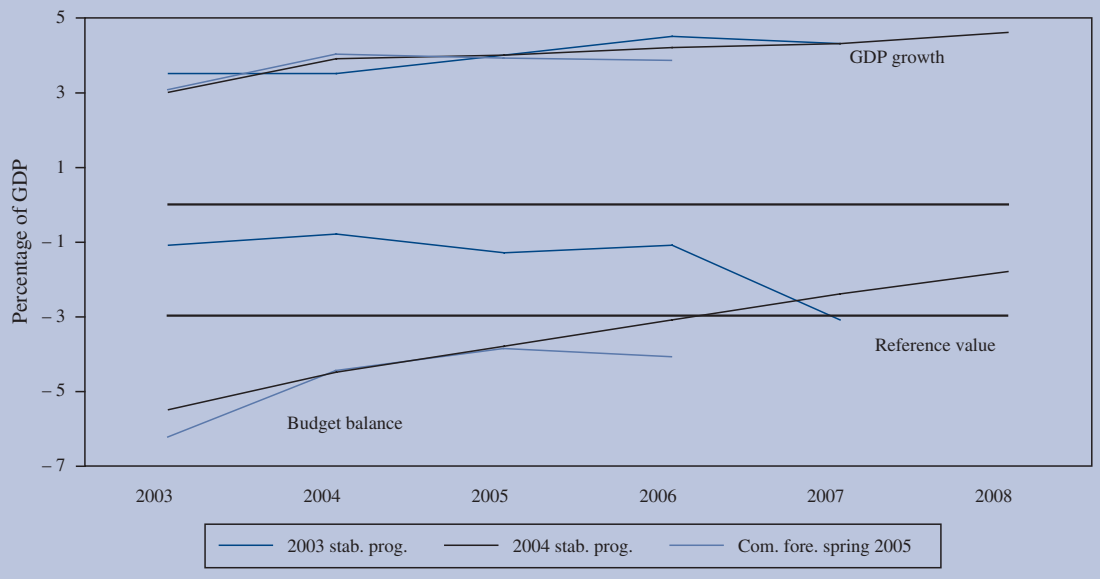
The spring 2005 forecast of the Commission services of a deficit of 4.5 % of GDP in 2005 confirms that the measures taken by the Czech authorities should be sufficient to achieve the 2005 deficit target. The Commission projects a further decline in the deficit in 2006, at 4.0 % of GDP.

Cyprus

The Council recommended the Cypriot authorities to take effective action by 5 November 2004 in order to achieve their objective of bringing the deficit below 3 % of GDP in 2005 in a credible and sustainable manner.

According to the projections in the 2005 budget, the deficit would decrease to 2.9 % of GDP in 2005, i.e. just below the reference value of 3 % of GDP. The deficit reduction in 2005 is projected to be achieved through

Graph I.11: **Budgetary plans, forecasts and outcomes in Hungary**



Source: Commission services.

revenue increases and expenditure cuts. The measures ensuring expenditure restraint appear to be mostly structural (cap on current expenditure, increase in the retirement age for public sector employees). Revenue measures are a mix of structural and one-off measures (tax amnesty, fees for issuance of title deeds for certain real estate).

In spring 2005, the Commission services projected a decline in the deficit ratio to 2.9 % of GDP in 2005 and, on a no-policy-change basis, to 1.9 % in 2006. This confirms that the consolidation impact of the envisaged measures should be sufficient to achieve the 2005 deficit target.

Malta

The Council recommended to the Maltese authorities to correct the excessive deficit by 2006 and to take action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target set in the May convergence programme at 3.7 % of GDP.

The 2005 budget confirmed this projection, targeting a decline in the deficit ratio from 5.2 % in 2004 to 3.7 % in 2005. Two thirds of the total deficit reduction would result from structural measures consisting mainly of tax increases (introduction of an excise duty on mobile telephony services, increase in the departure tax on air fares, imposition of VAT and excise duty on kerosene, increase in excise duty on tobacco). The remaining third would be generated through one-off measures on the revenue side (sale of government property, revenues to be raised from listed/unlisted companies).

The Commission services' spring 2005 forecast projects the 2005 deficit at 3.9 % of GDP, confirming that the budgetary target set in the budget for 2005 (3.7 % of GDP) is plausible.

Poland

The Council recommended to the Polish authorities to correct the excessive deficit by 2007 and to take action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target of 4.2 % of GDP set in the convergence programme of May 2004.

The budget for 2005 foresees a reduction in the government deficit from 5.6 % of GDP in 2004 to 3.9 % in 2005. The deficit would decrease further to 3.1 % of GDP in 2006. Measures from the Hausner plan contained in the budget would have a deficit-reducing impact of 1.1 percentage points in 2005 and 0.8 percentage points in 2006. The authorities expect to achieve a further deficit reduction of up to 0.6 % of GDP by implementing measures aiming at a widening of the tax base. The measures adopted and planned appear to be mostly of a structural nature, thus also having a deficit-reducing impact in subsequent years.

The Commission services' spring 2005 economic forecasts confirm that the consolidation impact of the envisaged measures should be sufficient to achieve the 2005 deficit target in the budget. In particular, against the background of the projected strong growth and the corrective measures taken by the government, the projections by the Commission services show a decline in the deficit to 4.4 % of GDP in 2005 from the estimated 4.8 % in 2004 and, on a no-policy-change basis, further to 3.8 % in 2006.

Slovakia

As regards Slovakia, the Council recommended to correct the excessive deficit by 2007 and to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target set at 3.9 % of GDP in the May convergence programme.

On 9 December 2004, the Slovak Parliament adopted the budget for 2005, setting the 2005 deficit target at 3.8 % of GDP (3.4 % of GDP without the revenue loss stemming from the introduction of a funded pension pillar). The budget incorporates: (i) a systemic pension reform, leading to a redirection of social security contributions to a newly introduced funded pension pillar; (ii) the last tranches of the current government's healthcare reform agenda; and (iii) further public sector rationalisation. These reforms almost fully completed the current government's reform agenda, most of which had already been implemented in the budget year 2004 and which encompassed, in particular, a comprehensive tax reform package.

In their spring 2005 forecast, the Commission services projected an increase in the general government deficit from 3.8 % of GDP in 2005 to 4.0 % in 2006, on a no-policy-change basis. This confirms that the measures presented up to now are broadly sufficient to achieve the 2005 deficit target set in the May 2004 convergence programme.

Table I.7

Overview of ongoing excessive deficit procedures

	DE	FR	NL	EL	CZ	CY	HU	MT	PL	SK
Early steps of the procedure										
Adoption by the Commission of a report according to Article 104(3)	19.11.2002	2.4.2003	28.4.2004	19.5.2004	12.5.2004	12.5.2004	12.5.2004	12.5.2004	12.5.2004	12.5.2004
Adoption by the EFC of an opinion on this report according to Article 104(4)	29.11.2002	13.4.2003	12.5.2003	2.6.2004	24.5.2004	24.5.2004	24.5.2004	24.5.2004	24.5.2004	24.5.2004
Decision on the existence of an excessive deficit										
Commission adopts:										
— an opinion on the existence of an excessive deficit according to Article 104(5)	8.1.2003	7.5.2003	19.5.2004	26.4.2004	24.6.2004	24.6.2004	24.6.2004	24.6.2004	24.6.2004	24.6.2004
— a recommendation for a Council decision on the existence of an excessive deficit										
— a recommendation for a Council recommendation to put an end to the excessive deficit position										
Council adopts:										
— a decision that an excessive deficit exists										
— a recommendation for taking measures to put an end to this situation	21.1.2003	3.6.2003	2.6.2004	5.7.2004	5.7.2004	5.7.2004	5.7.2004	5.7.2004	5.7.2004	5.7.2004
Deadlines for actions and correcting the excessive deficit										
Deadline for taking effective action	21.5.2003	3.10.2003	2.10.2004	5.11.2004	5.11.2004.	5.11.2004	5.11.2004	5.11.2004	5.11.2004	5.11.2004
Deadline set for the correction of the excessive deficit	2004	2004	2005	2005	2008	2005	2008	2006	2007	2007
Compliance with the Article 104(7) recommendation	No	No	Yes	No	Yes	Yes	No	Yes	Yes	Yes
Compliance cases										
Status of the procedure: abrogated/abeyance (ABR/ABE)			ABE [1]		ABE	ABE		ABE	ABE	ABE
Non-compliance cases										
Commission adopts:										
— a recommendation for a Council decision establishing that no effective action has been taken according to Article 104(8)	18.11.2003	8.10.2003		22.12.2004						
— a recommendation for a Council decision to give notice according to Article 104(9)	18.11.2003	21.10.2003		22.12.2004			22.12.2004			
Council adopts:										
— a decision establishing that no effective action has been taken according to Article 104(8)				18.1.2005			22.12.2004			
— for euro-area countries: a decision to give notice according to Article 104(9)				18.1.2005						
— for non-euro-area countries: a new recommendation according to Article 104(7)							18.1.2005			
— Council does not adopt Commission recommendations, but instead adopts conclusions	25.11.2003	25.11.2003								
New deadline for the correction of the excessive deficit	**2005**	**2005**		**2006**			**2008**			

([1]) Commission proposed abrogation on 18 May 2005.

3. Overview of the 2004 updates of the stability and convergence programmes

3.1. Growth projections

The examination of the sixth round of updates of stability and convergence programmes (SCPs), covering the period up to 2008, was completed by March 2005 for all the countries apart from Portugal, which was expected to deliver the final update only in spring 2005 ([1]).

In order to make an assessment of the budgetary targets set by Member States in the 2004 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 increase to 2.3 % in 2005 and to reach around 2.4 % in 2006 and in the following years (see Table I.8). Particularly favourable growth prospects are expected to continue in the EU-10.

In comparison with the 2003 updates of the programmes, growth projections have been revised downwards (see the lower half of Table I.8 and Table I.9). The negative revisions concern the whole period, but, in particular, 2005 and 2006. Nevertheless, growth projections are still more favourable than the Commission services' autumn 2004 forecast, by on average 0.3 and 0.2 percentage points per year respectively in 2005 and 2006. This was also the case for the previous updates. The growth projections seem to be even more optimistic in comparison with the Commission services' spring 2005 forecasts (see last row of Table I.8).

The aggregate potential GDP growth in the euro area is projected to be relatively stable at between 2 and 2.2 % throughout the entire programme period. The output gap in the euro area is projected to narrow but remain negative throughout the programme period. More precisely, the euro-area output gap would be – 1 % of potential GDP in 2005, fall further in 2006 to – 0.8 % and to – 0.6 % in 2007 (see Graph I.13). Because of more favourable growth scenarios in the updates on average, the output gap projections are less negative than in the Commission services' autumn 2004 forecasts. Outside the euro area, the new Member States exhibit the highest rates of potential GDP growth in the Union.

3.2. The medium-term budgetary targets

Based on these growth assumptions, the nominal deficit in the euro area would, according to the updated programmes, amount to 2.8 % of GDP in 2004, which is a ½ percentage point higher compared with the previous updates (see Table I.9). The nominal deficit is, thereafter, projected to be gradually reduced to 1.3 % of GDP by 2007. The overall improvement relies strongly on the budgetary consolidation projected in the large Member States, such as Germany (2¼ percentage points over the period 2004–08), France (2.7 percentage points over the same period) and Italy (1.5 percentage points over the period 2004–07) and also in Greece (3.7 percentage points over the same period). Outside the euro area, substantial consolidation of public finances is foreseen in recently acceded Member States with budget deficits. Among these, particularly strong reductions are expected in the countries with initially high deficits, such as Cyprus (3.9 percentage points over the next four years), Malta (3.8 percentage points over the next three years), Poland (2.8 percentage points over the same period) and Hungary (2.7 percentage points over the next four years).

([1]) See Table I.17. for a summary of the Council examinations of the 2004 updates of the stability and convergence programmes.

Table I.8

Euro area: growth projections and macroeconomic developments in the 2004 updates (percentage change on preceding year), and comparison with the Commission forecasts and the 2003 updates (percentage points)

	2003	2004	2005	2006	2007
2004 updates of the stability programmes					
Real GDP growth	0.6	2.1	2.3	2.4	2.5
GDP deflator	2.0	2.0	1.9	1.8	1.7
HICP change	2.1	2.1	1.8	1.6	1.5
Employment growth	0.1	0.5	0.9	1.1	1.2
Labour productivity growth	0.8	2.2	1.4	1.3	
2003 updates of the stability programmes					
Real GDP growth	0.6	2.0	2.5	2.6	2.5
Difference from 2004 updates	0.0	0.1	– 0.2	– 0.2	– 0.1
Commission services' autumn 2004 forecasts					
Real GDP growth	0.6	2.1	2.0	2.2	
Difference from 2004 updates	0.0	0.0	0.3	0.2	
Commission services' spring 2005 forecasts					
Real GDP growth	0.6	2.0	1.6	2.1	
Difference from 2004 updates	0.0	0.1	0.7	0.3	

NB: Commission services' calculations. Discrepancies are due to rounding. The Commission services' autumn 2004 forecasts were used to obtain a representative aggregate by replacing the missing information on HICP in the German programme and for Greece and Portugal (both 2004–06). For Spain and France, the private consumption index was used instead of the HICP. The missing information on employment growth for France was replaced by reported information on dependent employment growth in the market sector.

The excessive deficits in Germany and France are foreseen to be corrected in 2005 according to the respective stability programme. However, there are risks that the deficits in both countries will remain above the 3 % of GDP reference value also in 2005, in particular as growth may be lower than expected. In Greece, the expected deficit is projected to be corrected in 2006.

The Netherlands also appears to be on track to correct its excessive deficit in 2005.

Outside the euro area, sizeable budgetary improvements are expected in all six Member States under the excessive deficit procedure, of which only Cyprus is projected to bring the deficit below the 3 % of GDP reference value in 2005.

According to the latest updates, Malta will follow in 2006, Slovakia and Poland in 2007, and Hungary in 2008, while the Czech Republic does not plan to correct the excessive deficit before the end of the programme period ([1]).

Ireland and Estonia are the only Member States that project a budgetary deterioration between 2004 and the end of the programme period, albeit from a surplus budgetary position. A comparison between the projections provided by the Member States (the left panel of Table I.10) and the Commission services' autumn 2004 and spring 2005 forecasts (right panels) shows that most updates are more optimistic about budgetary developments in 2005 and 2006 than the Commission services' forecasts, in particular those of France, Greece, Italy and Luxembourg. The only countries projecting less favourable budgetary developments compared with the Commission services' spring 2005 forecasts are Ireland, the Netherlands, Denmark, Estonia and Lithuania, reflecting among other things more cautious growth assumptions.

([1]) According to the Council recommendation under Article 104(7), its deadline to correct the excessive deficit is 2008.

Table I.9

Projections of real growth in the 2004 updates (percentage change on preceding year)

	2003	2004	2005	2006	2007	2008
BE	1.3	2.4	2.5	2.5	2.1	2.0
DE	– 0.1	1.8	1.7	1 ¾	2.0	2.8
EL		4.2	3.9	4.0	4.2	
ES	2.5	2.6	2.9	3.0	3.0	3.0
FR		2.5	2.5	2.5	2.5	2.5
IE	3.7	5.3	5.1	5.2	5.4	
IT	0.3	1.2	2.1	2.2	2.3	
LU	2.9	4.4	3.8	3.3	4.3	
NL	– 0.9	1.3	1.5	2.5	2.5	
AT	0.8	1.9	2.5	2.5	2.2	2.4
PT						
FI	2.0	3.2	2.8	2.4	2.2	2.0
EUR-12	**0.6** (1)	**2.1**	**2.3**	**2.4**	**2.5**	
CZ	3.1	3.8	3.6	3.7	3.8	
DK	0.5	2.2	2.5	1.3	1.9	
EE	5.1	5.6	5.9	6.0	6.0	6.0
CY		3.6	4.0	4.4	4.5	4.5
LV	7.5	8.1	6.7	6.5	6.5	
LT	9.7	6.5	6.5	6.2	6.0	
HU	3.0	3.9	4.0	4.2	4.3	4.6
MT	– 0.3	0.6	1.5	1.8	2.2	
PL	3.8	5.7	5.0	4.8	5.6	
SI	2.5	4.0	3.8	3.9	4.0	
SK	4.2	5.0	4.5	5.1	5.4	
SE	1.6	3.5	3.0	2.5	2.3	
UK (2)	2 ¼	3 ¼	3	2 ½	2 ¼	
EU-25	**1.2** (1)	**2.5**	**2.6**	**2.6**	**2.7**	

(1) In the calculation of the euro-area and the EU averages for the year 2003, data from the Commission services' autumn 2004 forecasts were used for France and Cyprus. The same source was used for Portugal for the period 2004–06 to get a representative aggregate.
(2) Financial years ending in the following March.

All countries provided figures for the cyclically adjusted budget balance (CAB) in their updates of the programmes. They are presented in the left panel of Table I.11 The central panel of the table shows the CAB derived by the Commission services, on the basis of the figures provided by the Member States in the updates. According to these figures, the CAB for the euro area, which amounted to – 2.1 % of GDP in 2004, is projected to improve by, on average, 0.4 percentage points of GDP annually in the coming years.

Although for the euro area in 2005 the Commission services' forecasts foresee a similar size of adjustment (the right panel of Table I.10), no significant improvement is expected in 2006.

One reason for this divergence could be the no-policy-change assumption for 2006 in the Commission services' forecasts.

According to the Commission services' calculations, of the six euro-area countries showing a deficit in the CAB in 2004, only Spain is expected to be in balance in 2008, while the projected budgetary adjustment in Germany, France, Greece, Italy and the Netherlands is insufficient to ensure that a budgetary position close to balance is achieved within the programme period.

In particular, attention should be paid to the planned adjustments in Member States in excessive deficit positions. According to the Commission services' calcula-

Table I.10

Nominal budget balances in the 2004 updates and the Commission services' autumn 2004 and spring 2005 forecasts (1)

(% of GDP)

	2004 updates of the stability and convergence programmes						Commission services' autumn 2004 forecasts			Commission services' spring 2005 forecasts		
	2003	2004	2005	2006	2007	2008	2004	2005	2006	2004	2005	2006
BE	0.4	0.0	0.0	0.0	0.3	0.6	– 0.1	– 0.3	– 0.5	0.1	– 0.2	– 0.6
DE	– 3.8	– 3¾	– 2.9	– 2½	– 2.0	– 1½	– 3.9	– 3.4	– 2.9	– 3.7	– 3.3	– 2.8
EL	– 5.2	– 6.1	– 3.7	– 2.9	– 2.4		– 5.5	– 3.6	– 3.0	– 6.1	– 4.5	– 4.4
ES	0.4	– 0.8	0.1	0.2	0.4	0.4	– 0.6	– 0.1	0.0	– 0.3	0.0	0.1
FR		– 3.6	– 2.9	– 2.2	– 1.6	– 0.9	– 3.7	– 3.0	– 3.3	– 3.7	– 3.0	– 3.4
IE	0.1	0.9	– 0.8	– 0.6	– 0.6		– 0.2	– 0.6	– 0.5	1.3	– 0.6	– 0.6
IT	– 2.4	– 2.9	– 2.7	– 2.0	– 1.4		– 3.0	– 3.0	– 3.6	– 3.0	– 3.6	– 4.6
LU	0.8	– 1.4	– 1.0	– 0.9	– 1.0		– 0.8	– 1.6	– 2.0	– 1.1	– 1.5	– 1.9
NL	– 3.2	– 3.0	– 2.6	– 2.1	– 1.9		– 2.9	– 2.4	– 2.1	– 2.5	– 2.0	– 1.6
AT	– 1.1	– 1.3	– 1.9	– 1.7	– 0.8	0.0	– 1.3	– 2.0	– 1.7	– 1.3	– 2.0	– 1.7
PT							– 2.9	– 3.7	– 3.8	– 2.9	– 4.9	– 4.7
FI	2.1	2.0	1.8	2.1	2.2	2.0	2.3	2.1	2.2	2.1	1.7	1.6
EUR-12	**– 2.7** (1)	**– 2.8**	**– 2.3**	**– 1.8**	**– 1.3**		**– 2.9**	**– 2.5**	**– 2.5**	**– 2.7**	**– 2.6**	**– 2.7**
CZ	– 12.6	– 5.2	– 4.7	– 3.8	– 3.3		– 4.8	– 4.7	– 4.3	– 3.0	– 4.5	– 4.0
DK	1.2	1.2	2.0	1.6	1.7		1.0	1.5	1.7	2.8	2.1	2.2
EE	3.1	1.0	0.0	0.0	0.0	0.0	0.5	0.2	0.1	1.8	0.9	0.5
CY		– 4.8	– 2.9	– 1.7	– 1.5	– 0.9	– 5.2	– 3.0	– 2.4	– 4.2	– 2.9	– 1.9
LV	– 1.5	– 1.7	– 1.6	– 1.5	– 1.4		– 2.0	– 2.8	– 2.9	– 0.8	– 1.6	– 1.5
LT	– 1.9	– 2.5	– 2.5	– 1.8	– 1.5		– 2.6	– 2.5	– 1.9	– 2.5	– 2.4	– 1.9
HU (2)	– 5.5	– 4.5	– 3.8	– 3.1	– 2.4	– 1.8	– 5.5	– 5.2	– 4.7	– 4.5	– 3.9	– 4.1
MT	– 9.6	– 5.2	– 3.7	– 2.3	– 1.4		– 5.1	– 4.0	– 3.3	– 5.2	– 3.9	– 2.8
PL (2)	– 3.9	– 5.4	– 3.9	– 3.2	– 2.2		– 5.6	– 4.1	– 3.1	– 4.8	– 4.4	– 3.8
SI	– 2.0	– 2.1	– 2.1	– 1.8	– 1.1		– 2.3	– 2.2	– 1.9	– 1.9	– 2.2	– 2.1
SK (2)	– 3.7	– 3.8	– 3.8	– 3.9	– 3.0		– 3.9	– 4.0	– 4.1	– 3.3	– 3.8	– 4.0
SE	0.5	0.7	0.6	0.4	0.9		0.6	0.6	0.8	1.4	0.8	0.8
UK (3)	– 3.2	– 2.9	– 2.8	– 2.3	– 2.1	– 1.7	– 2.8	– 2.6	– 2.4	– 3.2	– 3.0	– 2.7
EU-25	**– 2.8** (1)	**– 2.7**	**– 2.3**	**– 1.8**	**– 1.4**		**– 2.8**	**– 2.4**	**– 2.3**	**– 2.6**	**– 2.6**	**– 2.5**

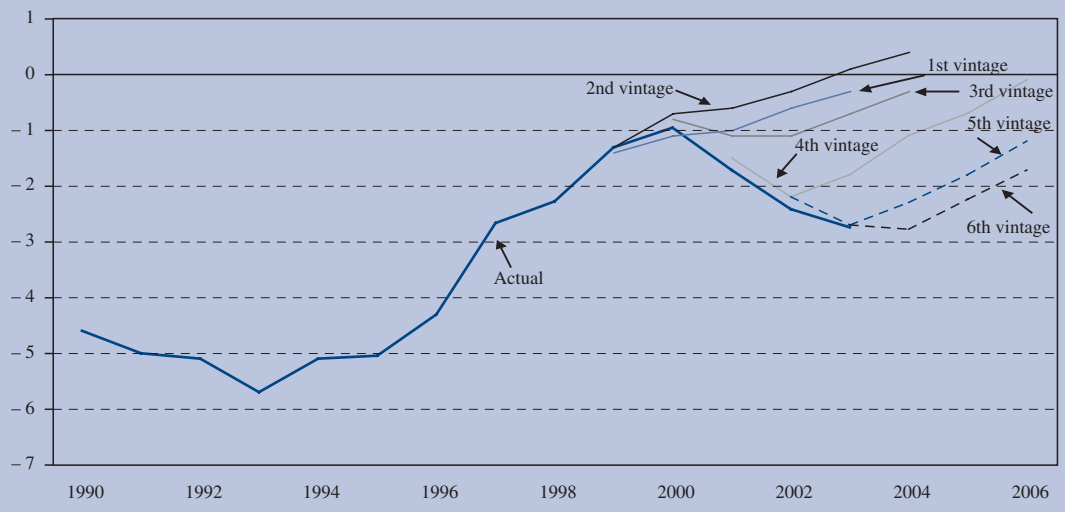
(1) In the calculation of the euro-area and the EU averages for the year 2003, data from the Commission services' autumn 2004 forecasts were used for France and Cyprus. The same source was used for Portugal for the period 2004–06.

(2) For Hungary and Poland, the budgetary burden arising from their respective pension reforms is not included in the left panel. According to the March 2005 EDP notification, the budgetary effect for Hungary was 0.9 % of GDP p.a. in 2003 and 2004. According to Hungarian national sources, the effect in 2005 and 2006 is expected to be of 1.1 % of GDP in 2005 and 1.2 % of GDP p.a. for the period until 2008. The budgetary effect on the deficit for Poland was, according to the March 2005 EDP notification, 1.7 % of GDP in 2003 and 2.0 % of GDP in 2004. According to Polish national sources, the effect on the deficit in 2005 and 2006 is expected to be 1.9 % of GDP p.a. For Slovakia, the figures include the deficit-increasing effect of the introduction of a funded pension scheme in 2005 (estimated in the convergence programme at 0.4 % of GDP in 2005, 1 % of GDP in 2006 and 1.1 % of GDP in 2007).

(3) Financial years ending in the following March, excluding the UMTS receipts.

tions, Germany projects an improvement in the CAB of 0.6 percentage points in 2005, of 0.5 percentage points in 2006 and of only 0.3 percentage points in 2007. As regards France, the Commission services' calculations indicate a planned improvement in the CAB of 0.6 to 0.7 percentage points of GDP per year as from 2005. Greece foresees a particularly important adjustment of 2.6 percentage points in 2005, of 0.9 percentage points in 2006 and of 0.5 percentage points in 2007. For the three Member States, the size of the projected adjustments in the updates is broadly in line with that calculated by the Commission services (based on the updates) and for Germany it is also in line with the Commission services' autumn 2004 forecast. For the Netherlands, the Commission services' calculations foresee an improvement in the CAB by 0.4 percentage points in 2005 and no changes beyond that, which makes the update tilted towards the optimistic side.

Graph I.12: **Nominal budget balances in the euro area: evolution in projections from the 2000–04 updates of the stability programmes (% of GDP)**



Source: Commission services.

The development in the general government balance can be decomposed by sectors of government (see Table I.12). Table I.12. Euro area: net lending by subsectors in the 2004 updates shows that the budget deficit of the general government in the euro area is mainly the result of a large deficit of the central government, with a far smaller deficit for the state/local governments. The social security sector is foreseen to be recording a small surplus.

3.3. 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 euro area, total receipts are expected to fall by 0.6 percentage points between 2004 and 2007, to below 45 % of GDP by the end of the programme period. This is more than compensated by reductions in the expenditure ratio which, over the same period, are expected to amount to almost 2 percentage points of GDP. Revenue ratios are projected to decline in all Member States with the exception of Greece, Spain and France, where they are expected to increase. Contrary to this, outside the euro area, total receipts are foreseen to rise in all countries except for the Czech Republic, Denmark, Estonia, Hungary, Malta and Sweden, where they are set to decrease. Particularly strong reductions in revenue are projected in Estonia, Ireland and Austria. Almost all Member States are set to decrease the expenditure ratio, with the exception of Latvia, Lithuania, Luxembourg and the UK. Particularly strong reductions are planned by the Czech Republic, Germany, Hungary, Malta and Austria. For Germany and France, the size of projected adjustments in the updates is very much in line with that calculated by the Commission services (based on the updates) and for Germany also in line with the Commission services' autumn 2004 forecast.

A closer look at the euro-area budgetary developments for the general government over the programme period reveals that the abovementioned reduction in total receipts can be ascribed to a planned fall in social contributions and other revenues. As to the components of public expenditure, very limited data are provided for collective consumption. According to the updates, most of the planned reduction in total expenditure is due to a decrease in social transfers in the euro area, both in kind and other than in kind, as they are projected to fall by 1.8 percentage points over the programme period. The rest is due to lower gross fixed capital formation,

Table I.11

Cyclically adjusted budget balances in the 2004 updates and the Commission services' autumn 2004 and spring 2005 forecasts on the basis of the production function method

(% of GDP)

	2004 programme updates					Commission services' calculations based on the 2004 updates (1)					Commission services' autumn 2004 forecasts (1)			Commission services' spring 2005 forecasts (1)		
	2004	2005	2006	2007	2008	2004	2005	2006	2007	2008	2004	2005	2006	2004	2005	2006
BE	0.4	0.0	– 0.2	0.2	0.5	0.5	0.3	0.1	0.5	0.9	0.4	0.0	– 0.4	0.6	0.3	– 0.2
DE	– 3.0	– 2.5	– 2.0	– 1.5	– 1.0	– 3.0	– 2.4	– 1.9	– 1.6	– 1.3	– 3.4	– 2.9	– 2.4	– 3.3	– 2.8	– 2.3
EL	– 6.9	– 4.4	– 3.8	– 3.3		– 7.0	– 4.4	– 3.5	– 3.0		– 6.1	– 4.4	– 3.8	– 7.1	– 5.5	– 5.3
ES	– 0.7	0.3	0.3	0.4	0.4	– 0.7	0.2	0.3	0.5	0.4	– 0.7	– 0.1	0.0	– 0.3	0.0	0.2
FR	– 2.6	– 2.0	– 1.5	– 1.0	– 0.5	– 3.4	– 2.7	– 2.0	– 1.4	– 0.7	– 3.5	– 2.8	– 3.1	– 3.6	– 2.8	– 3.1
IE	1.4	0.0	0.4	0.3		1.2	– 0.2	0.1	0.0		0.1	0.0	0.3	1.6	– 0.1	0.1
IT	– 2.2	– 2.2	– 1.6	– 1.2	– 0.9	– 2.1	– 2.1	– 1.6	– 1.2	– 1	– 2.4	– 2.6	– 3.4	– 2.4	– 2.9	– 4.0
LU	– 1.4	– 0.9	– 0.5	– 0.6		0.7	0.3	1.4	2.0		0.4	0.3	0.7	– 0.3	– 0.6	– 0.6
NL	– 2.1	– 1.4	– 1.1	– 1.2		– 1.6	– 1.2	– 1.2	– 1.3		– 1.4	– 1.0	– 1.0	– 1.2	– 0.4	0.0
AT	– 0.6	– 1.5	– 1.5	– 0.7	0.0	0.9	– 1.7	– 1.6	– 0.8	– 0.1	– 1.0	– 1.9	– 1.7	– 1.1	– 1.9	– 1.6
PT (2)											– 1.9	– 2.7	– 2.8	– 2.1	– 3.9	– 3.7
FI	2.1	1.7	2	2.1	1.9	2.2	1.9	2.2	2.4	2.4	2.8	2.3	2.3	2.4	1.9	1.8
EUR–12	**– 2.1**	**– 1.8**	**– 1.4**	**– 0.9**		**– 2.2**	**– 1.8**	**– 1.4**	**– 1.0**	**– 0.7**	**– 2.5**	**– 2.1**	**– 2.2**	**– 2.4**	**– 2.1**	**– 2.2**
CZ	– 5.2	– 4.7	– 3.8	– 3.3												
DK	1.2	1.5	1.7	1.7	2.0	1.7	2.0	2.0	2	2.3	1.5	1.8	1.9	3.4	2.5	2.4
EE	1.1	0.1	0.1	0.1	0.1											
CY	– 4.3	– 2.7	– 1.7	– 1.5	– 0.9											
LV	– 1.7	– 1.3	– 0.9	– 0.6												
LT	– 3.1	– 3.1	– 2.4	– 2.1												
HU	– 4.4	– 3.6	– 2.9	– 2.2	– 1.7											
MT	– 3.8	– 2.2	– 0.9	– 0.1												
PL	– 5.3	– 3.9	– 3.1	– 2.3												
SI	– 1.7	– 1.6	– 1.5	– 1.0												
SK	– 3.8	– 3.4	– 2.9	– 2.0												
SE	1.7	1.0	0.6	0.9		0.8	0.5	0.5	1.2		0.7	0.4	0.6	1.7	0.8	0.7
UK (3)	– 2.2	– 2.5	– 2.2	– 2.0		– 2.8	– 2.9	– 2.3	– 2.0	– 1.6	– 2.7	– 2.4	– 2.1	– 3.0	– 2.9	– 2.6
EU-25 (4)	**– 2.1**	**– 1.8**	**– 1.5**	**– 1.1**		**– 2.1**	**– 1.9**	**– 1.4**	**– 1.0**							

(1) Based on the production function method, except in the case of Spain, where the HP filter method was used. The Commission services' autumn 2004 forecasts are based on pre-budget figures for the UK; for 2006, on the assumption of unchanged policies.
(2) For Portugal (2004–06), the Commission services' autumn 2004 forecasts have been used to have a representative aggregate for the 2004 updates and the Commission services' calculations.
(3) Financial years ending in the following March for data on the convergence programme update.
(4) For the Commission services' calculations, it concerns the EU-15.

planned cuts in subsidies as well as slightly reduced interest and other expenditure. Graph I.14 presents the contribution to the change in the budget balances from four budget components, namely primary current expenditures, interest expenditure, gross fixed capital formation and total revenues. A number of remarks can be made.

Firstly, Member States that have been under the excessive deficit procedure project a substantial improvement in budget balances via cuts in primary current expenditures. However, excluding Greece, France, Cyprus, Slovakia and Poland, further tax cuts are also foreseen. In the case of Hungary, the Netherlands, Poland and Slovakia, the budgetary adjustment involves a decline in public investments (1). The

(1) The apparent decline in Cyprus, which mainly occurs in 2004, is attributable to the reclassification of certain expenditures previously included in the development expenditures to ordinary or current expenditures.

Table I.12

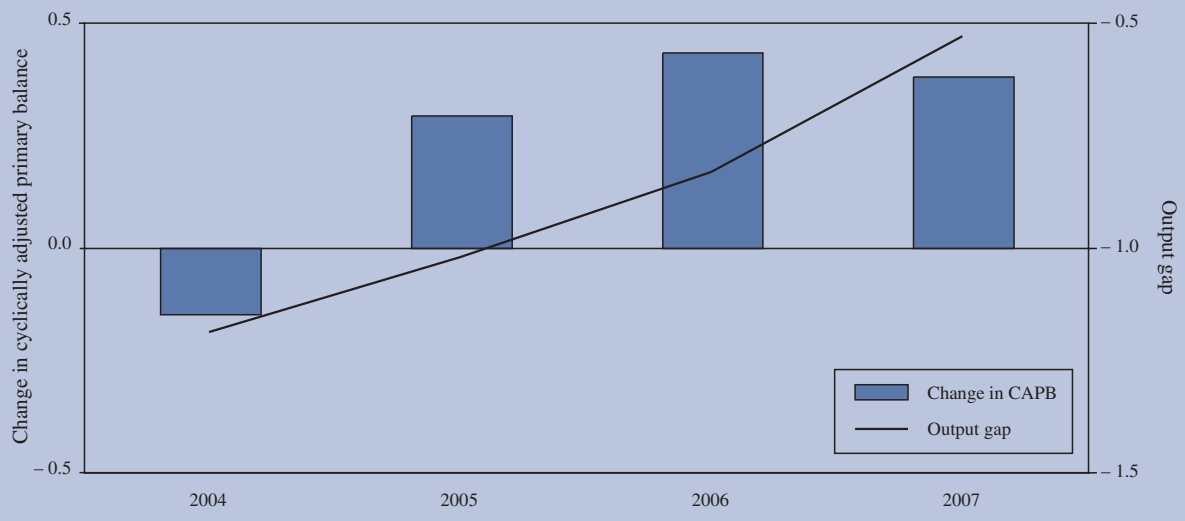
Euro area: net lending by subsectors in the 2004 updates

(% of GDP)

	2003	2004	2005	2006	2007
General government	– 2.7	– 2.8	– 2.3	– 1.8	– 1.3
Central government	– 1.7	– 2.3	– 2.0	– 1.9	– 1.7
State plus local governments	– 0.8	– 0.4	– 0.3	– 0.2	– 0.1
Social security funds	0.1	0.0	0.1	0.2	0.4

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

Graph I.13: **Fiscal stance and cyclical conditions in the euro area, 2004–07**



NB: The changes in the cyclically adjusted primary balance are used as a proxy of the fiscal stance, while the size of the output gap is used as a proxy of the cyclical conditions. A positive value for the fiscal stance represents a tightening of discretionary fiscal policies.
Source: Commission services' calculations based on the 2004 updates of the stability programmes.

decline in the new Member States implies that the budgetary adjustment arising from this item is coming to an end, particularly given their substantial investment needs to improve infrastructure. In Hungary, a significant fall in interest expenditure over the programme period is expected to contribute to an improvement in the budget balance. Secondly, Latvia, Lithuania, Luxembourg and the UK plan to increase the expenditure ratio (notably public investments). This will be financed by an increase in the revenue ratio, which should help in reducing the deficit bringing it closer to balance. Thirdly, several Member States with a budget close to balance or in surplus in 2004 (Belgium, Denmark 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. Finally, deterioration in the budget balance over the period is expected in Estonia and Ireland, albeit from a position of budget surpluses. The reduction in revenues in both countries is partially compensated by cuts in primary current expenditures, and in public investments.

Table I.13

Revenue and expenditure ratios in the 2004 updates

(% of GDP)

	Total revenue			Total expenditure		
	2004	2007	2004–07	2004	2007	2004–07
BE	49.6	49.1	– 0.5	49.6	48.8	– 0.8
DE	43½	42½	– 1.0	47½	44½	– 3.0
EL	44.4	46.7	2.3	50.4	48.9	– 0.5
ES	39.9	40.1	0.2	40.6	39.8	– 0.8
FR	50.4	50.8	0.4	54.0	52.4	– 1.6
IE	35.2	33.2	– 2.0	34.3	33.8	– 0.5
IT	45.6	44.1	– 1.5	48.5	47.1	– 1.4
LU	43.4	44.7	1.3	44.8	45.7	0.9
NL	45.0	44.1	– 0.9	48.0	46.0	– 2.0
AT	48.7	46.0	– 2.7	50.0	46.7	– 3.3
PT (1)						
FI	50.5	50.5	0.0	48.5	48.4	– 0.1
EUR-12	**45.5**	**44.9**	**– 0.6**	**48.3**	**46.5**	**– 1.8**
CZ	49.3	47.5	– 1.8	54.6	50.8	– 3.8
DK	55.6	54.5	– 1.1	54.4	52.8	– 1.6
EE	41.0	37.6	– 3.4	40.0	37.6	– 2.4
CY	39.0	40.6	1.6	43.8	42.1	– 1.7
LV	34.3	35.1	0.8	36.0	36.5	0.5
LT	33.0	34.5	1.5	35.5	36.0	0.5
HU (2)	44.8	43.2	– 1.6	49.3	45.6	– 3.7
MT	44.7	42.9	– 1.8	49.9	44.3	– 5.6
PL (2)	43.2	44.0	0.8	48.6	46.2	– 2.4
SI	46.1	46.3	0.2	48.2	47.4	– 0.8
SK (2)	35.3	35.8	0.5	39.1	38.8	– 0.3
SE	55.5	54.1	– 1.4	54.8	53.2	– 1.6
UK (3)	37.9	39.9	2.0	40.9	42.0	1.1
EU-25	**44.6**	**44.4**	**– 0.2**	**47.4**	**45.9**	**– 1.5**

(1) For Portugal (2004–06), the Commission services' autumn 2004 forecasts have been used to have a representative aggregate for the 2004 updates and the Commission services' calculations.
(2) See footnote 2 to Table I.10.
(3) Financial years ending in the following March. Concerns total current revenue.
NB: Commission services' 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 that in Table I.10.

3.4. Debt projections

The gross debt-to-GDP ratio in the euro area is expected to have increased to 71.1 % of GDP in 2004 (see Table I.15). As was the case in the previous vintages of updates, most Member States revised their debt level upwards but project a gradual improvement in the debt ratio over the programme period. However, the adjustment path is slower and the debt ratio for 2006 is projected to be 1.3 percentage points higher than the figure projected in the 2003 updates (see Graph I.15) and even higher compared with the previous updates. This is mainly due to smaller primary surpluses, while the contribution from the increasing nominal GDP growth is projected to remain broadly unchanged.

Table I.15 also shows that the estimated stock-flow component on average increases the debt ratio over the programme period. This could stem from plans to build up financial assets (e.g. public pension reserve funds which are invested in non-governmental assets) (1).

(1) As in the previous updates, large contributions of the stock-flow component over the 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.14

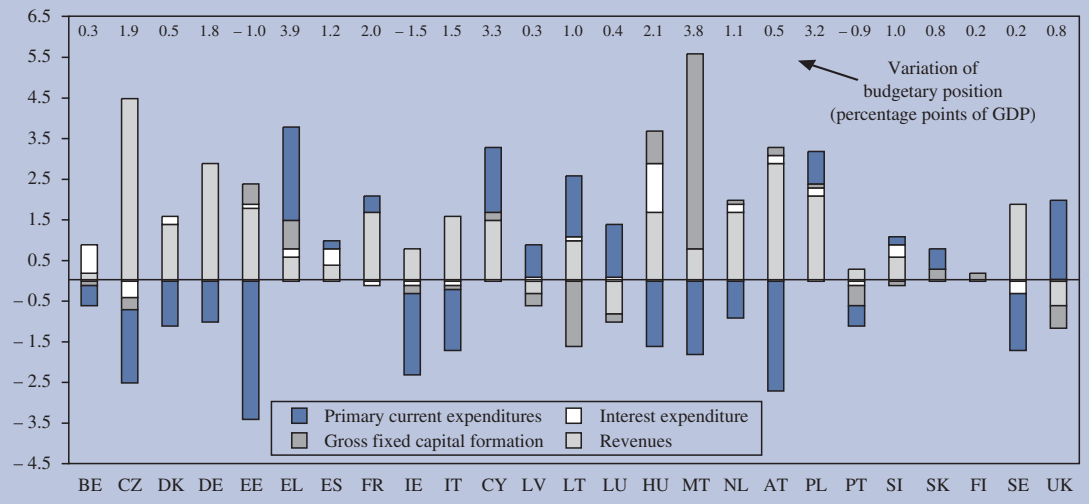
Euro area: budgetary developments within the general government

(% of GDP)

	2003	2004	2005	2006	2007	2004–07
Components of revenue						
Taxes	25.6	26.8	26.7	26.7	26.8	0.0
Social contributions	15.6	15.3	15.2	14.9	14.9	– 0.4
Other revenue	4.4	4.0	3.7	3.7	3.7	– 0.3
Total revenue	**46.2**	**45.5**	**45.2**	**45.0**	**44.8**	**– 0.7**
Components of expenditure						
Collective consumption						
Social transfers in kind	14.8	14.6	14.2	14.1	13.8	– 0.8
Social transfers other than in kind	17.7	17.6	17.2	16.9	16.6	– 1.0
Interest expenditure	3.5	3.4	3.3	3.3	3.3	– 0.1
Subsidies	1.4	1.3	1.3	1.3	1.2	– 0.1
Gross fixed capital formation	2.5	2.5	2.4	2.5	2.2	– 0.3
Other	3.3	3.1	3.1	3.1	3.0	– 0.1
Total expenditure	**48.9**	**48.3**	**47.5**	**47.1**	**46.4**	**– 1.9**

NB: Commission services' calculations. Discrepancies are due to rounding, lack of data or inconsistencies in the data provided in the programmes.

Graph I.14: **Contribution to change in budgetary position, 2004–07 (percentage points)**



NB: A positive value indicates a positive contribution to the change in budgetary position. A positive value in total variation of budgetary position (value is presented on top of columns) implies an improvement in the balance. For UK data, refer to 2004–06. For Portuguese data, refer to the period 2004–06 from the Commission services' autumn 2004 forecast. For Hungary, Poland and Slovakia, see footnote 2 to Table I.10.
Source: 2004 updates of the stability and convergence programmes.

Table I.15

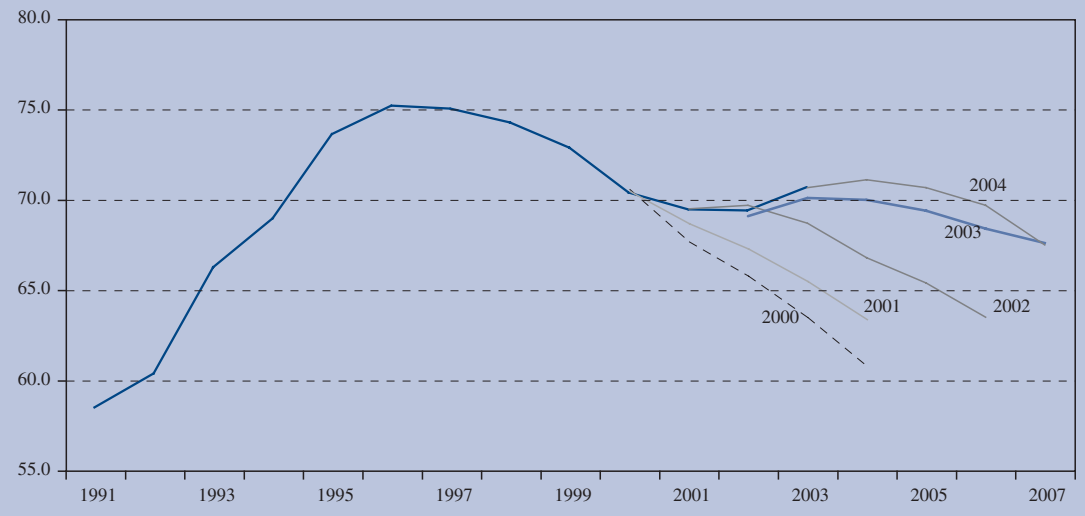
Euro area: gross debt level and changes in the 2004 updates

(% of GDP)

	2004	2005	2006	2007
Gross debt level	71.1	70.7	69.7	68.3 (1)
Change in gross debt	0.4	– 0.4	– 1.0	– 1.4
Previous updates of the programmes	70.0	69.4	68.4	67.6
Difference	1.1	1.3	1.3	– 0.7
Contributions to change in gross debt				
Primary balance	– 0.6	– 1.0	– 1.5	– 2.1
Interest expenditure	3.4	3.3	3.3	3.3
Nominal GDP growth	– 2.7	– 2.8	– 2.8	– 2.8
Stock-flow adjustment (2)	0.3	0.2	0.1	0.2

(1) For Portugal (2004–06), the Commission services' autumn 2004 forecasts have been used to have a representative aggregate for the 2004 updates and the Commission services' calculations. Therefore, the 2007 projection of the aggregate gross debt level does not include information on projected debt in this country.
(2) 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 derive 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 services' calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes.

Graph I.15: **Debt-to-GDP ratio in the euro area: evolution in projections from the 2000 updates to the 2004 updates of the stability programmes (% of GDP)**



Source: Commission services.

Table I.16 shows that, although all seven euro-area Member States with debt levels currently above the 60 % of GDP ceiling (Belgium, Germany, Greece, France, Italy, Austria and Portugal) that plan to reduce their debt levels over the programme period, only Austria expects it to be below the debt reference value by the end of it. On the other hand, by the end of the programme period, only Ireland and Luxembourg plan not to have their debt levels above 30 % of GDP.

In the Member States outside the euro area, government debt is on average lower. Overall, apart from the Czech

Republic, Latvia, Poland, Slovakia and the UK, all these Member States are expected to have lower debt levels in 2007 than in 2003. By the end of the programme period, only in Malta is government debt expected to stay above the 60 % of GDP reference value. Finally, in four countries, namely Estonia, Latvia, Lithuania and Slovenia, debt levels are expected to be below 30 % of GDP at the end of the programme period.

Table I.16

Debt levels in the 2004 updates (1)

(% of GDP)

	2003	2004	2005	2006	2007	2008
BE	100.0	96.6	95.5	91.7	88.0	84.2
DE	64.2	65½	66.0	66.0	65½	65.0
EL		110.5	108.0	103.9	99.9	
ES	50.7	49.1	46.7	44.3	42.0	40.0
FR		64.8	65.0	64.6	63.6	62.0
IE	32.1	30.5	30.1	30.1	30.0	
IT	106.2	106.0	104.1	101.9	99.2	
LU	5.3	5.0	5.0	4.6	4.5	
NL	54.1	56.3	58.1	58.6	58.3	
AT	64.5	64.2	63.6	63.1	61.6	59.1
PT						
FI	45.6	44.6	43.4	42.5	41.7	41.1
EUR-12	**70.7**	**71.1**	**70.7**	**69.7**	**67.5**	
CZ	37.8	38.6	38.3	39.2	40.0	
DK	44.7	42.3	39.4	37.4	35.3	
EE	5.3	4.8	4.6	4.3	3.1	2.9
CY		74.9	71.9	69.2	65.7	58.1
LV	14.4	14.2	14.5	14.8	15.0	
LT	21.4	20.1	20.9	20.3	20.1	
HU	57.0	57.3	55.3	53.0	50.6	48.3
MT	70.4	73.2	72.0	70.5	70.4	
PL	45.4	45.9	47.6	48.0	47.2	
SI	29.4	30.2	30.7	30.9	29.7	
SK	42.8	43.0	44.2	45.3	45.5	
SE	52.0	51.7	50.5	50.0	49.0	
UK (2)	39.5	40.9	41.8	42.4	42.8	42.8
EU-25	**63.3**	**63.7**	**63.4**	**62.7**	**60.9**	

(1) In the calculation of the euro-area and the EU averages for the year 2003, data from the Commission services' autumn 2004 forecasts were used for France and Cyprus. The same source was used for Portugal for the period 2004–06.
(2) Financial years ending in the following March.

Source: Commission services.

Table I.17

Council examinations of the updated SCPs, 2004

	Period covered	Data requirements code of conduct	Macroeconomic scenario	Balance of risks to budgetary targets	EDP correction on track?	Close to balance?	Safety margin?	Consistency, budgetary BEPGs	Debt below 60 % in 2004?	Long-term sustainability	Recom-menda-tions?
Euro-area Member States											
BE	2004–08	Broadly complies	Plausible	Broadly balanced	n.a. (1)	Yes	Yes	Broadly	96.6 %	At some risk	No
DE	2004–08	Broadly complies	Plausible (2005 rather favourable)	Worse than projected	Yes	No	Yes in 2008	Partly	65½ %	At some risk	Yes
EL	2004–07	Broadly complies	Plausible	Worse than projected	Yes	No	No	Partly	110.5	At serious risk	Yes
ES	2004–08	Complies	Rather favourable	Broadly balanced	n.a. (1)	Yes	Yes	Partly	Yes	Relatively favourable position	Yes
FR	2004–08	Broadly complies	Plausible	Worse than projected	Yes, (but 2006 at risk)	No	No (esp. in 2006); Yes in 2008	Partly	64.8 %	At some risk	Yes
IE	2004–07	Complies	Plausible	Broadly balanced	n.a. (1)	Yes	Yes	Broadly	Yes	Relatively favourable position	No
IT	2004–08	Partly complies	Somewhat favourable	Worse than projected	n.a. (1)	No	No	Partly	106.0 %	At some risk	Yes
LU	2004–07	Broadly complies	Plausible	Broadly balanced	n.a. (1)	Yes	Yes	N.A. (3)	Yes	Favourable position	No
NL	2004–07	Complies	Broadly plausible	Broadly balanced	Yes	No	No	Partly	Yes	Relatively favourable position	Yes
AT	2004–08	Complies	Plausible	Worse than projected	n.a. (1)	No, possibly in 2008	Yes	Partly	64.2 %	Relatively favourable position	Yes
FI	2004–08	Broadly complies	Rather cautious	Worse than projected	n.a. (1)	Yes	Yes	Broadly	Yes	Favourable position	No
Non-euro-area Member States											
CZ	2004–07	Broadly complies	Plausible	Broadly balanced	Yes	n.a. (2)	n.a. (2)	Partly	Yes	At serious risk	Yes
DK	2004–10	Fully complies	Relatively cautious	Fairly balanced, towards better balance in first years	n.a. (1)	Yes	Yes	Broadly	Yes	Favourable position	No
EE	2004–08	Complies	Plausible (even though cautious)	Broadly balanced	n.a. (1)	Yes	Yes	Broadly	Yes	Favourable position	No
CY	2004–08	Complies	Plausible	Broadly balanced	Yes	No	Yes (from 2006)	Broadly	74.9 %	Some risks	Yes
LV	2004–07	Broadly complies	Plausible	Broadly balanced	n.a. (1)	No	No	Broadly	Yes	Relatively favourable position	No
LT	2004–07	Broadly complies	Plausible	Broadly balanced	n.a. (1)	No	No	Broadly	Yes	Relatively favourable position	Yes

(Continued on the next page)

Table I.17 (continued)

	Period covered	Data requirements code of conduct	Macroeconomic scenario	Balance of risks to budgetary targets	EDP correction on track?	Close to balance?	Safety margin?	Consistency, budgetary BEPGs	Debt below 60 % in 2004?	Long-term sustainability	Recom-menda-tions?
HU	2004–08	Complies	Somewhat favourable	Worse than projected	Yes if further measures	n.a. (2)	n.a. (2)	Partly	Yes	At some risk	Yes
MT	2004–07	Broadly complies	Plausible	Broadly balanced	Yes	Maybe not	Yes	Broadly	73.2 %	At some risk	Yes
PL	2004–07	Partly complies	Rather favourable	Worse than projected	Yes (risk 2007)	n.a. (2)	n.a. (2)	Partly	Yes	At some risk	Yes
SI	2004–07	Partly complies	Plausible	Broadly balanced	n.a. (1)	No	Maybe not	n.a. (3)	Yes	At some risk	Yes
SK	2004–07	Complies	Plausible	Broadly balanced	Yes	n.a. (2)	n.a. (2)	Broadly	Yes	Relatively favourable position	Yes
SE	2004–07	Broadly complies	Plausible	Broadly balanced	n.a. (1)	Yes	Yes	n.a. (3)	Yes	Relatively favourable position	No
UK	2003/04–2009/10	Partly complies	Broadly plausible	Worse than projected (in short term)	n.a.	No	No	Partly	Yes	Relatively favourable position	Yes

(1) Not relevant because the country is not in excessive deficit.
(2) Not relevant because the country corrects the excessive deficit only at the end of the programme period.
(3) Not relevant because the country has no BEPGs in the area of public finances.

Sources: 2004 stability and convergence programmes and the Commission services.

4. The sustainability of public finances based on the 2004 updates of stability and convergence programmes

4.1. Introduction

The projected demographic changes, with the old-age dependency ratio doubling over the coming decades in the EU, have led to growing concerns regarding the long-term sustainability of public finances. 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. In addition, the 20 March 2005 Ecofin Council emphasised long-term sustainability issues in the context of the reform of the Stability and Growth Pact.

The Commission is therefore regularly producing the assessment of long-term sustainability of public finances in the context of the Stability and Growth Pact. This chapter presents the overview of the assessment of the long-term sustainability of public finances based on the 2004 updates of stability and convergence programmes, carried out by the Commission for the fourth year in a row. With this round of assessments, the quantitative analysis also includes for the first time the recently acceded Member States.

The assessment of long-term sustainability of public finances is a multifaceted 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, drawing on 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 that used in previous assessments (see European Commission, 2002a, 2003a and 2004a for a review of the first three assessments), it is important to note a number of improvements undertaken in order to enhance the quality of the assessment.

As regards the quantitative indicators, in the previous assessment round the cyclical component of the budget balance was netted out so that the long-term projections were only affected by the more structural components of the budget. With the current assessment round, one-off measures have also been netted out so that such temporary measures do not affect the long-term projections. In practice, the tax-to-GDP ratio in the last year of the programme has been corrected by the cyclical component and in addition by any possible one-off measures. In addition, public pension funds with the strict purpose of covering pension-related expenditures have been netted out from Maastricht debt, as this adjusted gross debt measure better reflects the sustainability challenge.

Also, greater attention has been devoted to qualitative features when making the assessment, which is a key aspect in enriching the interpretation of the results obtained. The main qualitative features shaped into the assessment deal with the current level of the debt ratio, the impact of structural reforms and the reliability of the projections, and the current level of the tax burden.

([1]) See the report of the Economic Policy Committee (2003), '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).

4.2. The assessment of sustainability of public finances based on the 2004 updates

4.2.1. Quantitative indicators

Table I.18 summarises the data included in the 2004 updates of the stability and convergence programmes that were used to run the sustainability indicators. Priority has been given to the national projections reported in the programmes, complemented, if necessary, with the commonly agreed EPC projections.

Table I.19 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 especially pension but also healthcare-related expenditures are of the highest concern for the long-term sustainability of public finances. In fact, in 12 Member States, healthcare expenditure is expected to grow faster than pension spending, notably in France, Malta, Austria, Slovakia, Sweden and the UK. In turn, other age-related expenditures — among which education — are projected to decline in the majority of countries, although insufficiently to offset the increase in pension and healthcare expenditures.

EPC projections on unemployment benefits and education, carried out for the first time in 2003, were added to the age-related expenditures for all EU-15 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 for almost all EU-15 Member States which contributed to increased comprehensiveness of the quantitative assessment. For the new Member States, the long-term projections relied on information contained in the December 2004 convergence programmes and in some cases in the May 2004 programmes.

On the revenue side, the level of revenue-to-GDP ratio was kept constant at the underlying level (net of the cycle and one-off measures) reached in the last year of the programme period for most countries ([2]). The experience so far suggests that, in the current policies scenario, dynamics may be present not only on the expenditure side, but also on the revenue side, the latter due to country-specific factors. It could be envisaged to review the criteria for which dynamics on the revenue side should be considered in the sustainability analysis. The adjustment for the cycle and one-off measures has, in general, the larger impact on the '2004' scenario compared with the 'baseline' scenario, as: (i) countries are expected to gradually close the output gap thus reducing the cyclical impact on the budget balance; and (ii) countries do not plan major one-off measures for the last year of the programme period. For most Member States, the cyclically adjusted balance is higher than the nominal budget balance, as the output gap is estimated to be negative in most countries. This improves the primary balance. By contrast, netting out one-off measures with a positive impact on the budget balance lowers the primary balance.

With this assessment exercise, public pension fund assets were taken into consideration in the sustainability analysis for those Member States which provided information in sufficient detail ([3]). In brief, such funds should be taken into account as several Member States have established funds with the strict purpose of using them to cover pension-related expenditure. Reducing debt, and accumulating national government bonds or other liquid financial assets in public pension funds have a similar effect on sustainability. In the assessment round of the 2004/05 updated stability and convergence programmes, the Commission services adjusted Maastricht gross debt by taking into account such fund assets when assessing the sustainability of public finances. Adjusted gross debt equals Maastricht gross debt net of consolidated public pension fund assets with a market value in the general government sector accumulated for the strict purpose of covering pension-related expenditure. Six Member States (Denmark, Spain, Ireland, Cyprus, Finland and Sweden) provided the size of public pension fund assets

([1]) For a detailed analysis of long-term education expenditure see Economic Policy Committee (2003) and Montanino et al. (2004).

([2]) Changes in the tax ratio were included for seven Member States (Denmark, Germany, Estonia, Latvia, Lithuania the Netherlands and Sweden) in line with the assumption of unchanged legislation. In Denmark, the Netherlands and Sweden, projected tax revenues vary as they can largely be attributed to the deferred tax revenues from contributions to funded pension systems as well as accumulated earnings prior to disbursement. For Germany, the projected rise in the revenue-to-GDP ratio was additionally influenced by the path of social security contributions which follows the laws that govern the social security system resulting from unchanged legislation including the pension insurance sustainability law. In the countries that implemented systemic reforms of pension systems, total revenue projections were adjusted for the projected dynamics in the pension contributions to the statutory funded pillar (Estonia, Latvia and Lithuania), in order to ensure consistency with the public pension expenditure projections where such a delimitation was made available.

([3]) In the assessment of the 2002 and 2003 updated stability and convergence programmes, such assets were taken into account in the case of Finland and Sweden.

Table I.18

Data used to run the sustainability indicators

(% of GDP)

	Age-related expenditure								Total non-age-related expenditure	Total revenues	
	Pensions		Healthcare		Education		Others				
	2009	2050	2009	2050	2009	2050	2009	2050	2009 (const.)	2009	2050
BE	8.8	13.0	7.7	10.6	4.1	3.7	6.5	4.9	17.2	49.0	49.0
CZ	8.6	15.2	6.5	9.3	3.8	3.6			30.2	47.5	47.5
DK	5.5	7.8	8.2	11.0			17.2	18.5	18.9	54.0	57.0
DE	10.9	13.8	7.0	9.5	3.9	3.6	2.5	1.1	16.0	42.1	45.3
EE	6.4	3.7	4.6	4.6					26.2	37.5	36.9
EL	12.3	22.6	5.1	6.6	3.2	3.2	0.4	0.2	22.4	46.2	46.2
ES	8.0	13.0	5.8	7.2	3.9	3.7	0.6	0.4	19.6	40.2	40.2
FR	12.9	14.5	8.1	12.6	5.9	5.5	1.0	0.7	21.0	51.1	51.1
IE	4.1	7.7	6.1	7.8	3.9	3.2	1.0	1.0	17.3	34.1	34.1
IT	13.6	14.4	6.5	8.1	4.5	4.2	0.4	0.3	14.1	43.9	43.9
CY	4.2	9.2	3.5	4.0					30.5	40.6	40.6
LV	5.0	5.2	4.1	4.5	5.9	5.8			20.4	34.8	33.3
LT	5.3	7	4.6	4.6					25.1	34.8	33.3
LU	7.5	9.3					0.3	0.3	37.8	45.1	45.1
HU	7.4	7.6							34.6	42.4	42.4
MT	7.8	8.0	4.7	7.1					28.2	42.9	42.9
NL	5.2	8.3	7.5	10.7	5.0	4.9	6.2	6.6	19.2	45.0	48.4
AT	14.2	13.6	5.2	6.4	5.6	5.0	1.5	2.0	16.4	45.8	45.8
PL	7.1	4.5	4.4	3.5					31.8	42.5	42.5
PT											
SI	12.8	18.2	6.8	9.6					26.1	46.3	46.3
SK	6.9	7.4	5.0	6.6	3.4	3.4	0.8	0.6	20.3	36.9	36.9
FI	12.3	15.2	10.3	13.4	5.6	5.4	1.7	0.8	17.1	50.6	50.6
SE	8.6	9.4	10.8	13.1	8.1	8.5	5.3	7.4	16.6	54.4	54.6
UK	6.8	7.7	8.8	10.9	5.3	5.2	2.1	2.6	18.6	40.2	40.2

NB: Data refer to the first year of projections, 2009, 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. CZ: The starting year is 2008. DK: The starting year is 2011. Other expenditure items are transfer payments. Concerning the change in tax revenues, the net tax on net pension payments is projected to increase by 3.0 percentage points of GDP by 2050. DE: Projections were made by the IFO Institute for Economic Research. Revenues are projected to increase by 3.2 percentage points by 2050, including a rise in net tax on net pension payments and a rise in social security contributions in line with current legislation. EE: Revenue includes contributions to the funded pillar of the pension system. EL: The revised updated stability programme of March 2005. Therein, the Alternative 2 scenario was used as the reference scenario. The starting year is 2008. Healthcare does not include care for the elderly. 'Others' include unemployment benefits. ES: The projections come from the 2003 updated stability programme. FR: The projections for pensions and healthcare end in 2040 and were kept constant as a share of GDP until 2050. IE: The starting year is 2008. LV: The starting year is 2008. Revenue includes State social security contributions. LT: The starting year is 2008. Revenue includes social contributions to old-age pensions. LU: The starting year is 2008. No projections on healthcare and education expenditures were reported. Equally, the EPC projections for Luxembourg do not include information on these two items. MT: The starting year is 2008. NL: The starting year is 2008. Other age-related expenditure includes disability benefits. Net old-age-related direct tax revenues are projected to increase by 3.4 percentage points by 2050. AT: Other age-related expenditure includes care expenditure. PL: The starting year is 2008. SI: The starting year is 2008. SK: The starting year is 2008. Other expenditure item is child allowances. FI: Healthcare includes sickness insurance payments. SE: The starting year is 2008. Healthcare expenditure includes ill-health and medical care expenditure. Other age-related expenditure also includes labour market training grants and wage guarantees, childcare and care of the elderly. The net old-age-related tax revenues are projected to increase by 0.2 percentage points by 2050. UK: Public pension services expenditure is included in pensions. The non-age-related expenditures are projected to decline by 1.8 percentage points by 2050.

Sources: Commission services, EPC and national updated stability and convergence programmes (2004).

Table I.19

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

(% of GDP)

	Age-related expenditure					Total revenues	Net change
	Pensions	Healthcare	Education	Other age-related expenditure	Total		
BE	4.2	2.9	– 0.4	– 1.6	5.1	0.0	5.1
CZ	6.6	2.8	– 0.2		9.2	0.0	9.2
DK	2.3	2.8		1.3	6.4	3.0	3.4
DE	2.9	2.5	– 0.3	– 1.4	3.7	3.2	0.5
EE	– 2.7	0.0			– 2.7	– 0.6	– 2.1
EL	10.3	1.5	0.0	– 0.1	11.7	0.0	11.7
ES	5.0	1.4	– 0.2	– 0.2	6.0	0.0	6.0
FR	1.6	4.5	– 0.4	– 0.3	5.4	0.0	5.4
IE	3.6	1.7	– 0.7	0	4.6	0.0	4.6
IT	0.8	1.6	– 0.3	– 0.1	2.0	0.0	2.0
CY	5.0	0.5			5.5	0.0	5.5
LV	0.2	0.4	– 0.1		0.5	– 1.5	2.0
LT	1.7	0.0			1.7	– 1.5	3.2
LU	1.8			0.0	1.8	0.0	1.8
HU	0.2				0.2	0.0	0.2
MT	0.2	2.4			2.6	0.0	2.6
NL	3.1	3.2	– 0.1	0.4	6.6	3.4	3.2
AT	– 0.6	1.2	– 0.6	0.5	0.5	0.0	0.5
PL	– 2.6	– 0.9			– 3.5	0.0	– 3.5
PT							
SI	5.4	2.8			8.2	0.0	8.2
SK	0.5	1.6	0.0	– 0.2	1.9	0.0	1.9
FI	2.9	3.1	– 0.2	– 0.9	4.9	0.0	4.9
SE	0.8	2.3	0.4	2.1	5.6	0.2	5.4
UK (1)	1.0	2.1	– 0.1	0.0	3.0	0.0	1.2

(1) A decline in non-age-related expenditure of 1.8 percentage points of GDP was incorporated into the 'net change'.
NB: Concerning the first year of the projections, see the note to Table I.18.

Sources: Commission services, EPC and national updated stability and convergence programmes (2004).

in sufficient detail according to the required specifications and an adjusted gross debt-to-GDP ratio was calculated for these countries. In the case of Denmark, Finland and Sweden, where the accumulation of funds has taken place for many years, this adjustment had a considerable impact (the adjusted gross debt measure is described in detail in Part II of this report).

Table I.20 and Table I.21 present, respectively, the extrapolation of the debt-to-GDP ratio and the sustainability gaps under two scenarios. Under a so-called 'baseline' scenario, the starting position in terms of the underlying budget balance (i.e. net of the cyclical component and any one-off measures), the level of the debt-to-GDP ratio, the primary spending and the tax revenues are the figures reported by the Member States for the final year of their 2004 updated stability or convergence programme: for most Member States, this is 2008.

The extrapolation of the debt-to-GDP ratio relies on several assumptions.

(i) 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 reflecting unchanged legislation. Thus, future additional revenue from taxes on pension benefits resulting from the accumulation of non-taxable contributions are included, while changes in revenues due to assumptions on future trends in private consumption or due to special sources are not considered.

(ii) Age-related expenditures evolve in line with the available projections. This implies that increasing the number of life years does not reduce the number of years of illness and that the level of services provided remains unchanged.

(iii) Non-age-related primary expenditures remain constant as a share of GDP at the 2008 level over the projection period ([1]). These include mainly public investment, other social expenditure apart from education, healthcare and pensions, purchases of goods and services not due to age-related expenditures, compensation of employees (excluding the staff in the education and healthcare sectors).

(iv) The GDP deflator is fixed at 2 % for the whole projection period.

(v) The GDP real growth rate is country specific and relies on the information submitted in the 2004 updated programmes, or, if absent, on the agreed EPC assumptions ([2]).

([1]) The Commission took into account the decline in the non-age-related expenditures in the case of the UK only. The dynamics reflect the current set of legislation in place, according to which most non-pension social benefits will rise in line with prices after 2009–10, reducing their share of GDP.

([2]) See Economic Policy Committee (2001).

Table I.20

Projected evolution of debt levels up to 2050

(% of GDP)

		Programme scenario			2004 scenario		
	2004	2010	2030	2050	2010	2030	2050
BE	96.6	75.7	24.7	28.8	73.2	19.0	18.3
CZ	38.6	41.4	83.2	305.8	54.8	140.8	447.1
DK ([1])	24.8	9.8	– 28.1	– 23.1	8.0	– 26.3	– 16.1
DE	65.5	62.2	39.6	23.0	73.6	91.0	138.7
EE	4.8	2.2	– 22.8	– 84.2	– 3.5	– 52.1	– 153.5
EL	110.5	94.7	139.5	403.3	105.2	202.4	562.80
ES ([1])	49.0	35.1	4.3	55.9	36.1	5.6	58.0
FR	64.8	59.0	89.5	219.3	70.3	158.4	383.3
IE ([1])	21.7	12.0	12.0	62.6	3.6	– 0.6	42.5
IT	106.0	90.7	31.2	– 5.7	99.1	119.8	218.0
CY ([1])	73.8	46.9	36.6	83.2	72.2	125.5	253.8
LV	14.2	15.1	35.4	109.3	16.0	40.4	122.0
LT	20.1	19.1	20.9	76.7	23.8	40.3	115.9
LU	5.0	5.8	31.8	74.4	11.2	49.7	104.0
HU	57.3	45.8	42.4	49.9	57.8	77.9	119.9
MT	73.2	65.8	64.1	60.1	89.8	177.0	286.3
NL	56.3	55.6	81.9	154.5	55.8	98.9	195.4
AT	64.2	54.2	16.4	– 18.6	55.3	24.9	0.6
PL	45.9	44.9	– 8.3	– 68.8	61.4	57.2	69.8
PT							
SI	30.2	25.9	37.7	187.4	28.0	54.2	229.3
SK	43.0	46.0	56.2	110.6	49.0	76.5	153.8
FI ([1])	6.4	– 4.5	– 30.5	– 13.7	– 14.7	– 45.1	– 35.1
SE ([1])	28.8	17.7	3.5	59.6	13.4	14.6	92.1
UK	40.9	42.7	52.5	89.9	46.4	71.2	128.7

([1]) Adjusted gross debt.

Source: Commission services.

With regard to the latter, it results from assumptions both on employment trends and labour productivity trends. However, labour productivity is assumed to converge at a common rate of growth of 1.75 % per year by 2030.

(vi) The nominal interest rate converges towards an EU average level of around 5 to 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 ([1]). 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 baseline scenario assumes that Member States actually achieve the budgetary targets laid 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 '2004 position' scenario was run in the same way as the baseline scenario, except that the starting budgetary position was different since it was based on the budgetary data for 2004. Debt levels are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the underlying primary balance in 2008 remains the same as the 2004 level and no stock-flow operations take place.

Once the debt-to-GDP ratio has been projected up to 2050, a series of synthetic indicators can be produced to assess the degree of sustainability of the projected debt-to-GDP ratio. These indicators — called sustainability gaps — indicate the scale of budgetary adjustment required for a Member State to reach a sustainable public finance position over the long run.

They measure the difference between the current tax ratio and the constant tax ratio over the projection period necessary to achieve a predetermined debt level in the future. The choice of both the targeted debt ratio and the length of the projection period is arbitrary and can affect the results. Thus, the Commission calculated two sustainability gaps for both the baseline and the 2004 scenarios. Another indicator was also calculated this year, the required primary balance. The indicators are described in more detail in Part II of this report.

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 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 quantitative assessment can be summarised as follows.

First, even assuming that all Member States achieve their medium-term budgetary targets (baseline scenario), and assuming a full impact of legislated structural measures incorporated into the long-term projections, there is a risk of unsustainable public finances (measured against the 60 % of GDP reference value in 2050) emerging in about half of the EU Member States.

Second, debt developments for most Member States follow a U-shaped pattern. In the next 15 to 20 years, debt levels are projected to decrease due to the running of balanced budget positions. This trend would, however, 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. Following the projected dynamics of the debt levels in the future, there is now a clear window of opportunity to contain the risks of increasing debt that will emerge in the future (see Graph I.16 for the EU aggregate).

Third, the risk of unsustainable public finances increases considerably if Member States do not achieve their targets in the medium term. An indication of this can be seen by comparing the projected debt levels under the baseline scenario with the 2004 scenario ([2]). This issue is relevant for a majority of Member States and especially for those which had a high cyclically adjusted deficit in 2004.

([1]) Economic Policy Committee (2001).

([2]) This latter scenario assumes that no budgetary consolidation takes place during the programme period, i.e. that the underlying primary balance remains at its 2004 level.

Table I.21

Results of the sustainability gap indicators

	Programme scenario			2004 budget scenario		
	S1	S2	RPB	S1	S2	RPB
BE	– 0.5	0.5	5.2	– 0.7	0.4	5.1
CZ	4.3	7.5	6.1	6.7	10.0	6.2
DK (1)	– 1.4	– 0.5	3.1	– 1.2	– 0.4	3.0
DE	– 0.8	– 0.1	2.0	1.2	1.6	2.2
EE	– 2.5	– 1.8	– 1.3	– 3.7	– 2.9	– 1.4
EL	4.0	6.5	9.3	7.9	10.4	9.4
ES (1)	– 0.1	1.9	4.3	0.0	1.9	4.3
FR	2.3	3.2	5.1	4.6	5.5	5.3
IE (1)	0.1	1.9	3.4	– 0.3	1.6	3.3
IT	– 0.9	– 0.9	4.0	2.2	2.3	4.0
CY (1)	0.6	2.7	4.8	4.7	6.6	5.0
LV	0.8	2.1	1.6	1.0	2.3	1.6
LT	0.4	2.7	2.6	1.4	3.6	2.6
LU	0.4	2.1	1.5	1.1	2.9	1.5
HU	– 0.2	0.6	1.1	1.2	1.9	1.3
MT	0.0	– 0.1	1.7	4.1	3.9	1.9
NL	1.5	2.0	3.2	2.3	2.8	3.2
AT	– 1.3	– 1.0	1.9	– 1.0	– 0.7	1.9
PL	– 2.9	– 1.8	– 1.8	0.2	1.3	– 1.7
PT						
SI	2.1	4.7	5.5	2.9	5.4	5.5
SK	1.0	2.3	2.0	1.8	3.2	2.0
FI (1)	– 1.0	0.4	3.4	– 1.4	0.1	3.2
SE (1)	0.0	1.5	4.5	0.6	2.0	4.4
UK	0.5	1.3	1.3	1.2	2.7	2.1

(1) Adjusted gross debt.

NB: S1 measures the required change in tax revenues as a share of GDP over the projection period that guarantees to reach a debt-to-GDP ratio of 60 % in 2050. S2 indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e. that equates the actualised flow of revenues and expenditures over an infinitive horizon to the debt as existing at the outset of the projection period. Based on S2, the required primary balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP over the first five years of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

Source: Commission services.

Fourth, the sustainability gap indicators provide some order of magnitude to the budgetary adjustment needed to ensure sustainable public finances. The sustainability gap according to the S2 indicator under the baseline scenario indicates that an additional permanent budgetary adjustment of more than 2 percentage points of GDP is needed in several Member States, and in some cases considerably more. This thus suggests that there could be sustainability risks even if the planned consolidation takes place.

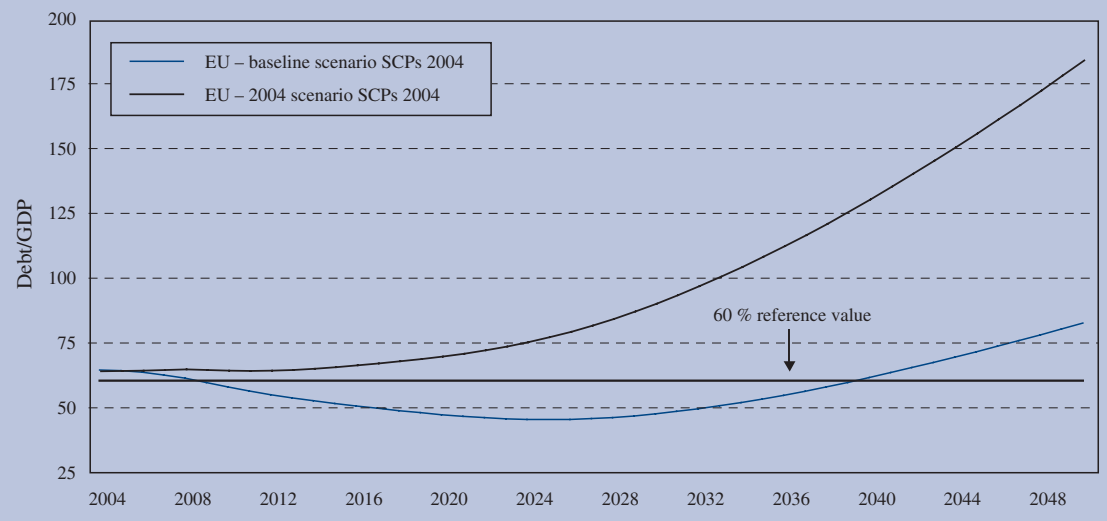
The scale of budgetary adjustment efforts could be even greater if account is taken of the stated budgetary objectives of some Member States such as a reduction in the tax ratio (1).

4.2.2. Comparison with 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.

(1) The sustainability gap indicators do not suggest that taxes should be increased, but rather that there should be an appropriate combination of tax increases, reducing the level of non-age-related primary spending and/or reform of pension and healthcare systems to curtail the impact of ageing on expenditure growth.

Graph I.16: **Debt development in the EU**



Source: Commission services.

In making the comparison with last year's results, the key aspects relating to the input data should be borne in mind: (i) national projections included in the stability and convergence programmes were used for almost all countries, which may hamper the comparability of the results to some degree; (ii) budgetary positions at the end of the programme period were adjusted so as to net out not only the effect of the cycle but also from this year onwards any one-off measures, i.e. an underlying budgetary position.

Table I.22 shows why this year's results of the quantitative indicators differ from last year's results. It analyses reasons for such development, based on a pure comparison of the projections used in the two years for the baseline scenario. By comparing the baseline scenarios, the adjustment for one-off measures should not have a large impact on the comparability, as most countries do not plan major one-off measures at the end of the programme period.

4.2.3. Qualitative considerations

The 2004 updated programmes contain useful information to better qualify the long-term sustainability of public finances. The level of the public debt-to GDP ratio in 2004 is a source of concern in at least three countries, namely Belgium, Greece and Italy. In order to reduce debt towards 60 % before the impact of ageing takes place, these countries have to run sustained high primary surpluses (above 4 %) over the next 10 to 15 years, and even more in the case of Greece. Such an ambitious budgetary strategy is subject to risk and it cannot be excluded a priori that pressures to reduce the tax burden or to increase some expenditure items may arise, putting at risk long-term sustainability. In addition, the medium-term dynamic of the debt-to-GDP-ratio is affected by stock-flow operations. In previous years, debt has been reduced at a slower pace due to such operations, especially in Greece and Italy, while in Belgium gross debt has been reduced significantly in recent years, aided by the achievement of a balanced budget position.

The current level of the debt-to-GDP ratio puts several countries in a safer position than the main quantitative indicator (S2) would suggest ([1]). Ireland, the UK, Finland, Luxembourg, Denmark, Sweden, Spain and all the

([1]) To remedy this, the new S1 indicator attempts to capture the scale of adjustment necessary to comply with the 60 % of GDP reference value in the long term, namely in 2050.

new Member States except Cyprus, Hungary and Malta have a relatively low level of debt-to-GDP ratio.

This gives some room to tackle the problem if future imbalances arise. For other countries (namely Germany and France), a source of concern is not the very high level of debt-to-GDP ratio but rather its recent upward trend. The budgetary deterioration has pushed debt up over the last few years and it has quickly reached levels close to or above the reference value of the Maastricht Treaty.

An important aspect of long-term sustainability is to implement measures of a structural nature that help to ensure that a sound budgetary position can be maintained in the longer term.

Reform measures in the fields of pensions and healthcare are the main areas for which expenditures are expected to rise, but there are also others, for example long-term care, education and childcare and more general programmes such as unemployment and sickness benefit/insurance schemes. In many respects, structural reforms can be beneficial both in improving or modifying certain expenditure trends and in strengthening the potential growth rate of the economy. Both these aspects can be difficult to quantify, not least the latter.

Directly linked to this is the issue of the robustness of the projections. This aspect is crucial in making the assessment of long-term sustainability. 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 expenditures are indeed surrounded by considerable uncertainty regarding demographic changes and the Spanish authorities did not present long-term projections in the 2004 update with reference to this uncertainty. In Poland, the lack of long-term projections beyond 2020 prohibits a complete sustainability analysis. This is underlined by the fact that most of the impact of ageing populations is expected to take place after 2020.

The projections for Poland keep the age-related expenditure-to-GDP ratio unchanged from that year onwards and thus probably underestimate the budgetary impact of population ageing. For Hungary, there is a lack of long-term projections for expenditure items other than pensions and the longer-term expenditure trends may be underestimated there too.

The projected increase in age-related expenditures in Germany also warrants consideration. The German authorities provided a set of projections up to 2050 which include the impact of the recent reforms under Agenda 2010, including reform of the pension system which is projected to reduce the pension expenditure dynamics. The positive impact of the reform of the labour market, the so-called Hartz IV, has also been included in the projections. These are projected to result in a significant strengthening of labour supply and employment, which in turn should reduce the unemployment rate. The projected results for age-related expenditures hinge on the achievement of these underlying projections, for which it may be too early to draw firm conclusions. The German authorities also included a rise in the revenue-to-GDP ratio in the long-term projections, consistent with current legislation in place. This implies a considerable rise in pension contributions (of about 2 percentage points) over the coming decades, which may have implications for the achievement of other policy objectives. In France, a reform of the healthcare system was implemented in 2004, which should result in budgetary savings up to 2008. However, the savings over the longer term are subject to some uncertainty. The French updated stability programme therefore included several scenarios for the evolution of healthcare expenditures over the longer term. The Commission services considered that healthcare spending is likely to rise faster than income over the longer term, compared with the main scenario in the French stability programme. In Italy, the pension system was reformed in 2004, which is projected to result in budgetary savings over the coming decades. However, this reform will take effect only from 2008 onwards, which introduces some uncertainty concerning its impact on the projected budgetary savings included in the Italian stability programme.

Another factor to be considered as a potential risk is whether debt projections rely on a very high tax burden compared with the EU average or other industrialised countries. This is the case in Denmark and Sweden where the tax burden is around 50 % of GDP, and slightly less so in Austria, Belgium and Finland. Even if each Member State can decide on 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.

As highlighted in this section, the qualitative considerations are a very important element in the sustainability analysis in order to enrich the information provided by the sustainability indicators.

Table I.22

The 2004 projections compared with the 2003 projections (EU-15)

	Results compared with last year	What are the differences between this and last year's projections?
BE	Worsened	• Greater increase in healthcare expenditures. • Slightly higher total revenues in the first year of the projection.
DK	Similar	• Greater increase in pension and healthcare expenditures. • Higher total revenues in the first year of the projection.
DE	Improved	• Age-related spending is higher in the first year of the projection, but increases less in the period to 2050 compared with last year, reflecting a lower projected rise in pension expenditure and unemployment benefits. • The revenue-to-GDP ratio in the first year of the projection is lower compared with last year, but a stronger rise in the period to 2050 is projected.
EL	Worsened	• Non-age-related spending is much higher in the first year of the projection. • The revenue-to-GDP ratio in the first year of the projection is also higher, but does not offset the higher expenditures. • The gross debt-to-GDP ratio is much higher in the first year of the projection.
ES	Slightly worsened	• This year's projections were run on the basis of information provided last year, as new projections were not provided in the updated programme. • Higher non-age-related expenditures in the first year of the projection. • Partly compensated by higher revenues in the first year of the projection.
FR	Worsened	• The revenue-to-GDP ratio in the first year of the projection is slightly lower compared with last year. • Age-related spending is higher in the first year of the projection and increases more in the period to 2050 compared with last year, reflecting a higher share of healthcare expenditure at the outset and also a greater rise, resulting from an improved, broadened estimate provided in the French update. Correcting for the broadened estimate, the 2004 healthcare reform reduces the projected rise in healthcare spending.
IE	Improved	• Some of the improvement is due to a recalculation of the pension and healthcare expenditures from GNP to GDP terms, which results in a smaller increase in age-related expenditures over the projection period. • The projected tax revenues are higher in the first year of the projection. • Lower debt in the first year of the projection.
IT	Similar	• The pension expenditure is lower over the first decades of the projections and higher towards the end (last 10 years). • The starting underlying budgetary position is worse this year (a deficit of 0.9 percentage points of GDP instead of a balanced budget).
LU	Worsened	• The projected tax revenues are lower in the first year of the projection. • The lower revenues are only partially countered by slightly lower expenditures in the first year of the projection.
NL	Similar	• The projected tax revenues are slightly higher in the first year of the projection and the increase is greater. • Higher revenues are partly countered by a slight increase in non-age-related expenditures in the first year of the projection. Higher debt level in the first year of the projection.
AT	Improved	• Mainly lower pension expenditures stemming from the expected impact of the pension reform.
PT		
FIN	Worsened	• The projected age-related expenditures are very similar to last year. • The projected tax revenues are lower in the first year of the projection, as are the increases. • A lower debt level in the first year of the projection.
SE	Worsened	• The projected tax revenues are lower compared with last year. • The lower revenues are only partially countered by slightly lower expenditures over the projection period.
UK	Improved	• A higher rise in age-related expenditures, including public pensions, is offset by a fall in non-age-related expenditures over the projection period and total spending is projected to rise less than last year. • The projected revenues are somewhat higher in the first year of the projection.

Source: Commission services.

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 budgetary imbalances and the seriousness of the risk as follows.

Very high-debt countries (Belgium and Italy). The source of risks for these countries is mainly the level of the debt-to-GDP ratio. It should be noted that Belgium has reduced its debt ratio very resolutely, by almost 15 percentage points of GDP since 2000, benefiting from the achievement of a balanced budget position, while Italy's debt ratio has been reduced considerably less, by around 5 percentage points of GDP over the same period. 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 implies that very high-debt countries are able to sustain large primary surpluses over several (15 to 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 (Germany, France, Hungary, Poland and Slovakia). These countries have recently adopted 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. The systemic pension reforms in Hungary, Poland and Slovakia contribute to a more sustainable position over the long term, though the projections in Poland are subject to considerable uncertainty as they end in 2020. 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 the debt-to-GDP ratio is then likely to show explosive paths.

Countries with risks due to pension developments (the Czech Republic, Greece, Spain, Cyprus, Malta and Slovenia). These 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 in most other Member States, reflecting only limited progress in the pension reform process. In Greece and the Czech Republic, age-related expenditure is projected to rise by more than 10 percentage points in the period to 2050. The exception is Malta, where a very small rise is projected until 2050, which hinges on significant savings from 2030 onwards, resulting from a cap on pension expenditure. A pension reform is under discussion which should address both sustainability and adequacy. This means that, in addition to a policy of running down debt (where Spain is performing particularly well and Slovenia and the Czech Republic have relatively low debt levels), measures to better control future trends in pension expenditure should be envisaged. In the Czech Republic and Slovenia the rise in pension expenditure is very high, beyond 2020 in the case of Slovenia, suggesting that corrective measures will have to be taken. Risks rely also on the uncertainties surrounding pension projections. In the case of Spain, there are large differences between the EPC projections and the Spanish projections on future pension expenditure, influenced by different demographic scenarios.

Countries with some risks due to the uncertainties over the medium term (Latvia, Lithuania, the Netherlands and the UK). These countries face risks mainly linked to the medium-term budgetary developments. These countries appear to be in a relatively favourable position to meet the cost of ageing populations. Measures have been put into place in order to meet the ageing challenge. However, reducing the fiscal deficit in the medium term is important, as highlighted by the difference between the baseline and 2004 scenarios in the Commission's analysis. Also, projections in the medium term rely on several assumptions. Revenue projections are subject to macroeconomic uncertainty whereas expenditure projections include announced policies and might therefore be less straightforward to change in case of adverse economic developments. In the UK's case, there is a possibility of insufficient provision of private pensions which might have implications for the UK public finances. The authorities have introduced the pension protection fund, from April 2005, to protect members of private defined-benefit schemes where the sponsoring firm becomes insolvent and there are insufficient assets in the scheme to meet its liabilities. The effectiveness of these measures is yet to be tested.

Countries with limited risk (Denmark, Estonia, Ireland, Luxembourg, Austria, Finland and Sweden). These

countries share a number of common characteristics, including sound budgetary 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 most of these countries, the development of gross debt does not reflect properly the soundness of their budgetary position due to the accumulation of liquid financial assets to cope with future challenges. In the case of Denmark, Ireland, Finland and Sweden, this was taken into consideration in the quantitative analysis, but Estonia and Luxembourg also have public pension funds.

Table I.23 summarises the main conclusions reached by the Ecofin Council in its opinions on the stability and convergence programmes on the basis of the Commission's assessment. It shows how, for a number of countries, the long-term budgetary position has improved due to structural reforms and the increased focus on long-term challenges.

4.4. Conclusions

This assessment round suggests that the increased focus on long-term sustainability in the EU has resulted in some further improvement to cope with the budgetary impact of ageing populations. In Part II of this report, an evaluation of how the sustainability analysis has improved over the last few years is provided. Several countries, including larger ones, have implemented reforms with a view to strengthening sustainability; for example, Germany and Italy reformed their pension systems and France reformed its healthcare system, which represent important steps in the right direction. With the current assessment, the recently acceded Member States have been fully included in the analysis for the first time. The situation for these is in general positive; a majority have implemented major reforms of their pension systems and they generally have a relatively low debt-to-GDP ratio, which contributes to a more sustainable position over the long run.

However, there is a serious concern regarding the achievement of the planned budgetary consolidation in the medium term for most Member States. According to this year's assessment, if the fiscal consolidation foreseen in the medium term does not materialise, the projected debt dynamics would worsen considerably. This underlines the importance of strengthening the fiscal positions sooner rather than later.

Overall, the results show that there are risks to long-term sustainability in 10 countries (Belgium, the Czech Republic, Germany, Greece, France, Italy, Cyprus, Hungary, Malta and Slovenia). In another seven (Spain, Latvia, Lithuania, the Netherlands, Poland, Slovakia and the UK), there could be some risks due to the projected medium-term budgetary developments, the budgetary impact of enacted reforms or, as is the case for Spain and Poland, due to considerable uncertainties concerning the long-term age-related expenditure trends. Finally, seven countries (Denmark, Estonia, Ireland, Luxembourg, Finland, Austria and Sweden) appear to face only limited risks in view of the budgetary costs of an ageing society, though it nevertheless represents a challenge.

Table I.23

Policy conclusions on the sustainability of public finances

	Are public finances sustainable?	What are the main issues?	Do policy conclusions differ from last year?
BE	Belgium still appears to be at some risk on grounds of the current level of gross debt.	While declining, the debt ratio is still high and a steady reduction hinges upon sustaining high primary surpluses for a prolonged period. Containing primary expenditures might prove difficult, especially in the healthcare sector, but is important in view of the government's strategy of reducing the tax burden in order to create employment. Given the projected increase in the old-age dependency ratio, pursuing this broad strategy with determination is crucial to the achievement of long-term sustainability.	No. Belgium's strategy for coping with the budgetary cost of an ageing population is mainly based on gross debt reduction through maintaining a balanced budget position or a small surplus (itself relying primarily on primary expenditure restraint) and an ageing fund.
CZ	The Czech Republic appears to be at serious risk, on grounds of the very important projected budgetary costs of an ageing population.	The strategy of fiscal consolidation outlined in the programme needs to be complemented with additional reforms to reduce the sustainability risks associated with the projected increase in pension and healthcare expenditures.	No.
DK	Denmark appears to be in a favourable position, despite significant projected budgetary costs of an ageing population.	Achieving continued tight expenditure control and a considerable rise in employment on which the Danish strategy also relies may prove challenging.	No. The Danish budgetary strategy is mainly based on further debt consolidation through continued budget surpluses and should result in a sustainable position over time.
DE	Germany still appears to be at some risk on grounds of the projected budgetary cost of an ageing population. However, with the implementation of structural reforms and budgetary consolidation in the medium term, as planned, Germany could be in a relatively favourable position.	The already legislated structural reforms of Agenda 2010 and, in particular, the pension reform are likely to reduce the budgetary impact of ageing, although the expenditure-reducing effect of the ongoing reforms is subject to uncertainty. Moreover, long-term sustainability hinges crucially on the achievement of the planned budgetary consolidation in the medium term and on reducing the debt level; both the federal states and social security systems play a role in this.	No. This year's policy conclusions are similar. The 2004 pension reform puts Germany on a better footing, however, maintaining that there is a need to achieve a budgetary position close to balance or in surplus.
EE	Estonia appears to be in a favourable position, despite important projected budgetary costs of an ageing population.	A low government debt level, considerable government financial reserves and a medium-term budgetary strategy that is fully consistent with the objective of a close-to-balance or in-surplus budgetary position, together with credible and thorough reforms of the pension and healthcare systems which are meant to stem budgetary pressures in the longer term, should ensure that public finances remain on a sustainable footing.	No.
EL	Greece appears to be at serious risk with regard to the long-term sustainability of public finances, also on account of the very important projected budgetary costs of an ageing population.	The considerable increase projected in age-related spending suggests that additional measures to control public pension expenditures, including the resolute implementation of reform measures enacted, are necessary. The gross debt-to-GDP ratio, while projected to fall, remains above 100 % of GDP throughout the programme period.	No. Even if the planned budgetary consolidation should materialise over the programme period, a considerable sustainability gap emerges, pointing to the need for a broad-based approach to ensure the sustainability of the public finances.

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Table I.23 (continued)

	Are public finances sustainable?	What are the main issues?	Do policy conclusions differ from last year?
ES	Spain appears to be in a relatively favourable position, in spite of the projected budgetary costs of an ageing population.	The large increase in pension expenditure projected in the very long term suggests that current policies need to be supplemented by measures to prevent the emergence of unsustainable trends in public finances in the long run, in particular through a comprehensive reform of the pension system in line with the recommendations of the multi-partisan agreement 'Pacto de Toledo'.	No. There are however risks surrounding the long-term expenditure projections.
FR	France still appears to be at some risk on grounds of the large projected budgetary costs of an ageing population. However, the implementation of major structural reforms of the pension and health systems in 2003 and 2004 respectively put France on a better footing.	Further efforts, both additional budgetary consolidation and additional reforms, would be needed in the years ahead in order to ensure fully the sustainability of government finances.	No.
IE	Ireland appears to be in a relatively favourable position, despite significant projected budgetary costs of an ageing population.	The Irish strategy is mainly based on conformity to the Stability and Growth Pact framework and further asset accumulation in the National Pensions Reserve Fund (NPRF). Overall, Ireland's relatively low tax ratio should ease the accommodation of any sustainability gap that might arise in the longer term.	No. The relatively low debt ratio in Ireland, the pension reform measures already enacted and the accumulation of reserves in the National Pension Reserve Fund will contribute to budgetary sustainability and help cope with the impact of ageing.
IT	Italy appears to be at some risk. However, if the expected savings of the pension reform are achieved and budgetary consolidation in the medium term is implemented and maintained, as planned, Italy could be in a relatively favourable position.	In Italy, it is important that the budgetary targets are fully implemented, the expected savings from the pension reform are achieved and any departure from the strategy of running large primary surpluses, effectively leading to rapid debt reduction, is promptly corrected.	No. The adoption in 2004 of a pension reform is an important step towards addressing the budgetary consequences of an ageing population and will contribute to improving the situation of Italy in this respect.
CY	Cyprus appears to be at some risk on grounds of the projected budgetary costs of an ageing population.	It is imperative for Cyprus to pursue the reform process in order to reduce the sustainability risks associated with the future evolution of age-related expenditures, together with the planned and necessary budgetary consolidation in the medium term.	No. Cyprus's strategy is mainly based on the budgetary consolidation in the next few years and additional reforms of the pension and healthcare systems to be implemented in the future.
LV	Latvia appears to be in a relatively favourable position, despite significant projected budgetary costs of an ageing population.	Reforms in the field of health and long-term care could involve higher expenditures and risks to sustainability may emerge in the long run. Latvia's relatively low tax ratio should, however, ease the accommodation of any such sustainability gap that may arise. Latvia also relies on a contained budget deficit over the medium term.	No. Latvia's relatively low debt ratio, pension reform measures enacted, including the introduction of the funded pillar, and the accumulation of assets in the funded pension scheme will contribute to limiting the budgetary impact of ageing.
LT	Lithuania appears to be in a relatively favourable position, despite the projected budgetary costs of an ageing population.	Risks related to the costs of the pension reform should be monitored. In addition, reform measures in the field of healthcare could involve higher expenditures. Lithuania's relatively low tax ratio should, however, ease the accommodation of any such sustainability gap that may arise. Lithuania also relies on a contained budget deficit over the medium term.	No. Lithuania's relatively low debt ratio and pension reform measures enacted, including the introduction of the funded pillars, will contribute to limiting the budgetary impact of ageing.

(Continued on the next page)

Table I.23 (continued)

	Are public finances sustainable?	What are the main issues?	Do policy conclusions differ from last year?
LU	Luxembourg appears to be in a favourable position, despite important projected budgetary costs of an ageing population.	The ratio between contributors to and beneficiaries of the pension system will deteriorate, even under a favourable scenario whereby employment growth keeps up with the exceptional rates recorded in the last two decades. Therefore, some restraint is called for in order to ensure that government spending remains in line with revenue and that the policy of accumulating reserves can be maintained, together with the adoption of measures aiming at raising the currently low employment rate of residents, especially older ones.	No. The large net positive asset position can be expected to offset at least in part the future costs of ageing.
HU	Hungary appears to be at some risk on grounds of the projected budgetary costs of an ageing population.	Risks are in part related to the uncertainty regarding the long-term budgetary trends due to the lack of information on healthcare expenditure projections. It is moreover important to pursue reforms, particularly in the field of healthcare, as well as to implement resolutely the planned budgetary consolidation in the medium term.	No. Hungary's strategy is mainly based on budgetary consolidation in the next few years and additional reform measures to be implemented in the future. The reformed pension system, including the introduction of the funded pillar, contributes to reducing the budgetary impact of ageing and to reducing risks of unsustainable public finances.
MT	Malta appears to be at risk on grounds of the projected costs of an ageing population.	While failure to achieve the budgetary targets would clearly put sustainability at risk, the pursuit of the reform process of the pension and healthcare systems is also important for the containment of the increase in age-related public expenditure in the long term.	No. Malta's strategy for ensuring sustainability is dependent on the achievement of the budgetary targets.
NL	The Netherlands appears to be in a relatively favourable position, despite important projected budgetary costs of an ageing population.	Given the projected increase in the old-age dependency ratio, and in the absence of further fiscal consolidation leading to a budgetary position close to balance or in surplus in the medium term, further reforms that would modify the trends in age-related expenditures and raising further participation rates would reduce sustainability risks over the longer term.	This year's policy conclusions emphasise progress in the implementation of reforms in the areas of social security, pensions and healthcare in 2004. In addition, sizeable net assets in large funded-pillar private pension systems outside general government contribute to a more sustainable position, which merits a more positive tone than last year.
AT	Austria appears to be in a relatively favourable position, despite important projected budgetary costs of an ageing population.	After the pension reform of 2003, Austria passed a further pension reform in 2004, with the aim of bringing all groups of private and public sector employees into a harmonised pension system. The significant contribution of the 2004 law to long-term financial sustainability is being backloaded to take effect only after 2030, while the medium-term savings from the 2003 law were partly reduced.	No. The pension reforms of 2003 and 2004 are set to provide substantial budgetary relief in the long term.
PL	The lack of budgetary projections beyond 2020 makes it difficult to assess the long-term sustainability of the Polish public finances. On the basis of the information available, some risks cannot be ruled out.	Uncertainties regarding the budgetary impact of policies aimed at strengthening the long-term budgetary trends remain, as most of the budgetary impact of ageing is likely to take place after 2020. Moreover, the resolute implementation of the planned budgetary consolidation in the medium term should be an important contribution to the achievement of a sustainable position.	No. The pension reform in Poland, which includes the creation of a funded pension pillar, should contribute to the long-term sustainability of the public finances. However, the lack of information on other age-related expenditures gives rise to major uncertainties regarding the long-term budgetary trends in Poland.

(Continued on the next page)

Table I.23 (continued)

	Are public finances sustainable?	What are the main issues?	Do policy conclusions differ from last year?
SI	Slovenia appears to be at some risk on grounds of the projected budgetary costs of an ageing population.	The projected increase in pension expenditure beyond 2020 remains very high. In addition, despite the introduction of some rationalisation measures of the healthcare system in 2004, a further substantial reform of the healthcare system would contribute to the improvement of the long-term sustainability of the public finances.	No. However, the ongoing pension reform has had a positive budgetary impact.
SK	Slovakia appears to be in a relatively favourable position, despite the projected budgetary costs of an ageing population.	Full implementation of the pension and healthcare reforms is a key condition for reaching a sustainable position, in addition to the achievement of the planned budgetary consolidation path over the programme period and until 2010.	No. The structural reforms adopted, in particular in the pension and health areas, contribute to longer-term sustainability.
FI	Finland appears to be in a favourable position, despite important projected budgetary costs of an ageing population.	The strategy outlined in the programme is broad-based and consists of further debt consolidation and structural reforms, for example further steps of the pension reform and measures aimed at raising the exit age.	No. The structural reforms enacted and planned should have beneficial effects on the public finances. Also, the considerable public pension fund assets will help to ease the budgetary pressure in the longer term.
SE	Sweden appears to be in a relatively favourable position, despite important projected budgetary costs of an ageing population.	A risk to long-term sustainability may emerge in the long run. This is based on the projected increase in the old-age dependency ratio and existing trends in healthcare-related expenditures, labour force participation and employment. Without further reforms, modifying these trends, aiming at a budget surplus over the next 10 years of 2 % of GDP, in line with the government's budgetary target, becomes a key factor in addressing sustainability over the longer term.	No. The structural reforms enacted and planned should have beneficial effects on the public finances. Also, the considerable public pension fund assets will help to ease the budgetary pressure in the longer term.
UK	The UK appears to be in a relatively favourable position, despite the projected budgetary costs of an ageing population.	However, higher age-related expenditures cannot be excluded as there is a possibility of insufficient provision of private pensions which might have implications for the public finances. The authorities are introducing the Pension Protection Fund, from April 2005, to protect members of private defined-benefit schemes where the sponsoring firm becomes insolvent and there are insufficient assets in the scheme to meet its liabilities. The effectiveness of these measures is yet to be tested.	This year's policy conclusions emphasise the UK's relatively low debt-to-GDP ratio and the strong focus that the authorities have placed, in existing policies, on long-term sustainability of the public finances. The relatively low tax ratio should ease the accommodation of any imbalances that may arise in the longer term. These aspects merit a more positive tone than last year.

Sourcses: Council opinions on the 2004 updated stability and convergence programmes on the basis of the Commission's assessments.

Part II

Evolving budgetary surveillance

Summary

This part of the report describes the major innovations in the EU framework for fiscal policy and reviews notable developments in budgetary surveillance. It is divided into three chapters. The first chapter illustrates the main features of the agreed lines for revising the Stability and Growth Pact. The second chapter deals with several topics of relevance in EU fiscal surveillance: the discrepancy between budgetary plans in stability and convergence programmes and outcomes; the determinants of debt dynamics; the role of national budgetary institutions in shaping budgetary results. The third chapter reviews the Commission's methodology for assessing the long-term sustainability of public finances.

The debate on the reform of the Stability and Growth Pact

The European Council of 22 and 23 March 2005 endorsed the Council report 'Improving the implementation of the Stability and Growth Pact', agreed by the Ecofin ministers at their extraordinary meeting of 20 March. It updates and complements the Stability and Growth Pact. It also recommends measures for improving fiscal and statistical governance both at the national and at the EU level. This agreement on the revision of the rules of the Pact is the result of a comprehensive review of the Stability and Growth Pact that followed the Commission communication of September 2004. In conjunction with the renewed commitment from all Member States to stability-oriented budgetary policies and effective fiscal surveillance, the compromise agreement of March 2005 puts an end to the uncertainty that has surrounded the interpretation of the existing budgetary rules in the last few years. Following the agreement by the Council, the Commission has launched the legislative procedures for amendment of the existing regulations where necessary to implement the agreement. Final adoption of the revised set regulations lies with the Council.

In the agreement, the Treaty's reference values for government deficit and debt remain the anchors of the system. 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. In future, the medium-term objective of a country will be defined on the basis of its current debt ratio and potential growth. For Member States having adopted the euro and for those participating in the European exchange rate mechanism, the agreed range of medium-term objectives is between – 1 % of GDP for countries with a combination of low debt and high potential growth, and balance or in surplus for countries with a combination of high debt and low potential growth. The preventive dimension of the Pact is further underpinned by the strengthened commitment of Member States to actively consolidate public finances under favourable economic conditions and the possibility for the Commission to act by issuing timely policy advice if this is not the case. The new agreement also includes incentives for Member States to embark upon structural reforms. In particular, major structural reforms that have direct long-term cost-saving effects and verifiably improve fiscal sustainability over the long term will be considered. The main modifications in the corrective arm of the Pact concern the definition of 'excessive deficits', the possible extension of the existing deadline for the correction of an excessive deficit, and the introduction of the possibility of repeating steps in the implementation of the excessive deficit procedure (EDP). Considerations are also included related to the assessment of systemic pension reforms in the EDP, and the enhanced focus on surveillance on government debt.

In particular, the new rules allow expanding the one-year deadline for the correction of an excessive deficit by an additional year in case a correction in the year directly following the identification of an excessive deficit is not warranted on economic grounds. Moreover, under the strict provision that effective action has been taken by the country concerned, the Council can decide to repeat certain steps in the excessive deficit procedure, in the case of an unexpected adverse economic event hitting a

country in the course of correcting its excessive deficit. Finally, the new agreement specifies a set of 'relevant factors' that the Commission and the Council can take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction. These factors include, *inter alia*, developments in potential growth and prevailing cyclical conditions, but also considerations with respect to debt sustainability, the implementation of policies geared towards meeting the objectives of the Lisbon agenda or the record of fiscal consolidation in 'good times' will be assessed.

These modifications will increase the room for judgment in the application of the excessive deficit procedure. However, a number of complementary elements built into the new agreement will effectively constrain the scope for discretion, preserving strong incentives for fiscal discipline in the EU on the basis of a rules-based EU framework. First of all, both the Commission, when considering whether an excessive deficit exists or may occur, and the Council, when deciding on the existence of an excessive deficit, will take into account any relevant factors only if the general government deficit remains close to the reference value and its excess over the reference value is temporary. Second, other relevant factors are always considered in an overall assessment, in which a large number of factors, including those that may call for a stricter interpretation of the deficit figures, are examined. No simple discounting of certain categories of public expenditure from the deficit calculations is foreseen. Third, Member States in excessive deficit are requested to achieve a minimum annual budgetary effort of 0.5 % of GDP irrespective of relevant factors. Fourth, the Commission will always issue a report under Article 104(3), if the deficit of a Member State exceeds 3 % or if it sees a risk of an excessive deficit. Finally, the obligation of the Council to impose sanctions in case a Member State in excessive deficit repeatedly fails to act in compliance with the successive decisions of the Council remains unchanged as the ultimate threat against non-compliance.

The 2005 Ecofin report recognises that modifications to the provisions of the Pact are not sufficient to ensure a meaningful improvement in their implementation. In order to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline, the report contains a number of complementary elements designed to increase the ownership of the Pact provision and clarify the respective roles and responsibilities of the various actors involved as well as measures to improve the quality and timeliness of statistical data, both at the national and at the EU level.

Issues in EU budgetary surveillance and sustainability analysis

Since the inception of the EU fiscal framework, budgetary surveillance in the EU has been evolving. This evolution has been partly driven by the need to tackle specific issues that have been encountered in the practical application of the framework (e.g. measuring the countries' fiscal effort), partly in response to a changing economic and institutional landscape (e.g. ageing populations, EU enlargement), and partly as a result of efforts to upgrade the analytical toolkit used in EU budgetary surveillance though technical work carried out in working groups attached to the relevant Council committees (e.g. the agreed methodology for computing potential output and output gaps). The 'Public finances in EMU' report regularly collects analytical work undertaken by the Commission services with the aim of improving the understating of public finance issues in the EU and upgrading budgetary surveillance. This year, the focus is on the discrepancy between budgetary plans from stability and convergence programmes and results, the analysis of debt dynamics, the role of national budgetary institutions in shaping fiscal outcomes, and the assessment of public finance sustainability in the long term.

The process of fiscal surveillance has provided a wealth of data on budgetary plans, outcomes and assessments. This information is used in this report for two purposes: (i) comparing budgetary developments in the Member States relative to plans; (ii) investigating how the Commission's assessment of stability and convergence programmes has evolved over time. As regards the first aspect, the data show that slippages between budgetary plans and outcomes have been common and sizeable in some years, even after 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. As far as the Commission's assessment of stability and convergence programmes is concerned, retrospective analysis shows that the Commission has responded to the discrepancy between budgetary plans and outcomes by focusing the assessment increasingly on the credibility of the adjustment path described in the programmes. Moreover, the scope in fiscal surveillance has broadened over time and Member States' fiscal policies are assessed in a more comprehensive way.

In EU fiscal surveillance, increasing focus is put on debt developments. The dynamics of the debt-to-GDP ratio can be decomposed into three components: one related to the budget balance realised, one associated with nominal growth, and one, named the stock-flow adjustment, capturing the discrepancy between the change in the outstanding debt stock and the government budget balance as defined in the protocol to the Maastricht Treaty. The usual analysis focuses on the first two elements, with much less attention being paid to the magnitude, characteristics and determinants of the stock-flow adjustment. However, this component of the debt dynamics could convey relevant information concerning the evolution of government assets and liabilities and the reconciliation between cash and 'Maastricht' deficit figures. Analysis contained in this report aims at filling this gap, providing analysis on the determinants of the stock-flow adjustment for EU Member States. It is shown that the stock-flow adjustment in past years has been positive on average (adding therefore to the build-up of debt), and that in some countries the stock-flow adjustment is partly associated to cash deficits being systematically higher than Maastricht deficits.

There is growing agreement among economists and policy-makers that institutional aspects, related, for instance, to the procedures and practices for the preparation, approval and implementation of the budget law, or the existence of medium-term expenditure frameworks, are key determinants of budgetary outcomes. The relevance of national budgetary institutions in supporting the effectiveness of the EU fiscal framework has been recognised in the EU Treaty and the debate leading to the agreed lines for revising the SGP. A section in this part of the report reviews the existing economic literature on the role of budgetary institutions in shaping fiscal outcomes and provides analysis on EU Member States. Although there is evidence of a possible link between national budgetary institutions and budgetary outcomes, difficulties in interpreting the results should not be underestimated.

For instance, it has been argued that the very different degree of effectiveness of the EU fiscal framework in inducing budgetary discipline across EU countries could be explained by differences in the overall budgetary arrangements and institutions across Member States. According to this argument, countries which base the containment of deficits on a strong role of finance ministries ('delegation countries') are less likely to be strongly affected by fiscal rules at the EU level than countries whose fiscal governance is based instead on procedures and arrangements among different spending ministries and levels of government ('commitment countries'). However, given that delegation countries also tend to be large countries, it could be difficult to disentangle the role of institutions from sheer country size in determining budgetary outcomes: in larger countries, the EU budgetary objectives may have received less weight than in smaller countries and there may have been a perception of larger costs of fiscal consolidation in larger countries.

At the EU level, sustainability analysis has been carried out since 2001 in the context of the assessment of the stability and convergence programmes. It is based on debt projections on the basis of budgetary data provided in stability and convergence programmes and estimates of age-related expenditures (mainly pension, healthcare and education) up to 2050. A set of indicators is constructed to provide a synthetic quantification of sustainability risks. Given the uncertainty surrounding the far future, judgment is a key aspect of sustainability analysis: robustness of budgetary projections, reliability of planned or implemented reforms, composition of the budget, risks associated with the medium-term scenario are all elements to be considered when performing the sustainability analysis. In light of the general agreement on the need to increase the focus of EU budgetary surveillance on long-term public finance developments, this part describes the current Commission approach for 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 particular, it is suggested that increased information exchange within the Ageing Working Group attached to the Economic Policy Committee for what concerns national projections on age-related expenditures, including on the models to carry out such projections, would increase transparency and contribute to upgrading the overall assessment of the long-term sustainability of public finances.

1. The debate on the EU fiscal framework

1.1. Introduction

On 22 March 2005, the EU Heads of State or Government endorsed the report of the Ecofin Council entitled 'Improving the implementation of the Stability and Growth Pact' ([1]). Two days before, at their extraordinary meeting of Sunday 20 March, ministers for finance had reached consensus on the reform of the Pact after several months of intense discussion.

The new set of rules introduces more economic rationale and flexibility in the application of the EU fiscal framework and encourages Member States to achieve the necessary budgetary consolidation when economic conditions are favourable. In conjunction with a renewed commitment from all Member States to stability-oriented budgetary policies and the surveillance procedures, the new agreement puts an end to the uncertainty that has surrounded the interpretation of the existing budgetary rules since November 2003 and can reinforce the credibility of the EU fiscal framework.

The 2005 Ecofin report updates and complements the Stability and Growth Pact (SGP). It recommends, furthermore, complementary measures for improving fiscal and statistical governance both at the national and at the EU level.

The agreement on the revision of the rules of the Pact is the result of a comprehensive review of the Stability and Growth Pact. It was launched by the Commission with its September 2004 communication against the background of past and prospective budgetary developments and challenges as well as in light of the experience with the implementation of the budgetary rules in the EU Member States.

Overall, the agreement reached by the Council reflects a broadly balanced compromise. On the one hand, more economic judgment will be introduced in the application of the rules in order to better reflect the economic realities in the enlarged EU. This will help in fostering the acceptability and ownership of the budgetary rules in Member States. On the other hand, renewed commitment of Member States to sound budgetary policy throughout the economic cycle provides a solid basis for improved and economically sensible implementation of the Pact.

The fundamental rules remain unchanged. In particular, the Ecofin report reconfirms the agreement that the Treaty's reference values for government deficit and debt will remain the anchor of the system. This is underpinned by the commitment of the Commission always to make a report under Article 104(3), the initial step of the excessive deficit procedure, if a deficit exceeds 3 %. Any excess of the deficit that will not be small and temporary will be considered excessive, whatever the influence of 'other relevant factors'. An excessive deficit will still need to be corrected promptly, despite the new extension of the deadlines in the excessive deficit procedure. A new annual minimum budgetary effort has been introduced for countries in EDP.

The Commission will ensure a forceful implementation of the agreement and continue the impartial and equal application of the rules to all Member States. Following the agreement by the Council, the Commission has swiftly moved on and presented to the Council for adoption the necessary legislative proposals for implementing the agreed changes ([2]).

This chapter of the report describes and explains the main elements of the 2005 reform package. It provides,

([1]) See Presidency conclusions of the Brussels European Council of 22 and 23 March 2005 (7619/05) and the (Ecofin) Council report to the European Council of 21 March 2005 (7423/05).

([2]) The legislative procedure was still ongoing at the time the 2005 public finance report went to press.

furthermore, a first and tentative assessment of the changes against a set of established criteria for optimal fiscal rules and provides the reader with information about the main stages of the debate. In order to put the changes into perspective, it begins by briefly recapitulating the key features of the existing EU fiscal framework.

1.2. The architecture of the existing EU fiscal framework

When the project of European economic and monetary union (EMU) was launched, there was widespread recognition that enhanced economic coordination mechanisms were needed among the countries sharing the single currency.

In order to ensure the benefits of Union-wide financial stability, Member States in the 1990s reached consensus on the design of a supranational fiscal policy framework at the level of the EU. The rules were adapted to the institutional characteristics of EMU and designed with a view to encouraging Member States to pursue sound budgetary policies while allowing sufficient margins for national budgetary flexibility.

The EU fiscal framework provides a combination of numerical and procedural rules enshrined in the Treaty and the Stability and Growth Pact ([1]).

The Maastricht Treaty of 1992 established the requirement for Member States to keep their public deficit below 3 % of GDP and the general government debt level below 60 % of GDP (or diminishing at a satisfactory pace towards this reference value) as well as disciplinary rules to be followed in case a Member State fails to meet these criteria. According to Article 104(3), when assessing a Member State's compliance with these criteria, the Commission shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors. The Stability and Growth Pact, adopted in 1997, further complemented and specified the rules of the Treaty with a view to reinforcing the preventive elements of the framework and inducing Member States to correct excessive deficit positions speedily if they occur.

The 1997 SGP consists of two Council regulations, which are politically underpinned by the resolution of the 1997 Amsterdam European Council. The first regulation ((EC) No 1966/97) on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies constitutes the preventive arm of the Pact. The regulation lays down a monitoring and early-warning system with a view to preventing government deficits from becoming excessive. It requires Member States to achieve and maintain budgetary positions of 'close to balance or in surplus'. This is meant to ensure that fiscal policy contributes to an environment in which monetary policy can effectively maintain price stability whilst being growth supportive. Moreover, by maintaining a budgetary position of 'close to balance or in surplus', Member States would have the necessary room for manoeuvre for cyclical stabilisation through the working of the automatic stabilisers without the 3 % of GDP reference value for deficits being breached (see, for example, Buti and Sapir, 2002). In addition, it would lead to a rapid reduction in the government debt-to-GDP ratio, implying a lower interest burden and creating further scope for governments to pursue growth-enhancing reforms.

In order to allow for a consistent monitoring of the budgetary developments, the regulation requests Member States to submit stability or convergence programmes ([2]). They include the medium-term objective for their budgetary position and describe the adjustment path towards it. In addition, since 2001, the annual updates of the stability and convergence programmes have contained complementary information on the long-term sustainability of public finances.

The Council is at the core of the peer review mechanism established by the Treaty and specified by the Pact. Based on the assessment of the Commission, the Council examines the programmes and formulates an opinion for each Member State. If the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective or the adjustment path towards it, it can decide to address a recommendation to the Member State concerned to take the necessary action.

([1]) For a more detailed description of the EU fiscal rules see Buti and Sapir (1998) and Cabral (2001). On the optimal design of fiscal policy rules, see Kopits and Symansky (1998).

([2]) Member States having adopted the euro submit stability programmes, and the other Member States submit convergence programmes. The main difference between the stability and convergence programmes concerns the quality of the monitoring of implementation. In terms of content, convergence programmes have to provide additional information on the medium-term monetary policy objectives, and price and exchange rate stability (see European Commission, 2000).

The dissuasive dimension of the Pact is laid down in Council Regulation (EC) No 1467/97 ([1]). The main purpose of the regulation is to speed up and clarify the excessive deficit procedure as defined in Article 104 of the Treaty. It introduces a rigorous timetable for the procedure designed to strengthen the dissuasive nature of the Treaty requirements and provide incentives to ensure a sufficient safety margin from the reference value of 3 % of GDP for the government deficit.

Main elements of Regulation (EC) No 1467/97 include the following:

- The definition of the existence of an excessive deficit, including the concepts of 'exceptional and temporary' excess over the reference value and 'severe economic downturn'. According to the regulation, the excess of a deficit can be considered exceptional if it results (a) from an unusual event outside the control of the Member State or (b) from a severe economic downturn. In either case, and provided that the deficit remains close to the reference value, no excessive deficit would be identified.

- The deadlines for the correction of the excessive deficit. The regulation stipulates that within four months the Member State has to take effective action for the correction of an excessive deficit and that the correction of the excessive deficit should be completed in the year following its identification by the Council, unless there are 'special circumstances' ([2]). The latter concept is not specified and leaves discretionary room for decision-making in the Council.

- Rules for the monitoring and assessment of the results of corrective actions taken.

- Deadlines for the subsequent steps in the procedure, including the application of sanctions.

([1]) Council Regulation (EC) No 1467/97 on speeding-up and clarifying the implementation of the excessive deficit procedure.

([2]) See Council Regulation (EC) No 1467/97, Article 3(4).

Box II.1: **Why fiscal rules?**

Unsustainable budgetary positions are a major threat to macroeconomic stability. The experience of lax fiscal policies in several European countries up to the early 1990s had provided evidence of the adverse effects of high public deficits and rising debt levels on economic growth and stability. The existence of large deficits and debt levels tends to push up prices and interest rates, distorts the allocation of resources and constrains the economy's capacity to respond countercyclically in case of an economic downturn. Effective multilateral fiscal rules can play an important role in countering the frequent deficit bias of fiscal policies by providing an external anchor to domestic budgetary reforms.

The formation of the economic and monetary union created additional arguments for fiscal rules at the supranational level. The combination of a single currency and decentralised fiscal policies carried out by sovereign countries calls for enhanced coordination of macroeconomic policies within EMU. With the adoption of a single currency, the potential for economic spillover between the participating Member States, including through the conduct of budgetary policy, increases considerably. At the same time, market discipline tends to diminish as the risk of exchange rate changes and the ability of national central banks to influence the national interest rate of a specific country disappear. Such constellations open the possibility for free-riding and give rise to the risk of moral hazard behaviour. In the absence of fiscal rules, governments in Member States may have an incentive to run overly expansionary policies because the costs in the form of higher interest rates are spread across all members and can be expected to remain muted for the (ir-)responsible country. As a result of such behaviour, the aggregate deficit and debt in the euro area could rise to levels well beyond what is sustainable and socially acceptable. There is also a risk of impairing the functional independence of the European Central Bank (ECB), if Member States were allowed to accumulate unsustainable levels of public debt. High-debt countries, in order to avoid a default with negative repercussions on the euro-area-wide financial market, could de facto force the ECB to either accept a higher level of inflation than warranted (inflationary bail-out) or to bail out the indebted country at the cost of the whole union, despite the no-bail-out rule enshrined in the Maastricht Treaty. (See, for example, Eichengreen and Wyplosz, 1998.)

The regulation focuses on the budget deficit and does not explicitly specify the application of the debt criterion of the Treaty, as compliance with the deficit criterion was deemed sufficient to ensure a satisfactory rate of debt reduction.

The rules of the Pact are embedded in a wider framework of economic governance and coordination in the EU and complemented by a more comprehensive set of policy instruments and rules, both at the EU level (e.g. the broad economic policy guidelines) and at the national level. Moreover, statistical governance, both at the level of the EU and at that of the Member States, including rules concerning the timely provision of correct and comparable budgetary data, is another key element of the EU fiscal framework.

1.3. Improving the implementation of the SGP — The 2005 reform package

The review of the SGP provisions took place against the background of a deteriorating budgetary performance of many EU Member States as well as in light of the changes in economic circumstances of the enlarged EU. By and large, in line with the ideas presented by the Commission in its communication of 3 September 2004 ([1]), the 2005 Ecofin report identifies five areas where improvement is warranted, notably to:

(i) enhance the economic rationale of the budgetary rules to improve their credibility and ownership;

(ii) improve 'ownership' by national policy-makers;

(iii) use more effectively periods when economies are growing above trend for budgetary consolidation in order to avoid procyclical policies;

(iv) take better account in Council recommendations of periods when economies are growing below trend;

(v) give sufficient attention in the surveillance of budgetary positions to debt and sustainability.

([1]) Commission communication 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' (COM(2004) 581 final, 3.9.2004). See, also, Deroose and Langedijk (2005) for a concise presentation of the reasons for reform. An alternative view focusing on effective and full application of the original SGP is presented by Annett et al. (2005).

While some of these objectives could only be achieved by reducing the degree of automaticity of the existing rules and allowing for more economic judgment, the achievement of others is facilitated by adequately strengthening the incentives for compliance and enforcement. Moreover, the Commission, being the guardian of the Treaty and responsible for equal treatment in the application of EU rules, was concerned to ensure that by improving the economic underpinning of the Pact its rules-based character would not be jeopardised. Overall, the agreement reached by the Council reflects a balanced compromise.

The 2005 Ecofin report, endorsed by the European Council, updates and complements the existing SGP. For the implementation of some of the agreed changes, it is necessary to formally amend the Council regulations which underpin the SGP. Beyond these legal changes, the Ecofin report provides guidance for the Member States, the Council and the Commission in the application and interpretation of the Pact provisions. In line with the commitment of the Council to limit legislative changes to a minimum, the report actually suggests only minimal changes to the regulations (including in the preventive arm of the Pact (Regulation (EC) No 1466/97), notably on how to take structural reforms into account in the context of budgetary surveillance, and in the corrective arm of the Pact (Regulation (EC) No 1467/97), notably the new definition of a 'severe economic downturn'; the nature of 'other relevant factors' and the steps of the EDP in which they should be considered; and the extension of the deadlines for taking effective action and measures in the course of the excessive deficit procedure).

Elements designed to improve the economic underpinning and to increase the ownership of the Pact provisions are introduced both in the preventive arm of the Pact and in the application of the rules of the excessive deficit procedure. Moreover, the agreed measures to improve economic, fiscal and statistical governance are cross-cutting by nature. Their main aim is to strengthen the legitimacy and ownership of the Pact and thereby foster its preventive power.

In order to facilitate comparability with the existing Pact, the following three sections review the major modifications of the Pact provisions, by looking in turn at the changes in the preventive and the corrective arms and the measures related to the dimension of fiscal and statistical governance.

1.3.1. Changes in the preventive arm

Both the Commission and the Council considered enhancing the preventive dimension of the Pact a central objective of the reform ([1]). Experience in the run-up to the recent protracted economic slowdown had highlighted the importance of prudent and symmetric-over-the-cycle fiscal policies and, in particular, the need to achieve surpluses in economically good times. Moreover, in light of the increased economic diversification in the EU of 25 Member States, there is a need to better differentiate the medium-term budgetary policy objective according to relevant country-specific features. For lack of economic rationale, uniform budgetary objectives for all countries no longer appeared appropriate.

In response to these challenges, the new agreement includes four major innovations in the preventive arm: (i) the definition of country-specific medium-term objectives within a given range and the procedure to set and revise them; (ii) agreement on a minimum annual budgetary effort for countries that have not yet reached the medium-term objectives; (iii) policy advice by the Commission to encourage Member States to stick to their adjustment path; (iv) the treatment of structural reforms.

These reform elements are designed to enhance the economic underpinning of the EU's medium-term fiscal policies, by providing more room for country-specific considerations. They are intended to raise Member States' compliance with their medium-term objectives. and strengthen the incentives for prudent fiscal policies over the cycle and the implementation of structural reforms. The main modifications in the preventive arm are described below.

(i) Country-specific medium-term objectives

The new definition of the medium-term budgetary objective (MTO) is designed to better take into account the diversity of economic and budgetary positions and risks across Member States. In future, the medium-term budgetary objective of a country will be defined on the basis of its current debt ratio and potential growth, while the overall objective of achieving over the medium term a budgetary position of close to balance or in surplus remains. For Member States having adopted the euro and for those participating in the exchange rate mechanism (ERM II), the agreed range of MTOs is between – 1 % of GDP for countries with a combination of low debt and high potential growth and balance or in surplus for countries with a combination of high debt and low potential growth.

The aim of the new country-specific MTO is threefold. It is designed to provide a safety margin with respect to the 3 % deficit limit, to ensure fiscal sustainability in the long run, and to improve the scope for productive public investment.

By taking into account relevant economic fundamentals, the new provision on the MTO allows for a better differentiation among countries while preserving the simplicity and transparency of the rule. Sustainability risks associated with implicit liabilities are indirectly addressed by ensuring that debt converges towards and remains at prudent values. Member States are thus offered the choice of combining different degrees of structural reform and debt reduction according to national preferences. Incentives for structural reform are not compromised.

The report invites the Commission to continue methodological work on measuring and assessing implicit liabilities and to provide a progress report by the end of 2006. Once criteria and modalities for the assessment of implicit liabilities are established and agreed by the Council, the definition of the MTO will be reviewed with a view to reflecting such implicit liabilities more explicitly in the medium-term objective. As in the past, the MTO is defined in cyclically adjusted terms, net of one-off and temporary measures. The MTO for every Member State will be reviewed every four years and revised in light of the respective developments in government debt, potential growth and fiscal sustainability.

(ii) Minimum annual budgetary effort for countries that have not yet reached the medium-term objectives

Member States of the euro area and of ERM II that have not yet reached their MTO have agreed to achieve, as a benchmark, an annual adjustment of 0.5 % of GDP ([2]). All Member States that have not yet reached their MTO are expected to achieve it over the cycle, by implementing more ambitious fiscal adjustment during good times. The new agreement on a minimum budgetary effort

([1]) See the Council declaration on the Stability and Growth Pact of 18 June 2004 and the Commission communication of 3 September 2004.

([2]) Measured in cyclically adjusted terms, net of one-off and other temporary measures.

underpins the medium-term orientation of the European fiscal rules. The 1997 Pact provisions contain no explicit reference to the appropriate adjustment path.

The 2005 Ecofin report contains, furthermore, a commitment of Member States for the conduct of more symmetric fiscal policies over the cycle. Governments have agreed to pursue active consolidation of the budget when the economic conditions are favourable, i.e. in 'good times', and to use windfall revenues, as a rule, for the reduction of government deficit and debt. The report defines 'good times' as periods during which actual GDP growth is above potential growth, 'taking into account tax elasticities'. This implies that the magnitude of consolidation in good times will depend on the actual impact of growth on public revenues. The latter is largely determined by the composition of the sources of growth.

(iii) Early-warning system

With a view to strengthening the preventive character of the Pact, the 2005 Ecofin report clarifies and expands the existing early-warning mechanism. The report expects the Commission to issue direct, i.e. without prior Council involvement, policy advice to encourage Member States to realise the agreed adjustment path. Accordingly, the Commission will address the Council in future not only if there is an acute risk of breaching the 3 % of GDP reference value, but also in cases of unjustified deviations from the adjustment path towards the MTO or the MTO itself, including in good times. The agreement pertains to the transition period until the new Constitution becomes effective. Once it is in force, the instrument of 'policy advice' will be replaced by a Commission 'opinion' in line with the new Article III-184(5), directly addressed to the Member State concerned.

(iv) Structural reforms

With a view to eliminating possible disincentives for structural reforms, the Council agreed that, under certain conditions, certain structural reforms can justify a temporary deviation from the MTO and, for Member States that have not yet reached their MTO, temporary deviations from the adjustment path towards the MTO.

Provided that respect of the 3 % of GDP reference value is not jeopardised and the budgetary position is expected to return to the MTO within the four-year programme period, the Council, when assessing the MTO or the adjustment path towards it, will take into account major structural reforms. Only major structural reforms that have direct long-term cost-saving effects and verifiably improve fiscal sustainability over the long term will be considered. This rule pertains, in particular, to systemic reforms of the pension scheme of a Member State. Such reforms typically imply budgetary costs in the short run to the benefit of lower ageing-related implicit liabilities in the long run. Significant other supply-side reforms that raise potential growth can also be considered. These modifications should be seen in the context of increasing the consistency of the various policy objectives and instruments at the EU level, in particular with the objectives of the Lisbon strategy.

In order to allow the Commission and the Council to scrutinise the envisaged structural reforms and assess their impact on the MTO and the adjustment path towards it, Member States will be requested to provide detailed documentation of the expected cost–benefit effects of the envisaged reforms in the context of the annual updates of stability and convergence programmes. It is furthermore envisaged to give the Council three, instead of two, months for the examination of the programmes following their submission.

1.3.2. Changes in the corrective arm

The main modifications in the corrective arm of the Pact concern: (i) the definition of 'excessive deficits', including the revision of the concept of 'severe economic downturn' and the role of 'other relevant factors'; (ii) the possible extension of the existing one-year deadline for the correction of an excessive deficit following its identification by one year and the introduction of repetition of steps in the EDP; (iii) considerations related to the assessment of systemic pension reforms in the EDP; and (iv) focus on debt and fiscal sustainability.

Many commentators have criticised the revisions in the excessive deficit procedure as a significant weakening of the dissuasive dimension of the Pact. It is argued that, in particular, the agreement on the application of other relevant factors de facto erodes the 3 % of GDP reference value, and that the lack of constraint would give rise to growing deficits in the future ([1]). However, such an assessment overlooks key elements of the new 2005 reform.

([1]) See, for example, Feldstein (2005) and Deutsche Bundesbank press release of 21 March 2005.

Table II.1

Main changes to the Stability and Growth Pact following the Council agreement of 20 March 2005

	Original	Revised
1. Changes in the preventive arm		
Medium-term objective (MTO)	All Member States (MS) have a medium-term budgetary objective of 'close to balance or in surplus'.	• Country-specific differentiation of MTOs according to stock of public debt and potential growth. • MTOs for euro-area and ERM II MS are set between – 1 % of GDP and balance or in surplus (in cyclically adjusted terms and net of one-offs). • Implicit liabilities to be taken into account at a later stage, when modalities for doing so are agreed by the Council.
Adjustment path towards the MTO	No specific provisions.	• MS to take active steps to achieve the MTO. • Annual minimum adjustment for MS of the euro area or of ERM II of 0.5 % of GDP. • The effort should be higher in 'good times'. • 'Good times' are identified as periods where output exceeds its potential level, 'taking into account tax elasticities'.
Early policy advice	Early warnings are adopted/addressed by the Council, upon recommendation of the Commission.	In addition, the Commission can issue direct 'early policy advice' to encourage MS to stick to their adjustment path. To be replaced by 'early warnings' in accordance with the Constitution once applicable.
Structural reforms	No specific provision.	Reforms will be taken into account when defining the adjustment path to the MTO and may allow a deviation from it under the following conditions: • only major reforms (direct/indirect impact on sustainability); • safety margin to the 3 % reference value is guaranteed; • the deficit returns to the MTO within the programme period; • detailed information is provided in the stability/ convergence programmes. Special attention to systemic pension reforms.
2. Changes in the corrective arm		
Preparing a report under Article 104(3)	No obligation for the Commission to prepare a report if a deficit exceeds 3 %.	• The Commission will always prepare a report in cases where there is a deficit above 3 %. • The report will examine whether the exceptions in Article 104(2) apply. • It will take into account whether the deficit exceeds government investment expenditure and all 'other relevant factors'.
Severe economic downturn	'Severe economic downturn' if there is an annual fall in real GDP of at least 2 % for the preparation of the report under Article 104(3) by the Commission, and in decisions under Article 104(6) by the Council, if observations by the Member State concerned show that the downturn is exceptional in light of evidence of the abruptness of the downturn and the accumulated loss of output with respect to past trends. The MS commit not to invoke the severe economic downturn when growth is above – 0.75 %.	An economic downturn may be considered 'severe' in cases of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth.

(Continued on the next page)

Table II.1 (continued)

	Original	Revised
'Other relevant factors' (ORFs)	No specific definition of 'ORFs' and their role in the excessive deficit procedure.	• The Commission report under Article 104(3) will take into account: – developments in the medium-term economic position (potential growth, cyclical conditions, implementation of policies); – developments in the medium-term budgetary position (public investment, quality of public finances, as well as fiscal consolidation in 'good times', debt sustainability); – any other factors, which, in the opinion of the MS, are relevant in order to assess the excess over the reference value. • ORFs will be considered in the steps from Article 104(4) to (6) only if the excess over the reference value is temporary and the deficit remains close to the reference value. Any deficit above 3 % that is neither close to the reference value nor temporary will be considered excessive. • If the Council has decided that an excessive deficit exists, the ORFs will also be considered in the subsequent procedural steps of Article 104 (except in Article 104(12), i.e. abrogation, and when deciding to repeat steps in the EDP).
Systemic pension reforms	No specific provision.	• These are treated like an ORF, but under strict conditions also with a role in abrogation. • Consideration to the net cost of the reform will be given regressively for the initial five years after an MS has introduced the reform (or five years after 2004).
Increasing the focus on debt and sustainability	No specific provision.	• The debt criterion, and in particular the concept of a debt ratio 'sufficiently diminishing and approaching the reference value at a satisfactory pace', will be applied in qualitative terms. • The Council will formulate recommendations on the debt dynamics in its opinions on the stability and convergence programmes.
Extending deadlines for taking effective action and measures		• Deadlines are extended: for a decision under Article 104(6) — from three to four months after notification; • for taking effective action following Article 104(7) — from four to six months; • for moving to Article 104(9) — from one to two months; • for taking action following a notice under Article 104(9) — from two to four months.
Minimum fiscal effort	No specific provision.	Countries in excessive deficit are required to achieve a minimum fiscal effort of at least 0.5 % of GDP as a benchmark.
Initial deadline for correcting the excessive deficit	The excessive deficit has to be corrected in the year following its identification, unless there are 'special circumstances'.	The rule remains; possible extension by one year based on ORFs and on the condition that minimum fiscal efforts have been taken.
Repetition of steps in the EDP	Not foreseen.	Deadlines for correcting the excessive deficit can be extended if: • effective action has been taken by the MS concerned in compliance with the initial recommendation or notice, and • unexpected adverse economic events with major unfavourable budgetary effects occur during the correction phase.

Source: Commission services.

In practice, the room for discretionary judgment in the excessive deficit procedure to better capture economic reality, including the consideration of the agreed wider set of 'other relevant factors' or the possibility to incur a repetition of procedural steps, is effectively constrained by complementary provisions of the new agreement, preserving the character of the rules-based system. Firstly, both the Commission, when considering whether an excessive deficit exists or may occur, and the Council, when deciding on the existence of an excessive deficit, will take into account any relevant factors only if the general government deficit remains close to the reference value and its excess over the reference value is temporary.

Secondly, there will be no simple discounting of certain categories of public expenditure from the deficit calculations. Other relevant factors are always considered in an overall assessment, in which a large number of factors, including those that may call for a stricter interpretation of the deficit figures, are examined symmetrically to assess compliance with budgetary discipline.

Thirdly, Member States in excessive deficit are requested to achieve a minimum annual budgetary effort of 0.5 % of GDP ([1]) irrespective of relevant factors.

Fourthly, the Commission will always issue a report under Article 104(3) if the deficit of a Member State exceeds 3 % or if it sees a risk of an excessive deficit.

Finally, the obligation of the Council to impose sanctions in cases where a Member State in excessive deficit repeatedly fails to act in compliance with the successive decisions of the Council remains unchanged as the ultimate threat against non-compliance. The various modifications in the corrective arm are presented in more detail below.

(i) Definition of 'excessive deficits'

The identification of an excessive deficit is the cornerstone of the SGP's dissuasive arm. According to Article 104(2a) of the Treaty (and the protocol on the excessive deficit procedure), a government deficit above 3 % of GDP is considered to be excessive unless the excess over the 3 % is only exceptional and temporary and the government deficit ratio remains close to the reference value ([2]). Existing Council Regulation (EC) No 1467/97 specifies in Article 2 that the excess over 3 % can be considered exceptional if it results (a) from an unusual event outside the control of the Member State (e.g. a natural disaster) or (b) from a severe economic downturn, which is defined as an annual fall in real GDP of at least 2 % (Article 2(2). In order for the excess to be considered temporary, the Commission's forecast must indicate that the deficit will fall back below the reference value following the end of the unusual event or the severe economic downturn. The Commission's usual forecasting period is two years.

'Severe economic downturn' redefined

In order to reformulate the exceptionality clause more in line with economic reality in the EU Member States, the Council agreed to make the condition of 'severe economic downturn' less demanding and suggested adapting Article 2(2) and (3). Accordingly, both the Commission and the Council, when assessing and deciding on the existence of an excessive deficit according to Treaty Article 104(3) to (6), may consider as exceptional in the sense of Article 104(2a) an excess over the reference value 'which results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential growth'. However, the overarching conditions of 'close to the reference value' and 'temporariness' continue to apply.

The role of 'other relevant factors' clarified

Moreover, with a view to ensuring a balanced and comprehensive assessment of the budgetary developments in the context of the economic and fiscal conditions prevailing in a country, the 2005 Ecofin report clarifies a set of 'other relevant factors' that the Commission and the Council will take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction ([3]). In particular, the Commission when preparing the report under Article 104(3), which initialises the excessive deficit procedure, 'should appropriately reflect developments in the medium-term economic position (in particular, potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to

([1]) In cyclically adjusted terms net of one-off and temporary measures.

([2]) See Cabral (2001) for details.

([3]) The Treaty provisions on the excessive deficit procedure (Article 104) include the concept of other relevant factors. However, in practice, it did not play a significant role in the excessive deficit procedures in the past.

foster research and development and innovation) and developments in the medium-term budgetary position (in particular, fiscal consolidation efforts in "good times", debt sustainability, public investment and the overall quality of public finances)'.

Furthermore, the Commission shall give 'due consideration' 'to any other factors, which in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value'. Such factors may include 'budgetary efforts towards increasing, or maintaining at a high level, financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe'.

Once the Council has taken the decision that an excessive deficit exists, 'the other relevant factors will also be considered in the subsequent steps' of the procedure, including in the decision on the appropriate deadline for the correction of the excessive deficit and the assessment of effective action, but not 'in the decision of the Council whether a Member State has corrected its excessive deficit'.

The 2005 Ecofin report stresses that other relevant factors are taken into account only under the condition that 'the excess over the reference value is temporary and the deficit remains close to the reference value'. In other words, if a deficit above 3 % exceeds what is considered 'close to the reference value' or if there is no indication in the budgetary forecast provided by the Commission that the deficit will fall below the reference value, the presumption prevails that an excessive deficit exists despite all 'other relevant factors', and the Council shall decide accordingly.

(ii) Deadlines and repetition of steps in the excessive deficit procedure

The 1997 Pact provisions are characterised by a high degree of automatism both with respect to the timing and the sequence of the respective steps in the EDP. The 2005 Ecofin report, while upholding the principle that an excessive deficit should be corrected promptly, introduces more flexibility to respond to changes in economic circumstances. The new agreement sticks to the provision that, as a rule, an excessive deficit should be corrected the year after it is identified by the Council, i.e. usually the second year after it occurs. However, in cases where a correction in the consecutive year would be unwarranted for economic reasons, the Council may decide to set the deadline for the correction of the excessive deficit in the second year after its identification. When deciding on the appropriate deadline for the correction of the excessive deficit, the other relevant factors analysed by the Commission in its report under Article 104(3) will be taken into account.

The increased flexibility with respect to setting the initial deadline for correction is counterbalanced by the Council agreement that, as a benchmark, countries in excessive deficit have to implement a minimum fiscal adjustment of at least 0.5 % of GDP [1] irrespective of the existence of other relevant factors. The Council, on the basis of a recommendation of the Commission, can intervene at any time, if it finds that the action implemented by the country concerned is inadequate to bring the excessive deficit to an end as recommended, and move to the next step in the procedure.

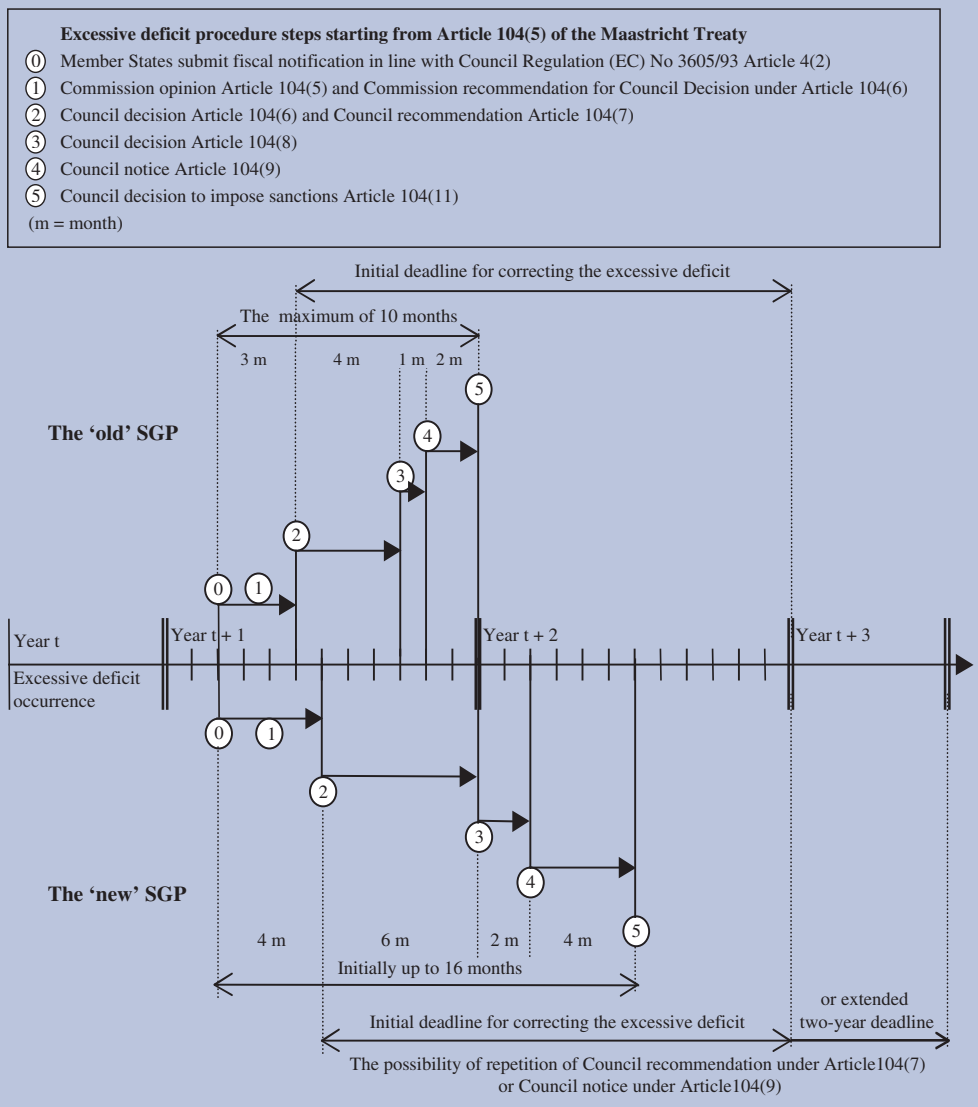
With a view to allowing both the Commission and the Council to provide an appropriate assessment of all aspects, the delay for adoption of a decision under Article 104(6) establishing the existence of an excessive deficit is extended from three to four months after the notification deadline. By the same token, to facilitate the effective adoption of more comprehensive consolidation packages in the context of national budgetary processes, the delay for taking effective action is extended from four to six months. For the same reasons, the one-month deadline for the Council to take a decision to move from Article 104(8) to Article 104(9) is extended to two months, and the two-month deadline under Article 104(9) to four months. As a result, the overall maximum period of 10 months within which the Council is obliged to take a decision to impose sanctions in cases where a Member State participating in the euro area fails to comply with the successive decisions of the Council [2] is effectively extended to 16 months.

The 2005 Ecofin report also introduces the possibility of repeating steps in the excessive deficit procedure, thereby correcting what has been seen as one of the main sources of rigidity of the current Pact.

In cases where an unexpected adverse economic event with a considerable negative impact on the budget hits a

(1) In cyclically adjusted terms, and net of one-off and other temporary measures.
(2) Council Regulation (EC) No 1467/97, Article 7.

Graph II.1: **Extended deadlines for the steps in the EDP**



Source: Commission services.

country in the course of correcting its excessive deficit, the deadlines initially agreed by the Council following Article 104(7) or (9) can be revised and expanded.

However, a repetition of these steps can only be invoked under the provision that effective action has been taken by the country concerned in compliance with the initial recommendation or notice. This implies that, as a minimum, measures of the magnitude of 0.5 % of GDP in cyclically adjusted terms, net of one-off and other temporary measures, must be in place.

(iii) Taking into account systemic pension reforms

In line with the provisions concerning the treatment of so-called second-pillar pension reforms in the definition of the MTO, the 2005 Ecofin report commits the Council and the Commission to 'consider carefully' in the

context of the EDP an excess close to the reference value caused by the introduction of a multi-pillar pension system that includes a mandatory, fully funded pillar.

In particular, when assessing whether the excessive deficit has been corrected, the Commission and the Council will compare the developments of the nominal deficit figures under the EDP with the net costs related to the implementation of the second pillar.

Over the first five years after the implementation of such a reform, and following a regressive mode, the deficit figures can be corrected for the net costs of the pension reforms. The correction will be for 100 % of the net costs in the first year, for 80 % in the second year, and for 60, 40, and 20 % in the third, fourth and fifth years respectively. For Member States that have already implemented such reforms, the same five-year mechanism would apply, starting in 2005.

While these provisions are generally designed to provide further incentives for increasing the long-term sustainability of pension systems, they pertain particularly to a number of new Member States which have recently started with the build-up of a fully funded second pillar. While most of these countries are currently in EDP, a certain proportion of the excessive deficit is attributable to the pension reform. Thus, the agreement reached by the Council on the treatment of second-pillar pension reforms in the EDP may have implications for the assessment of fiscal convergence in line with the deficit criteria laid down in the Treaty for deciding on membership in the euro area.

(iv) Focus on debt and fiscal sustainability

The Commission intends to apply in full the provisions of the Treaty. Under the current legal provisions, according to Article 104(2) of the Treaty, the Commission monitors whether the debt ratio exceeds the reference value and, if so, whether it is sufficiently diminishing and approaching the reference value at a satisfactory pace. The Commission has the possibility, where it is of the opinion that there is an excessive deficit for non-compliance with the debt criterion, to recommend to the Council to take a decision on the existence of an excessive deficit according to Article 104(6) of the Treaty.

The 2005 Ecofin report recalls the Commission's obligation to examine compliance with budgetary discipline on the basis of both the deficit and the debt criterion and reaffirms the need to reduce government debt to below 60 % of GDP at a satisfactory pace. The Council calls, in particular, for a strengthening of the debt surveillance framework by applying the Treaty's concept of 'sufficiently diminishing and approaching the reference value at a satisfactory pace' for the debt ratio in qualitative terms. This implies that macroeconomic conditions, in particular the level of potential growth and the cyclical position, and debt dynamics should be taken into account, including the pursuit of appropriate levels of primary surpluses as well as other measures to reduce gross debt, including one-off and other temporary measures, and debt management strategies. Following such an approach avoids a mechanistic interpretation of gross debt figures.

In cases where the Council identifies a situation of non-compliance with the debt criterion, it will formulate a recommendation in the context of the Council opinions on the stability programme.

1.3.3. Improving governance

The 2005 Ecofin report recognises that modifications to the provisions of the Pact are not sufficient to ensure a meaningful improvement of their implementation. In order to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline, it is important that complementary measures are taken to enhance the institutional conditions for fiscal and statistical governance. The report contains a number of elements designed to increase the ownership of the Pact provisions and clarify the respective roles and responsibilities of the various actors involved as well as measures to improve the quality and timeliness of statistical data, both at the national and at the EU level.

(i) Fiscal governance

The 2005 Ecofin report stresses that increasing the effectiveness of peer support and pressure is an integral part of a reformed Stability and Growth Pact. With a view to strengthening the central peer support functions of the Pact, the Council and the Commission are committed to explaining publicly their positions and decisions at all appropriate stages of the fiscal surveillance procedure established by the Treaty and the Pact.

The report highlights, furthermore, the importance of national budgetary rules complementing Member States' commitments under the Stability and Growth Pact at the EU level. It suggests that national institutions

could play a more prominent role in domestic budgetary surveillance, thereby underpinning and complementing the monitoring and surveillance procedures at EU level. A more effective mobilisation of the national public opinion is seen as a useful measure to strengthen national ownership and enhance enforcement.

Following the same rationale, it is foreseen that a new government taking office will show continuity with respect to the budgetary targets endorsed by the Council on the basis of the Member State's previous update of the stability/convergence programme. When the new government prepares its first update of the programme, it is expected to present its budgetary strategy, outlining the means and instruments which it intends to employ to achieve the agreed targets.

With due respect to the subsidiarity principle, the report suggests a greater involvement of national parliaments in the EU fiscal surveillance process. It invites Member State governments, in particular, to present to their national parliaments their stability or convergence programme and the respective Council opinions thereupon, and to discuss with the national parliaments the follow-up to recommendations in the context of the early-warning and excessive deficit procedures.

In order to facilitate better differentiation between forecasting and policy errors, Member States are requested in future to include more comprehensive sensitivity analysis and/or develop alternative scenarios in their respective stability and convergence programmes. This will enable the Commission and the Council to consider a wider range of possible fiscal outcomes.

In this context, the report points to the important contribution that Commission forecasts can provide for the coordination of economic and fiscal policies. It calls, in particular, on the Member States of the euro area and ERM II to use the 'common external assumptions' provided by the Commission in its forecasts. More generally, Member States are called upon to explain divergences in the national and the Commission forecasts in their stability or convergence programmes and their respective updates, and also to assess possible forecast errors.

(ii) Statistical governance

The 2005 Ecofin report recognises that the credibility and implementation of the fiscal framework rely crucially on the availability of correct and reliable fiscal data. Transparent budgetary statistics are also seen as instrumental in enabling financial markets to better assess and distinguish the creditworthiness of the different Member States, thus providing an important signalling device for policy errors.

The report recalls, in particular, the need to have in place adequate practices, resources and capabilities to produce high-quality statistics at the national and European level and to ensure the independence, integrity and accountability of both national statistical offices and Eurostat. With respect to Eurostat, the report emphasises the importance of further developing its operational capacity, monitoring power, independence and accountability.

Given the crucial importance of reliable data for the functioning of the EDP and in order to avoid moral hazard behaviour, the report makes reference to the possibility of invoking sanctions, to be considered in cases of an infringement of the obligations to duly report government data.

The Commission and the Council pursue the objective of improving the governance of the European statistical system in parallel with the reform of the SGP. In December 2004, the Commission presented three main lines of action towards a European governance strategy for fiscal statistics ([1]). They include the further elaboration of the legal framework related to the reporting of fiscal data; the development of European standards for the institutional set-up of statistical authorities; and, finally, the provision of additional resources to enable the relevant Commission services to enhance their activity level with respect to budgetary surveillance and the verification of the quality of budgetary statistics (see Box II.2 on strengthening the governance of budgetary statistics).

1.4. An assessment of the 2005 SGP reform according to criteria for an optimal fiscal policy rule

Buti et al. (2003) assess the design and compliance mechanisms of the Stability and Growth Pact rules against the set of eight criteria for an ideal fiscal rule established by Kopits and Symansky (1998). They conclude that EU fiscal rules appeared to fare relatively well against the Kopits–Symansky criteria. The SGP's

([1]) See the Commission communication 'Towards a European governance strategy for fiscal statistics' (COM(2004) 832, 22.12.2004).

strongest point was its simplicity while its weakest aspects concerned enforceability and support of structural reforms. Buti et al. highlight the existing trade-offs between the various criteria, namely between simplicity and flexibility, between simplicity and adequacy, and between flexibility and enforceability. These trade-offs are influenced by the multinational setting in which the rules are applied. In particular, Buti et al. argue that a multiplicity of countries increases heterogeneity and dispersion of preferences with the consequence that a one-size-fits-all fiscal rule is likely to be suboptimal.

Against this background, the 2005 reform of the SGP, as reflected in the Ecofin report, can be tentatively assessed. Overall, the analysis suggests that the changes result in a broadly balanced set of new rules. Table II.2 shows that the Kopits–Symansky (KS) score deteriorated on the criteria on which the SGP scored high in the assessment of Buti et al. In particular, it appears that in comparison with the original Pact, the new provisions are less well defined, contain a higher risk of interpretative ambiguity, and are less transparent and more complex. On the other five criteria, where the ratings had been less positive, its score improved.

***KS-1* —** A **well-defined** fiscal rule, in terms of the indicator to be constrained, institutional coverage and escape clauses, is paramount for effective enforcement. Whereas the Treaty criteria remain well defined as to the policy variables subject to constraints (i.e. budget balance and gross public debt) and the institutional coverage (i.e. general government), the escape clauses specified by the SGP are widened and subject to some more ambiguity. The concepts of closeness and temporariness are activated, but not fully specified; overall judgment of 'other relevant factors', as well as of 'cumulative loss of output' to identify a severe economic downturn, is introduced in the decision on the existence of an excessive deficit; room for judgment is introduced in setting the deadline for correction of the excessive deficit. On the other hand, the SGP medium-term objectives, which remained vague under the 1997 SGP, are specified. Moreover, the fiscal adjustment required both in the excessive deficit procedure and towards the medium-term objective is specified, while additional judgment is introduced by allowing for the consideration of structural reforms. The SGP remains silent on how to apply the excessive deficit procedure in the case of violation of the public debt criterion of the Treaty which requires the debt ratio to be on a declining trend as long as it is above the 60 % of GDP reference value. Overall, the adjustments of the SGP which introduced more room for judgment have resulted in a deterioration against the KS criteria of a well-defined system.

***KS-2* — Transparency** has several dimensions. For fiscal rules to score high on transparency, they need to include provisions on accounting conventions, forecasting exercises, reporting practices, and interpretation of data. The Treaty and the SGP continue to be based on ESA 95 accounting. The Commission's forecasts are the reference point for assessing the risk of an excessive deficit or for detecting a 'significant divergence' from the set of budgetary targets. The respective roles of Commission and national forecasts in the assessment of stability and convergence programmes and in the EDP (repetition of steps) have been partly clarified. However, increased use of non-measurable indicators in the assessment, in order to allow for a richer judgment of the economic and budgetary circumstances, reduces transparency. The 2005 reform of the SGP formalises the practice of previous years to increasingly use cyclically adjusted measures, indicators of implicit and contingent liabilities and estimates of potential growth which are all subject to uncertainty. In addition, the assessment of structural reforms for which no conventions or reporting practices exist reduces transparency of the fiscal rules. The reform of the statistical governance, on the other hand, addresses moral hazard problems and incentives for creative accounting by enhancing statistical surveillance. Overall, the more complex and richer framework with increasing importance of non-measurable and uncertain indicators, in addition to the data based on ESA 95 accounting, will reduce transparency.

***KS-3* —** The EU fiscal rules were **simple** and easily understandable. Some of the simplicity has been lost by introducing room for judgment in the decision on the existence of an excessive deficit and in the adjustment path. The large range of possible relevant factors which need to be assessed renders the system more sophisticated and complex. In addition, the factors mentioned under KS-1 and KS-2, affecting transparency and the concept of a well-defined framework, also affect simplicity. On the other hand, the agreement that the Commission shall always prepare a report under Article 104(3) if the EDP deficit exceeds the 3 % of GDP reference value is straightforward. It enhances simplicity and clarifies accountability in decision-making. Overall, the increased room for judgment and the wider range — and more uncertain nature — of indicators that are assessed imply increased complexity of the rules.

Box II.2: Strengthening the governance of budgetary statistics

Main elements of the governance of budgetary statistics. The main elements of the governance of budgetary statistics in the EU were described in Part II, Chapter 4, of the 2003 edition of the report 'Public finances in EMU'. They consist in: (i) a consistent set of accounting rules; (ii) the Commission authority in providing the data for budgetary surveillance, though statistics are compiled from basic sources by the national authorities in compliance with the principle of subsidiarity; (iii) well-defined deadlines for the transmission of the main government figures — i.e. deficit and debt — as well as for the transmission of the complete underlying accounts; (iv) the role of Eurostat in the assessment of the quality of data reported by Member States; and (v) multilateral discussion of methodological issues within the Committee on Monetary, Financial and Balance-of-Payment Statistics (CMFB). The 2003 report also described developments such as the adoption by the Ecofin Council, on 18 February 2003, of a code of best practice and a number of steps towards the compilation of government accounts with quarterly frequency.

Some progress … In the meantime, there has been progress notably concerning the timeliness, completeness and consistency of government accounts. There have also been important decisions concerning the accounting of innovative and complex transactions — for example, public–private partnerships — and the government delimitation, for example in relation to the reform of pension systems. A major achievement was the remarkably smooth integration of new Member States into the transmission and validation of fiscal statistics. As regards the compilation of quarterly accounts and their use in budgetary surveillance — which were characterised in the 2003 report as a medium-term project and a major challenge for the future — there have also been some steps forward. Quarterly government revenue and expenditure accounts are already available for the euro area ([1]), though data per country are under embargo until the end of 2005; the quarterly government debt is available for most countries.

… but evidence of data quality problems. However, evidence of substandard quality in the budgetary statistics of some Member States — which materialised notably in the exceptionally large revision in the Greek government accounts in 2004 ([2]) — the discrepancies in the accounts of some Member States ([3]) and the ensuing suspicions about the quality of budgetary data have led the Council and the Commission to propose strengthening the governance of these statistics.

The Council calls for action. On 2 June 2004, the Ecofin Council noted that 'reliable fiscal statistics are essential for the credibility of the excessive deficit procedure (EDP). The EDP notification of March 2004 showed rather good compliance with the code of best practice as regards the reporting deadlines. There was also a considerable improvement in the availability of detailed data on the government subsectors …'. However, 'on several occasions, fiscal statistics have been revised after a new government took office. The Council considers that the compilation and reporting of statistics for the EDP must not be vulnerable to political and electoral cycles'. Therefore, 'the Council invites the Commission to strengthen the monitoring of the quality of reported fiscal data and report back to the Council before the end of the year 2004'.

From a more general perspective, the Council also concluded that 'high-quality statistics are fundamental for European policies. The Council considers that integrity, independence and accountability of data compilers, and the transparency of the compilation methods, underpinned by the appropriate institutional arrangements, are crucial to ensure such high-quality statistics. It would therefore be recommendable to develop minimum European standards for the institutional set-up of statistical authorities. The Council invites the Commission to make, by June 2005, a proposal for such standards, which reinforce the independence, integrity and accountability of Member States' national statistical institutes. These standards should also help to address the specific concerns on the quality of fiscal statistics'. The importance given by policy-makers to the quality of budgetary statistics is illustrated by the fact that this topic was also in the agendas of the 10 September and 7 December 2004 and 17 February 2005 Ecofin Council meetings.

([1]) See Table 6.4 of the ECB monthly bulletins (euro-area statistics).
([2]) See Box I.1 on the revision in the Greek accounts.
([3]) See Part II, Section 2.2, of this report for a detailed discussion on the stock-flow adjustments in the EU Member States.

(Continued on the next page)

Box II.2 (continued)

The Commission proposes three lines of action. The Commission response to the Ecofin Council conclusions was outlined in the communication 'Towards a European governance strategy for fiscal statistics' ([4]) adopted on 22 December 2004. The Commission strategy involves three lines of action: (i) building-up the legislative framework; (ii) the development of the operational capacity of the Commission; (iii) the preparation of European standards on the independence of statistical institutes. The rest of this box elaborates on the first and third items of this strategy. The second line of action consists mainly of increasing the resources devoted to budgetary surveillance and to checking the quality of budgetary statistics in the relevant Commission services (Eurostat and the Economic and Financial Affairs DG).

Completing the legal framework. On 2 March 2005, the Commission adopted a proposal for a Council regulation which is intended to strengthen the quality of the statistical data for the excessive deficit procedure ([5]). The proposal consists of amending Council Regulation (EC) No 3605/93, which is the legal act governing the reporting of fiscal data for the EDP. The amended regulation will enter into force after formal adoption, by qualified majority, by the Ecofin Council. The European Parliament and the ECB are also participating in the adoption of this regulation as they are required to prepare non-binding opinions.

Regulation (EC) No 3605/93 currently has two sections on (1) definitions and (2) rules and coverage of reporting. According to the Commission proposal, these two sections will be kept basically unchanged. However, Section 2 will be completed with two new articles establishing the Member States' obligation to report and properly document revisions in data, and clarifying that the tables transmitted by Member States are public.

The Commission proposes to add three new sections (3, 4 and 5) to the regulation. Section 3 establishes a number of processes to check that data compiled and reported by national authorities comply with the accounting rules and are reliable, complete and consistent. In a number of respects, the proposal enshrines existing practices, such as the preparation and publication by the national authorities of statistical inventories for government accounts ([6]), the regular dialogue between Eurostat and the Member States' statistical authorities, and a procedure involving the CMFB when there is a need to complete and clarify the accounting rules. However, the proposal goes further than existing practice by establishing further visits, during which Eurostat will look at the detailed economic data which justify the reported figures. The association of experts from other Member States to these visits will broaden the expertise. Moreover, transparency will be ensured by making public the conclusion of the quality assessment ([7]).

Section 4 clarifies the provision in the Treaty protocol, according to which the statistical data for the EDP are provided by the Commission. The provision of data is done by Eurostat, by publishing the data three weeks after the deadlines for the transmission of data by the Member States. The new section makes clear that the Eurostat task is not simply to reiterate Member States' figures; it can publicly raise reservations to the data transmitted by Member States in case there is enough evidence that data compiled by the national authorities are of substandard quality, or even unilaterally amend these data in case reported figures do not comply with the rules and there is sufficient information to provide alternative estimates.

Section 5 answers specifically concerns on the vulnerability of fiscal statistics to political cycles. It establishes that the compilation of fiscal statistics data is done in accordance with a number of principles, most notably impartiality ([8]) and that the officials responsible for the compilation of government accounts should abide by these principles.

([4]) COM(2004) 832.

([5]) COM(2005) 71.

([6]) Statistical inventories are documents prepared by the national statistical authorities, describing the methods, procedures and sources for the compilation of statistics. Rather than a description of the accounting rules, the inventories should detail how Member States apply the rules, which services provide which data, the estimation procedures to deal with missing data, etc.

([7]) In the communication of 1 December 2004 (COM(2004) 784), the Commission acknowledged that discussions on the quality of fiscal statistics often took place within a restricted circle of statisticians and were not effectively communicated to the political level and to the public.

([8]) According to Council Regulation (EC) No 322/97 on Community statistics, statistics shall be compiled according to the principles of impartiality, reliability, relevance, cost-effectiveness, statistical confidentiality and transparency. Specifically, impartiality means that data are compiled 'in an objective and independent manner, free from any pressure from political or other interest groups'.

(Continued on the next page)

Box II.2 (continued)

European standards for the statistical institutes. The third line of action — which covers all economic statistics and not simply fiscal data — concerns the development of European standards for the institutional set-up of statistical authorities. Such standards should reinforce the independence, integrity and accountability of statistical institutes, which should improve trust and confidence in statistical authorities and the credibility and quality of their statistics. On 24 February 2005, the Statistics Programme Committee (SPC), comprising the directors-general of the national statistical institutes and of Eurostat, unanimously adopted a European statistics code of practice. This code of practice includes 15 principles ranging from professional independence of data compilers, statistical confidentiality, impartiality and objectivity, accuracy, reliability and timeliness of data to adequacy of resources of statistical institutes. On 25 May 2005, the Commission endorsed this code, recommending that Member States recognise it as a common set of standards at the European level for statistical authorities, and intends to set up a reporting system to monitor adherence within the European statistical system ([9]).

([9]) Communication from the Commission to the European Parliament and to the Council and recommendation on the independence, integrity and accountability of the national and Community statistical authorities (COM(2005) 217).

Table II.2

Trade-offs according to good fiscal policy rule criteria

Kopits and Symansky (1998) criteria	Buti et al. (2003) assessment of the SGP	Impact of the 2005 reform on fulfilment of the criteria
Well-defined: no ambiguous definitions, competence divisions or escape clauses	+ +	(–)
Transparent: data reporting and data analysis according to the same rules/ procedures; no interpretation problems	+ +	(–)
Simple: rules being easily understandable and observable	+ + +	(–)
Flexible: allow for capturing of the impact of important influences not captured in the framework, making its application less mechanistic	+ +	(+)
Adequate to goal: rules should not be too broad nor too narrow; legal instruments should be capable of obtaining the goal	+ +	(+)
Enforceable/credible: rules should be credible; application impartial; susceptible to subjective pressures	+	(+) ([1])
Consistent — internally and with other policy objectives	+ +	(+)
Supportive of structural reforms: rules should take due account of the importance of structural reforms for the economy	+	(+)

([1]) The (+) assessment of the enforceability/credibility of the rules is compared with the situation existing after November 2003.
NB: Buti et al. (2003) assessment: +++ very good, ++ good, + fair. Assessment of the 2005 reform of the SGP: (+) improvement, (–) deterioration.

KS-3 — The EU fiscal rules were **simple** and easily understandable. Some of the simplicity has been lost by introducing room for judgment in the decision on the existence of an excessive deficit and in the adjustment path. The large range of possible relevant factors which need to be assessed renders the system more sophisticated and complex. In addition, the factors mentioned under KS-1 and KS-2, affecting transparency and the concept of a well-defined framework, also affect simplicity. On the other hand, the agreement that the Commission shall always prepare a report under Article 104(3) if the EDP deficit exceeds the 3 % of GDP reference value is straightforward. It enhances simplicity and clarifies accountability in decision-making. Overall, the increased room for judgment and the wider range — and more uncertain nature — of indicators that are assessed imply increased complexity of the rules.

KS-4 — A number of factors have been adjusted allowing more **flexibility** in different stages and parts of the fiscal framework. The tight specification of the escape clauses of the 'severe economic downturn' has been widened, allowing judgment by the Commission and Council. Also, the consideration of other relevant factors in the decision on the existence of an excessive deficit increases flexibility, though within the margins of 'temporariness' and 'closeness to the reference value'. The Council also has the flexibility to grant at the start an additional year for the correction of an excessive deficit if 'special circumstances' occur. As to deviation from the medium-term objective and the adjustment path to it, certain structural reforms may be considered. Overall, the flexibility is clearly enhanced — though within constraints — to better capture economic reality and allow sound policy advice.

KS-5 — **Adequacy** of the rules has to be assessed in relation to their final goal. Rules should be neither too broad nor too narrow. The goal of the EU fiscal rules is to ensure budgetary prudence. The concept of budgetary prudence has widened over the years (see Part II, Chapter 3, on increased focus on sustainability and growth). The deficit limit guaranteed fiscal discipline on a yearly basis, but was no longer adequate for long-term sustainability. Increased focus on debt and future debt developments as well as catering for structural reforms enhances the adequacy of the rules of this long-term objective.

Moreover, differentiation of the medium-term objective according to risks to sustainable debt developments (initially on the basis of debt levels and potential growth; in the future, possibly also on the basis of implicit liabilities) allows better catering for adequate policies in all countries, including, in particular, in peripheral countries that are characterised by large public investment needs, low debt level and high growth potential. While the goal remains budgetary prudence, a more sophisticated approach is taken to minimise short-term policies which are excessively procyclical and inconsistent with budgetary stabilisation over the cycle. To this end, the economic situation and developments are considered in the deadlines for correcting excessive deficits and early warnings or early policy advice will be applied to avoid procyclical policy in good times. Overall, the adequacy of the rules to their goal has improved.

KS-6 — The narrow specification in the SGP of the timetable of the excessive deficit procedure and the application of sanctions was set to improve **enforceability**. Experience has shown that the narrow specification did not contribute to the enforceability in the existing institutional setting. Instead, it led to rising tensions and a loss of credibility after the events of November 2003. Against this background, the renewed commitment and consensus among the 25 Member States as reflected in the 2005 Ecofin report constitute a solid fundament for restoring the dented credibility of the framework. Agreement to enhance fiscal governance, through development and increased involvement of national institutions and parliaments, could also contribute to enhancing peer pressure and increasing reputational costs to discipline national authorities. As in the old system, subjective political pressure on the enforcement can be expected to remain, which proves that the renewed SGP continues to bite.

KS-7 — **Consistent — internally and with other policy objectives.** A good fiscal rule has to be internally consistent and consistent with other policies. The SGP implies that countries attain broadly balanced budgets in cyclically adjusted terms and then let automatic stabilisers play freely. Empirical evidence shows that this would be consistent with attaining a relatively high cyclical smoothing while safeguarding the 3 % deficit ceiling. Such behaviour would imply a neutral fiscal stance at the euro-area level and be consistent with a monetary policy entrusted with maintaining price stability. This could be considered an internally consistent framework in its steady state, if all countries have achieved their medium-term objectives. However, as long as the medium-term objectives had not been achieved, excessively procyclical policies were required in economic downturns, which could be considered inconsistent with the objectives of (automatic) fiscal stabilisation. Allowing for considering the economic situation and developments of a country in EDP addresses this inconsistency between policy objectives. It should be noted, however, that this also reduces the possible deterrent effect of high economic (and political) costs of an EDP which provided Member States with an incentive to pursue ambitious consolidation towards the medium-term objective. In addition to the consideration to avoid excessively procyclical policies in bad times, the 2005 reform allows the taking into account of structural reforms, thus addressing a major criticism and potential external inconsistency between the policy objectives of the budgetary framework and structural reforms (see also KS-8).

KS-8 — Fiscal rules should be **supportive of structural reforms**. The reformed framework explicitly takes better account of structural reforms, in particular those that

enhance long-term sustainability, both in the preventive arm (deviation from the MTO or adjustment path) and the corrective arm (other relevant factors, special circumstances, possible early abrogation for specific second-pillar pension reforms).

Overall, the comparative assessment of the new rules against the established set of criteria for ideal fiscal rules provides a useful indication of the quality and direction of the various changes. The interpretation of the results, however, must be viewed with caution. Some of the criteria partly overlap and some are highly interlinked. Moreover, it is important to keep in mind that the various qualitative scores in Table II.2 cannot be summed up. While the results suggest a broadly balanced set of rules, it cannot be concluded that the new rules are 'better' or 'worse' than the existing rules.

After six years of accumulated experience with the existing rules of the Pact, the 2005 report reflects Member States' shifted preferences along the trade-offs towards greater flexibility, in order to better respond to the changing economic conditions, such as those related to enlargement, demographic ageing and the low-growth conditions. There are basically two distinct options to allow for greater flexibility in the application of fiscal rules. Either the sophistication of the provisions themselves is increased by adding more contingencies to the rules while their implementation is kept straightforward, or the rules are kept simple, but a more flexible application is introduced, thus exerting more economic judgment of the individual case ([1]).

Following the intention to preserve the rules-based character of the EU fiscal framework, the Commission initially favoured responding to the increased preference for flexibility with the development of a significantly more sophisticated set of rules. While this would have been at the expense of simplicity and transparency, it would have minimised the room for discretionary judgment and facilitated equal treatment. In light of these considerations, the agreement finally reached by the Council constitutes a compromise.

Whereas the legal content of the rules remains by and large unchanged, the new agreement introduces more room for economic judgment in their application. However, given the limits of enforcement power in a supranational setting, in order to contain deficits from becoming excessive, the new procedural flexibility is effectively restricted to relatively small fiscal slippages by holding on to simple and transparent conditions, including the deficit and debt reference values and the principles of closeness and temporariness, and by requesting an annul minimum fiscal effort.

The increased scope for judgment raises the responsibility for both the Commission when assessing budgetary developments in Member States and the Council when deciding on the appropriate steps in the surveillance procedure. It also elevates the need to ensure transparency and accountability in decision-making by the various actors.

1.5. The road to the 2005 SGP reform

The agreement on the 2005 reform marks the end of a longer-drawn review and discussion process at the level of the EU about the further development of the EU fiscal rules. The interpretation and application of the rules have evolved over time and discussions about reinforcing the fiscal coordination have been ongoing since the start of EMU ([2]).

1.5.1. Early stages of the reform debate

Following the conclusions of the 2002 Barcelona European Council on the need to reinforce existing fiscal policy coordination mechanisms, the Commission adopted on 27 November 2002 five proposals to improve the interpretation of the SGP ([3]). Against the background of mixed budgetary performance since 1999 and emerging difficulties in the implementation of the rules, the Commission proposed: (i) to establish medium-term budgetary objectives that take account of the economic cycle, i.e. measured in cyclically adjusted terms and net of one-off measures; (ii) for countries that have not yet realised a budgetary position of 'close to balance or in surplus' to achieve an annual improvement in the underlying budgetary position of at least 0.5 % of GDP; (iii) to avoid procyclical policies in economically good times; (iv) to ensure consistency between the Pact rules and the goals

([1]) Beetsma and Debrun (2003) also make this point.

([2]) Previous editions of 'Public finances in EMU' provide ample evidence. See also Deroose and Langedijk (2005) for a concise overview of the experiences with the Stability and Growth Pact in the first six years and a description of the Commission's approach for improving it.

([3]) See the Commission communication 'Strengthening the coordination of budgetary policies' (COM(2002) 668 final, 27.11.2002) and European Commission (2003a).

of the Lisbon strategy, by allowing for small and temporary deviations from the underlying budgetary position of 'close to balance or in surplus' or the adjustment path towards it; and (v) to attach greater weight to the sustainability of public finances, including by making the Treaty's debt criterion operational. Moreover, the Commission pointed to the need to take complementary measures in order to foster the overall fiscal and statistical governance, including through more transparent communication so as to enhance external incentives for Member States to run sound fiscal policies and improvements concerning the quality and timeliness of government finance statistics.

In March 2003, the Ecofin Council endorsed in its report to the spring European Council ([1]) most of the Commission's proposals to improve the effective application of the SGP, yet agreed that there was no need for legal changes to the current EU fiscal rules ([2]).

In parallel, the debate on the coordination of budgetary policies in the framework of EMU continued in the Convention on the Future of Europe. The new Treaty establishing a Constitution for Europe, which was signed in Rome on 29 October 2004 and currently subject to the ratification procedures in the 25 Member States, strengthens the role of the Commission in the excessive deficit procedure. Notably, it establishes the right for the Commission to address an early warning directly to a Member State if it considers that an excessive deficit in that Member State exists or may occur. Furthermore, the Council's decision on the existence of an excessive deficit will in future be based on a 'proposal' from the Commission, which is more difficult for the Council to overrule than a Commission 'recommendation', which is the current basis for the Council decision.

Tensions in the application of the SGP continued to accumulate, creating considerable institutional uncertainty. They culminated in the legal dispute between the Commission and the Council concerning the excessive deficit procedure for France and Germany ([3]). These tensions gave further evidence of diminished ownership of the rules in several Member States and undermined the credibility of the framework as a whole.

([1]) Ecofin Council report on strengthening the coordination of budgetary policies of 7 March 2003, 6877/03 (Press 61).
([2]) See European Commission (2003a), pp. 78–79.
([3]) See Box II.3 on the decision of the Court of Justice of 13 July 2004.

Even though the budgetary framework set by the Maastricht Treaty and the Stability and Growth Pact helped to deliver overall macroeconomic stability in the EU and to keep budgetary positions at prudent levels in most EU countries, it became clear that the fiscal rules needed to be adapted in light of changing economic circumstances in order to remain relevant and acceptable to Member States. A further stretching of the Pact provisions by simply modifying their interpretation would have jeopardised the rules-based character of the system. Against this background, the Commission launched a major review of the Stability and Growth Pact, by examining both its performance in the past as well as its potential to adequately respond to the prospective challenges, notably those associated with the increased economic heterogeneity in the enlarged EU and the demographic changes ahead.

On 18 June 2004, when agreeing on the Draft Treaty establishing a Constitution for Europe, the European Council adopted a declaration on the Stability and Growth Pact. It stressed that raising growth potential and securing sound budgetary positions are the two pillars of the economic and fiscal policy of the Union and the Member States. The European Council also invited the Commission to put forward proposals towards a further development of the SGP.

1.5.2. The launch of the review

The Commission with the adoption of its communication 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact' on 3 September 2004 launched a major review process of the SGP and provided further orientation for the future set-up of the SGP. Building on the communication of November 2002, it proposed four main areas for reform, notably: (i) to place more focus on debt and sustainability in the surveillance of budgetary positions; (ii) to introduce the concept of country-specific medium-term objectives; (iii) to increase the economic underpinning of the excessive deficit procedure; and (iv) to ensure earlier action to correct inadequate budgetary developments. In addition, the communication contained a number of ideas to improve the fiscal governance, enforcement and ownership of the EU fiscal rules. Particular proposals included measures to improve the consistency between national and EU processes, including through more involvement of national institutions in budgetary surveillance, and to increase the transparency and accountability of the various actors in the surveillance process.

On 10 September 2004, the Council, in its Ecofin formation, stated that the Commission communication provided a good basis for discussion. There was consensus not to envisage any changes to the Treaty provisions and to keep legal modifications of the regulations underlying the SGP to a minimum.

On the basis of the communication, the Council's further guidance, and drawing from abundant input from academics and policy-makers, the Commission services further analysed and developed the options for strengthening the Stability and Growth Pact, expanding the main ideas into a practical coherent framework. A set of technical issues papers addressing the key elements of the fiscal framework was prepared by the Commission services for discussion in the Economic and Finance Committee. Together with contributions from Member States, they provided the basis for in-depth discussions with the Member States from September 2004 until March 2005.

On 16 November 2004, Ecofin ministers had an exchange of views on the substance of a number of the issues at stake. The discussions followed by and large the proposals made by the Commission. Ministers agreed to explore a limited number of practical options, so as to be able to agree on concrete proposals to the Heads of State or Government at the spring European Council in March 2005. The main focus of the debate was, in particular, on ways to better use periods of economic recovery to consolidate public finances, how to take into account sustainability of public finances in defining medium-term targets, how to increase the focus on debt and sustainability, how to take into account economic circumstances in the excessive deficit procedure, and about whether and, if so, how to take into account

Box II.3: **The Court of Justice of the European Communities decision on the EDP for France and Germany of 13 July 2004**

On recommendation by the Commission, the Council decided in the first half of 2003 that an excessive deficit existed in Germany and France and adopted recommendations with a view to bringing this situation to an end by 2004. In autumn 2003, the Commission recommended that the Council should establish that the actions implemented by Germany and France were not adequate and should give them notice to take measures to remedy the situation. In light of the weaker-than-expected economic situation, the Commission recommended that the deadline for correcting the deficit should be extended to 2005. On 25 November 2003, the Council voted on the recommended decisions but did not achieve a majority. (See 'Public finances in EMU — 2003', Box II.1.) Instead, the Council adopted conclusions addressing recommendations to Germany and France for the correction of the excessive deficit by 2005 and stating that in light of the commitments by the two Member States the excessive deficit procedure was held in abeyance. The Commission challenged certain elements of the Council conclusions of 25 November before the Court of Justice.

In its judgment of 13 July 2004 (see Case C-27/04 *Commission of the European Communities* v *Council of the European Union*), the Court annulled the Council conclusions in so far as they aimed at formally suspending the procedure and modifying the existing recommendations. The Court, recalling the Commission's right of initiative in the excessive deficit procedure, argued that the Council went beyond its competence by de facto modifying the recommendations decided by the Council under Article 104(7) EC. While it acknowledged the Council's right for discretion, the judgment clarified that '… the Council cannot break free from the rules laid down in Article 104 EC and those which it set for itself in Regulation 1467/97 …'.

The Court's judgment created unique circumstances in relation to the excessive deficit procedure concerning Germany and France. In substance, the annulled Council conclusions went along the same lines as the recommendations of the Commission for remedying the situation, notably that the deadline for the correction of the excessive deficit should be extended to 2005. Moreover, the actions of the Council in November 2003 had a factual effect on the path of fiscal adjustment in the countries concerned. In its communication concerning the situation of Germany and France in relation to their obligations under the excessive deficit procedure following the judgment of the Court of Justice of 14 December 2004 (COM(2004) 813), the Commission took the position that a satisfactory resolution of the budgetary problems of Germany and France within the framework of the Stability and Growth Pact demands the assessment of the actions taken to correct the excessive deficit should refer to 2005 as the relevant deadline.

structural reforms and investment needs in the budgetary framework. The agenda was widened in the course of the subsequent meetings of ministers, notably to address aspects of fiscal and statistical governance.

The negotiations revealed differing views among Member States on how much judgment was deemed necessary to sufficiently capture economic reality and pursue economically sound policies. While mainly the larger countries tended to be in favour of ensuring more room for case-specific judgment, the Commission and most of the smaller countries expressed a high preference for the predictability of the Pact as a rules-based system.

At the ministerial level, discussions in the Ecofin Council, including all 25 Member States, were usually preceded by an exchange of views within the Eurogroup. The capacity of the Luxembourg Presidency, starting in January 2004, to mediate a compromise was boosted by the unique triple function of Luxembourg's Prime Minister and Minister for Finance, Jean-Claude Juncker, being simultaneously President of both the Eurogroup and the Ecofin Council as well as presiding over the European Council.

1.5.3. The 2005 Council agreement on the reform of the SGP and follow-up

Following the failure of the Ecofin meeting of 8 March 2005 to reach agreement on the reform package, Jean-Claude Juncker convened an extraordinary meeting on Sunday 20 March 2005, two days prior to the start of the 2005 spring European Council. Ministers met first in the formation of the Eurogroup, followed by the meeting of the Ecofin Council in the afternoon. Ministers were keen to conclude their review of the SGP in time for the spring European Council in order to avoid a reopening of the debate by the Heads of State or Government. The specification of 'other relevant factors' and the treatment of second-pillar pension reforms in the excessive deficit procedure were the main issues of debate until the last moment. Agreement was finally reached later in the day. The Ecofin Council adopted the report to the European Council 'Improving the implementation of the Stability and Growth Pact'.

The European Council endorsed the report on 22 March 2005, stating that it updates and complements the Stability and Growth Pact. It furthermore invited the Commission to adopt the necessary legislative proposals to adapt the existing Regulations (EC) No 1466/97 and (EC) No 1467/97 in accordance with the new agreement.

On 20 April, the Commission adopted the draft proposals for amending Council Regulations (EC) No 1466/97 and (EC) No 1467/97, which were subsequently submitted to the Council.

The Council is the decisive body for the adoption of the Commission draft proposals. The two regulations are based on different legal bases, requiring distinct legislative procedures. *Inter alia*, they foresee a different degree of consultation of the European Parliament and the European Central Bank. By the time the 2005 report 'Public finances in EMU' went to press, the procedure for the adoption of the legislative package was still ongoing. In parallel, work has started to amend and update the code of conduct in light of the 2005 Pact reform.

2. Developments in EU budgetary surveillance

2.1. The stability and convergence programmes: a retrospective overview of plans, outcomes and assessments, 1998–2005

2.1.1. Introduction

Over the years, the process of fiscal surveillance of stability and convergence programmes has provided a wealth of data on budgetary plans, outcomes and assessments. The aim of this section is to make a first use of these data over the 1998–2005 period to analyse: (i) the magnitude, main features and determinants of the discrepancy between budgetary plans in stability and convergence programmes and actual outcomes; and (ii) the way in which stability and convergence programmes have been assessed by the Commission services.

The analysis highlights the following points:

- slippages between budgetary plans and outcomes have been common and in some years quite sizeable;
- the difference between the budgetary plans in stability and convergence programmes and actual data is mainly associated with slippages on the expenditure side, discrepancies in revenues having played a relatively minor role;
- growth which is different than expected contributes to explaining part of the difference between data on stability and convergence programmes and actual outcomes;
- the scope of the assessment of stability and convergence programmes by the Commission services has broadened over time.

Section 2.1.2. analyses the main features of the slippages recorded between budgetary plans in stability and convergence programmes and results. A short overview of the topics considered in the Commission's assessment of stability and convergence programmes is presented in Section 2.1.3. 'Evolving budgetary surveillance: the Commission's assessment of stability and convergence programmes'. Section 'Conclusions' concludes.

2.1.2. The stability and convergence programmes: plans and outcomes

The role of the stability and convergence programmes in EU fiscal surveillance

In the run-up to the introduction of Stage III of EMU in 1999, all EU Member States committed to regularly submitting programmes, convergence programmes for non-euro-area countries and stability programmes for euro-area countries ([1]). The programmes are a requirement under the Stability and Growth Pact, and since 1998 all EU Member States have submitted updates yearly.

From the outset, the content of the programmes has varied in terms of the variables included, the length of the forecasting period and the focus and degree of thoroughness of the qualitative analyses. Since 1998, the content of the programmes has been governed by a code of conduct endorsed by the Council. The code of conduct stressed the importance of the information being suitable and allowing for comparison across Member States, while also acknowledging that the programmes are the responsibility of national authorities and that the possibilities and practices differ across countries. The code of conduct was upgraded in 2001 to increase the streamlin-

([1]) The first convergence programmes were delivered in 1991. The submission of these programmes was not compulsory, but took place at the initiative of the Member States. Updates and revisions of the programmes have since been presented with varying time spans.

ing and thus facilitate the assessments and improve the comparability of the programmes. The changes include both the status of the code of conduct and the variables specified. The code of conduct of 1998 'does not suggest that the guidelines be made obligatory, but any departure would have to be justified by the Member States concerned'. In 2001, the wording was slightly stricter, asking 'that the guidelines be followed as far as possible, and any departure would have to be justified by the Member States concerned'. The 2001 code of conduct also specifies more variables including a standardised set of tables that should be presented. The required time horizon has remained the same throughout the EMU period, demanding annual forecasts for at least the preceding, the current and the three following years.

The 1998 code of conduct refers to discussions in the Monetary Committee promoting the use of a common set of macroeconomic projections, but recognising the practical difficulties involved. It is mentioned, however, that significant differences from the Commission's projections should be justified. By 2001, Member States were asked to present at least one set of projections based on common basic assumptions for the main extra-EU variables, the assumptions being provided by the Commission after consultation with national experts. For intra-EU variables, the wording is the same as in 1998, requiring justifications of significant differences from the Commission's projections.

This analysis focuses on the euro-area countries. The 10 recently acceded Member States have only had time to produce two programmes, and including all Member States in the averages for the last few years would thus make the figures less comparable over time. The analysis below is limited to the EMU period, i.e. programmes under the code of conduct of 1998 or 2001. The figures for this period are more complete and comparable than in earlier programmes, but, even for this period, challenges remain. Some countries present two or more scenarios. Unless the programmes clearly state on which scenario policy forecasts are based, this analysis considers the more cautious one. Some other discrepancies also remain, including missing data. For total revenues and total expenditures, a large number of data are missing for early years, when their provision was not clearly specified in the code of conduct, while data for the budget balance and GDP growth are much more complete. This underlines the indicative nature of the results, especially regarding the breakdown on revenue and expenditure discrepancies for the first part of the period analysed.

Since the introduction of the 2001 code of conduct, the data used in this analysis have almost always been available. Still, both for the euro area and for the whole EU, less than half of the Member States were in full compliance with the code of conduct in the 2004 updates. Most of these broadly complied, but one euro-area country and three other Member States only partly complied (see Part I, Chapter 3).

Budget balances

Graph II.2 displays the development of actual general government budget balances in the EUR-12 for the 1998–2004 period and compares this to the estimates given in the stability and convergence programmes over the same period. The graph shows that actual balances were higher than expected in 1999 and 2000, but lower in the last four years. It also shows that the programmes have consistently forecast improved budget balances, while in reality deficits increased in most of the period.

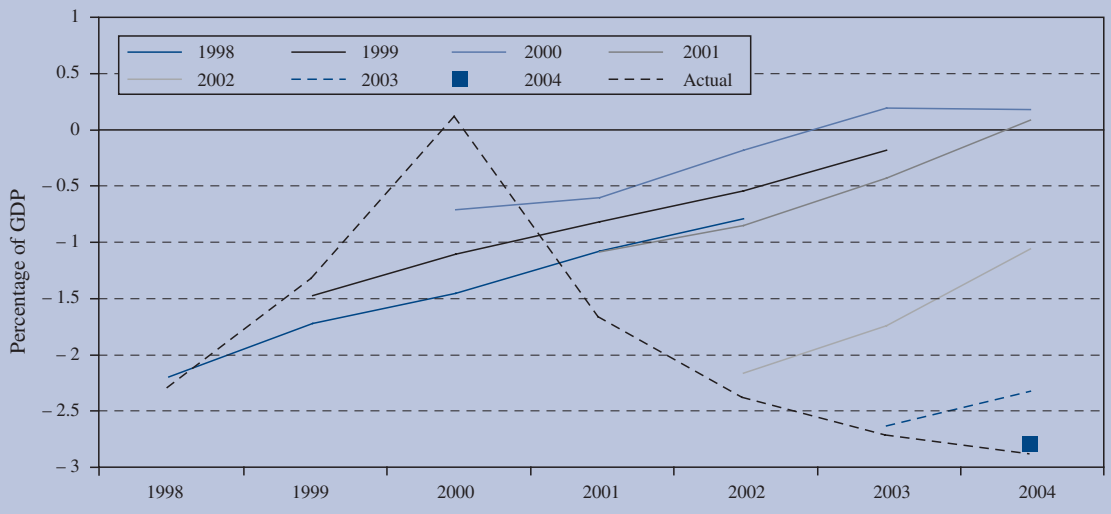
Graph II.3 presents the same information in a different way. This graph presents the budget balance slippages, i.e. the actual outcome less the budget balance envisaged in the relevant programme. Negative figures thus mean that the actual outcome was lower than expected. In this graph, the slippages are presented according to time horizon. The line marked t thus represents projections for the year the programme was published, the line t + 1 represents projections for the year ahead, and so on. When all the lines are below zero for 2001, this means that for all years the projections made in (the average of) the 2001 programmes were above the actual outcomes. This is also the case for the programmes from 2002, 2003 and 2004. Not surprisingly, the graph shows that the discrepancies between plans and actual outcomes are larger for long time horizons than for short ones.

Significant deteriorations in the budget balance in some large Member States heavily influence the EUR-12 weighted averages. However, even though the exact numbers change and the budgetary developments appear less dramatic, the qualitative picture remains the same if one looks instead at unweighted averages. The above description thus seems broadly to fit many Member States.

Expenditures and revenues

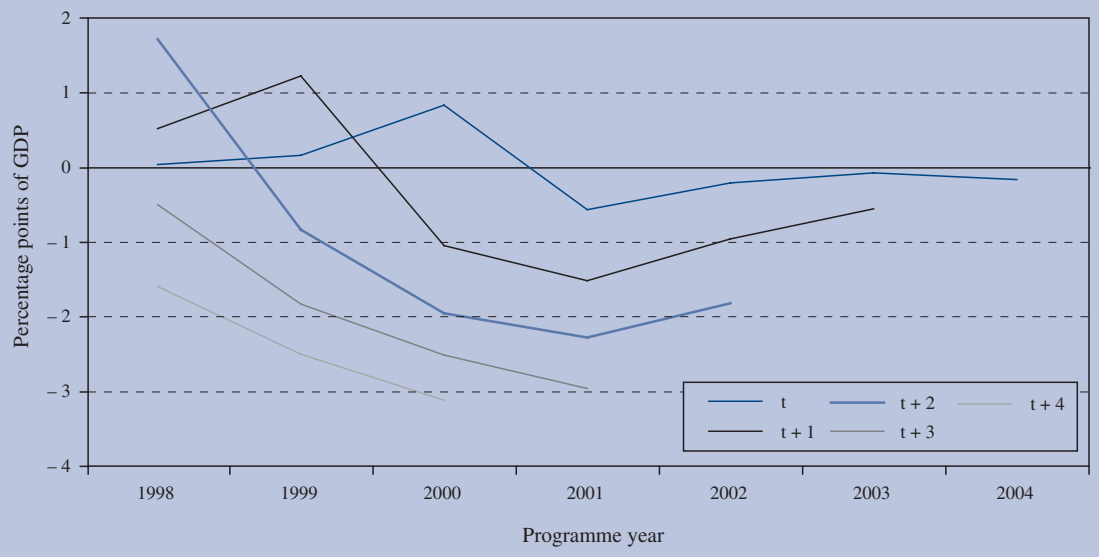
A key issue in the public finance debate is the composition of fiscal consolidations. For all years since 1998, most Member States have projected expenditure-based consolidations. However, while the average expenditure

Graph II.2: **General government budget balances — Projections from different programmes — Weighted averages, EUR-12** (1)



(1) In the 1998 programme averages, three observations are missing for 2002. In the 1999 programme averages, three observations are missing for 2003. In the 2000 programme averages, one observation is missing for 2002 and 2003 and two observations are missing for 2004.
Sources: National stability and convergence programmes and the European Commission.

Graph II.3: **Budget balance slippages — Various time horizons — Weighted averages, EUR-12** (1)



(1) In the 1998 programme averages, three observations are missing for 2002. In the 1999 programme averages, three observations are missing for 2003. In the 2000 programme averages, one observation is missing for 2002 and 2003 and two observations are missing for 2004.
Sources: National stability and convergence programmes and the European Commission.

share fell between 1998 and 2000, it has mostly increased since. At the same time, the average revenue share has fallen, and the failure to implement the planned expenditure cuts has resulted in a worsening of the average budget balance, as opposed to the planned budgetary consolidation. Overall, while actual expenditures have been higher, and partly substantially so, than planned, most forecasts for revenues have been much closer to the actual outcomes (see Graphs II.4 and II.5).

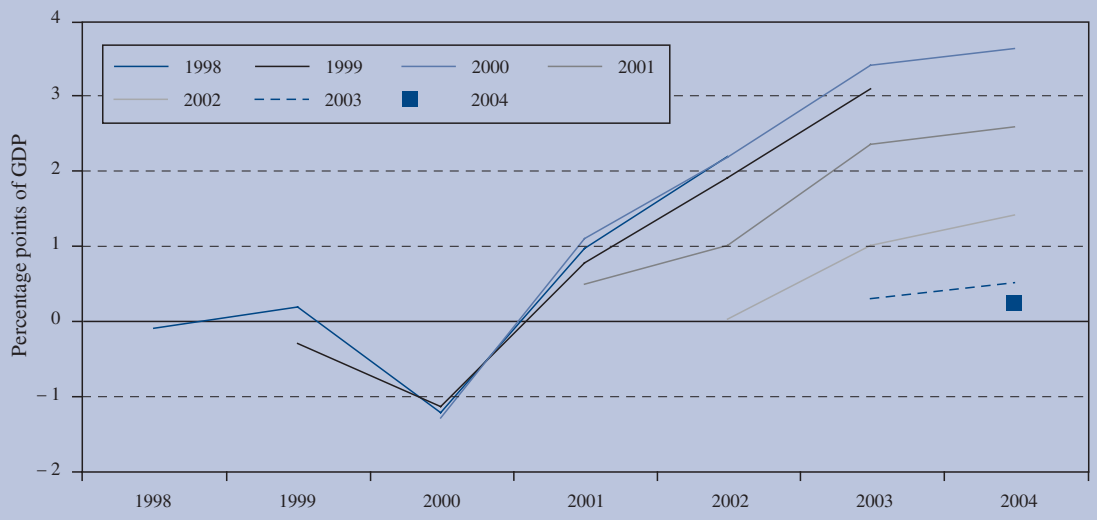
Growth corrections

Deficits are influenced by many factors which are difficult to foresee and are unlikely to exactly replicate the budgetary plans made in advance. An important distinction can be drawn between deviations from plans mainly within and mainly outside the control of the government. One central factor is unexpected changes in economic growth. Economic growth directly affects budgets through automatic stabilisers. If growth is low, labour and capital incomes grow more slowly than normal, thus lowering the level of tax revenues compared with a high-growth situation. On the expenditure side, social expenditures, especially unemployment benefits, increase when the cycle is weak. As Graph II.6 shows, there were positive growth surprises in 1999 and 2000, and negative growth surprises in the years after. Slippages caused by growth surprises can to a considerable degree be contributed to factors outside government control. However, it should also be noted that producing realistic estimates of growth is an important task and a necessary basis for responsible economic policy formulation (see Section 2.3.7).

A first rough evaluation of whether failure to forecast growth correctly explains the budget balance slippages can be obtained by (i) multiplying the growth errors with the sensitivity of budget balances to the effects of the cycle, and (ii) correcting the slippages for this factor.

This correction shrinks the differences between plans and actual outcomes, but does not remove them. On average across programmes and forecast horizons, growth surprises seem to explain about two thirds of the budget balance overruns. This still leaves important leeway for national authorities in the endeavour for improving budget balance control.

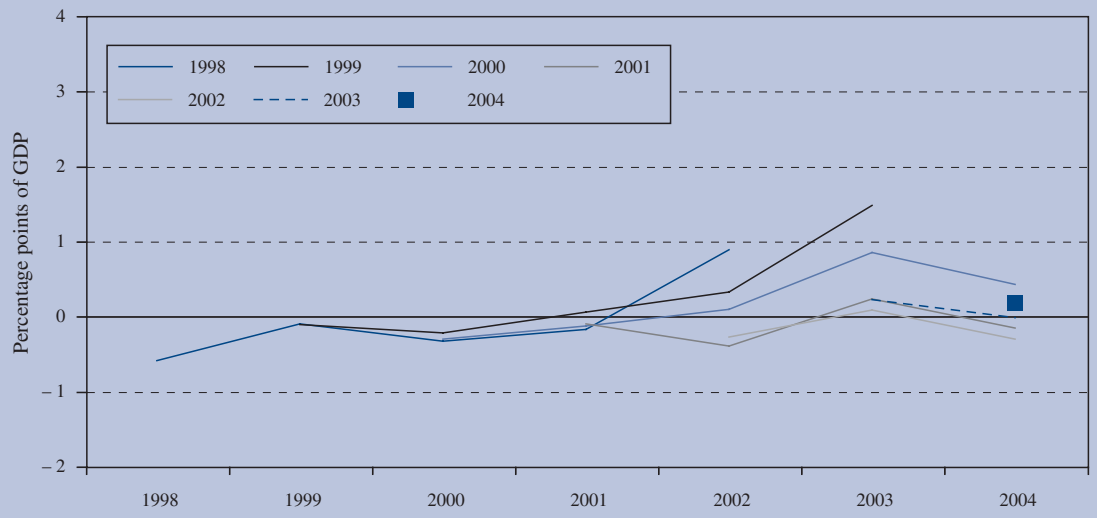
Graph II.4: **Expenditure slippages — Projections from different programmes — Weighted averages, EUR-12** (1)



(1) In the 1998 programme averages, five observations are missing for 1998 and 1999 and six observations are missing for 2000, 2001 and 2002. In the 1999 programme averages, two observations are missing for 1999, 2000, 2001 and 2002 and three observations are missing for 2003. In the 2000 programme averages, two observations are missing for 2000 and 2001 and four observations are missing for 2002, 2003 and 2004. In the 2001 programme averages, one observation is missing for 2003 and 2004.

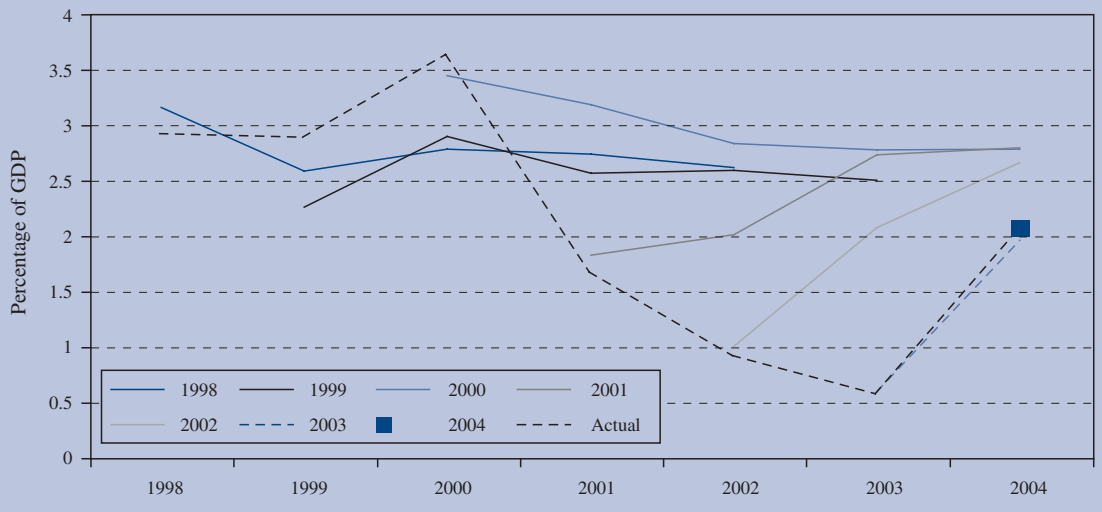
Sources: National stability and convergence programmes and the European Commission.

Graph II.5: **Revenue slippages — Projections from different programmes — Weighted averages, EUR-12** (1)



(1) In the 1998 programme averages, seven observations are missing for 1998 and 2002 and six observations are missing for 1999, 2000 and 2001. In the 1999 programme averages, four observations are missing for 1999, 2000, 2001 and 2002 and five observations are missing for 2003. In the 2000 programme averages, three observations are missing for 2000 and 2001 and five observations are missing for 2002, 2003 and 2004. In the 2001 programme averages, one observation is missing for 2003 and 2004.
Sources: National stability and convergence programmes and the European Commission.

Graph II.6: **Growth rate forecasts from stability and convergence programmes — Projections from different programmes — Weighted averages, EUR-12** (1)



(1) In the 1998 programme averages, one observation is missing for 1998 and three observations are missing for 2002. In the 1999 programme averages, three observations are missing for 2003. In the 2000 programme averages, two observations are missing for 2004.
Sources: National stability and convergence programmes and the European Commission.

2.1.3. Evolving budgetary surveillance: the Commission's assessment of stability and convergence programmes

The purpose of this section is to analyse the evolution of the Commission's assessments of the stability and convergence programmes. Information about the evolution of fiscal surveillance over time can be obtained by systematically comparing the content of the Commission's assessments in different years. Table II.3 compares the assessments of 2005 with those of early 2000 ([1]).

The first column summarises the main topics that could be included in the assessments of Member States' medium-term fiscal strategies. Typically, the following topics are covered in the assessments: (i) the underlying assumptions (e.g. are growth projections on which the programmes are based realistic?); (ii) the risks to the adjustment path (e.g. are budgetary measures taken of a temporary or structural nature?; does the budget balance leave sufficient margin for not breaking the 3 % of GDP reference value in the event of an economic downturn?); (iii) the analysis of debt and sustainability (e.g. are debt levels declining at a satisfactory pace of reduction in countries with a debt ratio above 60 % of GDP?; how will ageing populations affect the long-term budgetary outlook?); (iv) a range of issues related to structural reforms and the quality of public finances, including the composition of public expenditure (e.g. protecting productive expenditure such as education, R & D or public investment), the budgetary impact of structural reforms and national budgetary institutions that are conducive to fiscal discipline such as medium-term expenditure frameworks for controlling public expenditure.

The last three columns of Table II.3 report the percentage of programmes in which a clear independent and normative assessment by the Commission was made ([2]). For example, a score of 100 for 'underlying assumptions' implies that all the Commission's assessments included a clear assessment of the underlying assumptions of the medium-term budgetary strategy ([3]).

The content of Table II.3 can be summarised as follows:

- Assessments of the underlying assumptions are a key part of fiscal surveillance, both in 2000 and 2005.

- In 2000, assessing compliance with the numerical rules of the EU Treaty was the key topic in fiscal surveillance: does the adjustment path leave enough room for normal cyclical variations of the budget without surpassing the 3 % of GDP reference value? On the basis of this condition, the assessments concluded whether a country did or did not comply with the medium-term objective of the SGP. Instead, by 2005, the overall assessment has become more refined. The question of whether the adjustment path leaves enough room for normal cyclical variations is still assessed, but complemented with a separate assessment of compliance with the medium-term objective of close to balance (CTB) or in surplus. In addition, and more important, an overall judgment has been added on the question of whether the proposed adjustment path is credible. This reflects the experience of systematic underperformance of budgetary policies with respect to plans (see previous section).

- The analysis of the long-run fiscal sustainability, completely absent in 2000, has become an important part of every individual assessment in 2005.

- In 2000, a high percentage of assessments contained a decomposition of debt developments, separating the impact of relevant factors (i.e. the budget balance, interest rate developments, growth developments and so-called 'stock-flow operations', i.e. operations that influence the stock of gross debt but not the deficit). However, an overall assessment of compliance with the debt criterion of the Treaty was included only in about one third of the cases. In contrast, by 2005, both the decomposition of debt developments and the assessment of compliance with the debt criterion had become a standard part of the analysis.

- Regarding the assessment of structural reforms and also the quality of public finances, there is a clear trend towards concentrating the assessment on the budgetary impact of structural reforms and on institutional issues (expenditure control, fiscal rules for lower levels of government). Given the further increase in the attention for the budgetary

([1]) Stability and convergence programmes and Commission assessments are published on the Economic and Financial Affairs DG's website (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).
([2]) Hence, the criterion in doing the survey was not whether a topic has been mentioned in the assessment. Instead, phrases such as 'too optimistic', 'more ambition is needed', etc. indicate a clear assessment.
([3]) In a large number of cases, the judgment pointed to too optimistic growth assumptions.

Table II.3

Assessments of stability and convergence programmes: 2000 versus 2005

Broad topic	Specific topic	EU-15 2000	EU-15 2005 (1)	NMS 2005
		Percentage of programmes including an assessment		
Adjustment path: underlying assumptions	Underlying assumptions (growth)	100	100	100
Adjustment path towards 3 % of GDP or close to balance or in surplus	Sufficient margin for not breaking 3 % of GDP?	100	100	60
	Compliance with CTB?	n.a. (2)	93	50
	Credibility measures expenditure side (one-off?)/revenue side	67	100	100
	Overall assessment of credibility of adjustment path	47	93	100
	Sensitivity analysis?	40	100	20
Debt	Decomposition of debt developments	60	100	100
	Overall assessment of debt development/ satisfactory rate of reduction	33	100	70
Sustainability	Quantitative assessment of long-run sustainability	0	100	100
	Qualitative assessment of long-run sustainability	0	100	100
	Analysis of contingent liabilities	0	0	30
	Overall assessment of sustainability	0	100	100
Quality of public finances	Composition of adjustment (revenue/ expenditure side)	13	14	0
	Composition of expenditure (redirecting towards productive items)	27	21	0
	Composition of revenue, including tax burden on labour	20	0	0
	Impact of structural reforms on budgetary position	7	36	50
	Impact of structural reforms on potential growth and employment	0	14	0
Fiscal governance	Role of expenditure rules and expenditure control	13	43	20
	Federalism/national stability pacts	13	21	0
	Efficiency of public sector	0	14	0

(1) The assessment for Portugal was not available when this report was finalised.
(2) In 2000, if a country had established a sufficient safety margin for not breaking the 3 % of GDP reference value, then the assessments concluded that the country complied with the medium-term objective of a budgetary position of close to balance or in surplus (CTBOIS). By 2005, compliance with CTBOIS was subject to a separate assessment, based on the cyclically adjusted balance (when available).

Source: Findings of the authors on the basis of the Commission's assessments of the stability and convergence programmes.

impact of structural reforms (see Part III of this report), the degree of assessment could be expected to increase further on this topic. Similarly, the role of domestic budgetary institutions in ensuring compliance with budgetary discipline is now widely recognised, so that also this is an important aspect of fiscal surveillance that could be developed further in the years to come (see also Part II, Section 2.3, on the role of national budgetary institutions in this report).

In sum, the analysis shows that the scope of fiscal surveillance has broadened significantly in recent years. Fiscal policies are assessed on the basis of a range of fiscal indicators that account for different aspects of fiscal policy behaviour. Fiscal surveillance thus complements the simple and transparent reference values of the EU fiscal framework and serves as a basis for using the room for economic judgment that is given by the EU Treaty to the European Commission in operating the system.

2.1.4. Conclusions

The stability and convergence programmes provide a valuable source for comparing budgetary developments in the Member States relative to plans. Lessons drawn from such comparisons are central to evaluate the realism in future budgetary plans. To improve comparability, the progress made over the last year in streamlining the content of the programmes is important. Still, some areas remain to be tackled.

The analysis carried out in this section of the report has pointed to frequent and sometimes sizeable slippages in budget balances relative to medium-term plans. In order to improve adherence to planned budgetary developments, it is important to understand why slippages occur and how they can be avoided. Better estimation of growth is no doubt important. Still, the analysis has shown that discretionary measures have also played a central role during the last seven years. As a consequence, there is clearly room for better adherence to expenditure plans in the endeavour to improve budget balance control.

The way the assessment of the stability programmes is done by the Commission services has been evolving over the past few years. This has partly reflected improvements in the analytical toolbox for budgetary surveillance (e.g. the use of budget balance measures adjusted for the cycle, the development of sustainability indicators, etc.), and has partly been driven by the experience accumulated with the operation of the EU fiscal framework. Overall, the scope of the assessment has broadened: the number of factors taken into account in assessing fiscal plans has increased. This tendency is likely to continue in the coming years, as a result of the increased focus on long-term public finance developments (e.g. the impact of pension reforms) and on factors related to fiscal governance (e.g. the working of national budgetary institutions) which is present in the revised SGP.

2.2. The dynamics of government debt: decomposing the stock-flow adjustment

2.2.1. Introduction

The government deficit and debt are closely interrelated concepts. Deficits imply debt issuance while surpluses lead to debt repayments. However, given the specific definitions of deficit and debt applied for the EU budgetary surveillance ([1]), the change in the debt level in any given year can be larger or smaller than the deficit.

The difference between the change in the outstanding debt stock and the yearly deficit flow is known as the stock-flow adjustment (SFA), or less frequently as deficit–debt adjustment. A positive (negative) SFA means that factors other than the government deficit increase (reduce) the government debt. In some cases, the nominal debt level can even fall while there is a deficit, or can increase in the presence of a surplus ([2]). As is shown below, while the SFA is typically set to zero in the theoretical analysis of debt dynamics, in real life such an assumption is unwarranted.

The reconciliation of deficit and debt figures requires a number of intermediate steps involving the breakdown of the SFA into several categories. The analysis of the SFA is all the more important as the EU budgetary surveillance — which so far has focused on the deficit — may have provided incentives for shifting items from the deficit to the SFA, i.e. from above to below the line. A careful analysis of the SFA is therefore important to countercheck the reliability and plausibility of the deficit figures.

This section is organised as follows: Section 2.2.2 provides an overview of the available SFA data and spells out concerns associated with the high and persistent levels of SFA in some Member States. Section 2.2.3 breaks down the SFA into three main components, which correspond to differences in the definitions of deficit and debt. Each component is also split into sub-categories. Section 2.2.4 concludes.

([1]) The deficit and debt definitions that are relevant for the EU budgetary surveillance procedures have been established by the Treaty protocol on the excessive deficit procedure and specified in Council Regulation (EC) No 3605/93. The deficit and debt are defined through cross-references to the European system of accounts (nowadays ESA 95).

([2]) The developments in the debt-to-GDP ratio also depend on the GDP growth rate, as can be seen in the usual equation:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{y_{t-1}} = \frac{NB_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} \cdot \frac{y_t}{1+y_t} + \frac{SFA_t}{Y_t}$$

, where t denotes a time subscript, D is the government debt level, NB is the government deficit (net borrowing with a plus sign), Y represents GDP at current market prices and y the nominal GDP growth rate.

2.2.2. SFAs: main data and concerns

The main data

Graph II.7 shows annual data on the SFA for EU Member States from 2000 to 2004 ([1]). The data show that the SFA is rarely zero or close to zero. In other words, the change in the debt level rarely corresponds to the deficit. SFAs in the vicinity of zero (in the interval – 0.2 % to + 0.2 % of GDP) are relatively rare. Moreover, SFAs tend to be positive and not to cancel out over time; for most countries, in most years, the government debt has increased by more than the deficit. For the EU-15, the weighted average SFA over the last 10 years or so has been + 0.4 % of GDP. In cumulative terms, this means that the government debt ratio for the EU-15 is now 4.1 percentage points higher than could be expected if the SFA had been set to zero since 1994.

Concerns

Large SFAs are often presented as a source of concern, as a suggestion of inconsistent and low-quality statistics. In fact, high positive SFAs even over a protracted period are not necessarily an indication of any fundamental error in statistics. As is shown below, high and positive SFAs are even the normal outcome for low-debt governments in surplus. However, the high and persistent SFAs in some Member States, in particular in those which are in deficit and have large debts, need to be closely scrutinised and explained, or the consistency of government accounts and truthfulness of deficit statistics will be put into question.

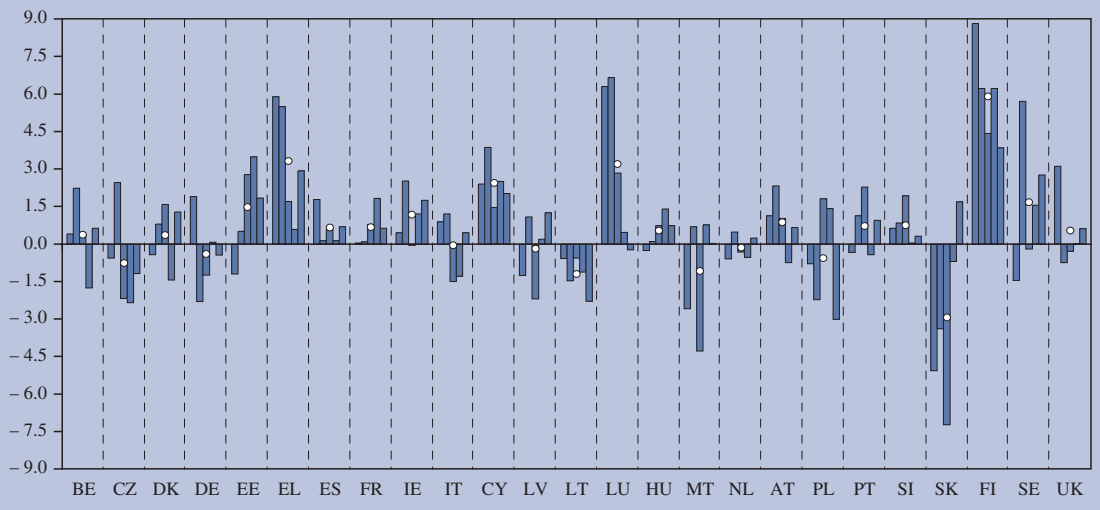
2.2.3. The main components of the SFA

The SFA exists because of differences in the basic accounting principles according to which the government deficit and debt are defined and compiled. Accordingly, the SFA can be split into three components along with these differences:

- differences between the accrual and cash bases of recording transactions;
- differences in the gross and net recording of transactions with financial assets;
- valuation effects and remaining statistical adjustments.

([1]) Longer time series on the SFA per Member State (though not on its components) are available on the AMECO database.

Graph II.7: **Stock-flow adjustment, 2000–04 (% of GDP)**



NB: The five bars for each country depict the SFAs for each year during the period 2000-2004. The white dot is the average of these five years.
Source: Commission services.

Cash versus accruals: the time of recording of transactions in the deficit and the debt

Deficit on an accrual basis. Expenditure and revenue are recorded in the government accounts at the time of the underlying transaction — that is 'when economic value is created, transformed or extinguished, or when claims and obligations arise, are transformed or are cancelled' — irrespective of effective cash payments and receipts. For example, interest is recorded as accruing continuously during the lifetime of a bond or a loan, and not when lenders receive the corresponding cash payments. For conventional bonds and loans that pay interest every year, the difference between interest accrued and effective cash payments in each year is very small, if any. However, the difference between interest accrued and paid can be quite considerable in the case of zero-coupon bonds or other financial instruments which do not regularly pay interest, as well as in other circumstances when the issuance price is significantly different from the redemption price.

Lags between the underlying transactions and the related cash payments are also very frequent for other expenditure categories. If the government takes delivery of some equipment in year t, expenditure must be recorded in year t even if the payment is deferred to a later period. Likewise, expenditure of year t must be recorded as expenditure in that year, even if, for any reason, the effective payment is postponed to $t + 1$. The transactions that have already been recorded as expenditure, but for which the effective cash payment has not yet taken place, are called accounts payable ([1]).

There are also lags between accrual accounting and cash accounting for revenue. For example, in many countries, taxes and social contributions collected in the very first months of year t are allocated to the government accounts of $t - 1$, as the obligation of paying the tax was generated by transactions that took place in year $t - 1$. In the case of revenue, the difference between accruals and cash accounting gives rise to accounts receivable. There are also accounts payable in relation to revenue (e.g. taxes to be reimbursed), and accounts receivable in relation to expenditure (e.g. cash payments in advance of deliveries).

The government debt is a cash concept. Debt is recorded when financial instruments have been effectively issued. Moreover, the government debt is defined at face value. This means that interest which has accrued but has not yet been effectively paid to bondholders — for example, in the case of saving certificates or of bonds with a grace period — is not included in the government debt ([2]).

Furthermore, the debt definition that is relevant for the budgetary surveillance in the EU does not include accounts payable ([3]). Therefore, the debt does not increase when the government commits a payment, but only when the government has to obtain resources from financial markets to finance effective cash outflows.

Data on the difference between cash and accruals. The different accounting bases of the government deficit and debt imply that the net accumulation of accounts receivable and payable, and the difference between interest accrued and paid contribute to the SFAs ([4]).

It is crucial to note that the difference between cash accounting and accrual accounting is only a matter of timing. In principle, the differences between effective cash payments and the underlying expenditure, between interest accrued and interest paid, and between the effective cash receipts and the underlying revenue cancel each other out in the medium term ([5]). Large and protracted differences between accrual and cash data may suggest data quality problems.

Accrual data are considerably more difficult to estimate than cash figures and compilation errors are not rare. As a result, unexplained discrepancies between the accrual- and cash-based data, and between deficit and debt

([1]) Here, the term 'accounts payable' does not include lags in relation to interest expenditure, which are considered separately.

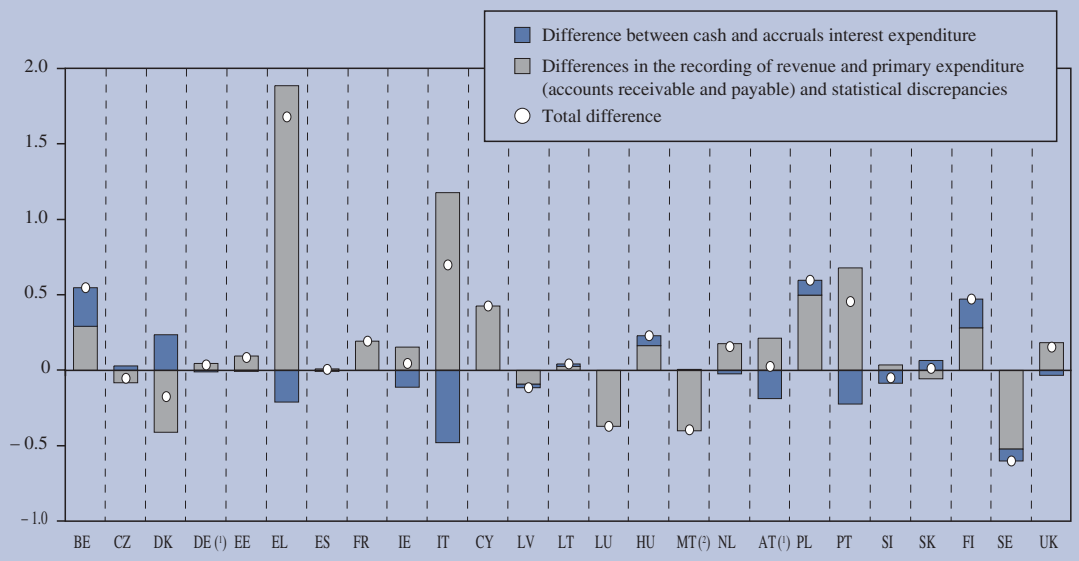
([2]) When the face value of a bond, for example a zero-coupon bond, is higher than the issuance price, the debt increases at issuance of the bond by more than the financing received from financial markets. This means that the cumulated interest of zero-coupon bonds, that is the difference between the face value and the issuance price, is treated in the debt definition as if it were paid at issuance.

([3]) The exclusion of accounts payable from the government debt was decided mainly for pragmatic reasons, in relation to the difficulty in collecting reliable data and the little macroeconomic relevance of these liabilities. In several EU Member States, a relatively frequent example of accounts payable is healthcare-related payment arrears (delays in payments by social security to pharmacists or to hospitals).

([4]) The issuance of zero-coupon bonds, the reimbursement of bonds that do not regularly pay coupons, the accumulation of revenue arrears, the settlement of payment arrears and the payment of expenditure in advance, etc., result in positive SFAs. Symmetrically, interest accrued by zero-coupon bonds, or by other bonds that do not regularly pay coupons, the accumulation of payment arrears, the collection of revenue in arrears, etc., lead to negative SFAs.

([5]) Differences may persist in two cases: exceptional transactions with particularly long lags for effective cash disbursements or because of nominal growth (e.g. it is normal that VAT revenue on an accrual basis is persistently higher than effective VAT collection on a cash basis).

Graph II.8: **Time of recording: cash and accruals, average 2000–04 (% of GDP)**



(1) For Germany and Austria, data refer to 2000–03.
(2) For Malta, data refer to 2001–03.
Source: Commission services.

figures are relatively frequent, though they are not macroeconomically relevant in most countries. In this section, statistical discrepancies — i.e. the differences that statisticians cannot allocate to any specific SFA category — are deemed to come mainly from the differences between accrual and cash accounting and included in this first component of the SFA.

Graph II.8 shows the component of the SFA that is due to the difference between cash and accruals in each of the EU Member States. Given the volatility of data, the graph shows the average for the last five years, rather than annual data. For most countries, the difference between accruals and cash interest (the light coloured bars in the graph) is very small. The most significant difference (a negative SFA) exists for Italy, given the weight of bonds that do not regularly pay interest to bondholders (notably postal bonds) in its debt structure. It corresponds to interest that accrued during the period considered and was properly recorded as deficit-increasing expenditure, but that has not yet been paid to the bondholders.

Cash–accruals differences in the recording of revenue and primary expenditure (the darker bars in the graph) are also small for most countries, and figures would be even smaller if the average was extended over longer periods. However, Greece, Italy and Portugal are outliers and their data have given reason for concern (1).

Net versus gross: accounting for financial assets in the deficit and the debt

The government deficit (surplus) is a net concept. The government deficit is defined in the protocol on the excessive deficit procedure as net borrowing. This means that, when compiling the government deficit (surplus), one should consider the government net financial transactions. In practice, the government deficit is mainly compiled on the basis of the government non-

(1) In the case of Italy, the difference comes notably from lags in the payment of social contributions, the settlement of healthcare-related arrears, the reimbursement of taxes, the recording of transactions with the EU budget and exceptionally large statistical discrepancies. In Greece, most of the difference concerns statistical discrepancies, which are, by their own nature, not explained, though accounts receivable (presumably on taxes) and an inconsistent recording in structural fund revenue also play a role. It should be noted that the difference between cash and accrual accounting in Greece is now much smaller (in particular, for the most recent years) than before the revision of the deficit and debt time series in 2004. In the case of Portugal, the difference between cash and accrual data has been clarified. It is explained by the large stock of spending arrears at the beginning of 2000 and their settlement in the following years, notably in 2002.

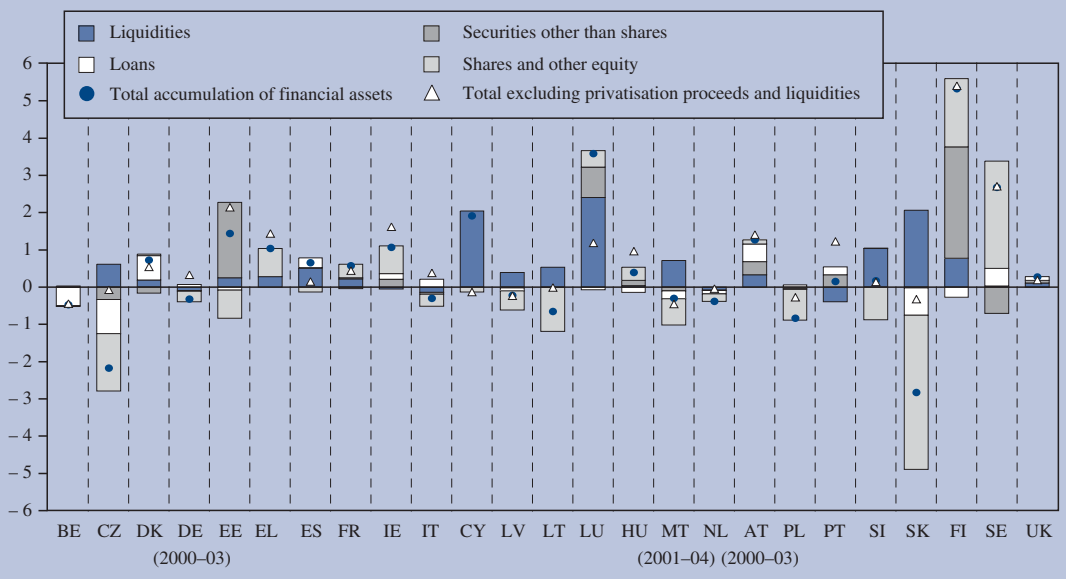
financial expenditure and revenue (salaries earned by civil servants, purchases of goods and services, transfers paid, taxes and contributions collected, etc.), and not the financial transactions. However, by accounting identity, the balance of financial transactions must be the same as the balance of non-financial operations. Seen from this perspective, the government deficit (surplus) is the difference between revenue and expenditure excluding financial transactions.

The government debt is valued in gross terms. The government debt is gross. This implies that the government debt changes when government accumulates financial assets and therefore needs to finance this acquisition. Moreover, the debt is consolidated between and within the government subsectors. If a government sector (say social security) sells private bonds and buys securities issued by central government, the consolidated gross debt falls and there is a negative SFA. If social security buys private bonds and sells central government securities, the SFA is positive and the consolidated gross debt of the government as a whole increases.

Data on the accumulation of financial assets. The accumulation of financial assets by the government is quantitatively the most significant component of the SFA. An accumulation of financial assets leads to a positive SFA; a reduction in financial assets implies a negative SFA. Graph II.9 shows the accumulation of financial assets by the EU Member States over the period 2000–04. (Note that the scale of this graph is not comparable to Graphs II.8 and II.10 on the other components of the SFA.) The accumulation of financial assets is broken down into four subgroups: liquidities (i.e. currency and deposits with banks), securities other than shares (i.e. bonds issued by non-government units), loans and shares. It should be noted that 'shares' include equity in public enterprises as well as in privately controlled companies, and covers both quoted and non-quoted shares. It also includes privatisation proceeds, with a minus sign.

The Member States that have registered the largest accumulation of financial assets are those that have been in surplus and have relatively small debts, such as Denmark, Estonia, Luxembourg, Finland and Sweden. These governments prefer to invest their surpluses in financial assets, rather than reimbursing government debt. For some of them — such as Estonia and Luxembourg — the government debt is so low that the accumulation of assets is the only option, as there is virtually no debt to

Graph II.9: **Accumulation of financial assets, average 2000–04 (% of GDP)**



Source: Commission services.

redeem. In some countries, for example Sweden, data on the accumulation of financial assets depend heavily on changes in the investment strategy of social security, shifting investment from government paper to private bonds and shares.

A number of countries with relatively high deficits and high debts — such as Greece, Cyprus and Austria ([1]) — have also accumulated a considerable stock of financial assets over the last five years. Moreover, the accumulation of financial assets is also significant for countries such as Portugal and Hungary if privatisation proceeds and liquidities are accounted separately. The countries showing a larger reduction in their financial assets are the Czech Republic and Slovakia given their privatisation programmes.

In many cases, the accumulation of financial assets corresponds to an accumulation of wealth, and the government behaviour when accumulating financial assets is not much different from the behaviour of a private profit-driven agent. However, in some cases, financial assets accumulated by the government might include a disguised subsidisation of certain economic activities.

The following questions are relevant when considering the accumulation of financial assets by the government: Will loans granted by the government to public enterprises or to developing countries be reimbursed at market conditions? Are shares in public enterprises worth the money that the government paid for them? In the case of negative answers, the logic is that the purchase of these 'assets' is recorded as capital expenditure thus increasing the government deficit.

For effective budgetary surveillance, the Commission services (in particular Eurostat) regularly request detailed data on the accumulation of financial assets from Member States, for example on the financial situation and outlook of the public enterprises receiving capital injections. In several cases, Eurostat requested Member States to reclassify capital injection into public enterprises, from below to above the line, thus revising the government deficit upwards. The rules on the accounting classification of capital injections into public enterprises are now relatively strict, but their implementation has been particularly difficult. These strict rules might have to widen to all kinds of financial assets, for example loans granted to public and private enterprises and to developing countries.

Valuation effects and residual adjustments

The third component of the SFA corresponds to valuation effects with an impact on the government debt and a number of residual adjustments. These cases are depicted in Graph II.10.

Foreign exchange. The government debt denominated in foreign currencies is valued according to the market exchange rates. Therefore, movements in the exchange markets lead to changes in the value of government debt, though the debt face value was kept constant. These increases or reductions in the debt value do not have any direct impact ([2]) on the government deficit and are therefore booked as SFAs ([3]).

The valuation of foreign-currency-denominated debt used to be a significant component of the SFA in a number of Member States until some years ago. It is now almost irrelevant in those which are part of the euro area. If one considers the average from 2000 to 2004, the Member States where the exchange rate developments have contributed most to the SFA are Greece ([4]) and Slovenia (positive SFAs) and Lithuania, Slovakia and Sweden (negative SFAs).

Early reimbursements. There is also a need to register an entry in the SFA when the government reimburses debt at a price other than its face value, in particular in the case of early redemptions in secondary markets ([5]). These transactions and the respective SFAs are very frequent, though with relatively small macroeconomic relevance. The cases of Italy and Sweden are worth mentioning. In Italy, at the end of 2002, the government

([1]) In the case of Cyprus, most financial assets accumulated by the government are reported as deposits with the central bank. In Greece, most financial assets are social security investment in shares. In the case of Austria, most financial assets are loans granted by central government to other sectors.

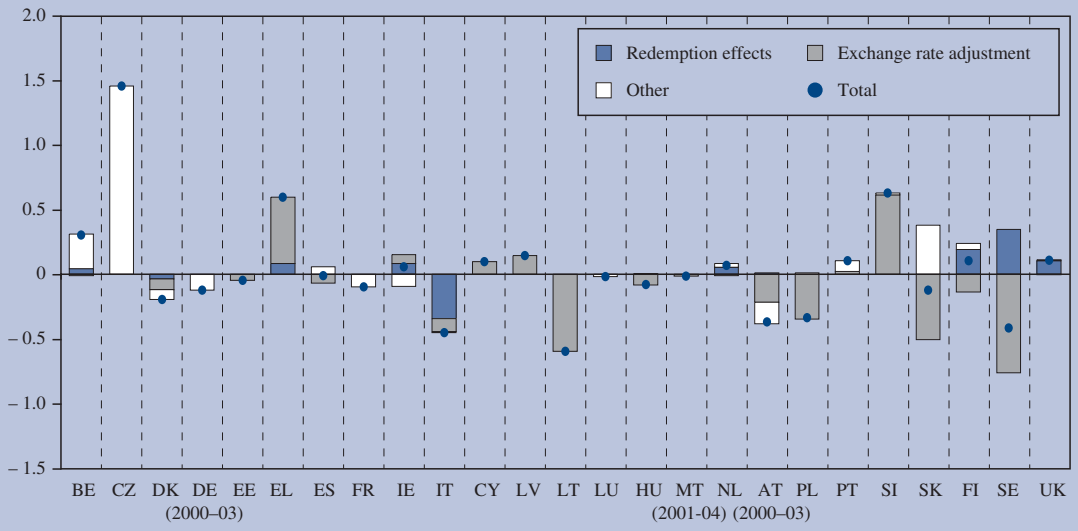
([2]) There is an indirect impact in the sense that exchange rate movements may increase or reduce interest expenditure on foreign debt.

([3]) A depreciation of the national currency vis-à-vis the currencies represented in the government debt leads to a positive SFA, while an appreciation implies a negative SFA. It should be noted that the change in the value of foreign-currency-denominated debt is treated as capital gains and losses, which are always recorded below the line and have no direct impact on the deficit. Member States may have an incentive in issuing debt in low-yield currencies, as this would reduce their interest spending, even if it would increase their risk exposure.

([4]) In Greece, the exchange rate effects were quite significant until joining the monetary union in 2001; it reached annual adjustments of almost 3 % of GDP in 1999 and 2000. However, such an effect is now negligible.

([5]) Included here are the cases where a government subsector other than the debt issuer buys the government liability in the secondary market.

Graph II.10: **Valuation effect and residual adjustments, average 2000–04 (% of GDP)**



Source: Commission services.

replaced low-interest-rate bonds with bonds at market rate and correspondingly lower face value. This operation led to a negative SFA and a reduction in the debt level by almost 2 % of GDP. In the case of Sweden, the 2000–04 average is heavily influenced by a large reimbursement of high-interest-rate bonds with new bonds in 2000.

Other adjustments ([1])**.** Finally, there are other residual and relatively exceptional adjustments, which might lead to increases or reductions in the government debt and to positive and negative SFAs. An interesting case is when some units are reclassified from non-government sectors to government and vice versa. In these cases, the government debt may increase or decrease because the debts of the reclassifying units are included in, or excluded from, the government debt. The consolidating financial assets of the unit being reclassified also need to be taken into account, therefore a reclassification of a unit into government might increase or reduce the debt. The most remarkable cases in the last few years concern the reclassification as government of the Czech Banking Consolidation Agency in 2002 or of a Belgian unit that used to be involved in mortgage loans in 2001. Another kind of 'other adjustments' was the loss of the legal tender status of the coins denominated in the former national currencies in 2002 ([2]). Some rare debt assumptions in the context of liquidation of public enterprises also imply an entry under 'other adjustments'.

2.2.4. Conclusions

The high level of the SFA in some countries, i.e. the large discrepancies between the deficit and debt developments, has raised concerns about the quality of the government finance statistics, and even about the appropriateness of the existing deficit and debt definitions. The fact that the deficit is not the only determinant in the evolution of the debt level is not an indication of any fundamental error in the accounts of Member States. A large SFA is not, by itself, a source of concern. High positive

([1]) It should be stressed that the statistical discrepancies are not classified under this heading, but as timing differences, as most statistical discrepancies originate in the complexities of the accrual accounting.

([2]) In most countries, coins are issued by the Treasury — not by central banks — and constitute government debt. The coins that lost their legal tender status and were not exchanged against the euro were removed from the government debt. This operation was recorded without any impact on the government deficit and led to a negative SFA.

SFAs are even the normal outcome for low-debt governments in surplus. The issue is more worrying when there are protracted high positive SFA components in high-debt countries in deficit.

All Member States transmit data on the SFA to the Commission on the occasion of the EDP reportings. Data on the SFA transmitted by Member States are available both for general government as a whole and for each of the government subsectors. These figures are now publicly available, as the Commission publishes the complete tables transmitted by Member States in the context of the EDP notification ([1]). Some Member States also took the initiative of elaborating on the sources and components of their SFA in their stability and convergence programmes. The Commission has increased its examination of the quality of the Member States' government accounts. This involves careful scrutiny of the size and the components of the SFA to identify issues that are relevant for budgetary surveillance or suggesting accounting difficulties.

2.3. The role of budgetary institutions in shaping budgetary outcomes

2.3.1. Introduction

In the European Union, while the coordination of fiscal policies is based on the common objectives of sound and sustainable fiscal policies, the implementation of fiscal policy remains in the hands of domestic authorities. The implication of this institutional set-up is that, for the system to function properly, the EU's budgetary goals must be embedded in the machinery of national policy-making. The EU Treaty explicitly recognises this point when it calls on Member States to 'ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty'. The relevance of this point has been confirmed by a growing body of research that has investigated the interaction between national fiscal rules and institutions and budgetary outcomes. It has thus become increasingly clear that, whatever steps are taken to improve surveillance at EU level, it is equally important to ensure that domestic budgetary rules and institutions contribute towards sound public finances (European Commission, 2004a). The Ecofin Council report of March 2005 'Improving the implementation of the Stability and Growth Pact' reflects these points in concluding that 'national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact' and 'the Council considers that domestic governance arrangements should complement the EU framework. National institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level'.

The aim of this section is to contribute to the debate on the role of national budgetary institutions in shaping budgetary outcomes. Sections 2.3.2 and 2.3.3 briefly review the conceptual issues and available empirical evidence. Section 2.3.4 concentrates on the role of optimistic forecasts and creative accounting in explaining budget deficits. Section 2.3.5 discusses a specific institutional issue, i.e. whether the EU fiscal rules are compatible with fiscal policies in so-called delegation States. The next two sections focus in more detail on two topics that have arisen in the context of EU fiscal surveillance, i.e. the interaction between the EU fiscal rules, national expenditure rules and fiscal outcomes (Section 2.3.6) and the role of national forecasting authorities in producing unbiased forecasts (Section 2.3.7). Section 2.3.8 concludes.

2.3.2. Conceptual framework

Fiscal institutions are 'all the rules and regulations according to which budgets are prepared, approved and carried out' (Alesina and Perotti, 1999) while a fiscal rule can be defined as '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' (Kopits and Symansky, 1998). It follows from these definitions that fiscal rules can be seen as a subset of the budgetary institutions that guide the preparation, approval and implementation of budgets.

Fiscal institutions structure the decision-making process and restrain the range of possible budgetary outcomes. Why institutions matter can be understood on the basis of problems of spending bias, deficit bias and a lack of transparency that characterise unstructured and unrestrained budgetary processes. First, externalities that influence the size of government (the expenditure-to-GDP ratio). Oversized government may arise from the common pool resource problem. Individual spending ministers, local governments or representatives in parlia-

([1]) See the Economic and Financial Affairs DG's website (http://europa.eu.int/comm/economy_finance/about/activities/sgp/natnot.htm).

ment are assumed to cater only for their small constituency, thus, when making demands on the budget, they fail to realise that their spending implies a cost to the public at large. If budget constraints or the minister for finance are weak, adding up the spending demands in the budgetary process will underplay the total cost of spending and lead to an excessively high budget. Strong institutionalised constraints or a strong minister for finance, representing the interests of all taxpayers, may ensure that the budget reflects the true cost to the public and define the size of the budget accordingly.

Second, governments may overspend relative to revenue, i.e. run deficits that lead to unsustainable government debt. Several explanations have been put forward as to why fiscal policy may suffer from a deficit bias, including political inaction due to conflicts of interest and debt as a strategic variable to affect policy choices of future governments (see Alesina and Perotti, 1994, for an overview). The typical institutional response to the deficit bias has been to introduce permanent constraints on fiscal policy, such as the fiscal rules that were introduced both in Europe and in the United States of America in the early 1990s.

Lastly, even if fiscal arrangements are found that are designed to eliminate these above externalities, any particular budget may still overshoot, i.e. deviate from its planned outcome. This may be the case when the fiscal arrangements work improperly, are based on unrealistic assumptions, are loosely implemented or not enforced, or softened when unforeseen economic developments affect the budget, or when the budgetary authority is not able to control fully side budgets (e.g. social security). A possible remedy is to create independent bodies in charge of evaluating the transparency, accuracy, and projections of the government budget (Alesina and Perotti, 1999).

2.3.3. Budgetary outcomes and the centralisation of the budgetary process: survey of empirical evidence

Empirical research on the interaction between budgetary institutions and measures of fiscal discipline has typically used indices that aim at capturing the key characteristics of the institutions in a single number. Such an approach requires making assumptions on which institutional aspects to include in the index and how to weigh them. In practice, the indices as used in different studies show overlap but also differ with respect to the emphasis that the researcher has put on different aspects. For example, the pioneering study by von Hagen (1992) emphasises common pool problems and builds an index that captures the degree of centralisation of the budgetary process. It covers the stages of: (i) budget formulation (including restrictions on the budget and the relative position of the minister for finance vis-à-vis the spending ministers); (ii) budget approval (focusing on the degree to which amendments in parliament may increase the size of the budget); and (iii) budget implementation (e.g. can the minister for finance block expenditures?) ([1]). The index as developed by Alesina et al. (1999) is built around three insights: (i) fiscal constraints may be conducive to fiscal discipline; (ii) hierarchical procedures should be conducive to fiscal discipline; (iii) transparent procedures should lead to more fiscal discipline ([2]). In comparison with the index as developed in von Hagen (1992), this index thus puts a somewhat larger weight on *ex ante* constraints on the budget.

In interpreting the results from empirical research on the interaction between fiscal institutions and fiscal outcomes, a key consideration is whether the causality runs from institutions to outcomes or the other way round. On the one hand, the argument that the causality may run from budgetary outcomes to institutions is based on the observation that fiscal rules and institutional reform have generally been introduced in response to dissatisfaction with budgetary outcomes. They are therefore at least to some extent exogenous, with the implication that they cannot be used as explanatory variables of budgetary outcomes. On the other hand, the argument that budgetary institutions are exogenous to budgetary outcomes, so that they can be included in regression analysis as an explanatory variable, is based on the fact that institutions (laws, decision-making procedures) change very slowly over time so that it is reasonable to assume that they are exogenous. Finally, it may also be the case that both budgetary institutions and budgetary outcomes may be a function of a third variable of voter preferences (Poterba, 1996). If this view is right, then countries with a strong preference for particular types of budgetary outcome use the institutions as tools for reaching this particular budgetary outcome.

([1]) The original index as developed by von Hagen also contains a section on the responsiveness of the budget. Given that this element was dropped in later studies, it is not mentioned here.

([2]) This index was used to study the effects of budgetary institutions in Latin American countries and has subsequently been used by de Haan et al. (1999) for EU Member States.

Graphs II.11 and II.12 briefly summarise the messages of research that uses budgetary institutions as an explanatory variable for budgetary outcomes. Graph II.11 visualises the correlation between the index of the degree of centralisation of the budgetary process, based on von Hagen et al. (2002) for the period 1981–95, and average budget balances. Following the same approach, Graph II.12 presents the results for the period 1994–98 for several recently acceded Member States on the basis of Gleich (2003). Both studies thus find evidence of a statistically significant link between budgetary institutions and budgetary outcomes. In addition to such bivariate correlations, studies that have included the indices of fiscal institutions in fuller models of fiscal reaction functions have also concluded that budgetary institutions influence budgetary outcomes in EU Member States, although the effect may be small (de Haan et al., 1999). The policy implication is that appropriate institutional reform of national budgetary institutions may be conducive to fiscal discipline.

2.3.4. Explaining budgetary slippages: the role of optimistic forecasts and creative accounting

The previous section discussed research that investigates institutional explanations for the fiscal deficit bias. As a complement to this approach, recent research has investigated how institutionally weak governments may use a strategy of window dressing, i.e. of appearing in line with the objectives of the EU fiscal rules in the short run, while showing a deficit bias in a longer-term perspective.

A first possibility to do so is to base the budget on overly optimistic growth assumptions. In this case, expenditures are set in relation to revenue projections that are based on overly optimistic growth assumptions. Corrective measures can then be avoided *ex ante*, while *ex post* revenues will be lower than expected and a deficit bias will arise due to inertia on the expenditure side (i.e. overshooting). On this point, Milesi-Ferretti and Moriyama (2004) argue that opportunistic governments may try to avoid the costs of improving budgetary positions by using more favourable growth assumptions so that the negative outcome can later be blamed on bad luck.

Another possibility for window dressing is to resort to creative accounting, as it allows for steering the measured deficit in the desired direction while avoiding structural adjustment measures. In this context, the model of creative accounting developed by Milesi-Ferretti (2003) points to a trade-off between window dressing and real fiscal adjustment, and relates it to the transparency of the budget ([1]).

These arguments may be generalised into the hypothesis that budgetary outcomes may be correlated with overoptimistic budgetary projections and creative accounting/one-off measures.

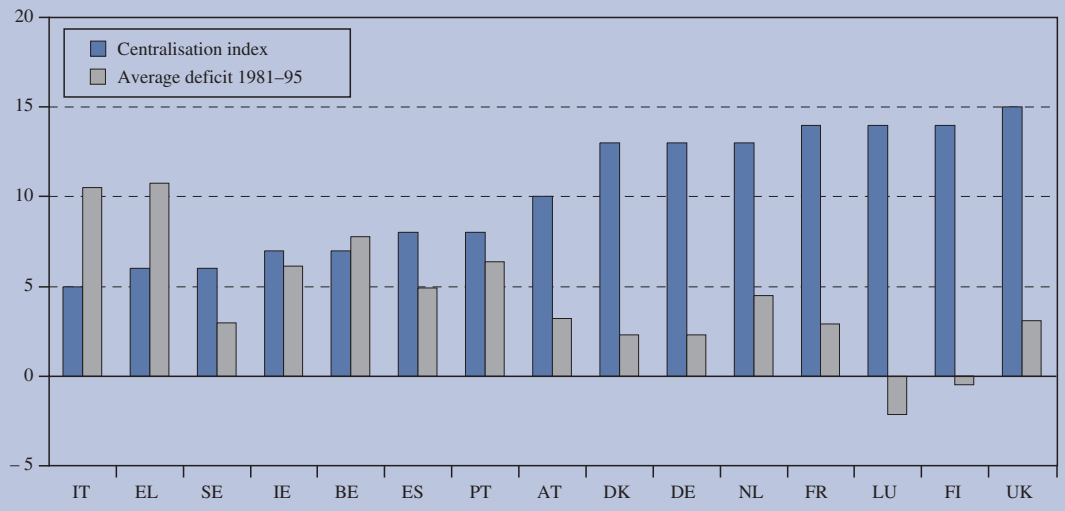
Graph II.13 shows the correlation of the degree in optimism in growth forecasts on which the budgetary projections in the stability and convergence programmes are based with average budget deficits for EU Member States since the early 1990s. It confirms that, for the period as a whole, countries that have systematically based their budgetary projections on overly optimistic growth forecasts have recorded higher deficits. This evidence is further underpinned by the finding that overoptimistic projections for the budget balance are related to the size of deficits across countries, as shown in Graph II.14.

Graph II.15 shows the correlation between the average yearly incidence of one-offs and creative accounting for the period 1993–2003 and the average deficit for the same period ([2]). It confirms that countries that have used more one-offs and creative accounting have also recorded higher deficits.

Whereas these data point to an interaction between budgetary institutions and budgetary outcomes, they do not reveal the direction of causality. On the one hand, following a strategy of window dressing through overoptimistic growth assumptions and creative accounting will itself also lead to a deficit bias in a longer time perspective. On the other hand, it might be that countries that do not address the problems of deficit bias and non-transparent fiscal procedures through appropriate budgetary institutions at national level will more easily run against the constraints of the EU fiscal rules, and then may choose a strategy of window dressing to circumvent those rules.

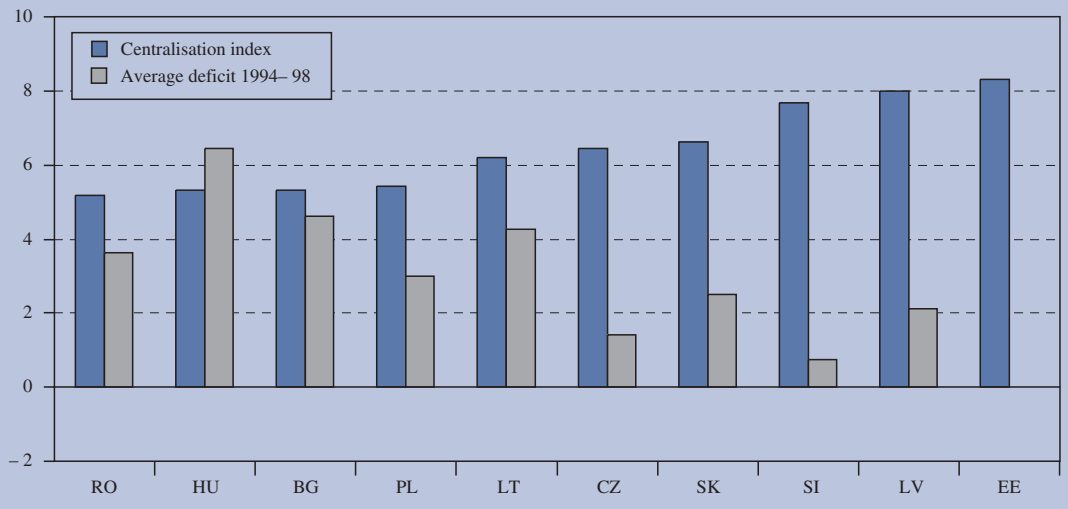
([1]) *Ceteris paribus*, a rule imposed when the budget is not transparent yields more creative accounting and less fiscal adjustment.
([2]) Based on Koen and van den Noord (2005).

Graph II.11: **Centralisation of the budgetary process and average deficits, 1981–95**



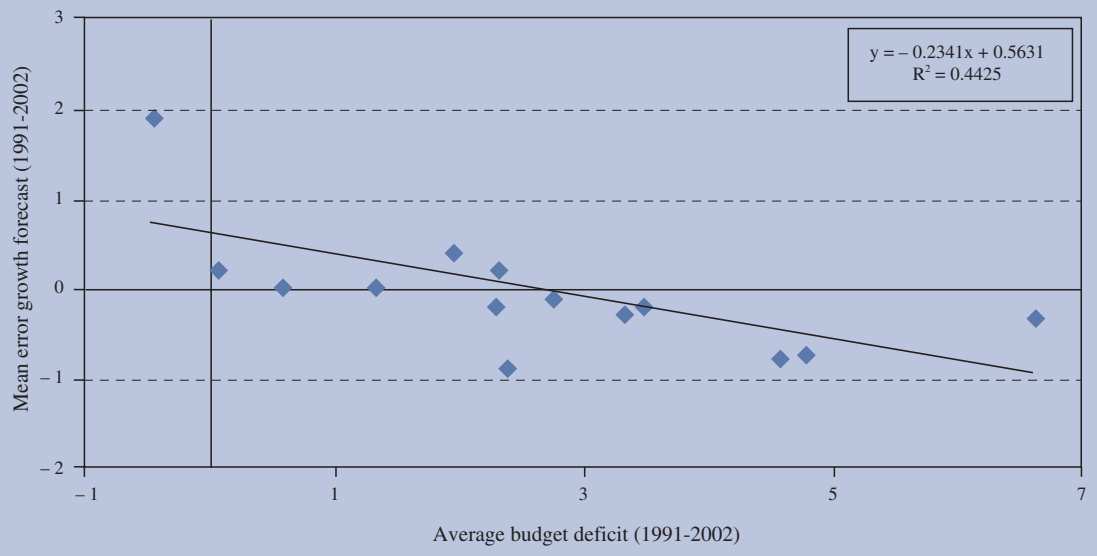
Sources: Centralisation index: von Hagen et al. (2002). Deficits (% of GDP): AMECO database.

Graph II.12: **Centralisation of the budgetary process and average deficits in central and east European countries, 1994–98**



Sources: Centralisation index: Gleich (2003). Deficits (% of GDP): EBRD transition report 2000.

Graph II.13: **Degree of optimism in growth forecasts and budget deficits, averages 1991–2002**



Sources: AMECO database for average budget deficits (1991–2002) and Strauch et al. (2004) for mean error in difference between growth forecast and outcome in stability and convergence programmes for 1991–2002. Countries included are EU-15 Member States except Luxembourg. Variables are measured as a percentage of GDP.

Graph II.14: **Degree of optimism in budgetary projections and budget deficits, averages 1991–2002**

Sources: AMECO database for average budget deficits (1991–2002) and Strauch et al. (2004) for mean error in difference between planned budget balance and outcome in stability and convergence programmes for 1991–2002. Countries included are EU-15 Member States except Luxembourg. Variables are measured as a percentage of GDP.

Graph II.15: **Incidence of one-off measures and creative accounting and budget balances, averages 1993–2003**

Sources: AMECO database for average budget deficits (1993–2003) and Koen and van den Noord (2005) for measures of average one-offs, creative accounting operations and classification errors for 1993–2003. Countries included are EU-15 Member States except Luxembourg. Variables are measured as a percentage of GDP.

2.3.5. Performance of EU Member States under the SGP: commitment versus delegation as the key variable?

In addition to the argument that fiscal discipline is correlated with indices of budgetary institutions, it has also been argued that fiscal performance of EU Member States under the SGP depends somehow on the institutional setting, i.e. whether a country uses a commitment or a delegation strategy for centralising the budgetary process (Hallerberg, 2004; IMF, 2004b). The key argument is that the ideal way for a country to address common pool problems by centralising its budgetary process depends on its electoral system. Countries with an ideologically unified government (i.e. a one-party government or if the parties in government are close to one another ideologically) need a strong minister for finance to centralise the budgetary process in order to obtain aggregate fiscal discipline. Conversely, in countries in which the government is less unified ideologically — notably multi-party governments — fiscal contracts (e.g. coalition agreements) are more suited to achieve a better control of the budgetary process. The underlying idea is that it is difficult for a strong minister for finance to constrain him/herself to fiscal rules, whereas rules are more useful in coalition governments.

It follows from the above reasoning that delegation States (typically Germany, Greece, France and Italy in the current context) should centralise the budgetary process by relying on the budgetary discretion of a strong minister for finance, whereas the commitment States (Belgium, the Netherlands and Finland) should rely on a rules-based approach. Since the SGP rules-based framework is a type of commitment approach, it should fit commitment countries very well, while in delegation countries there would be fewer incentives to follow the SGP rules.

A difficulty in identifying the approach to centralising the budgetary process (delegation versus commitment) as a key explanatory factor in explaining budgetary performance under the SGP is that the choice of a delegation approach is strongly correlated with the size of the country: large Member States are mostly delegation countries. Buti and Pench (2004) address the question of why large countries have flouted the SGP. They put forward

several related arguments to support the view that size has mattered: (i) in larger countries, EU considerations may receive less weight than domestic considerations; (ii) large countries have more voting power in the enforcement procedures of the SGP; (iii) there may have been a perception of larger costs of fiscal consolidation in larger countries. Moreover, it may be difficult to distinguish between commitment and delegation countries since reforms of the fiscal institutions may change the classification of given countries over time ([1]). Finally, it is also possible to directly question the argument that fiscal rules (i.e. either national fiscal rules or the rules of the SGP) are not suitable for delegation States, as there are examples of countries like the UK that combine a strong finance minister with a rules-based approach ([2]). Moreover, Hallerberg et al. (2004) in a paper based on an update of the data set in von Hagen (1992) argue that budgetary rules also seem to operate as disciplining devices for delegation States. The authors claim that, over the 1990s, fiscal constraints such as expenditure rules were given a more prominent role in several EU Member States.

2.3.6. Expenditure rules and expenditure outcomes

Conceptual issues

The EU fiscal rules apply to the budget balance, i.e. the difference between total revenue and expenditure. Many Member States have also introduced national fiscal rules that aim at controlling public expenditure in the context of medium-term expenditure frameworks. In many countries, such national fiscal rules are seen as a key institutional tool for complying with the EU fiscal rules.

European Commission (2003a) contains a detailed discussion of the interaction between the EU fiscal rules and national expenditure rules. National expenditure rules can complement the EU fiscal rules in several ways:

- they help in tackling the deficit bias by addressing the principal source of the fiscal profligacy: political and institutional temptation to raise expenditure in good times;
- they support the operation of the automatic stabilisers by helping to prevent tax increases in bad times;
- they can contribute to the policy objective of improving the quality of public spending;
- if adequately set and enforced, they make tax reductions more credible by making economic agents anticipate that they will be permanent;
- they are helpful in the implementation of durable consolidation packages: the literature suggests that expenditure-based consolidations are more likely to be long-lasting.

In European Commission (2003a), there is also an empirical analysis on the design and implementation of expenditure rules in EU Member States. The design includes the definition of the target (in real or nominal terms, as a ceiling or a rate of growth), what to leave out of the rule (cyclically sensitive items and/or productive expenditure categories), the legal base of the rule (political agreement or based on law) and the enforcement of the rules. The analysis suggests that the rules had contributed to expenditure control in countries that had implemented more ambitious rules. Subsequent analysis in European Commission (2004a) shows that consolidations are more likely to be expenditure-based in countries with stronger rules (Denmark, the Netherlands, Austria, Finland, Sweden and the UK).

Expenditure developments in countries with strong and weak expenditure rules

In order to further illustrate the interaction between expenditure developments, expenditure rules and political priorities, Graph II.16 shows the developments in primary expenditure for two groups of countries. The first group consists of countries that have pioneered the use of medium-term expenditure frameworks (Denmark, Finland, the Netherlands and Sweden) ([3]). The second group consists of countries with less emphasis on expenditure rules in the context of a medium-term expenditure framework (Germany, Italy and Portugal) or for which a weak design and frequent overruns have made the rule largely ineffective (France). Expenditure

([1]) For instance, Spain and Austria have moved towards a delegation approach as from 2000 (Hodson, 2005).

([2]) The two formal fiscal rules in the UK are the golden rule and the sustainable investment rule. Government departments are also given three-year spending limits (departmental expenditure limits), while any spending that cannot reasonably be subject to such multi-year limits is included in annual managed expenditure.

([3]) The UK could also be included in this group. It has been excluded, however, given that total expenditure in the UK is much lower than that in these countries and given that the political preferences in the UK have strongly shifted towards expenditure increases in recent years.

trends are represented by index numbers for primary government expenditure-to-GDP ratios, with 1997 chosen as the base year ([1]).

In the first group of countries primary expenditure was at a high level of 56 % of GDP in 1993. In all countries within this group, a strong political consensus emerged on the need to bring down public expenditure. An interesting feature is that public expenditure had been on a downward path for several years already when the rules were introduced. To some extent, the expenditure rules may therefore signal the political consensus rather than being an exogenous budgetary institution that can explain why expenditure was reduced by large amounts. A structural break in this trend of expenditure reductions seems to have occurred in 2000. In the second group of countries, primary expenditure started from a much lower level of 31 % of GDP in 1993 and has since moved slowly upwards.

([1]) The choice of the base year is dictated by the fact that most countries introduced their expenditure rules around 1997 (the rules were introduced in 1994 in the Netherlands, in 1997 in Denmark and Sweden, and in 1999 in Finland).

This trend continued despite the reductions in budget deficits during the 1990s that were based on increases in revenues. Again, the year 2000 represents a structural break after which expenditure has been rising again.

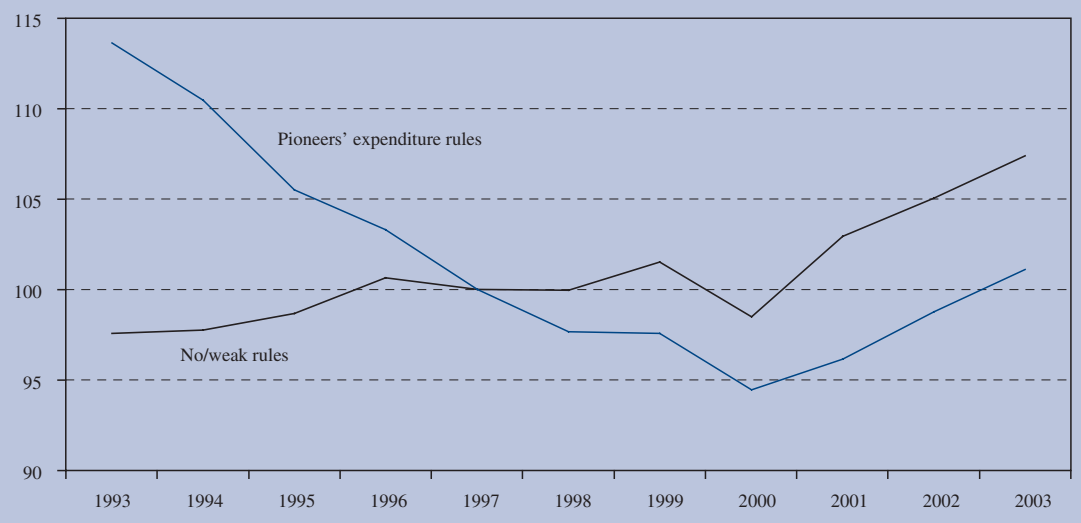
2.3.7. Explaining budgetary outcomes: the role of macroeconomic forecasts

Conceptual issues

Expenditure rules that are cast in numerical targets require an accurate revenue projection — based on unbiased economic growth forecasts — if these rules are intended to support the SGP's budget balance target. In its March 2005 agreement, the Ecofin Council confirmed the relevance of this topic: 'The Council recognises that it is important to base budgetary projections on realistic and cautious macroeconomic forecasts. It also recognises the important contribution that Commission forecasts can provide for the coordination of economic and fiscal policies.'

Conceptually, the observed link between the optimism on the growth outlook and fiscal performance can be explained by inertia in the execution of the budget. On the revenue side, it is reasonable to assume that any variation in the rate of economic growth will automatically

Graph II.16: **Expenditure developments: effects of expenditure rules, 1993–2003**



Source: Commission services.

translate into a corresponding variation in governments' receipts, as under unchanged fiscal policy tax bases should bear a stable relationship to the level of economic activity ([1]). In the planning stage of the budget, projected revenues are a determinant of expenditures. In the execution phase of the budget, however, preset expenditure lines are hard to adjust to deviations in economic growth from the *ex ante* projection. Targeting the budget balance is thus facilitated if budgetary projections can rely on unbiased forecasts in the planning stage.

If official growth forecasts were unbiased (i.e. on average the projection does not differ from the true value), the effect of overestimating or underestimating economic growth on the budget balance target would have to be accepted as the price of uncertainty. However, a completely different conclusion is warranted if official growth forecasts suffer from some sort of structural optimism, systematically overrating the underlying rate of the economy.

Optimistic forecasts: empirical evidence

Strauch et al. (2004) analyse the track record of budgetary forecasts contained in the stability and convergence programmes presented between 1991 and 2002. Their results support the view that several Member States produced optimistic growth assumptions. Moreover, countries with the most optimistic growth outlooks are also those with the largest slippages from budgetary targets. The link between the forecast bias and fiscal performance is confirmed by Larch and Salto (2003). Focusing attention on the four largest economies of the EU (Germany, France, the United Kingdom and Italy) and using a longer sample (1987–2003), they show first that forecast errors of potential output growth are significant in explaining variations in the CAB and second that official growth forecasts have an optimism bias in three of the four countries considered. The same authors show that the bias can be as high as 0.2 to 0.3 % of GDP per year, producing a measurable impact on the debt-to-GDP ratio in the medium term. For instance, over the past five years, since the beginning of EMU, the optimism bias can, *ceteris paribus*, account for around one full additional percentage point of the debt-to-GDP ratio. These estimates are confirmed by Forni and Momigliano (2004). They conclude that the misjudgment of cyclical conditions has an average yearly impact of 0.2 % of GDP on the budget in more than half of the OECD countries.

Institutional issues

Table II.4 summarises current practice in forecasting in EU Member States. In most Member States, the government itself is responsible for the economic forecasts that underlie the budgetary planning. Usually, the forecasts are produced by the Ministry of Finance. In a few cases, other government agencies are involved, for example the Economics Ministry in Germany and the statistical institute as a division of the Economics Ministry in Luxembourg. Only four Member States have their economic forecast produced outside the government. It should be noted that these countries are small, so that the forecasting institute almost has a monopoly position (the Netherlands and Belgium) or only few competitors (Austria) within the country's forecasting landscape. The extent of delegation ranges from a pure gentleman's agreement in Austria to a formal obligation in Belgium. As regards the legal status of the external forecasters, they are all intellectually independent, but receive most of their funds from the government and are in some cases government agencies. In Belgium, the most formalised case of delegation, the National Accounts Institute, comprising the national statistical institute, the central bank and the Federal Planning Bureau (a public agency with legally granted intellectual independence), produces the forecast. The government is expected by law to use this forecast in the budgetary process. The year 2001 was the only year, in which the government made use of its power to override the forecast — for a more prudent one.

In those cases where the forecast remains within the domain of the government, it can still be subject to outside checks before it is published. The central bank is consulted in many Member States, though on a formal basis only in those that delegated the forecast.

Academic institutes are consulted in many cases. In the UK, the National Audit Office has the mandate to audit many of the assumptions on which the forecasts are based, for example on trend growth, price developments, claimant unemployment, etc., with access to all relevant government documents. The weakest form of outside control during the forecasting process is the timing of the forecast. Despite the lack of outside consulting, in Germany, for example, the forecast is con-

([1]) In addition, if the tax system is taken to be roughly proportional, which would seem to be the case for most EU countries, the revenue-to-GDP ratio should be broadly neutral with respect to growth.

Table II.4

Characteristics of forecasting institutions in EU Member States

	Responsibility for forecast			Consultation process			Publication		
	Ministry of Finance	Independent institute	Government can override forecast	Statutory involvement of central bank	Consultative involvement of central bank	Academic and/or political peer review	Comparison with other forecasts	Explicitly errs on the side of caution	Date of last update
BE		X	X						Sept./Oct.
CZ	X				X	X	X		Sept.
DK	X						X		Aug.
DE	Econ. Min.				X				Oct.
EE	X					X	X		Aug.
EL	X								June
ES	X								Sept.
FR	X								Sept./Oct.
IE	X					X			Dec.
IT	X								Sept.
CY	X				X				Sept.
LV	X			X					Aug./Sept.
LT	X				X	X			Sept.
LU	Statec/Econ. Min.			X		X			Nov.
HU	X				X		X		Sept./Oct.
MT	X				X				Oct.
NL		X					X		Aug./Sept.
AT		X					X		Sept.
PL	X								Aug./Sept.
PT	X						X		Oct.
SI		X	X				X		Oct.
SK	X				X	X	X		Aug./Sept.
FI	X								Sept.
SE	X					X	X		Sept.
UK	X				X	X	X	X	March (1)

(1) Fiscal year starts in April.

Source: Commission services.

strained as it is published usually after the independent institutes published their joint forecast. In France, in contrast, no independent institute systematically monitors the government's growth and budgetary forecasts. Smaller countries, especially the new Member States but also Greece and Portugal, sometimes lack a monitoring infrastructure of independent research institutes, so that forecasts of international institutions are the only comparator.

Upon publication, the government forecast is compared with other forecasts in about half of the countries. The degree of openness about competing forecasts varies. In Italy, for example, a formally independent public body (ISAE), the central bank and the national statistical institute discuss the government's forecast during a parliamentary hearing. The UK Treasury, for example, makes a comparison of independent forecasts available on its website, which is updated monthly. The UK employs a further safeguard against overoptimism: it is the only country that bases budgetary projections explicitly on trend growth of a ¼ percentage point below its neutral view.

Due to the implementation lag of corrective measures on the expenditure side, frequent updates of forecasts can

win time. Although the Finance Ministries in almost all countries record public finance developments on a monthly basis, most countries produce official macroeconomic forecasts only twice a year, at the beginning of the budgetary process and towards its end.

Towards unbiased forecasts: do institutional characteristics matter?

Strauch et al. (2004) investigate for the EU-15 in the period 1991–2002 whether there is a forecasting bias, using the projection horizons contained in the stability and convergence programmes. These are usually submitted in December by the Member States, after the budgetary process for the forthcoming year is completed, although before 1998 they were not always submitted regularly. Thus, they are based on the most recent forecast underlying the budget. An interesting finding is that national forecasts of GDP growth that are produced by independent institutes (in Belgium, the Netherlands and Austria) show no bias. This is confirmed by Jonung and Larch (2004) with data taken directly from the national forecast publication and with a longer time horizon.

A further noteworthy result is that forecasts produced by the government may be biased but need not be. Germany, Italy, Luxembourg and Portugal (according to Strauch et al., 2004) plus France (according to Larch and Salto, 2003) are systematically optimistic in their growth projections. However, in Denmark, Greece, Spain, Finland and the UK, where the Finance Ministry also produces the official forecast, a significant bias could not be detected.

Moreover, it is also found that, where the forecast is produced by the government, other institutional characteristics do not seem to fully explain the difference between having a bias or not. In Spain and the UK, the official (unbiased) forecasts are validated against competing forecasts from the central bank or other forecasters and academics. In contrast, this is not the case in France, but neither in Denmark nor Greece. Yet, according to Strauch et al. (2004), the French and the Greek budgetary forecasts have systematically underestimated the deficit. Furthermore, Ireland and Sweden systematically err on the side of caution, according to Strauch et al. (2004). Nonetheless, it seems that the more transparent the official forecast is towards peer review and the stronger the outside monitoring, the less tendency there is for an overoptimistic bias.

In sum, available analysis provides some support to the view that one way to reduce the optimism bias in official growth forecasts and thus the ensuing effect on the budget is delegation to a body that is protected against political pressure. The task of producing forecasts of relevant variables for the budgetary process could be assigned to an independent institution with the commitment by the Ministry of Finance to use these forecasts in the planning of the official budget. A less clear-cut route to safeguard the forecast against political pressure could be to expose it to outside scrutiny by consultation processes with independent forecasters and, after publication, provide comparisons with other forecasts. The frequency of the forecasts is also important: while the forecasts are often timed to the budget preparation with two exercises per year, in the execution phase of the budget more frequent updating could be useful, given the time lags in making adjustments on the expenditure side. For example, there could be two major official forecasting exercises per year, which are updated twice after the release of quarterly data.

2.3.8. Conclusion

The EU Treaty calls upon Member States to ensure that national procedures in the budgetary area enable them to meet their obligations deriving from the Treaty. The recent Council agreement on improving the implementation of the Stability and Growth Pact has confirmed the importance of this issue and has included references to national fiscal rules, national institutions, and realistic and cautious macroeconomic forecasts. In this context, this section has reviewed the interaction between domestic budgetary rules and institutions and budgetary outcomes. Overall, the data seem to provide a certain support to the view that deficit bias, overoptimistic budgetary projections, creative accounting and one-off measures may all be linked to underlying institutional weaknesses. Given that the literature stresses that both budgetary outcomes and budgetary institutions may also be related to political priorities, it seems that a virtuous circle of improved policy outcomes across all these indicators may require improved national ownership of common objectives as well as institutional reforms of national budgetary processes.

3. Sustainability analysis in EU multilateral surveillance: what has been done, what should be done?

3.1. Introduction

During the 1980s and the first half of the 1990s, significant rises in the level of public debt increased concerns about the sustainability of deficit spending policies in the very long run. For the EU-15 countries on average, public debt shifted from around 30 % of GDP in the mid-1970s to almost 75 % of GDP in the mid-1990s. During the same period, the old-age dependency ratio (measured as population aged 65 and over as a share of population aged 15 to 64) increased only slightly, from 20.6 % to 23 %, showing that the majority of the shift in debt ratios could not be attributed to demographic pressure ([1]). In the second half of the 1990s, preliminary estimates of the budgetary impact of ageing populations pointed to an additional risk ([2]). This has been the backdrop for the increased focus on long-term fiscal sustainability.

In EU countries, sustainability of the public finances is typically analysed with a long-term perspective ([3]). Available demographic and budgetary projections show increases in budgetary expenditures driven by demographic changes in all countries over the next 30 years. A currently sustainable position may thus easily turn unsustainable if the expected cost of ageing is not anticipated somehow, for example through budgetary or structural reforms or through accumulation of budget surpluses.

Monitoring the likely trends of public finances is therefore of paramount importance in preventing the burden of public debt from becoming unsustainable. The revised code of conduct on the content and format of the stability and convergence programmes (July 2001) commits Member States to include information on the quality and sustainability of public finances, including long-term budgetary projections on the implications of ageing populations ([4]).

However, fiscal surveillance of long-term sustainability entails a high degree of uncertainty. The results may differ according to assumptions on future trends of, for example, demographic developments, macroeconomic developments (mainly growth conditions), and budgetary development of age-related expenditures. In addition, sustainability depends on the impact of structural reforms that may affect either the potential growth rate or the budgetary profile of certain expenditure categories (see Part III).

In the reformed SGP, sustainability is at the core of budgetary surveillance. Sustainability concerns are reflected in several ways: (i) in formulating an opinion

([1]) *Source:* Eurostat's NewCronos database.
([2]) See the work conducted at the OECD by Roseveare et al. (1996).
([3]) This is not the case, for instance, for emerging economies where debt sustainability is mainly a short- to medium-term issue. See IMF (2002).

([4]) Available at http://europa.eu.int/comm/economy_finance/about/activities/sgp/codeofconduct_en.pdf . In the last part of the second paragraph under the heading 'Objectives' it is stated '… furthermore, appropriate medium-term budgetary targets, consistent with the general and country-specific recommendations in the BEPGs, should also take into account the need to cater for the costs associated with population ageing'; the last paragraph of the heading 'Measures' says 'furthermore, the programmes should outline the countries' strategies and provide summary information on the countries' short- to medium-term concrete measures to tackle the long-term budgetary implications of ageing'; the second paragraph of the heading 'Time horizon' lays down that 'given the impact of longer-term demographic developments on the sustainability of public finances, information over a longer period should be included in the annual updates of the programmes in summary form. However, more detailed information should be included and updated regularly, at least every three years, …'.

on the annual update of the stability or convergence programme; (ii) the definition of the medium-term objective for a Member State's budgetary position will take account of the Commission and Council assessment of the sustainability risks; (iii) if a Member State introduces a major reform that has direct long-term budgetary saving, for example a reform of the pension system, then a deviation from the medium-term objective or the adjustment path towards it can be allowed; and (iv) in applying the excessive deficit procedure, the net cost of pension reforms that introduce a mandatory fully funded pillar will be considered carefully, as such reforms involve a short-term budgetary cost, while the long-term impact is positive ([1]); (v) there will be an increased focus on the debt criterion set down in the Treaty. In particular, Member States with high debt-to-GDP ratios should make great efforts to reduce them rapidly, thus contributing to the sustainability of the public finances.

The increased relevance of longer-term issues in the context of the Stability and Growth Pact requires a well-established methodology to gauge possible sustainability risks. This chapter presents the state of the art of long-term sustainability analysis and its use in fiscal surveillance at EU level. It both discusses how the methodology has developed since the first round of assessment in 2001, and presents possible future developments.

3.2. The current assessment of sustainability of public finances in the stability and convergence programmes

Since 2001, long-term sustainability of public finances has been examined in the context of the annual assessment of the stability and convergence programmes and their updates. Sustainability is thus discussed both in the technical assessment prepared by the Commission services ([2]) and in the Council opinions.

These assessments are based on both quantitative and qualitative tools which try to capture the degree of budgetary risks associated with current policies and ageing populations. Sustainability refers to the capacity of a country to be solvent now and in the future given current legislation and policies and without major corrections of the budget. The assessment of sustainability is a matter of judgment of what a 'major correction' is: this depends on the size of the required correction and the specific conditions linked to the country (its past history, the presence of reserves, the level of taxation, etc.). As underlined by the International Monetary Fund (IMF), 'no framework can dispense with the need for making judgments: at best, it can help inform such judgments' ([3]). The Commission's and the Council's assessment of sustainability of public finances takes into consideration both quantitative information (sustainability indicators based on the projected evolution of the debt-to-GDP ratio, see Section Debt projections) and qualitative considerations. In Part I, Chapter 3, the latest assessment is described.

The experience accumulated during the four rounds of sustainability analysis in the context of the SGP allows some preliminary conclusions. Four particular aspects of the Commission's approach merit consideration: (i) the cooperation with Member States in the Ageing Working Group attached to the Economic Policy Committee (EPC); (ii) the yearly sustainability analysis in the context

([1]) The terminology used when distinguishing between different pension 'pillars' characterising the pension arrangements prevailing in a country is not universally agreed. In the EU, a three-pillar terminology is generally used: (i) first pillar: consisting of statutory basic schemes; (ii) second pillar: consisting of occupational schemes; and (iii) third pillar: consisting of individual pension plans. A pension system might be statutory, comprising both a PAYG part and a funded part. This could be seen as a statutory two-tiered first-pillar pension system, comprising a public PAYG part and a funded part being privately managed. The different 'pillar terminologies' do not have any direct legal implications. The World Bank has instead developed a multi-pillar terminology as follows: 0 pillar: social assistance schemes; first pillar: earnings-related schemes; second pillar: mandatory savings; third pillar: occupational schemes; fourth pillar: individual pension plans; and fifth pillar: family plans (World Bank, 2005, 'Terms behind pension discussions', http://www.worldbank.org/). However, a pension reform that introduces a 'mandatory fully funded pillar' has a special significance in terms of the Ecofin report of 20 March 2005 on the reform of the SGP (see Part II, Chapter 1). Such a reform normally involves a partial shift to funding within the statutory pension system. According to Eurostat's decisions of 2 March and 23 September 2004, contributions to a funded defined-contribution pension scheme should be classified outside government by March 2007 at the latest (see Boxes II.5 and III.3). This normally implies a loss of social security contributions recorded in government and therefore a short-term deterioration in the general government budget balance when such a scheme is introduced.

([2]) Available on the Economic and Financial Affairs DG's website (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

([3]) See IMF (2002, p. 6). As developed in 'Public finances in EMU — 2004', sustainability is not a purely quantitative issue. For example, and this may be a particular challenge in some recently acceded Member States on which Part IV provides a specific focus, underinvesting today in environmental protection and technologies may lower government expenditures in the short term, and thus have a temporary positive impact on public finances, but it would usually imply much larger spending in the future, with an overall significant negative impact on intergenerational discounted financial sustainability. Hence, the necessity to follow both a quantitative and a qualitative approach.

of the overall assessment of the updated SCPs; (iii) the input data of the sustainability analysis (the medium-term scenario, the long-term budgetary projections and the long-term macroeconomic assumptions); (iv) the debt projections (the set of quantitative indicators, sensitivity tests and qualitative factors used in the assessment).

3.2.1. The cooperation with EU Member States

In 1999, the Ageing Working Group (AWG) was established as a technical working group attached to the EPC. The purpose of the AWG was to build the framework for monitoring and assessing the budgetary impact of ageing populations. This framework included a first set of long-term budgetary projections which took place in 2001 and covered pension and healthcare expenditures ([1]). The exercise was completed in 2003, when additional age-related expenditures (education and unemployment transfers) were added. This meant that, by the end of 2003, long-term budgetary projections for EU-15 Member States covered around two thirds of primary expenditures ([2]). The projections were based on national quantitative models for pension expenditures and common methodologies for the other budgetary items. To project these items, an agreed demographic scenario prepared by Eurostat and agreed macroeconomic assumptions were used.

The harmonised projections were based on consistent assumptions across countries in terms of GDP and demographic developments. However, the national models used to produce pension projections remain to a great extent unknown at EU level (see Section 3.2.3). Comparability has also been reduced by subsequent revisions of the national projections taking place without peer reviews within the AWG.

In addition, the AWG became the forum to discuss methodological aspects for the assessment of long-term sustainability of public finances. An *ex post* evaluation of the exercise from a methodological point of view has allowed regular improvements in the methodology.

3.2.2. The annual assessment

The Stockholm European Council of March 2001 agreed that 'the Council should regularly review the long-term sustainability of public finances, including the expected strains caused by the demographic changes ahead. This should be done both according to the broad economic policy guidelines (BEPGs) and in the context of the stability and convergence programmes'. This has been implemented by carrying out annual reviews of sustainability in the context of the updated stability and convergence programmes and including a summary assessment in the BEPG implementation report.

The annual assessment has helped maintain political pressure for structural reforms (in particular in the field of pensions) and on running down debt ([3]). The pressure has increased over the years given the higher relevance devoted to the assessment of long-term sustainability in both the technical Commission documents and the Council opinions. While in the first two rounds of assessment, sustainability analysis was presented as an annex to the main Commission technical document, it became part of the core assessment in the following rounds.

However, the annual assessment has some drawbacks. Because of timing and space limitations, it keeps the analysis fairly general and based on few indicators. This has raised some criticism and the issue of a possible need for a more in-depth assessment of underlying budgetary risks. As the long-term budgetary projections are not updated every year, and as major reforms generally take place rather infrequently, only very limited changes in the assessment of public finance sustainability can be expected from one year to the next.

3.2.3. The input data

Input data in the sustainability analysis are a key concern to produce reliable estimations of sustainability risks. Three types of input are necessary to perform the analysis:

- the budgetary profile for the medium term;
- the long-term budgetary projections;
- the long-term macroeconomic assumptions.

([1]) See Economic Policy Committee (2001).
([2]) For the methodology applied to project education expenditures, see Montanino et al. (2004). For an overall view of the budgetary projections, see Economic Policy Committee (2003).
([3]) Pension reforms have taken place in a number of countries since 2001 (Germany, France, Italy and Austria) while other countries (notably Denmark, the Netherlands, Finland and Sweden) have aimed at running down the debt. In other cases (such as Belgium, Spain and Ireland), Member States have started accumulating reserve funds to deal with the ageing problem in the future.

The medium-term scenario relies on data provided by Member States in their updated stability or convergence programmes. This information includes primary expenditures and total revenues, interest payments, debt ratio and the stock-flow component, one-off measures with budgetary impact, and the cyclical component of the budget balance. The main advantage of using such data is that the sustainability analysis incorporates the planned policies for the medium term, making it fully consistent with the overall strategy of the government.

However, the medium-term scenario planned by governments in their updated programmes has in a number of cases been fairly optimistic, underestimating sustainability risks (see Part II, Section 2.1). The Commission services therefore also analyse a scenario that assumes no consolidation in the medium term (see Part I, Chapter 4).

Long-term budgetary projections and macroeconomic assumptions may either come from a national source or be the result of common projections carried out at EU level. The sustainability analysis uses both sources. Table II.5 shows the source of budgetary projections for pensions (either national or EPC) used in the sustainability analyses for EU-15 Member States. In most cases, the common pension projections of 2001 are not used. This is mainly because national projections are considered to be more updated and more detailed on the country-specific pension systems.

Box II.4: **Sustainability analysis carried out by the IMF**

Sustainability analysis is carried out by the IMF under the Article IV reports. The standard template considers a five-year horizon where debt dynamics are assessed ([1]). However, for industrialised countries, this standard approach is modified somewhat to include the risks associated with ageing populations. The framework applied to EU countries consists of three main elements. First, a baseline scenario for the public debt dynamics is defined, which includes estimates of age-related expenditure trends provided either by the Member State or by the IMF staff. The main macroeconomic assumptions are set by the IMF staff. Projections are generally carried out up to 2050. Second, on the basis of this scenario, a series of sensitivity tests is applied. The sensitivity tests mainly include macroeconomic shocks to GDP growth and real interest rates (risks associated with exchange rates are of limited relevance in EMU). These sensitivity tests provide different scenarios for the debt dynamics over the long term. Third, a judgment of the resulting debt dynamics under the baseline and alternative scenarios is made. The interpretation of the debt ratio tries to answer the following questions: (i) Is the debt ratio, either along the path or at the end of the horizon, so high that the country is vulnerable to a crisis? (ii) Can the country plausibly generate and maintain the primary surpluses required over the medium term to at least stabilise the debt ratio? (iii) Are the gross financing needs required along the path so large that the country may run into a funding crisis?

Clearly, the answers to these questions need to take into consideration the country-specific context and therefore a good deal of judgment is needed. This is particularly true for EU countries, where crises are not associated with levels of public debt similar to those of emerging countries and thus past crises cannot be used as a benchmark for assessing sustainability risks ([2]).

Overall, the IMF's and the Commission's approaches are similar. Both are based on the public debt dynamics over the long term, which includes estimates of age-related expenditures and some judgment of the sustainability risks associated with the results. However, some differences should be underlined. First, the Commission produces sustainability analysis for all EU countries on a regular basis, i.e. following the yearly submission of updated stability or convergence programmes, while the IMF covers around half of the countries on a regular basis. A second difference is the design of the sensitivity tests. The Commission produces tests for an alternative medium-term scenario and higher (nominal and) real interest rates, while the IMF tests real interest rates and GDP growth (and, if relevant, exchange rate shocks). Third, the Commission publishes synthetic indicators (sustainability gaps and the required primary balance) to make more explicit the budgetary effort needed to reach sustainable positions.

In terms of input, both institutions rely on national projections, although the Commission also uses some harmonised projections for education and unemployment transfers. It should be noted that the Commission will use harmonised projections for age-related expenditures and macroeconomic variables once updated projections are produced by the Economic Policy Committee.

([1]) The main references for the methodology used by the IMF are IMF (2002) available at http://www.imf.org/external/np/pdr/sus/2002/eng/052802.htm and IMF (2003) available at http://www.imf.org/external/np/pdr/sustain/2003/061003.htm.

([2]) IMF (2003) reports that more than half of the sovereign debt crises have occurred at public (or external) debt ratios of below 40 % of GDP.

The use of national projections in the context of multilateral surveillance provides a regular update of the common projections. However, detailed information regarding the differences between the national and common projections is frequently lacking, making an analysis based on the national projections more difficult. As illustrated in Table II.6, the future changes in pension expenditures as reported in the updated stability programmes are in a number of cases quite different from the 2001 EPC projections. Still, very little or no information is available to explain and thus exert multilateral surveillance with regard to these differences. Possible explanations include different underlying assumptions on macroeconomic variables or demographic trends, different assumptions on agents' behaviour, new reforms, or a revision of actual data on pension expenditure.

National projections are also in a better position to incorporate relevant country-specific detail. In addition, common projections are normally not run every year because of the complexity of setting the common framework.

In general, common projections still fit better with the need of multilateral surveillance as they facilitate the Commission's and the Council's interpretation of the results. As there is, in principle, full transparency regarding the methodology and the underlying assumptions, the results are easy to compare across Member States.

Long-term macroeconomic and demographic assumptions must be coherent with budgetary projections. If the latter incorporate national scenarios which are different from the common assumptions, this must be explicitly spelled out and information should be provided in order to facilitate multilateral surveillance. However, the use of national scenarios may risk providing long-term assumptions that are not consistent with one another. This could go against expectations of some convergence among EU countries as regards labour productivity growth rates, life expectancy, and interest rates on public debt.

3.2.4. Debt projections

As mentioned in Section 3.2, a country is often considered to be in an unsustainable situation if the debt-to-GDP ratio reaches a level beyond which the country faces difficulties in issuing new debt ([1]). Since this maximum level of debt is not measurable *ex ante*, sustainability is measured looking at the dynamics over time, in particular whether debt is stable, declining or increasing ([2]).

([1]) See Blanchard (1984).
([2]) See Perotti et al. (1997).

Table II.5

The source of pension expenditure projections in the sustainability analysis

	2001	2002	2003	2004
BE	National	National	National	National
DK	National	National	National	National
DE	EPC	National	National	National
EL	EPC	National	National	National
ES	National	National	National	National
FR	EPC	EPC	National	National
IE	EPC	EPC	EPC	EPC
IT	EPC	National	National	National
LU	EPC	EPC	EPC	EPC
NL	National	National	National	National
AT	EPC	National	National	National
PT	EPC	National	National	National
FI	National	National	National	National
SE	National	National	National	National
UK	National	National	National	National

Sources: EPC, national stability and convergence programmes and European Commission technical assessments.

The main indicator of the sustainability analysis is the gross debt dynamics over the long term ([1]). This requires the estimated trends of age-related expenditures (pension, healthcare, education, long-term care and unemployment transfer). Such long-term debt projections take account of future obligations that are not necessarily backed by law but are very likely to translate into actual government expenditure. These are often referred to as implicit liabilities ([2]). While implicit liabilities are highly relevant to sustainability analysis, their definition and measurement are in general not straightforward (see Box II.5).

In the first two waves of assessment (2001 and 2002), the budgetary position of the last year of the programme was measured in nominal terms (not adjusted for the cycle). This implied that temporary budgetary effects due to the cycle or to one-off measures were assumed constant over time. In the subsequent rounds of assessment, the way debt is projected has been modified to better take into account the underlying budgetary position. Since the 2003 assessment, the budgetary figures have been corrected for the cycle and in the 2004 assessment they were also corrected for one-off measures. Below-the-line operations which affect the debt have, on the other hand, always been included in the medium-term debt development and from the first year of projection onwards a zero stock-flow adjustment has been assumed.

The revenue-to-GDP ratio and ratio of other primary expenditures to GDP are in general held constant over the projection period. However, projections of national revenue dynamics based on legislation already in place are taken into account. This largely concerns deferred tax revenues from contributions to funded pension systems as well as accumulated earnings prior to disbursement ([3]).

The definition of debt

For the assessment of sustainability, different definitions of public debt can be envisaged. The definition also depends on statistical conventions. The debt concept used by the Commission, Maastricht gross debt, is defined in the protocol on deficit and debt to the Maastricht Treaty. Although gross debt is only a partial indicator of sustainability, the concept entails the advantage of being measurable with a high degree of certainty and being comparable across countries in the EU and across time. The choice of focusing on gross debt keeps the analysis simple and transparent while giving enough information on sustainability risks.

However, it has been argued that governments may hold assets which might guarantee the sustainability of public finances even at a very high level of outstanding gross debt, or they may decide to use budget surpluses to accumulate assets instead of repaying the stock of gross debt. In those cases, the gross debt ratio may not decline or decline at a slower pace without signalling a deterioration in sustainability.

To remedy this, an adjusted gross debt measure was used for several countries in the 2004 assessment round. This elaboration of the Maastricht gross debt measure takes into account the financial position of public pension funds, in particular those funds that are established and/or legislated with a strict purpose of using them only to cover the future pension-related public expenditures (see Box II.6).

Synthetic indicators

On the basis of the debt dynamics, three synthetic indicators of the so-called sustainability gaps have been calculated in the 2004 round of assessments.

S1 indicates the difference between the constant tax ratio required to reach a debt ratio in 2050 of 60 % of GDP and the current tax ratio. If the difference is positive, the Member State concerned is not able to ensure respect of the 60 % reference value over the very long run on the basis of the current policy. An increase in the primary balance is therefore required. However, even a zero or negative value of this indicator does not ensure sustainability after 2050 since debt dynamics can be on an explosive path. The intertemporal budget constraint may then not be respected.

([1]) See European Commission (2002a) for the way public debt is projected.
([2]) See European Commission (2004a).
([3]) In Denmark, the Netherlands and Sweden, projected tax revenues vary as they can largely be attributed to the deferred tax revenues from contributions to funded pension systems as well as accumulated earnings prior to disbursement. For Germany, the projected rise in the revenue-to-GDP ratio was additionally influenced by the path of social security contributions which follows the laws that govern the social security system resulting from unchanged legislation including the 'pension insurance sustainability law'. In the countries that implemented systemic reforms of pension systems, total revenue projections were adjusted for the expected dynamics in the pension contributions to the funded pillar (Estonia, Latvia and Lithuania), in order to ensure consistency with the public pension expenditure projections where such delimitation was made available. Changes in non-age-related expenditures over time were incorporated only in the UK, as several transfer payments from the government are indexed to inflation and should therefore fall in relation to GDP.

The S2 indicator is based on the intertemporal budget constraint. It indicates the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt (Blanchard, 1990). Given the government intertemporal budget constraint, the evolution of the debt-to-GDP ratio is a reflection of (i) the inheritance from the past, in the form of the product of the ratio of accumulated debt to GDP times the difference between the real interest rates and the growth rate, and of (ii) the current spending policies, in the form of a primary balance.

The value of the S2 indicator depends on the differential between the interest rate and the growth rate, i.e. on the discount factor, the level and the profile of age- and non-age-related expenditures, the current stock of gross debt and the current tax-to-GDP ratio ([1]).

([1]) In more practical terms, as an assumption during the calculation of the indicator, the interest rate growth differential is positive.

The indicators S1 and S2 both have a long-term character. Thus, while the size of the two indicators points to the required magnitude of change in the tax policy if the respective sustainability conditions are to be fulfilled at some point, their informational content with regard to the short- to medium-term policy-making may be limited.

The required primary balance (RPB) is an indicator with a medium-term focus that has been introduced to translate the messages of the S2 indicator into requirements for medium-term policy-making. Calculated on the basis of the fulfilled sustainability condition for the indicator S2, the RPB indicates the average required primary balance to be maintained over the first five years of projections after the end of the programme period.

The time profile of the RPB is negatively correlated to the projected dynamics of the age-related expenditures. Given a previously set tax rate that would ensure sustainability and assuming an increasing path of the age-related expenditures, the RPB time profile will be downward sloping. The steeper the time profile, the higher the

Table II.6

Change in government expenditure on pensions over the period 2005–50

(% of GDP)

	EPC 2001	2001 update ([1])	2002 update	2003 update	2004 update	Difference between 2004 update and EPC 2001
BE	3.8	3.9	2.9	3.7	4.0	0.2
DK	2.0	1.9	2.5	2.3	3.0	1.0
DE	5.5	4.8	5.4	3.9	2.7	– 2.8
EL	12.4	9.8	10.2	10.2	10.2	– 2.2
ES	8.2	8.3	5.1	5.1	5.1	– 3.1
FR ([2])	3.6	3.6	3.6	2.2	2.2	– 1.4
IE	4.5	4.5	3.9	3.8	3.8	– 0.7
IT	0.3	– 0.2	0.2	0.0	0.3	0.0
LU	1.9	:	1.9	1.9	1.9	0.0
NL	5.3	5.3	3.6	3.7	3.3	– 2.0
AT	2.5	0.7	1.8	0.4	– 0.6	– 3.1
PT	2.5	4.4	2.3	1.2		
FI	5.0	5.1	3.1	3.2	3.6	– 1.4
SE	1.4	1.2	1.8	1.1	0.9	– 0.5
UK	– 0.9	– 1.0	– 0.2	0.3	0.6	1.5
EU-15	3.3	3.0	3.0	2.4	2.2	– 1.1

([1]) The starting year for Greece, Spain and Portugal is 2000 instead of 2005.
([2]) The projections end in 2040.

Sources: Economic Policy Committee (2001), Commission services' technical assessments of the stability and convergence programmes and Commission services' calculations.

sustainability concerns arising from the population ageing. Thus, the change in the policy needs to be more substantial in the Member States that are projecting a higher increase in the age-related expenditures in the period.

The evolution of sustainability indicators across different rounds of assessments

During the different rounds of assessments, these indicators have developed over time to better summarise sustainability risks in the EU context. Table II.7 presents the methodological evolution of these indicators. In the first three rounds of assessments (from 2001 to 2003), the main indicator was the so-called T1 (in 2003 renamed S1), which was based on the SGP requirement of keeping a close-to-balance or in-surplus budgetary position every year up to 2050 ([1]). Clearly, this indicator leads to a convergence towards zero of the debt-to-GDP ratio. Despite the fact that low levels of debt reduce the vulnerability of public finances and risks of big policy changes to correct imbalances, a zero debt ratio may even be counterproductive ([2]). Therefore, the policy advice derived from this indicator may imply a more restrictive budgetary policy relative to what would be needed to ensure sustainability over time.

In addition, this indicator would lead to a stricter policy than what is envisaged in the SGP, targeting a debt-to-GDP ratio clearly below the Maastricht ceiling of 60 %. The debt ratio in 2050 according to the T1 indicator (S1 in 2003) was for all countries far below the Treaty threshold. In 2004, the AWG and the Commission therefore replaced this indicator with the new S1 which explicitly includes the reference value for debt in the long term.

The 2002 assessment also included an indicator called T2 (see Table II.7 for an explanation). Experience showed that this indicator did not add additional information to that already available with the other two indicators (renamed S1 and S2 in 2003). Thus, it has been decided to discontinue its use.

Three lessons are derived from an evaluation of the use of the sustainability indicators.

First, there is a clear need to translate the results of the long-term indicators into short-term policy. The indication of a medium-term requirement to respect a sustainable path may help the conduct of economic policies.

Second, attention should be focused on the sign of the indicators and their magnitude, not the exact value. The sign gives information on whether a budgetary consolidation is needed to cope with sustainability risks, while the magnitude indicates whether a budgetary consolidation is feasible or whether large structural reforms are indispensable ([3]). The exact value of the indicator is clearly highly sensitive to the underlying debt projections and, for what concern the S2, to the applied discount factor.

Third, once correctly interpreted for their sign and magnitude and not for their exact value, the two long-term indicators S1 and S2 give broadly the same message. Currently, the sustainability analysis provided by the Commission presents six sustainability indicators for

([1]) See European Commission (2002a) for an explanation of the T1 indicator.
([2]) Bishop (2003) argues that government debt plays a role in determining the structure of interest rates and it is also a risk-free investment for families and pension funds.
([3]) Clearly, the feasibility of a fiscal adjustment depends on the initial level of revenues. Countries with a low level of revenue-to-GDP ratios may consider it feasible to adjust on the revenue side because this may have a limited impact on the allocation of factors.

Box II.5: **Different measures of implicit liabilities**

A key factor for governments' expected future expenditure commitments is the projected demographic change. In most Member States, the old-age dependency ratio is projected to double over the coming decades (see, for example, Economic Policy Committee, 2001, and Heller, 2004). Implicit liabilities linked to the projected demographic change have therefore been given special attention and are an integral part of the EU's multilateral budgetary surveillance. However, countries also face other long-run budgetary risks, for example contingent liabilities in the form of bail-outs of insolvent companies, disaster relief or climate change. One possibility would thus be to add implicit liabilities to the explicit liabilities or debt (e.g. Wyplosz, 2004).

(Continued on the next page)

Box II.5 (continued)

Pension debt arises in PAYG pension schemes when current liabilities are not met by current contributions. This could result from a rise in the old-age dependency ratio while at the same time contributions to and disbursements from the pension scheme are kept unchanged. Franco et al. (2005) distinguish between three different definitions of pension liabilities: accrued-to-date liabilities include the present value of pensions to be paid in the future on the basis of accrued rights. Neither the future contributions of existing workers nor their accrual of new rights are considered; current workers' and pensioners' net liabilities also include the present value of both the future contributions of existing members and their new rights; open-system net liabilities also include the present value of future contributions and pensions of new workers under current rules. One can choose to include only children born, but not yet in the labour force, or to use an infinite perspective. Among these three definitions, only accrued-to-date liabilities — or pension debt — could be linked to conventional explicit public debt. The other two definitions are only potential liabilities, while explicit debt is backward-looking.

There are several different possibilities to measure accrued implicit pension debt, ranging from leaving the SNA unchanged to including all unfunded pension obligations as liabilities. These issues are being discussed in the current review of the system of national accounts (SNA) and the European system of accounts (ESA) ([1]). The latter approach could very significantly change the government finance position compared with the current methodology ([2]). Moreover, there may be considerable measurement problems involved, such as delimitations of expenditure and revenue linked to pension obligations and its implications for discounting such future flows, which could compromise the reliability and usefulness of the government accounts. In this context it should be borne in mind that the multilateral budgetary surveillance in the EU, and in particular in the euro area, is based on the national accounts and the government finance statistics according to ESA. Changes in the compilation of government finance statistics might therefore require a review of the budgetary surveillance framework in the EU and in particular in the euro area.

In addition, pension debt is a rather different concept from conventional explicit debt: (i) the maturity and principal of pension debt are uncertain; (ii) pension rights are not always embodied in formal contracts; (iii) pension rights are not tradable and therefore do not exert any direct pressure on financial markets.

An alternative possibility to acquire estimates of pension debt in the SNA/ESA framework could be to introduce such estimates as a compulsory memorandum item or as specific satellite accounts. Such an approach would have the advantage of leaving the national accounts unchanged, while at the same time providing important additional information. In addition, the measurement problems involved would be kept separate from the government accounts.

The Commission services' current approach to measuring implicit liabilities is to project expenditures over the long run, given a demographic scenario. This means a flow concept is used, instead of an estimate of the stock of implicit liabilities. This approach may be better suited to providing useful policy-relevant input for the purposes of assessing the fiscal position over the long term. It takes the explicit debt and deficit situation of the country as the starting point and, on the basis of the projected expenditures and revenues over the long run, extrapolates the evolution of deficit and debt for a given demographic scenario. In this sense, the analysis takes implicit liabilities into account from two strands: (i) the impact of accrued pension rights, as well as other welfare payments, or provisions; (ii) the impact of projected future welfare payments. The Ageing Working Group attached to the Economic Policy Committee has stated a preference for the flow approach as a measure of the stock of implicit pension liabilities since it is (i) a narrower concept, as it does not include other age-related expenditure items, and (ii) is very sensitive to starting conditions and underlying assumptions ([3]).

Nevertheless, estimates of implicit pension liabilities, for example in the form of calculating these as memorandum items of satellite accounts in the SNA/ESA framework, can provide useful insights for other purposes. For example, they can be used to provide an estimate of shifting implicit liabilities to explicit liabilities. This would contribute to raising awareness of future fiscal obligations.

([1]) See the electronic discussion forum 'The treatment of pension schemes in macroeconomic statistics' set up by the IMF at the request of the Intersecretariat Working Group on National Accounts (ISWGNA) (http://www.imf.org/external/np/sta/ueps/index.htm).

([2]) Boskin et al. (1987) note that, referring to the United States, 'moving all of the economic and demographic projections from intermediate to optimistic or pessimistic [assumptions] results in a change which is larger than the privately held national debt'.

([3]) Economic Policy Committee (2003).

each country (S1, S2 and RPB, all under two different scenarios — see Part I, Chapter 4). It may be considered whether a reduction of the indicators may increase clarity in the sustainability analysis.

Sensitivity tests

Debt developments are extrapolated up to 2050 under two different scenarios. Under a baseline or programme scenario, the starting position in terms of the underlying balance, level of debt, primary spending and tax revenues (all expressed as percentages of GDP) corresponds to the final year of the period covered by an update of the stability or convergence programme. In order to fully consider the impact of current budgetary policies on long-term sustainability, the underlying balance is calculated net of the cyclical component and one-off measures.

This baseline scenario assumes that Member States actually achieve the budgetary targets (for the final year) set in their programmes. However, such an outcome is by no means assured. In order to assess the importance of the medium-term consolidation process for the achievement of long-term sustainability, an alternative scenario is run. In this scenario, debt levels are extrapolated for the period between the year in which the update was submitted and 2050, assuming that no budgetary consolidation is achieved. This means that the underlying primary balance in the last year of the programme period remains at the same level as in the starting year and no stock-flow operations take place.

In addition, a sensitivity test on interest rates has been introduced for both scenarios. This is done by running debt projections assuming an interest rate that is 50 basis points higher throughout the projection period.

Qualitative considerations

Most, but not all, information regarding long-term sustainability of public finances can be quantified. Besides, the quantitative sustainability indicators should not be interpreted in a mechanical manner. Table II.8 summarises the various types of qualitative information used by the Commission in reaching its policy recommendations. For example, several Member States are implementing structural reforms, in particular in the fields of pensions and healthcare. While this is reflected in the quantitative indicators through the country-specific budgetary projections of age-related expenditures, qualitative information and analysis regarding the reform strategy and implementation should also be considered. In this context, the overall analysis is enriched with qualitative considerations, which include an assessment of relevant strategies/reforms and points to the risks that could jeopardise their implementation and therefore their projected benefits.

Such an approach also contributes to an evaluation of whether the government strategy is sufficient to achieve the medium-term policy objectives regarding government balances, debt and, where relevant, planned implementation of structural reforms. In addition, it ensures continuity in the qualitative assessments of the strategy, and allows for a consistent and comprehensive analysis as regards the changes in quantitative indicators over time.

3.3. An EU-wide perspective of long-term sustainability of public finances

Sustainability concerns differ widely across EU countries. Focusing on the EU-15, Graph II.18 plots debt dynamics in the EU-15 from the mid-1970s onwards, including the projected path under the different rounds of assessments. It also plots the old-age dependency ratio over the same period (people aged 65 or more as a share of people aged 15 to 64). All variables are indexed (1977 = 100). As shown, from the mid-1970s to the mid-1990s, debt increased much faster than the old-age dependency ratio, suggesting that demographic change was not the main explanation for the increase in debt. In fact, the old-age dependency ratio increased by around 10 % while the debt ratio increased by around 70 % during that period. The debt ratio then declined somewhat in the run-up to joining the euro for most of the EU-15 countries. For the coming decades, debt dynamics are forecast to be less pronounced than the old-age dependency ratio dynamics in all the baseline scenarios. Debt dynamics are, on the other hand, more pronounced in the alternative scenario, in which the planned budgetary consolidation does not take place.

At country level, three main issues are relevant in the context of the results of the sustainability analysis.

(i) Are public finances sustainable?

(ii) Do the budgetary measures in the programme improve sustainability?

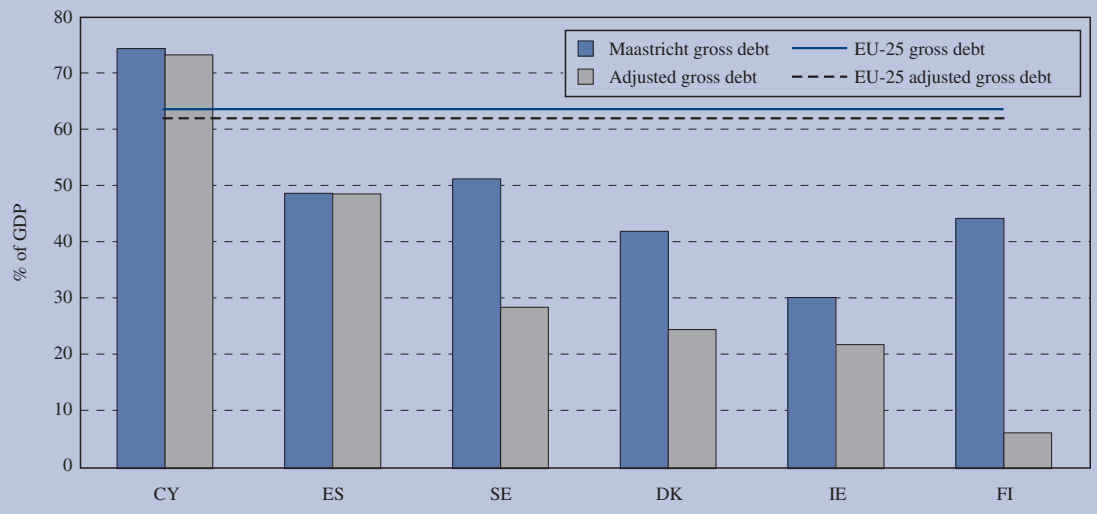
(iii) What are the key policy challenges?

Box II.6: **The adjusted gross debt**

Several Member States have established funds with a strict purpose of covering pension-related expenditure. Accumulating financial assets has a similar effect on sustainability as reducing debt. In the assessment round of the 2004/05 updated stability and convergence programmes, the Commission services adjusted gross (i.e. Maastricht) debt by taking into account certain financial assets when assessing the sustainability of public finances. In order to make this adjustment, three issues need to be addressed: (i) which assets should be considered; (ii) which funds should be considered; (iii) how to distinguish between national government bonds and other bonds.

In principle, all assets held by governments contribute to easing the pressure on the public finances in the longer term. For some financial assets, such as shares in non-floated public enterprises, it may not be straightforward to determine their current value or they may not be considered liquid. This is one reason why the adjusted gross debt concept used does not include all assets. First, only currencies, deposits and tradable securities for which a market value can be determined are considered as liquid assets. Second, public pension fund assets that are established or legislated with a strict purpose of covering pension-related expenditure are included and not fund assets accumulated for other purposes. In principle, dedicated pension funds should not be used for any other purpose and therefore explicitly ease the budgetary impact of ageing. The sectoral delimitation within general government of pension fund assets is not uniform across Member States and a case-by-case approach was followed to include all the relevant assets. Third, in order to avoid double-counting, the consolidated financial balance sheet is used, in which national government bonds have already been netted out when calculating gross debt.

Graph II.17: **Maastricht gross debt and adjusted gross debt, 2004**



Source: 2004 updates of the stability and convergence programmes.

Some countries have chosen to accumulate liquid assets in public pension funds, and for these this adjustment had a considerable impact (see Graph II.17). This is particularly true for Finland, Sweden and Denmark, where the accumulation of funds has taken place for many years. Other countries have started accumulating funds recently, and in the Spanish case the fund has only a small fraction in assets other than national government bonds, which are already netted out in the Maastricht gross debt measure. At the EU aggregate level, the differences between the debt definitions are small, reflecting that asset accumulation predominantly takes place in small Member States. Maastricht gross debt in 2004 in the EU-25 was 63.9 % of GDP, dropping to 62.2 % when looking at adjusted gross debt.

(Continued on the next page)

Box II.6 (continued)

Looking ahead, a review of the concept of adjusted gross debt could be considered. First, Eurostat's decision of 2 March 2004 on the classification of pension schemes implies that funded defined-contribution pension schemes should be classified outside government. The argument is that pensions to be paid depend on financial market developments (and on households' investment choices), not on government decisions. According to Eurostat's decision of 23 September 2004, Member States are required to implement this by March 2007 at the latest. In the Swedish and Danish cases, this will in all likelihood involve a reclassification of a part of their funds outside government. This will imply an upward revision of both Maastricht gross debt and adjusted gross debt. The public pension projections would then, for reasons of consistency, need to be adjusted downwards. Second, all liquid assets for which a market value can be determined when making the adjustment could be considered. While public pension fund assets that are established or legislated with a strict purpose of covering pension-related expenditure explicitly ease the budgetary impact of ageing, assets accumulated for other purposes also contribute to reducing the net debt position. The issue of establishing a value would be feasible with the restrictions currently used, i.e. liquid assets for which a market value can be determined.

Table II.7

The evolution of the indicators in the Commission's sustainability analysis

2001	2002	2003	2004
T1 (the difference between the current tax ratio and the constant tax ratio required to reach the same debt level in 2050 that would result from a balanced budget position over the entire projection period)	T1 (same as T1 in 2001)	S1 (same as T1 in 2001 and 2002)	S1 (the difference between the current tax ratio and the constant tax ratio required to reach a debt-to-GDP ratio of 60 % in 2050)
	T2 (the difference between the current tax ratio and the constant tax ratio required to reach a debt level of 40 % of GDP in 2050)		
	T3 (the change in the revenue-to-GDP ratio that would guarantee respect of the intertemporal budget constraint)	S2 (same as T3 in 2002)	S2 (same as T3 in 2002)
			RPB (the average required primary balance in the first five years of projections needed to respect the intertemporal budget constraint)

Source: Commission services.

An overview of the assessments of sustainability for the EU-15 Member States across rounds is provided in Table II.9 ([1]). As can be seen, the assessments have shown a high degree of stability in the judgment across years for half of the EU-15 countries (i.e. Denmark, Greece, France, Ireland, Luxembourg, Finland and Sweden). In some of these countries, reforms and/or a budgetary strategy to cope with budgetary pressures were already implemented several years ago, while, in others, such actions have yet to be taken.

In the other half of the countries, some improvement can also be observed.

Table II.9 essentially reflects the judgment of the Council expressed in its opinion on the stability and convergence programmes. The Council opinion implies judgment on the likely future developments of the budgetary

([1]) With regard to the assessment of the 2004 round of stability and convergence programmes, these issues are analysed in Part I, Chapter 4, of this report.

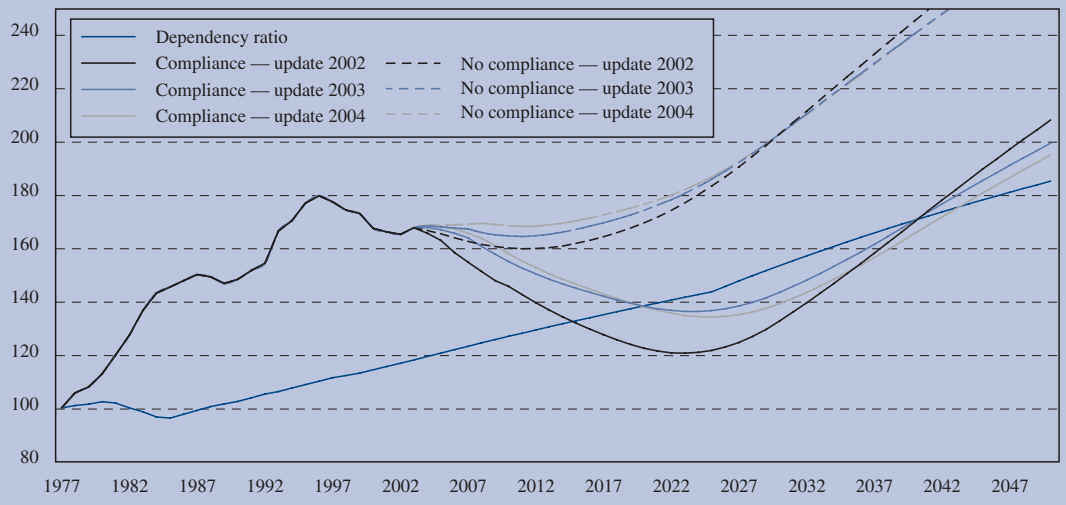
Table II.8

Qualitative factors taken on board by the Commission in reaching policy recommendations on the sustainability of public finances

Area	Specific issue	Concern about sustainability	Explanation
Public debt	High level of outstanding public debt well above 60 % of GDP reference value	Increases	Vulnerability to negative interest rate shocks, and a deterioration in the underlying budget balance could lead to a more rapid accumulation of public debt. A higher-than-average primary surplus required for several decades which in practice may be hard to achieve given competing budgetary pressures.
	Low debt levels	Decreases	Reverse of explanations above.
	Debt-increasing financial operations (e.g. contingent liabilities)	Increases	Large positive stock-flow adjustments linked to debt-increasing financial operations. Particularly relevant in MS where debt reduction is central to meeting the budgetary costs of ageing.
Budget balance	One-off budgetary operations	Increases	Only a transitory improvement in the budget balance and debt reduction. Measures of a structural nature required for a permanent improvement.
	Contribution to pension reserve funds and other budget reserves	Decreases if large but no effect if small	Contributions to pension reserve fund may be recorded as current expenditure and thus increase the recorded deficit level; hence, the positive contribution of contributions to pension reserve funds to the sustainability of public finances needs to be taken on board.
Robustness of age-related expenditure projections	Sensitivity of projections to key parameters	Increases	High sensitivity of results to demographic factors, indexation rules and numbers of cross-border workers. An appreciation of risk factors complements the analysis of projected changes in public expenditure.
	Underlying assumptions	Increases	Earlier cut-off dates than 2050 may underestimate budgetary impact as effects of baby-boom generation on population size and age structure may not have peaked. Projections in some cases are based on assumptions of large increases in labour force participation rates. While in line with the upper limit of the AWG, increases of this magnitude may require additional policy measures to be taken.
Tax ratio	High tax ratio	Increases	The viability and desirability of high tax ratios (e.g. above 50 % of GDP) over the long term may be affected by increased factor mobility affecting tax bases. Also, some governments have the stated objective of lowering the tax burden. The challenge is to do so while preserving sustainable public finance positions and adequate provision of public services.
	Low tax ratio	Decreases	A low tax ratio provides a greater margin to raise taxes (if necessary) to meet increased age-related expenditures.
The impact of structural reforms	Pension/healthcare system reforms	Decreases	Efficient, effective and streamlined pension and healthcare systems contribute to reduction of the budgetary risks.
	Risk of implicit contingent liabilities related to performance of private occupational schemes	Increases	In some MS, the performance of overall pension system will be increasingly reliant on private occupational schemes and individual pension savings. Pressure for higher public spending could emerge (implicit contingent liability) if such schemes have insufficient coverage or fail to generate returns that secure an adequate-level retirement income.
		Limited for now	In countries where success of reforms partially depends on an effective regulatory and fiscal framework for private occupational and individual pension schemes, and thus allow citizens to supplement their retirement income.

Source: Commission services based on Economic Policy Committee (2003).

Graph II.18: **Old-age dependency ratio against different rounds of assessments**



Source: Commission services.

position of a country. It thus reflects both the current budgetary situation, and the overall framework including considerations on the evolution of this framework in the past and on its likely future developments, as based on legislated reforms.

Most countries have implemented strategies to deal with sustainability issues. Budgetary measures in the programmes presented in the last few years have tended to improve sustainability to a great extent. The tax reforms implemented in Germany (2001) and Italy (2004) are exceptions as their first-round effects are direct budgetary costs that worsen sustainability. This may be counteracted if the reforms entail higher potential growth over time.

Denmark, Finland and Sweden began to prepare for the impact of the ageing population earlier than other European countries. They have devised similar approaches to the ageing challenge. In order to ensure long-term sustainability and intergenerational fairness, the governments have started to accumulate assets specifically allocated to financing future pension expenditure. These three countries are also making similar attempts to shrink future public expenditure through streamlining of their social security systems (both pension and healthcare). This approach is likely to find followers from other Member States. For instance, Belgium has adopted a law aiming to ensure that sufficient attention is paid to long-term sustainability when a government defines its fiscal policy. The same law has set up a fund, financed by means of budget surpluses, to help match the increased expenditure on pensions during the period 2010–30. Early in 1999, Ireland had already decided to reform its pension system in order to address the ageing challenge, and a National Pensions Reserve Fund was established. In 2004, a new regulation affecting the pensions of the public sector was introduced. Spain already has, or plans to set up, different initiatives to face the challenge of the ageing population. Amongst them is the accumulation of assets in specific funds to be allocated to financing future public spending on pensions, and the creation of a complementary pension scheme.

Not all Member States have pursued the strategy of setting apart specific assets in order to absorb the impact of the increased age-related expenditure. Germany pursues a comprehensive approach including reform of the social security system and reform to curb healthcare costs. In addition, reform of the labour market should help tackle

Table II.9

Assessment of the sustainability of public finances across the period 2001–04

	Are public finances sustainable?			
	2001	2002	2003	2004
BE	+	+	=	=
DK	+	+	+	+
DE	–	–	=	=
EL	–	–	–	–
ES	–	–	+	+
FR	–	–	–	–
IE	+	+	+	+
IT	–	–	–	=
LU	+	+	+	+
NL	+	+	=	+
AT	–	–	=	+
PT	–	–	=	
FI	+	+	+	+
SE	+	+	+	+
UK	+	+	=	+

NB: Ratings have been attributed as follows: + for 'appear to face limited risks', = for 'risks cannot be ruled out', – for 'risk of emerging budgetary imbalances'.

Source: Commission services.

the burden of the ageing population by increasing the employment rate and productivity. The Federal Ministry of Finance has announced its intention to submit a report on the long-term sustainability of public finances, in order to increase awareness and the credibility of its commitment.

This sustainability report should present the most recent reform measures, set out the need for further action and identify starting points for prompt countermeasures both in fiscal policy (e.g. continued consolidation, greater emphasis on future-oriented tasks, subsidy cuts, sustainable tax policy) and in other areas such as the social security systems. The strategy of France is also based on a two-pronged approach: (i) fiscal policy aimed at a reduction of the government debt thus lowering debt service charges; (ii) structural reform of the social security system (enacted in 2003 and planned to be reviewed in 2005) and of the healthcare system. The effectiveness of this approach has not yet been proved as many difficulties have been encountered in making the foreseen reforms operational. Italy's approach aims to gain control of the two main age-related items. To ensure effective control of healthcare spending, the government will fully implement the State–regions agreement, which calls for the stabilisation of healthcare expenditure at 6 % of GDP. Measures to this end are included in the finance bill for 2003. As for the social security system, pension reforms have been put in place (last one in 2004) aiming to curb the dynamics of the pension expenditure. The Netherlands relies on reducing the level of government debt. However, this reduction has not yet taken place. In 2003, Austria adopted a pension system reform that will decrease the future burden on the government finances. Similarly, advances towards improved sustainability are expected from a higher rate of participation in the labour market in the next few years.

The United Kingdom seems to be in a very special situation as the ageing of the population will only have a feeble impact on the public finances. Together with the fact that the government gross debt is among the lowest in the EU, this places the UK in a comfortable situation to face the ageing challenge. The UK government has nevertheless not neglected the issue. Since 2002, it has produced the yearly 'Long-term public finance report' providing a comprehensive analysis of long-term economic and demographic developments, and their likely impact on the public finances.

Table II.10

Assessing sustainability according to the S2 indicator, 2004 assessment round

	Small or negative S2	Positive but limited S2	Positive and high S2
2004 scenario (1)	BE, DK, EE, AT, FI	DE, ES, IE, HU, PL, SE	CZ, EL, FR, IT, CY, LV, LT, LU, MT, NL, SI, SK, UK
Baseline scenario (2)	BE, DK, DE, EE, IT, MT, AT, PL, FI	ES, IE, HU, NL, SE, UK	CZ, EL, FR, CY, LV, LT, LU, SI, SK

(1) No budgetary consolidation over the medium term.
(2) Budgetary consolidation achieved as planned in the stability or convergence programme.
NB: Where applicable, the S2 indicator was calculated on the basis of adjusted gross debt.

Source: Commission services.

At the other end of the scale, Greece still seems to be lacking a serious approach to the challenge of the ageing population. Reforms already enacted or even planned are clearly not sufficient to face the forthcoming burden.

The S2 indicator discussed above can be used to indicate whether budgetary strategies can be considered sufficient to ensure sustainability. The size of the indicator indicates the scale of the budgetary effort required. One can assume that a large permanent increase in the revenue-to-GDP ratio to ensure sustainability over time may prove to be unwarranted and unfeasible. In such cases, a broad-based approach based both on budgetary consolidation and reforms that aim at, for example, increasing labour force participation rates or reducing the dynamics of age-related expenditures is vital. For the 2004 assessment round, Table II.10 shows for which countries sustainability concerns may be tackled solely through a budgetary consolidation strategy and for which countries this seems unfeasible, given that the limit is set at 2 percentage points. To do so, the S2 indicator according to both the 2004 scenario of non-consolidation and the baseline scenario of consolidation was used.

Countries are divided into three categories (1): (i) limited sustainability problems (S2 equal to 0.5 or less); (ii) a sustainability problem that can be tackled solely through budgetary consolidation (S2 between 0.5 and 2); (iii) cases where budgetary consolidation may not be sufficient (S2 higher than 2).

Table II.10 indicates that there could be sustainability risks in about half of the Member States in the 2004 scenario. Moreover, there could be sustainability risks in about a third of the Member States even if the planned budgetary consolidation in the medium term is achieved. This suggests that in these cases more than a budgetary consolidation strategy may be required.

Even countries in the first two columns of Table II.10 should, of course, implement structural reforms if judged beneficial to the functioning of the economy at large. The grouping is purely meant to illustrate the size of the challenge to public finances.

It is important to recall that the purpose of debt extrapolation is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, 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 likely or even possible outcomes and should not be taken at face 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'. Qualitative considerations are therefore central in order to enrich the information provided by the sustainability indicators.

3.4. Are the results stable?

Sustainability indicators help in assessing budgetary risks over the long term. They will change with major structural changes, such as shifts in demographic or macroeconomic trends or major reforms affecting permanently government revenues and expenditures. Relevant structural changes do not take place every year; thus, in principle, quantitative indicators of sustainability should be stable for several years.

(1) The values distinguishing these categories are arbitrary and are used as an illustration.

The left-hand side of Table II.11 shows the debt ratio in 2050 under the programme scenario. The last two columns show to what extent the outcomes are stable. Debt levels in 2050 are very different across different rounds of assessments in most countries, in several cases the change is more than 100 percentage points of GDP from one year to the next.

Attempts to explain these differences need to distinguish between the sources from which they stem. A first explanation is methodological. Slightly different approaches have been used to determine the starting value of the primary balance. In the 2002 round of assessments, the budgetary position of the last year of the programme was measured in nominal terms, implying that temporary budgetary effects due to the cycle or one-off measures were projected over the time. In the 2003 round, the budgetary figures were corrected for the cycle, while in the 2004 round they were also corrected for the one-off measures reported in the updated programmes.

The importance of these differences can be illustrated by calculating the debt dynamics that one would have obtained under the 2002 round of assessments if the primary balance had been calculated in underlying terms as in the 2004 round.

The following step is to identify the main sources of the difference in debt dynamics once the same methodology is applied over the different rounds of assessments. To this end, it is useful to group the non-methodological factors in three different categories (see Graph II.19):

- the medium-term scenario, i.e. the debt ratio and the underlying primary balance at the end of the programme period;
- the long-term budgetary projections, in particular age-related expenditures (pensions, healthcare, long-term care, education and unemployment benefits);
- elements that affect the long-term macroeconomic scenario, for example long-term economic growth, interest rates on public debt and the GDP deflator.

To calculate the relative contribution of each of these elements, the 2002 macroeconomic scenario, long-term budgetary projections and medium-term scenario (up to 2010) have been substituted one by one with the corre-

Table II.11

Projection of the debt level in 2050 in the EU-15 across the long-term projection exercises on the basis of the programme scenario

	2002	2003	2004	2003 versus 2002	2004 versus 2003
BE	– 108	– 5	29	103	34
DK	– 51	– 35	18	16	53
DE	89	176	23	87	– 153
EL	160	151	403	– 9	252
ES	89	37	56	– 52	19
FR	248	72	219	– 176	147
IE	220	105	81	– 115	– 24
IT	– 38	– 28	– 6	10	22
LU	51	1	74	– 50	73
NL	99	140	154	41	14
AT	123	16	– 19	– 107	– 35
PT	107	– 42	181	– 149	223
FI (1)	– 39	6	– 14	45	– 20
SE (1)	– 35	47	60	82	13
UK	78	139	90	61	– 49

(1) Government debt net of financial assets.

Source: Commission services.

sponding figures coming from the 2004 round of assessments. However, in the 2002 round, long-term projections were based almost exclusively on information about pension and healthcare expenditure, while in the 2004 round information on education and unemployment benefits was also included. Therefore, it is not possible to apply the different dynamics to each single item of the overall age-related expenditure. The dynamics of the overall total age-related expenditure of 2004 have thus been applied to the 2002 exercise.

Changes due to new macroeconomic scenarios are in general minimal, underlying that the scenario set up by the Economic Policy Committee in 2001 has remained fairly stable and has been widely used by Member States in evaluating long-term budgetary trends (see interest rate growth differential in Graph II.20). Most of the gap is instead due to either revisions in the age-related expenditure projections or different medium-term outcomes. Revisions of the age-related expenditure projections have contributed negatively in more than half of the countries, with Germany and Austria as the most notable exceptions.

However, a significant role is also played by the medium-term scenario. In the majority of the EU-15 countries, the medium-term scenario has been revised downwards, showing a lower primary surplus (or a higher primary deficit) in 2004 than planned two years earlier. This revision leads to unstable debt projections since debt dynamics are greatly influenced by the structural primary balance in the medium term. It seems that the stability and convergence programmes of most countries tend to overestimate their structural balance in the medium term. Since projections are based on the medium-term scenario provided by the Member State in its programme, this reduces the stability of the long-term debt projections.

At country level, the decomposition shows some interesting features. For instance, no reforms were adopted in Greece between 2002 and 2004 and a worsening of the short- to medium-term budgetary position has thus led to a considerable worsening of its long-term sustainability position. In France, the worsening over the assessments is mainly due to the long-term age-related expenditure. These results are quite surprising considering that France adopted a pension reform in 2003 which, according to the more recent estimate, should bring savings amounting to at least 1 % of GDP. The explanation can be found in Table II.12: an increase in healthcare and long-term care expenditures more than offsets the benefits of the pension reform ([1]). In Table II.12 projected expenditures in 2050 on healthcare and long-term care are reported together, for simplicity. It should, however, be noted that they are distinct separate expenditure items and that a country with a possible need to reform its healthcare system does not necessarily need to reform its long-term care system.

In the case of Italy, Graph II.20 shows a positive contribution of the revision of age-related expenditure projections despite the fact that both pension and healthcare expenditures have been revised upwards. The likely explanation relates to the particular structure of the pension reform in Italy, where savings are foreseen between the time of the application and 2050, while at around 2050 the pension expenditure should be higher than prior to the reform ([2]).

3.5. Possible avenues for improving the assessment of long-term public finance sustainability

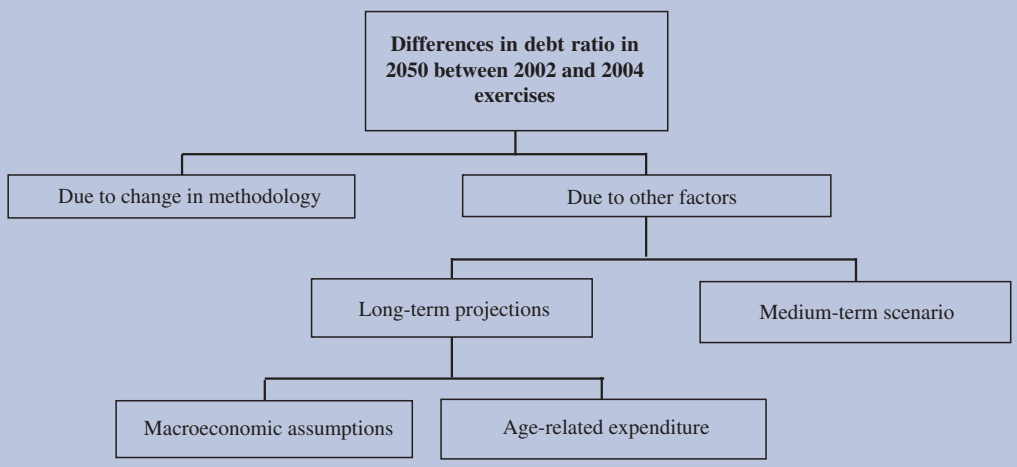
As noted above, remarkable progress has been made in the EU over the last few years in terms of sustainability analysis. The Commission, the AWG and the EPC have gained considerable experience in terms of long-term budgetary projections and the analysis of the sustainability of public finances. The quantitative indicators have been improved and greater effort has been made to incorporate qualitative considerations in a systematic manner in order to enrich the sustainability assessment. This has successfully contributed to an increased policy focus on safeguarding the sustainability of public finances.

However, the assessment of sustainability could be further developed through a more in-depth analysis of the different sustainability risks.

([1]) It should be noted that in the 2004 update of the French stability programme an improved, broadened estimate of healthcare expenditures was provided. Therefore, despite a healthcare reform in 2004 in France, healthcare spending rises more up to 2040 according to the 2004 update compared with the 2003 update.

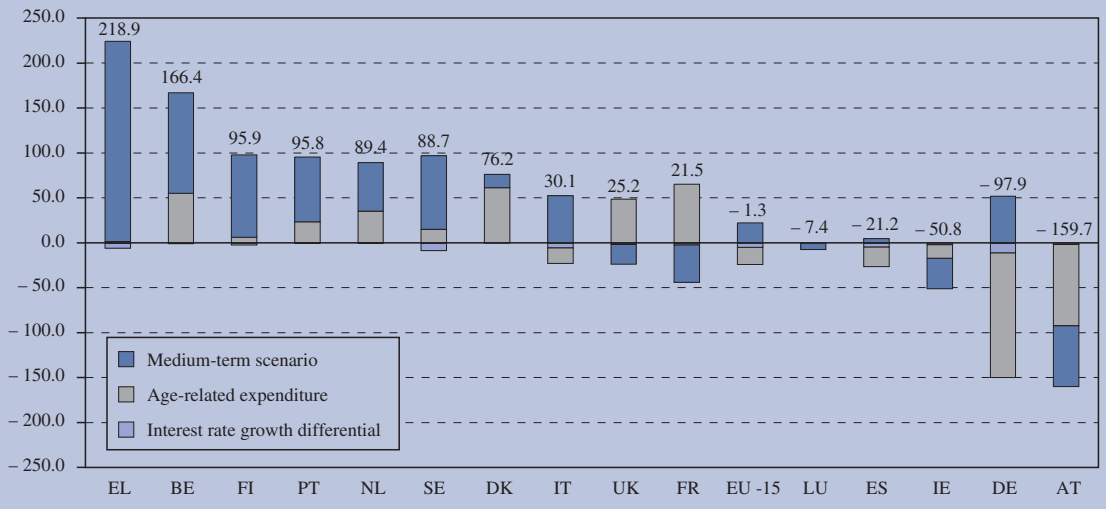
([2]) From the 2004 update of the stability programme of Italy: 'Compared with the previous 2003 update (which did not take into consideration the effects of the recently approved reform), the current projections of pension expenditure as a percentage of GDP will be significantly lower for about a 30-year period starting from 2009, with a saving of around 0.7 percentage points from 2012 to 2020 and 0.6 from 2020 to 2035. Then, until the end of the forecast period, the expenditure-to-GDP ratio will be 0.3 percentage points higher than that presented in the 2003 stability programme update.'

Graph II.19: **Analysis of the source of the difference in the long-term debt dynamics indicator**



Source: Commission services.

Graph II.20: **Graphic illustration of the difference in the debt ratio in 2050 across rounds of assessment**



Source: Commission services.

Table II.12

Comparison of 2050 pension and healthcare expenditure according to the 2002 and 2004 updates of the stability and convergence programmes

	Pension expenditure		Healthcare and long-term care expenditure	
	2002 update	2004 update	2002 update	2004 update
BE	11.4	13.0	8.2	10.6
DK	7.2	7.8	9.3	11.0
DE	14.9	13.8	7.1	9.5
EL	22.6	22.6	6.6	6.6
ES	13.0	13.0	n.a.	7.2
FR	15.8	14.5	8.9	12.6
IE	7.7	7.7	7.8	7.8
IT	14.1	14.4	7.6	8.1
LU	9.3	9.3	n.a.	n.a.
NL	13.6	8.3	10.4	10.7
AT	16.4	13.6	7.9	7.9
PT	15.3		n.a.	
FI	14.4	15.2	9.1	13.4
SE	10.9	9.4	14.4	13.1
UK	4.8	5.5	9.8	10.9

Source: Commission services.

3.5.1. Comparable budgetary projections

In order to have a comparable view of the long-term budgetary trends across EU Member States, it is crucial that they have been calculated on the basis of commonly agreed coverage, methodology and underlying assumptions. Furthermore, information on how the long-term budgetary trends are affected by changes in the underlying assumptions provides valuable insights into their sensitivity.

Based on the results of the common budgetary projection exercise expected to be finalised at the end of 2005, a comprehensive assessment of sustainability could be made. Such an analysis concerning long-term issues should remain valid for some time. This may imply an in-depth assessment every three years.

At the same time, an annual update of the assessment in the context of the stability and convergence programmes may consider possible new information available and the impact of short- to medium-term budgetary developments on sustainability.

3.5.2. A comprehensive assessment of possible risks to sustainability

The sustainability analysis based on debt projections over the long term would benefit from additional sensitivity tests in order to better highlight policy challenges that a country may be facing.

In addition to the currently used budgetary 'non-consolidation' scenario, the impact of modifying long-term macroeconomic assumptions (e.g. long-term growth, employment, productivity) as well as budgetary projections (e.g. age-related expenditures) could add important insights into possible sustainability risks.

3.5.3. Assessing the impact of structural reforms

A distinction needs to be made between reforms that improve public finances by affecting directly the current and future stream of government revenues and expenditures (e.g. pension reforms) and those reforms whose impact on public finances is mainly indirect, via improved potential output.

The distinction between reforms having mainly a direct or indirect impact on public finances is crucial with regard to the methodological approach for their quantitative assessment. The assessment of the long-term public finance impact of reforms directly affecting revenues or expenditures may involve updating revenue or expenditure projections on the basis of the new policies. However, when reforms mostly have an indirect impact, it is

also necessary to have at hand modelling techniques that permit the linking of the policy change to the determinants of potential output.

Better knowledge on the impact of reforms with a direct budgetary impact on public finances, notably pension reforms but also healthcare reforms, can be obtained by performing simulations with national models and a process of peer review by the AWG. This would increase transparency of how the projections are made. In this way, consistency across Member States in terms of underlying assumptions would be ensured while at the same time the most recent reform measures would be taken into consideration in the peer review by the AWG and in the assessment of sustainability of public finances by the Commission and the Council.

3.5.4. Sustainability considerations in the definition of budgetary medium-term objectives

The 20 March 2005 Ecofin Council emphasised in its report that the Stability and Growth Pact should increase the focus on safeguarding the sustainability of public finances. To this end, the budgetary consequences in light of ageing populations should be taken into account when specifying the MTO for the Member States' budgetary position, as soon as the criteria and modalities for doing so are appropriately established and agreed by the Council.

While it is premature to point to specific criteria and modalities at this stage, some broad characteristics of how sustainability risks to public finances could be taken into account in the context of defining the MTO may be identified.

First, the method should consider the risks to public finance sustainability over the long term. This implies that future projected developments on both the expenditure and the revenue side should be taken into account, as the overall budgetary position affects the debt position over the long term.

Second, the method should lead to a stable solution so that risks to the sustainability of public finances are not unduly influenced by factors that can be expected to have a non-lasting impact on public finances or that are surrounded by a high degree of uncertainty. To this end, sensitivity tests provide valuable information on how changes in assumptions, including changes due to implemented reform measures, impact on possible risks to the sustainability of public finances.

Third, the method should be transparent and simple so as to facilitate a broad understanding. In this regard, basing the analysis of risks to the sustainability of public finances on information which has been compiled in a transparent and comparable way across the Member States and conducting and using this analysis according to a transparent and clearly defined method will lead to greater acceptability and enforceability.

These very broad considerations will be duly explored further and the Commission will prepare a report to the Council on progress made in view of preparing a methodology for incorporating the sustainability of public finances into the medium-term objective before the end of 2006.

3.6. Conclusions

The sustainability analysis conducted by the European Commission during the last few years has demonstrated that this is a multifaceted issue that needs several indicators and a lot of qualitative judgment. Experience showed some drawbacks with the current approach. First, common budgetary projections are only available every three to four years. The previous projections were published in October 2001 and the new projections will be ready by the end of 2005. In between, Member States have updated their projections as, for example, new national demographic projections have become available or reforms with an impact on long-term budgetary trends have been implemented. On the one hand, national projections may have the advantage of being more up to date. On the other hand, they may not be fully comparable across countries in terms of the underlying assumptions, which is vital for the purposes of budgetary surveillance in the EU. Second, the annual assessment of the SCPs is constrained in terms of timing and space. Very few sensitivity tests are used and the richness of the analysis is therefore limited. This has raised some criticisms and the issue of a possible need for a more in-depth assessment of underlying risks to the sustainability of public finances.

Experience so far demonstrates the importance of having a comprehensive sustainability analysis to guide policymakers in the conduct of their budgetary policies and to pursue structural reforms. A comprehensive analysis of sustainability should have the following elements.

Comparable budgetary projections. At EU level, a reliable and comparable budgetary projection exercise is made every three to four years by the Council committees (the AWG/EPC) and the Commission.

This exercise uses common methodologies, agreed macroeconomic assumptions and agreed demographic projections. This makes projections comparable across countries and sufficiently transparent to gauge sustainability risks on the basis of such projections. However, common projections do not take place every year. To this end, possible new information may be considered in the context of the annual stability and convergence programmes.

A comprehensive assessment of possible risks to sustainability. The analysis of possible risks to sustainability cannot be summarised in a single figure; several indicators are necessary to support the judgment. Sensitivity tests around a baseline scenario may help in assessing the robustness of the main results to different hypotheses.

The sensitivity tests developed by the Commission and the AWG provide insights into risks associated with different scenarios. However, a more comprehensive analysis may improve the capacity to gauge sustainability ([1]).

Assessing the impact of structural reforms. Assessing risks to long-term budgetary projections involves formulating a view of the probability that a certain outcome will actually materialise.

In addition, expenditure projections are also affected by the future impact of structural reforms currently under way. Better knowledge on the impact of reforms with a direct budgetary impact on public finances, notably pension reforms but also healthcare reforms, can be obtained by performing simulations with national models and a process of peer review by the AWG.

This would increase the transparency of how the projections are made. Such an assessment requires detailed knowledge of the institutional functioning of the economy, not least with regard to the pension systems, and would benefit from a close involvement of national experts in the relevant Council committees.

Such a revised analysis would better serve the purpose of increasing the focus on sustainability concerns and could also increase the consistency between medium-term budgetary strategies and longer-term sustainability concerns.

([1]) To give an example, the UK report on long-term sustainability produced by the HM Treasury is around 60 pages long. Also, in Sweden (the 2003/04 long-term survey) and in Denmark (the Welfare Commission), comprehensive studies on long-term sustainability have been prepared recently.

Part III

Structural reforms and budgetary objectives

Summary

Structural reforms are at the heart of the EU's economic agenda. Reforms in the functioning of markets and the government sector are perceived as a necessary ingredient for relaunching the growth potential of the Union in accordance with the Lisbon agenda priorities. In addition, as a result of the revision of the Stability and Growth Pact (SGP), the focus is increasingly being placed on the link between structural reforms and public finances in implementing the EU framework for fiscal policy. It is often claimed that the Stability and Growth Pact neglects a possible trade-off between short-term budgetary objectives and the implementation of reforms that could durably improve public finances over the medium to long term. Accordingly, it has been agreed in the European Council that the Stability and Growth Pact needs to be revised in such a way as to avoid a possible short-term bias arising from neglect of the abovementioned trade-off (see Part II, Chapter 1, of this report). The aim of this part of the report is to review and discuss the arguments that budgetary discipline in the short term may be achieved at the expense of the implementation of reforms. It also conducts original analysis on EU countries to shed light on the links between budgets and reforms in the short term, given that this is an under-researched issue that is likely to become more relevant in EU budgetary surveillance.

Reforms can improve budgets durably in the medium to long term via alternative channels. Reforms directly aimed at containing the dynamics of certain types of government expenditure (for instance, pension or healthcare reforms to enable the system to cope better with ageing-related pressures) can have a relevant impact on the future path of government budgets and debt. Indirect positive effects can also be associated with the adoption of reforms that improve potential output and growth (as is the case for certain types of labour and product market reforms). However, any *ex ante* assessment of the indirect impact of reforms on public finances is generally subject to substantial difficulties and uncertainty.

A first reason why there could be a trade-off between reforms and budgetary objectives is the fact that reforms have direct budgetary costs. This is the case of pension reforms that introduce a funded pillar classified outside the government sector. In this case, budgets would normally undergo a temporary deterioration (due to lost social security contributions by the government), offset by long-term improvements (associated with saved pension payments by the government). A second broad reason for a trade-off is the fact that reforms can be politically costly. This has two implications. First, loosening budgetary policy could, under certain circumstances, be a way of overcoming resistance to reforms via, for instance, tax cuts or government transfers. Second, to the extent that fiscal expansions are expected to produce a positive short-run impact on economic activity and employment, keeping an accommodating fiscal stance could help ease the political cost of reforms. However, arguments that there may be a complementarity relationship between reforms and budgetary discipline should also be considered. There are, in fact, instances in which reforms aimed at improving the sustainability of public finances already produce positive effects on the budget in the short term (e.g. parametric pension reforms). Moreover, a strengthened commitment towards budgetary discipline (because of looming critical public finance conditions or as a result of participation in international arrangements) reduces the political cost of reforms and can have a positive impact on confidence under certain circumstances.

This part of the report analyses the short-term relation between the budgetary stance of governments and product, labour and pension reforms. Two main issues are investigated. First, what impact do reforms have on budgets in the short term? Second, is there evidence that fiscal consolidations prevent reforms? Although the analysis suffers from limitations related to the quality and availability of data on structural reforms, there are some results of interest that can be summarised as follows.

- On average, across the sample, the evolution of the primary cyclically adjusted budget balance is not significantly different in the aftermath of reforms compared with years not following reforms. Product market reforms are associated with slower growth in government revenues — accompanied, however, by correspondingly slower growth in expenditure. After pension reforms, social benefits paid by the government grow at a significantly slower rate, but the overall impact on the budget is compensated by government revenues also growing at a slower rate. There is also evidence to suggest that the impact of reforms can be quite different depending on the characteristics of the reform, notably whether it mainly introduces parametric changes or also allows for systemic changes in the national pensions framework. Estimating the budgetary impact of reforms after controlling for the response of fiscal authorities to the cycle and debt developments, there is evidence of a slight deterioration in budgets (in the order of a few decimal points of GDP) which is however statistically different from zero only in the case of labour market reforms.

- The expectation that reforms are less frequent in years where a budgetary consolidation takes place is not strongly supported by the data: product market and pension reforms are actually more frequent in these years. Moreover, there is no clear systematic evidence that after the introduction of the EU fiscal framework reforms became less frequent: while this does seem to be true for labour market reforms, the opposite holds for product market and pension reforms. Once an attempt is made to control for other possible factors explaining the implementation of reforms, the analysis shows that fiscal consolidations do not have a strong performance in explaining the probability of reforms, and that the introduction of the EU fiscal framework did not have any significant impact on this relation.

Overall, there is a strong indication that it is not easy to make generalisations about the link between structural reforms and budgets in the short run. Results differ depending on the specific type of reforms considered. Also, within a given type of reforms (e.g. pension reforms), the fiscal implications are likely to differ considerably depending on the main elements of the reform and on how reforms are designed. The main implication for policy is that, when taking account of economic reforms in the implementation of the Stability and Growth Pact, a mechanistic, one-size-fits-all approach where all reforms, or all reforms belonging to certain broad categories, are judged the same way should be avoided. Judgment should be used on a case-by-case basis, by assessing the relevant features of the various reforms at issue.

1. Introduction

This part of the report focuses on the interaction between public budgets and structural reforms. A common criticism of the EU fiscal framework is that it may prevent the implementation of structural reforms with long-term benefits for public finances. Improved public finances in the long term may be associated either with a direct contribution of certain reforms to containing the dynamics of age-related expenditures or with an indirect effect, acting via an increase in potential growth. The reasons why structural reforms may be prevented by budgetary targets and ceilings may be related to the possible presence of direct short-run budgetary costs or to the fact that reforms are costly in political terms, so that higher spending or tax cuts may help to obtain the necessary consensus. However, one could also find opposing arguments. There are pension reforms, in fact, that entail short-term budgetary improvements. Furthermore, a strengthened commitment towards budgetary discipline, including through the participation in the EU fiscal framework, improves the credibility of government action and reduces the political cost of reforms.

This part of the report discusses the relationship between structural reforms and the pursuit of budgetary objectives. It also carries out original empirical analysis on EU countries aimed at addressing the following questions: Do structural reforms generate budgetary costs in the short term? Is there evidence that budgetary consolidations are associated with a lower probability of structural reforms?

The remainder of this part of the report is structured as follows. Chapter 2 discusses the main arguments in favour and against the existence of a trade-off between reforms and budgetary discipline in the short run. It surveys the main reasons for why there could be resistance to economic reforms in spite of benefits arising in the medium to long term and highlights the main channels through which economic reforms may improve public finances in the long run. It also includes a discussion of how the long-term impact of reforms could be measured *ex ante*. Model simulations are performed to illustrate how pension reforms that introduce a funded pillar classified outside the government sector may lead to a short-run budgetary deterioration coupled with long-term gains in terms of public finance sustainability. Chapter 3 presents empirical analysis on a sample of EU countries on the link between short-term budgets and reforms in labour and product markets and pensions. First, it analyses whether in the aftermath of reforms budgets deteriorate and by how much. Subsequently, the analysis focuses on the link between budgetary consolidation and the probability of reforms being implemented.

2. Is there a trade-off between structural reforms and budgetary objectives?

2.1. Defining reforms

The term reform is used with reference to rather different types of policy interventions: trade reforms, labour market reforms, tax reforms, pension reforms, health sector reforms, etc. In general, compared with other types of policies, reforms (i) have a long-lasting impact and (ii) concern the general functioning of economic (market or State) institutions rather than specific elements. The adjective 'structural' often accompanies the word reform to indicate the fact that the policy concerned is aimed at affecting the structure of the economy.

Sometimes reform means a policy aimed at modifying the institutional setting, shaping the interplay among private economic agents. This is typically the case of reforms changing the functioning of markets (product or factor markets). In other instances, reforms may be aimed at modifying the working of public institutions. This is the case, for instance, of reforms affecting the working of the welfare state (e.g. pension or healthcare reforms) or the set-up of policy institutions (e.g. reforms concerning the institutional set-up of monetary authorities, or the status of authorities enforcing competition policy or regulating public utilities).

Another relevant distinction is between reforms that modify the features of existing policies and institutions (e.g. pension reforms modifying social security rates) and those that replace or complement existing policies and institutions with new ones (e.g. pension reforms introducing new pension pillars). The former are often referred to as parametric reforms, the latter as systemic ([1]). A further distinction is that between reforms that concern all agents in a given sector or only particular groups. An example is that of labour market reforms extending to all labour market participants as opposed to reforms addressed only to individuals entering the labour market for the first time.

Reforms can be seen as the outcome of a continuous effort to adapt market and public institutions to changing fundamentals: technological progress, evolving needs of individuals and society, demography, etc. In spite of such a constant need for adapting institutions to fundamental changes, the process of reform of a given sector of the economy is not always smooth and gradual. Indeed, the reform process seems to be quite often characterised by jumps and discontinuities: substantial policy changes are concentrated in a few periods of time. For instance, in most advanced countries, reforms in the banking sector were concentrated in the early 1980s, while the deregulation of air transportation was mostly achieved between the mid-1980s and the early 1990s. A common thesis is that reforms tend to follow periods of crisis ([2]). Moreover, when evaluated over sufficiently long periods of time, there is evidence that reforms in one particular sector of the economy are quite often accompanied by reforms in other sectors. In several advanced countries, labour market, product market and tax reforms occurred broadly at the same time (IMF, 2004a). Finally, the international dimension seems to matter: reforms in a given country are more likely if other countries have already carried out reforms in the same sector or are in the process of doing so.

That reforms are not a smooth process has mainly to do with the fact that the gains from reforms may be unevenly distributed across sectors, individuals, and time and this could

([1]) It should be stressed, however, that the distinction between systemic and parametric reforms is often blurred. Quite often, systemic reforms also introduce changes in specific features of the existing system. Moreover, there are reforms affecting the incentive structure that may be difficult to classify as purely parametric or systemic (e.g. pension reforms that introduce a link between pension contributions and benefits).

([2]) See, for example, Drazen (2000) for a discussion of this thesis and for a survey on empirical evidence. The point here is not so much that reforms follow periods of unsatisfactory economic performance ('[that] the reform should follow crisis … is no more surprising than smoke following fire' (Rodrik, 1996, p. 27). The thesis is rather that reforms are triggered only by periods of exceptionally bad economic performance.

explain resistance in the policy-making process (see next section). The fact that reforms in different sectors of the economy tend to occur together could be explained by complementarity relations that often characterise reforms ([1]). For instance, a labour market reform aimed at increasing the employment rate would be more effective if not acting exclusively on one aspect of the labour market legislation (e.g. only on legislation concerning firing practices) but rather when considering several aspects at the same time interrelated among them (e.g. both hiring and firing practices, unemployment benefits). Complementarities could even be more far-reaching and concern reforms in different sectors of the economy. For instance, product market reforms that increase the degree of contestability of sectors may trigger reforms in labour markets ([2]). The relevance of the international dimension for economic reforms could be due to several reasons, including international agreements on reforming sectors for which cross-border spillovers are relevant (e.g. trade and trade-related reforms as a result of WTO agreements), peer pressure within the context of regional arrangements (e.g. labour market reforms within the context of the EU open method of coordination), pressure to reform associated with the direct spillovers from other countries' reforms (e.g. as in the case of tax competition or deregulation of particular industries) or learning spillovers occurring across the border.

European countries are currently focused on reforms aimed at increasing growth and employment in line with the goals of the Lisbon strategy and at making public finances sustainable ([3]). The objective of improving the growth potential is mainly pursued through reforms strengthening the incentives for the supply of labour and human and physical capital (e.g. via reforms in product and factor markets), innovation and the contribution of the public sector to growth (e.g. tax reforms, reforms in the education sector, R & D, etc.). As far as the goal of public finance sustainability is concerned, there is agreement among experts and policy-makers on reforms aimed at limiting the upward tendency in age-related expenditures, increasing employment rates, and favouring a reduction in public debt ([4]).

2.2. Why is there resistance to structural reforms?

One of the most salient features of economic reforms, which has attracted the increasing attention of academic and applied economists, is the considerable resistance that reforms could encounter in the policy-making process. Even when there is quite widespread perception that carrying out reforms in a given sector would be in the general interest, action could be delayed or blocked altogether, for the basic reason that there can be particular groups in society that may instead expect losses.

A series of specific explanations has been identified in the economic literature for why reforms could be delayed or blocked ([5]).

A first reason is the presence of uncertainty on the type of reforms needed (technical uncertainty). Reforming the functioning of markets or the way government intervention works could be technically complex and give rise to disagreement among policy-makers ([6]). Such disagreement may in turn translate into delays and the continuous postponement of reforms. This is especially the case when lack of knowledge concerns whether a particular problem (e.g. high unemployment levels) requires reforms (e.g. labour market reforms) or is rather mainly related to adverse cyclical condi-

([1]) See, for example, Coe and Snower (1997) for an analysis of complementarities in economic reforms applied to labour market policies.

([2]) The reduction in the extra profits associated with entry barriers and anti-competitive practices could reduce the incentives by organised labour to capture part of these rents, thereby leading to a higher probability of success for reforms aimed at better aligning wages to productivity. This argument has been put forward, for instance, by Blanchard and Giavazzi (2003).

([3]) Objectives related to social cohesion and environmental quality are also among those shared by European institutions. The Ecofin Economic Policy Committee (EPC) in its 2005 annual report on structural reforms has identified seven key areas for refocusing the core goals of the Lisbon strategy, taking into account the conclusions of the Ecofin Council of 16 November 2004 and the work of the high-level group chaired by Wim Kok. The areas are as follows: (i) realising the knowledge society and boosting innovation; (ii) keeping the commitments to the internal market; (iii) creating the right climate for the entrepreneurs; (iv) building a labour market for higher employment and stronger social cohesion; (v) working towards an environmentally sustainable future; (vi) ensuring sustainability and quality of public finances; (vii) enhancing external openness. The February 2005 Commission communication to the European Council 'Working together for growth and jobs — A new start for the Lisbon strategy' proposes 'a new start of the Lisbon strategy focusing … on delivering stronger, lasting growth and creating more and better jobs' and aims at focusing European action, better mobilising support for change, and simplifying and streamlining the instruments of the Lisbon strategy.

([4]) The Stockholm European Council of March 2001 agreed on a three-pronged strategy for ensuring public finance sustainability: increasing employment rates, reducing public debts, and reforming pension and healthcare systems.

([5]) See, for example, Williamson (1994), Rodrik (1996) and Drazen (2000).

([6]) Rodrik (1996) quotes the healthcare reform proposed by the Clinton presidency as an illustrative example of reform on which disagreement was related, among other things, to uncertainty on whether the proposed one was technically the best solution. See also Sachs (1994) for anecdotal evidence on the frequent disagreement within governments on how to proceed with economic reforms in countries facing macroeconomic crises.

tions ([1]). Despite technical uncertainty being widespread, it seems a relevant obstacle to reforms only when the costs of non-reforming are not particularly high. Moreover, this argument can mostly explain why reforms are delayed rather than why reforms that are largely judged as being beneficial could be blocked.

Political economy arguments can explain both why reforms are delayed and why reforms are blocked. A common explanation for why potentially beneficial reforms could be blocked for a long time is the role of lobbying in the policy-making process ([2]). According to this explanation, reforms, even when they can potentially benefit a majority of citizens, often produce losses to particular groups in society, and resistance by such groups cannot be fully eliminated through compensation schemes (e.g. through targeted transfers and subsidies) ([3]). The groups that expect to lose from reforms, even if comprising a minority, could be better motivated to organise resistance to reforms. In fact, reform losers often have a relatively high stake in blocking reforms (e.g. fear of losing jobs or extra profits). Moreover, the group of reform losers, being relatively small, also tends to have a small cost to organise itself into an effective pressure group to convey its interest to the government. Conversely, since reform winners are often many, with quite limited individual gains, they will have less incentives and higher costs to organise lobbies in favour of reforms. Lobbies can explain quite successfully why reforms aimed at reducing protection to given sectors of the economy (e.g. trade protection, regulation of industries, etc.) are blocked ([4]). However, arguments based on lobbying are probably less suited to explaining resistance to reforms with effects on all sectors of the economy (e.g. labour market reforms, tax reforms).

An alternative political economy explanation for why reforms could be blocked relies on uncertain reform pay-offs at the individual level ([5]). When individuals are uncertain about whether they will benefit from a given reform, there could be *ex ante* a majority of individuals in favour of blocking the reform even when *ex post* the reform benefits a majority of citizens ([6]). Moreover, under these conditions, compensation schemes would not be credible and therefore could not help to ease resistance to reforms. *Ex post*, in fact, the gainers are a majority of citizens who would oppose the implementation of the redistribution. Although it is quite difficult to assess the empirical relevance of this argument, it provides an explanation for the observed case of reforms that, after being blocked for long times, find gradual support among the public once, for some reason, the reform process is put in place.

An explanation for reform deadlocks that has received much attention from both the experts and policy-makers is based on uneven distribution of reform pay-offs over time coupled with short-sightedness of governments ([7]). In the presence of short-run costs from reforms and reform gains materialising only in the long run, politicians who base their decisions on a short time horizon (because, for instance, of uncertainty about being re-elected) may opt not to carry out welfare-enhancing reforms. The fact that the reform gains could be delayed could in turn be related either to the way reforms are designed (e.g. pension reforms that modify only gradually the retirement age) or to the fact that the economic effects of reforms need time to materialise ([8]). Short-run costs from structural reforms could be associated with several factors. First, there could be a temporary loss in

([1]) If the effects of reforms are to a large extent irreversible, it has been shown in theory that the presence of uncertainty on the best way to tackle given economic issues gives rise to 'an option value of waiting' (Dixit and Pindyck, 1994). Namely, policy-makers would be induced to delay action because this would permit the disposal of new information to better judge the necessity of carrying out structural reforms.

([2]) Such arguments were first put forward in Olson (1971).

([3]) Putting in place a scheme to compensate individuals losing from reforms may be very costly for the budget or may lack credibility. In the case of comprehensive reforms, the high costs could be related to the amount of transfers necessary to avoid losses. Such costs are made worse by pervasive information asymmetries. The government does not dispose of all the information necessary for putting in place a compensation scheme that permits all reform losers to be compensated for their actual losses. Under most conditions, this information asymmetry would translate into high costs for the government (see, for example, Dewatripont and Roland, (1992). The issue of the credibility of compensation schemes is related to the possibility that the promise of compensation will not be kept *ex post*, once the redistribution associated with the reform has taken place, because at that point such compensation would not be politically profitable (see, for example, Fernandez and Rodrik, 1991, for a formal argument).

([4]) See Grossman and Helpman (2002) for theory and empirical evidence on the idea that lobbies can explain the presence and persistence of protection.

([5]) This argument was first put forward by Fernandez and Rodrik (1991).

([6]) The argument can be illustrated via an example. Consider two groups of individuals. The first group is made up of 10 individuals who know with certainty that they will gain one unit of income from the reform, while the second group comprises 15 individuals who expect to lose one unit with probability 2/3 and to gain one with probability 1/3. All people in the first group will vote in favour of the reform, while all the people in the second group will vote against (since for them the expected gain from the reform is 1/3 – 2/3 = – 1/3). The reform will not pass. However, in case of adoption, the reform would have benefited a majority of individuals and generated 10 – (1/3 x 15) = 5 additional units of income to the society.

([7]) In this vein, Alesina and Drazen (1991) show theoretically how governments may be induced to delay reforms aimed at stabilising public finances. See also Tabellini and Alesina (1990) for a model explaining the origin of a deficit bias by governments on the basis of short-sighted politicians.

([8]) Available evidence shows that the timing of economic reforms on growth depends quite crucially on the specific type of reform considered. Simulations based on a small-scale econometric model contained in IMF (2004a) show that while product and labour market reforms take time to produce positive effects on output, financial market and tax reforms already have effects on output in the short term. Kim (2003) calibrates a model of corporate sector restructuring on Japanese data and shows that product market reforms boost output in the long term but have short-term costs. Econometric estimates in Salgado (2002) point to a U-shaped impact of labour and product market reforms on productivity growth. Mendoza et al. (1997) report that tax cuts can already have significant positive effects on output in the short term.

terms of level of output, due to resources shifting across sectors and firm restructuring after reforms take place (as in the case, for example, of far-reaching trade reforms or liberalisation and privatisation of economic activities in transition countries). Second, there may be a direct negative budgetary impact from the reform (e.g. tax reforms). Third, there could be indirect budgetary costs associated with the compensation of reform losers. The argument explaining reform deadlocks on the basis of an uneven time distribution of reform pay-offs is based on few testable assumptions. Its validity depends on the empirical assessment of a number of issues. To what extent are reform gains delayed? Do reforms generate costs in the short term? Is the magnitude of these costs relevant or negligible? Because economic reforms are very different as regards their direct impact on aggregate economic activity, income distribution and public budgets, the overall time pattern of the effects of economic reforms will mainly depend on the particular type of reform considered.

The next sections discuss the implication for public finances of the unequal distribution of reform gains and losses over time. First, there is a review of the channels through which economic reforms can affect public finances in the long term. Afterwards, the short-term relationship between reforms and budget balances is discussed.

2.3. The long-term effects of economic reforms on public finances

Most economic reforms produce an effect on the government net worth, i.e. the difference between the expected present value of government revenues and expenditures. It is useful to distinguish between direct and indirect effects of economic reforms on public finances. Effects are direct when reforms cause a change in government expenditures or government revenues. Effects are indirect when the effect on public finances occurs through changes in the overall economic environment. Indirect effects arising through changes in potential output and potential growth are of particular relevance, but indirect effects may come also via other macroeconomic variables, for instance interest rates.

Among the reforms having a major direct positive effect on public finances in the long term there are pension reforms. These could concern parametric reforms, namely reforms revising specific elements in government pension schemes, for instance the criteria for the determination of pension contributions and benefits, the retirement age or the eligibility criteria of pension treatment. Pension reforms could also be systemic, i.e. could consist of changing the functioning of the pension system, for instance the introduction of funded schemes in addition to pay-as-you-go (PAYG) schemes. In addition to pension reforms, other reforms in the functioning of the welfare system, in particular healthcare reforms, could help to keep public finances under control against the background of ageing populations. This would be achieved, for instance, by improving the cost-effectiveness of welfare services and by reducing the agency costs related to their provision (e.g. by reducing moral hazard via an improved design of eligibility criteria).

Reforms having an indirect impact on public finances mainly comprise all the reforms that could contribute to increasing the growth potential. An increase in growth potential would normally translate into long-term budgetary improvements associated with more favourable dynamics for government revenues ([1]).

In general, product market reforms aimed at preventing anti-competitive practices and improving the contestability of markets (e.g. by reducing the administrative burden for setting up new firms, etc.) would contribute to improved potential output and growth. Static gains would manifest with a one-off increase in potential output associated with lower equilibrium unemployment ([2]). In addition to such static gains, product market reforms are also likely to bring about gains in terms of higher productivity growth ([3]).

([1]) However, budgetary gains are certain only if the reaction of government expenditures to increased potential output does not fully offset the increase in revenues. If, for instance, government expenditures increase proportionally with potential output (e.g. government employees' wages and salaries and government transfers grow in proportion to potential output) while revenues increase less than proportionally (because, for instance, a change in potential output translates into a less than proportional increase in the tax base), higher potential output would be associated with worsening budget balances.

([2]) Enhanced competition would reduce markups and increase output in imperfectly competitive sectors. Increased demand for labour in these sectors would translate, in turn, into lower equilibrium unemployment (see, for example, Pichelmann and Roeger, 2004).

([3]) The link between competition and innovation is a priori ambiguous. On the one hand, the existence of monopolistic profits offers a bigger reward for carrying out R & D. On the other hand, it is in competitive industries where the incentive to defeat actual and potential competitors, including through own innovation and the adoption of others' innovations, is stronger. Moreover, in industries characterised by lower barriers to entry, productivity growth may be enhanced by the fact that firms' turnover there tends to be higher and that new entrants tend to be characterised by a higher level of technology compared with incumbents. Overall, available cross-country empirical evidence points to a negative relation between measures of regulations limiting the degree of contestability of markets and growth (Nicoletti and Scarpetta, 2003). Furthermore, it has been shown at the firm level that the growth rate of productivity is positively related to measures of competition (Nickell, 1996).

Most reforms in labour markets are also likely to entail static gains which appear as one-off increases in potential output. These static gains are mainly related to the impact of labour market reforms on the NAIRU and on participation rates ([1]). The impact of labour market policies on potential output, however, may also show up in terms of higher growth rates. Productivity growth is to a relevant extent associated with the reallocation of resources towards high-growth sectors. Reforms enhancing the efficiency of labour markets, including via an improved design of labour market institutions, would permit a smoother reallocation of resources across sectors and the achievement of higher productivity growth ([2]).

Reforms in capital markets would also have a positive impact on potential output. Static gains associated with more efficient capital markets would mainly correspond to improved intersectoral allocation of resources. Moreover, improved possibilities for borrowing against future incomes and for hedging risk would increase productive investment. To the extent that new investments in physical capital tend to increase the average level of technology embodied in the existing stock of capital, more efficient capital markets would also be associated with higher rates of productivity growth ([3]).

Reforms may have at the same time direct and indirect effects on public finances. For some reforms, these indirect effects reinforce the direct budgetary effects. For instance, pension reforms increasing the retirement age also tend to raise the participation rate in the labour force, and therefore potential output. In other cases, the direct and indirect budgetary effects of reforms could go in opposite directions. This is typically the case of tax reforms aimed at reducing the tax burden on production factors. The direct negative impact on the budget (lower government revenues associated with a given level of the tax base) is accompanied by an indirect positive impact, associated with a higher tax base. A reduction in the tax burden normally results in improved incentives and then in higher potential output. Moreover, higher-than-expected business profits would lead to increased investment in physical capital or R & D, and then, via an endogenous growth mechanism, to higher potential growth ([4]). Hence, in the long term, a lower tax burden tends to be associated with an expanded tax base. A similar situation of direct and indirect budgetary effects acting in opposite directions could also occur in the case of reforms increasing expenditures that could bring higher rates of potential growth in the long term (e.g. reforms enhancing human capital investment via an improved education system).

The measurement of the long-term public finance impact of reforms requires estimates on the present and future impact of reforms on government budgets and assets/liabilities. Estimating the budgetary impact of reforms could be particularly complex when the indirect effects involved are relevant. In such a case, an estimate is also needed of how reforms affect the overall economic environment (e.g. economic activity, interest rates, exchange rates) and how the change in the economic environment affects public finances. Box III.1 provides a technical discussion on the issue of assessing the long-term public finance impact of economic reforms.

2.4. Economic reforms and government balances in the short run: is there a trade-off?

In the policy debate, it is sometimes claimed that carrying out economic reforms could go at the expense of the respect of budgetary objectives, and criticisms have been moved to the Stability and Growth Pact for not taking properly into consideration this trade-off ([5]). In particular, it has been argued that an excessive focus on short-term budgetary discipline could act as a constraint on the pursuit of reforms that could improve public finances in the long term. This could occur if reforms worsen the budgetary position in the short to medium term while gains appear mainly after some time, so that a choice has

([1]) See, for example, European Commission (2002b) for a review of arguments as to why labour market reforms could translate into higher potential output via reduced NAIRU and increased participation rates.

([2]) A related argument supporting the view that efficient labour markets can increase growth has been put forward by Saint Paul (2002). Labour markets characterised by high firing costs would, in fact, discourage risky innovative activity by firms, reducing in this way the rate of productivity growth. Such an argument has found some support from empirical analysis (Bassanini and Ernst, 2002).

([3]) See, for example, Levine (2004) for a recent survey on theory and empirical evidence on the links between the functioning of capital markets and growth.

([4]) Easterly and Rebelo (1993), in a cross-country growth regression including both advanced and developing countries, find empirically that higher taxation contributes negatively and significantly to per capita output growth. Similar results are obtained by Kneller et al. (1999) for OECD countries only and by Romero de Ávila and Strauch (2003) for a sample limited to EU countries.

([5]) Among the first criticisms following this line of argument, see Eichengreen and Wyplosz (1998). Razin and and Sadka (2002) develop a model analysing the trade-off between the budgetary objectives of the Stability and Growth Pact and social security reforms. Beetsma and Debrun (2003, 2005) analyse the trade-off between budgetary discipline and reforms in a formal model comprising inefficiencies related both to governments' deficit bias (justifying the need for fiscal rules) and to lack of reforms.

Box III.1: **Assessing *ex ante* the long-term impact of reforms on public finances: methodological issues**

There are several methods followed in practice for measuring the *ex ante* impact of reforms on public finances. It is common practice in Finance Ministries and other policy institutions to rely on non-behavioural simulation models. These techniques are mainly used for estimating the impact on public finances of reforms that have a direct impact on government budgets with relevant repercussions in the long term, for instance pension reforms or reforms concerning the health or education sector or other social security programmes.

Non-behavioural simulation models use detailed data on:

- institutional characteristics of the sectors subject to reform (e.g. in the case of pension reforms, how pension contributions and pension benefits are structured depending on earnings, age, seniority at work, type of labour contract, etc.),
- elements of the reform (e.g. again in the case of pension reforms, how the regime governing the determination of pension contributions and benefits changes, how entitlement provisions are modified, how retirement age is affected, etc.), and
- current and projected values for economic and social variables of direct relevance (e.g. still in the case of pension reforms, projections on the demographic structure of population by cohorts, labour force statistics, statistics on wages and salaries, etc.),

to obtain projections on how the future path of specific budgetary items would be affected by particular reforms (e.g. in the case of pension reforms, how the time path of social contributions and pension reforms would be affected).

Given the estimated impact of the reform on the path of government revenues and expenditures, the impact of the reform on future developments in government budget balances and debts can in turn be assessed on the basis of assumptions on the future path of government budgetary items not directly affected by the reform and the future path of macroeconomic variables of relevance (e.g. growth and interest rates).

The European Commission regularly performs an assessment of the long-term sustainability of public finances in EU Member States on the occasion of the evaluation of stability and convergence programmes on the basis of projections on age-related expenditures based on national models and assumptions on macroeconomic variables agreed within the EPC Ageing Working Group (AWG) (see Part II, Chapter 3, of this report). The projections on age-related expenditures used in this assessment are updated with different frequency depending on the specific country concerned. Revisions in the projections of age-related expenditures reflect, *inter alia*, the effect of newly introduced structural reforms. Hence, the comparison between recent and previous Commission sustainability assessments gives an indication of the impact of the whole package of structural reforms enacted during a given period but is not informative on the impact of specific reforms. Moreover, such an indication is only indirect and imperfect, since between one assessment and another the fiscal variables (included in stability and convergence programmes) used in the simulation are changed.

A more direct route for assessing the long-term public finance impact of reforms has been followed in Economic Policy Committee (2002), which includes the assessment of alternative hypothetical parametric pension reforms in EU countries (concerning the calculation of pension benefits and the effective retirement age) using simulations based on the national non-behavioural models used in EU Member States. Results indicate that a reduction in the indexation of pensions by a ½ percentage point would contribute to reducing pension expenditures projected for 2050 by a range of between 0.5 and 2 % of GDP in systems where pension benefits are earnings related, and by 0.6 to 3 GDP points in systems where pensions are paid on a flat rate. Moreover, increasing by one year the effective retirement rate would lead to a reduction in pension expenditures in 2050 in the order of 0.6 to 1 % of GDP.

Estimates of the long-term budgetary impact of various types of pension reforms have also been provided by EU Member States in their updated stability and convergence programmes. All programmes report long-term budgetary improvements associated with the reforms, which range between 0.6 and almost 2 % of GDP (stability and convergence programmes are available at http://europa.eu.int/comm/economy_finance/about/activities/sgp/scplist_en.htm).

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Box III.1 (continued)

Simulations based on non-behavioural models have the advantage of including a large amount of information on the institutional features of the sectors subject to reform. The disadvantage with this approach is the neglect of the reaction in the behaviour of economic agents to the introduction of economic reforms, and of the associated implications for the macroeconomic environment. This means that the range of effects considered by the simulations is generally incomplete. For instance, in the case of pension reforms, non-behavioural models would mainly focus on the impact of these reforms on the time path of government revenues and expenditures. However, especially in the case of systemic reforms, pension reforms will also affect individual retirement and saving decisions, thereby having an impact on the supply of labour and capital, and therefore on potential output ([1]). Moreover, in the case of reforms whose impact on public finances is mainly indirect, the recourse to models incorporating behavioural relations is a necessary step for performing *ex ante* simulations.

Applied equilibrium models, calibrated to replicate the data of specific countries in given periods, permit the interaction between public finances and the macroeconomic environment to be taken into account and therefore the analysis of the indirect impact that economic reforms have on government revenues and expenditures. A relevant feature of applied macroeconomic models for the analysis of the long-term public finance impact of structural reforms is the presence of an overlapping generations structure, which allows different cohorts of economic agents to have varying sizes and behaviour. Overlapping generations models permit the impact of ageing populations on government accounts and on macroeconomic variables like savings, investment, or labour supply to be accounted for and the analysis of the direct and indirect public finance impact of reforms aimed at containing the impact of ageing on government budgets. The pioneering large-scale applied model with an overlapping generations structure was developed by Auerbach and Kotlikoff (1987) for the United States, and was further enriched in its structure and also applied to Japan, Germany and Sweden in Auerbach et al. (1989). Simulations on the impact of pension reforms using overlapping generations applied macro models have been performed by the OECD (Hviding and Merette, 1998) and the European Commission (McMorrow and Roeger, 2004).

In spite of their advantages, behavioural models have limitations that must be taken into account. First, there is a fundamental uncertainty as to what concerns the best model to represent the functioning of a particular sector of the economy. For instance, labour market reforms could have a relevant impact on public finances via a reduction in the NAIRU and a consequent improvement in potential output. However, involuntary unemployment may be associated with alternative explanations (e.g. minimum wages, the presence of unions, matching frictions in the labour market, etc.), each one leading to alternative modelling. Depending on the specific model chosen to represent the labour market, the same type of reform may have a quite different impact on the NAIRU, and then on potential output, government revenue and public finances. Second, there is uncertainty concerning the value of structural model parameters (e.g. the elasticity of labour demand). Third, there can be major difficulties in translating particular reforms into a shock to the parameters of the model. Whereas in the case of, say, tax reforms, there is a clear model counterpart to real-world policies, this may not be the case in other instances. This point can be highlighted via an illustrative simulation of labour market reform performed with the European Commission's QUEST model ([2]). The simulation considers a reform that helps to reduce the excess of wages above the level that would be consistent with full employment. A major difficulty in performing such a simulation is that no clear benchmark may exist for translating concrete reform proposals (e.g. a reform of the conditions in which collective bargaining takes place etc.) into a shock to the parameters of the model. Given the particular representation of the labour market in the QUEST model, the following simulation assumes a downward shift in the wage-setting curve resulting in a labour market characterised by imperfect matching (Pissarides, 1990) ([3]). Moreover, a great deal of uncertainty on the exact magnitude of the shock is inevitable. Graph III.1 illustrates how uncertainty on the magnitude of the shock could translate into uncertain estimates of the public finance impact of reforms. Two scenarios are shown: one in which the shock to the wage-setting curve leads to a 0.5 % *ex ante* wage reduction and one in which the *ex ante* reduction in the wage rate is 1 %.

([1]) Work is currently ongoing in the EPC AWG to incorporate the impact of pension reforms on the projections for labour force participation rates. On the methodology of how to estimate the impact of pension reforms on participation rates, see Burnieaux et al. (2003).

([2]) See Roeger and in't Veld (1997) for a description of the QUEST model.

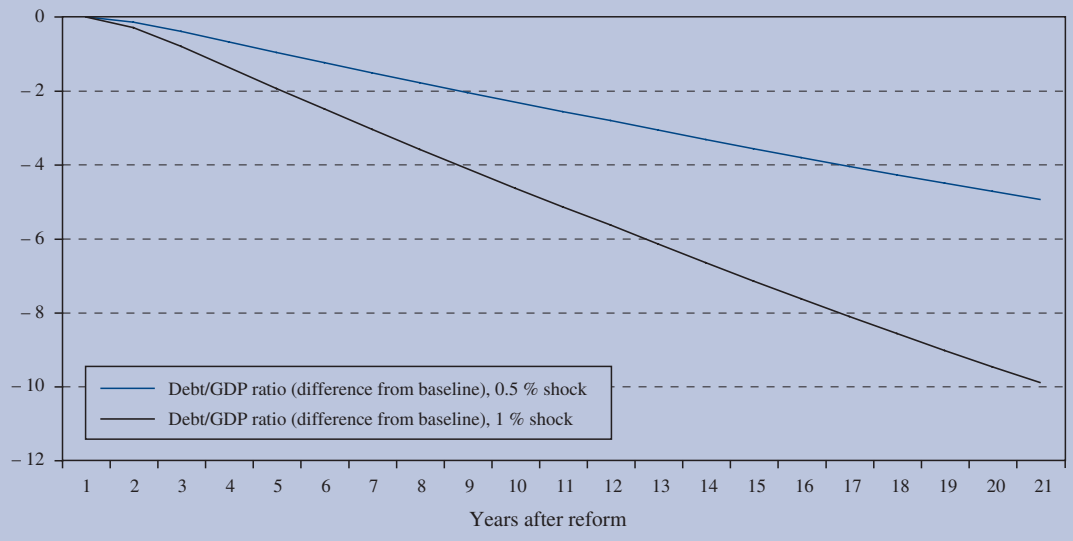
([3]) The shock is applied in all EU countries.

(Continued on the next page)

Box III.1 (continued)

Given the model set-up, wage moderation leads to lower unemployment and to an increase in potential output. This translates in turn into improved government budgets over time and falling debt/GDP ratios. Depending on the assumed magnitude of the shock, however, the estimated impact on debt will differ considerably. With a 0.5 % shock, after 20 years the debt for the EU-15 aggregate would be reduced by between 4 and 5 GDP points, while with a 1 % shock the impact would amount to about 10 GDP points.

Graph III.1: **Assessing the long-term effects of labour market reforms on debt: simulation with the QUEST model**



Source: Commission services.

to be made in the short term between implementing the reform and keeping deficits unchanged.

There are several arguments that could provide a justification for the claim that structural reforms could worsen the budget in the short run in spite of an improvement in the medium/long term in public finances.

The first argument is that reforms may entail direct budgetary costs, at least in the short/medium term. A notable example is that of systemic pension reforms implying that the social contributions previously collected by the government are diverted to a new pillar, which may be privately run or classified outside the government. This type of reforms helps to contain the impact of ageing on the dynamics of government expenditure related to the payment of pensions. However, it will also normally entail a reduction in government revenues not immediately compensated by reduced pension payments. Box III.2 presents model simulations illustrating that the negative budgetary impact of this type of reforms can be quite persistent. A somehow related argument rationalising short-term budgetary losses associated with reforms is the possibility that economic reforms have a temporary effect on output, and therefore on the cyclical component of budgets.

A second reason for why reforms that could be beneficial in the long run may imply budgetary deteriorations at least in the short term is that the resistance to reforms coming from reform losers can be overcome by means of compensation packages having a cost on the budget. This could either mainly take the form of increased expenditures (government transfers and subsidies) or of reduced revenues. A significant example of increased government transfers related to the implementation of structural reforms is that of several east European countries during the transition process. The liberalisation and

privatisation of economic activities were often followed by the temporary provision of government subsidies to permit the restructuring of firms. On the revenue side, economic reforms were quite often implemented together with tax cuts; this seems especially the case for product and labour market reforms (IMF, 2004a).

A different argument is based on a trade-off between budgetary adjustment and economic reforms associated with political costs. Carrying out reforms could be costly to governments in terms of lost consensus (due to resistance by pressure groups, voters being averse to uncertain effects of reforms, temporary losses in output and jobs, etc.). Fiscal consolidations could, in fact, be politically costly due to possible losses of output and jobs in the short term ([1]). Given that governments dispose of 'political capital' in limited supply, whenever part of this political capital is allocated to carrying out economic reforms, little could be left for adjusting budgets. By the same token, expanding budgets could compensate for using up political capital in carrying out reforms.

Although there could be some foundation for the above arguments under given circumstances, generalisations are difficult. In fact, there is also a series of reasons that point rather to a positive relation between economic reforms and short-term government budgets.

First, there are reforms with a direct positive impact on budgets. This is, for instance, the case of many parametric pension reforms or of labour market reforms (e.g. labour market reforms reducing the generosity of unemployment subsidies).

Moreover, compensation packages to ease resistance to reforms, if appropriately designed, are not necessarily costly to the budget. Schemes could be found such that the groups that lose from reforms are compensated via transfers paid by the groups benefiting from reforms ([2]).

Second, a credible commitment by the government to medium-term budgetary discipline could help to win the resistance of groups opposing reforms. Once governments are credibly committed to sound public finances, the adoption of reforms that permit structural improvements in public finances in the medium/long term may

([1]) However, there have been documented cases in which the impact of fiscal consolidation on economic activity has been positive rather than negative as predicted by standard Keynesian models (e.g. Giavazzi and Pagano, 1990, and Alesina and Ardagna, 1998). European Commission (2003a) and Giudice et al. (2003) analyse cases in which fiscal consolidation periods were followed by increased growth in the EU.

([2]) There are anecdotal cases which seem consistent with this possibility. The Dutch labour market reform which started in 1982 and aimed at supporting wage moderation was accompanied by cuts in labour taxes and social security contributions paid by employees. This permitted a reduction in labour costs to businesses without losses in net wages. Employment growth followed from 1984 onwards. At the same time, government expenditure was cut substantially, so that, in spite of the tax cut, the government budget balance improved.

Box III.2: Systemic pension reforms and the trade-off between the short-term and the long-term impact on public finances: an illustration via simulations with the QUEST ageing model

This box illustrates, via model simulations, the possible trade-off between higher budgets and debt in the short term and lower debt in the long term that may arise as a consequence of systemic pension reforms that shift pension contributions to funded schemes privately managed or classified outside the government sector.

The simulations are performed with the QUEST ageing model (see McMorrow and Roeger, 2004, for a description). This model is a variant of the European Commission macro model, allowing for an overlapping generations structure where households can be either workers or pensioners (as in Gertler, 1999). Demographic trends are explicitly modelled. The demographic parameters are calibrated to the main features of the Eurostat projections until 2050. The model distinguishes between a corporate sector, a household sector and a government sector. Income transfer across generations is governed by a PAYG system. The corporate sector is modelled along standard neoclassical lines with firms maximising their market value. The model distinguishes between various tax and expenditure categories and the government is constrained by an intertemporal budget constraint.

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Box III.2 (continued)

The simulations are aimed at illustrating the debt implications up to 2050 of two alternative hypothetical strategies for financing additional pension expenditures related to ageing. The first alternative (the 'no-reform scenario') considers a PAYG system in which pension contribution rates and replacement rates are kept constant over time. The second alternative (the 'reform scenario') considers a partial move to a funded system, with a government guarantee of accrued pension rights for current pensioners and the cohorts currently in the labour force that contributed to the PAYG system for a longer period.

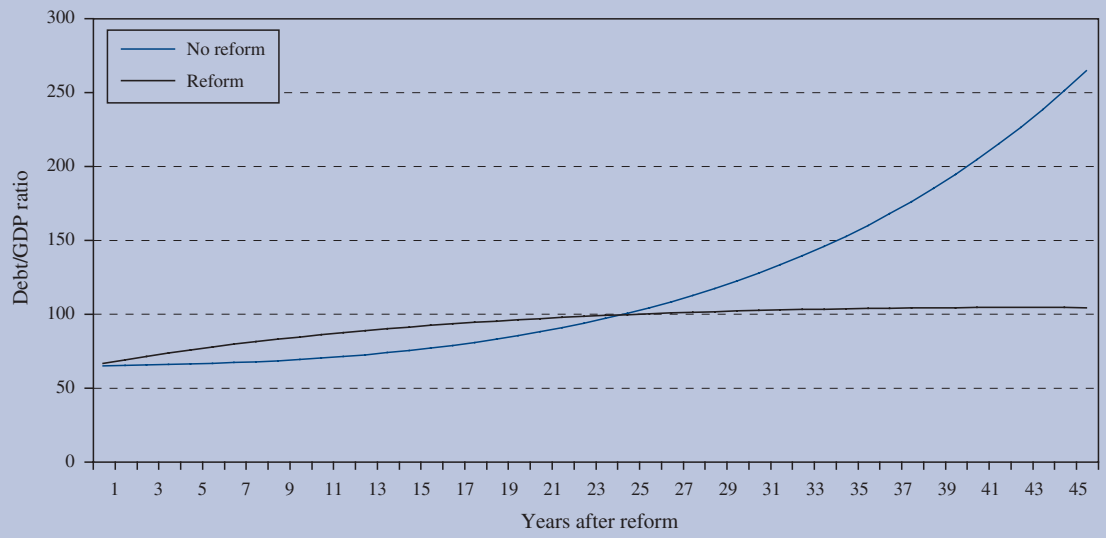
More precisely, the two scenarios are modelled as follows.

No-reform scenario: The government guarantees a constant pension contribution and replacement rate throughout the whole period equal, respectively, to 16 % of the net wage and 75 % of the gross wage.

Reform scenario: The government implements a reform that: (i) shifts pension contributions into a non-government funded scheme so that the amount of contributions received by the government falls from 16 % to 11 % of the net wage; (ii) reduces the pension benefits paid by the government, guaranteeing accrued rights to PAYG pensions. It is assumed that young workers (aged under 40 years at the time of the reform) are entitled to pension benefits from the government equal to 50 % of the gross wage (additional pension benefits being related to the stock of their contributions to the funded scheme). At the opposite end, workers retiring at the time of the reform receive pension benefits from the government equal to 75 % of the gross wage, as before the reform. The cohorts in between receive pension benefits from the government of between 50 and 75 % of their gross wage in proportion to their age, i.e. to the length of the period during which they have been contributing to the PAYG system.

In the model, any difference between the amount of pension contributions received by the government in a given year and the amount of pension benefits paid is financed in the model via deficits, i.e. an increased stock of government debt. It is also assumed that at the date of the reform the PAYG system is in equilibrium (i.e. that the amount of pension contributions received each year by the government exactly covers the amount of pension benefits paid) and that government deficits are equal to zero. The initial debt/GDP ratio corresponds instead to that recorded for the EU-15 aggregate.

Graph III.2: **Debt dynamics with and without pension reform: simulations with the QUEST ageing model**



Source: Commission services.

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Box III.2 (continued)

Graph III.2 shows the evolution of government debt under the two alternative scenarios. The evolution of debt under the no-reform scenario reflects a growing deficit in the PAYG system associated with rising old-age dependency ratios. With a constant contribution rate, the share of pension benefits paid by the government covered by PAYG contributions would decline from 100 % to about 66 % in 2050. This would imply an explosive path for the debt, exceeding 250 % of GDP by 2050. Under the reform scenario, the path of the debt/GDP ratio differs considerably. Since this scenario implies an immediate reduction in pension contributions coupled with a phased-in reduction in pension benefits, there will be an immediate increase in government deficits and a relatively fast accumulation of debt just after the reform. However, since the amount of pension benefits paid by the government falls over time, deficits will also fall and the debt/GDP ratio will tend to stabilise.

become easier. Since voters and interest groups know that governments will not loosen budgetary policy to ease the resistance to reforms, there will be less resistance to reforms in the first place.

The credibility of government commitment to budgetary discipline is enhanced when there is a wide perception of the need to take action to reverse unsustainable trends in public finances. The credibility of government commitment is also strengthened when taken at the international level. Experience with the pension reforms in several EU countries in the run-up to EMU (Spain, Italy and Portugal) seems consistent with this argument.

Overall, whether a trade-off exists between budgetary discipline in the short run and the adoption of reforms is mainly an empirical question. Analysing empirically the issue in the EU is the object of the next chapter of this part of the report.

3. The short-term link between structural reforms and public budgets: a close look at the EU data

3.1. Introduction

The aim of this chapter is to assess empirically the link between fiscal consolidation and economic reforms. The analysis focuses on EU-14 countries, given the lack of systematic data for the new Member States. Three types of reforms are considered: labour market reforms, product market reforms, and pension reforms. First, the issue of how reforms can be measured is discussed and the data used for measuring reforms in the analysis are described. Second, the short-term impact of economic reforms on budgets is assessed. This is one of the most frequently alleged reasons for why a trade-off may arise between budgetary discipline and the adoption of reforms in the short run. The assessment concerns the overall short-term impact on budgets, without distinguishing between the direct and the indirect effects (e.g. arising via the provision of compensation packages) of reforms. Third, since the presence of budgetary costs associated with reforms is one but not the only reason for a possible trade-off between budgetary discipline and reforms, the analysis also addresses directly the link between fiscal consolidations (measured by improvement in primary cyclically adjusted budget balances) and the probability of implementing reforms.

3.2. The measurement of structural reforms

A first necessary step for the analysis is the measurement of economic reforms. Such measurement involves the major difficulty of having to quantify the degree of intensity of policies of very different types. Several attempts have been made in recent times by academia and policy institutions to collect data on economic reforms and to develop indicators for the measurement of the effectiveness of such reforms.

A first approach for measuring reforms consists of constructing indicators based on information on actual policies that have been implemented in given sectors, periods and countries. Information is generally provided on the number of policy measures of certain types, possibly accompanied by an evaluation of such policies according to predefined criteria. This approach permits information to be obtained on the action taken by governments with the purpose of reforming the functioning of markets or State institutions ([1]). A second approach consists of constructing indicators measuring the extent of existing distortions associated with government policies, for instance the distortions associated with taxation or with the presence of regulations in particular markets ([2]). The impact of reforms is measured in this case by the change in the level of the indicator measuring the degree of distortions. This second approach does not account directly for government reform initiatives, but permits gauging of the impact of such initiatives on the structural conditions of the different sectors considered. This approach also permits the assessment of the extent to which reforms are needed.

([1]) Databases on policy measures of different types are constructed and maintained by national and international policy institutions and by independent research centres (e.g. the Rodolfo de Benedetti Foundation (FRDB) as regards labour market policies).

([2]) Abundant work in this area has been carried out by the OECD. See, for instance, Nicoletti and Pryor (2001) and Nicoletti and Scarpetta (2003).

Table III.1

Source and coverage of data on structural reforms

	Source	Description of data from which reform indicators have been constructed	Country coverage	Year coverage	Reform indicator
Labour market reform	IMF	Labour market index consisting of the unweighted average of indicators of employment restriction, unemployment benefit replacement rate and benefit duration. The index is normalised in such a way as to be between 0 and 1 and to increase as labour market restrictions are reduced. Original data sources: Nickell and Nunziata (2001), labour market institutions database and OECD data.	EU-14 except Greece	1970–98 (1)	The yearly change in the labour market index is positive and bigger than the median positive change.
Product market reform	IMF	Index measuring entry barriers, public ownership, market structure, vertical integration and price controls in public utilities and transport services. The index is normalised in such a way as to be between 0 and 1 and to increase as product market restrictions are reduced. Original data source: Nicoletti and Scarpetta (2003).	EU-14 except Greece	1975–98	The yearly change in the product market index is positive and bigger than the median positive change.
Pension reforms	FRDB	Data indicating the years in which reforms in pension systems were approved by parliaments and the major characteristics of reforms.	EU-14	1985–2001	A pension reform making the system less generous took place in the year

(1) Except Austria (1973–98), Portugal (1975–98) and Finland (1971–98).

Whenever the indicator reveals a high degree of distortions in particular sectors (as compared with other countries or periods), there is indication of a stronger need to carry out reforms (1).

In the following analysis, indicators for labour and product market reforms are constructed on the basis of structural indices measuring the degree of policy-induced distortions used in IMF (2004b), while pension reform indicators are built on information collected and processed by the Rodolfo de Benedetti Foundation (FRDB) reporting the year of adoption and the main characteristics of reforms (2).

Table III.1 describes the sources of the original data and the methodology followed for constructing the reform indicators used in the analysis that follows. The indicators take value 1 in countries and years in which reforms took place and zero otherwise. Indicators constructed in this way permit better comparison of results across different types of reforms starting from data representing different types of information (indices summarising the degree of distortions in the economy for labour and product market and tax reforms, and dichotomic variables reporting when and where reforms took place for pension reforms) (3). These indicators also account for the discrete character of reforms, i.e. the fact that reforms are generally not evenly spread across time and space (4). The indicators constructed cover EU-14 countries (except Greece as regards labour and product market reforms). Data are available starting from the 1970s and up to the late 1990s or early 2000 for product and labour market reforms and for the 1985–2001 period for pension reforms.

(1) A further method for measuring reforms is the use of structural indicators providing information on the functioning of the economy. For instance, in the case of the measurement of the functioning of the labour market, this approach would imply using a number of indicators concerning the magnitude and the characteristics of unemployment, job-creation and job-destruction flows, etc. This approach has been followed at the EU level to measure the progress towards the goals of the Lisbon strategy. Progress is benchmarked against indicators measuring outcomes achieved in specific sectors of the economy in EU Member States.

(2) Xavier Debrun is gratefully acknowledged for providing the data on structural indices used in IMF (2004a).

(3) Reforms in labour and product markets correspond to changes in the structural indices indicating a sufficiently big reduction in the degree of policy distortions. A similar approach is followed, for instance, in Heinemann (2004). By convention, it is assumed that reforms need to induce a reduction in the degree of distortions greater than the median reduction observed across the sample. The choice of the median value as a benchmark allows an easy interpretation (reforms are events leading to a reduction in the degree of distortions belonging to the top 50 %) and implies a frequency of events classified as reforms in the order of 20 to 30 % of the total, which permits using statistical inference in the analysis of the links between reforms and fiscal variables across the sample.

Table III.2

Frequency of different types of reforms in different time periods (EU-14)

	Before 1980	Between 1980 and 1990	After 1990
Labour market reforms	0.1	0.24	0.38
Product market reforms	0	0.16	0.62
Pension reforms	n.a.	0.16	0.31

NB: Figures represent the ratio between the total number of cases in which reforms occurred over the total number of years for which information is available on reform indicators. See Table III.1 for the definition of reform indicators and for country/year availability.

Table III.2 reports the frequency across the sample of the types of reforms considered distinguishing between different decades. It shows that labour and product market reforms were more frequent in the 1990s than in the 1980s and especially in the 1970s. As for pension reforms, they were considerably more frequent in the 1990s than in the 1980s (information on the 1970s is not included in the data set used).

3.3. Do reforms worsen government budgets in the short run?

The purpose of this section is to provide evidence on the short-term budgetary impact of structural reforms. As discussed in the previous section, the presence of short-term costs to the budget could be one reason explaining a possible trade-off between budgetary discipline and reforms. A negative budgetary impact of reforms could be due either to direct effects associated with the reform (e.g. losses of pension contributions in the case of systemic pension reforms) or to costs associated with the need to win resistance to reforms via increased budgets (e.g. via subsidies or tax cuts). Due to the absence of systematic evidence on the budgetary impact of reforms that can be attributed exclusively to direct effects, in the following analysis no distinction is made between the direct component and the component associated with the implementation of compensation schemes.

3.3.1. Labour and product market reforms

There is no obvious way in which labour market and product market reforms could impact directly on budgets in the short term. Depending on the particular reforms considered, the effect could be either negative or positive. For instance, labour market reforms could either contribute to containing government expenditure if including reductions in unemployment subsidies or raise expenditure if comprising active labour market policies to promote employability (e.g. training programmes). As for product market reforms, they can, for instance, have a direct effect on budgets by altering the size of government subsidies and transfers to the corporate sector. Although the direct budgetary impact of labour and product market reforms is likely to be quite limited in the short run, one needs to take into account the impact on public budgets that could be associated with the implementation of compensation schemes.

A first approach to assessing the short-term budgetary impact of reforms is to look at the change in various budgetary items in years immediately following reforms and to compare them with that in years where no reforms took place. Table III.3 reports average changes in primary cyclically adjusted budgets (primary CABs) and selected components distinguishing between years immediately following the adoption of reforms and remaining years. T tests are performed to check whether differences in reform and non-reform years are statistically significant.

Results indicate that neither in the case of labour market reforms nor in that of product market reforms is the variation in primary CABs significantly different in reform or non-reform years. In the case of labour market reforms, a weaker reduction in government investment is observed on average. In the case of product market reforms, the growth in cyclically adjusted revenues is significantly lower in reform years, but the effect on budgets is compensated by lower growth in primary expenditures.

(4) However, the use of discrete reform indicators has the drawback of not permitting the different intensity of the impact of policies in different countries and periods to be taken into account, while this can be captured by using directly indices summarising the extent of policy-induced distortions.

Table III.3

Average changes in budgetary variables during reform periods and periods where no reforms took place: labour and product market reforms (EU-14 except Greece, 1972–98)

Year-to-year change in fiscal variables (% of GDP), simple average	Labour market reforms			Product market reforms		
	No reforms	A reform took place in the current or previous year	t test for	No reforms	A reform took place in the current or previous year	t test for
	(1)	(2)	(1) ≠ (2)	(1)	(2)	(1) ≠ (2)
Primary CAB	0.06	0.08	– 0.14	0.15	0.15	– 0.0
Cyclically adjusted revenues	0.43	0.3	0.65	0.54	0.01	2.89***
Social security contributions	0.17	0.08	1.3	0.12	0.017	1.7*
Primary expenditure	0.38	0.19	0.93	0.36	– 0.11	2.44**
Social benefits other than in kind	0.2	0.05	1.6	0.17	– 0.005	1.97**
Government subsidies	– 0.003	– 0.048	0.85	– 0.033	– 0.072	0.79
N. obs	238	114		153	141	

NB: *, **, and *** denote, respectively, t tests significant at the 10, 5 and 1 % level.

Source: Commission services.

From this prima facie evidence, there is no strong support for the view that labour or product market reforms are associated with short-term budgetary costs. However, the analysis so far has not controlled for other factors that may have affected government budgets.

A common way to perform such control is to estimate 'fiscal rules', describing the reaction of fiscal authorities (in terms of chosen levels of budget balances) to key macroeconomic developments, such as those related to the cycle and the level of debt ([1]). The strategy followed in the following analysis is therefore that of augmenting fiscal rules with variables relating to the implementation of reforms ([2]). The budgetary impact of reforms can be gauged by looking at the regression coefficient of the reform variables.

Table III.4 reports the results for panel data estimation of fiscal rules. The dependent variable is the primary CAB, the explanatory variables are the output gap, the debt/GDP ratio and a dummy variable taking value 1 if reforms were implemented in the current or previous year. Estimates have been performed separately for the case of labour and product market reforms. In accordance with existing estimates of fiscal rules for EU countries, results indicate a non-significant response of fiscal authorities to output gaps and a significant positive response to debt ([3]). As for reform variables, in the case of product market reforms the coefficient is negative but statistically insignificant (though close to the 10 % significance level), while in the case of labour market reforms the coefficient is negative and significant.

The size of the coefficients is also similar, indicating that in correspondence with both labour and product market reforms budgets are loosened by about 0.3 GDP points.

([1]) The basic 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 a debt stabilisation motive (so that a positive response of budget balances to the existing stock of debt is expected). For the estimation of fiscal rules for EU countries see, for example, von Hagen et al. (2001), Gali and Perotti (2003), European Commission (2004a) and Ballabriga and Martinez-Mongay (2004).

([2]) An alternative analytical strategy is followed in Pirttila (2001) in analysing the impact of reforms in transition countries (privatisation, price liberalisation, trade liberalisation) on fiscal adjustment. In that analysis, the change in the budget balance is regressed against reform variables and on measures of growth, unemployment, private firms' entry and initial conditions (number of transition years). Results indicate that while privatisation has a significantly negative impact on the fiscal balance, the impact of price liberalisation was significant and positive.

([3]) However, it has been shown that the coefficients of output gaps and debt of fiscal rules have not been constant over time (e.g. Gali and Perotti, 2003, European Commission, 2004a, and Ballabriga and Martinez-Mongay, 2004).

Table III.4

Budget balances and labour and product market reforms: estimating fiscal rules (EU-14 except Greece, 1972–98)

Dependent variable: primary CAB, Explanatory variables	(1)	(2)
Constant	– 1.35***	– 1.58***
	(– 5.49)	(– 5.15)
Lagged dependent variable	0.75***	0.76***
	(23.74)	(23.71)
Output gap	– 0.21	– 0.06
	(– 0.48)	(– 1.43)
Lagged debt/GDP ratio	0.032***	0.036***
	(6.78)	(6.21)
Dummy for labour market reforms	– 0.306*	
	(– 1.65)	
Dummy for product market reforms		– 0.29
		(– 1.53)
N. obs	342	293
R sq.	0.73	0.76
Chi sq.	1 121	1 171

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and the US lagged output gap. Z statistics are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 % level. Coefficients for country fixed effects are not reported.

The analysis does not permit distinguishing whether this budgetary effect is a direct one or whether it is related to the objective of policy authorities of winning resistance to reforms by relaxing the budget. It should be stressed that these results must be interpreted with care. In particular, they are likely to be affected significantly by the chosen method for measuring structural reforms.

3.3.2. Pension reforms

The short-term direct budgetary impact of pension reforms depends crucially on the elements touched upon by the reform and on how the reform is designed. Parametric reforms in government pension schemes that reduce the generosity of the system are likely to exert a direct positive impact on budgets. This is generally the case of reforms increasing pension contributions, revising the criteria for the determination of pension benefits (e.g. modifying the indexation criterion of pensions), tightening the entitlement criteria for pensions, or increasing the statutory retirement age. As illustrated in Section 2.4 of this part (Box III.2), systemic reforms may have instead a short-term negative impact on budgets even when having a possible long-term impact on public finances if they imply the shifting of social contributions into pension schemes privately run or classified outside the government. It should also be taken into account that the short-term budgetary impact of pension reforms could be affected to a relevant extent by the fact that reforms are quite often designed in such a way as to take effect gradually.

Table III.5 compares average changes in primary CABs and selected budgetary items in periods with and without reforms. Results show that, in spite of a non-significant difference in the changes in the primary CAB between periods with and without reforms, there is a statistically significant difference in the short-term dynamics of social benefits other than in kind, which on average rise in periods without reforms and fall immediately after the implementation of reforms ([1]). The difference in the change in social contributions in reform and non-reform years appears instead negligible.

Since the short-term budgetary impact of pension reforms could be quite different depending on the spe-

([1]) The ESA 95 item 'social benefits other than in kind' (D.62), comprises four sub-items: social security benefits in cash (D.621), private funded social benefits (D.622), unfunded employee social benefits (D.623), social assistance benefits in cash (D.624). Pension reforms are likely to affect especially the first two categories, that on average have constituted about two thirds of the aggregate social benefits other than in kind in the EU-15 in the past 10 years.

cific reforms considered, it could be helpful to look closely at budgetary variables of interest in the years before, during and after each one of the selected structural pension reforms. Of course, such an analysis would not be very informative on the impact of reforms on budgets (since there is no counterfactual analysis for judging what would have been the evolution of budgetary variables without the reform), but it could help to shed light on whether there are systematic differences in the evolution of reforms depending upon the type of reforms considered. The reforms included in the analysis are all those reducing overall the generosity of the system and classified as structural in the FRDB database, i.e. reforms applying to the whole population and not only to particular categories.

Table III.6 reports the value (as a percentage of GDP) of the primary CAB, cyclically adjusted revenues, primary expenditure, social security contributions and social benefits other than in kind in the year before, during and in the two years after each reform. Almost all the reforms considered were mainly of the parametric type, aimed at modifying the functioning of PAYG government pension schemes. The only exceptions are the 1996 reform in the Netherlands, the 1998 reform in Sweden, and the 1987 reform in the UK.

The 1996 Dutch reform consisted in the privatisation of the pension fund for civil servants. The reform carried out in Sweden in 1998 was a broad reform, that implied, *inter alia*, revising the functioning of the government PAYG pension scheme (from defined benefit to notional defined contribution) and the gradual introduction of an additional funded, defined-contribution pillar (see Box III.3). The 1987 UK reform introduced the possibility of opting out of the government PAYG scheme and joining individual private funded schemes ([1]). In almost all the parametric reforms considered in Table III.6, elements aimed at reducing pension benefits and increasing pension contributions were present, together with revisions in the statutory retirement age ([2]).

The following points emerge from the data reported in Table III.6. First, the evolution of the primary CAB in correspondence with reform years was to a considerable extent driven by changes in cyclically adjusted revenues and primary expenditures not directly related to changes in pension contributions and social benefits. Second, the pension contributions as a share of GDP moved little after the reform in almost all cases (never more than 1 GDP point between the year of the reform and the two consecutive years).

([1]) See http://www.frdb.org/documentazione/scheda.php?id=55&doc_pk=9027.
([2]) The FRDB reports as uncertain the impact of the German reform of 1992 on pension benefits, while in all other cases reforms are indicated as reducing benefits and increasing contributions. As for revisions in the retirement age, all reforms include an increase in the statutory retirement age, generally introduced gradually, except for the 1995 Italian reform where the retirement age was made more flexible compared with the regime introduced in 1992. Moreover, the Italian reforms of 1992 and 1995 were not purely parametric in that they also introduced fiscal incentives for the accumulation of individual private pension schemes

Table III.5

Average changes in budgetary variables during reform periods and periods where no reforms took place: pension reforms (EU-14, 1986–2001)

Year-to-year change in fiscal variables (% of GDP), simple average	Pension reforms		
	No reforms (1)	A reform took place in the current or previous year (2)	T test for (1) ≠ (2)
Primary CAB	0.012	0.18	– 0.87
Cyclically adjusted revenues	0.16	– 0.04	1.06
Social security contributions	0.02	– 0.015	0.6
Primary expenditure	0.11	– 0.23	1.54
Social benefits other than in kind	0.06	– 0.11	1.85*
Government subsidies	– 0.08	– 0.09	0.11
N. obs	123	101	

NB: *, **, and *** denote, respectively, t tests significant at the 10, 5 and 1 % level.

Source: Commission services.

Table III.6

Budgetary variable evolution during structural pension reforms (EU-15, 1986–99)

(% of GDP)

Pension reform	Budgetary items	t – 1	t	t + 1	t + 2
DE 1992	Primary CAB	– 2.0	– 1.1	0.0	0.6
	Cyclically adjusted revenues	42.6	44.1	46.2	46.5
	Primary expenditure	44.3	44.8	45.9	45.6
	Social security contributions	17.2	17.6	18.2	18.6
	Social benefits other than in kind	15.7	16.3	17.4	17.7
ES 1997	Primary CAB	1.4	2.2	1.4	2.1
	Cyclically adjusted revenues	40.0	39.5	38.7	39.2
	Primary expenditure	38.4	37.0	37.1	36.7
	Social security contributions	13.2	13.1	13.0	13.1
	Social benefits other than in kind	13.8	13.3	12.8	12.4
IT 1992	Primary CAB	– 0.5	1.7	3.7	2.8
	Cyclically adjusted revenues	43.4	46.1	48.3	45.8
	Primary expenditure	43.7	44.1	44.6	43.1
	Social security contributions	14.8	15.1	15.3	15.0
	Social benefits other than in kind	15.6	16.5	17.0	17.3
IT 1995	Primary CAB	2.8	4.0	4.7	7.1
	Cyclically adjusted revenues	45.8	45.7	46.1	48.1
	Primary expenditure	43.1	41.9	41.7	41.7
	Social security contributions	15.0	14.8	15.0	15.3
	Social benefits other than in kind	17.3	16.7	16.9	17.3
NL 1996	Primary CAB	2.7	4.7	4.3	3.3
	Cyclically adjusted revenues	47.8	48.2	47.2	46.0
	Primary expenditure	45.5	44.1	43.1	42.4
	Social security contributions	17.2	16.6	16.6	16.4
	Social benefits other than in kind	15.3	14.8	13.9	13.0
PT 1993	Primary CAB	2.8	0.3	0.1	1.6
	Cyclically adjusted revenues	40.9	40.5	39.6	40.4
	Primary expenditure	37.7	40.0	39.4	38.8
	Social security contributions	10.4	10.7	10.8	11.0
	Social benefits other than in kind	10.2	11.2	12.6	11.8
FI 1997	Primary CAB	3.8	3.1	4.0	3.9
	Cyclically adjusted revenues	58.0	54.8	53.3	53.3
	Primary expenditure	55.5	52.2	49.2	49.0
	Social security contributions	14.2	13.4	13.1	13.2
	Social benefits other than in kind	21.5	19.8	18.3	18.1
SE 1998	Primary CAB	6.5	7.7	6.4	7.2
	Cyclically adjusted revenues	63.7	63.9	62.9	61.7
	Primary expenditure	56.7	55.3	55.5	53.3
	Social security contributions	14.5	14.5	13.2	15.1
	Social benefits other than in kind	18.9	18.7	18.2	17.5
UK 1987	Primary CAB	2.9	2.1	1.7	2.5
	Cyclically adjusted revenues	44.4	42.8	40.8	39.9
	Primary expenditure	41.6	40.7	39.0	36.9
	Social security contributions	8.35	8.4	8.1	8.0
	Social benefits other than in kind	14.1	14.3	13.5	12.5

NB: Including only structural reforms decreasing the generosity of the pension system as reported in the FRDB database. Social benefit figures refer to the 'social benefits other than in kind' category in the ESA 95 government accounts.

Source: European Commission computations on the FRDB and AMECO databases.

There is some indication that the evolution of social contributions differed depending on whether reforms were mainly parametric or systemic. After all parametric reforms, social contributions increased or stayed roughly constant, while, in the case of the Dutch and UK reforms, there was a slight reduction in pension contributions (see Box III.3 for the Swedish reform). Third, social benefits changed quite substantially after reforms. They fell after all systemic reforms.

The case of parametric reforms is instead mixed: an increase is observed after the German reform, the two Italian reforms and the Portuguese reform, while, after the Spanish and the Finnish reforms, a reduction in benefits is observed. Overall, the evidence broadly supports the expectation that the impact of reforms is likely to be quite different depending on the specifics of the reforms considered, in particular whether they are mainly parametric or systemic reforms.

Since short-term budgetary outcomes are determined by a series of factors other than pension reforms, an appropriate assessment of the impact of pension reforms on budgets needs to control for such factors. The estimation of augmented fiscal rules allows this type of control to be performed. Table III.7 presents the results for fiscal rules analogous to those estimated previously for the case of labour and product market reforms, introducing this time a pension reform dummy that takes value 1 if a pension reform was implemented in the current or previous year. The analysis in this case refers separately to the determinants of the primary CAB, cyclically adjusted revenues and primary expenditure. Results show that the pension reform dummy has a negative but non-significant impact on primary CABs. The coefficient indicates that a reform implemented in the current or previous year reduced the value of the primary CAB by about 0.2 GDP points. However, given the high uncertainty surrounding this estimate (a high standard error of the regression coefficient), it cannot be judged to be significantly different from zero. By carrying out the same analysis using a dependent variable, the cyclically adjusted government revenues and primary expenditure, one notices that most of the deterioration in the primary CAB in the aftermath of pension reforms is associated with a reduction in revenues rather than with increased expenditure. Again, the impact on revenues is however not statistically significant. Moreover, the analysis does not permit distinguishing whether the budgetary impact of pension reforms is a direct one or whether it is related to a budgetary relaxation to ease resistance to the implementation of the reform.

Table III.7

Budget balances and pension reforms: results from the estimation of fiscal rules (EU-14, 1986–2001)

Dependent variables Explanatory variables	Primary CAB	Cyclically adjusted government revenues	Primary government expenditure
Constant	−2.48*** (– 4.40)	8.14*** (5.54)	4.99*** (2.85)
Lagged dependent variable	0.71*** (17.57)	0.78*** (21.89)	0.91*** (22.76)
Output gap	−0.003 (– 0.08)	0.14*** (3.65)	0.14*** (2.86)
Lagged debt/GDP ratio	0.048*** (5.5)	0.034*** (4.21)	−0.018** (– 2.18)
Dummy for pension reform	−0.24 (– 1.18)	−0.22 (– 1.3)	−0.05 (– 0.24)
N. obs	224	224	224
R sq.	0.69	0.79	0.73
Chi sq.	1 128	405 731	255 782

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and the US lagged output gap.
Z statistics are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 % level.
Coefficients for country fixed effects are not reported.
The pension reform dummy is constructed as an indicator taking value 1 if a pension reform was carried out in the current or previous year and zero otherwise.

Box III.3: The multi-pillar pension reform in Sweden: main characteristics, statistical classification issues and its impact on the government budget

Following an almost decade-long political process, on 8 June 1998 the Swedish Parliament (the *Riksdag*) adopted a decision on a new system for retirement pensions. The long process reflected the intention from the outset to obtain broad political support in favour of a reform leading to a new pension system that could remain stable over a long time. The main aspects concerned by the reform were as follows: (i) a revision in the functioning of the government PAYG system; (ii) the creation of a new funded pillar.

The implementation of the reform foresees a phasing-in period: pension beneficiaries born before 1937 are not affected by the reform and are entitled to pension benefits according to the old system; generations born after 1953 will receive pensions according to the new system; beneficiaries born between 1938 and 1953 will receive pensions computed according to both the old and the new systems. The social insurance offices, the National Social Insurance Board and the Premium Pension Authority (PPM) administer the system.

The main feature of the reform in the PAYG pillar is the introduction of an actuarially fair system for computing benefits in terms of accrued contributions ([1]). The reform transformed the previous defined-benefit system into a notional defined-contribution system. Pension contributions to the PAYG system amount to 16 % of income. The growth of pension rights is calculated on the basis of the cohort-specific life expectancy and is indexed to income growth in the economy. Moreover, the system includes an adjustment mechanism to the indexation of pension benefits to ensure financial sustainability. Finally, the new PAYG scheme defines an upper limit on pension rights earned for high incomes and provides a minimum pension regardless of contributions paid financed by the central government budget.

As regards the funded defined-contribution pillar, it collects contributions equal to 2.5 % of income. For the funded part of the system, future individual pension benefits are determined on the basis of the stock of contributions accumulated and of the returns on the fund, whose assets are invested in financial markets. Due to the phasing-in of the reform, in the short to medium run, when the scheme has not yet reached the steady state, contributions to the funded scheme will be larger than disbursements, i.e. the scheme will exhibit surpluses.

Against the background of several countries implementing or being in the process of implementing multi-pillar pension reforms, Eurostat set up a task force in 2003 on the classification of pension schemes with a view to interpreting the ESA 95 rules. The decision by Eurostat of 2 March 2004 on the classification of pension schemes implies that funded defined-contribution (DC) pension schemes should be classified outside the government sector ([2]). The rationale underlying the decision is that these schemes, even when run by the government, should be considered as owned by the pension beneficiaries, who are the ultimate economic owners, i.e. those bearing most of the risk (associated mainly with financial market developments). Member States are required to implement the Eurostat decision, by classifying funded, defined-benefit schemes outside the government sector, by March 2007 at the latest ([3]).

In the case of Sweden, the reclassification of the funded DC pension scheme introduced with the reform of 1998 will result in a reduction in the general government budget balance estimated in the order of 1 % of GDP per year. Table III.8 reports national source estimated figures for the balance of the funded DC scheme. Up to 2000, contributions were recorded in the central government. In 2000, all the contributions paid up to 2000 were recorded altogether in the fund, and this explains the large surplus for the fund in that year. In subsequent years, the surplus is estimated to be around 1 % of GDP. At the time of the reclassification of the fund outside the government sector in line with the Eurostat decision, the government budget balance will be reduced accordingly.

([1]) Other elements of the reform concerned the revision of the minimum pension guarantee and the determination of the statutory retirement age. An overview of the Swedish pension system is provided in 'The Swedish national pension system', Ministry of Health and Social Affairs and National Social Insurance Board, September 2003, and can be found at http://regeringen.se/content/1/c4/05/07/aa589a7c.pdf.

([2]) This principle means that the expected present value of pension contributions received by the government equals that of pension benefits paid.

([3]) See Eurostat News Release 30/2004, 2.3.2004, available at http://epp.eurostat.cec.eu.int/cache/ITY_PUBLIC/2-02032004-BP/EN/2-02032004-BP-EN.HTML

(Continued on the next page)

Box III.3 (continued)

Table III.8

General government budget and funded DC pension scheme balance, Sweden

(% of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
General government budget balance	1.9	2.3	5.1	2.9	– 0.3	0.5	0.7	0.6	0.4	0.8
Funded DC pension scheme balance	0.0	0.0	2.6	0.9	0.9	0.9	1.0	1.0	1.0	1.1
General government budget balance excluding the balance of the funded DC pension scheme	1.9	2.3	2.5	2.0	-1.2	– 0.4	– 0.3	– 0.4	– 0.6	– 0.3
Funded DC pension scheme assets, market value	0.0	0.0	2.4	2.9	2.9	3.8	4.6	5.4	6.2	7.1

Sources: Swedish budget bill for 2005 (September 2004), Swedish Ministry of Finance, national accounts and Statistics Sweden.

3.3.3. Do fiscal consolidations hamper the adoption of reforms?

The previous section analysed whether reforms had a negative impact on budgets in the short term. As argued previously, a deterioration in budget balances associated with reforms (either because of direct budgetary costs or because resistance to reforms is contained via tax cuts or increases in particular types of expenditures) is one reason why budgetary discipline in the short term could hamper the adoption of reforms, but is not the only one. Fiscal consolidations could be perceived as politically costly (mainly via their negative impact on economic activity in the short term). If reforms are costly politically too and governments dispose of 'political capital' in limited supply, a trade-off may emerge between adopting reforms and taking the necessary measures for ensuring budgetary discipline. In this section, therefore, the relation between the stance of budgetary policy and the implementation of reforms is directly analysed.

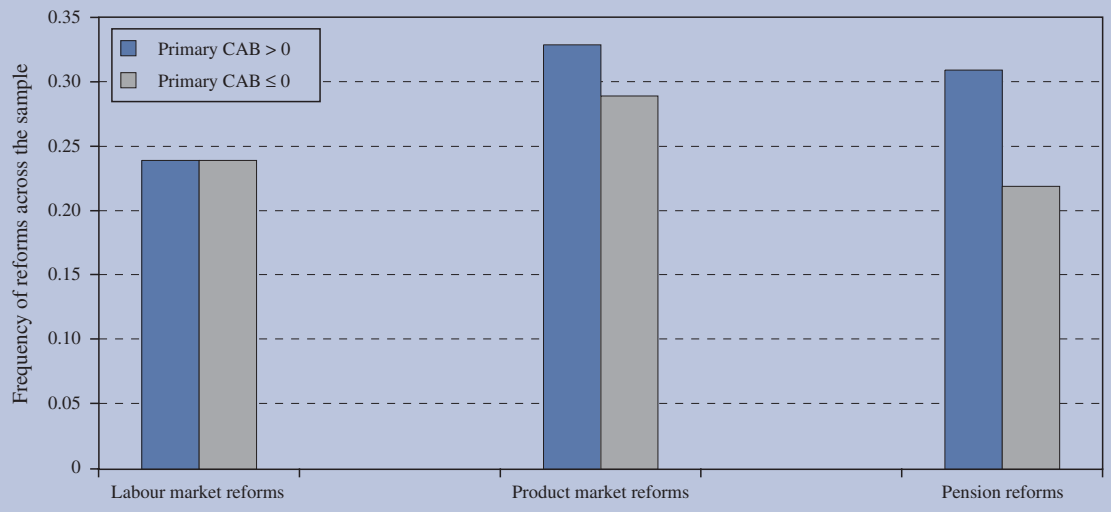
A first approach to analysing whether fiscal consolidations were negatively associated with the adoption of reforms is to compare across the EU countries included in the sample the frequency of reforms in years during which there was an improvement in primary cyclically adjusted budgets (primary CABs) with that in years in which primary CABs deteriorated. Graph III.3 reports such information. The difference is negligible in the case of labour market reforms, it is slightly higher in consolidation years for product market reforms, while in the case of pension reforms there is a quite substantially higher frequency of reforms in years in which primary CABs improved (31 % of the cases as compared with 22 % when a reduction in the primary CAB was recorded).

Additional useful prima facie information on the link between fiscal consolidation and the implementation of reforms is obtained by comparing the frequency of reforms across the sample before and after the introduction of the EU fiscal framework. This permits a first check on the presumption that the EU framework for fiscal discipline acts as a constraint on the implementation of reforms.

Graph III.4 reports data on the frequency of reforms in the 1990s, separately for the period before and after the start of Stage II of EMU (i.e. 1994). The data suggest that while labour market reforms became less frequent in the EU countries covered by the sample, after the introduction of the EU fiscal framework, the opposite holds for product market and pension reforms.

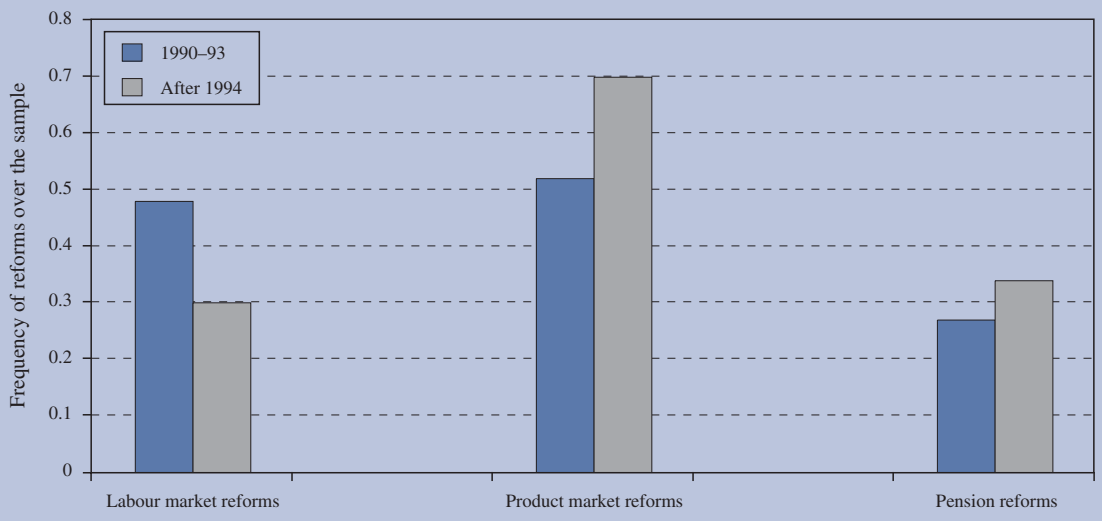
Looking simply at the difference between reform frequencies in years with and without budgetary consolidation does not permit the taking into account of the impact that factors different from budgetary policy had on the timing of the adoption of economic reforms. There are very few attempts to estimate empirically whether fiscal consolidation has a negative impact on the probability of carrying out economic reforms controlling for other factors. In IMF (2004a), regression analysis on a panel of advanced countries is performed to assess the impact of alternative determinants of various reforms, including

Graph III.3: **Frequency of reforms during years of consolidations and years where primary cyclically adjusted budget balances worsened**



Source: Commission services.

Graph III.4: **Frequency of reforms before and after Stage II of EMU**



Source: Commission services.

budget balances ([1]). Results indicate that fiscal consolidation could be negatively associated with tax reforms and labour and product market reforms, while there is no significant relation to financial market reforms and trade reforms. Conversely, the level of the cyclically adjusted budget balance is generally significantly and positively related to structural reform indicators ([2]).

There is very little work which investigates the impact that the introduction of the EU fiscal framework had on the link between public budgets and the probability of carrying out structural reforms in EU countries. Original empirical analysis has therefore been undertaken in this report with the aim of addressing this issue (see Box III.4). The econometric specification adopted permits the analysis of (i) whether the introduction of the EU fiscal framework (identified with the start of Stage II of EMU, i.e. 1994) had any direct impact on the probability of reforms and (ii) whether the effect exercised by fiscal variables (the change in the primary CAB, the level of the CAB, the level of debt) on the probability of reforms changed after EMU. A negative sign for the regression coefficient of the EMU variable would be consistent with the view that there is a trade-off between budgetary discipline and structural reforms in the short term, and that the EU fiscal framework, by introducing ceilings and targets for deficits, has shifted the balance against structural reforms. There is no clear a priori reasoning regarding the impact of the EU fiscal framework on the way structural reforms are affected by fiscal variables. This is because there are no clear *ex ante* expectations on whether the presumed trade-off between budgetary discipline and structural reforms could have become more or less binding after EMU. On the one hand, the need to consolidate public finances in the run-up to EMU and adhere to numerical rules for deficits thereafter may have led to 'consolidation fatigue', so that policy authorities may now attach a bigger weight to the political costs of fiscal consolidation. According to this argument, the trade-off between budgetary discipline and reforms could have become more stringent. On the other hand, after EMU, the policy authorities' commitment to budgetary discipline has become more credible, and this contributes to reducing the political costs associated with fiscal consolidation and to easing the supposed trade-off between budgetary discipline and reforms.

Overall, the results from the analysis point to a negative but non-significant relation between the consolidation variable and labour and product market reforms and to a highly insignificant relation between consolidation and pension reforms. Moreover, the introduction of the EU fiscal framework does not appear to have exercised either a significant direct effect on the probability of reforms or a systematic and significant impact on the relationship between fiscal variables and the probability of reforms.

3.4. Summary of findings

The main messages from the empirical analysis on the short-term budgetary impact of product market and labour market reforms and of pension reforms can be summarised in the following way.

- Looking at average changes in budget balances in years with and without reforms, no significant differences emerge concerning the evolution of the primary CAB in the short term, irrespective of the type of reform considered. Product market reforms are associated with slower growth in government revenues accompanied by correspondingly slower growth in expenditure. In the aftermath of pension reforms, social benefits paid by the government grow at a significantly slower rate, but the overall impact on the budget is compensated by government revenues also growing at a slower rate. The analysis of the evolution of budgetary variables during the implementation of selected structural pension reforms suggests that the impact of reforms can be quite different depending on the characteristics of the reforms, mainly on whether the reforms mainly introduce parametric changes or also allow for systemic changes in the national framework for pensions.

([1]) The analysis concerns several types of reforms: labour product and financial market reforms, tax reforms and trade reforms. The following set of explanatory factors are considered: initial structural conditions, variables relating to international factors and openness, macroeconomic variables, and factors affecting the policy-making process. The initial structural conditions are captured by lagged variables of the structural indicators used as dependent variables and by demographic variables. International factors are captured by the share of trade on GDP (trade openness) and by a dummy variable for EU membership. The macroeconomic variables used include cyclically adjusted primary budget balances, both level and year-to-year changes and dummy variables denoting years with very low growth (bad years) and how many of the previous three years were bad years. Factors affecting the policy-making process were captured by a list of dummies capturing political variables (e.g. whether in the year there were elections, electoral rule followed, etc.).

([2]) Analogous analysis to that contained in IMF (2004a) has been carried out in IMF (2004b) separately on a sample comprising EU countries only. It is shown that when the analysis is restricted to EU countries, the impact of fiscal consolidation on the implementation of reforms becomes significantly weaker.

Box III.4: Estimating the impact of fiscal consolidation on reforms

The approach followed to analyse econometrically the impact of fiscal consolidation on reforms has some distinguishing features. First, discrete variables for labour and product market and pension reforms have been used as dependent variables in regression analysis (see Table III.9). This means that the impact of the alternative explanatory factors of reforms is interpreted as affecting the probability of carrying out reforms (probit analysis). Second, since the aim of the analysis is to highlight a possible trade-off between fiscal consolidation and reforms rather than to provide a whole assessment of the determinants of structural reforms, only explanatory variables relating to cyclical and public finance conditions appear as distinctive explanatory factors, all other factors (e.g. relating to the initial structural conditions, political and institutional factors, etc.) being captured by country-specific trends ([1]). Third, the econometric specification chosen permits the assessment of what impact the introduction of the EU fiscal framework had both on the probability of reforms and on the link between fiscal variables and economic reforms.

Table III.9

Public budgets and the probability of reforms: probit regressions

Dependent variables Explanatory variables	Labour market reforms indicator	Product market reforms indicator	Pension reforms indicator
Output gap	0.006 (0.38)	– 0.0003 (– 0.04)	– 0.01 (– 0.70)
Change in output gap	0.021 (1.05)	– 0.02 (– 1.23)	– 0.001 (– 0.05)
CAB (year<=1993)	0.027 (1.08)	0.03*** (2.76)	– 0.016 (– 1.56)
Change in primary CAB (year<=1993)	– 0.02 (– 1.31)	– 0.015 (– 0.64)	0.008 (0.26)
Debt (year<=1993)	0.009*** (4.22)	0.009 *** (4.14)	0.0003 (0.17)
CAB (Δ after 1993)	– 0.09*** (– 2.76)	– 0.01 (– 0.36)	– 0.003 (– 0.11)
Change in primary CAB (Δ after 1993)	0.087 (1.45)	– 0.012 (– 0.2)	0.004 (0.10)
Debt (Δ after 1993)	– 0.003 (– 0.87)	0.0019 (0.89)	0.001 (0.42)
Dummy year>=1993	– 0.24 (– 1.17)	– 0.16 (– 0.79)	– 0.13 (– 0.46)
N. obs.	309	297	210
Pseudo R sq.	0.21	0.32	0.14
Log likelyhood	– 143	– 124	– 109

NB: Estimation method: probit regressions on panel data, standard errors adjusted for clustering within countries. Coefficients represent the marginal contribution of the explanatory variables (measured at sample mean) to the probability of reforms being carried out. All equations include country-specific trends, whose coefficient, significant in most cases, is not reported.
Z statistics for the significance of probit coefficients are reported in parentheses. *, **, and *** denote, respectively, significance at 90, 95, and 99% confidence.

([1]) It should also be noted that in the case of pension reforms there is no obvious measure of the initial state of structural conditions, being the reform indicator constructed on the basis of policy measures implemented rather than on the basis of a sufficiently large improvement in structural indices as in the case of labour market and product market reforms.

(Continued on the next page)

Box III.4 (continued)

The cycle is captured by the level and the year-to-year change in the output gap. Output gap levels become negative (positive) after consecutive years of growth below (above) trend. The expected sign of the variable is therefore negative, indicating that a protracted disappointing growth performance is likely to trigger reforms. The change in the output gap is negative (positive) if current growth is below (above) trend. There is no clear a priori reasoning for this variable. A positive sign would signal that reforms are more likely to be implemented when growth picks up. The fiscal variables included are the level of the CAB (aimed at capturing whether room in the budget to cater for reform costs facilitates the adoption of reforms), the change in the primary CAB (which measures the stance of fiscal policy) and the debt/GDP ratio (to capture the impact of structural and persistent fiscal imbalances on the probability of carrying out reforms). Both the variables capturing the cycle and the fiscal situation are included with 1 year lag to avoid problems of simultaneity.

A dummy variable taking value 1 after 1993 (i.e. starting from Stage II of EMU) captures the direct impact of the EU fiscal framework on reforms. Fiscal variables are included in the specification which also interacted with the EMU dummy variable. The coefficient of the fiscal variables without interaction is interpreted as applying to the sample years up to 1993, while the coefficient of the variables interacted with the EMU dummy measures the change in these coefficients after 1993.

The results, reported in Table III.9, can be summarised as follows. First, the direct impact of EMU is negative but never significant, irrespective of the type of reform considered. Second, the estimated impact of fiscal consolidation (i.e. the change in the primary CAB) is negative for labour and product market reforms while it is positive in the case of pension reforms. In no case is the coefficient of the fiscal consolidation variable significantly different from zero. Moreover, there is no significant change in the coefficient of the consolidation variable after EMU. Third, there is evidence pointing to a generally positive effect of the level of the CAB in the case of labour and product market reforms, while the coefficient is negative for pension reforms. A statistically significant coefficient is obtained only for the case of product market reforms. There is evidence that EMU changed significantly the impact of the CAB only for labour market reforms: the impact of the CAB on the probability of reforms turned from positive to negative after EMU. Fourth, debt levels are positively related to the probability of reforms, with significant coefficients in the case of labour and product market reforms but not in the case of pension reforms. Finally, the variables capturing the effect of the cycle are never significant.

This analysis, though, suffers from the caveat that the impact of reforms is not isolated from that of other factors which may also have affected budget balances.

- When the short-term budgetary impact of reforms is evaluated after controlling for the response of fiscal authorities to the cycle and debt developments, there is evidence that labour market reforms, product market reforms and pension reforms are associated with a deterioration in budgets (due either to a direct budgetary impact of reforms or to other reasons, such as tax cuts or expenditure increases aimed at easing resistance to reforms). The impact appears rather weak (a primary CAB reduced by a fraction of a GDP point) and statistically significant only in the case of labour market reforms. This evidence, pointing to a possible trade-off between short-term budgetary discipline and structural reforms in the case of labour market reforms, may be explained on the ground of relatively strong resistance to the introduction of this type of reforms.

- Budgetary deteriorations following reforms are not the only reason why a trade-off between budgetary discipline and reforms could emerge. Looking directly at the relation between fiscal consolidation variables and the frequency of reforms, the expectation that reforms are less frequent in years where a budgetary consolidation takes place seems disconfirmed by the data. On the contrary, product market and pension reforms are more frequent in these years. There is also no systematic evidence that after the introduction of the EU fiscal framework (which has corresponded in some Member States to consolidation efforts in the run-up to EMU and with a subsequent prudent budgetary strategy) reforms became less frequent: while this seems true for labour market reforms, the opposite result is obtained for product market and pension reforms.

- There are many factors that account for the adoption of reforms: structural, macroeconomic, institutional. Once an attempt is made to control for these factors in assessing the role of fiscal variables in determin-

ing the probability of reforms, the analysis shows that the impact of the consolidation variable (the change in the primary CAB) is negative, weak and non-significant for labour and product market reforms and positive and highly insignificant for pension reforms. Moreover, the introduction of the EU fiscal framework had a negative but not significant impact on the probability of reforms and did not change significantly the impact of consolidation on the probability of reforms. Conversely, for product market reforms, there is some support in the data for the view that low deficits (more room in budgets to accommodate possible budgetary costs of reforms) contribute to increasing the probability of reforms. Furthermore, for both labour and product market reforms, high debts (stronger need to put an end to unsustainable trends in public finances) increase the probability of reforms.

The results from the empirical analysis suffer from the fact that the data set is of limited size and because any measurement of reforms involves to a certain degree arbitrary choices which may, however, matter for results.

Overall, there is a strong indication that generalisations are not easy to make concerning the link between structural reforms and budgets in the short run. Results differ depending on the specific type of reforms considered. Also, within a given type of reforms (e.g. pension reforms), the fiscal implications are likely to differ considerably depending on the main elements of the reform and on how reforms are designed. Furthermore, the weak statistical significance of results reveals, in general, a high degree of dispersion in results across the sample, i.e. each reform case cannot be easily assimilated to the average ([1]).

These results point to some lessons for policy. In the implementation of the EU fiscal framework, there are reasons for taking better into account the role of economic reforms, especially when there is a strong *ex ante* expectation that reforms may have a positive impact on public finances in the long term coupled with budgetary costs in the short term. However, a mechanistic, one-size-fits-all approach whereby all reforms or all reforms belonging to some broad categories are judged the same way should be avoided. Judgment should also be made on a case-by-case basis, on the ground of information on the relevant specificities of the various reforms at stake.

([1]) The interpretation of results concerning the impact of Stage II of EMU on the probability of reforms should be viewed with caution. In fact, monetary integration in Europe was supplemented by other processes, notably the European employment strategy (introduced in 1997) which presumably had a positive impact on labour market reforms.

Part IV

Fiscal challenges during convergence in the recently acceded Member States

Summary

The Member States that joined the EU in May 2004 are at different stages in the catching-up process towards average EU levels of income and financial development. Fiscal policy can make a key contribution in this process through efficient tax and expenditure policies and also through helping to stabilise the economy. Over the long run, these two roles are complementary. Strong growth enhances the economy's debt-carrying capacity, while stability is crucial for sustainable catching-up. In the short run, though, policy-makers in the recently acceded Member States may face difficult choices. Spending more on infrastructure, training or R & D can make it harder to contain deficits, and tax and pension reforms involve upfront costs. In many cases, such costs can be offset by restructuring existing programmes in ways that benefit growth — reducing subsidies and streamlining administration; and preliminary analysis suggests significant scope for such restructuring in the new Member States that face major deficit challenges. Moreover, the EU makes a significant contribution through the Structural Funds.

Still, there can be tensions between financing priority programmes and safeguarding stability. Policy-makers in the new Member States have to make case-by-case judgments on priorities, taking into account their differing economic and financial circumstances — stages in economic catching-up, the structure of the public finances, and plans for adopting the euro. In terms of such specifics, fiscal challenges in all the recently acceded Member States except Cyprus and Malta have been dominated by the transition from central planning. This left the Baltic States and most central European Member States with far to go in catching-up with EU living standards, and their economies have also been somewhat more volatile as a result. The most sweeping challenges of transition are over, but there are still sources of volatility ahead. It will be important to ensure room to cope with shocks to the economy when setting medium-term fiscal goals.

A relevant feature in most of the new Member States is that the financial sector is now expanding rapidly, following crises and reforms in the 1990s. This deserves special attention in assessing the environment for fiscal policy. Healthy growth in credit is a key support for catching-up, but it will be important to guard against excessively strong cycles in credit, asset prices, the external current account and the real exchange rate, which could misallocate resources and jeopardise stability. Banking supervision can play a valuable role here. Also, monetary policy, where free to address specifically domestic developments, can contribute by moderating inflationary booms and discouraging unhedged borrowing through exchange rate variability.

Fiscal policy can also contribute importantly to safeguarding stability at times when credit booms are under way, and when strong private investment causes the external current account deficit to widen. Here, varying experience in other Member States is informative. In some cases, policy-makers helped keep the economy stable by allowing strong booms to swing the budget towards smaller deficits or a surplus. That required care in not overestimating the sustainable growth trend, and recognising that strong tax gains might in part prove temporary. This helped to moderate booms, and provided a cushion when growth slowed down as a result of external shocks or retrenchment by households and firms. In some cases, periods of strong growth were used to speed up fiscal consolidation. Prudent fiscal policy in such cases helped complement and balance strong private sector expansion.

Should fiscal policy, during an extended boom, go further by temporarily running smaller deficits or larger surpluses than required for debt sustainability or the free play of stabilisers within the limits of the Maastricht Treaty? The case for this is less clear-cut than the need to avoid procyclical easing. Some additional headroom could, however, be prudent if private sector exuberance is setting the stage for a crisis — for example, if the cur-

rent account deficit widens so steeply as to threaten confidence. Should one-off adjustments become necessary, these can be costly if they fall on investment, and policy lags mean that tightening may take effect just as the economy is slowing down.

This highlights the case for fostering stability in complementary ways. Notably, there is scope to foster stable expectations through transparent and credible medium-term frameworks, which are well understood by markets and can help protect strategic tax and spending priorities. This is one way in which strong fiscal institutions can help to improve the prospects for stability. It is also valuable to review microeconomic aspects of policy, such as distortions resulting from subsidies to real estate credit.

All of the new Member States need to take account of a further element in the environment for fiscal policy: actual and planned monetary and exchange regimes. This is evident from recent experience. In the Baltic States hard currency pegs have been underpinned by goals of budget balance and low levels of public debt, while in most central European economies flexible exchange rates are associated with higher deficits and debt. Monetary regimes are now evolving again, as the new Member States approach euro adoption at varying speeds. Where national currencies are retained for some years, it will be particularly important to slow the build-up of euro-denominated borrowing — which, over an extended period, could expose economies to balance-sheet risks in the event of depreciation. Monetary and supervisory policies can contribute to this, as can fiscal policy, by helping to avoid excessively high domestic currency interest rates. On the other hand, where the EU-10 progressively give up the freedom to use interest rates for domestic purposes, there could be greater risks of strong credit cycles — and thus of stresses for fiscal policy during periods when adjustment through relative prices may take place slowly.

An implication of regimes, such as ERM II, that involve exchange rate targeting is that fiscal performance and internal policy coordination are highlighted in terms of market credibility. The possibility of contagion in financial markets means, moreover, that instability affecting one economy could spread to another. The run-up to euro adoption also places special demands on policy-mix — the relative burden borne by fiscal and monetary policy — to ensure that the euro conversion rate and the market approach path correctly reflect fundamentals. For example, a combination of tight money and an easy fiscal stance during the approach to euro adoption could cause both volatility and an overly appreciated entry rate.

In sum, fiscal policy needs to support growth through expenditure and tax reforms, while also containing deficits and debt as an insurance against risks to stability. High potential growth rates and, in some cases, low public debt are elements that suggest some deficit leeway as policy-makers in the recently acceded Member States seek to protect growth-supportive fiscal programmes. But several factors also underscore the need for prudence in formulating fiscal goals: the scope for somewhat greater volatility in the public finances; the risks of overestimating potential growth and revenue buoyancy during credit and asset price booms; and policy-mix and credibility challenges during the run-up to euro adoption. Also, where medium-term goals can be eased, it will be important to avoid a stimulus at times of concern about domestic and external imbalances. As policy-makers take these factors into account, actions to strengthen fiscal institutions provide important scope to improve possible trade-offs, thus helping to ensure that convergence towards higher living standards is both strong and sustainable.

1. Introduction

The Member States that joined the European Union in May 2004 have income levels below the average of the EU-15. A majority of those in the Baltic region and central Europe face a particularly steep convergence path, and they also have financial sectors that are still developing strongly. The challenge they face, from very differing starting positions, is to ensure that macroeconomic and structural policies are well designed and well coordinated, so as to foster strong and sustainable convergence.

Fiscal policy can contribute to this in two ways. First, tax and expenditure policies can help create conditions for strong growth in the private sector — for example, adequate infrastructure and education; a level and structure of taxation that ensure incentives for investment and employment; fiscal support, where required, for economic restructuring; and social safety nets that help cushion distributional hardships caused by economic change and reorient those affected towards new jobs. Second, fiscal policy can help preserve macroeconomic stability — by offsetting fluctuations in private sector activity, achieving a balanced policy-mix, and credibly assuring sustainability of the public debt.

These priorities for fiscal policy are, over the long run, strongly complementary. Sustained expansion in the private sector makes a major contribution to public debt sustainability, and vice versa. Tax and expenditure reforms can both reduce public imbalances and, through a range of channels, improve incentives for the private sector. Nonetheless, tensions can arise in the shorter term between containing deficits and implementing programmes to foster growth. This may be especially so where there is a marked scarcity of public goods, or where restructuring entails sizeable fiscal costs — both of which apply in a majority of the recently acceded Member States.

The possibility of trade-offs between growth and stability in the EU-10 has been discussed in recent academic and policy literature on the design of fiscal policy — with varying conclusions regarding medium-term goals and the pace of consolidation. For example, the Sapir report ([1]) saw potential to support growth by accommodating wider fiscal deficits in the EU-10 (by comparison with SGP norms). On the other hand, an IMF report on the central European new Member States ([2]) cautioned that the potential for rapid domestic credit growth as part of the convergence process, as well as the risk of exchange market turbulence, should prompt a very cautious fiscal stance.

In this context, it is important to recall that the EU-10 present a highly varied group in the profile of their public finances. There are wide differences in taxation and expenditure levels, deficit and debt trajectories, progress with convergence, and the influence of monetary and exchange regimes. Any analysis must take full account of such differences — of course, without losing sight of a common environment that includes the *acquis communautaire*, the priority of sustained convergence priorities and, at some point in the future, the challenge and opportunity of euro adoption.

To shed light on such issues, this chapter provides a brief review of fiscal trends over the past decade, and considers policy complementarities and trade-offs in the period ahead. It focuses, in particular, on the scope to enhance potential growth through tax and expenditure reforms and strengthening fiscal institutions; and the stabilising role of fiscal policy — including the implications of private sector imbalances and of possible volatility in the real and financial economy (which is explored in terms of the components of a debt dynamics equation).

Against this background, it suggests, in conclusion, some possible priorities for medium-term fiscal frameworks and comments on complementarities and trade-offs that deserve further study in light of country-specific circumstances.

([1]) See Sapir et al. (2004).
([2]) See IMF (2004c).

2. Macroeconomic and financial background

2.1. Key macroeconomic developments

The recently acceded Member States have made remarkable progress in aligning their institutional and economic features with those of longer-standing members of the EU. This has been particularly marked in the former centrally planned economies, where great strides have been made in macroeconomic stabilisation and real and nominal convergence since the beginning of transition. Nevertheless, in spite of these advances, these economies still show significant differences from the EU-15, of which low per capita income and a less developed financial sector are of particular relevance ([1]).

Growth performance in the Baltic and central European new Member States (except for the Czech Republic) was consistently better than in the euro area during 1997–2004 (see Table IV.1). The three Baltic countries with lower per capita incomes achieved notably high growth rates. However, GDP per capita levels in the EU-10 are still considerably below the euro-area level — on average, half that level. Apart from the Baltic States, the lowest level occurs in Poland, while the highest levels are in Cyprus, Malta and Slovenia, bringing them close to some euro-area members. The relationship between growth and scope for catch-up is illustrated in Graph IV.1.

Over the last decade, inflation in the EU-10 has fallen substantially — in all cases to single-digit levels (see Table IV.1 and Graph IV.2). This reflected a clear orientation of monetary and exchange rate policies. Recent fluctuations were mostly explained by cyclical and other short-term influences, in particular the exchange rate, food and commodity prices, and tax and administered price adjustments. Although the cross-country dispersion of inflation has also fallen, there are still substantial divergences. In 2004, HICP inflation figures ranged from some 1 % in Lithuania to 7.4 % in Slovakia, with the latter being a prime example of adjustments in administered prices and indirect taxes. The containment of inflationary pressures will remain a challenge as the Balassa–Samuelson effects work their way through the system, wage pressures remain strong, and indirect taxes are further adjusted in line with EU legislation.

Unemployment remains a major policy challenge in many new Member States and, in particular, in Poland and Slovakia (see Graph IV.2), due to, *inter alia*, labour shedding during ongoing restructuring, which often is not matched by absorption capacity and flexibility in the labour market.

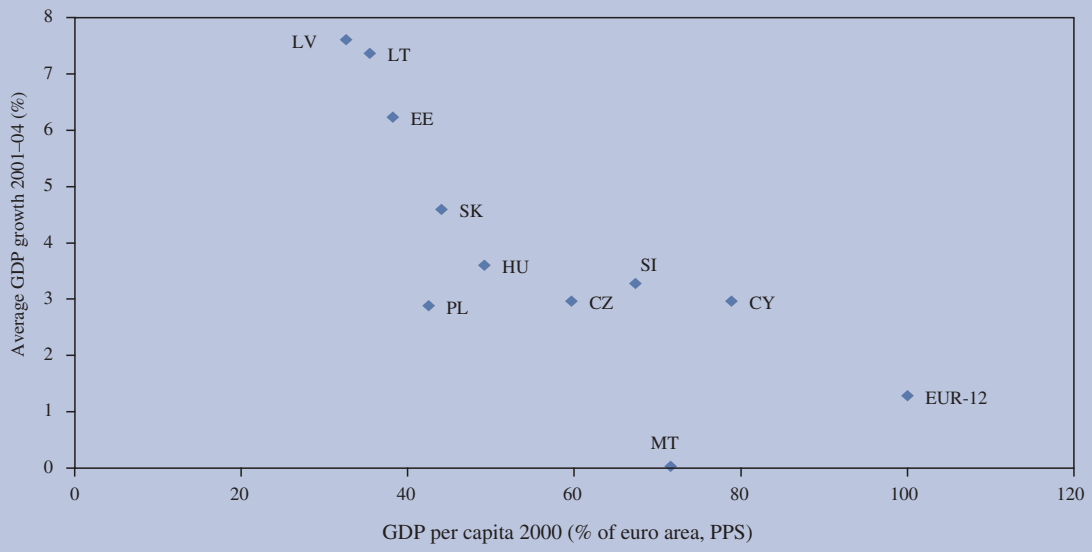
Interest rates have fallen substantially over recent years, and have become less dispersed. This reflects favourable inflation expectations, declining risk premiums, and convergence plays with a view to euro adoption. However, Hungary in particular stands out as a case where this tendency has recently been reversed.

The new Member States are very open economies. The GDP share of exports and imports far exceeds 100 % in most, with the exception of Poland. Their openness has to some extent influenced past and present choices of exchange rate regimes. The current gamut of regimes ranges from a freely floating currency in Poland to currency boards with the euro in Estonia and Lithuania. The Baltic States, Cyprus, Malta and Slovenia have already become members of ERM II.

Current account deficits have, in general, been significant in most countries over recent years, which is typical for converging economies. The Baltic countries, in particular, have experienced large current account deficits. As the latter have also had relatively small general government deficits or, in the case of Estonia, a surplus, private sector net saving has been particularly negative — in the case of Estonia and Latvia notably also in 2004. In contrast, the picture has been rather mixed in the central European new Member States: while the Czech Republic, Hungary and

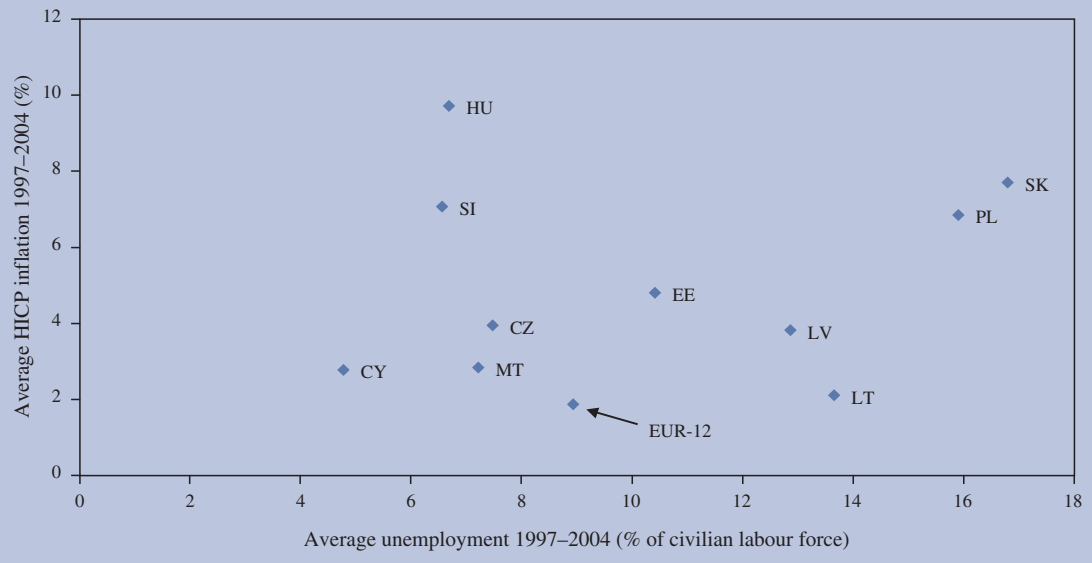
([1]) For a recent review of macroeconomic and structural developments in the EU-10, see European Commission (2004b).

Graph IV.1: **Real convergence**



Source: AMECO database.

Graph IV.2: **Unemployment and inflation**



Source: AMECO database.

Table IV.1

Selected macroeconomic indicators

	GDP per capita	GDP growth		Unemployment		HICP inflation	GDP deflator		Standard deviation of % change	Interest rates	
	(% of euro area, PPS)	% (annual average)	Standard deviation of growth	(% of civilian labour force)		(annual % change)	(% change)			(long-term nominal)	
	2003	1997–2004	1997–2004	1997	2004	2004	1997	2004	1997–2004	2001	2004
CZ	64.3	1.8	2.0	4.7	8.3	2.6	8.3	3.7	3.4	6.3	4.8
EE	45.6	6.1	3.0	9.6	9.2	3.0	10.5	3.3	2.6	10.2	4.4
CY	76.0	3.6	1.3	4.9	5.0	1.9	2.8	2.2	1.0	7.6	5.8
LV	38.3	6.7	1.8	15.2	9.8	6.2	7.0	7.3	1.5	7.6	4.9
LT	42.8	5.7	3.4	12.5	10.8	1.1	14.0	3.3	5.0	8.2	4.5
HU	56.6	4.1	0.7	9.0	5.9	6.8	18.5	4.7	3.8	8.0	8.2
MT	68.3	2.4	2.9	6.3	7.3	2.7	2.3	1.7	1.6	6.2	4.7
PL	43.0	3.9	1.9	10.9	18.8	3.6	13.9	2.9	4.8	10.7	6.9
SI	71.8	3.8	1.0	6.9	6.0	3.6	8.8	3.0	1.9	n.a.	4.7
SK	48.9	3.8	1.3	12.3	18.0	7.4	6.7	4.6	1.5	8.0	5.0
EU-10 (2)	55.6	4.2	1.9	9.2	9.9	3.9	9.3	3.7	2.7	8.1 (1)	5.4
Baltic EU-10 (2)	42.2	6.2	2.7	12.4	9.9	3.5	10.5	4.6	3.0	8.6	4.6
Central European EU-10 (2)	56.9	3.5	1.4	8.8	11.4	4.8	11.2	3.8	3.1	8.2 (1)	5.9
Island EU-10 (2)	72.2	3.0	2.1	5.6	6.2	2.3	2.5	2.0	1.3	6.9	5.2
Euro area (2)	100.0	3.2	1.5	9.1	7.5	2.2	2.5	2.3	0.9	5.0	4.1
Standard deviation across EU-10	13.7	1.6	—	3.5	4.8	2.1	5.1	1.6	—	1.5	1.2

(1) Excluding Slovenia.
(2) Unweighted average.

Sources: AMECO database and ECB annual public finance report 2004 (unpublished).

Slovakia featured negative private net saving in 2004, private sector net saving was positive in Poland and Slovenia. So far, relatively high current account deficits have been financed to a considerable extent by foreign direct investment (FDI). However, as privatisation-related FDI has fallen to a trickle in some countries, and is declining in others, current account financing may now rely more on short-term capital inflows, thus increasing inherent volatility.

2.2. Macroeconomic volatility: recent experience

The EU-10 have, in general, enjoyed considerably stronger growth than the euro area since the mid-1990s, but rapid growth typically went together with greater macroeconomic volatility (see Graphs IV.4 and IV.5). Part of this may be due to the greater degree of openness of the EU-10, but, in addition, they faced significant adjustment costs in their transition from central planning to a market economy. Unproductive industries had to be closed, bad debts had to be assumed by the State, and social support had to be provided for a growing number of unemployed. In the early 1990s, this led to a considerable output loss and pressure on public finances. For example, GDP contracted in 1992 by more than 30 % in Latvia.

With the perspective of EU accession, the economic situation turned for the better. Strong growth rates were realised, but remained vulnerable to shocks: large swings in GDP growth were still observed. Several recently acceded Member States experienced setbacks in the late 1990s due to failed adjustment programmes, while some proved particularly vulnerable to the Russian crisis in 1998.

Table IV.2

Selected external indicators

	Exchange rate (domestic currency per euro, % change)			Exchange rate regime	Openness (2) (exports + imports, % of GDP)	Current account balance (% of GDP)	
	1997–2003	2004	2005 (1)		2004	1997	2004
CZ	– 3.4	– 6.4	– 1.3	Managed float	143.0	– 6.3	– 5.2
EE	0.3	0.0	0.0	ERM II, since 28.6.2004	169.3	– 11.4	– 13.5
CY	– 0.2	– 1.3	0.8	ERM II, since 2.5.2005	97.0	– 4.8	– 5.6
LV	– 3.7	2.9	– 0.1	ERM II, since 2.5.2005	103.7	– 5.6	– 12.7
LT	– 29.0	0.0	0.0	ERM II, since 28.6.2004	112.1	– 10.0	– 8.4
HU	31.1	– 7.0	0.7	Euro peg, 15 % band	133.6	– 4.4	– 9.1
MT	– 3.8	0.6	– 0.9	ERM II, since 2.5.2005	158.1	– 5.9	– 2.7
PL	30.9	– 12.3	0.1	Float	80.0	– 3.5	– 1.9
SI	33.7	1.0	0.0	ERM II, since 28.6.2004	120.4	0.3	– 0.7
SK	4.9	– 4.6	0.0	Managed float	156.3	– 8.7	– 3.5
Euro area (3)	0.0	0.0	0.0	—	71.3	1.6	0.8

(1) January to March 2005.
(2) Goods and services.
(3) Weighted average.

Source: AMECO database.

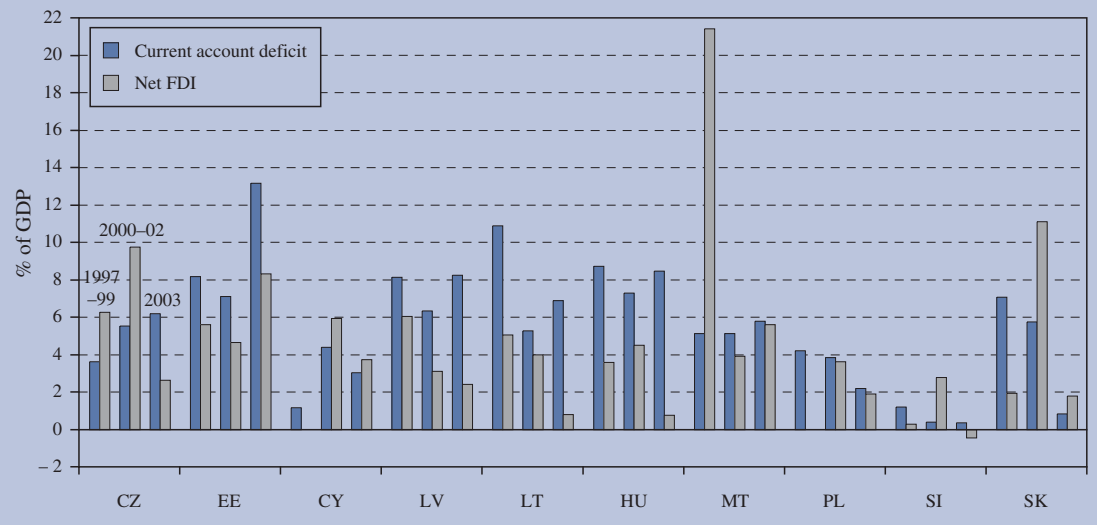
Volatility in the past is not necessarily a good guide for the future, particularly if special events occurred. In the present analysis, when assessing volatility, the early 1990s are excluded from the reference period, since that was the time when transition shocks were largest. The reference period used starts in 1997, when 'Agenda 2000: For a stronger and wider Union' was published (European Commission, 1997), offering a concrete perspective of accession, though without yet specifying a date.

The standard deviation of growth rates in the EU-10 can be compared with that in euro-area countries calculated over the same reference period, 1997–2004, during most of which the euro existed (see Table IV.1). The focus here is on two main macroeconomic drivers of fiscal developments: growth and inflation. Greater volatility is observed in the EU-10, which could weigh on the stability of the public finances. In particular, a high volatility in inflation (as measured by the GDP deflator) is noted.

Of course, the euro may have had a stabilising impact on the area economy, and it could be argued that the EU-10 should be compared with a period prior to the euro. To allow for that, comparison can also be made with volatility in euro-area economies in the period 1994–99, mostly ahead of euro adoption and in that respect more similar to the period that the EU-10 are presently experiencing. This would begin after the exchange rate turmoil of 1992–93 and the associated recession and high fiscal deficits. From 1994, it gradually became clear that the euro would be introduced, a similar situation to that today in most of the EU-10. Using this reference period, the findings above are confirmed. (In the euro-area countries, the unweighted standard deviation of growth was 1.1, and that of the GDP deflator was 1.2.) In general, macroeconomic volatility in the EU-10 emerges as higher, even if one excludes the early 1990s, when transition shocks were strongest.

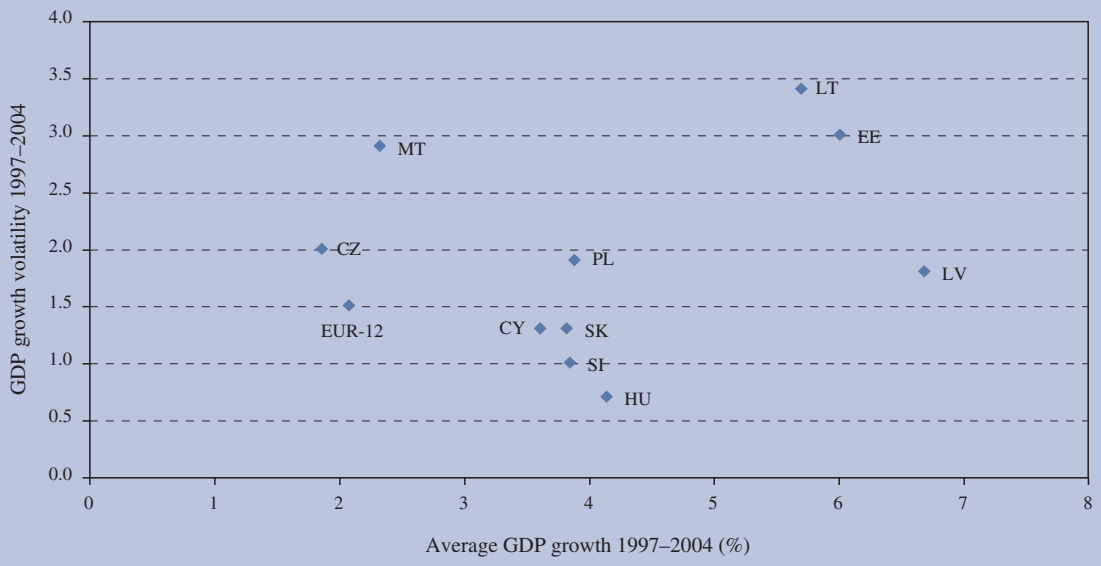
At the country level, there are differences. The Baltic States (Estonia, Latvia and Lithuania) experienced

Graph IV.3: **External current account and FDI**



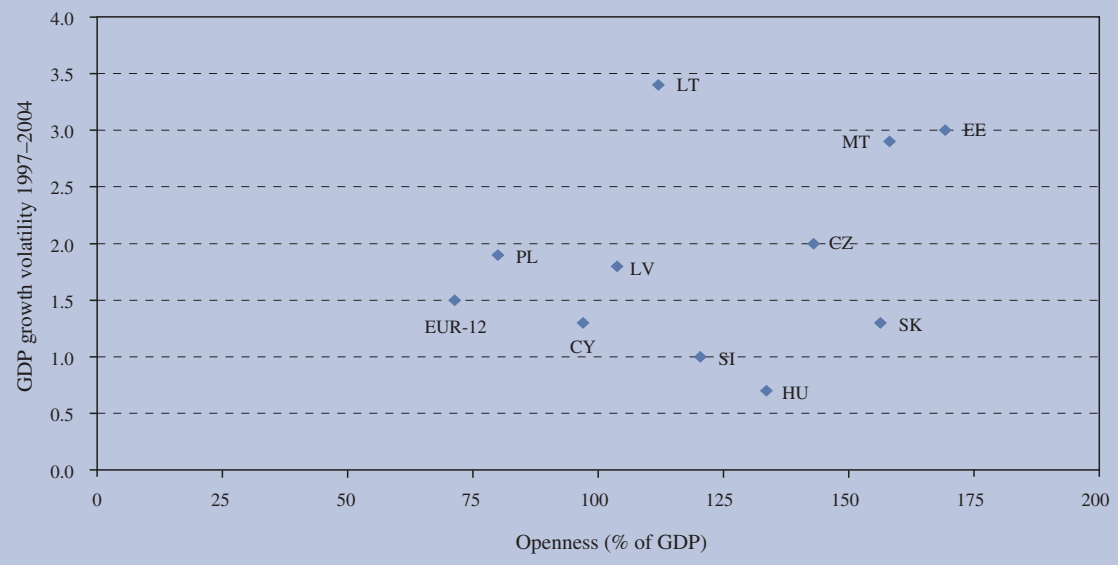
Sources: AMECO and Eurostat databases.

Graph IV.4: **GDP growth and growth volatility**



Source: AMECO database.

Graph IV.5: **Openness and growth volatility**



Source: AMECO database.

particularly large swings in output. All the Baltic and central European new Member States except Slovenia saw marked fluctuations in inflation. Cyprus and Malta were characterised by a high level of nominal stability as illustrated by fairly low volatility in inflation, but output variation was high in Malta.

2.3. Main financial sector characteristics

The level of domestic financial intermediation in the Baltic and central European new Member States is characterised by a still large gap with the euro area. Financial intermediation in these countries occurs mostly through the banking system. However, the size of the banking sectors is small, relative to GDP, compared with the euro area. This is evidenced by the low GDP ratios of broad money and domestic bank claims on the private sector, although the latter are now growing very rapidly in most countries. Cyprus and Malta, by contrast, have a banking sector broadly comparable to the EU-15.

The financial systems of the EU-10 that were formerly centrally planned economies have only been built up over the past 15 years. They have high degrees of interlinkage with the euro area, notably with regard to the

Table IV.3

Financial intermediation

	M2 2004 (% of GDP)	Domestic bank claims to private sector 2003 (% of GDP)	Domestic bank claims to private sector (% change Dec. 2003/Dec. 2002)
CZ	70.0	30.7	8.6
EE	42.2	33.1	32.6
CY	125.3	119.4	5.1
LV	39.8	34.6	45.3
LT	32.8	20.4	58.9
HU	48.1	43.0	33.3
MT	n.a.	114.7	2.3
PL	42.1	29.0	6.7
SI	54.1	41.5	15.4
SK	59.7	31.6	13.9
EU-10 (1)	57.1 (2)	49.8	22.2
Euro area (3)	94.2	112.1	5.5

(1) Unweighted average.
(2) Excluding Malta.
(3) Weighted average.

Sources: IMF, IFS and national sources.

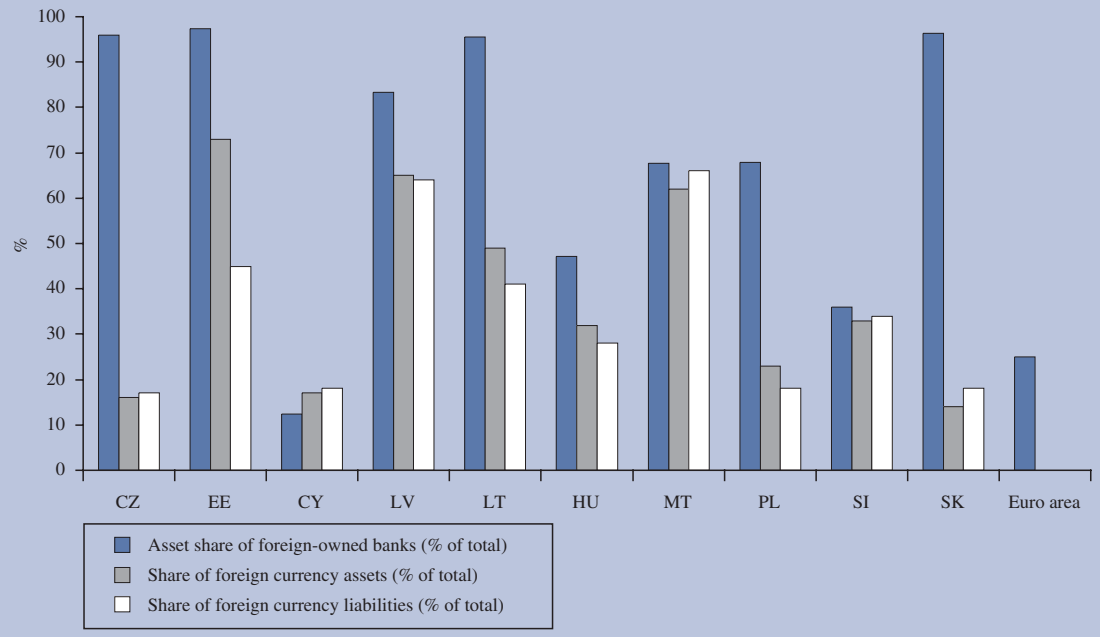
ownership of intermediaries and use of the euro as a loan and deposit currency. Indeed, while strategies have varied, almost all the new Member States have encouraged the involvement of foreign investors in the restructuring of their banking sector ([1]). Attracted by high margins and growth prospects in the EU-10, foreign investment has helped recapitalise banking systems, while transferring important expertise and technology. Banking systems are largely well capitalised and profitable, even if the share of non-performing loans remains higher than in other EU countries. The insurance, pension and mutual fund industries are still very small, but fast growing. Facing constraints from underdeveloped domestic markets, they have invested substantially in foreign assets in several recently acceded Member States.

Although all the EU-10 have established domestic markets for money, bonds and equities, these are small in absolute terms and relative to GDP, with a generally limited number of issuers and secondary market activity. Indeed, both fixed-income and equity markets are still small and illiquid. In terms of securities outstanding, the EU-10 account for 2 % of the EU-25 fixed-income markets, with only the three biggest markets — i.e. Poland, the Czech Republic and Hungary — larger than the Irish market, which is currently the smallest in the euro area. A common feature of fixed-income markets is the dominance of central government issuance, which accounts for between 80 and 100 % in most cases. Issuance by the private sector represents a significant share only in the Czech Republic, Slovenia and Estonia.

Equity markets in the EU-10 are not yet a major source for corporate financing. Market capitalisation in terms of GDP is less than half that in the euro area for most of the EU-10 and turnover is generally less than one sixth. Levels of development vary widely, however, in part reflecting the choice of privatisation method between voucher and other schemes. Poland, the Czech Republic and Hungary have the largest markets in absolute terms, while Estonia has the largest markets in terms of GDP. To acquire access to a wider investor base, and cheaper capital, a significant number of companies in the new Member States have been cross-listing abroad, mostly in New York and London and to a much lesser extent within the euro area. Several exchanges in the EU-10 have entered strategic partnerships with other exchanges.

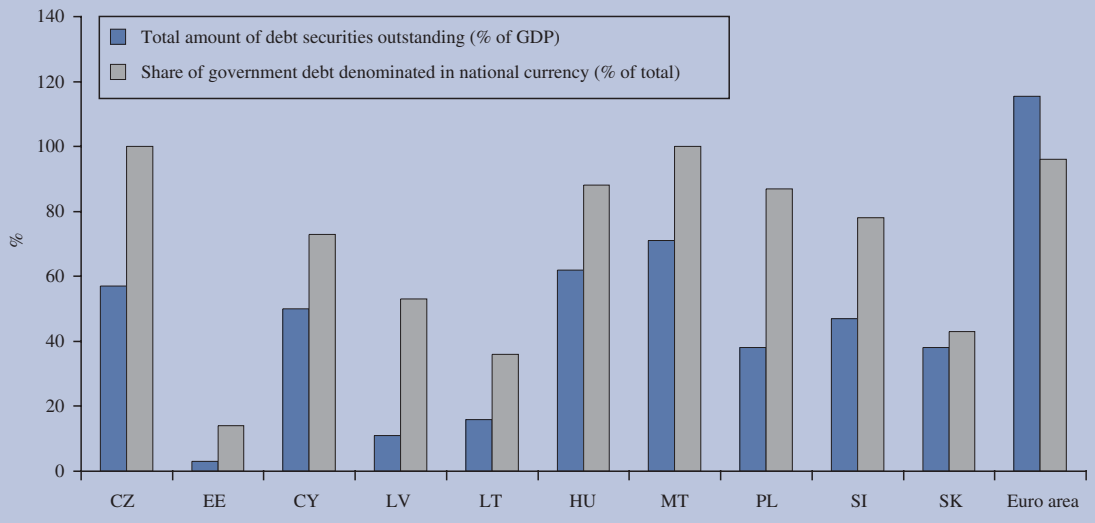
([1]) Public banks have retained a significant share of the market only in Poland and Slovenia.

Graph IV.6: **Basic characteristics of the EU-10 banking sector**



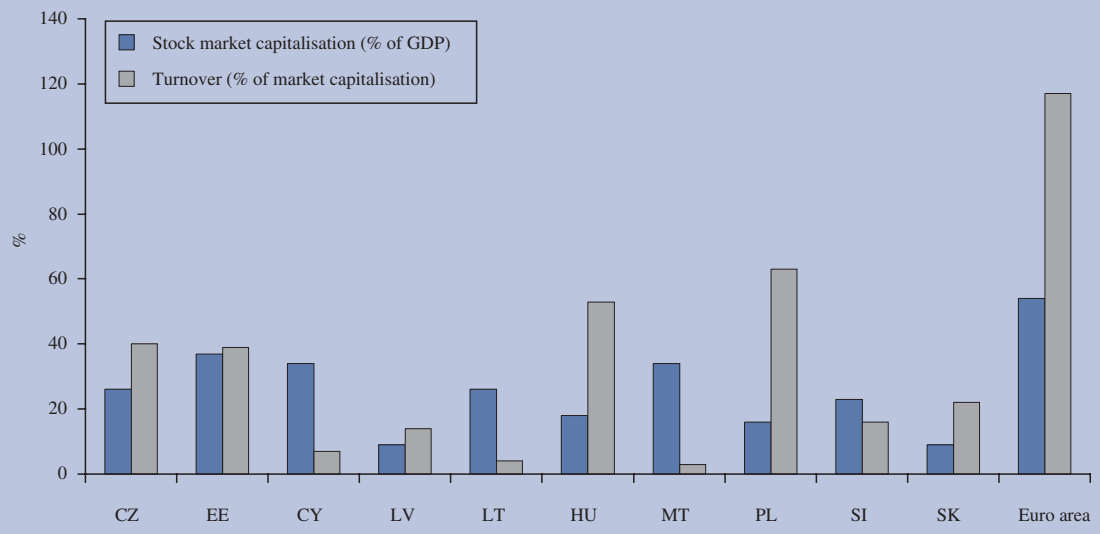
NB: Data for euro-area foreign currency loans and assets are not available. For CY, the figures exclude international banking units.
Sources: ECB and 'Banking structures in the new EU Member States', January 2005.

Graph IV.7: **Basic characteristics of the EU-10 bond markets**



Sources: ECB, Eurostat and own calculations; end-2003 data.

Graph IV.8: **Basic characteristics of the EU-10 stock markets**



Sources: ECB, Eurostat and own calculations; end-2003 data.

3. Recent developments in the public finances

3.1. Fiscal deficits and public debt

Experience in managing the public finances has varied widely across the recently acceded Member States. For the former centrally planned economies, budget balances were strongly affected by transition-related effects, including bank restructuring operations — even to some extent after 1997 ([1]). Apart from a few exceptions, general government deficits have not shown a clear tendency to decline.

In 2004, Estonia was exceptional in registering a budget surplus, while the other Baltic States had deficits well below 3 % of GDP — a performance that in part reflects the context of hard-peg exchange regimes. Apart from Slovenia and the Czech Republic, the deficit of the other countries exceeded 3 % of GDP by varying margins. Slovakia came closest to this level, while Poland had the highest deficit among the central European new Member States. The deficits of Cyprus and Malta were around 4 and 5 % of GDP, respectively. The deficit-to-tax revenue ratio in the central European countries (except Slovenia), in the islands and in Lithuania was significantly higher than in the euro area, suggesting that it would be more difficult to eliminate the deficit or part of it through revenue measures.

Public debt ratios in 2004 were below the 60 % of GDP Treaty reference value in all the new Member States except Cyprus and Malta. Estonia had a very low debt (some 5 %), whereas Hungary was close to 60 %. Taking tax revenues as a reference point, the picture relative to the euro area typically is less favourable. The interest burden as a ratio of tax revenues is also higher than in the euro area in Hungary, Cyprus and Malta, and close to the euro area in Poland and Slovakia. Debt maturities show a fairly high short-term share in the Czech Republic and Hungary. Foreign-currency-denominated debt is particularly high in the Baltic States, reflecting their currency arrangements and advanced progress towards euro adoption, as well as in Slovenia and Hungary.

Experience across the EU-10, finally, illustrates the influence of monetary and exchange rate regimes on deficits and debt levels. In the Baltic States the introduction of hard pegs was underpinned by medium-term goals of budget balance and low levels of public debt. In most central European Member States, by contrast, more flexible exchange arrangements are associated with higher deficits and debt.

3.2. Composition of public revenues and expenditures

About half of the EU-10 have reduced their revenue-to-GDP ratios since 1997 (or the earliest year thereafter for which data are available). A caveat applies here, since data suffer frequently from inadequate consolidation practices, in particular in the earlier years. As regards direct and indirect taxes and social contributions, again about half of the countries have reduced the ratio. In the Baltic and central European countries, the largest combined reductions are observed in Slovakia and Poland, and also reflect an increase in the relative share of indirect taxes. All the Baltic countries have also reduced taxation. No reductions took place in the Czech Republic, Hungary and Slovenia. As for social contributions, any reductions were relatively marginal.

On the expenditure side, apart from the Baltics, only two countries apparently reduced primary expenditure-to-GDP ratios in the period from 1997 (or the earliest year, for which data are available thereafter) to 2004 — with some earlier reductions being reversed in the latter year. Again, however, the caveat of potentially inadequate consolidation applies. Examining individual expenditure components reveals that only four countries managed to reduce general government consumption, most notably Estonia and Lithuania.

([1]) For a discussion of fiscal trends and issues in the late 1990s, see European Commission (2002a).

Table IV.4

Selected fiscal indicators

	General government net borrowing				General government gross debt				General government interest payments			
	% of GDP		% of tax revenues (1)		% of GDP		% of tax revenues (1)		% of GDP		% of tax revenues (1)	
	1997	2004	1997	2004	1997	2004	1997	2004	1997	2004	1997	2004
CZ	2.4	3.0	6.9	8.4	12.7	37.4	35.6	103.6	1.2	1.3	3.4	3.5
EE	– 1.7	– 1.8	– 4.8	– 5.5	6.3	4.9	17.5	15.1	0.4	0.2	1.2	0.7
CY	n.a.	4.2	n.a.	12.6	n.a.	71.9	n.a.	213.8	n.a.	3.4	n.a.	10.0
LV	– 1.5	0.8	– 4.5	2.6	11.1	14.4	33.9	50.7	1.0	0.8	3.1	2.7
LT	1.2	2.5	3.9	9.0	15.8	19.7	53.0	71.8	0.8	1.0	2.8	3.7
HU	n.a.	4.5	n.a.	11.3	63.9	57.6	166.6	145.4	n.a.	4.3	n.a.	10.8
MT	n.a.	5.2	n.a.	14.6	48.1	75.0	n.a.	211.4	n.a.	4.1	n.a.	11.4
PL	4.5	4.9	11.7	14.0	n.a.	43.6	n.a.	123.7	4.4	2.6	11.3	7.8
SI	n.a.	1.9	n.a.	4.7	n.a.	29.4	n.a.	73.8	n.a.	1.9	n.a.	4.7
SK	6.2	3.3	16.2	11.1	33.0	43.6	86.7	145.7	2.2	2.2	5.8	7.4
Euro area (2)	2.7	2.8	6.4	6.7	75.1	71.3	176.6	173.0	5.1	3.3	12.2	8.1

(1) Including social contributions.
(2) Weighted average.

Source: AMECO database.

Table IV.5

Government debt composition, 2003

	Gross consolidated debt (% of GDP)	Of which initial maturity up to one year (% of GDP)	Of which foreign-currency-denominated (% of GDP)
CZ	37.6	10.9 (1)	1.1
EE	5.3	0.3	2.9
CY	72.2	1.9 (2)	13.8 (2)
LV	15.3	0.8 (2)	9.4 (2)
LT	21.5	1.1	13.9
HU	59.0	11.7	14.4
MT	72.0	n.a.	n.a.
PL	45.4	n.a.	n.a.
SI	27.0	2.0	13.5
SK	42.8	5.8	6.7
Euro area (3)	70.6	9.2	1.0

(1) Figure refers to 2001.
(2) Figure refers to 2002.
(3) Weighted average.

Source: Commission services.

Reductions in cash social benefits basically occurred only in Latvia and Slovakia, and subsidies have been cut sizeably only in Poland and Slovakia. Slovakia also reduced considerably gross fixed capital formation (GFCF), though from a very high level in 1997.

Taking 2003 as a reference year, two points are striking as regards the overall expenditure share. First, in spite of significantly lower per capita income, the GDP shares of total and primary expenditure are in many cases in the same range or above the euro-area average. This is out of line with traditional theoretical considerations (e.g. Wagner's law), which imply a positive correlation between income level and government size. Second, the shares of key expenditure components vary considerably among the new Member States, even those with similar per capita income, although the Baltic States are closely clustered. Indeed, the GDP shares of key expenditure components among the EU-10 (even those with similar income levels) vary by factors between roughly 1½ and 6. The highest variation occurs in subsidies (around 3 % of GDP in the Czech Republic and ½ % of GDP in Poland) and in gross fixed capital formation (around 5½ % of GDP in Malta and 1½ % of GDP in Latvia).

More specifically, the GDP shares of total and primary expenditure of the central European new Member States (except Slovakia) and the two islands are in the same range or above the euro-area level. By contrast, the Baltic States and Slovakia cluster around a considerably lower GDP share. Broadly similar results hold for total government consumption, although here Latvia and Slovakia join the group in the range of the euro area level, while Poland (with low social transfers in kind) forms a cluster with Estonia and Lithuania. The GDP share of public employees' compensation is typically high. Subsidies are higher in all central European new Member States except Poland.

The GDP share of gross fixed capital formation is similar to, or exceeds, that in the euro area, except in Latvia. This could indeed be expected in catching-up economies, but across the EU-10 there does not seem to be a close correlation between GDP per capita and the share of capital formation, which varies widely.

3.3. Volatility in the public finances: recent experience

In some respects, the public finance situation in the EU-10 compares favourably with that in the euro area. Public debt ratios are in many cases lower, and strong nominal growth contributes to virtuous debt dynamics. Moreover, fiscal balances may be somewhat less sensitive to the economic cycle. On the other hand, the economies of the new Member States have been subject to somewhat greater macroeconomic and fiscal volatility. Experience in recent years provides a number of indications in these respects, which are a useful context for considering medium-term fiscal goals.

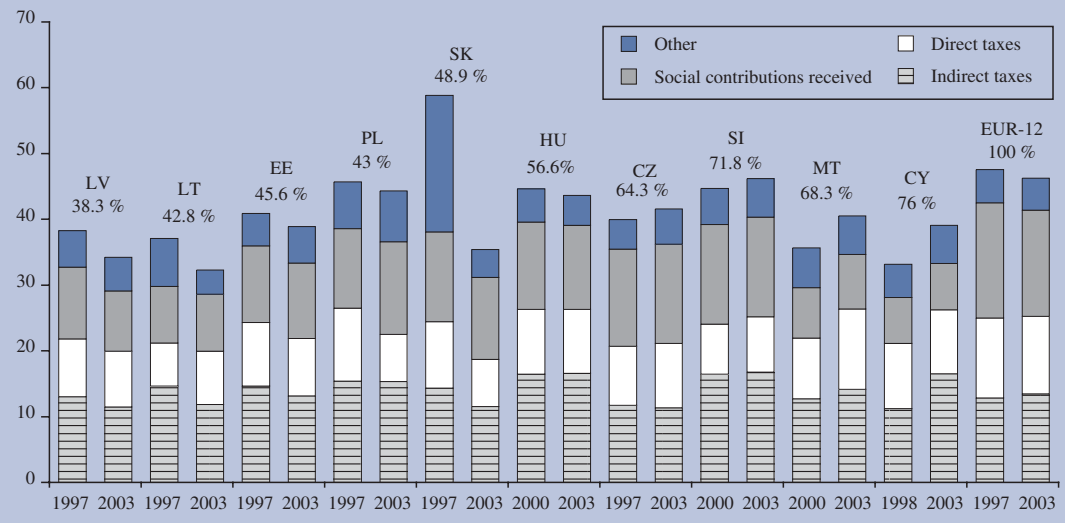
Regarding fiscal performance and nominal growth, there appears to be less of a link between these developments than in euro-area members. This may reflect a lower size of the public sector in the EU-10, the impact of structural reforms, and the broad economic transformation that is still under way in the EU-10.

The importance of nominal growth for revenue and expenditure dynamics in the euro area and the recently acceded Member States is different. The relationship in the euro area is much stronger than in the recently acceded Member States, as reflected in the steeper cross-country regression slope between changes in nominal revenues and nominal GDP (see Graph IV.11, mid-panel and lower panel) ([1]). This is in part explained by the higher weight that the government represents in the euro area compared, on average, with the EU-10. Revenue takes a share of 46 % of GDP (unweighted, 1997–2004) in the euro area compared with 41 % of GDP in the EU-10, while for total expenditures the figures are 47 % of GDP versus 44.5 % of GDP. Furthermore, the transition process in the EU-10 led to structural change in the economy and in public finances weakening the relation between GDP growth and government revenue or expenditure. Statistical revisions of the classification of certain expenditure and revenue categories and the consolidation of the different levels of government may add to the weaker relation between nominal developments and public finances in the new Member States.

As in the euro area, a strong relation between government revenue and expenditure is observable across the EU-10. Both across euro-area countries and new Member States, primary expenditure growth was on average faster than total revenue growth in the period examined (see Graph IV.11, top panel), and contributed to deficits.

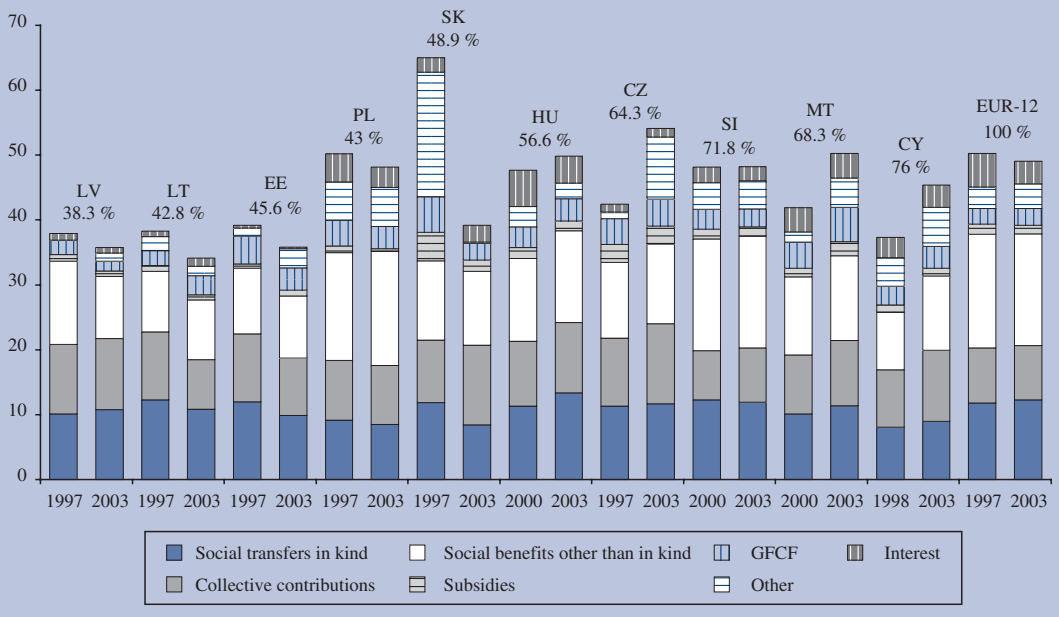
([1]) However, there are important country differences. In Cyprus and Malta expenditure and revenue grew more strongly than GDP, while in Slovakia fiscal consolidation led to a reduction of the weight of the government in the economy (see Graph IV.11, mid-panel and bottom panel).

Graph IV.9: **Composition of general government revenues (% of GDP)**



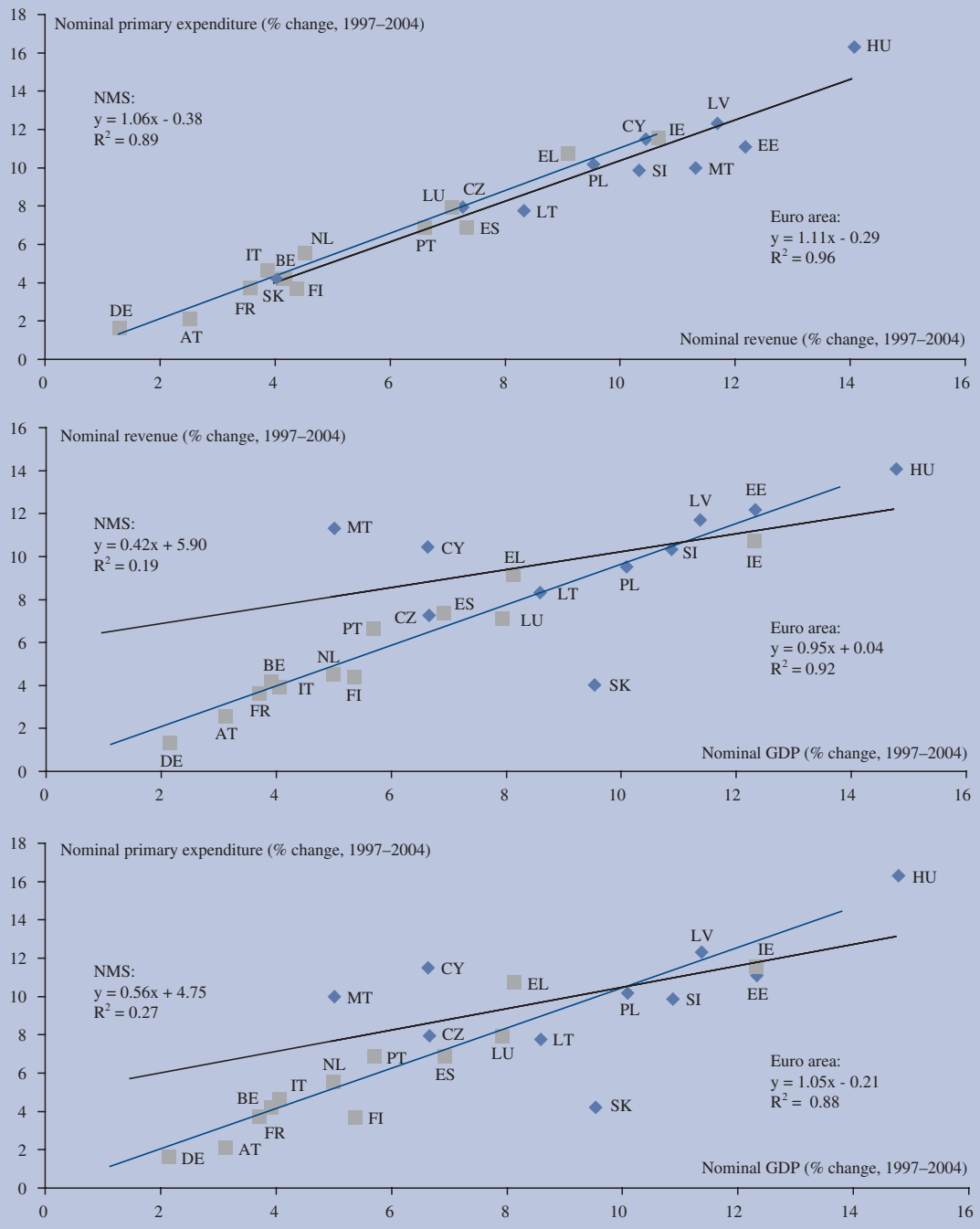
NB: Countries are ordered, within the main geographic regions, by per capita income (PPS) as a percentage of the euro area (EUR-12) in 2003, which is indicated below the country identifier.

Graph IV.10: **Composition of general government expenditure (% of GDP)**



NB: Countries are ordered, within the main geographic regions, by per capita income (PPS) as a percentage of the euro area (EUR-12) in 2003, which is indicated below the country identifier.

Graph IV.11: **Expenditure and revenue dynamics in the new Member States and the euro area**



Source: Commission services.

In the EU-10, Hungary stands out as a country where primary expenditure growth was particularly rapid compared with revenue growth, while in Estonia the opposite is noted.

Although the link between nominal growth and revenues and expenditures appears weaker in the EU-10, there is evidence that the public finances in the EU-10 are less stable than those in the euro area. This can be gauged by directly looking at the standard deviation of fiscal aggregates over past years. The shares of both general government revenues and primary expenditures in GDP were much more volatile over the 1997–2004 period compared with the euro area. The Baltic States, in particular, experienced large swings and variability in government expenditure and revenue, but the impact on volatility of debt and primary deficit appeared to be contained. The four larger new Member States (the Czech Republic, Hungary, Poland and Slovakia) are characterised by relatively large variability in primary expenditure which in some cases fuelled instability in the primary deficit. As regards the two islands (Cyprus and Malta), the public finances appeared subject to shocks to revenues in Malta, and both countries saw some debt volatility.

Interest rates, especially short-term interest rates, have been very volatile in the EU-10. However, this has not led to a large difference with the euro area in volatility as far as the implicit interest rate on government debt is concerned. Volatility in the debt ratio is about the same size, but behind this is a rising trend in the EU-10, while the debt ratio has declined in the euro area.

In general, however, volatility measured by the annual standard deviation is wider in the recently acceded Member States compared with the euro-area countries. The difference is most striking for nominal expenditure and revenue growth, which is partly explained by higher inflation in the EU-10. The primary balance also displays a higher volatility in the new Member States.

Table IV.6

Volatility in fiscal variables, 1997–2004

	General government primary deficit (% of GDP)		General government debt (% of GDP)		General government revenues (% of GDP)		General government primary expenditure (% of GDP)		Implicit interest rate on debt (%)	
	Avg.	Standard deviation	Avg.	Standard deviation	Avg.	Standard deviation	Avg.	Standard deviation	Avg.	Standard deviation
CZ	4.4	3.0	23.9	10.0	39.9	1.3	44.3	3.8	6.7	2.4
EE	– 0.8	2.0	5.3	0.6	38.9	1.3	38.1	2.1	6.5	1.3
CY	0.7	1.5	64.0	5.1	36.2	2.7	36.9	3.3	5.7	0.4
LV	1.0	2.0	13.0	1.8	36.2	2.5	37.2	2.5	7.7	1.2
LT	1.2	1.3	20.7	3.0	34.8	2.3	36.0	3.2	7.2	1.0
HU	1.0	2.9	57.9	3.9	44.9	2.1	45.9	3.0	9.0	1.1
MT	2.9	1.8	60.8	9.1	40.5	5.0	43.4	4.8	6.4	0.7
PL	0.7	0.8	40.6	3.5	44.3	0.9	45.0	1.4	7.4	1.1
SI	0.3	0.4	27.5	2.4	45.4	0.6	45.7	0.2	9.0	1.4
SK	3.2	2.3	42.8	6.3	46.7	8.8	50.0	9.5	8.2	1.5
EU-10 (1)	1.5	1.8	35.7	4.6	40.8	2.8	42.2	3.4	7.4	1.2
Baltic EU-10 (1)	*0.5*	*1.8*	*13.0*	*1.8*	*36.6*	*2.0*	*37.1*	*2.6*	*7.1*	*1.2*
Central European EU-10 (1)	*1.9*	*1.9*	*38.5*	*5.2*	*44.2*	*2.7*	*46.2*	*3.6*	*8.1*	*1.5*
Island EU-10 (1)	*1.8*	*1.7*	*62.4*	*7.1*	*38.4*	*3.9*	*40.2*	*4.1*	*6.1*	*0.6*
Euro area (1)	– 2.9	1.5	66.0	4.7	46.1	1.0	43.1	1.4	5.8	0.9

(1) Unweighted average.

Sources: AMECO database and ECB.

4. Financial challenges during convergence

4.1. Introduction

A key question, particularly in the Baltic region and central Europe, is whether the recent economic and financial environment for fiscal policy is a relevant guide to the future. Many sources of economic volatility now lie in the past, and the structure of economies and the public finances have matured greatly during the course of transition over the past decade and a half. However, significant structural transformations are still under way. In both trade and financial terms, these economies are very open, and those in the Baltic region and central Europe also have fairly small and undiversified financial systems. They are thus particularly dependent on financing from international capital markets, and, as privatisation-related FDI tapers off, the composition of this financing may become more volatile. A number of these economies, moreover, have sizeable public sector borrowing requirements, in addition to the financing needs of the private sector.

As regards the setting for fiscal policy, three elements of financial market dynamics are potentially important in this regard: a further expansion of debt-creating capital inflows; an associated rapid catch-up in levels of domestic credit to the private sector; and, at varying points in the future, the approach to euro adoption.

To shed light on these challenges, this chapter explores aspects of financial convergence and private sector imbalances, and considers the potential fiscal impact of shocks in the real and financial economies. It then brings these elements together in the framework of a standard debt dynamics approach. This places in a single perspective several key elements that will influence public debt developments in the EU-10 over the period ahead — including possible shocks to interest rates and exchange rates, as well as output, emanating from financial markets. Finally, the scope of contingent liabilities is discussed. These elements thus provide an input to the analysis of sustainable medium-term fiscal goals, with an emphasis on potential financial risks.

4.2. Credit booms and private sector imbalances

In the Baltic States and the five central European recently acceded Member States, levels of credit to the private sector are likely to rise sharply over the coming decade from levels that are currently very low, even relative to GDP. This process has the potential to accelerate real sector convergence through investment financing and consumption smoothing. However, experience in other countries illustrates potential hazards in rapid financial sector growth. Capital markets could place economic gains at risk by transmitting external shocks. In addition, financial market imperfections, including swings in risk assessment, could lead to a misallocation of resources or jeopardise the funding of fiscal and external deficits.

Research on credit booms suggests that most systemic stresses result from common exposures across institutions to macroeconomic risk factors, and that this type of financial distress carries the more significant and longer-lasting real costs (Borio, 2003). The trigger for a downturn may be in the financial sphere (e.g. asset price correction) or in the real economy (e.g. unwinding of an investment boom). A key difference in recent models of credit cycles compared with traditional ones is that the boom–bust dynamics are largely endogenous. The boom sows the seeds of the subsequent bust (Borio et al., 2001). In particular, investors' attitude towards risk tends to behave procyclically, supporting the building-up of large financial imbalances and then aggravating the correction. Moreover, economies at an intermediate level of financial development may be more unstable than either very developed or underdeveloped economies in terms of the impact of shocks and of cyclical behaviour (Aghion et al., 2004). Fully open capital accounts, moreover, can complicate the goals of stabili-

sation ([1]). Resilience is likely to increase as the structure of financial systems and the composition of asset portfolios become more diversified.

These considerations underscore the need to evaluate possible risks to financial stability when forming a judgment on the optimal fiscal stance. Two financial scenarios for convergence may help illustrate this. In a benign scenario, favourable rates of return to capital in the EU-10 (due to low capital/labour ratios) lead to high investment. Together with consumption smoothing, this results in external current account deficits that could be sizeable but are financed by stable capital inflows. Including a high share of FDI, this import of savings induces beneficial microeconomic effects through improvements in know-how, technology spillovers, etc. As a setting for this process, the strengthening legal and institutional framework helps create an enabling environment for efficient financial intermediation. Risk premiums act as a balancing influence that helps keep credit growth, capital accumulation and expanding consumption on a sustainable path. This helps ensure sustainable domestic counterparts to the current account deficit and avoid volatility in financial and economic conditions.

There are, however, financial risks to this scenario. A core concern is that market imperfections (asymmetric information, moral hazard, procyclical behaviour of risk premiums) could result in risks to stability. In other words, domestic and foreign creditors' perception of income prospects and economic risks could initially be 'exuberant,' resulting in credit expansion above an equilibrium path, in an environment of strong foreign capital inflows. Procyclical behaviour of risk premiums might lead to a misallocation of credit (e.g. a bias towards property and consumption), asset price bubbles, and exposure of non-financial firms to unhedged foreign currency borrowing. At the macroeconomic level, the counterparts of these distortions would be unproductive investment and unduly strong consumption. These could drive the external current account deficit into unsustainable territory, while market financing could become more short term and volatile. At some point, this cycle could go into reverse in a potentially disruptive fashion. This could result in currency and financial market turbulence, and, depending on rigidities in real sector markets and unhedged financial exposures, it could lead to deep and protracted losses of output. Since the sources of such volatility would lie in risk premium problems in the private sector, they could emerge even if fiscal policy were observing the reference values of the Treaty.

While the risks of increased interest and exchange rate volatility may be especially relevant before euro adoption, credit booms can occur in any economy, including under the euro. Under monetary union, the risk of an exchange market crisis is partially transformed into a risk of unwarranted real appreciation (through relative price movements) that could be hard to reverse, due to the downward stickiness of wages and prices. Damage to growth through this route would also impact on the public finances.

4.3. Potential sources of financial risk

In general, progress in macroeconomic stabilisation and the perspective of EU accession have supported increasingly stable financial market conditions in the EU-10 over recent years. While the financial systems of the EU-10 are at present generally considered to be sound ([2]), there is nevertheless a set of potential vulnerabilities that can be identified for several Member States of the EU-10, such as increased interest rate volatility, foreign currency exposures, high domestic credit growth rates and contagion risks.

Driven by economic convergence, progressive capital account liberalisation and the medium-term perspective of euro adoption, long-term government bond yields in the new Member States have already converged significantly towards euro-area levels. Any emerging stress in the financial system may be reflected first in the development of short-term interbank rates. The evolution of domestic three-month interbank spreads to the euro has varied among the EU-10, with, for example, rather narrow spreads in recent years for Estonia, Lithuania, the Czech Republic and Latvia, and wider spreads in Hungary, Poland and, until very recently, Slovakia.

In practice, a reversal in market sentiment — leading to a reduction in capital inflows or even capital outflows — could be triggered by either a specific event in the country itself, or a sudden or sharper-than-expected rise in

([1]) In this latter context, it is important to keep in mind the broader global context of abundant liquidity and low inflationary pressures: the recent compressed risk premiums in global bond and credit risk markets will typically not be sustained over the economic cycle.

([2]) See IMF FSAP country reports (http://www.imf.org/external/np/fsap/fsap.asp#cp).

global interest rates or credit risk premiums vis-à-vis emerging markets. Efforts to constrain exchange rate movements would then trigger interest rate responses and — if market sentiment failed to recover — a possibly sharp realignment of the exchange rate. As fixed-income markets in the EU-10 are generally small and illiquid, they are potentially vulnerable to reversals in capital flows. Moreover, there is a danger that, in illiquid bond markets, prices signal imperfectly and probably with a lag changes in financial market views.

The impact of interest rate and exchange rate variability on the real economy depends on the extent to which specific sectors are exposed — including through unhedged foreign currency borrowing by corporations and households. The share of net foreign liabilities to GDP is above 60 % in Estonia and Latvia, and relatively high in some others. Facilitated by cross-ownership with euro-area Member States, the share of foreign currency lending — mainly in euro — is notable in Estonia, Lithuania and Hungary, while Latvia has a high dollar exposure. Only in the Czech Republic can the share of foreign currency loans in total be described as low. While foreign currency deposits partly counterbalance exposure in the EU-10, it is probable that foreign currency borrowing by some firms and by households is unhedged, creating an exposure to depreciation.

A further common characteristic of the EU-10 has been a rapid credit expansion over the past few years. Even though this expansion started from very low levels and is an integral part of the progressing economic catching-up process as well as the deepening of financial intermediation, the development of exposures of different sectors and the allocation of capital have to be monitored carefully over the next few years. While the convergence process started off mostly with a strong expansion of FDI and government debt, strong credit growth in the private sector is now fuelled by the decline in domestic interest rates and the compression of credit spreads, as well as the economic recovery and associated shift in expected earnings. In many of the EU-10 countries, the credit expansion is at present mostly dynamic in the household sector, mainly in the form of mortgages, but also in the form of consumer loans and credit cards.

Although risks are mitigated by the low starting levels and the expectations of rising income levels, sustained dynamic credit growth might, over time, raise questions about the quality of credit allocation, the indirect vulnerability of the financial system via exposures of borrowers vis-à-vis exchange rate movements as part of the borrowing is foreign currency based and — ultimately — the sustainability of the level of indebtedness in case of an economic downturn. Moreover, there are risks of fuelling asset price bubbles, notably in the housing sector. If credit booms suddenly end, for example related to banks abruptly tightening credit conditions or in the event of a sharp and unexpected rise in interest rates, the ensuing potentially significant deterioration in banks' loan portfolio could weaken the financial system and dent real convergence and economic growth.

A final common risk in the EU-10 is the transmission of financial instability via contagion in capital markets — a phenomenon that is not unusual across countries which share similar characteristics. This could be particularly damaging during ERM II participation, as this is a critical phase of economic and financial convergence in view of fulfilling the Maastricht criteria. Moreover, even though the foreign ownership of the EU-10 banking system is, in principle, a main asset for a sustained convergence process, special attention has been drawn to circumstances where the concentration of foreign ownership could become a liability to new Member States with a specifically high exposure. Even though currently this risk seems of theoretical rather than practical relevance, it nevertheless highlights the more general need to improve cross-border and cross-sector supervision in an increasingly integrated EU financial system.

To put these issues in perspective, it is important to weigh a number of core financial strengths in the EU-10, which differentiate them from the experience of many other economies at this stage of financial development. First, financial supervision has been developing strongly as a result of the observance of international standards and codes and the alignment of domestic frameworks with the *acquis communautaire.* Second, banks are on average well capitalised, leverage in the household and corporate sectors is typically low, and foreign currency borrowing is at this point still modest relative to GDP — implying that unhedged exposure is smaller still. Third, comprehensive assessments under the IMF–World Bank financial stability assessment programme in the early years of this decade indicated that systems were typically resilient to shocks. Therefore, since the issues discussed in this section raise potential concerns, these relate mainly to the scope for dynamic trends to emerge over time, posing challenges for policy-makers during the course of the convergence process.

In assessing how strong credit growth and wide private sector imbalances may shape the setting for fiscal policy, past experience of converging economies within the EU is a valuable reference point. In some cases, the public sector balance played an important compensating role during phases of strong expansion, but there was also experience of an easy fiscal stance during booms resulting in a need for restraint at a later stage, thus precluding flexibility when there was a sharp slowdown in activity.

Experience with private sector dynamics during convergence in Portugal and Spain sheds interesting light on this topic (see Box IV.1). In terms of the financial market setting, it underscores the importance of policy-mix issues as these affect the exchange rate in the run-up to euro adoption, and also the concern that potential growth and revenue buoyancy may be overestimated in the late stages of a credit and asset price boom.

As regards the contribution of fiscal policy specifically, the experience in Portugal and Spain also highlights important opportunities, risks and limitations. There is the scope — in a context of falling interest rates and the elimination of liquidity constraints under monetary union — to advance with needed budgetary consolidation. There is the risk of an 'exit problem' from a boom in the form of simultaneous retrenchment in both the private and the public sectors. Finally, as this experience underscores, there are also limits to what fiscal policy can deliver in any given monetary and real sector setting. Sound fiscal policy, by itself, can only go so far in containing economic imbalances and cushioning shocks to growth or problems with competitiveness over the medium or long term.

Box IV.1: Financial imbalances on the road to EMU: lessons from Portugal and Spain

Since the late 1990s, Portugal and Spain have shared a number of economic features associated with accession to EMU and the related convergence process ([1]). Strong anti-inflationary commitment, coupled with structural reforms, underpinned the credibility of policies in a setting of economic expansion. GDP grew in both countries by more than 3.5 % annually. Rising income expectations linked to the run-up to the euro, together with supply-side developments in financial markets (including factors such as tax incentives for house purchase), supported a very strong momentum in private consumption and investment, and, in particular, construction. Although real estate was the main target of the credit boom, consumer credit also grew rapidly, from a low base. A decline in saving and rising private indebtedness were evident. In Spain, real estate appreciation was a factor ([2]).

Both economies experienced adverse cost developments in this phase. In Spain, there was a positive inflation differential relative to the euro area, apparently due to higher markups in sheltered sectors, in a context of wage moderation. In Portugal, wage increases in excess of productivity gains occurred in a tight labour market. Unit labour costs, which rose at 1 % annually in the euro area, rose by close to 4 % annually in Portugal and nearly 2.5 % in Spain.

One differentiating aspect lay in exchange rate policies during the run-up to the euro. While Spain experienced depreciation until 1995, Portugal supported an appreciated currency. In fact, Portugal was almost the only country in the current euro area whose real effective exchange rate did not depreciate in the second half of the 1990s. The result was a worse external competitiveness position in Portugal than in Spain. Consequently, the external balances performed differently in the two countries. In 2000, Portugal registered a peak current account deficit of above 10 % of GDP, the highest in the euro area, and the State's net lending worsened to some 9 % of GDP from a situation of close to balance in 1995. In Spain, during the 1995–98 high-growth period, a balanced position on the current account was registered, coupled with a net lending position of the nation of 1 % of GDP (see Graph IV.12).

([1]) See Banco de España (2003) and European Commission (2004d).
([2]) See Malo de Molina (2003).

(Continued on the next page)

Box IV.1 (continued)

Against a similar backdrop of strong internal demand, the stance of fiscal policy differed markedly (see Graph IV.13). In Spain, balancing the public finances was a key tenet of policy. Adjustment was based on a reduction in the current expenditure (e.g. civil servants' salaries were frozen in 1994 and 1997) and a restructuring of revenues, including a full reform of personal income taxation. Moreover, the government promoted an important privatisation policy. Gross debt, and the debt service burden, continued to fall. Spain reached a position of budgetary balance in 2001, which was maintained during the following years. This consolidation effort allowed policy to work as a stabilisation instrument. Despite a fall in private saving, national saving was maintained. Fiscal policy in Portugal, by contrast, amplified the effects of easy monetary and financial conditions over the second half of the 1990s. Current primary expenditure was kept on a clearly expansive path until 2001, mainly reflecting higher pay and numbers in the public service, and also non-cash social transfers. Strong revenue growth resulting from lively domestic demand, together with falling interest expenditure, provided sufficient margin to meet the Maastricht requirements. With no fiscal offset to private sector developments, the national savings rate gradually declined.

In Portugal, after a period of strong credit growth, high indebtedness and rising interest rates triggered a sharp reassessment by private sector agents amid a more gloomy growth outlook. Household consumption decelerated and the savings rate started to increase. Almost simultaneously, corporations also started boosting their savings rates. The strongest effects were felt in 2003, the year in which Portugal went into a recession, as real GDP fell by 1.1 % on account of a shrinking domestic demand. After 2001, Portugal registered improvement in its external imbalance. But the loose fiscal stance pushed Portugal into a situation of excessive deficit in 2001, and in mid-2002 policy was shifted — with a sharp slowdown in current expenditure, mainly reflecting near-freezes of public wages and employment, coupled with one-off revenue measures. Against the background of weak domestic demand and an adverse external outlook, fiscal policy continued to amplify the business cycle, but now in its downturn.

In Spain, since budgetary adjustment had been relatively intense since 1995, there was no need to tighten policy at a time of sluggish growth. Still, private sector imbalances have left a legacy in terms of economic vulnerability. Easy monetary and financial conditions have continued to stimulate household spending. In this sense, the ratio of household debt to disposable income has risen more rapidly throughout the cycle — reflecting the major importance of housing finance, mainly at short-term variable interest rates. The demand for credit has shown strong inertia, with growth rates persistently higher than 15 % throughout 2004, for instance. These factors confer certain elements of risk to the sustainability of financial balances in the household sector. In fact, financial wealth has been shrinking progressively as a result of increasing indebtedness (currently above 100 %). As a consequence, the saving capacity of households has been neutralised, showing a net borrowing capacity since 2004 (see Graph IV.14). Consequently, in Spain, no adjustment in domestic demand has so far been observed. Savings rates of both households and enterprises have continued to decrease throughout the period and until the present. Other signs of risk in Spain relate to an intensification of the unbalanced growth pattern noted above. Exports and investment in equipment have been losing dynamism. A gradual deterioration of competitiveness is driven by persistent differentials in unit labour costs. Low relative productivity of market goods has persisted. Since 2000, a weakening of the balance of payments has emerged (see Graph IV.12). This has led to measures to increase productivity in sectors such as energy, transport, and telecommunications.

From this comparative overview, several elements emerge. Firstly, strong domestic demand — in a context of falling interest rates and the elimination of liquidity constraints under monetary union — presents a favourable scenario to advance budgetary consolidation. Secondly, there are risks of facing multiple imbalances, the simultaneous correction of which may trigger a slump in output as the economy shifts abruptly from overheating to subdued growth. Thirdly, it is important to enhance competitiveness and productivity as lasting routes to growth.

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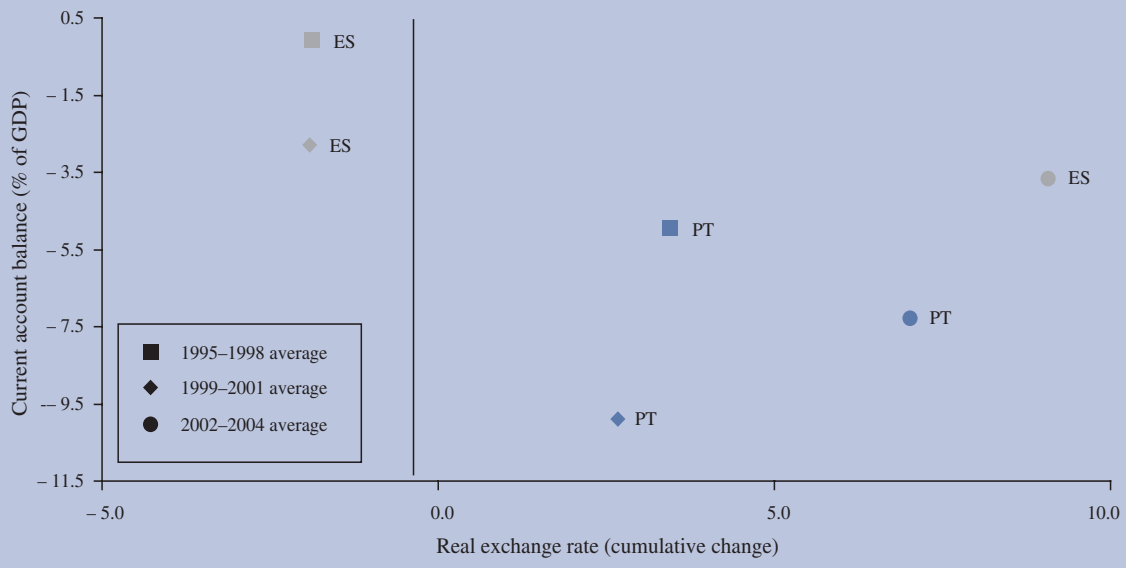
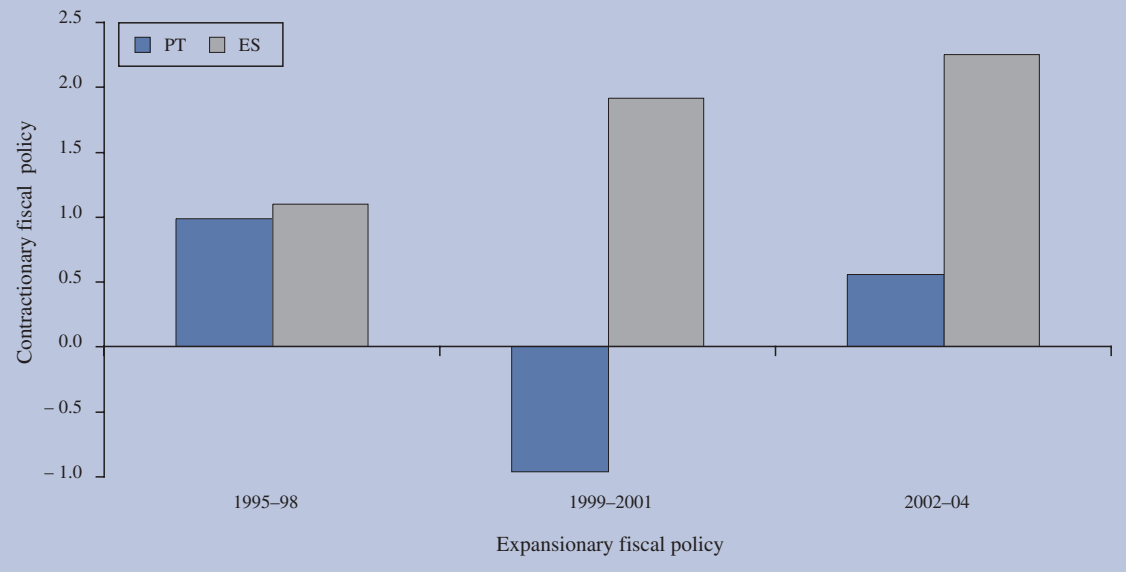
Box IV.1 (continued)

Graph IV.12: **Competitiveness and external balance**



Source: Commission services.

Graph IV.13: **Cyclically adjusted primary balance (% of GDP)**



Source: Commission services.

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Box IV.1 (continued)

Graph IV.14: **Private saving and net lending/borrowing (% of GDP)**

Source: Commission services.

4.4. Quantifying risks to public debt sustainability

4.4.1. Volatility and public finances

The preceding discussion explored past economic and financial volatility, and went on to consider possible sources of future volatility — including in the course of financial sector convergence. A key aspect of the setting for fiscal policy lies in the potential impact on the public debt of volatility in key variables such as interest rates, exchange rates and output as well as contingent liabilities.

The impact of such developments on the recently acceded Member States is strikingly diverse. Starting levels of debt are very low in some cases — but in others shocks to the public debt could result in serious risks to private confidence and thus to strong and sustained growth. This sheds light on the complementarities and trade-offs facing fiscal policy. This section considers these issues in the framework of a standard debt dynamics equation, and presents an overview of contingent liabilities. It thus pulls together a number of strands in the discussion so far, and sets the stage to consider policy priorities.

A country's public finances are sustainable ([1]) if it is able to continue servicing debt without unrealistically large adjustment efforts. Thus, sustainability is not associated with a particular debt ratio, but is conditional on a number of factors, some of which are not under the full control of the authorities. Key factors include the cost of market financing, policy with respect to income and expenditure, and variables such as growth, inflation and the exchange rate. Vulnerability is the risk that debt sustainability can only be maintained with large corrections to the balance of income and expenditure which are socially or politically difficult to bear.

Stress tests are valuable in assessing the vulnerability of the debt position to potential shocks. With a standard debt

([1]) For a full analysis, see IMF (2002). Assessing debt sustainability is a standard section in the IMF's Article IV evaluations.

dynamics equation (see Box IV.2), one can examine the relative importance of the main driving forces of public finances under conditions of uncertainty. The sensitivity of the debt position is analysed by applying a series of shocks to the baseline. The shocks are assumed to be temporary, so that the relevant time horizon is the medium term (2005–10).

Before turning to the nature of the shocks, the baseline has to be explained. It is assumed in the baseline that the debt/GDP ratio does not change with respect to the year 2004. In other words, the baseline represents a constellation of macroeconomic variables which keeps the debt/GDP ratio constant. This may not in certain countries be the most plausible scenario (see Commission's spring 2005 forecasts), but it facilitates the analysis of the shocks. Where continuing fiscal deficits are projected, for example, baseline projections of the public debt would need to incorporate these.

Constructing the most useful type and size of shock poses difficult issues. Shocks should be sufficiently large to capture most of the risk. On the other hand, if the shock is too extreme, the likelihood of its occurrence is very small and not of great practical significance. The probability of a shock larger than two standard deviations from the mean is rather small (assuming a normal distribution, the probability is about 2 %). This suggests that two-standard-deviation shocks encompass most of the risks. A low sensitivity to such a shock is an indication of a certain degree of robustness of public finances.

The sensitivity of the debt/GDP ratio is examined here with respect to six shocks: (i) the historical averages for the key variables observed are substituted in the period 2005–10 to check the realism of the baseline scenario of an unchanged debt ratio; (ii) a negative shock to GDP growth; (iii) a rise in the interest rate; (iv) a negative shock to the primary balance; (v) a depreciation of the domestic currency by 25 % against all the other currencies; (vi) a combination of shocks (ii), (iii) and (iv) to which is added shock (v) in the case of floating currencies (the Czech Republic, Poland and Slovakia). The historical averages are calculated on the available data for the period 1997–2004 and the standard deviations as well (see Table IV.7).

For shocks (ii) to (iv), the simulations concern two standard deviations from the historical mean, applied to two consecutive years (2005–06), followed by a return to the baseline constellation. The justification for a fixed depreciation (shock (v) in a particular year (2005) is that in fixed-rate regimes the volatility of the exchange rate may be rather low (resulting in a small standard deviation). The motivation for shock (vi) is that usually shocks do not occur in isolation; this combined shock can be considered a worst-case scenario.

Table IV.7

Macroeconomic and public finance performance and volatility in the recently acceded Member States

	CZ	EE	CY	LV	LT	HU	MT	PL	SI	SK
					Annual average 1997–2004					
Real GDP (% change)	1.8	6.1	3.6	6.7	5.7	4.1	2.4	3.9	3.8	3.8
GDP deflator (% change)	4.8	5.9	2.9	4.4	2.7	10.2	2.5	5.9	6.8	5.5
Primary deficit (% of GDP)	4.4	– 0.8	0.7	1.0	1.2	1.0	2.9	0.7	0.3	3.2
Implicit interest rate on debt (%)	6.7	6.5	5.7	7.7	7.2	9.0	6.4	7.4	9.0	8.2
Exchange rate (USD/domestic currency, % change)	1.3	0.0	0.4	0.5	4.9	– 2.7	0.8	– 3.3	– 3.7	0.1
					Annual standard deviation 1997–2004					
Real GDP (% change)	2.0	3.0	1.3	1.8	3.4	0.7	2.9	1.9	1.0	1.3
GDP deflator (% change)	3.4	2.6	1.0	1.5	5.0	3.8	1.6	4.8	1.9	1.5
Primary deficit (% of GDP)	3.0	2.0	1.5	2.0	1.3	2.9	1.8	0.8	0.4	2.3
Implicit interest rate on debt (%)	2.4	1.3	0.4	1.2	1.0	1.1	0.7	1.1	1.4	1.5
Exchange rate (USD/domestic currency, % change)	11.8	11.4	10.3	4.8	7.5	13.4	8.1	9.2	11.5	13.2

Source: Commission services.

As regards the vulnerability of budgetary developments, there are marked country differences. The Baltic States (see Graph IV.15) are characterised by low debt levels which make public finances in general less sensitive. Vulnerability to growth variations as well as interest rate volatility is low. If the recent past were to recur, debt developments would remain benign on the whole; only in Latvia would the debt/GDP ratio increase to a certain extent on account of lower growth, a higher primary deficit, but also lower inflation, which have been observed in the reference period compared with 2004.

In the Baltic States, sudden shocks to the primary balance represent the largest risk. Compared with the other EU-10 countries, the impact is not negligible. Given high shares of foreign currency debt in total debt (more than 90 % in Estonia, about 75 % in Latvia and 60 % in Lithuania), the public finances would be vulnerable to a depreciation. However, the solid track record of these countries, which have now all joined ERM II, makes such an event rather implausible. In a 'realistic' worst-case scenario where growth would be significantly lower, the primary balance wider, the interest rate higher, but the exchange rate peg would be maintained, the debt ratio would nonetheless increase considerably.

Higher debt/GDP ratios make the public finances in the four large new Member States (see Graph IV.15) more vulnerable than in the Baltic States. The proximity of the 60 % reference value (particularly in Hungary) adds to the concerns. Based on experience in 1997–2004, notably a small and stable primary deficit (see Table IV.7), the Polish public finances appear more shock resistant than those of the Czech Republic, Hungary and Slovakia, but remain more sensitive to variations in output and interest rates than the Baltic States. However, recent difficulties with consolidation in Poland, and notably with the implementation of the Hausner plan, require some caution.

Debt developments in Hungary would in theory be favourable in the medium term if historical macroeconomic conditions occurred again. But it is unlikely and undesirable that the high inflation rate (the average GDP deflator was 10.2 % in 1997–2004 — see Table IV.7), which was one of the drivers of the favourable debt dynamics in Hungary, would recur.

In the Czech Republic, Poland and Slovakia, a recurrence of past conditions would lead to a sharp increase in the debt ratio — in the Czech Republic and Slovakia, even beyond the 60 % reference value (see Table IV.8).

High interest rates are a source of vulnerability in Hungary, as well as volatility of the exchange rate, because of the large share of foreign currency (about 33 % of total debt). In Poland, also, a depreciation would weigh on public finances despite the considerable reduction of the foreign currency share in total debt from about 55 % in 1997 to 30 % in 2004. Exchange rate volatility is less of an issue in the Czech Republic, where foreign currency debt represents only 5 % of total debt, and in Slovakia where the foreign currency share is limited to about 20 %. Output swings could be a concern in the Czech Republic and Poland. Difficulties in containing primary expenditure, and hence the primary balance, appear for all four countries (including Poland based on recent developments) the largest source of vulnerability. The sensitivity of the public finances is further highlighted if several shocks would occur at the same time, including a depreciation of the currency in the case of the Czech Republic, Poland and Slovakia.

Among the EU-10, the two islands have the highest debt ratios. The Maltese public finances, in particular, appear vulnerable if the output volatility and relatively high primary deficit observed in the past were to occur again. The outlook would remain benign in Cyprus if recent developments in the economy and in the primary balance were to continue. Nevertheless, if the past debt-increasing stock-flow adjustments would become a feature of the future, the benign outlook may have to be qualified. Due to the high foreign currency share in total debt (about 55 %), Cyprus is sensitive to a depreciation of the currency, while this is not an issue in Malta (foreign currency debt is about 7 % of total debt). However, exchange rate vulnerability has to be assessed in light of the good track record of currency stability in the two countries.

Slovenia has a low debt and is the most stable economy among the new Member States — with only a small primary deficit in the period considered here, and relatively stable government expenditure and revenue flows. It had, however, an inflationary past leading to high interest rates and a continuous depreciation of the currency. With the successful ERM II entry in June 2004, there came an end to this type of uncertainty. In consequence, the vulnerability to exchange rate volatility stemming from the relatively high share of about 55 % of foreign currency debt in total debt is mitigated. Even in a worst-case scenario, vulnerability of public finances appears contained.

Box IV.2: **Determinants of the debt/GDP ratio**

The standard debt equation reads as follows:

$$D_{t+1} = (1+i)D_t + \varepsilon\ \alpha(1+i)D_t - PB_{t+1} + OD_{t+1}$$

Where

D: total general government debt;

i: nominal interest rate on debt (total interest divided by outstanding debt in previous year);

ε: depreciation of the domestic currency (indicated by an increase in the exchange rate expressed as units of domestic currency for one unit of foreign currency);

α: share of foreign currency debt in total debt;

PB: primary balance, equal to primary expenditure (PE) minus total receipts (TR);

OD: other debt, including privatisation (reduces debt), debt assumption by the State;

$_t$: (subscript) time dimension of the variables without time dimension are in t+1.

Dividing the debt equation by GDP_{t+1} and some rearranging in order to obtain the determinants of the change in the debt/GDP ratio results in:

$$d_{t+1} - d_t = \frac{(1-\pi)(1+g)}{(1+\pi)(1+g)}d_t \quad \text{(real interest rate)}$$

$$- \frac{g}{(1+\pi)(1+g)}d_t \quad \text{(real GDP growth)}$$

$$+ \frac{\alpha\ \varepsilon(1+i)}{(1+\pi)(1+g)}d_t \quad \text{(exchange rate)}$$

$$- \left[\frac{(1+g_{pe})}{(1+\pi)(1+g)}pe_t + \frac{(1+g_{tr})}{(1+\pi)(1+g)}tr_t\right] \quad \text{(primary balance)}$$

$$+ od_{t+1} \quad \text{(other debt)}$$

Where

d, pe, tr, od: (small letters) debt primary expenditure, total receipts, other debt as % of GDP;

π: GDP deflator;

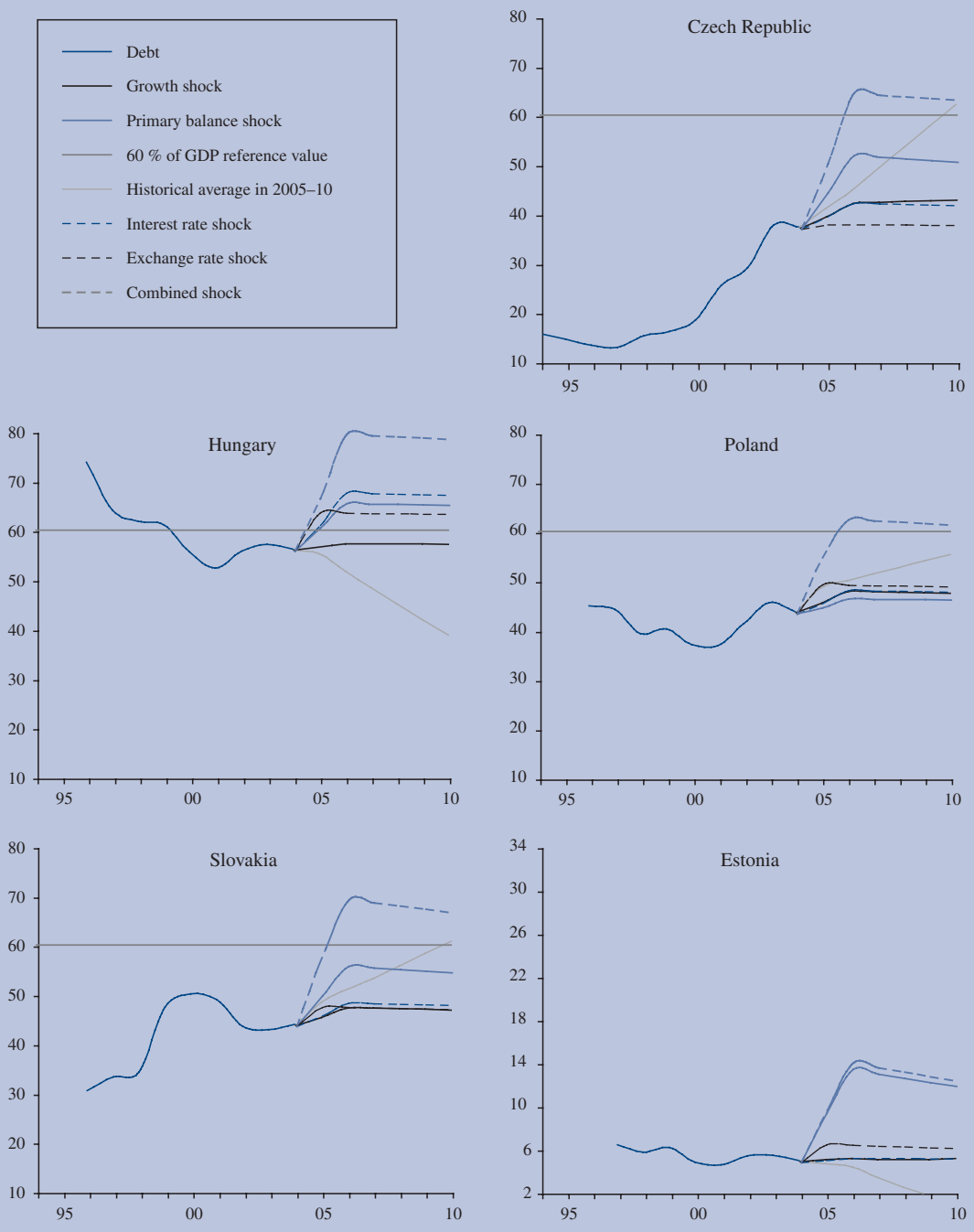
g: real GDP growth;

g_{pe}-g_{tr}: nominal growth of primary expenditure and total receipts.

4.4.2. Contingent liabilities in the recently acceded Member States

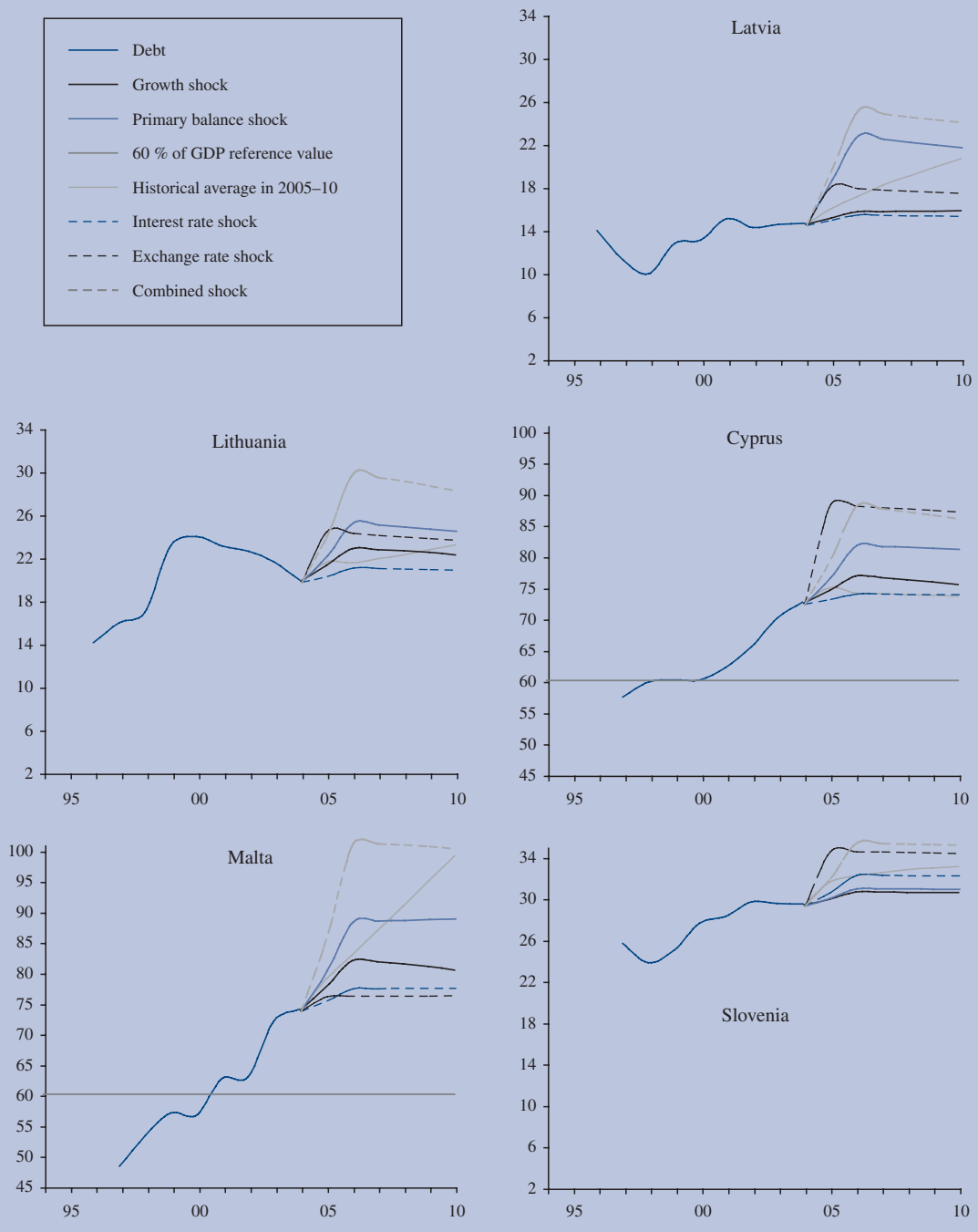
The EU-10 countries, like many other countries, face major fiscal risks as a result of contingent liabilities which are not recorded in government debt or effectively captured in budget documentation. While the ESA 95 definition of the government debt, like most such definitions, includes government obligations backed by law and that will arise in any event, contingent liabilities are obligations that are triggered by the occurrence of a specific but uncertain event. In general, such liabilities are politically more attractive than budgetary support, as their fiscal cost remains invisible until they are realised. However, they increase risks for the public finances in the long run. Quite often, contingent liabilities may arise from fiscal opportunism. As they strive to comply with the requirements of the Stability and Growth Pact and target a reduction in their government deficits below the reference value of 3 % of GDP, some of these countries may be tempted to shift part of the budgetary cost of their

Graph IV.15: **Stress tests for the recently acceded Member States**



NB: Impact of following simulations on debt/GDP ratio :
Average (growth, deflator, prim. bal., int. and exch. rates) 1997–2004 in 2005–10
Growth, prim. bal., interest rate: average 1997–2004 in 2005–06 plus 2 standard deviations
Exchange rate: 25 % depreciation in 2005
Combined shock: growth, prim. bal., int. rate plus 2 st. dev. and 25 % deval. in CZ, PL, SK
Source: Commission services.

Graph IV.15 (continued)



NB: Impact of following simulations on debt/GDP ratio :
Average (growth, deflator, prim. bal., int. and exch. rates) 1997–2004 in 2005–10
Growth, prim. bal., interest rate: average 1997–2004 in 2005–06 plus 2 standard deviations
Exchange rate: 25 % depreciation in 2005
Combined shock: growth, prim. bal., int. rate plus 2 st. dev. and 25 % deval. in CZ, PL, SK
Source: Commission services.

policies to the future by using contingent forms of government support. The analysis of fiscal risks stemming from such liabilities is particularly relevant for the EU-10 as they tend to accumulate obligations outside the budgetary framework. There are several types of contingent liabilities which may threaten the stability of the public finances. They can be either explicit or implicit, depending on the existence of a legal basis.

Explicit contingent liabilities are government obligations defined by law or contract that arise only if a particular event occurs. State guarantees and financing through State-guaranteed institutions represent the most prominent form of explicit contingent liabilities in the EU-10. State guarantees can be either credit guarantees to State-owned companies or private entities, or government guarantees issued on debt or other obligations of local governments. Other types are statutory guarantees on liabilities of financial institutions, or State guarantees issued to private sector investors and service providers. State insurance schemes are another common example of explicit contingent liabilities in the EU-10. In Lithuania, deposit insurance schemes represent a significant source of contingent liabilities. Also, nearly all the recently acceded Member States that undertook extensive pension reforms (Estonia, Hungary, Poland and Slovakia) have provided insurance schemes to private pension funds, guaranteeing to pensioners minimum benefits or minimum returns on their contributions. Finally, in some countries (Poland and Slovakia), contingent liabilities stem from litigation cases, often concerning the restitution of property taken by the State or arising from privatisation or restructuring.

Implicit contingent liabilities are obligations triggered by uncertain events which do not have a legal basis, but may arise as a result of expectations created by past practice or political pressures. A common example is the bail-out of defaulting public sector or private entities (e.g. State-owned companies, local governments, banks or other financial institutions such as pension and social security funds or credit and guarantee funds). Other forms of implicit contingent liabilities identified in the new Member States are possible obligations related to environmental damage (e.g. decommissioning of the Ignalina nuclear power plant in Lithuania) and non-contractual claims arising from private investment, for instance in infrastructure (e.g. possible claims arising from public–private partnerships for motorway construction in Hungary).

Table IV.8 provides an overview of contingent liabilities in the EU-10, together with a tentative estimate of their potential fiscal costs, based on the information reported in the December 2004 updates of the convergence programmes. Overall, State guarantees appear to constitute the main source of fiscal risk in most EU-10 countries. The stock of government guarantees is particularly high in Malta (17 % of GDP), Cyprus, the Czech Republic and Slovakia (10 % of GDP), and somewhat lower in Slovenia (7.5 % of GDP) and Hungary (around 5.5 % of GDP). In the past, transition and privatisation have contributed to the accumulation of public guarantees and other off-budget support in the former centrally planned economies. As restructuring and privatisation are typically far advanced, the stock of guarantees will likely start to fall. However, in Poland, contingent support to State-owned companies in the sectors in need of restructuring (i.e. in coal mining, the steel industry and railways) is expected to remain a significant source of risk in the coming years.

Although transition is no longer a major source of contingent liabilities, new sources of risk have emerged in the recent period. In particular, Polackova Brixi (2004) has highlighted two factors that will likely lead to increased risk exposure in the future: the need to close the infrastructure gap, and fiscal decentralisation. First, many recently acceded Member States tend to promote private participation in financing infrastructure investments by establishing public–private partnerships. However, experience shows that these frequently require government support through explicit guarantees or other disguised subsidies. Second, the growing autonomy and involvement of local governments in promoting regional development may generate contingent liabilities. Most EU-10 countries have established strict limits on local borrowing, but forms of off-budget finance are available. These contingent liabilities as well as the debt of local governments often expose the central government to risk.

In recent years, the new Member States have achieved a number of improvements in recording and monitoring contingent liabilities. In accordance with ESA 95 requirements, all have made considerable progress in incorporating the activities of extra-budgetary funds and off-budget agencies into the general government, thus converting their liabilities from contingent to direct liabilities for the government. Also, these countries have made efforts to reveal and assess fiscal risks emerging from State guarantees. The Czech Republic and Slovakia have assessed most or part of their outstanding govern-

ment guarantees as risky and have reported their full value as government debt (ESA 95 definition). In the case of Poland, the risk-weighted stock of outstanding guarantees is included in the public debt (national definition). Other countries, like Hungary, provide detailed information on the expected cost of the guarantees in the documents attached to the budget. Moreover, in most countries, the volume of guarantees issued by the government is limited by law. Nonetheless, effectively capturing contingent liabilities in the fiscal framework and assessing related fiscal risks remain key challenges for these countries.

Table IV.8

Contingent liabilities in the recently acceded Member States

	Explicit (government obligation defined by law or contract)	Implicit (government obligation arising from public expectations or political pressures)
CZ	• State guarantees (10 % of GDP) and liabilities of the Czech Consolidation Agency (CKA) (7.5 % of GDP) — included in the ESA 95 government debt • State guarantees (0.7 % of GDP) — not included in the government debt	• Liabilities of the National Property Fund associated with the removal of ecological damage in privatised properties • Bail-outs related to hospital arrears
EE	• State guarantees (3.3 % of GDP) — student loans, export guarantees, loan contracts	
CY	• State guarantees on borrowing provided to semi-government organisations and domestic institutions (10 % of GDP)	
LV	• State guarantees (2.1 % of GDP)	
LT	• Government-guaranteed loans (2 % of GDP) • Credit guarantees to SMEs • Deposit insurance (25.6 % of GDP) • Restitution of rouble savings and property rights (4.4 % of GDP)	• Municipal budget arrears (0.4 % of GDP) • Decommissioning of the Ignalina nuclear power plant
HU	• State guarantees (5.4 % of GDP) — including guarantees to the Hungarian Railway Company	• Potential liabilities arising from public–private partnership arrangements (motorway construction, construction of student hostels and prisons)
MT	• State guarantees (17 % of GDP) — mainly to public sector entities	
PL	• State guarantees (3.9 % of GDP) — mainly to State-owned companies • Litigation (legal claims concerning 1944–62 property losses: 6.6 % of GDP)	• Debt relief in the health sector (0.7 % of GDP) • Potential liabilities arising from the restructuring of industries (railways, coal mining, steelworks) • Possible claims arising from private investment in infrastructure (motorway construction co-financed by international financial institutions)
SI	• State guarantees (7.5 % of GDP) — mainly to public sector entities for the financing of infrastructure and export guarantees	• Debt of State-controlled financial institutions and their guaranteed debt to third parties (4.1 % of GDP)
SK	• State guarantees (approximately 10 % of GDP) — out of which more than half included in the ESA 95 government debt. Litigation (legal claims by Ceskoslovenka Obochdni Banka and the Slovak Gas Company)	• Debt relief in the health sector

NB: The figures refer to the outstanding stock of State guarantees and other contingent liabilities at the end of 2003.

Sources: December 2004 updates of the convergence programmes, Commission services and Polackova Brixi (2004).

5. Fiscal policies for stable convergence

5.1. Introduction

Major progress has been achieved in strengthening the public finances of the recently acceded Member States — most strikingly so in cases where systemic transformation was required in the transition from central planning. Significant challenges still lie ahead during the course of steep real and (in most cases) financial convergence, and as the EU-10 move at varying speeds towards euro adoption. This chapter discusses several issues for fiscal policy that arise in this setting.

First, it will be important to assure scope for growth-supportive expenditure priorities, while exploiting the scope to achieve fiscal savings by reforming existing programmes — an approach evidenced in various ways in the recent convergence programmes of the new Member States.

Second, medium-term fiscal plans need to assure public debt sustainability, keeping in mind the possibility of future shocks to the economy and the public finances. Most of the recently acceded Member States face major demographic challenges: they are typically moving to address these through growth-oriented approaches based on structural reform of pension systems — though action is still needed in some cases, and supportive labour market reforms are also crucial.

Third, those new Member States with developing financial sectors may face extended periods of rapid credit expansion and wide private sector imbalances. It is important not to overestimate underlying trends in potential growth or in revenues: an unintentionally procyclical stance could cause external financing risks, and limit the scope for fiscal flexibility during a subsequent slowdown.

Fourth, monetary and exchange regimes influence the way that risks for policy crystallise. In the run-up to euro adoption, there are special demands on market credibility and the macroeconomic policy-mix during a period of exchange rate targeting. If, on the other hand, national currencies are retained for an extended period, it will remain important to guard against a build-up of risks through unhedged foreign currency borrowing by the non-bank private sector (which could be accelerated by high domestic interest rates associated with fiscal tensions). Under the euro, exchange rate risks disappear, but external adjustment challenges do not: sound fiscal policy in 'good times' can increase flexibility at times of setbacks to growth.

Fifth, there are questions as to how to address possible market tensions during convergence — including the risk of a loss of access to international capital markets, or of market pressures in the run-up to euro adoption. Responding to shocks and emerging risks through discretionary fiscal adjustment has costs, such as the risk that budgetary cuts fall on investment. This argues for setting prudent medium-term goals, with adequate safety margins. But it also highlights the case for strengthening fiscal institutions — and thus improving the underlying trade-offs for policy.

Finally, the situation in the public finances differs widely across the EU-10. Encouragingly, those economies which face the tougher fiscal deficit and debt challenges may also have the greater scope to meet these through structural fiscal reforms that are themselves growth enhancing. Effective fiscal strategies need to be developed on a case-by-case basis, and the convergence programmes will continue to provide a valuable vehicle for this.

5.2. Tax and expenditure strategies consistent with stable convergence

There is wide consensus that fiscal policy can make a contribution to potential growth through supply-side effects ([1]). The strong catching-up potential of the EU-10 and the need to complete restructuring suggest

([1]) See, for example, Bleaney et al. (2001) and Kneller et al. (1999) for an empirical analysis of OECD countries, and Romero de Ávila and Strauch (2003) for an application to EU countries. European Commission (2004a) provides a literature survey.

that the public finances can provide powerful support in this regard. So far, total factor productivity and capital accumulation have been key sources of growth. In the period ahead, both will remain important, while — with the right skills available and sufficient mobility — labour input should shift towards a positive contribution.

To support this process, the public sector needs to commit adequate resources to key priorities such as infrastructure investment, and education and training. Policy-makers should also be mindful of research and development needs, while taking full account of rates of return and the role of the private sector. Pension reforms can improve employment incentives and the profile of the public finances, and these too entail upfront costs. It is the need to assure adequate financing for such areas that has raised questions whether growth would be enhanced by tolerating wider fiscal deficits (e.g. Buiter and Grafe, 2002). Indeed, the important medium-term contribution of pension reforms has led to their special treatment under the revised Stability and Growth Pact (see Box IV.3).

A second element in support of growth is the incentive effects and signals to the private sector that result from structural features of policy. These can enhance the setting for investment and job creation. Taxation needs to be broad-based and to avoid distorting economic activity. Tax and social security charges together should not represent an unduly heavy burden on labour income. Marginal rates of taxation and benefit withdrawal need to avoid discouraging employment. Well-targeted benefits can facilitate restructuring by easing adjustment strains. Also, transfers to firms that distort resource allocation need to be phased out. A number of these approaches can increase public savings even in the short run. It would thus be wrong to equate growth-oriented reform of the public finances, mechanically, with a net widening of fiscal deficits.

In this connection, key features of the composition of the public finances in the new Member States, as these emerge from Chapter 3 above, can be summarised as follows:

- Despite a cut in taxes on capital and labour over the past decade, the total burden on labour often remains high compared with other countries of similar per capita income.

- Primary expenditure as a share of GDP in the central European new Member States (except Slovakia) and the island economies is in the same range as in euro-area members, despite substantially lower income levels. This contrasts with the Baltic States.

- Collective consumption and employee costs are relatively high (including in the Baltic States) — suggestive of overstaffing.

- Cash social transfers do not exceed the euro-area level, but show wide variations across the EU-10. Some countries such as Poland and Slovenia exhibit high shares compared with other countries with similar per capita income.

- Subsidies are fairly high in some cases, but the picture is very differentiated across countries.

Both the relatively high GDP share of certain key expenditure categories and the variation in these shares across countries suggest, at least prima facie, that there is still scope for revenue and expenditure rationalisation, in particular in the central European new Member States.

However, this pattern also highlights that expenditure challenges cannot be reduced to a rule-of-thumb formula, or just achieved through a compression of rates of pay. The nature of the expenditures that could be reduced suggests that structural reforms are required. Similarly, it is tax bases, not tax rates, that need to be strengthened. Countries, moreover, show major differences: tailor-made approaches are called for. Given the structural nature of the challenges, this may imply a multi-year approach.

On the revenue side, most recently acceded Member States have been reducing personal, and especially corporate, income tax rates with the aim of supporting private sector growth. While this trend is not likely to continue at the same pace, it is also not likely to be reversed. Notably, most new Member States still have high taxation of personal incomes, typically resulting from social security contributions on wages and salaries higher than in other countries with similar per capita income, including EU cohesion countries. Moreover, in some of the EU-10 countries (Hungary, Poland and Slovakia), pension reforms introducing funded pillars will cause a loss of contributions for the government (since these are to be recorded outside the government sector according to the 2 March 2004 Eurostat decision after a transition period).

Box IV.3: The Stability and Growth Pact — 2005 reform package and its consequences for the recently acceded Member States

The agreement on a reform of the Stability and Growth Pact endorsed by the EU Heads of State or Government on 22 March 2005 introduces more economic rationale and greater differentiation reflecting the increased economic heterogeneity in the enlarged EU of 25 Member States. While all changes introduced by the reform will, of course, apply to the EU-10, the following elements of the reform are of particular importance.

Country-specific medium-term budgetary objectives. The reform foresees that medium-term budgetary objectives (MTOs) will be differentiated across countries according to their debt ratio and potential growth (and, later, sustainability of government finances). This has a clear implication for the new Member States, which in many cases have relatively low debt ratios and high potential growth, and may therefore need to pursue less ambitious MTOs to comply with the reformed SGP than would have been the case previously. The reform specifies that new Member States participating in ERM II (and, later, in the euro area) will have an MTO in a range between – 1 % of GDP for countries with low debt and high potential growth and balance or in surplus for countries with high debt and low potential growth; if they have not achieved the MTO, they should pursue, as a benchmark, an annual adjustment of 0.5 % of GDP, net of one-off and other temporary measures. For EU-10 countries not participating in ERM II, the MTO will be set at a level providing a safety margin with respect to the 3 % of GDP deficit limit, ensuring rapid progress towards sustainability, and allowing room for budgetary manoeuvre, in particular taking into account the need for public investment.

Deeper and more differentiated assessment of budgetary developments in the excessive deficit procedure. The new agreement specifies a set of 'other relevant factors' that the Commission and the Council will take into account when deciding on the existence of an excessive deficit and when determining the deadline for its correction. These factors include, *inter alia*, developments in potential growth but also considerations with respect to debt sustainability, and can be taken into account in all the steps of the excessive deficit procedure (except abrogation). For the same reasons as mentioned above, this may be relevant in the case of the recently acceded Member States. The reformulation of the exceptionality clause of a 'severe economic downturn' is also important for the EU-10. Both the Commission and the Council, when assessing and deciding on the existence of an excessive deficit, may consider an excess above 3 % as exceptional as long as it remains 'close to the reference value' and 'temporary' and if it results from a negative growth rate or from the output loss accumulated during a protracted period of very low growth relative to potential growth. While the EU-10 have usually higher potential growth and should only extremely rarely face periods of negative growth, they may, like other Member States, face protracted periods of very low growth.

Taking into account systemic pension reforms. The Commission and the Council, in all budgetary assessments in the framework of the EDP, will give due consideration to the implementation of these reforms. This is particularly relevant for the EU-10 since several of them have introduced such reforms in recent years or plan to introduce such reforms. The agreement stipulates, in particular, that an excess close to the deficit reference value which reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar should be considered carefully. Consideration will be given to the net impact on the EDP deficit of multi-pillar pension reforms for the initial five years after a Member State has introduced a mandatory fully funded system, or five years after 2004 for Member States that have introduced such a reform before 2005, in a regressive way over five years. This is potentially important for decisions on euro adoption.

Room for increasing revenues efficiently, however, can be found in several areas. Excise rates can be raised in line with the typically higher rates in the EU-15. Savings can also be achieved by expanding the tax base and rationalising the tax system. Stronger tax administration may increase collections, especially of VAT. Revenue sources can be broadened via the introduction of taxes on bases that are not taxed or taxed at a low rate, and also by reducing exemptions and preferential rates — especially for indirect, but also for direct taxes. While VAT rates are relatively high compared with the EU-15 countries, there are more exemptions and reduced-rate items. There is also rather extensive recourse to tax expenditures for personal and corporate income tax rates, i.e. exemptions to promote goals similar to those of traditional expenditures. Moreover,

gains could be obtained by reducing the amount of 'revenue churning' associated with overlapping income transfer flows via preferential taxation, and social transfer schemes (Cavalcanti and Li, 2000; Burns and Yoo, 2002a, 2002b).

On the expenditure side, there are some constraints that affect potential reforms to increase savings: accession-related expenditures (including those in connection with environmental standards, transport infrastructure and administrative costs), the need to improve infrastructure throughout the catching-up process, and the impact of population ageing, which (even with pension and health reforms) will trigger pressures on social security systems over time. Moreover, healthcare spending is generally no higher than in the other cohesion countries.

Substantial savings, however, can be found in containing wage dynamics and limiting the growth of health expenditures and social transfers. The first typically requires structural approaches along the lines of civil service reform and/or a hiving-off of functions. On average, the earnings of public employees have been lower in the EU-10 than in the EU cohesion countries (Funck, 2002). Moreover, strong dynamics in private sector earnings will increase upward pressures on pay scales (Kohler-Toglhofer et al., 2003). In healthcare, most gains are to be found through more effective expenditure control mechanisms and improved cost efficiency. In pensions, reform of social security systems recently implemented in most EU-10 countries will contribute to containing the increase in benefits associated with ageing populations — though further action may be needed in some countries to ensure dynamics of pension payments consistent with budgetary objectives.

Importantly also, the discussion above pointed to the scope for curtailing subsidies to firms and rationalising transfers to persons, including through a better targeting of benefits. The former can imply significant adjustments in the real economy, while well-targeted social transfers can to some degree ease the strains associated with such adjustments.

The updated convergence programmes of the EU-10 set out priorities for tax and expenditure reform, as well as consolidation goals. They reflect several strategic concerns: the scale of adjustment to respect the Maastricht deficit criterion; the need to support private sector growth during catching-up (e.g. containing the tax burden on capital and labour); phasing out subsidies and 'extra-budgetary' funds; adaptation of institutions and services to changing conditions (e.g. pension, health and education reforms).

In their updated programmes, all the EU-10, with the exception of Lithuania and Latvia, plan to cut expenditures over the programme horizon (see Table IV.9). While the Czech Republic, Estonia, Hungary and Malta plan to reduce the government revenues/GDP ratio, others base their strategy on higher revenue shares. Among those currently in the excessive deficit procedure which committed to ambitious consolidation paths, strategies differ. Cyprus and Poland foresee increases in revenues relative to GDP, while Hungary and Malta foresee a decline.

Table IV.9

Projected change in government revenues and expenditures over the 2004–07 period (changes over the programme horizon in, respectively, the government revenues/GDP ratio and the government expenditures/GDP ratio are indicated in parentheses)

Government revenues/GDP Government expenditures/GDP	Cut	Increase
Cut	CZ (– 1.8, – 3.7) EE (– 3.5, – 2.5) HU (– 1.2, – 3.7) MT (– 1.8, – 5.6)	CY (+ 1.6, – 2.3) PL (+ 0.8, – 2.4) SI (+ 0.2, – 0.8) SK (+ 0.5, – 0.3)
Increase		LV (+ 0.8, + 0.5) LT (+ 1.5, + 0.5)

Source: 2004 updates of the convergence programme.

Updated convergence programmes indicate that cuts in expenditures are expected especially in terms of lower collective consumption, and cash and non-cash social benefits. Savings in collective consumption (mainly government wage bills) are foreseen especially in the Czech Republic, Estonia and Hungary. Ambitious health reform packages have been announced in the programmes of Cyprus and Hungary. Social transfers are planned to be reduced considerably, especially in the Czech Republic, Malta and Poland.

On the revenue side, plans are broadly consistent with the considerations discussed above. Improvements associated with enhanced tax administration and rationalisation of the tax system, for example, are foreseen in Estonia, Lithuania, Hungary and Poland.

Finally, when assessing the impact of convergence priorities on deficits and the public debt, account needs to be taken of the availability of EU budgetary transfers. Such transfers should help substantially in financing growth-enhancing expenditures (Hallet, 2004; Hallet and Keereman, 2005). Together with the volume of co-financing and fully nationally financed expenditures, however, they may in some cases test the limits of absorption capacities, and they do not fully offset the external impact of associated public expenditures.

5.3. Debt sustainability and ageing

Credible fiscal policy can help ensure that convergence is not interrupted by financial or real sector stress, and that investment is not held back by risk perceptions in the private sector. In this respect, the most fundamental requirement is to target a primary balance that assures satisfactory debt dynamics in terms of a public debt ratio that declines rapidly to — or remains below — the Treaty value of 60 % of GDP.

Discussion earlier in this chapter highlighted risks to the public debt that could arise from volatility in key real and financial variables. Among these is the possibility that future stresses during the expansion and transformation of the real and financial sectors could add to contingent liabilities. In all economies, it is prudent to allow public debt headroom for possible shocks. Among the EU-10, this is operationally most important in the larger economies of central Europe — given present debt ratios, the extent of future economic and financial transformation, the relatively high stock of contingent liabilities, and the sensitivity of debt levels to shocks originating in the real and financial economy. The extent of headroom below the 60 % debt ratio that is prudent on these grounds is an issue to be evaluated on a case-by-case basis.

The long-run sustainability of public finances embraces broader issues, some of which cannot be assessed in isolation from strategies for structural reform. A key issue in this respect is population ageing — and this is an area in which the underlying demographic situation and prospects of the EU-10 are typically unfavourable (see Box IV.4). Experience so far supports the view that the new Member States will opt for a growth-friendly strategy, based mainly on structural reforms rather than a higher primary surplus. But to contain risk in the economy, far-reaching action is still needed in some cases (see Graph IV.16). More generally, credible progress will need to be maintained in implementing reforms under way, and flanking measures are needed in the labour market.

Box IV.4: **Long-term sustainability of public finances in the new Member States**

Demographic projections show a particularly troubling outlook in the EU-10. At present, most have relatively low fertility rates and lower, though increasing, life expectancy at birth than the EU-15, and frequently also a negative migration balance. The age profile is typically more favourable, but the situation is expected to worsen much faster on average by the middle of the century. While the average old-age dependency ratio of the EU-15 is projected to double by 2050, it is expected to more than double in the Czech Republic, Cyprus and Slovenia and even triple in Slovakia (see Graph IV.16). These three countries and Poland are projected to face the most significant worsening in the dependency ratio among the EU-10. In other EU-10 countries, on the other hand, the dependency ratio is forecast to be closer to or even below the EU average. Nevertheless, this outlook also implies serious consequences for labour supply and growth unless a rise in total factor productivity compensates.

(Continued on the next page)

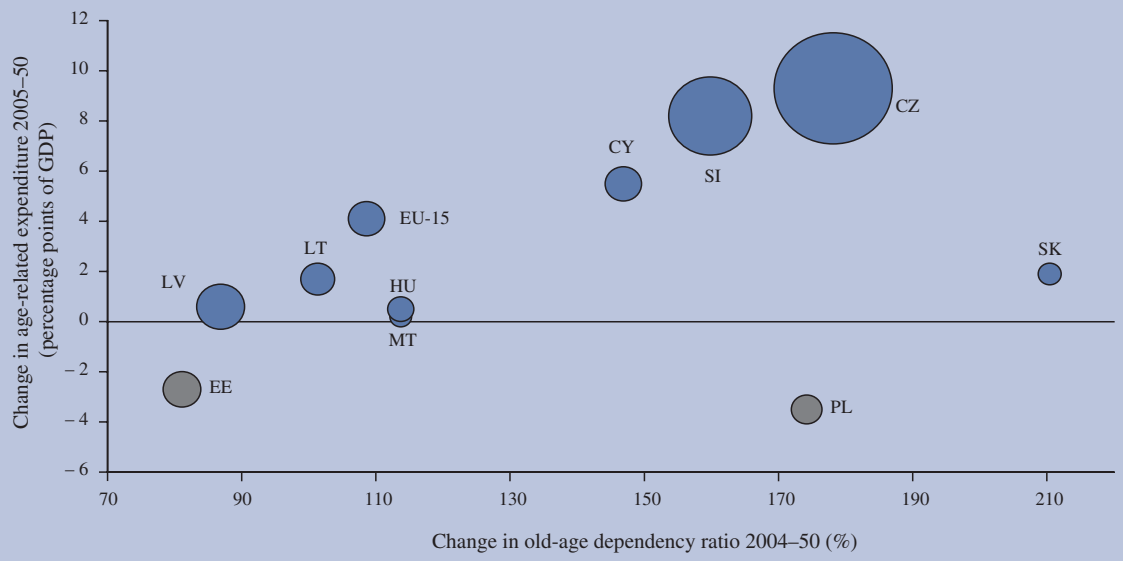
Box IV.4 (continued)

The budgetary impact, illustrated in the latest convergence programmes, is a large increase in age-related spending in countries where old-age dependency ratios worsen most steeply, and in those that have not so far significantly reformed pension or healthcare systems (see Graph IV.16 — depicted by the location of the centre of the bubble in relation to the two axes). This is evident in the Czech Republic, Cyprus and Slovenia, although the parametric measures adopted in the last in 2000 have mitigated risks. On the other hand, many new Member States have already implemented reform strategies in part or in full. In Slovakia, the ongoing pension reform is projected to result in a relatively low increase in spending compared with the Czech Republic. Estonia and Cyprus have similar dynamics in the old-age dependency ratio, but Estonia shows an actual decrease in pension and healthcare system expenditures over time, and a similar outcome may result from reforms planned in Poland (once technical details are available).

Sustainability risks from ageing can be seen from long-term debt projections, assuming that medium-term reform plans in the convergence programmes are implemented. While the highest debt levels in 2050 (depicted by the width of the bubble) are projected in the Czech Republic and Slovenia, the debt level in Cyprus is, given the projected increase in age-related spending, relatively low. This is mainly due to a relatively high constant revenue level over the entire projection period. In line with the projected fall in the age-related expenditures in Estonia and Poland, the debt ratio would fall to zero.

Comprehensive reform strategies to contain age-related spending are beneficial for both debt sustainability and growth — requiring lower primary balances than otherwise. In this context, the EU-10 have made considerable headway. Most of them have already introduced a three-pillar system, while others have adjusted parameters of their existing systems. To fully contain budgetary risks, additional and simultaneous structural reforms, particularly in labour market policies, are required. Pension measures such as postponement of retirement and/or restrictions on early retirement require a setting of increasing employment and participation rates to absorb the labour force. Higher participation rates of older people, a particular problem in the EU-10, as well as lower unemployment, can also mitigate the challenges of ageing populations.

Graph IV.16: **Budgetary pressures in the new Member States arising from population ageing**



NB: Projected government debt in 2050 is depicted by the width of the circle. The grey colour indicates negative gross debt in 2050. For Cyprus, it concerns the adjusted gross debt.
Sources: Eurostat, News Release 48/2005, 8.4.2005, 2004 updates of the stability and convergence programmes and Commission services' calculations.

5.4. Stabilisers and credit cycles

The stabilising role of fiscal policy also operates through the role of the public sector saving–investment balance in dampening economic fluctuations, including by ensuring a sound macroeconomic policy-mix. The core requirement in this regard, common to all Member States, is to create sufficient room for manoeuvre for the free play of automatic stabilisers over the business cycle without endangering policy credibility or SGP limits (see Box IV.5).

A more difficult issue, during catching-up, is how fiscal policy should respond to strong cycles in private sector activity lasting much longer than typical business cycles and frequently associated with rapid credit growth. These could give rise to sizeable external imbalances, with the counterparts being some mix of household consumption and private investment. This has been illustrated in the Baltic States, where large external current account deficits have been wholly or partly driven by the private saving–investment imbalance associated with strong credit growth. Ultimately, the impact of such cycles on sustainable growth will depend on factors that reflect the frameworks for private sector decision-making — the sound allocation of resources and prudent appraisal of funding risks. Nonetheless, the discussion in Chapter 4 of this part, with the aid of two country examples, highlighted the role that the public sector balance can play in moderating such cycles and assuring resilience during downturns. Its impact depends in part, of course, on the size of the sector relative to the economy.

This role of fiscal policy in dampening longer cycles during convergence depends on policy-makers avoiding procyclicality by correctly analysing elements in fiscal performance that are permanent as against those that are transient. This is relevant not only as regards the potential growth rate but — as recent literature has highlighted — also the performance of revenues relative to GDP during a strong private sector boom, especially where asset prices are rising strongly (Jaeger and Schuknecht, 2004). Fiscal receipts are frequently swollen by factors that reflect the ongoing credit and asset price boom: capital gains levies, securities transaction taxes, etc. The impact on revenues of booms related specifically to asset prices has been estimated at levels of 1 % of GDP. During such periods, it could be prudent to aim for a higher nominal surplus (or lower deficit) on this account.

More generally, where growth is well above its medium-term trend, this is also an opportunity to accelerate fiscal consolidation towards medium-term goals. Also, where there is a risk of downside shocks — such as shake-out costs in the real or financial sector after a protracted boom, or risks of a loss of access to international capital markets — it could also be prudent to allow for these in setting medium-term goals.

Box IV.5: **The elasticity of fiscal balances to economic activity**

Budgetary elasticities play an important role in assessing fiscal policy. They serve, inter alia, as an indicator for the strength of the countercyclical or stabilising effect of policy. Mainly because of data constraints, there have been no studies so far providing robust empirical estimates of budgetary elasticities in the EU-10 based on a common approach.

In 2004, OECD and Commission staff started work towards budgetary elasticities for the EU-10 following the more complex approach developed by van den Noord (2000). The elasticity includes two components. The first measures the impact of GDP on the tax base (or the macroeconomic variable more closely related to expenditure, for example unemployment in the case of unemployment benefits). It is estimated econometrically using time-series data. The second component links the tax or expenditure base to the budgetary component, derived from tax legislation and related fiscal data.

Very preliminary results of the joint OECD and Commission estimation work, including an update of the elasticities for the EU-15, were made available at the end of 2004. Before commenting on the figures reported in the table below, two qualifications should be noted. The presentation is limited to average tax and expenditure elasticities across groups of countries because of the preliminary nature of the estimates. Current results for all countries should thus be seen as work in progress.

(Continued on the next page)

Box IV.5 (continued)

Due to the lack of available data in the EU-10, the OECD methodology had to be adapted. In particular, the first component of the overall budgetary elasticity, which links the tax or expenditure base to GDP, was not derived from econometric regressions. By way of approximation, the OECD set it to the average of the small EU-15 countries. While this solution has the advantage of simplicity, it may be argued that countries undergoing major structural change are unlikely to exhibit elasticities similar to those of small open EU-15 economies. As an alternative, the Commission services estimated the first component of the budgetary elasticities for each individual EU-10 country econometrically and took the average across countries.

On this basis, fiscal balances in the EU-10 show on average a lower sensitivity to the cycle than those in the EU-15. This reflects the lower progressiveness of income taxes and their lower share in total revenues, less generous unemployment insurance, and labour market variables that are less responsive over the cycle, though there are some reservations on econometric robustness.

A further conclusion concerns the stabilising effect of the budget over the cycle. In addition to lower budgetary elasticities, the EU-10 have on average a smaller size of government than the EU-15, as measured by the expenditure-to-GDP ratio. Since most expenditure items do not vary automatically over the cycle, this implies a lower countercyclical impact.

These features, in the abstract, could seem to suggest that the EU-10 need less scope for the play of automatic stabilisers than the EU-15. Such a conclusion needs to be heavily qualified in three respects. It leaves out the possibility that fluctuations in output, the second ingredient of the budgetary safety margin, may be wider in the EU-10. The features of the economy that drive fiscal elasticity vary quite widely across the EU-10. Also, of course, these estimates by definition leave out the possible exposure of these economies to specific, non-cyclical demand shocks.

Table IV.10

Average budgetary elasticities and sensitivities in the EU-10 and EU-15
Preliminary estimates based on OECD methodology as described in van den Noord (2000)

	Budgetary elasticities				Budgetary sensitivity			
	Output elasticity of total taxes		Output elasticity of current primary expenditure		Tax burden	Total current primary expenditure to GDP ratio (2004)	Overall budgetary sensitivity	
	OECD (1)	COM (2)	OECD (1)	COM (2)			OECD (1)	COM (2)
		A		B	C	D	A*(C/100)-B(D/100)	
Average of EU-10 countries	0.90	0.71	– 0.07	– 0.03	34.1	36.1	0.33	0.25
	updated	previous(3)	updated	previous(3)			updated	previous(3)
		A		B	C	D	A*(C/100)-B(D/100)	
Average of EU-15 countries	0.94	0.84	-0.30	-0.14	41.9	40.8	0.50	0.41

(1) The link between output and the tax or expenditure base is set as equal to the average of the small EU-15 countries.
(2) The link between output and the tax or expenditure base is set to the average of individual estimates of the EU-10 excluding Malta and Cyprus.
(3) Released in 2000.

Source: Commission services.

5.5. Interactions with other policies

The contribution of fiscal policy to preserving stability needs to be evaluated in the context of other policy regimes. Monetary and exchange rate frameworks, in particular, are highly relevant to the way financial stress affects the real economy. They also influence private sector risk behaviour: for example, variability in the exchange rate encourages hedging of currency exposure, thus reducing the potential cost of financial stress in terms of the real economy. Monetary regimes thus affect the risks to output against which fiscal prudence can be seen as a form of insurance.

Monetary regimes vary markedly across the EU-10, and are set to change as they move at differing speeds towards euro adoption. Three examples help to highlight the risk characteristics of monetary frameworks, and related fiscal challenges.

- Under inflation targeting, monetary policy can help contain credit growth and dampen swings in private sector activity to the extent these are threatening the attainment — or tractability — of inflation over the central bank's time horizon. Financial stresses, meanwhile, typically crystallise in the exchange market. This may facilitate adjustment in the real economy. But if easy fiscal policy results in high domestic currency interest rates, and if the exchange rate is in practice somewhat rigid, these factors can encourage unhedged borrowing among firms and households, giving rise to potentially serious balance-sheet risks. While the stabilising role of monetary policy can ease the task of fiscal policy, unhedged exposure can increase adjustment costs and the burden on the public finances in a crisis.

- Exchange rate targeting regimes such as ERM II highlight the importance of a sound fiscal policy. They also place special demands on the policy-mix to help ensure that the exchange rate for euro adoption reflects economic fundamentals. Tight money and an easy fiscal policy, for example, could result in an overly appreciated exchange rate. Credibility also falls under a market spotlight, and evidence of contagion across some of the EU-10 countries underscores that this is potentially a matter of common concern. (As under inflation targeting, the extent of the associated risks to output would depend in part on the extent to which unhedged foreign currency liabilities had built up.)

- Under the euro and wholly credible pegs, there is no latitude to use interest rates to address asymmetric upswings in the domestic economy or to cushion negative shocks on output. Meanwhile, external adjustment plays out through relative price changes. Thus, problems associated with exchange markets are eliminated, but external adjustment can be a slow process if real sector markets are rigid — increasing some potential challenges for fiscal policy.

Such features of the monetary setting thus affect the challenges facing fiscal policy. Also, changes in monetary regime over time are important, including notably the shift towards ERM II and the euro. At a deep level, this transition can be taken to signal a growing maturity in monetary transmission channels and decisive progress in nominal convergence — factors that are clearly favourable to stability. However, reduced degrees of monetary freedom have implications for the challenges to fiscal policy. Fiscal trade-offs may need to pay greater heed to stabilisation issues. If fiscal policy is not yet well placed to engineer room for manoeuvre — for example, adequate safety margins in terms of the Maastricht criteria or policy-mix requirements — then policy-makers will need to weigh this carefully before shifting to a more constraining monetary regime.

In these respects, it is crucial to distinguish between Treaty requirements and the principles of prudent fiscal management — which will normally take account of financial market risks to the convergence path and the desirability of keeping stabilisers available at all times. It is prudent management that suggests minimising risks of a last-minute market disturbance (for example, following a shock to the public finances) during the approach to euro adoption, and also that adequate room for stabilisers within the SGP limits be built in at the time when Member States become members of the euro area. These considerations may imply a more ambitious consolidation path in the approach to ERM II and euro adoption than implied by a mechanical observance of the Maastricht reference value.

In addition to monetary policy regimes, the goals of supervisory policies in the financial sector, which address the health of institutions, are supportive of financial stability. Prudential frameworks can contribute particularly where supervisors internalise systemic risks in evaluating institutions' credit and market exposures. Concerns about stability during convergence arise in part

from capital market imperfections and risk assessment problems (for example, underpricing indirect exposure to currency risks, or the perception of implicit guarantees on funding). Several supervisory approaches — such as stress tests — can reduce risks, and so can close and active cooperation between home and host supervisors of systemically important foreign establishments.

Finally, it is important to bear in mind the influence on financial stability of governance standards and of real sector frameworks. Regarding the former, a range of official policies and private codes of conduct relating to governance in the non-financial sector affect the efficient and stable functioning of non-financial corporations. This is a question that deserves more attention in light of structural shifts which are under way in the distribution of risk in the economy: there is a tendency in all economies for financial institutions to pass on to clients financial risks that formerly they themselves bore. Regarding flexible real sector markets, these are clearly crucial in reducing the potential costs to growth when the economy needs to adjust to real or financial shocks. They are thus a key element in influencing the extent of output risks against which prudent fiscal policy is a form of insurance.

5.6. Risks, safety margins and fiscal institutions

A number of factors differentiate the EU-10 from other EU Member States. Most obvious, on the favourable side, is the potential for higher output growth, which will enhance debt-carrying capacity, and the fact that, in some cases, these Member States enjoy a much lower initial public debt ratio. On the more cautionary side, there may be continuing risks of economic and financial volatility affecting debt dynamics and output stability, especially in those cases where structural transformations and financial catching-up are still under way.

There is also a risk, during rapid convergence, of overestimating potential growth and, particularly, the durability of revenues associated with credit and asset price booms. This latter factor is especially relevant to the EU-10 countries that are likely to experience a very rapid growth in credit towards equilibrium levels over the next few years. These are arguments not for a more restrictive policy during convergence, but for a stance that takes underlying developments and their variability correctly into account.

There are, by contrast, two factors that could argue — on grounds of prudent fiscal management and market signals in some specific situations — for a fiscal stance more restrictive than those implied by the Maastricht fiscal criterion or by medium-term SGP goals. These are, first, the possibility that sizeable current account deficits could trigger, in the future, a rise in risk premiums that threatens capital market access, and, second, the need to pay close regard to issues of credibility, safety margins, and policy-mix in the run-up to euro adoption.

There are drawbacks in discretionary adjustments to fiscal policy to respond to such market risks at the time they emerge. In particular, ad hoc cuts in spending may fall heavily on investment, and time lags mean that the withdrawal may be mistimed. The uncertainties and costs of discretionary action underscore the case for prudent medium-term goals, but they also prompt the question as to what are complementary routes to help preserve stability. One obvious option to exploit is the stabilising role of strong fiscal institutions.

In this respect, a key challenge for fiscal authorities in the EU-10 is to establish credibility in sticking with budgetary plans and fulfilling commitments. A common source of slippage is the failure of spending ministers and local authorities to internalise the social costs of their demands, the so-called ‘common pool problem’. Fiscal institutions can be designed in ways that help limit this source of expenditure bias (see Part II, Section 2.3). One such approach is to delegate formation, monitoring and implementation of the budget to a single policy body — for instance, a finance minister with a leading role in the budgetary process (the ‘delegation approach’). Fragmentation of the process can also be limited by increased coordination among spending ministers and levels of government, possibly through formalised rules and procedures (the ‘commitment approach’). Most EU-10 countries seem to have embarked on reforms in their fiscal institutions in line with this approach (Ylaoutlinen, 2004).

Most EU-10 countries, in recent years, have also introduced multi-year budgetary frameworks to better internalise the medium-term consequences of decisions on spending programmes in the formation of the budget and to improve *ex post* monitoring. Many had already moved to better integrate the activities of extra-budgetary funds in the budgetary process and to increase the coordination of spending decisions across levels of government (Gleich, 2003; Ylaoutlinen, 2004).

In spite of this progress, there is still room to strengthen fiscal governance in the new Member States. First, the

introduction of agreed provisions on how to use better-than-expected budgetary outcomes in 'good times' will be helpful to avoid loosening the stance of fiscal policy during periods of strong growth. Second, future reforms could contribute to reducing the high share of so-called 'mandatory expenditures' in some EU-10 countries, i.e. those that need to be changed require additional legislation on top of the budget law, thus improving the ability of budgets to react to shocks. Third, strengthened practices in evaluating expenditure (e.g. via cost–benefit analysis techniques in project selection, periodic reviews of programmes, establishment of output-oriented indicators of government actions) could contribute to increasing the effectiveness of government expenditure and achieving cost savings.

In addition to strengthening institutions, a further approach may help improve potential trade-offs for fiscal policy: microeconomic aspects of policy that influence economic stability. A key priority in this regard is to avoid creating distortions that could amplify boom–bust cycles in the private sector (such as untargeted mortgage subsidy programmes and interest rate deductibility schemes).

Such institutional and microeconomic priorities need to be pursued over a medium-term time horizon. Nonetheless, they can offer important routes to strengthen the stabilising quality of fiscal policy for any given level of deficit and public debt. They thus can improve considerably the potential trade-offs or complementarities between stability and growth that face policy-makers during the convergence process.

5.7. Fiscal challenges and country situations

When assessing trade-offs or complementarities, a final key consideration is the wide variety of economic and fiscal circumstances in the EU-10.

- A number of the EU-10 economies in central Europe face significant challenges in keeping public debt ratios within prudent bounds. In these economies too, it is plausible that the elasticity of fiscal balances to output is close to that in the EU-15, albeit perhaps somewhat less. Larger fiscal deficits in some cases also pose policy coordination challenges that could affect the exchange market. Output costs of exchange rate variability have proved a concern. Seen from a stability perspective, these factors suggest significant challenges ahead in ensuring that fiscal policy contributes fully to economic stability. On the other hand, these economies may also have greater scope for a restructuring of existing expenditure programmes that is itself growth enhancing. Recent reforms in Slovakia (see Box IV.6) illustrate the scope for enhancing both growth and consolidation.

- Stability risks show a different profile in the Baltic States. Deficit and debt levels are on average far lower. The scope required for automatic stabilisers may be less, and the stabilising impact of fiscal policy is limited by the size of the public sector. Current constraints on policy result mainly from the need to underpin the credibility of currency-board-style exchange regimes, to provide assurance to financial markets that wide external current account deficits do not have their source in any misallocation in the public sector, and to avoid fiscal amplification of trends towards real appreciation.

- In the two island economies, debt and deficit challenges are coupled with the need to ensure the market credibility of their exchange rate pegs. These economies, like those in central Europe, appear to have significant scope for expenditure reforms in achieving consolidation. A factor that differentiates them from the other EU-10 economies is that their financial sectors are already much more fully developed: potential risks that could arise from rapid credit growth are less relevant for them.

The challenges for fiscal policy over the next few years will not be static. As the EU-10 countries, at different times in the future, enter ERM II and adopt the euro, the evolving monetary setting will modify fiscal challenges. Six of the EU-10 countries now participate in ERM II, but these do not include the four larger EU-10 countries in central Europe which currently have flexible exchange rates. For those four countries, policy-mix and credibility risks may come more strongly to the fore in the run-up to euro adoption. This could occur in an environment of rising levels of euro-denominated liabilities, and hence of balance-sheet risks. Moreover, contagion within the group could be an issue. Once they have adopted the euro, some of these economies may still face challenges to ensure scope for automatic stabilisers and to keep public debt on a credibly sustainable path.

In the Baltic States, by contrast, stability concerns may ease somewhat after euro adoption: the issue of hard-peg

credibility will disappear, and debt and automatic stabiliser profiles will remain undemanding. The potential challenge will lie more in how policy should respond to the scale and composition of private sector imbalances. A key will be to ensure that potential growth and revenue performance are assessed prudently. The outlook for public debt and potential growth may allow somewhat less constrained fiscal balance positions within the framework of the reformed SGP. However, in the process of transition, it would be crucial to avoid a fiscal stimulus at cyclically inappropriate times.

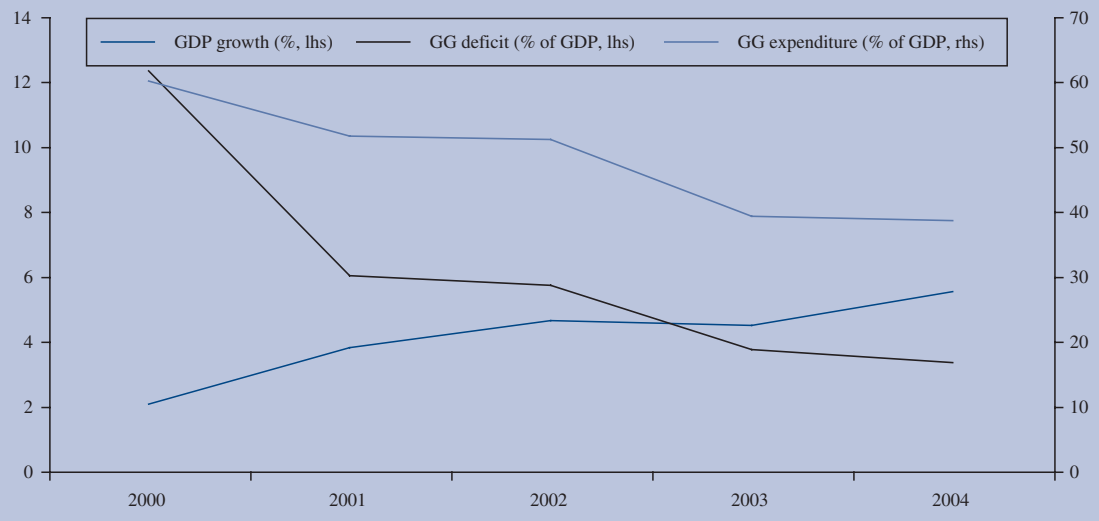
A stylised analysis along these lines is thus somewhat encouraging from a policy perspective. Taking into account the differing profiles of the EU-10, it is plausible that complementarities exist, even in the short run, between growth-enhancing tax and expenditure reforms and decisive progress with consolidation where this is needed.

If such a conclusion were borne out by in-depth country assessments, it would be very important: there is no escaping the urgency, particularly in certain cases in central Europe, of improving substantially both the prospects for growth and the outlook for the fiscal balance. The convergence programmes prepared by the EU-10 offer a vehicle to explore these issues, including dimensions that are matters of common concern.

Box IV.6: **Slovakia: fiscal reforms, strong growth and a declining deficit**

Slovakia illustrates the feasibility of far-reaching public finance reforms, combining growth orientation with fiscal consolidation. Since end-2002, it has implemented a comprehensive tax reform package and a broad array of structural expenditure reforms, while strengthening fiscal institutions. The fiscal deficit and the expenditure ratio fell substantially (to 3.3 % of GDP and 38.5 % of GDP in 2004, respectively), while growth accelerated (to 5½ % in 2004). A strong flow of (greenfield) FDI bodes well for future growth performance. This should facilitate further fiscal consolidation, in combination with a reorientation of expenditure towards Lisbon goals. Achievement of the Maastricht deficit reference value in 2007 is within reach.

Graph IV.17: **GDP growth and general government deficit and expenditure**



Source: Commission services.

(Continued on the next page)

Box IV.6 (continued)

On the revenue side, the tax reform package led to a considerable shift from direct to indirect taxation, simplified the system and increased transparency, strengthening incentives and enhancing growth. Based on preliminary estimates, the reform package appears to have been broadly revenue neutral. Key elements were: the 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 %; increases in several excise taxes; and abolition of some less significant taxes (inheritance tax, gift tax) and amendments to some other smaller taxes (real estate tax, vehicle tax). In addition, health and social insurance contribution rates for employers and employees have been reduced, albeit to a still relatively high total level of some 48 % of gross wages.

On the expenditure side, reforms focused, in particular, on the targeting and incentive aspects of social transfers — improving the growth-enhancing quality and the sustainability of the public finances. Key measures were: (i) reform of pensions: changes in key parameters of the pay-as-you-go pillar (benefit formula with a closer link between contribution history and pension claims, stepwise increase of the retirement age, indexation based more on inflation), and introduction of a sizeable funded pension pillar (diversion of contributions of 9 % of gross wages to that pillar); (ii) other changes to social insurance (e.g. unemployment and sickness benefits), benefits (e.g. child benefits), and assistance, emphasising targeting and incentives; and (iii) changes to healthcare systems (e.g. introduction of co-payments, introduction of individual private health insurance, streamlining of the health benefit package, better incentives and harder budget constraints for healthcare providers).

On the institutional side, as part of a comprehensive public finance management reform project supported by the World Bank, Slovakia has improved all steps of the budget cycle. In particular, the medium-term orientation has been strengthened and, together with the 2005 budget, a detailed multiannual budgetary framework for the years 2005 to 2007 was elaborated. The obligation to submit annual convergence programmes in the context of EU surveillance procedures acted as an additional catalyst for reforms.

Part V

Member State developments

1. Belgium

Recent developments and medium-term prospects

In 2004, the general government accounts posted a slight surplus of 0.1 % of GDP, close to the original target of a balanced budget in the 2003 update of the stability programme. However, this hides a considerable overrun in health expenditure (which grew by some 7.8 % in real terms instead of the planned 4.5 %). The (one-off) proceeds of the tax amnesty law (0.2 % of GDP) were 0.1 % of GDP lower than anticipated in the budget. These negative developments were more than compensated by higher-than-expected tax income (mainly VAT and direct taxes), supported by strong economic growth (2.7 % against 1.8 % projected in the 2003 update of the stability programme). In 2004, the debt-to-GDP ratio decreased further by 4.4 percentage points to 95.6 %, which is lower than foreseen in the 2003 update of the stability programme (97.6 %), mainly as a result of higher-than-anticipated economic growth and a number of financial operations such as the sale of government participations in the telephone company Belgacom and the Brussels airport corporation BIAC.

The 2005 budget was presented in October 2004 and finally approved by Parliament on 23 December 2004. The budget aims at limiting the real growth in federal primary expenditure to 1 % and at maintaining a balance in the social security system through improved expenditure control and a broadening of the tax base, while avoiding new taxes on labour. Although less than in 2004 (0.7 % of GDP), one-off measures still account for some 0.3 % of GDP in the 2005 budget. The initial target of a balanced budget for 2005 was confirmed in the latest update of the stability programme [1] (submitted on 6 December 2004). The Commission services' spring 2005 forecast foresees a small deficit (0.2 % of GDP), based on somewhat less optimistic growth assumptions (GDP growth of 2.2 % against 2.5 % in the budget) and because of some uncertainty regarding the impact of new measures to control spending in healthcare. Accordingly, it projects the cyclically adjusted balance to decrease to 0.3 % of GDP in 2005 (same figure as that based on the latest update of the stability programme).

As for 2006, a deficit of 0.6 % of GDP is projected in the Commission services' 2005 spring forecast, on the basis of a no-policy-change scenario. At this stage, no one-off measures are planned for 2006. Moreover, the implementation of the 2001 direct tax reform will have its main impact in 2006 (over 0.3 % of GDP). So far, the government has not yet announced any new measures that could compensate for these income losses in 2006. This explains the difference with the latest update of the stability programme, which foresees a balanced budget for 2006. For 2007, the government is planning a surplus of 0.3 % of GDP.

According to the spring forecast, the debt ratio is expected to decrease to 94.9 % of GDP in 2005, despite the takeover of an EUR 7.4 billion debt (2.5 % of GDP) from the national railway company SNCB [2]. In 2006, the debt ratio is forecast to reach 91.7 % of GDP, as also foreseen in the 2004 update of the stability programme.

The ageing fund

As in many European countries, Belgium will be confronted with the budgetary impact of an ageing population. The Belgian authorities estimate that the share of people older than 60 will increase from 22 % in 2003 to 31 % by 2030. As a result, the dependency ratio (i.e. the

[1] The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[2] The Belgian programme law of 24 December 2002 stipulates a number of conditions for the takeover of the SNCB debt, among which the condition that it can only take place if it does not affect the deficit and does not increase the debt ratio above 100 % of GDP. According to the programme law of 22 December 2003 and the corresponding royal decree of 30 December 2004, the debt transfer to the State-owned Fund for Railway Infrastructure has been effective since 1 January 2005.

Table V.1

Budgetary developments 2003–08, Belgium

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	0.4	0.1	– 0.2	– 0.6		
— Total revenues	51.3	49.6	49.1	48.5		
Of which: — current taxes	29.9	30.3	30.7	30.3		
— social contributions	16.5	16.0	15.8	15.5		
— Total expenditure	50.9	49.5	49.3	49.0		
Of which: — collective consumption	8.4	8.4	8.3	8.1		
— social transfers (2)	30.6	30.4	30.4	30.2		
— interest expenditure	5.4	4.7	4.5	4.2		
— gross fixed capital formation	1.6	1.5	1.8	2.0		
Primary balance	5.7	4.8	4.3	3.6		
Pm Tax burden	45.7	45.9	45.8	45.1		
Government debt	100.0	95.6	94.9	91.7		
Pm Cyclically-adjusted balance	1.2	0.6	0.3	– 0.2		
Pm Cyclically-adjusted primary balance	6.5	5.3	4.7	4.0		
Pm Real GDP (3)	1.3	2.7	2.2	2.3		
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	0.4	0.0	0.0	0.0	0.3	0.6
Primary balance	5.7	4.9	4.5	4.4	4.5	4.7
Government debt	100.0	96.6	95.5	91.7	88.0	84.2
Pm Real GDP (3)	1.3	2.4	2.5	2.5	2.1	2.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and stability programme of Belgium.

Table V.2

Main measures in the budget for 2005, Belgium

Revenue measures	Expenditure measures
• Continued implementation of the 2001 tax reform (– 0.2 % of GDP)	• Real growth in federal primary expenditure limited to 1 % (zero growth in defence, reduced expenditure by ministries, etc.)
• Reduction of social security contributions on labour, especially for low-income workers (– 0.1 % of GDP)	• Several measures to limit real growth in healthcare expenditure to 4.5 %, for example by freezing medical fees or by reducing the cost of medicine and medical treatment in hospitals (+ 0.2 % of GDP)
• Broadening the base for revenue of the social security system, for example social security contributions on the use of corporate cars and a levy on tobacco (+ 0.2 % of GDP)	
• Rearrangement of the budgetary calendar for a number of government programmes, both on the revenue and expenditure side, for example some planned tax cuts on energy products have been delayed (+ 0.1 % of GDP)	

Sources: Commission services and 2005 budget.

ratio of the number of people under 20 or older than 60 to the number of people between 20 and 59) is expected to increase from 82 % to 106 %.

The Belgian High Finance Council has estimated the direct annual budgetary impact of ageing at 3.4 % of GDP by 2030, mainly as a result of increased pensions

(+ 2.8 % of GDP) and healthcare cost (+ 2.4 % of GDP). This should be partly compensated by lower expenditure in other social benefits (– 1.8 % of GDP, mainly as a result of lower unemployment and family benefits). Indirectly, the demographic evolution could also reduce the budget for education by some 0.7 % of GDP. However, the High Finance Council's estimate of the budgetary impact of ageing can be considered somewhat optimistic, since it would entail a significant drop in the annual real growth rate of healthcare expenditure to 2.8 % on average for the period 2008–30. The official target for 2003–07 is still 4.5 %, whereas in 2004 this figure was overrun with an annual growth rate of 7.8 %. OECD projections also suggest that the Belgian authorities' assumptions on the increase in the employment rate and productivity growth could be on the high side. More cautious estimates lead to an additional 1 % of GDP impact stemming from ageing.

In order to prepare for the budgetary impact of ageing, the Belgian High Finance Council has estimated that increasing the structural budget balance to 0.3 % of GDP in 2007 and further to 1.5 % of GDP over 2011–18 would put public finances on a sustainable path. The structural balance would then fall back to close to zero by 2030, affected by the increasing effects of ageing. Meanwhile, the government debt would fall from about 94 % of GDP in 2007 to around 30 % of GDP by 2030, when it would stabilise.

The Belgian authorities reduced the debt considerably from 137.9 % of GDP in 1993 to 95.6 % in 2004 (according to the latest EDP notification), mainly by securing relatively high primary balances and by using the proceeds of a number of 'below-the-line' one-off operations. The proceeds of these one-off operations could have been used to reduce the debt directly, but instead the Belgian authorities decided to direct most of them to the 'ageing fund'.

The Belgian ageing fund was created by a law of 5 September 2001. It was to be funded with the proceeds from (below-the-line) one-off operations and/or from budget surpluses. A medium-term objective was formulated in 2003 in an agreement between the government partners, when a target of EUR 10 billion (some 3.2 % of GDP) by 2007 was envisaged. In 2004, the government increased its target to EUR 13 billion (about 4.1 % of GDP) by 2007. The ageing fund law of 2001 provided for the fund to be gradually dissolved starting at the moment when the debt ratio falls below 60 %, in order to 'finance' the increasing cost of pension schemes over the period 2010–30. However, the law of 2001 did not foresee any form of yearly mandatory funding, which remained at the full discretion of the federal government.

In 2001, the starting capital of the fund was EUR 615 million (0.2 % of GDP — see Table V.3). In the following years, the fund benefited from the proceeds of several one-off operations. Major contributions came from the sale of the State mortgage credit corporation Credibe (1 % of GDP) in 2003 and the proceeds from the Fadels operation (in which a State-owned social housing financing corporation was dissolved) in 2004 (0.1 % of GDP). The most important source of funding so far stemmed from the transfer of the Belgacom pension fund (1.9 % of GDP) in 2004. However, contrary to all previous cases, this transfer to the ageing fund was accompanied by a similar increase in government pension liabilities.

In 2005, the ageing fund could also benefit from the proceeds of a number of one-off operations, such as the sale of Belgacom shares (0.2 % of GDP), the tax amnesty law (0.2 % of GDP) and the privatisation of the Brussels airport operator BIAC (0.2 % of GDP, including the transfer of the BIAC pension fund). For a number of measures, the government has not yet decided to what extent the proceeds will be used to finance the ageing fund, but the target of EUR 13 billion is well within reach. On 25 February 2005, the government proposed to change the ageing fund law, to provide a fixed contribution to the ageing fund in the period 2007–12. Hence, in 2007 the fund should grow by 0.3 % of GDP. This amount would be increased by 0.2 % of GDP annually to reach a yearly contribution of 1.3 % of GDP in 2012. The share of below-the-line operations would be limited to EUR 250 million (some 0.1 % of GDP) annually until 2010 and to EUR 500 million (0.2 % of GDP) afterwards. The rest of the contribution should come from the government surplus. On the other hand, since the proposed contributions are less than the surpluses considered necessary by the High Finance Council to put Belgian public finances on a sustainable path, additional direct debt reduction will be required.

Assessment

From an economic point of view, investing in the ageing fund is similar to a direct debt reduction. In the case of a direct debt reduction, the government uses a surplus or the proceeds from a below-the-line operation to repay outstanding debt. In the case of an investment in the ageing fund, the public debt is converted into a debt to the

Table V.3

Financing sources of the ageing fund until 2004, Belgium

(million EUR)

Year	Source	Amount	Cumulative
2001	UMTS	437.8	
	Surplus value of gold reserves of the national bank	177.1	
	Short-term interests	9.2	624.0
2002	Profits of the national bank	429.0	
	Short-term interests	2.7	1 055.8
2003	Dividend 2002 Belgacom	237.3	
	Value of unreturned Belgian banknotes after the introduction of the euro	214.0	
	Credibe	2 645.7	4 152.7
2004	Dividend 2003 Belgacom	290.0	
	Short-term interests	6.2	
	Belgacom pension fund	5 000.0	
	Fadels	2 500.0	11 948.9

Source: 2005 budget.

ageing fund by means of a tailor-made 'ageing fund Treasury bond'.

Since the ageing fund falls within the government perimeter, the debt of the Treasury to the ageing fund is internal to the government sector. Consequently, according to the Maastricht definition, the Belgian debt ratio is net of all assets owned by the ageing fund (contrary to an 'external' pension fund, which constitutes an additional buffer against the cost of ageing). When the ageing fund is used for age-related spending in the future, the debt will increase accordingly.

Nevertheless, although an investment in the ageing fund is equivalent to a direct debt reduction of the same magnitude, it has the advantage that it reinforces the political commitment of the Belgian government to maintain the necessary (primary) surplus to prepare for the budgetary impact of population ageing.

The strategy for coping with the budgetary cost of an ageing population outlined by the Belgian High Finance Council is mainly based on gross debt reduction through building up budget surpluses (itself relying primarily on primary expenditure restraint) and an ageing fund. Containing primary expenditures might prove difficult, especially in the healthcare sector, but is important in view of the government's strategy of reducing the tax burden in order to create employment. Given the projected increase in the old-age dependency ratio, pursuing this broad strategy with determination is crucial to the achievement of long-term sustainability.

2. Czech Republic

Recent developments and medium-term prospects

Developments in public finances in 2004 were better than expected, as a result of stronger growth and of a change in budgetary rules in mid-2004 which made it possible for the first time to carry over unspent funds to 2005. This change in budgetary rules led to more prudent behaviour of spending departments. The general government deficit was 3.0 % of GDP, far below the target foreseen in the May 2004 convergence programme (5.3 % of GDP).

The State budget for 2005 was approved by Parliament on 15 December 2004. It reflected the fiscal measures presented in the May 2004 convergence programme. The 2005 budget is the second based on medium-term expenditure ceilings for central government.

On the expenditure side, several discretionary cuts were introduced in order to meet the 2005 expenditure ceiling. On the revenue side, personal and corporate tax relief is to some extent offset by an increase in revenues from VAT and excise duties, partly linked to tax harmonisation after EU accession.

The deficit target for 2005 set in the most recent convergence programme (submitted on 1 December 2004) is 4.7 % of GDP ([1]). This target is likely to be increased by about 0.3 % of GDP as a consequence of the recent decision to consider the spending on military jets as one-off expenditures in 2005. Given a track record of expenditure overestimation and revenue underestimation in the Czech budget, the Commission services' forecast for the 2005 general government deficit is 4.5 % of GDP. This projection assumes that half of the funds carried over from 2004 will be spent in 2005 and it also takes into account one-off military expenditures. If, however, the budget is implemented rigorously and the room for spending, as foreseen in the 2005 budget, is not fully used, as in 2004, the deficit could be lower.

The deficit target for 2006 set in the December 2004 convergence programme is 3.8 % of GDP. The Commission services' projection for that year is a deficit of 4.0 % of GDP, based on the no-policy-change assumption. In the absence of specific measures which are necessary to reach the official target in the election year 2006, the expenditure ceilings for 2006 are not taken into account in the spring forecast. The convergence programme further foresees a reduction in the deficit to 3.3 % of GDP in 2007 and to below 3 % of GDP by 2008.

Gross public debt is expected to decline in 2005 to 36.4 % of GDP, mainly due to privatisation proceeds. In 2006, debt is projected to reach 37.0 % of GDP.

Quality of the central government budgetary process

Fiscal targeting through medium-term expenditure ceilings was formally introduced by the new law on budgetary rules as of 2005. The introduction of expenditure ceilings is a major institutional innovation which should considerably enhance the quality of the budgetary process, in particular the medium-term budgetary planning. The Czech government intends to use expenditure ceilings as a key instrument for deficit reduction. The expenditure ceilings apply only to the central government. The reason is not only the direct control of the central government over those expenditures, but also the fact that the central government is the subsector of general government which historically exhibits the highest deficits. Medium-term ceilings thus apply to total expenditures of both the State budget and seven State 'extra-budgetary' funds (State Fund for the Environment, State Fund for Land Fertilisation, State Fund for Culture, State Fund for Czech Cinematography Support and Development, State Fund for Transport Infrastructure, State Fund for Housing Development, State Agriculture Intervention Fund).

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.4

Budgetary developments 2003–07, Czech Republic

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006	
General government balance	– 11.7	– 3.0	– 4.5	– 4.0	
— Total revenues	41.6	42.7	41.8	41.0	
Of which: — current taxes	21.1	21.3	20.1	19.7	
— social contributions	15.1	14.8	14.8	14.6	
— Total expenditure	53.3	45.7	46.3	45.1	
Of which: — collective consumption	12.3	11.6	11.7	12.1	
— social transfers (2)	24.0	23.2	22.7	21.9	
— interest expenditure	1.3	1.3	1.3	1.4	
— gross fixed capital formation	4.2	3.9	3.9	3.9	
Primary balance	– 10.3	– 1.8	– 3.2	– 2.6	
Pm Tax burden	36.2	36.1	34.9	34.4	
Government debt	38.3	37.4	36.4	37.0	
Pm Real GDP (3)	3.7	4.0	4.0	4.2	
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 12.6	– 5.2	– 4.7	– 3.8	– 3.3
Primary balance	– 11.3	– 4.0	– 3.3	– 2.3	– 1.7
Government debt	37.8	38.6	38.3	39.2	40.0
Pm Real GDP (3)	3.1	3.8	3.6	3.7	3.8

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and convergence programme of the Czech Republic.

Table V.5

Main measures in the budget for 2005, Czech Republic

Revenue measures	Expenditure measures
Personal and corporate tax relief (– 1.1 % of GDP): • a decrease in the corporate income tax rate from 28 % in 2004 to 26 % in 2005 • shortening of depreciation periods for investment • tax allowances for R & D (up to 10 % of the company's tax base) • joint income taxation for married couples (lowering average taxable income) • replacing tax-deductible child allowances with tax credits	• Reduction of social expenditures, notably in the areas of low-income support and unemployment and sickness benefits (0.15 % of GDP) • Discretionary measures in order to meet the 2005 expenditure ceiling (0.1 % of GDP)

Sources: Commission services and December 2004 convergence programme.

Despite this important progress, central government expenditures are not under the full control of the Ministry of Finance which directly controls only the State budget expenditure. The spending of the seven State funds is under the control of individual ministries. This is also reflected in the process of budgetary approval. The budgets of the seven State funds are approved both by the government and by Parliament not only separately from the State budget, but often also individually. This prevents their joint consideration in the context of the overall central government budget. Whereas the State budget is usually subject to an intense political debate, the State funds' budgets are usually passed without significant opposition, which allows their managers to bid

for high budget allocations. High budget allocations tend to result in underspending as was particularly observed for the largest fund (State Fund for Transport Infrastructure). This may lead, on the one hand, to an overestimation of central government expenditures, thus lowering the quality of the Ministry of Finance's medium-term budgetary planning. On the other hand, if budget allocations are unrealistically high, this creates difficulties for the assessment of progress towards the fiscal targets.

The absence of voting on the central government budget as a whole does not fully match the requirements of the central government expenditure ceilings. In particular, it reduces the transparency of the budgetary procedure by making the trade-offs between individual spending items less explicit.

Another major innovation of the budgetary process introduced by the law on budgetary rules is the possibility to carry over unspent funds to the following year. The main motivation of this modification was to change the behaviour of the spending ministries, in particular to minimise wasteful spending towards the end of the fiscal year.

As a result of this change, State budget allocations of about 1 % of GDP were unspent in 2004 and led to a better-than-expected deficit. However, the possibility to carry over the unspent funds creates a challenge for the fulfilment of the budgetary ceiling in 2005 and possibly in the following years. To mitigate this, the government agreed that, at most, 50 % of the expenditures unspent in 2004 can be carried over to 2005. While the change in the budgetary rules was designed to avoid overspending at the end of the year, the surprisingly large amount of unspent allocations in 2004 questions the economic efficiency of some expenditures.

3. Denmark

Recent developments and medium-term prospects

Public finances in Denmark in 2004 were substantially stronger than expected. In the March 2005 EDP notification, the general government surplus is estimated to have been 2.8 % of GDP, compared with the target of 1.3 % of GDP estimated in the 2003 update of the convergence programme. The main factors behind this outcome were higher-than-expected revenues from corporate taxes as well as from the pension fund yield tax, which tend to be volatile as they are linked to financial market developments. The level of the debt ratio continued to decline and stood at 42.7 % of GDP in 2004.

The budget for 2005 was adopted on 15 December 2004. The expenditure measures in the budget were limited and included setting up a high technology fund and spending targeted at health and education (see Table V.7). On the revenue side, the tax reform was fully implemented in the context of the March 2004 spring fiscal package. The so-called tax freeze remains in force (see following section). Against the background of an expected continued robust GDP growth, a general government surplus of 2.0 % of GDP is foreseen in 2005. This is close to the Commission services' spring 2005 forecast. As measured by the change in the cyclically adjusted balance, the fiscal stance in 2005 in the spring 2005 forecast is an easing, but this needs to be interpreted with caution ([1]).

In 2006, a general government surplus of 2.1 % of GDP is foreseen in the Commission services' spring 2005 forecast. This is overall in line with the projection in the November 2004 update of the convergence programme ([2]). Beyond 2006, the projected evolution of the general government balance in the convergence programme update is of surpluses between 1¾ % and 2 % of GDP. This is within the government's medium-term average target interval for the general government balance.

As a consequence of the successive general government surpluses, the government debt ratio is set to decline further and according to the spring 2005 forecast reach around 38 % of GDP in 2006.

Achieving the objective of modest real public consumption growth

In order to address the long-term challenge of an ageing population, Denmark's fiscal strategy aims at substantially reducing the gross government debt ratio between 2000 and 2010 by running yearly general government surpluses of 1½ to 2½ % of GDP on average to 2010. General government surpluses have been recorded since 1998 and continued sizeable surpluses are foreseen in the coming years. This strategy also foresees a lowering of taxes. To this end, income taxes were reduced in 2004 to the tune of ½ % of GDP in the context of the tax reform. In addition, the burden of taxation is being continuously lowered in real terms as a consequence of the so-called nominal principle of the tax freeze in force since 2002, which implies that taxes, whether expressed in fixed nominal krone terms or in percentage terms, cannot be raised. This includes residential property value taxes, where a nominal ceiling has been set for tax payments of homeowners. The revenues from these taxes and duties are thus eroded as a share of GDP as a consequence of inflation and growth.

An important element in the fiscal strategy to create room for the tax reductions is to set strict targets for the growth of real public consumption. Public consump-

([1]) Based on the fiscal projections at the time of the presentation of the budget, the budget for 2005 was set to be broadly neutral. However, mainly due to the exceptionally high tax revenues in 2004 mentioned above (not necessarily linked to the cycle), the surplus in 2004 has been revised upwards and the fiscal stance in 2005 thus appears as an easing.

([2]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.6

Budgetary developments 2003–10, Denmark

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**		
General government balance (2)	1.2	2.8	2.1	2.2		
— Total revenues	56.6	57.7	56.5	55.7		
Of which: — current taxes	46.8	47.9	47.0	46.5		
— social contributions	2.7	2.7	2.7	2.6		
— Total expenditure	55.3	55.0	54.3	53.5		
Of which: — collective consumption	7.6	7.6	7.5	7.4		
— social transfers (3)	37.1	36.9	36.5	36.0		
— interest expenditure	2.5	2.3	2.2	2.0		
— gross fixed capital formation	1.7	1.7	1.8	1.7		
Primary balance	3.8	5.1	4.3	4.2		
Pm Tax burden	48.9	50.1	49.1	48.6		
Government debt	44.7	42.7	40.5	38.2		
Pm Cyclically adjusted balance	2.0	3.4	2.5	2.4		
Pm Cyclically adjusted primary balance	4.5	5.7	4.7	4.4		
Pm Real GDP (4)	0.4	2.4	2.3	2.1		
Convergence programme (5)	**2003**	**2004**	**2005**	**2006**	**2007**	**2010**
General government balance	1.2	1.2	2.0	1.6	1.7	2.0
Primary balance	4.6	4.3	4.8	4.5	4.6	4.4
Government debt	44.7	42.3	39.4	37.4	35.3	28.8
Pm Real GDP (4)	0.5	2.2	2.5	1.3	1.9	1.8

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second-pillar pension funds, these funds can continue to be classified inside the general government sector until the March 2007 EDP notification. This is the case in Denmark and has an estimated positive effect on the general government balance of 1.1 % of GDP in 2003, 1.0 % in 2004 and 1.0 % in 2005 and 2006 and on the debt of 1.2 % of GDP in 2003–06.
(3) In kind and other than in kind.
(4) Annual % change.
(5) Submitted in November 2004.

Sources: Commission services and convergence programme of Denmark.

Table V.7

Main measures in the budget for 2005, Denmark

Revenue measures	**Expenditure measures**
• Adjusted excise duties (within the framework of the tax freeze), for example lower duties on beer and wine, higher duties on cigarettes • Lower taxes on 'green' fuels (– 0.04 % of GDP)	• High-technology fund (impact in 2005: 0.2 % of GDP) • Increased pension and health spending (0.04 % of GDP) • Strengthening science education (0.05 % of GDP)

Sources: Commission services and Danish Ministry of Finance.

tion represents around a quarter of Denmark's GDP and its development therefore has a large impact on public finances. Looking back, average yearly real public consumption growth since 1980 has been some 1.6 %. This is only slightly less than real GDP growth (1.7 %). In the present strategy, the targets for public consumption are a maximum growth of 0.5 % a year on average from 2005 to 2010. The target is thus markedly lower than the projected growth of the economy. The projected modest real growth rate of public consumption is a key target variable in the fiscal strategy and failure to comply with the targets could compromise the strategy,

including the fiscal leeway for the tax reductions implemented.

The largest share of public consumption, including healthcare and elderly care, is the responsibility of local governments. Direct control by the central government of local government public expenditure is therefore difficult. Aggregate public expenditure at local government level is determined in a system of formalised cooperation in the framework of the yearly budget negotiations between the local government associations and the central government. The agreements resulting from these negotiations include the aggregate expenditure levels and tax rates as well as the size of the block grants from central to local governments. This agreement is then part of the basis for the central government budget and the projections for the development of government finances as a whole.

Danish local governments have autonomous taxing powers. Against this background, a key instrument for achieving expenditure restraint is the tax freeze, in force for all levels of government since 2002. As borrowing by local governments is restricted, the tax freeze implies that local governments cannot raise taxes to finance additional expenditure and it thus promotes a stricter prioritisation of expenditures. Apart from preventing tax increases, the tax freeze is thus also intended as a disciplining factor in achieving the objective of modest growth in public consumption. However, the tax freeze is an indirect instrument and does not legally bind individual local governments. A sanction mechanism was therefore introduced, also as from 2002, which implies that local governments and counties could be penalised if they fail to respect the tax freeze. If the local governments' budgets imply a breach of the tax freeze, the block grants to local governments may be reduced or postponed. To keep total public sector revenues unaffected, central government taxation will in such a case be lowered correspondingly.

Overall, compliance with the expenditure and tax agreements across government levels seems to have improved in recent years and there have been no significant breaches of the tax freeze by local governments. Real public consumption growth has been on a downward trend since 2003. From 2.1 % in 2002, it fell to 0.7 % in 2003. While this outcome exceeded the official target of an average yearly growth of 1 % for 2002 and 2003, there seems to have been a shift towards more modest growth. This is confirmed by the growth of real public consumption in 2004 which is estimated to have been around the 0.7 % target for that year. The tax freeze thus seems to have been successful as a disciplining force for public consumption expenditure at local government level. Nevertheless, in view of past trends, the targets for the coming years remain ambitious. Restraining the growth of public consumption substantially below the growth of income and overall standard of living may prove challenging over time.

In this context, structural factors may also play a role. Increased efficiency in public services could potentially alleviate the pressure on public consumption spending. In this vein, a reform of Denmark's public sector structure has been adopted and will be implemented in 2007. In order to create larger units, more appropriate for dealing effectively with the tasks assigned to them, the number of municipalities will be reduced from 271 to around 100 and the 13 counties transformed into five regions. While spending increases in a context of a transition phase cannot be excluded, by creating larger administrative units this reform has the potential to improve efficiency in the provision of public services in the medium term through economies of scale.

4. Germany

Recent developments and medium-term prospects

The general government deficit edged down to 3.7 % of GDP in 2004 against a target of 3.3 % according to the 2003 update of the stability programme. The major measure on the revenue side was the income tax cuts worth 0.7 % of GDP implemented at the beginning of 2004 as part of the tax relief laws passed in 2000, which were partly financed by a broadening of the tax base. The deviation from the target has several causes. The increase in the tobacco tax rate in March 2004 did not generate as much revenue as expected. A tax amnesty, aimed at repatriating savings currently deposited undeclared abroad, fell short of plans by 0.2 % of GDP. Also, the Bundesbank profit of 2003 was below government expectations. Expenditures on transfers such as unemployment and social assistance benefits were higher than expected but this was offset by savings on the public sector wage bill. The deficit slippage translated into public debt at 66.0 % of GDP, higher than expected in the 2003 update of the stability programme.

The federal budget for 2005 was adopted retroactively on 18 February 2005. Tax receipts will be dampened by the implementation of the last stage of the tax relief law dating back to 2000, whereas the introduction of the road toll will add to revenues. Subsidy repayments by several *Landesbanken* add to several *Länder* budgets. The moderate wage agreements in the public sector, concluded in February 2005, were anticipated in the 2005 draft federal budget. Finally in 2005, the cash settlement office for the former postal civil servants plans to securitise future transfer income from the post office's successor companies, so that the cash office would not require a transfer from the federal budget to cover its liquidity deficit. If compatible with ESA 95 accounting rules — a specific Eurostat decision is still pending — this transaction would reduce government expenditure by 0.25 % of GDP. The 2004 update of the stability programme ([1]) targets the general government deficit at 2.9 % of GDP, compared with the Commission services' spring forecast at 3.3 % of GDP. The update projected the cyclically adjusted balance to decline by 0.6 percentage points in 2005, broadly in line with the Commission services' projection of a decline by 0.5 percentage points. Compared with the 2004 update of the stability programme, the widening of the headline deficit as projected by the Commission services is consistent with the estimated impact of the considerable downward revision of GDP growth since then.

The Commission services' spring forecast expects the deficit to fall to 2.8 % of GDP in 2006, compared with the update's projection of 2½ % of GDP. Growing private consumption is expected to bolster tax revenues, while the forecast assumes no further tax cuts, consistent with the usual assumption of unchanged policies. Subsequently, on 4 May 2005, the government presented a draft law proposing to reduce the corporate tax rate from 25 % to 19 % from 2006 onwards. It expects the rate cut to be financed by repatriation of taxable income, by limiting tax set-off from loss carry-forward and closed-end funds and by tax incentives for uncovering hidden real estate assets. A further draft law proposed inheritance tax relief upon transfer of business to relatives. The public sector wage agreements concluded in 2005 also provide budgetary relief in 2006. Expenditure growth should accelerate moderately. The 2004 update of the stability programme projects the deficit to decline to 1½ % of GDP in 2008. This path of budgetary adjustment seems rather optimistic, in particular as regards the expected surpluses of the social security system. Furthermore, tax revenues seem to be estimated somewhat favourably from 2006 onwards. It should also be noted that the one-off measure by the postal pension cash office has a negative impact on the budgetary position in the later years.

([1]) The programme (submitted on 1 December 2004), as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.8

Budgetary developments 2003–08, Germany

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	– 3.8	– 3.7	– 3.3	– 2.8		
— Total revenues	45.0	43.8	43.6	43.4		
Of which: — current taxes	22.6	22.1	22.0	22.1		
— social contributions	18.6	18.2	18.0	17.8		
— Total expenditure	48.8	47.5	47.0	46.2		
Of which: — collective consumption	7.9	7.7	7.5	7.3		
— social transfers (2)	31.1	30.4	30.2	29.7		
— interest expenditure	3.1	3.0	3.0	3.0		
— gross fixed capital formation	1.5	1.4	1.4	1.4		
Primary balance	– 0.7	– 0.6	– 0.3	0.2		
Pm Tax burden	40.7	39.9	39.6	39.5		
Government debt	64.2	66.0	68.0	68.9		
Pm Cyclically adjusted balance	– 3.2	– 3.3	– 2.8	– 2.3		
Pm Cyclically adjusted primary balance	– 0.1	– 0.3	0.3	0.7		
Pm Real GDP (3)	– 0.1	1.6	0.8	1.6		
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 3.8	– 3¾	– 2.9	– 2½	– 2.0	– 1½
Primary balance	– 0.7	– ½	0.0	½	1½	2.0
Government debt	64.2	65½	66.0	66.0	6½	65.0
Pm Real GDP (3)	– 0.1	1.8	1.7	1 ¾	2.0	2.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure. Note that the data do not include the recalculation of 'financial intermediation services indirectly measured' (FISIM) in GDP.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and stability programme of Germany.

The Commission services' spring forecast projects public debt to increase to 68.0 % of GDP in 2005, compared with the 2004 update's target of about 66 %. About 1 percentage point of the difference is due to the considerably lower GDP growth expected by the Commission services. The remaining difference can be explained by the different deficit projections and by below-the-line operations. In contrast to the update, the Commission services expect the debt ratio to increase further to 68.9 % of GDP in 2006.

Health sector reform: cost reduction in 2004, but more efforts needed

The public health system has been subject to repeated reforms in the past, with the most recent having entered into force in 2004, in response to an ageing population and technical progress in health technology. Rising expenditures by the system, which is organised as pay as you go and covers about 90 % of the population, are driving up non-wage labour costs and contribute to the increasing wedge between gross and net wages.

Expenditure by the public health system rose from 6.3 % of GDP in 1991 to 7.0 % in 1995, then dropped to 6.6 % after several cost-cutting measures but rose again to 6.8 % in 2003. The 2000 reform of the public sector strengthened global budgeting in the sectors ambulatory treatment, medication and hospitals, but also contained extensions in refundable services. In 2003, it emerged that the public health insurers had accumulated debt of about 0.5 % of GDP (according to the national accounts) between 2001 and 2003. By law, the public health insurers are independent units setting their own contribution rates, and were in general not allowed to run a deficit at the end of any year.

Table V.9

Main measures in the budget for 2005, Germany

Revenue measures	Expenditure measures
• Third and last stage of the 2000 tax reform enters into force. The linear-progressive income tax rate falls from 16 % to 15 % at the bottom, while falling from 45 % to 42 % at the top (– 0.3 % of GDP). • Introduction of road toll for lorries (0.1 % of GDP) • Old-age income law: gradually from 2005 onwards, pension contributions will be tax free for all pillars and types of pensions, while pension payments will be fully taxed (in 2005: – 0.05 % of GDP) • Changes in contribution rates to social security: the pension sustainability law (adopted in 2005) aims at a medium-term rate of 19.5 % (same as in 2004). From 1 July 2005, the contribution rate for persons insured in the public health system rises by 0.9 % to cover dental replacements. The law expects public health insurers to lower the contribution rate by the same amount for other health services as a consequence of the 2004 health reform. The contribution rate to the old-age care insurance rises for pensioners and persons without children. • *Länder* budgets: subsidy repayments by Landesbanken (0.1 % of GDP)	• One-off measure by the postal pension office will require no transfer from federal budget to the office (– 0.25 % of GDP) • A 'sustainability factor' is introduced in the public pay-as-you-go pension system that should automatically dampen pension payments (and hence the contribution rate) when the number of recipients rises relative to the number of contributors. However, the factor is capped so that nominal decreases in individual pension payments do not occur. With low nominal wage growth, the dampening effect of this factor is likely to be low in 2005. • The wage agreement for the federal and local levels was concluded in February 2005 and will be implemented on 1 October 2005 and last until December 2007. It foresees a fixed payment for employees for each year in the federal service and in municipalities in western Germany and a gradual wage increase for employees in eastern German municipalities. Bonus payments are frozen at current levels. Working hours are extended slightly.

Sources: German Federal Ministry of Finance and Commission services' estimates.

Thus, further health reforms became one of the central elements of the 'Agenda 2010' announced by the government in March 2003. The law on modernisation of the health sector was passed in October 2003 and entered into force on 1 January 2004.

Overall, the draft law foresaw relief for the health sector budget amounting to EUR 9.8 billion (0.5 % of GDP) in 2004, of which EUR 7.2 billion (0.3 % of GDP) is expenditure related. The total relief is expected to rise to EUR 23 billion in 2007 (also roughly 0.5 % of GDP then) compared with an unspecified baseline ([1]). However, from the draft law, it appears that the expenditure savings arise to a large extent in 2004, with only small lasting 'structural effects' from independent benefit analysis of medication (see below). The draft law further reckons on savings of 'several billion euro' from better incentives for service providers and consumers. However, as illustrated below, after 2004 the expenditure dynamics can be expected to be roughly unchanged from the trend before 2004. The expected rising nominal budgetary relief after 2004 is almost entirely due to expected receipts from increasing the tobacco excise duty and, from 2006 onwards, higher contributions.

The insurers were obliged by law to pass on the savings to patients via lowering of the contribution rates; however, they were also required to reduce their debt by at least one quarter annually until the end of 2007.

In detail, the 2004 law involved cuts in the catalogue of goods and services refundable by the system, a better incentive structure to raise cost-awareness of patients and providers, and some steps to strengthen competition in the sector. In the public health system, expenses for medical treatment are usually fully settled between service providers and insurers without the involvement of patients. To mitigate disincentives, a fixed quarterly fee for ambulatory health services was introduced. In addition, patients were offered the choice of switching to a system in which they receive the bill first and get reimbursed by the public insurer, which met with faint response. Although the number of medical consultations fell in 2004, incentives for cost-containment do not seem strong enough without some financial participation of patients for each ambulatory treatment.

([1]) Draft law of 8 September 2003, *Bundestags-Drucksache* No 15/1525.

The 2004 law also foresaw that from 2005 onwards dental replacements would be taken out of the statutory public health system and funded through a separate, still mandatory, system. Patients would have had to pay an amount per head (thus independent of the individual wage), having the choice between public and private insurers. As a result of the ongoing controversy over the financing mode of the system, this reform element was reversed before it was implemented.

Co-payments for prescribed medication were increased and the price regulation on prescription medication extended. Also, the remuneration of chemists was altered such as to provide incentives to sell lower-priced medication of the same class. Yet, despite permitting mail-order and small chains of pharmacies, barriers to entry into the retailing of medication remain. A newly established institute will provide producer-independent benefit analysis of medication and guidelines for treatment. The public health system is still characterised by collective contracting of fees between insurers and service provider organisations. Although a fair amount of competition takes place between public health insurers, it is almost non-existent between service providers. Individual contracting has now been permitted in limited areas, but this is only a first step in the right direction.

In 2004, expenditure in the public health sector fell by 3.3 % compared with 2003 (in financial accounts), equalling a year-on-year expenditure reduction of about 0.2 % of GDP. A reduction in medication expenditure by 9.5 % provided the largest contribution, reflecting both cost-cutting measures and reduced demand due to co-payments. Expenditure on ambulatory treatment declined by 5.8 % year on year, reflecting the positive allocation effect of the fixed quarterly fee. This matches roughly the projected expenditure reduction by 0.3 % of GDP compared with the (unspecified) 'baseline' as projected in the draft law, if it is assumed that without reform expenditures would have risen by 0.1 % of GDP, as they did annually between 2000 and 2003.

According to the financial accounts, the public health insurers ran a surplus of almost 0.2 % of GDP in 2004. This points to a debt reduction of more than the minimum legal requirement. Whether in 2005 contribution rates will indeed fall is not certain, however. If most of the expenditure savings in 2004 were indeed a one-off effect with unchanged dynamics, expenditures could be expected to continue rising by 0.1 % of GDP annually. It is not certain whether this leaves enough room for lowering contribution rates, in particular as the contribution base, the gross wage sum, is expected to rise only slightly. To hold future healthcare expenditure below past growth rates, further efficiency-enhancing measures are necessary in the medium term, not only for patients but also for healthcare providers and insurers.

At the same time, this underlines the still unresolved structural problem of the public health system, namely that its funding depends on the gross wages. This will have to be tackled by future reforms.

5. Estonia

Recent developments and medium-term prospects

The general government posted a surplus of 1.8 % of GDP in 2004. This compares with a targeted surplus of 0.7 % of GDP in the 2004 budget. The overshooting was due to public revenues being boosted by stronger-than-anticipated real growth coupled with nominal expenditure ceilings, and improving tax collection (see special topic section on e-tax below). The country's public debt ratio further declined to 4.9 % of GDP at the end of 2004, which is the lowest in the EU.

The budget for 2005 was adopted by Parliament on 8 December 2004. The main measures on the revenue side were a cut of the flat income tax rate by 2 percentage points to 24 %, combined with an increase in the tax-free threshold both of which entered into force on 1 January 2005. On the expenditure side, EU co-financing requirements and increases to family allowances as well as funding of an ongoing labour market policy package are the main budgetary measures.

The target for the general government balance in 2005 according to the December 2004 update of the convergence programme ([1]) is a balanced position, whereas the Commission services' 2005 spring forecast expects a surplus of 0.9 % of GDP, allowing for the upside risk to the cautious macroeconomic scenario underlying the Estonian budget forecast, which suggests that revenues could be higher and expenditure somewhat lower than budgeted. A strong echo effect from delayed VAT tax collection related to EU accession can be expected to provide an additional boost to budgetary revenues. On the other hand, unexpected revenue shortfalls from the tax cut or an adverse impact on growth from exogenous shocks cannot be excluded altogether. Although committed to continued fiscal discipline, the recent coalition agreement of a centre-left government which took office in April 2005 increases the possibility of a supplementary budget later in the year, using up some of the fiscal room for manoeuvre contained in the 2005 budget forecast to finance pension increases which are still planned this year. But on the whole, the new government will have little impact on the implementation of the 2005 budget, given the nominal expenditure ceilings. It will be rather with the 2006 budget currently under discussion that an impact will be made.

According to the Commission services' spring 2005 forecast, the general government balance in 2006 is expected at a reduced surplus of 0.5 % of GDP. Again, this is somewhat more optimistic than the December update of the Estonian convergence programme, which projects balanced budgets over the entire period 2005–08. The rationale for this assumption in the Commission services' forecast lies with Estonia's track record of prudent forecasting and repeated overshooting of fiscal targets over the past few years. Accordingly, the same caveats as for 2005 apply. The Commission services' forecast is based on the customary no-policy-change assumption. The 2005 income tax cut by 2 percentage points was planned as a first step of three successive tax cuts, which should lead to a 20 % flat tax rate by 2007. However, the new government's programme foresees a more gradual reduction in the tax rates from 2006 onwards, by just 1 percentage point per year, thereby reaching the 20 % rate by 2009 instead, while raising the tax-exempt threshold.

On the whole, there is still a considerable amount of uncertainty surrounding the economic policy of the new Estonian government, notably with regard to the possible introduction of a motor vehicle tax from 2006, in order to create higher revenues for increased expenditure on pensions, disability and other social benefits. Local

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/ectivities/sgp/main_en.htm

Table V.10

Budgetary developments 2003–08, Estonia

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	3.1	1.8	0.9	0.5		
— Total revenues	38.9	40.9	40.8	39.2		
Of which: — current taxes	21.9	21.4	21.2	20.4		
— social contributions	11.5	11.2	11.2	10.9		
— Total expenditure	35.8	39.1	40.0	38.7		
Of which: — collective consumption	8.8	8.7	9.0	8.8		
— social transfers (2)	19.5	20.2	20.9	20.8		
— interest expenditure	0.3	0.2	0.2	0.2		
— gross fixed capital formation	3.4	3.6	4.3	4.2		
Primary balance	3.3	2.0	1.1	0.7		
Pm Tax burden	33.4	32.9	32.7	31.7		
Government debt	5.3	4.9	4.3	4.0		
Pm Real GDP (3)	5.1	6.2	6.0	6.2		
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	3.1	1.0	0.0	0.0	0.0	0.0
Primary balance	– 3.4	– 1.3	– 0.2	– 0.2	– 0.2	– 0.2
Government debt	5.3	4.8	4.6	4.3	3.1	2.9
Pm Real GDP (3)	5.1	5.6	5.9	6.0	6.0	6.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and convergence programme of Estonia.

Table V.11

Main measures in the budget for 2005, Estonia

Revenue measures	Expenditure measures
• Personal income tax: increase in tax-free threshold for low income bracket (– 0.3 % of GDP)	• Increase in various labour market measures (+ 0.1 % of GDP)
• Personal income tax: lowering of tax deduction limit by half (effective from 2006 only: + 0.05 % of GDP)	• Increase in family allowances (+ 0.1 % of GDP)
• Personal income tax: reduction in income tax rate from 26 % to 24 % (– 0.8 % of GDP)	• Increase in agricultural subsidies and support to farmers (+ 0.2 % of GDP)
• Increases in excise duties on tobacco, alcohol and fuel (+ 0.2 % of GDP)	• Support to local governments including investment grants etc. (+ 0.3 % of GDP)
• Increase in gambling taxes (+ 0.1 % of GDP)	

Sources: Commission services and Estonian Ministry of Finance.

government deficits have started to come down, and can be expected to decline further as a result of a new legal framework which will enter into force in 2006.

Estonia's public debt is forecast to decline further to 4.3 % of GDP in 2005 and to 4 % in 2006, according to the Commission services' spring 2005 forecast.

Improving tax collection in Estonia: the e-tax

Tax collection in Estonia is probably the most advanced e-government feature in place in the EU. In 2000, the government established the so-called 'e-tax board', allowing for the entire tax declaration and collection cycle to be processed over the Internet, via e-mail, and through Internet banking. Both the income and corporate flat tax and VAT are collected through simple and partly pre-filled forms which are available both in electronic and paper versions. The electronic version can be downloaded from the government's websites or via the Internet portals of the country's leading banks. The forms for income tax are identical for employees and the self-employed, and thus companies are not burdened with the income tax administration of their employees. After just five years following its introduction, the e-tax system enjoys wide popularity among taxpayers. In 2005, already 78 % of total personal income tax returns for the year 2004 are being collected over the Internet. Also, companies rapidly embraced the new system. In 2004, 65.8 % of income and social tax declarations and 74.8 % of VAT declarations were submitted electronically to the tax authorities. The system is completed by a highly efficient Tax Fraud Investigation Centre, which has been granted powers of surveillance and pre-trial investigation. In order to counteract tax evasion, a statistical risk analysis of the average tax duties per industry and company size is carried out each year by the tax authorities. Companies or individuals that deviate strongly from these benchmarks or fail to declare at all receive a warning letter from the competent tax authority, and become the focus for onsite inspections. Sanctions are, however, not applied immediately, so the tax subject has a period of grace for filing a new tax return after the expiry date. The system has not only simplified the burden of tax administration for both sides, but it has also greatly speeded up the process. Repayments of tax to individuals are processed within a maximum of three working days following reception of the electronic declaration, although in reality this is often done within just one or two days. There are no hard estimates available on the impact ofthis taxpayer-friendly system on tax returns. However, the high flow of revenues in both 2003 and 2004 (which was one reason for the higher-than-forecast budget surpluses in each of these years) is most likely partly accounted for by these improvements in tax collection. A desirable side effect is that parts of the country's grey economy (which is still estimated at 12 to 15 % of GDP) are being successfully 'whitened' by this combination of simplicity in declaration and efficiency in surveillance.

6. Greece

Recent developments and medium-term prospects

According to the March 2005 EDP notification communicated by the Greek authorities but not validated by Eurostat (see Box I.1 in Part I, Section 2.3.1), the general government balance recorded a deficit in 2004 of 6.1 % of GDP, despite strong economic growth of 4.2 % achieved during the year. This compares with a deficit target of 1.2 % of GDP in the December 2003 update of the stability programme. The slippage of 4.9 % of GDP is only partly attributed to the statistical revisions of September 2004 amounting to 1.1 % of GDP. The bulk is explained by tax shortfalls and expenditure overruns, of which Olympic Games account for 0.7 % of GDP. On top of the slippages unveiled in the September 2004 EDP notification, which at that time estimated a deficit of 5.3 % of GDP, the EDP March 2005 notification shows additional slippages stemming from higher interest payments (0.3 % of GDP) and tax shortfalls (0.1 % of GDP), as well as primary expenditure overruns (0.5 % of GDP). In 2004, the debt ratio reached 110.5 % of GDP, well above the figure of 98.5 % projected in the 2003 update of the stability programme. The difference is the result of the statistical revisions in the debt figures over the period 2000–03 (7.7 % of GDP on average per year) and a higher deficit.

On 22 December 2004, Parliament adopted the 2005 budget. Based on an optimistic growth forecast of 3.9 %, the 2005 budget targets a general government deficit of 2.8 % of GDP and a debt ratio of 109.5 % of GDP. The 2005 budget includes a number of new measures. On the revenue side, a tax reform will be carried out, the main characteristics of which are: an increase in the non-taxable income threshold of certain categories of employees, a gradual reduction in corporate tax rates over the next three years, and the implementation of Law No 3259/2004, providing for a settlement of tax disputes including delinquent obligations to the State. On the expenditure side, the policy measures include a permanent reduction in expenditure following the completion of the Olympic Games, a reduction in investment grants, moderate increases in wages and pensions and an extremely restrictive hiring policy in the public sector.

On 29 March 2005, the government announced a package of additional measures, which should lead to a deficit reduction of 0.5 % of GDP in 2005 and 0.9 % in 2006. The target for the general government deficit in 2005 set in the March 2005 update of the stability programme [1] is 3.7 % of GDP with economic growth at 2.9 %. In the Commission services' spring 2005 forecast, a similar growth rate is projected for 2005 but the projected deficit outcome is significantly worse, at 4.5 % of GDP. The difference is explained partly by the budgetary impact of the additional fiscal measures to be implemented in 2005, which were announced after the cut-off date of the Commission forecast and partly by a more cautious assessment of social security contributions and expenditures on public health and wages.

According to the Commission services' spring 2005 forecast, the cyclically adjusted balance (CAB) in 2005 will improve by 1.6 percentage points of GDP. Despite this improvement, the deficit, net of cyclical factors, will be above 5 % of GDP, still far from a budgetary position of close to balance or in surplus. The estimated improvement in the CAB in 2005 according to Commission services' calculations on the basis of the projections in the updated stability programme is 2.6 percentage points. The difference of 1.0 percentage point with the Commission services' forecasts is due to (i) the fact that the additional fiscal package was not taken into account in the Commission services' forecasts and (ii) a lower Commission services' estimate of potential output.

[1] The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.12

Budgetary developments 2003–07, Greece

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006
General government balance	– 5.2	– 6.1	– 4.5	– 4.4
— Total revenues	43.5	43.9	44.3	44.3
Of which: — current taxes	23.5	23.2	23.2	23.1
— social contributions	15.5	16.3	16.8	17.2
— Total expenditure	48.0	50.0	48.8	48.7
Of which: — collective consumption	10.2	10.9	10.8	10.5
— social transfers (2)	24.1	24.8	25.7	26.4
— interest expenditure	5.8	5.8	5.5	5.5
— gross fixed capital formation	4.0	4.1	3.3	3.1
Primary balance	0.6	– 0.4	1.0	1.0
Pm Tax burden	36.5	36.9	37.4	37.6
Government debt	109.3	110.5	110.5	108.9
Pm Cyclically adjusted balance	– 5.7	– 7.1	– 5.5	– 5.3
Pm Cyclically adjusted primary balance	0.1	– 1.4	0.0	0.1
Pm Real GDP (3)	4.7	4.2	2.9	3.1

Stability programme (4)	2003	2004	2005	2006	2007
General government balance	– 5.2	– 6.1	– 3.7	– 2.9	– 2.4
Primary balance	0.6	– 0.4	1.8	2.7	3.3
Government debt	109.3	110.5	109.5	107.2	104.7
Pm Real GDP (3)	4.7	4.2	2.9	3.0	3.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2005.

Sources: Commission services and stability programme of Greece.

Table V.13

Main measures in the budget for 2005, Greece

Revenue measures	Expenditure measures
• Gradual reduction in corporate tax rates over the period 2005–07	• Permanent reduction in expenditure linked to the completion of the Olympic Games
• Implementation of Law No 3259/2004 (settlement of tax disputes including delinquent obligations to the State	• Reduction in investment grants
• Streamlining of the existing system of tax exemption	• Moderate increase in public wages
• Restructuring of tax brackets and increase in the non-taxable income threshold of certain categories of employees	• Restrictive hiring policy and reductions in current operating expenditure
• Increased efforts to fight tax evasion, illegal trade and financial crime	• Moderate increase in pensions

Source: Commission services.

Under the usual assumption of unchanged policy, the Commission services' spring forecast expects a marginal improvement in the deficit in 2006 reflecting the moderate acceleration of economic growth. The general government deficit is projected to reach 4.4 % of GDP compared with a target of 2.9 % of GDP in 2006 set in the reference scenario of the March 2005 update of the stability programme According to the update, the general government deficit is projected to reach 2.4 % of GDP in 2007.

According to the Commission services' spring 2005 forecast, the debt ratio is expected to stabilise at 110.5 % of GDP in 2005 and to decline slightly in 2006 to 108.9 % of GDP. This compares with the projections in the updated stability programme of 109.5 % of GDP in 2005 and 107.2 % in 2006. The difference is due to higher deficit projections and to lower nominal growth featured in the Commission services' outlook.

7. Spain

Recent developments and medium-term prospects

In 2004, according to the March 2005 EDP notification, the general government deficit is estimated to have been 0.3 % of GDP. This compares with a close-to-balance position projected in the 2004 budget law and a surplus of 0.1 % of GDP in the January 2004 updated stability programme. However, by the end of 2004, the authorities expected a deficit of 0.8 % of GDP due to one-off statistical operations. The better-than-expected outturn of the most recent estimation is explained by unexpectedly higher revenues, partially offsetting the effect of two one-off statistical operations, consisting of the reclassification of RTVE (the public broadcasting company), as requested by Eurostat, and the assumption of RENFE's (the railway network company) debt, decided by the government. Except for the annual RTVE deficit (at around 0.1 % of GDP), the reclassification of RTVE does not affect the general government balance and translates directly into a debt increase by the amount of RTVE's cumulated debt (about EUR 8 billion or around 1 percentage point of GDP).

Conversely, the assumption of RENFE's debt results in higher-than-initially-planned gross fixed capital formation and capital transfers by the general government sector with an impact on the 2004 deficit of 0.7 % of GDP. This reclassification neither involves any backward revision nor has carry-over effects in the coming years. After netting out such one-off operations, the budgetary outcome would have been a surplus of a ½ percentage point of GDP. Regarding the composition of the 2004 balance, the deficit of central government (1.3 % of GDP) is partially compensated by the surplus of the social security sector (1.0 % of GDP), whereas regional and local authorities are broadly in balance. Public debt is estimated at 48.8 % of GDP in 2004.

In 2005, according to the most recent update of the stability programme ([1]), a surplus for the general government of 0.1 % of GDP is projected. This coincides with the target set in the 2005 budget law adopted by the government on 27 December 2004. The central government presents a deficit of 0.6 % of GDP, whereas regional and local authorities are in balance and the social security sector expects a surplus of 0.7 % of GDP. This is in line with the Commission services' spring 2005 forecast, which projects a balanced budget in nominal and cyclically adjusted terms for the general government.

In more detail, according to the 2005 budget law, revenues should increase by 6.4 % in nominal terms. Direct taxes and social security contributions are expected to grow by 9.4 % due to strong job creation, while economic growth should increase indirect tax revenues by 8.1 %. Total expenditures are targeted to grow by 6.6 %. Particular efforts are devoted to productivity-enhancing budgetary measures on the expenditure side, which will concentrate on R & D, innovation, education and investment in infrastructure. Specifically, the budget encompasses a 25 % increase in funds devoted to R & D policies, including an endowment of EUR 3 billion (about 0.4 % of GDP), which will be allocated to research on information technologies (IT). Most of this endowment is meant to translate into loans to selected projects at low or zero interest rates. The government is committed to doubling expenditure on R & D within four years in order to catch up with the euro-area average. Expenditure on education will increase by 6 % with respect to the total amount allocated in the previous year. Most of this increase will translate into more and higher grants. Finally, the budget gives priority to investment in infrastructure, with spending planned to increase by 9.1 %. Special attention will be paid to improving terrestrial transport, notably motorways and the promotion of a high-speed railway network.

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.14

Budgetary developments 2003–08, Spain

(% of GDP

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	0.3	– 0.3	0.0	0.1		
— Total revenues	40.0	40.2	40.4	40.5		
Of which: — current taxes	22.6	23.1	23.2	23.3		
— social contributions	13.7	13.6	13.7	13.7		
— Total expenditure	39.7	40.5	40.4	40.4		
Of which: — collective consumption	n.a.	7.9	8.0	8.1		
— social transfers (2)	n.a.	22.6	22.7	22.7		
— interest expenditure	2.5	2.2	2.1	2.0		
— gross fixed capital formation	3.6	3.7	3.7	3.7		
Primary balance	2.8	1.9	2.1	2.1		
Pm Tax burden	36.3	36.6	36.8	36.8		
Government debt	51.4	48.9	46.5	44.2		
Pm Cyclically adjusted balance (3)	0.2	– 0.3	0.0	0.2		
Pm Cyclically adjusted primary balance	2.7	1.8	2.1	2.2		
Pm Real GDP (4)	2.5	2.7	2.7	2.7		
Stability programme (5)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	0.4	– 0.8	0.1	0.2	0.4	0.4
Primary balance	2.9	1.5	2.2	2.2	2.3	2.3
Government debt	50.7	49.1	46.7	44.3	42.0	40.0
Pm Real GDP (4)	2.5	2.6	2.9	3.0	3.0	3.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Calculated using the HP filter.
(4) Annual % change.
(5) Submitted in December 2004.

Sources: Commission services and stability programme of Spain.

Table V.15

Main measures in the budget for 2005, Spain

Revenue measures	Expenditure measures
• Freeze of non-taxable income threshold (0.06 % of GDP)	• Increase in R & D spending (0.06 % of GDP)
• Freeze of fuel duties (– 0.03 % of GDP)	• Increase in investment in transport infrastructure, namely roads and railways (0.1 % of GDP)
	• Increase in minimum non-contributory pensions (0.04 % of GDP)

Sources: Commission services and 2005 budget law.

In 2006, the most recent update of the stability programme targets a surplus of 0.2 % of GDP for the general government. This is comparable to the Commission services' spring 2005 forecast, in which, under a no-policy-change scenario, the general government balance is expected to achieve a surplus of 0.1 % of GDP. In 2007 and 2008, small but increasing surpluses are projected in the updated stability programme, reaching 0.4 % of GDP in 2008.

As regards gross public debt, the Commission services' spring 2005 forecast foresees a gradual decline over the forecast horizon, towards around 44 % of GDP in 2006.

This is in line with the projections in the updated stability programme.

Is public consumption too high?

Since 2000, public consumption has been growing above GDP, feeding both government total expenditure and domestic demand. This increase has so far been compatible with a consolidation process, which allowed Spain to reach the close-to-balance fiscal position already in 2003. The rise in public consumption has been offset by savings from interest payments. However, according to the Commission services' spring 2005 forecast, this might not be the case in the medium term. Furthermore, the expansion of public consumption is taking place in a context in which a buoyant domestic demand translates into higher imports, widening the trade deficit.

The story of public consumption during the last decade can be divided into two periods. Between 1995 and 1999, when within a process of strong expenditure retrenchment, public consumption fell, albeit marginally, in terms of GDP. This contrasts with the 2000–04 period in which the previous trend was reversed and government consumption accelerated sharply to come back to the levels observed in 1995 (see Graph V.1). Within this context, the issue of the compatibility of high rising public consumption with the maintenance of the close-to-balance position and with the need to rebalance the external sector appears relevant since government consumption encompasses not only the operational costs of the administration, but also items subject to long-run trends or drifts, such as healthcare and public wages, which may be difficult to revert.

Public consumption and fiscal consolidation

Between 1995 and 1999, public consumption fell from 18.1 % in 1995 to 17.4 % in 1999, the strongest phase of the consolidation process leading to a drastic deficit reduction. Total expenditures fell by 4.8 percentage points of GDP, from 45.0 % of GDP in 1995 to 40.2 % of GDP in 1999. With a reduction of only 0.7 percentage points of GDP, the contribution of public consumption to spending retrenchment was not particularly relevant. Interest payments, social benefits and capital expenditure each reduced its share in the nominal GDP by around 1.5 percentage points. During this period, the components of public consumption showed different behaviour. Whereas social transfers in kind remained roughly stable in terms of GDP at around 10 % (which include among others healthcare and education), collective consumption fell from 8 % of GDP in 1995 to 7.3 % in 1999 ([1]).

In line with its decreasing participation in GDP, public consumption grew in real terms by 2.9 % per year, which compares with a real GDP growth rate of 3.6 % per year (see Graph V.2). The contribution of public consumption to growth between 1995 and 1999 reached 0.5 percentage points per year. With a positive output gap during this first period, the behaviour of public consumption remained therefore anticyclical and helped to contain domestic demand. Public consumption explained around one sixth of domestic demand growth between 1995 and 1999, while private consumption explained around a half and gross fixed capital formation the rest, i.e. one third (see Graph V.3) ([2]).

A dynamic economy

Between 2000 and 2004, government final consumption gained momentum (0.6 percentage points of GDP along the period) to reach 18.2 % in 2004, 0.1 percentage point above the level recorded in 1995. In parallel, government total expenditure retrenchment had been fading since 2000. Total expenditures remained barely unchanged in terms of GDP during the period and a recomposition took place between interest payments and public consumption. While interest payments were falling, driven by debt reduction and decreasing interest rates, no other spending items recorded a significant reduction. In fact, savings from interest payments were used to finance government consumption.

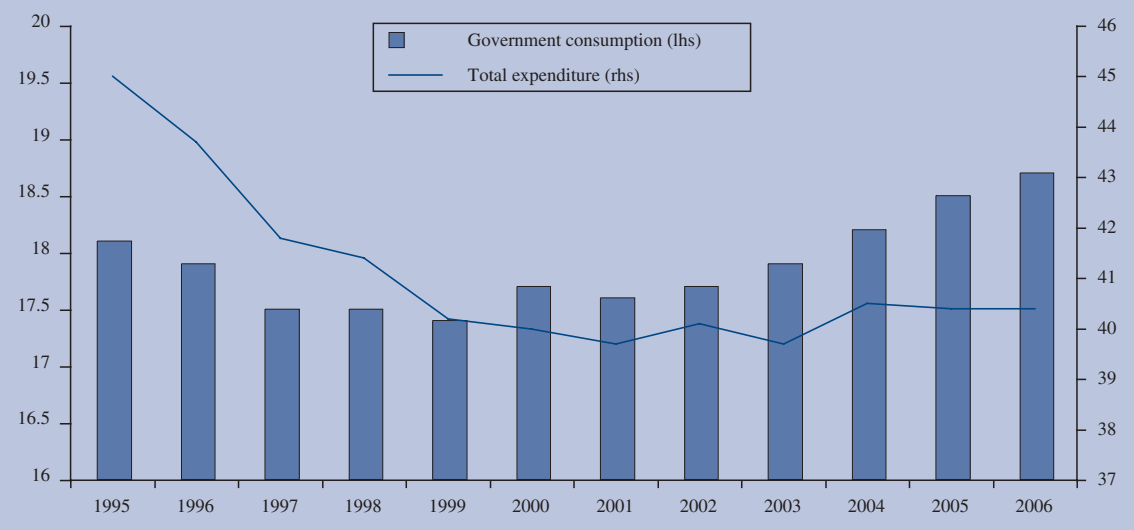
During this period, the two main components of public consumption, collective consumption and social transfers in kind, increased from 7.6 % of GDP in 2000 to 7.9 % in 2004 and from 10.1 % in 2000 to 10.4 % in 2004 respectively.

In real terms, public consumption grew by 4.3 % per year, well above the average growth rate of 2.9 % per year recorded by real GDP. Consequently, the contribution of public consumption to GDP growth jumped from 0.5 % over the period 1995–99 to 0.8 % per year between 2000 and 2004. Public consumption explained around one fifth

([1]) Public wages, which are also part of public consumption and are included in both social transfers in kind and collective consumption, fell from 11.3 % of GDP in 1995 to 10.6 % in 1999.

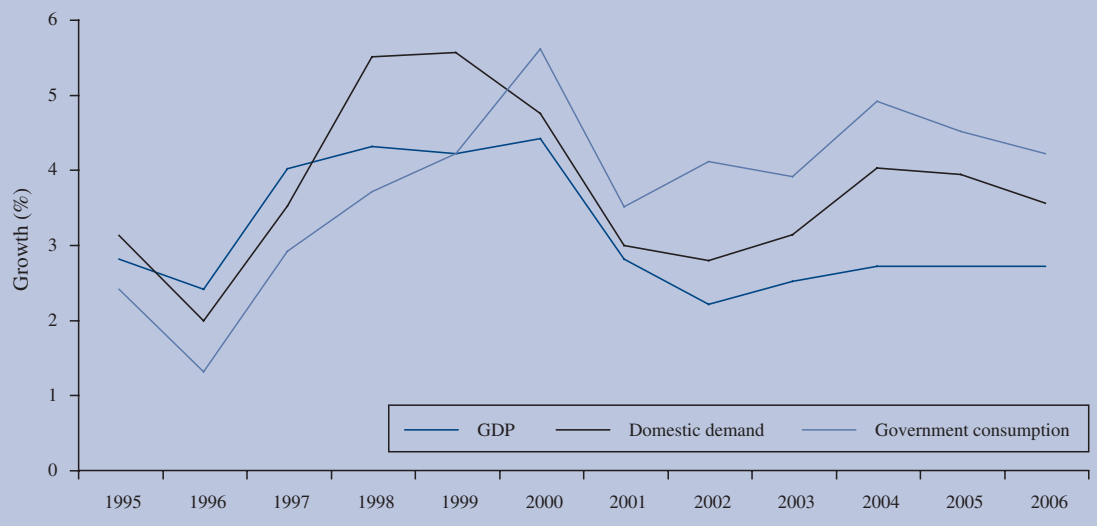
([2]) It is worth noting at this point that the external balance of goods and services deteriorated along the period, entering negative territory in 1999 (- 1.3 % of GDP) after three consecutive years in surplus.

Graph V.1: **General government total expenditure and government consumption as a percentage of GDP**



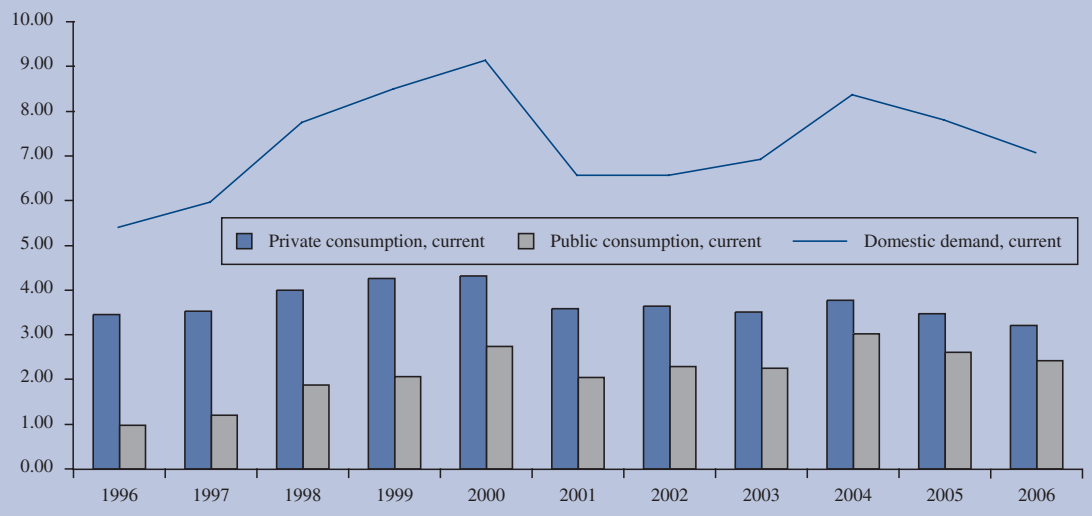
Sources: IGAE and Commission services' 2005 spring forecast.

Graph V.2: **Comparison between real GDP, domestic demand and government consumption growth**



Sources: AMECO and database Commission services' 2005 spring forecast.

Graph V.3: **Private and public consumption — Contribution to domestic demand growth at 1995 constant prices and at current prices**



Sources: AMECO and database Commission services' 2005 spring forecast.

of domestic demand growth, compared with one sixth in the period before. This is less than half the contribution of private consumption and slightly below the contribution of gross fixed capital formation. Consequently, the expansion of public consumption has been feeding more than in the previous period an already highly dynamic domestic demand, which is not fully translating into higher growth but into higher imports, thus steadily deteriorating the external position of the country.

The future outlook

According to the Commission services' spring 2005 forecast, public consumption is expected to increase by 0.5 percentage points of GDP until 2006 ([1]). Specifically, public consumption should reach 18.5 % of GDP in 2005 and 18.7 % in 2006, compared with 18.2 % in 2004. In contrast, interest payments are projected to fall by only 0.2 percentage points of GDP (2.1 % of GDP in 2005 and 2 % in 2006, from 2.2 % in 2004), while no other expenditure item is projected to decrease significantly in terms of GDP. Therefore, since the fiscal position is projected to remain at close to balance, three fifths of the increase in public consumption will be financed by additional revenues, coming from a particularly tax-friendly growth composition. Supported by strong domestic demand, total revenues are expected to increase slightly in terms of GDP (from 40.2 % in 2004 to 40.4 and 40.5 % in 2005 and 2006 respectively). This is enough to finance the public consumption increases along the forecast period. However, should this trend continue in the future, keeping a balanced budget would require higher tax rates. Both collective consumption and social transfers in kind are projected to grow above nominal GDP, each increasing by around a ¼ percentage point of GDP along the forecast period.

Public consumption is expected to grow in real terms by 4.5 and 4.2 % in real terms in 2005 and 2006 respectively, while GDP would grow by 2.7 % in both years. In parallel, domestic demand should grow at around 4 and 3.5 % in 2005 and 2006 respectively. At slightly over one fifth, the relative contribution of public consumption is projected to remain broadly stable compared with the period 2000–04, while the trade

([1]) Commission services' projections for 2006 are based on the usual no-policy-change scenario.

deficit is projected to widen to 7.7 % of GDP in 2005 and 8.3 % of GDP in 2006, compared with 6.8 % in 2004. Therefore, there might be a case to ask whether such trends in current public consumption are adequate at the current juncture when a dynamic domestic demand is widening external imbalances, while high inflation and low productivity are dragging competitiveness.

8. France

Recent developments and medium-term prospects

The general government deficit declined from 4.2 % of GDP in 2003 to 3.7 % of GDP in 2004, in line with the Commission services' autumn 2004 forecast. In view of the robust growth performance, the cyclically adjusted deficit improved by only 0.4 percentage points of GDP in 2004, as against a targeted 0.8 percentage points of GDP. The limited improvement in the 2004 deficit despite the additional revenues stemming from higher-than-expected growth (actual GDP growth was 2.6 % compared with 1.7 % expected in the December 2003 update of the stability programme) is due to a number of factors. First, the 2003 deficit estimate was revised slightly upwards (0.1 % of GDP), causing an unfavourable base effect. Second, the government decided not to compensate for the loss of revenues (0.1 % of GDP) triggered by the non-validation by the Conseil d'État of the tightening of eligibility conditions of the unemployment insurance system. Finally, although the expenditure target was met in the State sector, there were expenditure overruns in other subsectors and notably in the local authorities sector.

The increase in the 2004 general government debt ratio from 63.9 % of GDP in 2003 to 65.6 % of GDP was 0.3 percentage points of GDP larger than projected in the 2003 update of the stability programme. This was due to a higher deficit (0.15 percentage points of GDP) and higher stock-flow adjustment, partly offset by a more negative contribution stemming from stronger nominal GDP growth.

The budget for 2005 adopted by Parliament in December 2004 plans a marked slowdown in public spending through: (i) a stabilisation of State expenditures in real terms; (ii) a deceleration in health expenditure growth (to 3.2 % from 4.9 % in 2004); and (iii) a slowdown in local authorities' expenditures. On the revenue side, exonerations of taxes on intergenerational transfers and alleviation of social charges have been introduced. However, because of the introduction of other measures the overall tax burden would rise by 0.1 percentage point of GDP: notably, increases in social security contributions from civil servants and contributions of electricity and gas companies' (EDF/GDF) employees following the transfer of the responsibility for the payment of their pensions to the general social security regime. Finally, non-fiscal revenues are planned to increase by 0.5 percentage points of GDP, due to one-off measures related to the abovementioned transfer of EDF/GDF pensions. The Commission services' spring 2005 forecast projects the general government deficit in 2005 at 3 % of GDP, against an estimate of 2.9 % of GDP by the French authorities. The slight difference between the two deficit forecasts stems from two factors: (i) a more cautious macroeconomic scenario (2.0 % GDP growth foreseen by the Commission services as against 2.0 to 2.5 % by the French authorities); (ii) a smaller positive impact of the health insurance reform in the short term. The macroeconomic and budgetary projections of the Commission services' spring 2005 forecast are consistent with an improvement in the cyclically adjusted balance by 0.8 percentage points of GDP (in line with the adjustment included in the 2004 update of the stability programme), the largest part of which reflects the impact of the one-off measures cited above.

In 2006, based on the usual no-policy-change assumption, the Commission services project the general government deficit to increase to 3.4 % of GDP despite expected real GDP growth close to its potential rate. This reflects the fact that the exceptional payments contributing to the deficit reduction in 2005 will vanish in 2006 and that tax cuts are planned for that year (0.2 % of GDP based on the information available so far). Accordingly, real government expenditures are assumed to increase by about 2 % in the spring forecasts, compared with a pro-

Table V.16

Budgetary developments 2003–08, France

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	– 4.2	– 3.7	– 3.0	– 3.4		
— Total revenues	50.4	50.8	51.5	51.1		
Of which: — current taxes	26.3	26.7	26.9	26.8		
— social contributions	18.5	18.2	18.4	18.4		
— Total expenditure	54.6	54.5	54.5	54.4		
Of which: — collective consumption	9.5	9.4	9.3	9.3		
— social transfers (2)	33.2	33.2	33.2	33.0		
— interest expenditure	2.9	2.9	2.9	3.0		
— gross fixed capital formation	3.2	3.3	3.4	3.4		
Primary balance	– 1.3	– 0.8	– 0.1	– 0.4		
Pm Tax burden	43.8	44.1	44.3	44.2		
Government debt	63.9	65.6	66.2	67.1		
Pm Cyclically adjusted balance	– 4.0	– 3.6	– 2.8	– 3.1		
Pm Cyclically adjusted primary balance	– 1.0	– 0.7	0.2	– 0.1		
Pm Real GDP (3)	0.5	2.5	2.0	2.2		
Stability programme (4)		**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		– 3.6	– 2.9	– 2.2	– 1.6	– 0.9
Primary balance		– 0.7	0.1	0.8	1.5	2.2
Government debt		64.8	65.0	64.6	63.6	62.0
Pm Real GDP (3)		2.5	2.5	2.5	2.5	2.5

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and stability programme of France.

Table V.17

Main measures in the budget for 2005, France

Revenue measures	Expenditure measures
• Increase in social contributions to finance the health reform (0.2 % of GDP) • Increase in pension contributions of public employees (0.2 % of GDP) • Exonerations of taxes on intergenerational transfers • Alleviation of social charges (– 0.1 % of GDP) • One-off additional revenue (0.5 % of GDP) as a counterpart of the transfer to the general social security sector of the pension payments of the employees in public electricity and gas companies	• Stabilisation of State expenditure in real terms • Specific measures aimed at curbing the rapid growth in healthcare spending (stricter reimbursement of medicines, increase in the forfait hospitalier and in consultation prices by EUR 1, etc.)

Sources: Commission services and French Ministry of the Economy, Finance and Industry.

jection of 1.2 % in the December 2004 update of the stability programme ([1]); the update targets a general government deficit of 2.2 % of GDP in 2006, which the government revised to 2.7 % of GDP in March 2005 ([2]). In the subsequent years, the deficit is projected in the stability programme update to decline steadily by 0.6 to 0.7 percentage points of GDP per year to 0.9 % of GDP in 2008. Based on Commission services' calculations, the cyclically adjusted balance would accordingly also improve by 0.6 to 0.7 percentage points per year to reach – 0.7 % of GDP in 2008.

The Commission services project the debt-to-GDP ratio to increase further in 2005–06. This ratio would reach 66.2 % in 2005 and 67.1 % in 2006. Developments in the debt are projected to reflect those of the deficit and nominal GDP, since no significant stock-flow operations are incorporated into the forecast. This is worse than projected in the 2004 update of the stability programme, where the debt ratio is envisaged to stabilise, reflecting the higher deficit and lower GDP growth rate in the spring 2005 forecast.

Ageing of the population: a major challenge ahead

As in many other EU countries, large demographic changes will occur in the next few decades in France as a result of several developments: (i) post-war baby-boom cohorts will enter their retirement years; (ii) life expectancy is expected to continue increasing by approximately one year per decade; (iii) past fertility rates, although slightly better in France than in some other countries, have been insufficient to stabilise the age structure of the population implying notably that smaller cohorts will enter the labour force in the coming decades; (iv) net inward migration flows, which could partially offset the impact on the age structure of the population, are expected to remain limited.

According to INSEE ([3]), these developments will have two major consequences. First, the population of working age will start declining as from the end of the current decade. In its most recent projections, INSEE forecasts a decline in the population aged between 15 and 64 by about 2.5 millions between 2007 and 2040. Second, the number of persons aged 65 or over will increase faster in the coming decades ([4]). The changes in the rate of growth of these two groups have not yet started. They will occur simultaneously in a short transition period between 2010 and 2015.

As a consequence, the old-age dependency ratio (persons aged 65 or over to persons of working age, 15 to 64) is projected to increase from 24 % today to 46 % in 2040. Consequently, the ratio of working-age to elderly citizens will increase from four to one at present to two to one by 2040.

These changes in the demographic structure will exert strong pressures on government expenditure on pensions, healthcare and long-term care. In order to limit the magnitude of the shock, France has implemented in recent years major reforms so as to curb the dynamics of pension and health expenditure.

The pension and healthcare reforms

In summer 2003, France adopted a comprehensive reform of the pension system, which increased the number of contribution years for entitlement to a full pension in two steps. First, until 2008, the number of contribution years will progressively increase by six months per year in the public sector from 37.5 years to 40 years, the level currently prevailing in the private sector. In a second step, starting in 2008, the contribution period is foreseen to increase for all workers proportionally with life expectancy, with the aim of keeping constant the ratio between the number of contribution years and the number of pension years. The reform also aims at raising the financial incentives for workers to remain active until and after the legal retirement age, although this age has been maintained at 60 ([5]).

Following the pension reform, a reform of the health system was adopted in summer 2004 aimed at reaching budgetary balance by 2007 (from a deficit of about 0.8 % of GDP in 2004). About one third of the effort is planned

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

([2]) Figures mentioned in the March 2005 report 'Perspectives économiques 2005–06' published by the French Ministry of the Economy, Finance and Industry.

([3]) The demographic projections used here represent the baseline projection of INSEE, in which the fertility rate is projected to remain at 1.8 per 1 000 in line with the average level of the last 25 years, life expectancy is projected to rise by about seven years by 2050 and net inward migration is projected to be of 50 000 persons annually over the projection period, in line with the average of the last 10 years.

([4]) Of this group, the biggest increase will be amongst the very elderly, that is persons aged 80 or over, whose number will triple from now to 2050. This is relevant because this group is the most intensive user of healthcare and long-term care services.

([5]) This is among the lowest legal retirement ages in the OECD countries.

to be achieved through tax increases representing ¼ % of GDP and the remainder through expenditure savings. These savings are supposed to stem notably from: (i) the introduction of a charge of EUR 1 payable by patients for every medical consultation; (ii) measures aimed at tackling fraudulent sick leave and at facilitating the development of generic drugs; and (iii) better control of medical cost, deriving mainly from financial incentives for patients to use general practitioners rather than going straight to specialists and from the introduction of a personal medical record in order to improve cooperation between health professionals. The reform also aims at improving the management of the system through a clarification of the roles of the different parties involved (government, social partners, health insurance schemes) and the creation of an independent alert committee in charge of formulating recommendations in case of slippages from the official target.

Impact of the reforms on government finances

According to the French authorities, the pension reform will reduce by around 40 % the financial needs of the pension system in 2020. The remainder is expected to be financed through two channels. In the private sector, social contributions will be increased. In the public sector, the remaining financial needs will be met by a decline in other government expenditures. Expressed in terms of reduction of the tax gap, budgetary savings resulting from the pension reform would be equivalent to a permanent reduction in the deficit of 1.5 percentage points of GDP, 0.5 percentage points of which can be attributed to a rise in the participation rate.

The quantification of the effects of the pension reform in the long term appears plausible. However, these effects are subject to some uncertainties. First, after 2008 the increase in the contribution period for entitlement to a full pension foreseen by the reform will not be fully automatic since it will be conditional upon the agreement of an independent commission. Although unlikely, it cannot be excluded that this commission may not endorse the foreseen increases in the contribution period. Second, there are some uncertainties regarding the reaction of workers to the incentives introduced by the reform to postpone retirement. This is especially relevant since the reform did not modify the legal retirement age (60 years) which is relatively low.

Although the health reform is also likely to trigger substantial savings, the precise budgetary impact of some measures is more uncertain. While an impact should be visible in the short run, notably through the effect of the tax increases and of some well-defined measures on the expenditure side, assuming that new financial incentives and improvement in the governance of the system will imply a permanent reduction in the pace of growth of health expenditure appears overly optimistic. Notably, the large savings expected from the control of medical cost — representing one third of the total expected savings over 2005–07 — are conditional on a change in behaviour of the economic agents. The changes introduced in the structure of incentives will not be sufficient to trigger a permanent modulation of the growth rate of health expenditure.

On the basis of the 2004 update of the stability programme and additional information provided by the EPC ([1]), age-related spending is foreseen to increase by 5.5 % of GDP between 2009 and 2050, despite the expected impact of the 2003 pension reform. Indeed, the increase in public spending on pensions, healthcare and long-term care will be only partly compensated by a decline in expenditure on education and unemployment benefits.

France adopted important measures on pensions and health that should help improve the long-term sustainability of public financing without, however, fully securing it. Given the projected increase in the old-age dependency ratio, fiscal consolidation along with structural reforms are key factors in putting France on a sustainable path.

Table V.18

Projected budgetary impact of ageing on public expenditures between 2009 and 2050, France

(% of GDP)

	Total impact
Total age-related spending	5.5
Of which:	
— pension expenditure	1.6
— healthcare expenditure	4.6
— education expenditure	– 0.4
— unemployment benefits	– 0.3

Sources: Ageing Working Group of the EU Economic Policy Committee and 2004 update of the stability programme.

([1]) In October 2003, the Economic Policy Committee provided an overview of analyses carried out at EU level on the impact of ageing populations on public finances. The report took into account the expected impact of the 2003 pension reform, not obviously that of the 2004 health reform.

9. Ireland

Recent developments and medium-term prospects

For 2004, the general government is estimated to have recorded a surplus of 1.3 % of GDP, compared with the deficit of 1.1 % of GDP targeted in the December 2003 update of the stability programme.

This significantly better-than-expected outturn is mainly due to a sizeable tax overshoot, including the impact of one-off factors, notably receipts arising from the special investigations (of potential tax evasion) by the revenue commissioners (estimated to have yielded around 0.5 % of GDP). General government expenditure in 2004 is also estimated to have been lower than budgeted, especially investment and interest expenditure.

The budget for 2005 was unveiled on 1 December 2004 ([1]) ([2]) together with the stability programme update covering the period to 2007. The target for the general government deficit in 2004 in the updated stability programme is 0.8 % of GDP ([3]). The main 2005 budget measures on the revenue side include an upward adjustment of the standard tax band for personal income and some relief through changes in stamp duty. On the expenditure side, the increase in current discretionary spending ([4]) (of 10.1 % after 6.7 % in 2004) reflects a somewhat more generous social welfare package than in 2004. A significant rise in capital spending has also been budgeted, focusing, in particular, on improvements in transport infrastructure. Given the measures in the budget, in 2005 the Commission services' spring forecast projects the general government position to turn into a deficit of 0.6 % of GDP ([5]). Nevertheless, risks exist. In particular, a February 2005 court ruling on nursing home payments might entail significant government costs, though the exact implications are not yet known. On the other hand, the general government deficit might turn out to be lower than projected because of stronger-than-expected receipts from strengthened tax compliance (particularly as a consequence of further revenue commissioners' special investigations) and some underspending in capital outlays.

For 2006, the Commission services' spring forecast projects a deficit of 0.6 % of GDP, identical to the target set in the updated stability programme. This target includes a contingency provision against unforeseen developments of 0.4 % of GDP. Given the non-indexed nature of the tax and social benefit systems, the forecast's no-policy-change assumption is made operational, in the absence of previously announced measures, by freezing average tax rates and adjusting social transfer payments by the forecast of CPI inflation (with a small top-up).

Government gross debt is projected to stabilise at around 30 % of GDP. In the absence of the accumulation of non-general government assets in the National Pensions Reserve Fund (NPRF) ([6]), which was established in 2001 to pre-fund future pension liabilities, the gross debt ratio would be falling over the period to end-2006.

([1]) The detailed Exchequer cash data for 2004 reveal that personal income tax, VAT and stamp duty significantly exceeded budget forecasts, while corporation tax and excise duties were broadly on target.

([2]) The 2005 finance bill was signed into law by the president of Ireland on 25 March 2005.

([3]) In the March 2005 reporting of government deficits and debt levels, the Irish authorities forecasted for 2005 a slightly lower deficit of 0.7 % of GDP.

([4]) This refers to the concept of 'voted' current spending, for which annual approval by Parliament is needed and which excludes, *inter alia*, the service of national debt and the contribution to the EU budget.

([5]) The cyclically adjusted balances presented in Table V.19 show planned fiscal loosening of around 1¾ % of GDP. However, one-off factors boosting revenues in 2004 should also be taken into account (see above).

([6]) The National Pensions Reserve Fund (NPRF) receives annually around 1 % of GNP from general government resources. At the end of 2004, assets represented around 8 % of GDP.

Table V.19

Budgetary developments 2003–07, Ireland

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**	
General government balance	0.2	1.3	– 0.6	– 0.6	
— Total revenues	34.6	35.7	34.5	34.0	
Of which: — current taxes	24.8	25.7	24.8	24.5	
— social contributions	6.0	6.2	6.2	6.1	
— Total expenditure	34.4	34.3	35.1	34.6	
Of which: — collective consumption	5.6	5.6	5.6	5.6	
— social transfers (2)	19.2	19.6	19.9	19.6	
— interest expenditure	1.3	1.2	1.1	1.0	
— gross fixed capital formation	3.9	3.6	3.9	3.9	
Primary balance	1.5	2.5	0.5	0.5	
Pm Tax burden	30.0	30.9	30.0	29.7	
Government debt	32.0	29.9	29.8	29.6	
Pm Cyclically adjusted balance	0.2	1.6	– 0.1	0.1	
Pm Cyclically adjusted primary balance	1.5	2.8	1.0	1.1	
Pm Real GDP (3)	3.7	5.4	4.9	5.1	
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	0.1	0.9	– 0.8	– 0.6	– 0.6
Primary balance	1.4	2.1	0.6	0.6	0.7
Government debt	32.1	30.5	30.1	30.1	30.0
Pm Real GDP (3)	3.7	5.3	5.1	5.2	5.4

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and stability programme of Ireland.

Table V.20

Main measures in the budget for 2005, Ireland

Revenue measures	**Expenditure measures**
• Personal income tax measures: a widening of the tax band for personal income and an increase in employee and personal tax credits (– 0.4 % of GDP)	• Social welfare package: increase in social welfare benefit rates and measures to reinforce equal participation in society by people with disabilities (0.4 % of GDP)
• Stamp duty measures: relief for first-time purchasers of existing properties (less than – 0.1 % of GDP)	• Investment: addition to the available envelope for Exchequer-funded capital spending (around 0.2 % of GDP) plus a carry-over from unspent allocations in 2004 (0.2 % of GDP)

Sources: Commission services and Department of Finance, Ireland (2005 budget).

Recent initiatives to improve public expenditure control

Frequent expenditure overruns associated with the massive increase in government spending in the second half of the 1990s raised concerns about the effectiveness of control and management of public expenditure. This created the basis for the recommendation in the 2003–05 broad economic policy guidelines (BEPGs) that Ireland should 'enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term frame-

work building on the range of measures recently introduced to improve the planning, management and control of expenditure'.

Measures taken by the Irish government up to 2002 to address the occurrence of spending overruns and concerns about securing 'value for money' have been previously reviewed ([1]). In 2003 and 2004, measures to strengthen the monitoring and control of expenditures included ([2]):

- the publication of intra-year monthly profiles of expenditures (published in January);
- monthly expenditure management reports on the trends in the public finances submitted by the minister for finance to the Cabinet;
- bimonthly reports submitted by the four key government departments ([3]) to the Cabinet on emerging spending trends;
- improvements in risk assessment measures and contingency planning to cater for unforeseen intra-year expenditure pressures;
- further structural measures to improve expenditure management and control, including revised arrangements for managing capital spending and the provision of incentives for departments to produce savings.

The Irish authorities have also taken several steps to improve the multiannual medium-term framework for capital expenditures. In particular, the system of rolling five-year spending envelopes was extended from public transport to all areas of capital spending as from 2004, which should significantly strengthen the efficiency of planning of infrastructural investment. In addition, from 2004, departments were permitted to carry over to the following year up to 10 % of their voted capital allocations ([4]).

The figure below compares targets and actual outturns for discretionary spending and tax revenues. Taxes appear to be much more volatile than discretionary expenditure ([5]), but this reflects frequent swings in economic growth and unexpected one-off revenues ([6]). On the other hand, as regards the management of expenditure, discretionary spending has been maintained closer to plans in recent years.

The outturns for discretionary spending have gradually become closer to target over time, being marginally below target since 2002. In 2004, the detailed Exchequer cash data revealed that the outturn in 2004 was, in particular, due to capital underspending. This was partly due to the new provision for limited carry-over of capital expenditure (see above) ([7]).

In conclusion, the measures taken to improve public expenditure management have proven to be successful and have delivered an improvement in expenditure control. The introduction of the multiannual capital envelopes should allow for better budgeting of infrastructural projects, but the medium-term planning of current spending still requires ongoing attention since announced multiannual targets are apparently routinely revised. On a positive note, several initiatives are continuing in order to analyse in a more systematic manner the expenditure impact and to ensure the delivery of high-quality services, in particular in the health sector ([8]).

([1]) For a review of the measures taken between 1997 and 2002 aiming at improvements in expenditure management, see the section 'Ireland' in European Commission (2003a). These measures included, in particular, moving to multiannual budgeting, the expenditure review initiative (ERI) and the setting-up of an Independent Estimates Review Committee (IERC).

([2]) Measures announced by the minister for finance in his 2003 budget speech (http://www.budget.gov.ie/2003/speech03.asp).

([3]) The four departments with the largest current spending allocations are: (i) Education and Science; (ii) Health and Children; (iii) Justice, Equality and Law Reform; and (iv) Social and Family Affairs.

([4]) The Finance Act 2004.

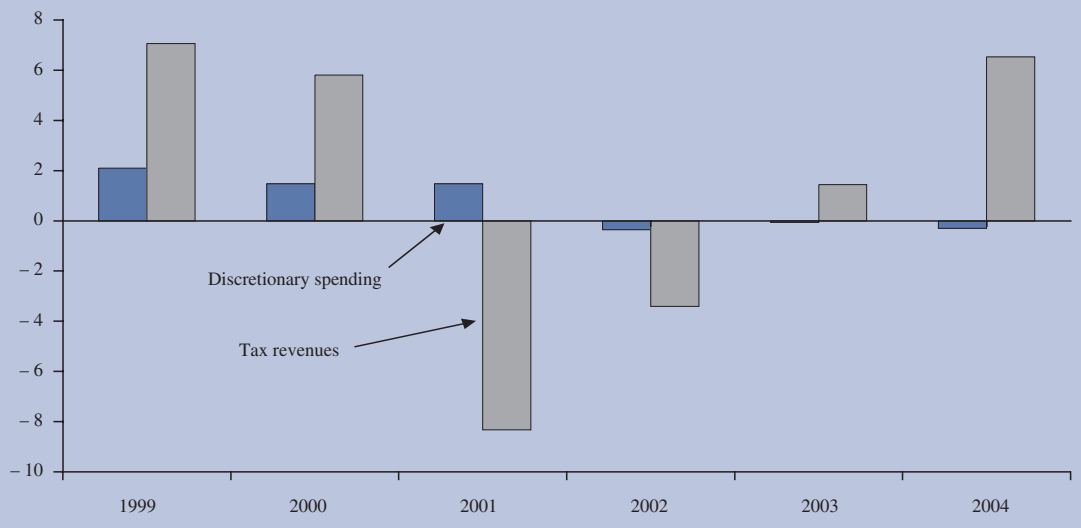
([5]) The deviations from revenue targets led the Irish authorities to a review of tax forecasting procedures. In particular, a new provisional methodology for forecasting corporation tax revenues in the multiannual projections was introduced in the budget for 2004 (BEPGs — 2004 implementation report).

([6]) A significant one-off factor that significantly influenced tax revenues in 2004 was receipts arising from the special investigations by the revenue commissioners, currently estimated to have yielded EUR 685 million (just below 0.5 % of GDP).

([7]) The carry-over under the multiannual capital envelope from 2004 to 2005 was around 4 % of the 2004 discretionary capital allocation or 0.2 % of GDP.

([8]) For further details, see Chapter 7 of the stability programme update of Ireland (December 2004).

Graph V.4: **Ireland — Outturn versus target for discretionary spending and tax revenues (Exchequer cash accounts; deviation in %)**



Sources: Commission services and Department of Finance, Ireland.

10. Italy

Recent developments and medium-term prospects

According to the EDP notification communicated by the Italian authorities on 1 March 2005 but not validated by Eurostat ([1]), the general government balance recorded a deficit of 3.0 % of GDP in 2004, compared with a targeted deficit of 2.2 % of GDP set in the 2003 update of the stability programme.

Overestimation of economic growth and the upward revisions of the deficits in the years from 2001 to 2003 largely explain the slippage from the budgetary objective.

At the Ecofin Council of 5 July 2004, Italy agreed to undertake additional fiscal measures worth around ½ % of GDP, including expenditure cuts amounting to around 0.3 % of GDP. Despite these savings, a postponement of wage agreement renewals and lower-than-officially-projected interest payments, overall spending ended up 1.1 % of GDP higher than targeted in the 2003 update of the stability programme. Part of the slippage was due to higher-than-expected healthcare expenditure and significantly lower-than-expected proceeds from sales of publicly owned real estate (classified as negative capital expenditure). In contrast, on the revenue side, some receipts (mainly a temporary rebate of taxation on capital gains from revaluation of firms' assets and revenues from lotteries) turned out higher than initially planned by the government. Thus, total revenue was 0.3 % of GDP above the amount expected in the 2003 update of the stability programme. The primary surplus decreased to 2.0 % of GDP, down from 2.4 % in 2003. Overall, the impact of temporary measures on the 2004 budgetary position is estimated at around 1½ percentage points of GDP, down from around 2 percentage points in 2003. Also due to privatisation proceeds amounting to around 0.6 % of GDP, the debt-to-GDP ratio declined by 0.5 percentage points to 105.8 %. The original target in the 2003 update of the stability programme was 105.0 %.

The 2005 budget law was adopted by Parliament on 29 December 2004. Measures aiming to reduce expenditure include a 2 % cap on the annual increase in nominal expenditure (excluding pensions, healthcare and local government expenditure), a new system of ceilings on subnational government expenditure and further sales of publicly owned real assets, including some State roads. On the revenue side, the budget law comprises cuts in personal income tax, an increase in indirect taxation and a strengthening of the schemes that aim at widening the tax base of small companies and self-employed people.

On 29 April, the Ministry of the Economy and Finance released a new target of 2.9 % of GDP for the general government deficit in 2005, while in the meantime listing a series of circumstances which could lead the deficit to reach 3.5 % of GDP. The Italian authorities explain the revision of the deficit target from the previous target of 2.7 % of GDP, set in the 2004 update of the stability programme ([2]), to 2.9 % of GDP on the basis of a lower growth forecast (1.2 % as against 2.1 %), the postponement of the renewal of the public wage agreements from 2004 to 2005 and lower dividend receipts. The negative impact of these items on the deficit would be partially offset by interest payments which are expected to be lower than previously projected. According to the Italian authorities, the deficit could increase from 2.9 % of GDP to 3.5 % of GDP as: (i) the capital injections into the State-owned

([1]) Eurostat did not validate the deficit figures for Italy notably because of: (i) the recording of payments by *concessionari d'imposta*; (ii) a securitisation operation; (iii) transactions with the EU budget; (iv) the classification of government-owned entities; (v) inconsistencies between cash and accrual data; and (vi) large statistical discrepancies. The clarification of these issues may lead to an upward revision in the deficit figures, notably for 2003 and 2004.

([2]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.21

Budgetary developments 2003–08, Italy

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	– 2.9	– 3.0	– 3.6	– 4.6		
— Total revenues	46.3	45.4	44.6	44.0		
Of which: — current taxes	28.2	28.2	28.0	27.7		
— social contributions	13.0	12.9	12.9	12.9		
— Total expenditure	49.2	48.4	48.2	48.5		
Of which: — collective consumption	7.6	7.4	7.3	7.2		
— social transfers (2)	29.1	29.2	29.2	29.1		
— interest expenditure	5.3	5.0	4.9	5.0		
— gross fixed capital formation	2.6	2.6	2.4	2.9		
Primary balance	2.4	2.0	1.3	0.4		
Pm Tax burden	42.9	41.9	41.1	40.6		
Government debt	106.3	105.8	105.6	106.3		
Pm Cyclically adjusted balance	– 2.6	– 2.4	– 2.9	– 4.0		
Pm Cyclically adjusted primary balance	2.7	2.6	2.0	1.0		
Pm Real GDP (3)	0.3	1.2	1.2	1.7		
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 2.4	– 2.9	– 2.7	– 2.0	– 1.4	– 0.9
Primary balance	2.9	2.4	2.5	3.3	4.0	4.7
Government debt	106.2	106.0	104.1	101.9	99.2	98.0
Pm Real GDP (3)	0.3	1.2	2.1	2.2	2.3	2.3

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and stability programme of Italy.

Table V.22

Main measures in the budget for 2005, Italy

Revenue measures	Expenditure measures
• Reduction in the number of personal income tax rates and increases in tax deductions (– 0.3 % of GDP)	• Savings on healthcare expenditure (0.3 % of GDP)
• New schemes aimed at widening the tax base of companies and self-employed people (studi di settore) (0.3 % of GDP)	• Disposal of publicly owned real assets (0.5 % of GDP)
• Postponement to 2005 of the tax amnesty for zoning regulation violations originally foreseen in 2004 (0.2 % of GDP)	• Implementation of a 2 % cap on the annual increase in nominal expenditure (0.4 % of GDP)

Sources: Italian Ministry of the Economy and Finance.

railway company amounting to 0.23 % of GDP could have to be classified as capital transfers; (ii) ANAS, the joint-stock company in charge of the maintenance of the State road network, could not meet the criteria to be classified outside the public administration, thus increasing the deficit by 0.14 % of GDP; (iii) the sale of publicly owned real assets could fall short of 0.35 % of GDP; and (iv) some government institutions may not respect the 2 % cap on the annual increase in nominal expenditure introduced by the 2005 budget law,

with a negative impact on the fiscal balance of 0.1 % of GDP. All these factors would increase the deficit to 3.75 % of GDP; however, the renewal of some wage agreements concerning public employees could be postponed to 2006, thus improving this figure by 0.25 % of GDP.

In the Commission services' spring 2005 forecast, the projected budgetary outturn is a deficit of 3.6 % of GDP ([1]). The difference of one decimal point with respect to the upper range limit of the deficit target of 3.5 % of GDP is explained by the different assessment of several items, which partially offset one another (proceeds from the sale of real estate, interest payments, compensation of public sector employees, intermediate consumption, revenue, ANAS's expenditure and capital transfers of the railways company).

One-off measures are estimated to improve the budget balance by around a ¾ percentage point of GDP. Net of cyclical factors, both the deficit and the primary balance are projected to worsen by around a ½ percentage point of GDP. By contrast, the cyclically adjusted budget deficit resulting from the application of the commonly agreed methodology by the Commission services to the projections in the most recent update of the stability programme remains unchanged compared with 2004, while the cyclically adjusted primary surplus worsens by 0.2 percentage points of GDP.

([1]) This forecast is based on the 2004 deficit notified on 1 March 2005. It does not include possible carry-over effects of potential upward revisions.

Table V.23

General government: decomposition of stock-flow adjustment, Italy

(% of GDP)

						Stability programme				Average	
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2000–04	2005–07
Difference due to time of recording: cash and accruals											
1. Differences in the recording of revenue and primary expenditure (accounts receivable and payable) and statistical discrepancies	1.4	1.6	1.2	1.1	0.6	0.9	0.9	0.9		**1.2**	**0.9**
2. Difference between cash and accrual interest expenditure	– 0.5	– 0.5	– 0.7	– 0.5	– 0.2	0.0	0.2	0.2	– 0.2	**– 0.5**	**0.1**
3. Total (1 + 2)	**1.0**	**1.1**	**0.5**	**0.6**	**0.4**	**0.9**	**1.0**	**1.1**		**0.7**	**1.0**
Accumulation of financial assets											
4. Liquidities	– 0.7	0.3	0.0	– 0.6	0.3	0.0	0.0	0.0		**– 0.1**	**0.0**
5. Securities other than shares	0.1	– 0.2	0.0	0.0	0.0	0.0	0.0	0.0		**0.0**	**0.0**
6. Loans	0.4	0.3	0.2	0.1	0.2	0.4	0.6	0.7		**0.2**	**0.6**
7. Capital injections in State-owned companies	0.1	0.1	0.0	0.0	0.3	0.5	0.5	0.3		**0.1**	**0.4**
8. Privatisation proceeds	– 0.4	– 0.4	– 0.1	– 1.3	– 0.6	– 2.1	– 2.0	– 1.9	– 0.6	**– 0.5**	**– 2.0**
9. Other shares and equity	0.4	0.0	0.0	0.2	0.0	0.1	0.0	0.0		**0.1**	**0.0**
10. Total (4 + 5 + 6 + 7 + 8 + 9)	**– 0.2**	**0.1**	**0.0**	**– 1.6**	**0.1**	**– 1.1**	**– 0.9**	**– 0.9**		**– 0.3**	**– 1.0**
Valuation effects and residual adjustments											
11. Redemption effects	0.0	0.0	– 1.7	0.0	0.0	0.0	0.0	0.0		**– 0.3**	**0.0**
12. Exchange rate adjustment	0.1	0.0	– 0.3	– 0.3	– 0.1	0.0	0.1	0.1		**– 0.1**	**0.1**
13. Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		**0.0**	**0.0**
14. Total (11 + 12 + 13)	0.1	0.0	– 2.0	– 0.3	– 0.1	0.0	0.1	0.1		**– 0.5**	**0.1**
15. Stock-flow adjustment (3 + 10 + 14)	**0.9**	**1.2**	**– 1.5**	**– 1.3**	**0.4**	**– 0.1**	**0.2**	**0.2**	**2.1**	**– 0.1**	**0.1**
16. SFA excluding changes in liquidities, privatisation proceeds, and valuation effects and residual adjustments (15 – 4 – 8 – 14)	**1.9**	**1.2**	**0.6**	**0.9**	**0.8**	**2.0**	**2.1**	**2.0**	**2.7**	**1.1**	**2.1**

Sources: Economic and Financial Affairs DG's calculations on March 2005 reporting of government deficits and debt levels (Table 3A), information provided by the Italian Ministry of the Economy and Finance, and 2004 updated stability programme.

The Commission services' forecast for 2006 is based on legislation currently in force. This approach does not account for increases in some spending items, namely compensation of public sector employees and government investment, to be adopted by the next budget law and thus tends to underrate expenditures compared with plausible developments. On this basis the deficit would reach 4.6 % of GDP, reflecting the expiry of one-off measures and the higher cost of the 2005 personal income tax relief in the year 2006. A very sizeable budgetary correction would be needed to achieve the official target of a deficit of 2 % of GDP set in the stability programme update submitted in December 2004. The latter plans the deficit to decline gradually to reach 0.9 % of GDP in 2008.

In the Commission services' spring 2005 forecast, the (gross) debt ratio is projected to decline marginally to 105.6 % of GDP in 2005, while the new target set on 29 April is 105.3 % of GDP, up from the 104.1 % in the 2004 update of the stability programme. The difference between the new official target and the Commission services' projection reflects the higher deficit forecast by the Commission services. Based on unchanged legislation, the debt ratio is expected to increase in 2006 to 106.3 % of GDP, well above the 101.9 % of GDP targeted in the stability programme.

The pace of debt reduction and the stock-flow adjustment

Since the late 1990s, the pace of debt reduction in Italy has been slower than warranted by the size of the primary surplus and privatisation proceeds. The inertia chiefly reflects persistent debt-increasing components in the so-called stock-flow adjustment (SFA). The SFA is the difference between the Maastricht deficit, which is recorded in accrual terms, and the change in the government debt, which is recorded in cash terms and gross of financial transactions. A positive SFA is the normal outcome for low-debt countries with a surplus, as they invest their surpluses and accumulate financial assets. By contrast, persistent debt-increasing components in the SFA are a cause of concern in a high-debt and high-deficit country like Italy (see also Part II, Chapter 2, Section 2.1). To understand the underlying debt dynamics, it is essential to analyse the different components of the SFA. The SFA can be divided into three aggregate components: (i) difference due to time of recording: cash and accruals; (ii) accumulation of financial assets; (iii) valuation effects and residual adjustments. Table V.23 provides a detailed breakdown of the actual SFA in Italy over the 2000–04 period. It also includes the available indications about future SFA developments as presented in the stability programme update submitted in December 2004 and details made available by the Ministry of the Economy and Finance.

The upward revision of the deficit-to-GDP ratio in 2001–03 included in the notification of March 2005 resulted from moving a part of debt-increasing SFA above the line. In particular, capital injections into the State-owned railway company, Ferrovie dello Stato, are now considered as capital transfers and not as financial transactions. In spite of these reclassifications, debt-increasing elements of the SFA continue to be particularly high in Italy.

As regards the recent past, the data show that in the 2000–04 period the debt-reducing components of the SFA amounted on average to 1½ % of GDP per year. They chiefly consisted of (i) privatisation proceeds realised in part thanks to the classification of Cassa Depositie Prestiti (the State-owned savings and loans bank) outside the general government sector in 2003, (ii) an exceptional conversion of Treasury bonds held by the Bank of Italy in 2002, and (iii) interest expenditure accrued but not yet paid on postal bonds.

However, over the same 2000–04 period, the abovementioned debt-reducing factors were offset by components producing the opposite result, i.e. an average increase in the government gross debt of 1½ percentage points of GDP per year. Specifically, around 1¼% of GDP per year was due to the difference between cash versus accrual accounting in primary items and large statistical discrepancies. This represents a cause of concern and was also mentioned in the Eurostat press release of 18 March 2005 (see footnote 192). In addition, accumulation of financial assets (excluding liquidities and privatisation proceeds) affected the government gross debt on average by a ¼ percentage point of GDP per year.

Data about future years presented in the 2004 update of the stability programme suggest that the pattern observed over the recent past is expected to persist. In particular, cash versus accrual accounting in primary items is expected to continue producing a debt-increasing effect at least until 2007.

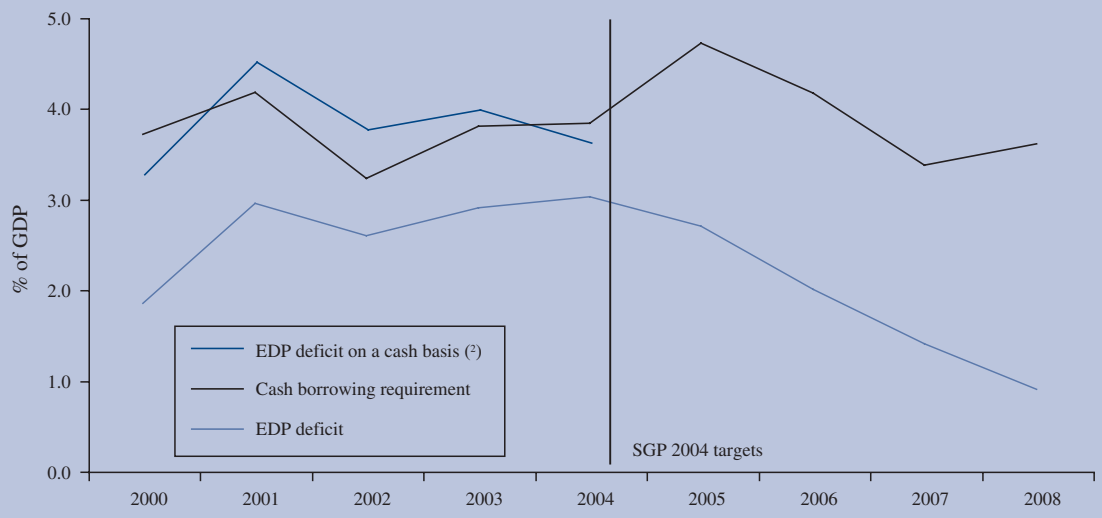
An indicator gauging the actual debt dynamics is the so-called cash borrowing requirement (*fabbisogno delle amministrazioni pubbliche*). It is regularly used by the

Italian Ministry of the Economy and Finance. On top of the Maastricht deficit, the indicator includes the difference between cash and accrual accounting and the accumulation of financial assets excluding privatisation proceeds. As shown in Graph V.5, the cash borrowing requirement has been above the 3 % of GDP reference value over the past few years.

As regards future years, the implicit cash borrowing requirement, i.e. the derived indicator excluding from the projected change in the gross debt level the effect of the privatisation proceeds envisaged in the 2004 update of the stability programme, continues to stay significantly above the targeted EDP deficit. As depicted in Graph V.5, the difference would even seem to increase in 2008.

If the difference between the deficit and the cash borrowing requirement continued to be as high as implicitly assumed in the 2004 update of the stability programme, it would represent a serious cause of concern for the quality of statistical indicators in Italy and above all for the sustainability of public finances over the medium and long term.

Graph V.5: **Comparison of different definitions of deficit** (1)



(1) Excluding UMTS receipts
(2) Interest on accruals
Source: Commission services.

11. Cyprus

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit for 2004 reached 4.2 % of GDP. Compared with the 2003 deficit outturn, this figure represents a reduction of more than 2 percentage points. Moreover, it is better than the estimated 4.8 % of GDP in the updated convergence programme submitted on 7 December 2004, which, in turn, is better than the 2004 deficit target of 5.2 % of GDP in the May 2004 convergence programme. This positive outcome is attributed to the impact of the fiscal consolidation measures affecting both expenditure and revenue. Extra revenues came from a more domestic-demand-based growth composition, which more than offset some revenue shortfalls arising from delays in the introduction of a number of measures initially planned for 2004. The debt ratio in 2004 reached 71.9 % of GDP, still higher than the 69.8 % of GDP recorded in 2003, but lower than the 74.9 % estimated in the updated convergence programme. This difference is explained by extra debt repayment in that year and by the lower-than-expected deficit.

The 2005 budget was approved by Parliament on 10 December 2004. It is consistent with the commitments and plans set out in the convergence programme to bring down the budget deficit to 2.9 % of GDP for 2005 and in line with the Commission services' spring 2005 forecast. The deficit reduction is achieved both through revenue increases and expenditure restraint. Some of the expenditure measures are permanent. This is the case of the increase in the retirement age for public sector employees. Caps on current expenditures have also been introduced. Overall, nominal expenditure growth is kept at 3 %. However, two items are projected to grow above this ceiling. Nominal wages and salaries, which account for 25 % of government expenditure, are set to grow by 5 % in 2005, while capital expenditure is planned to rise by 6 %. The budget foresees a nominal revenue increase of 9.5 %. Main revenue growth elements are social security contributions and indirect taxes. VAT rates were revised upwards, in line with the EU *acquis*, which indeed has carry-over effects in 2005. Revenues from direct taxes and social security contributions are expected to be pushed up by higher GDP growth. Additional revenues would be provided by some one-off measures (such as a tax amnesty and the introduction of fees for issuance of title deeds for certain real estate). It should also be noted that the updated convergence programme prudently takes revenues from a number of measures, not included in the 2005 budget, as a safety margin to offset the impact of possible delays in other measures planned for 2005. As a consequence, the deficit target of 2.9 % of GDP is considered as an 'upper limit'.

For 2006, based on the usual no-policy-change scenario, the Commission services' spring 2005 forecast projects a further reduction in the deficit to 1.9 % of GDP. This figure is marginally above the deficit target of 1.7 % of GDP set in the update of the convergence programme. The difference arises from the Commission services' slightly lower GDP growth projection for 2006. For 2007 and 2008, the updated convergence programme targets a further deficit reduction to 1.5 and 0.9 % of GDP respectively.

The spring 2005 forecast projects the general government debt level for 2005 to decrease to 69.1 % of GDP, with a further decline to 66.6 % by 2006. This drop is mainly driven by positive primary balances and an annual nominal GDP growth above the average nominal interest rate over 2005–06. Furthermore, debt-reducing stock-flow adjustments (SFAs) further push the debt ratio down, reversing earlier debt-increasing SFAs in 2000–03. The projected debt path in the Commission services' forecast is similar to that in the updated convergence programme, although the levels in the former are lower because the forecast already incorporates the lower starting debt level in 2004.

Table V.24

Budgetary developments 2003–08, Cyprus

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**		
General government balance	– 6.3	– 4.2	– 2.9	– 1.9		
— Total revenues	39.1	39.4	39.4	38.9		
Of which: — current taxes	26.6	25.3	25.97	25.5		
— social contributions	7.1	8.4	8.2	8.0		
— Total expenditure	45.4	43.6	42.3	40.7		
Of which: — collective consumption	11.0	10.1	9.9	9.7		
— social transfers (2)	20.4	19.9	19.8	19.2		
— interest expenditure	3.4	3.4	3.3	3.2		
— gross fixed capital formation	3.4	3.9	3.6	3.5		
Primary balance	– 2.8	– 0.9	0.4	1.4		
Pm Tax burden	33.3	33.9	34.1	33.6		
Government debt	69.8	71.9	69.1	66.6		
Pm Real GDP (3)	2.0	3.7	3.9	4.2		
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 6.3	– 4.8	– 2.9	– 1.7	– 1.5	– 0.9
Primary balance	– 2.8	– 1.3	0.7	1.8	2.0	2.5
Government debt	69.8	74.9	71.9	69.2	65.7	58.1
Pm Real GDP (3)	1.9	3.6	4.0	4.4	4.5	4.5

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and convergence programme of Cyprus.

Table V.25

Main measures in the budget for 2005, Cyprus

Revenue measures	**Expenditure measures**
• Implementation of legislation on bank secrecy and a tax amnesty on undeclared bank accounts (0.6 % of GDP) • Regularisation of dividend income policy for semi-government organisations (0.6 % of GDP) • Issuance of title deeds for buildings erected with minor irregularities (0.4 % of GDP)	• Introduction of overall annual ceilings on current expenditure increases (of at most 3 %) and on capital expenditure growth (of at most 4 %) • Freeze on public sector employment and wage increases (0.3 % of GDP) and increase in the retirement age in the public sector (0.2 % of GDP) • Increase in the minimum retirement age for eligibility for outlays from the Social Insurance Fund (0.2 % of GDP) • Containment of current transfers and subsidies (pensions, allowances) in line with inflation (0.2 % of GDP)

Sources: Commission services and updated convergence programme of Cyprus.

12. Latvia

Recent developments and medium-term prospects

In 2004, according to the March 2005 fiscal notification, the general government deficit was 0.8 % of GDP. This is about 1¼ percentage points lower than the targeted deficit of 2.1 % set in the May 2004 convergence programme and more than 1 percentage point better than the budgeted deficit of 2.2 %. The difference was mainly due to better-than-expected tax revenues coming from output growth significantly higher than foreseen (8.5 % instead of 6.7 % foreseen in the 2004 budget law) and improvements in tax collection. The 2004 budget was amended twice, in August and in December. The first budget amendments, with a cost of nearly 0.9 % of GDP, provided for additional increases in teachers' salaries and subsidies to farmers. The second set of amendments, with a cost of more than 0.4 % of GDP, included a number of one-off payments previously intended for 2005, such as direct payments to farmers, contributions to the 2005 EU budget and advances for financing development and structural projects. The debt-to-GDP ratio at end-2004 was 14.4 %. The 2005 budget law was presented to Parliament on 13 December 2004 and adopted on 20 December. The budget, in line with the December 2004 convergence programme, targets a deficit of 1.6 % of GDP, which is significantly more ambitious than the 2.2 % of GDP deficit target set in the May 2004 convergence programme though with an unchanged underlying growth assumption of 6.7 %.

Compared with the May programme, in the 2005 budget both expenditure and revenue ratios are projected to increase substantially. This is, most importantly, a result of the frontloading of EU funds-related budgeting programmed for the period 2004–07. Furthermore, starting from 2005, the government plans to commence the modernisation and restructuring of the healthcare system, requiring a 10 to 15 % annual increase in public financing over the medium term. Strong growth, changes to the spending structure including administrative reform, improved tax collection and VAT increases implied by EU accession are expected to finance these reforms. In the Commission services' spring 2005 forecast, the projected outcome is in line with the targeted deficit. Nonetheless, it is based on higher growth assumptions (a 7.2 % annual growth rate rather than 6.5 %) and a more cautious estimate of revenues from EU funds.

Based on a no-policy-change assumption, the Commission services' spring 2005 forecast projects the general government deficit to decrease slightly to 1.5 % of GDP in 2006. This is in line with the December 2004 convergence programme ([1]) that aims at a slight reduction in the general government budget deficit from 1.6 % of GDP in 2005 to 1.4 % of GDP in 2007.

The debt-to-GDP ratio is expected to remain broadly stable in 2005 and 2006 (with a small fall to 14.0 % in 2005 before rising to 14.3 % in 2006), a profile that is slightly more optimistic than in the December 2004 update of the convergence programme.

Public expenditure prospects: the case of a strongly growing catching-up economy

The 2005 budget is the first to be legally embedded within a multiannual budgetary framework, in this case covering the period 2005–09 in line with the government's policy document, 'Medium-term key concepts for macroeconomic development and fiscal policy, 2005–09'. This document sets out key funding priorities and outlines annual general government deficit and debt targets. For the period up to 2007, this document largely corresponds to the December convergence programme update. The 2005 budget provides for more funding for the defence, healthcare and education sectors. This is consistent with the govern-

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.26

Budgetary developments 2003–07, Latvia

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**	
General government balance	– 1.5	– 0.8	– 1.6	– 1.5	
— Total revenues	34.2	35.2	35.4	35.3	
Of which: — current taxes	19.9	19.7	19.4	19.2	
— social contributions	9.2	8.8	8.2	7.8	
— Total expenditure	35.7	35.9	37.0	36.8	
Of which: — collective consumption	11.0	10.9	10.7	10.5	
— social transfers (2)	20.3	18.9	18.5	18.1	
— interest expenditure	0.8	0.8	0.8	0.8	
— gross fixed capital formation	1.5	1.7	2.6	3.1	
Primary balance	– 0.7	0.0	– 0.8	– 0.7	
Pm Tax burden	n.a.	n.a.	n.a.	n.a.	
Government debt	14.4	14.4	14.0	14.3	
Pm Real GDP (3)	7.5	8.5	7.2	6.9	
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 1.5	– 1.7	– 1.6	– 1.5	– 1.4
Primary balance	– 0.7	– 0.9	– 0.9	– 0.8	– 0.7
Government debt	14.4	14.2	14.5	14.8	15.0
Pm Real GDP (3)	7.5	8.1	6.7	6.5	6.5

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and convergence programme of Latvia.

Table V.27

Main measures in the budget for 2005, Latvia

Revenue measures	**Expenditure measures**
• Increase in the personal income tax-free threshold from LVL 21 per month to LVL 26 per month and the setting of income tax rebates for dependants at LVL 18 per month (– 0.2 % of GDP) • Application of the reduced VAT rate (5 % instead of 18 %) to domestic public transport services (– 0.08 % of GDP) • Increase in excise duties on oil and tobacco products (+ 0.3 % of GDP)	• Expenditures based largely on financing from EU Structural Funds and other financial instruments (+ 3.6 % of GDP) • Reform of the national armed forces and NATO integration-related requirements (+ 1.9 % of GDP mainly financed through restructuring of the budget) • Modernisation and restructuring of the healthcare system (+ 0.4 % of GDP) • Increased teachers' salaries (+ 0.3 % of GDP) • Other measures to improve social conditions including pension indexation (+ 0.7 % of GDP)

Sources: Commission services and the explanations to the 2005 budget law (2005 gada budžeta paskaidrojumi).

ment's medium-term policy priorities and financial obligations related to EU accession and NATO membership. However, the budget preparation process in Latvia still shows signs of a relatively weak planning process, in particular an unclear link between policy priorities and the allocation of resources. Budget allocations tend to be subject to inertia and structural rigidities, with only marginal adjustments. Achieve-

ment of the budgetary targets in turn depends on cash rationing of resources for line ministries. Adjustments of expenditure in the form of freezing of programmes take place during the budget year, even without revenue shortfalls. This indicates underestimation of some expenditure categories during the budget preparation phase. The practice of putting on hold programmes that have been approved by Parliament and government dates back to the 1998 Russian crisis. These accumulated 'frozen' commitments are the main reason why budget negotiations are so cumbersome despite high growth rates of nominal and real expenditure.

Access to EU funds could help in the very short term to achieve closer alignment of policy priorities and budget expenditure. However, budgetary expansion implies a further stimulus to demand ([1]).

While the general government deficit is capped at some 1½ % of GDP, spending (financed largely by EU grants) is budgeted to increase substantially. In all, the annual EU grants and related expenditures are expected to total some 5 to 7 % of GDP over the next few years.

([1]) However, the disbursement on EU-supported programmes can be expected to directly impact mainly on the domestic business sector, and within this sector on less tradable subsectors (in particular, construction) with access to currently unused or underused resources. While there will clearly be some primary and secondary effects in terms of higher imported inputs and bidding-up of factor costs, these should be more muted relative to a 'classic' budget deficit expansion in a fully employed economy.

These EU-financed expenditures do not widen the measured deficit; nonetheless they represent a sizeable increase in claims on available resources that could add to pressures on inflation and the external balance. Thus, the challenge for fiscal policy is not only to aid restructuring of the economy, but also to avoid or contain cyclically undesirable stimuli. The savings necessary to increase funding for priority programmes will have to be addressed in a manner conducive to sustainable, cost-effective results without disruptions to service delivery.

The announced government priorities include: the modernisation and restructuring of the healthcare system; support for institution building and strengthening of public administration to ensure greater efficiency (including the civil service pay reform initiated in 2002 but stalled for lack of resources); a significant increase in the financing of fundamental research and higher education; pension indexation; and an increase in childcare allowances. Pressure to implement these various reforms arises from relatively low salaries in the public sector, the high share of employment in that sector (estimated at 40 % of total employment), unfavourable health outcomes and the very high share of private financing of healthcare (affecting vulnerable social groups), and a dangerously low fertility rate (in 2003, the total fertility rate in Latvia was 1.29 compared with 1.52 in the EU-15).

Inflexible expenditures, those budget components that are either non-discretionary or not adjustable within the span of a few months, include the wage bill, interest payments,

Table V.28

General government expenditure by function, Latvia 2003, the EU-15 2002

	% of GDP		% of total expenditure	
	Latvia	EU-15	Latvia	EU-15
General public services	5.3	6.8	15.0	14.3
Defence	1.3	1.8	3.6	3.8
Public order and safety	2.4	1.7	6.8	3.6
Economic affairs	3.7	4.1	10.3	8.6
Environment protection	0.4	0.7	1.2	1.5
Housing and community amenities	0.9	0.9	2.6	1.9
Health	3.3	6.5	9.1	13.6
Recreation, culture and religion	1.4	0.9	3.8	1.9
Education; total expenditure	6.2	5.2	17.3	10.9
Social protection	10.8	19.1	30.2	40.0
Total expenditure	35.7	47.7	100	100

Sources: Eurostat and World Health Organisation.

subsidies and transfers. Subsidies are mainly agriculture subsidies, and transfers are primarily to households (social protection) and grants for healthcare. As is evident from Table V.29, the inflexible part of the budget is rather substantial although proportionally smaller than in the EU-15. While these obligations are to be expected, they limit the government's margin for manoeuvre in the event of exogenous shocks or a decision to fund new policies. The budget's non-discretionary portion is growing as a result of EU accession. Most importantly, the portion of the capital expenditure covering counterpart funds for implementation of the EU-fund-financed project can be considered as non-flexible expenditure. Furthermore, ever increasing participation of Latvia in various international organisations and projects claims a growing share of the budget (estimated at 1.2 % of GDP in 2005). Unless action is taken to review sector policies in the direction of increased cost-effectiveness, pressures on the overall fiscal stance will be felt.

Two expenditure items, in particular, stand out, namely collective consumption expenditure and compensation of employees. The former could be curbed by rationalising and restructuring the currently prolific system of State-managed agencies (more than 200) and companies (mainly utilities). The wage bill can only be curbed by reducing the total number of public sector employees. The share of public sector employment in total employment is rather high: according to the Central Bureau of Statistics, the public sector accounted for around 40 % of total employment. Nonetheless, high growth and the recent inflation hikes will intensify pressures to increase wages for public sector employees. Thus, savings from reducing the number of employees might be outweighed by increases in wages. In this respect, the current discussion among the Latvian authorities on future budgetary planning seems to favour restricting growth of expenditures on wages, goods and services, and transfers to below nominal GDP growth.

Table V.29

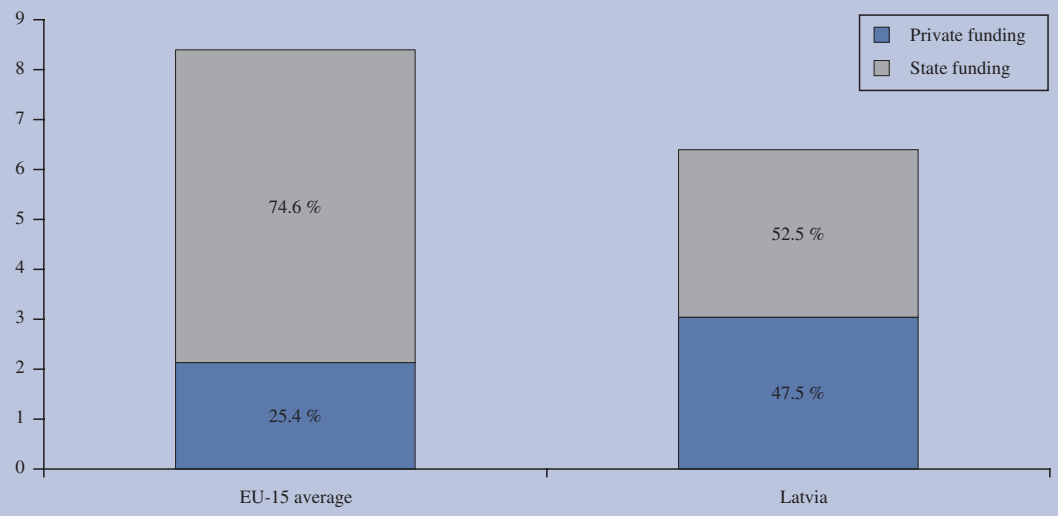
General government expenditure by national account categories in 2003, Latvia and the EU-15

	% of GDP		% of total expenditure	
	Latvia	**EU-15**	**Latvia**	**EU-15**
Collective consumption expenditure	11.0	8.3	29.7	17.3
Social transfers in kind	10.8	12.7	29.0	26.6
Final consumption expenditure of general government	21.8	21.0	58.7	44.0
— Of which compensation of employees	11.1	11.0	29.8	23.0
Other current expenditure	0.8	2.1	2.0	4.3
Social benefits other than social transfers in kind	9.6	16.6	25.8	34.8
Subsidies	0.8	1.2	2.4	2.6
Interest	0.8	3.2	2.2	6.7
Gross fixed capital formation	1.5	2.4	4.0	5.1
Other capital expenditure, including capital transfers	1.9	1.3	5.1	2.6
Total expenditure, general government (1)	37.1	47.8	100.0	100.0
Inflexible expenditures (2)	22.3	32.0	62.4	67.0

(1) The definition of government expenditure differs from the harmonised definition used in Table V.28.
(2) Inflexible expenditures, i.e. budget components that are either non-discretionary or not adjustable within the span of a few months, include the wage bill, interest payments, subsidies and social benefits other than transfers in kind.

Source: Eurostat.

Graph V.6: **Total healthcare expenditure in 2001 as a percentage of GDP**



Sources: Eurostat and World Health Organisation.

13. Lithuania

Recent developments and medium-term prospects

The general government deficit increased from 1.9 % of GDP in 2003 to 2.5 % in 2004. The outturn was slightly better than the 2.7 % of GDP target set in the budget for 2004. The main factor underlying the lower-than-projected deficit was a cautious forecasting of several categories of budgetary revenues by the authorities. As in recent years, revenues (excluding EU funds) were higher than expected, while expenditure related to co-financing of EU funds turned out lower than budgeted. These factors more than offset additional expenditure decided in June and December. A budgetary amendment allocated some 0.3 % additional spending in June, while in December, when it was clear that the deficit target would be met very comfortably, the decision was taken to raise 2004 spending by some 0.7 % of GDP. The major share of these expenditure adjustments were outlays related to compensations for lost savings and real estate restitutions. Despite the increase in the general government deficit, the debt ratio decreased slightly in 2004, due to strong growth and privatisation receipts, and remained relatively low at 19.7 % of GDP.

The budget for 2005 was approved by Parliament on 9 November 2004. The budget did not contain significant tax changes, apart from the planned abolition of the turnover tax in July 2005, which has not been replaced so far through compensating measures. In addition to a substantial increase in public investment and the costs of the pension reform, several measures are foreseen to entail significant additional spending in 2005 (e.g. increases of subsidies to agriculture, salary increases for public sector employees and payments related to the restitution of real estate assets and lost savings). Tax revenue growth, particularly that of corporate and personal income taxes, is expected to remain strong and, together with increasing EU transfers, broadly compensate for the expected increase in expenditure. The authorities' target for the general government deficit in 2005, as established in the January 2005 update of Lithuania's convergence programme, is 2.5 % of GDP ([1]). The target is in line with the Commission services' spring 2005 forecast.

The Commission services' spring 2005 forecast foresees the general government deficit to decrease to 1.9 % of GDP in 2006. The forecast was derived on a no-policy-change basis. The projected deficit is marginally higher than the 1.8 % of GDP target set in the January 2005 update of Lithuania's convergence programme. The update foresees a further reduction in the deficit to 1.5 % of GDP in 2007.

The debt ratio is expected to remain close to 21 % of GDP in 2005 and 2006 according to the Commission services' spring 2005 forecast.

The compensation for lost savings and restitution of property rights

In the aftermath of independence, the government decided to restore real estate assets confiscated during the Soviet times. In 1991, a law regulating the procedure and conditions for restoration of property was published. An amendment to the law in 1996 established that liabilities related to residential houses should be fully paid by 2011. Restoration of property has been primarily made in actual or equivalent property, or by pecuniary compensations. The outstanding amount to be repaid in relation to the restitution of real estate assets was estimated at 1.7 % of GDP in December 2004.

During the early years of transition, the Lithuanian economy endured a difficult process of hyperinflation, shortages of consumer goods and administrative restrictions in the form of freezing of savings deposits. Deposits denominated in roubles (and the surrogate currency talonas) depreciated rapidly during that period. Following the

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.30

Budgetary developments 2003–07, Lithuania

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**	
General government balance	– 1.9	– 2.5	– 2.4	– 1.9	
— Total revenues	32.3	31.8	32.3	31.6	
Of which: — current taxes	19.9	19.0	18.5	18.1	
— social contributions	8.7	8.4	8.6	8.5	
— Total expenditure	34.2	34.3	34.8	33.6	
Of which: — collective consumption	7.6	7.3	7.3	7.0	
— social transfers (2)	20.0	19.6	19.5	18.8	
— interest expenditure	1.3	1.0	0.9	0.9	
— gross fixed capital formation	3.0	3.2	3.4	3.4	
Primary balance	– 0.6	– 1.5	– 1.5	– 1.1	
Pm Tax burden	28.6	27.4	27.1	26.6	
Government debt	21.4	19.7	21.2	20.9	
Pm Real GDP (3)	9.7	6.7	6.4	5.9	
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 1.9	– 2.5	– 2.5	– 1.8	– 1.5
Primary balance	– 0.6	– 1.5	– 1.4	– 0.8	– 0.5
Government debt	21.4	20.1	20.9	20.3	20.1
Pm Real GDP (3)	9.7	6.5	6.5	6.2	6.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted on 14 January 2005.

Sources: Commission services and convergence programme of Lithuania.

Table V.31

Main measures in the budget for 2005, Lithuania

Revenue measures	**Expenditure measures**
• Abolition of the turnover tax (– 0.4 % of GDP)	• Increase of subsidies to agriculture (0.6 % of GDP) • Compensations for lost property and savings (0.4 % of GDP) • Salary increases for public sector employees (0.2 % of GDP)

Sources: Commission services and January 2005 update of the convergence programme.

introduction of the litas in 1993, the government decided to compensate for the losses of savings held in State banks by Lithuanian citizens due to the sharp currency depreciations. Initially, there was no formal calendar for repayments. A first wave of compensations started in 1993 and, after some interruptions, saving restitutions continued under the 1997 law on the restoration of savings of the population. Privatisation receipts were used as the main source of financing for these liabilities. As of December 2004, the amounts of savings compensations pending payment were estimated at some 2.5 % of GDP.

Compensations related to both real estate property confiscations and lost savings have so far taken place according to a schedule decided each year by the government, and the repaid amounts have typically differed from the budgeted amounts. In recent years, the government was flexible in the repayment of the savings and real estate liabilities in order to contain expenditure during cyclical downturns. This was particularly evident during the period following the 1998 Russian crisis, when the savings compensation and real estate restitution programmes were almost fully interrupted. In con-

trast, the government has recurrently repaid higher-than-budgeted amounts during the cyclical upswing of the last few years.

In Lithuania's first convergence programme submitted to the European Commission in May 2004, the government presented for the first time a medium-term plan for the payment of lost rouble savings and real estate assets for the period 2004–07, increasing transparency about the medium-term budgetary plans.

The January 2005 update of the convergence programme foresees the amounts to be paid related to compensations for lost savings and restitution of property rights to account for 0.4 % of GDP in 2005, 0.8 % in 2006 and 1.2 % in 2007.

Compensations for lost savings and confiscated real estate assets have so far been recorded in the government accounts as government expenditure in the year when they are paid, therefore increasing the general government deficit in the same year. The amounts yet to be paid are not included in the government debt at this moment. Classification changes in the future cannot be excluded, as there are ongoing discussions between Eurostat and Lithuania's statistical authorities on the recording of transactions related to the compensations. According to the Eurostat news release of 18 March 2005 ([1]), such classification changes could lead to a downward revision of the government deficit for 2004 and earlier years and a corresponding adjustment in the debt. It would also entail a revision of the budgetary and debt targets presented in the update of the convergence programme, as payments related to these liabilities are included in the budgetary targets (under the assumption that no other categories of expenditure would be increased to compensate for the statistical effect of removing these liabilities from the budgetary targets).

([1]) Eurostat: Euroindicators News Release 39/2004, 18.3.2005, 'First notification of deficit and debt data for 2004'.

14. Luxembourg

Recent developments and medium-term prospects

Following a sharp reduction in the general government surplus from a record 6.2 % of GDP both in 2000 and 2001 to 0.5 % of GDP in 2003, a deficit of 1.1 % of GDP was recorded in 2004, according to the March 2005 reporting by the Luxembourg authorities. This is, however, better than the 1.8 % of GDP deficit projected in the 2003 update of the stability programme and the 1.4 % deficit estimated in the 2004 update: tax revenues significantly exceeded projections whereas, at the same time, investment expenditure figures had to be revised upwards in order to take into account some big projects based on a public–private partnership that previously had not been recorded in the government sector; as a result, public spending figures were pushed up by about a ½ percentage point of GDP.

The final outcome for 2004 might well be even more favourable than the March reporting indicates since, according to data made available since then, the State (excluding the special funds — see footnote 1 this page) recorded a 0.3 % of GDP surplus in 2004, while a 0.3 % of GDP deficit had been initially projected in the budget. The debt ratio was also revised upwards for the same reason as government investment. It reached 7.5 % of GDP in 2004 instead of 5.0 % as indicated before (e.g. in the 2004 update of the stability programme), a slight increase with respect to 2003 (from 7.1 % of GDP).

The 2005 budget was adopted by Parliament on 9 December 2004. It foresees an increase of about 8 % both in the revenues and the expenditure of the State ([1]). According to the budget, the general government should record a 1.2 % of GDP deficit in 2005, with the central government (including the State and the special funds) deficit reaching 3.0 % of GDP, the social security surplus 1.8 % of GDP and the finances of local authorities being broadly balanced. These projections are close to those presented in the 2004 update of the stability programme, submitted on 30 November 2004 ([2]), where the 2005 general government deficit was projected at 1.0 % of GDP, a 0.4 percentage points of GDP improvement with respect to the 2004 deficit as estimated at that time. According to the Commission services' spring 2005 forecasts, based on the current policy stance, the general government deficit is expected to widen from 1.1 % of GDP in 2004 to 1.5 % in 2005. Reflecting the relatively strong growth in output and employment, government revenues would be buoyant (and even more than in the recent past), rising by about 6 %, compared with 4 % in 2003 and 5 % in 2004. However, government spending, though decelerating (it rose by 9 % in 2004), is still projected to increase by about 7 %. The main difference between the projections of the stability programme and the Commission services' forecasts is in the evolution of the revenues ratio, which the programme projects to increase by 1.2 percentage points of GDP in 2005, while the Commission services forecast it to decrease slightly. In cyclically adjusted terms, the deficit should deteriorate by 0.3 percentage points of GDP in 2005, a broadly neutral budgetary policy stance after the 1.6 percentage points of GDP worsening recorded in 2004. However, due to the very specific features of the economy, estimates of cyclically adjusted balances in Luxembourg are surrounded by a very high degree of uncertainty.

For 2006 and 2007, the 2004 update of the stability programme does not present a detailed budgetary strategy but rather a technical projection, where the expendi-

([1]) It is difficult to estimate developments in central government spending from the budget because a large part of public investment in Luxembourg is not made by the State itself but by special funds, financed by the State budget on a pluriannual basis. Investments made by these funds do not necessarily take place in the year the financing is provided and do not closely reflect developments in capital spending as presented in the budget.

([2]) The budget was adopted later, on 9 December, but the projections presented in the stability programme are more recent than those of the budget since the draft budget was submitted to Parliament on 20 October. The updated stability programme can be found at http://www.fi.etat.lu/6th_update_of_the_luxembourg_stability_and_growth_programme_2003_2007.pdf.

Table V.32

Budgetary developments 2003–07, Luxembourg

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**	
General government balance	0.5	– 1.1	– 1.5	– 1.9	
— Total revenues	45.5	44.9	44.4	44.2	
Of which: — current taxes	29.3	28.9	28.7	28.7	
— social contributions	12.4	12.2	12.0	11.9	
— Total expenditure	45.1	46.0	46.0	46.0	
Of which: — collective consumption	7.3	7.2	7.1	7.1	
— social transfers (2)	26.7	26.7	26.8	27.1	
— interest expenditure	0.3	0.2	0.2	0.2	
— gross fixed capital formation	4.9	5.0	5.1	5.1	
Primary balance	0.8	– 0.9	– 1.3	– 1.7	
Pm Tax burden	41.3	40.9	40.5	40.4	
Government debt	7.1	7.5	7.8	7.9	
Pm Cyclically adjusted balance	1.3	– 0.3	– 0.6	– 0.6	
Pm Cyclically adjusted primary balance	1.6	– 0.1	– 0.3	– 0.5	
Pm Real GDP (3)	2.9	4.2	3.8	4.0	
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	0.8	– 1.4	– 1.0	– 0.9	– 1.0
Primary balance	1.0	– 1.2	– 0.9	– 0.8	– 0.9
Government debt	5.3	5.0	5.0	4.6	4.5
Pm Real GDP (3)	2.9	4.4	3.8	3.3	4.3

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in November 2004.

Sources: Commission services and stability programme of Luxembourg.

Table V.33

Main measures in the budget for 2005, Luxembourg

Revenue measures	**Expenditure measures**
• Rise in the excise duty on diesel fuel (EUR 0.01 per litre) • Increase from 12 % to 15 % in the VAT on car fuel and tobacco products. According to the budget, these measures should yield together about 0.2 % of GDP. Moreover, it was decided in November to raise contributions for healthcare in kind from 5.1 % to 5.4 % of gross compensations, which should also yield about 0.2 % of GDP.	• Encouragement of alternative sources of energy (0.1 % of GDP) • Investments in railway infrastructure (0.1 % of GDP) • It was also decided to reduce health expenditure by 0.1 % of GDP (with respect to its 'spontaneous' increase as previously projected) • Pensions of the private sector were raised by 2 % in January 2005 in order to follow the rise in real wages, which should lead to a 0.2 % of GDP increase in pension expenditure. Such adaptations occur every two years.

Sources: Commission services and 2005 budget.

ture-to-GDP and revenue-to-GDP ratios are kept broadly constant. Consequently, the deficit is projected to fluctuate in a narrow margin around the 1.0 % of GDP level forecast for 2005, decreasing to 0.9 % of GDP in 2006 and coming back to 1.0 % in 2007. For 2006, the Commission services' spring forecasts, based on a no-policy-change assumption, project the general government deficit to deteriorate from 1.5 % of GDP in

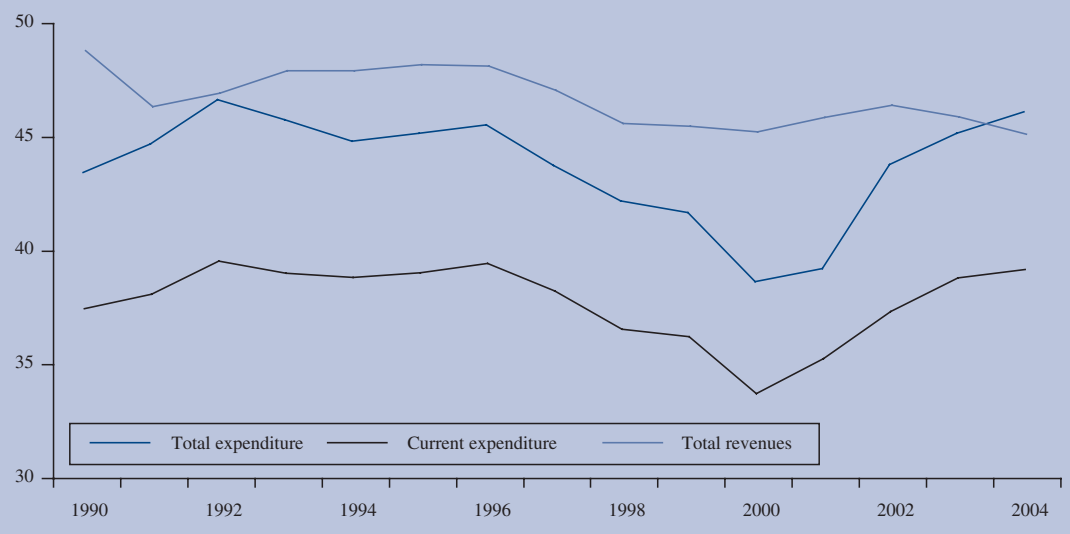
2005 to 1.9 % despite a 6 % rise in revenues due to a rather fast increase in output and employment, while expenditure should rise by about 7 % as in 2005. The deterioration in the government balance should thus occur despite a significant acceleration in revenues and a non-negligible slowdown in spending: for comparison, total government revenues rose by 4 to 5 % a year from 2002 to 2004, while total government spending increased by more than 8 % in 2003 and 2004. As a result of these widening deficits, the public debt is expected to rise to about 8 % of GDP in 2006.

Government spending in a medium-term perspective

In recent years, government finances have experienced major changes in Luxembourg: the general government surplus, which had been fluctuating around 2 or 3 % of GDP since the early 1990s, rose sharply at the end of the decade, reaching 6.2 % of GDP both in 2000 and 2001. As indicated above, it then declined abruptly and turned into a 1.1 % of GDP deficit in 2004, a 7.3 percentage points of GDP deterioration in only three years. These sharp fluctuations were related to the extremely high volatility in GDP growth, which reached 9.0 % in 2000 and then abruptly slowed down to 1.5 % in 2001. However, as shown by Graph V.7, fluctuations in the government balance in recent years were caused more by developments in expenditure than by changes in revenues, as the buoyancy in revenues induced by the record growth of the late 1990s was for a large part compensated by important tax cuts The biggest decline in the revenues ratio observed over the period occurred between 1996 and 2000, when the surplus was surging.

On the contrary, the expenditure ratio exhibited important fluctuations throughout the period, partly — but not exclusively — due to the volatility in real and nominal GDP growth: as shown by Graph V.7, government expenditure in Luxembourg has gone through three different phases since the beginning of the 1990s: from 1990 to 1996, the expenditure ratio fluctuated in a narrow margin around 45 % of GDP, from 1996 to 2000 it fell by almost 7 percentage points of GDP and since 2000 it has been increasing again, coming back to similar levels as in the period 1990–96. During the first phase, only social transfers, especially transfers in cash, rose significantly in relative terms, increasing by 2.4 percentage points of GDP from 1990 to 1996. During the same period, all the other main categories of public expenditure hardly rose by more than 0.2 or 0.3 percentage points of GDP and even often declined in relative terms.

Graph V.7: **General government expenditure and revenues, 1990–2004 (% of GDP)**



Source: Commission services.

From 1996 to 2000, all categories of public spending declined sharply in relative terms, with the exception of the residual item 'other current expenditure'. Overall, general government expenditure fell by 6.9 percentage points of GDP in four years, of which 5.7 percentage points of GDP were accounted for by current expenditure. This sharp fall did not result from spending cuts, since the rise in government spending was only slightly slower than during the previous years, but from a 'denominator effect': the main factor behind this strong fall in the expenditure ratio was the record real and nominal GDP growth of the late 1990s ([1]).

The reverse happened from 2000 to 2004: in four years, general government total expenditure rose by 7.5 percentage points and current expenditure by 5.5 percentage points of GDP. The sudden slowdown in real and nominal GDP growth played a major role in this evolution. However, there was an additional factor: as shown in Table V.34, the rise in all categories of government expenditure, with the sole exceptions of the interest payments and the item 'other current expenditure', accelerated with respect to the period 1996–2000. This acceleration was especially marked for social transfers (9.5 % a year on average as against 6.6 % for social transfers in kind and 8.6 % instead of 6.4 % for transfers other than in kind) and for capital expenditure (12.0 % as against 5.5 % for government investment and 21.2 % instead of 4.9 % for other capital expenditure).

It is often argued that the fast rise in public spending in Luxembourg in recent years is due to the very high and rapidly increasing investment by the government. This is only part of the explanation: capital expenditure explains 2.0 and current expenditure 5.5 of the 7.5 percentage points of GDP increase in total government spending from 2000 to 2004. Over the same period, social transfers (both in kind and in cash) rose by 3.9 percentage points of GDP, which means that they contributed nearly twice as much as capital expenditure to the global increase in government spending. They also accounted for about three quarters of the rise in current government expenditure. The rise in unemployment (the Eurostat harmonised unemployment rate rose from 2.0 % in the spring of 2001 to 4.4 % in the latest months) resulting from the economic slowdown played a role in this increase in social transfers but this role was limited as total government expenditure related to unemployment only rose from 1.0 % of GDP in 2000 to 1.2 % in 2004.

A much more important factor was some discretionary measures taken in the early years of the century, such as the creation of the dependency insurance ([2]) or the major rise in pensions decided in 2002 and known as the *Rentendësch* (altogether with a large increase in family allowances), which, according to some estimates, increased pension expenditure by about 10 %.

The situation of Luxembourg's public finances is certainly not bad: public debt remains extremely low despite its recent upward revision and assets held by the general government amount to about 50 % of GDP, according to most estimates. However, the experience of recent years shows that a sharp deterioration in the government balance can occur quite rapidly in periods of slower growth (and despite the fact that, during the recent slowdown, growth has remained significantly more robust in Luxembourg than in neighbouring countries). This requires some restraint in spending in the years to come, in order to ensure that government expenditure remains in line with revenues and that sufficient security margins may be kept to cope with a possible slowdown in growth in the medium term and with the burden that the ageing population will inevitably impose on public finances.

([1]) The annual growth rates in real GDP recorded from 1997 to 2000 ranged from 6.9 % in 1998 to 9.0 % in 2000 and the rate of increase in nominal GDP varied from 9.8 % in 1998 to 13.6 % in 2000.

([2]) It was created in 1998 but only progressively resulted in large outlays.

Table V.34

Main categories of government expenditure 1990–2004, Luxembourg

	Levels (% of GDP)			Differences (% of GDP)		Average annual growth rates (%)	
	1996	2000	2004	1996–2000	2000–04	1996–2000	2000–04
1. Total government consumption (1) = (2) + (3)	18.9	15.7	18.2	– 3.2	+ 2.5	6.2	8.6
1a. Of which: compensation of employees	*9.7*	*7.8*	*8.6*	*– 1.9*	*+ 0.8*	*5.4*	*7.4*
2. Collective consumption	8.0	6.5	7.2	– 1.5	+ 0.7	5.7	7.4
3. Social transfers in kind	10.9	9.2	11.0	– 1.7	+ 1.8	6.6	9.5
4. Social transfers other than in kind	16.2	13.6	15.7	– 2.6	+ 2.1	6.4	8.6
5. Total social transfers (5) = (3) + (4)	**27.1**	**22.8**	**26.7**	**– 4.3**	**+ 3.9**	**6.5**	**9.0**
6. Interest payments	0.5	0.3	0.2	– 0.2	– 0.1	0.8	– 3.3
7. Subsidies	2.0	1.6	1.7	– 0.5	+ 0.1	4.1	6.7
8. Other current expenditure	1.8	2.4	3.3	+ 0.7	+ 0.8	20.6	12.7
9. Current expenditure (9) = (1) + (4) + (6) + (7) + (8)	**39.4**	**33.7**	**39.1**	**– 5.7**	**+ 5.5**	**6.9**	**8.8**
10. Gross fixed capital formation	4.7	3.8	5.0	– 0.9	+ 1.2	5.5	12.0
11. Other capital expenditure (including capital transfers)	1.3	1.0	1.9	– 0.3	+ 0.8	4.9	21.2
12. Capital expenditure (12) = (10) + (11)	**6.0**	**4.9**	**6.9**	**– 1.2**	**+ 2.0**	**5.4**	**14.2**
13. Total expenditure (13) = (9) + (12)	**45.4**	**38.5**	**46.0**	**– 6.9**	**+ 7.5**	**6.7**	**9.5**
Pm Real GDP	—	—	—	—	—	8.0	2.8
Pm Nominal GDP	—	—	—	—	—	11.2	4.8

Source: Commission services.

15. Hungary

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit was reduced by 1.7 percentage points of GDP in 2004, reaching 4.5 % of GDP. This is worse than the 3.6 % of GDP deficit target of the May 2004 convergence programme. It should be noted that the 2004 deficit is significantly affected by an adjustment in the recording of VAT revenue, increasing the 2003 deficit by 0.7 percentage points of GDP while reducing the 2004 deficit accordingly, which may be subject to further revision. The debt-to-GDP ratio increased from 56.9 % of GDP in 2003 to 57.6 % of GDP in 2004.

The 2005 budget was adopted by Parliament on 20 December 2004, targeting a deficit of 3.6 % of GDP. The expenditure reduction would be mainly based on a 0.5 percentage point decline in the interest burden and a 1.7 percentage point reduction in public investment expenditure (which would be largely compensated by an increased recourse to PPP projects).

In light of the existing risks, notably a repeated shortfall in VAT revenues as in 2004 and the uncertain budgetary impact of the intended PPP projects, the Commission services' spring 2005 forecast projects an outcome of 3.9 % of GDP. This already takes into account the 0.3 percentage points of GDP increase in the 'emergency' reserve against a possible missing of the 2005 target contained in the budget, and some limited additional revenues, which are expected to result from the measures announced by the Hungarian government in March 2005.

The Commission services' spring 2005 forecast projects the deficit to rise to 4.1 % of GDP in 2006, compared with a target of 2.9 % in the December 2004 update of the convergence programme ([1]). The difference is due to the usual no-policy-change assumption underlying the Commission services' forecast. In particular, the increase in public investment projected in the update is not assumed to be compensated as the expenditure-saving effects of the measures contained in the 2005 budget were not backed by sufficient reforms. The convergence programme update plans a further deficit reduction in 2007 and 2008, to 2.2 % and 1.6 % of GDP respectively (figures including the pension reform burden would be 3.4 and 2.8 % of GDP respectively).

The Commission services' spring 2005 forecast projects the debt ratio to broadly stabilise in 2005–06, at around 58 % of GDP, rather than decline slightly, as targeted in the updated convergence programme, which is explained by the higher deficit forecasts in the spring forecast.

([1]) Taking into account the revised pension reform burden as explained in the second footnote to Table V.34.

Table V.35

Budgetary developments 2003–08, Hungary

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance (2)	– 6.2	– 4.5	– 3.9	– 4.1		
— Total revenues (2)	44.5	47.5	44.0	43.2		
Of which: — current taxes	25.5	26.0	25.2	25.5		
— social contributions (2)	135	13.6	13.6	13.4		
— Total expenditure	50.7	52.0	47.9	47.3		
Of which: — collective consumption	10.8	10.6	10.2	10.0		
— social transfers (3)	27.5	27.3	26.7	26.5		
— interest expenditure	4.2	4.3	3.8	3.4		
— gross fixed capital formation	3.4	3.5	2.3	3.1		
Primary balance (2)	– 2.2	– 0.2	0.0	– 0.7		
Government debt (2)	56.9	57.6	57.8	57.9		
Pm Real GDP (4)	3.0	4.0	3.9	3.8		
Convergence programme (5)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance (2)	– 5.5	– 4.4	– 3.6	– 2.9	– 2.2	– 1.6
Primary balance (2)	– 1.6	0.4	0.0	0.2	0.6	1.0
Government debt (2)	57.0	56.7	55.5	53.0	50.6	48.3
Pm Real GDP (4)	3.0	3.9	4.0	4.2	4.3	4.6

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second-pillar pension funds, these funds can be classified inside the general government sector until the March 2007 EDP notification. The figures indicated in this table take into account the decision by the Hungarian authorities to avail themselves of this possibility. The official general government deficit figures and targets have therefore been reduced by the estimated impact of the pension reform (as notified in March 2005) compared with the figures provided in the May convergence programme. According to the March 2005 EDP notification, the budgetary effect for Hungary was of 0.9 % of GDP in 2003 and 2004 and on the debt of 2.2 % of GDP in 2003 and 3.1 % of GDP in 2004. According to the Hungarian national sources, the effect in 2005 and 2006 is expected to be of 1.1 % of GDP in 2005 and 1.2 % of GDP p.a. for the period until 2008.
(3) In kind and other than in kind.
(4) Annual % change.
(5) Submitted in December 2004; the figures indicated as coming from the convergence programme have been adjusted by the change in the pension reform burden as notified in March 2005.

Sources: Commission services and convergence programme of Hungary.

Table V.36

Main measures in the budget for 2005, Hungary

Revenue measures	Expenditure measures
• Changes in the tax and contribution system, mainly in the personal income tax system and in some smaller tax categories (impact on tax revenues: – 0.35 % of GDP); two thirds of the impact due to one-off effects (such as the disappearance of customs revenues after EU accession and the non-adjustment of some excise taxes)	• Decrease in public investment expenditures (1.7 % of GDP) • Expected decline in interest expenditures (0.5 % of GDP) • A number of institutional changes to better control operational expenditure and the public sector wage bill • The freeze of the level of unused appropriations at their end-2004 level
• Revenues from the extension of expiring GSM licences	• Increase in 'emergency' reserve (from 0.5 to 0.8 percentage points of GDP) against a possible departure from the 2005 target

Source: Commission services.

16. Malta

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit for 2004 reached 5.2 % of GDP. This is half the 2003 outcome (10.5 % of GDP) and consistent with the deficit target set in both the May 2004 convergence programme and the updated version submitted on 7 December 2004. Part of the deficit reduction in 2004 (3.2 percentage points of GDP) reflects a one-off operation related to the restructuring of the shipyards in 2003. Another part is the result of the fiscal consolidation measures undertaken in the budget (around 1.5 percentage points of GDP). The rest is due to higher tax collection brought about by stronger economic growth. The debt ratio in 2004 increased to 75 % of GDP, which is above the 73.2 % estimated in the convergence programme. The difference is explained by the upward revision of the 2003 general government deficit.

Parliament approved the 2005 budget in December 2004. The budget seems consistent with the commitments spelled out in the convergence programme to cut the budget deficit to below 4 % of GDP in 2005. The Commission services' spring 2005 forecast projects the deficit to fall to 3.9 % of GDP in 2005, compared with a target of 3.7 %. The deficit reduction will be reached through revenue-enhancing measures and expenditure restraint. Only some of the revenue-enhancing measures are permanent (adjustments in taxes and strengthening of the fight against tax and benefit fraud) whilst others are one-offs (other minor receipts). On the revenue side, the measures announced in the budget are projected to lower the deficit ratio for 2005 by 1.5 percentage points of GDP. Expenditure cutbacks are expected from the restructuring of public entities, limiting public sector hiring and reducing administrative costs. The revenue and expenditure ratios are foreseen to decline by 0.8 and 1.5 percentage points of GDP respectively. As a result, the primary balance is expected to turn positive to 0.5 % of GDP, from – 1.1 % of GDP in 2004. The major revenue sources are current taxes, which are projected to grow by 2.2 percentage points of GDP, and social security contributions fuelled by gradually increasing job creation, which increase by 0.3 percentage points of GDP. However, the rise in taxes and social security receipts is more than offset by the fall in other current resources. On the expenditure side, while both social transfers and collective consumption marginally decline, gross fixed capital formation drops by 0.4 % of GDP, as project implementation linked to the Italian protocol ([1]) comes to an end. The bulk of the expenditure reduction comes from other current and capital expenditures.

For 2006, based on a no-policy-change assumption, the Commission services' spring 2005 forecast projects a further decrease in the general government deficit to 2.8 % of GDP. This is above the deficit target of 2.3 % of GDP presented in the update of the convergence programme. For 2007, the updated convergence programme targets a further fall in the deficit to 1.4 % of GDP.

The spring 2005 forecast projects the general government debt level for 2005 to increase to 76.4 % of GDP, with a further increase to 77.1 % by 2006. These projections do not take into account possible stock-flow adjustments produced by some privatisation operations foreseen by the government.

The reform of the pension system

In November 2004, the Maltese government presented as a White Paper the report prepared by the Pensions Working Group. The government aims at launching a process of discussion and consultations among the social partners leading to the reform of the Maltese pension system.

([1]) Cooperation agreement between Malta and Italy to finance works in Malta on a grant basis.

Table V.37

Budgetary developments 2003–07, Malta

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006	
General government balance	– 10.5	– 5.2	– 3.9	– 2.8	
— Total revenues	40.5	49.0	48.8	48.6	
Of which: — current taxes	25.6	27.2	29.4	29.3	
— social contributions	8.3	8.3	8.6	8.7	
— Total expenditure	50.9	54.1	52.6	51.4	
Of which: — collective consumption	10.1	10.2	10.1	10.0	
— social transfers (2)	24.4	24.5	24.3	23.5	
— interest expenditure	3.8	4.1	4.3	4.3	
— gross fixed capital formation	5.3	4.3	3.9	3.7	
Primary balance	– 6.7	– 1.1	0.5	1.5	
Pm Tax burden	32.5	35.7	38.1	37.8	
Government debt	71.8	75.0	76.4	77.1	
Pm Real GDP (3)	– 1.8	1.5	1.7	1.9	
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 9.6	– 5.2	– 3.7	– 2.3	– 1.4
Primary balance	– 6.0	– 1.4	0.3	1.6	2.4
Government debt	72.0	73.2	72.0	70.5	70.4
Pm Real GDP (3)	– 1.7	0.6	1.5	1.8	2.2

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and convergence programme of Malta.

Table V.38

Main measures in the budget for 2005, Malta

Revenue measures	Expenditure measures
• Inherited real estate within a specified period will be able to adjust the declared value in order to reflect the change in the value of the real estate up to 25 November 2003 • Broadening of items subject to eco-contribution • Introduction of excise duty and VAT on kerosene • Doubling of passenger departure tax payable on outgoing air fares • Introduction of excise duty on mobile telephony • Strengthening the fight against tax and benefit fraud	• Restructuring of public entities • Sale of government property in 2005 • Limiting public sector hiring and reducing administrative costs

Sources: Commission services and updated convergence programme Malta.

The White Paper identifies three crucial issues that concurrently threaten the future viability of the current system: (i) demographic developments; (ii) inefficiencies in the Maltese labour market; (iii) the financial constraints caused by the inadequacy and lack of sustainability of the existing scheme. The White Paper recommends changing the current PAYG scheme to a three-pillar system. The main principle is that health funding should be separated from social security funding. The retirement age is gradually increased to 65 years of age for both men and women.

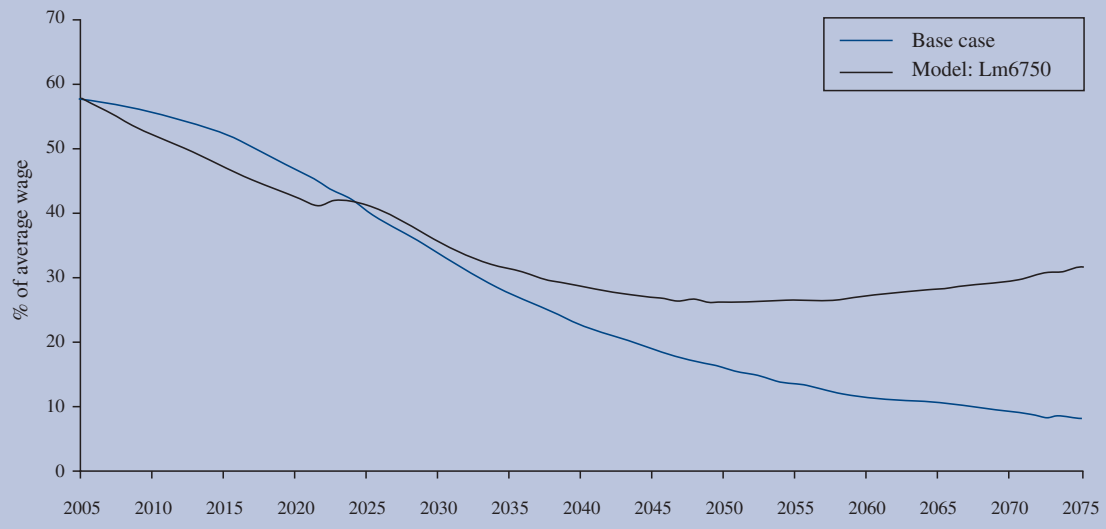
The first pillar should be mandatory and guarantee a minimum pension as a safety-net against poverty for those individuals with short careers or very low earnings during their working lives. Recipients of the first-pillar pension would have their retirement pension indexed to the retail price index. The contribution period should be increased from 30 to 40 years, while the baseline for the calculation of the pension should be changed from the best consecutive three years from the last 10 years to the average of the 40-year contribution accumulation history. The second pillar should also be mandatory but introduced in a gradual manner, first on a voluntary basis as from January 2006, to become mandatory by 2010, subject to an assessment to determine whether the prevailing conditions at that time require such a step. The second pillar should be devoted to supplementing pension benefits received. The third pillar should also provide for voluntary individual retirement provisions and should be introduced as from January 2006. The annual contribution to this pillar up to a capped value should not be taxed, while income tax on the basis of the individual's rate of PAYE (pay as you earn) will be paid upon maturity of the investment.

The demographic and economic projections modelled by the World Bank compare a baseline scenario of no change and a model scenario with the introduction of the proposed changes. The base case shows a social security deficit deterioration within a relatively short period of time, while in the model scenario this deficit increases steeply in the first 10 years, but less than in the base case, due to the transfer of first-pillar contributions to the health fund. However, under the proposed reform, the social security deficit will decrease from 3 % of GDP to 2 % of GDP by 2025.

The implementation of the reform should also notably smooth the deterioration in the benefits as a percentage of the average wage, stabilising at 30 % of the average wage by 2023 to improve gradually to 40 % of the average wage.

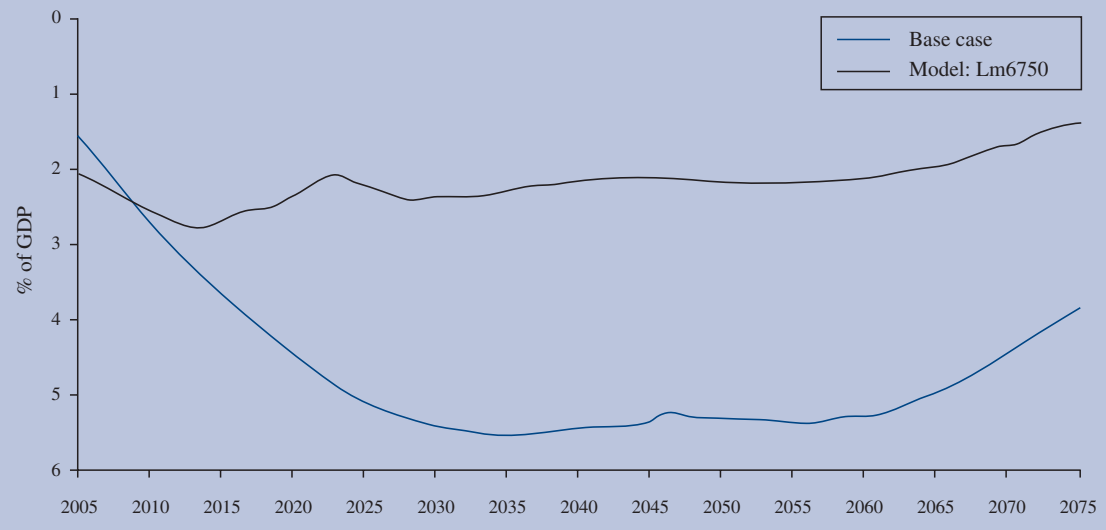
The White Paper draws a gradual and long-term scenario for the implementation of the reform of the pension system in order to make the transition to the new system easier and to smooth the impact on individuals, employers and the economy as a whole. It is noted that the reform must be managed in a gradual manner with structured periodic reviews to allow for the adoption of parametrical changes as and when appropriate. It is also pertinent to mention that the well-developed financial sector in Malta paves the way for the risk diversification of pension assets generated for a funded pillar and, at the same time, contributes to the expansion of the domestic financial market. The first measures to implement the reform of the Maltese pension system are expected in the forthcoming months.

Graph V.8: **Sustainability**



Source: World Bank, October 2004.

Graph V.9: **Adequacy**



Source: World Bank, October 2004.

17. The Netherlands

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit fell to 2.5 % of GDP in 2004. This is a slightly higher deficit than the 2.3 % of GDP foreseen in the October 2003 update of the stability programme. The composition of the deficit in 2004 was different from what was anticipated in the 2004 budget. Tax revenues were weaker, even though they recovered sharply towards the end of 2004, but receipts from the sale of natural gas were higher in the wake of rising oil and gas prices.

Some expenditure overruns were largely offset by non-recurrent lower public infrastructure investment and lower payments to the EU. The debt ratio increased by 1.4 percentage points of GDP, to 55.7 % at the end of 2004.

The budget for 2005 was presented to Parliament on 21 September 2004, and adopted shortly afterwards with some modifications that did not have an appreciable impact on the main budgetary aggregates. The 2005 budget contains substantial increases in the tax burden and expenditure cuts, aimed at further reducing the deficit (see Table V.40). The 2005 budget targets a general government deficit of 2.6 % of GDP in 2005. However, the March 2005 EDP reporting expects a lower deficit of 2.1 % of GDP ([1]). The Commission services' spring 2005 forecast also projects a lower deficit of 2.0 % of GDP, mainly on account of the more favourable starting position in 2004, higher receipts from the sale of natural gas, and tax receipts picking up due to the gradual cyclical upturn.

According to the Commission services' spring 2005 forecast, the fiscal stance as measured by the change in the cyclically adjusted balance will tighten markedly. The cyclically adjusted deficit is expected to fall from 1.2 % of GDP in 2004 to 0.4 % of GDP in 2005, in response to fiscal tightening. The improvement in the underlying budgetary position between 2004 and 2005 is stronger than was calculated using the data in the 2004 stability programme update. On the basis of the latter, the cyclically adjusted deficit would fall from 1.6 % of GDP in 2004 to 1.2 % of GDP this year, in view of a higher projected nominal deficit than in the Commission services' spring 2005 forecast, and a somewhat different profile for the determinants of potential growth.

Public finances are expected to improve further in 2006. This reflects the forecast economic upturn, as the fiscal stance will be broadly neutral under the no-policy-change assumption. The Commission services' spring forecast projects a deficit of 1.6 % of GDP in 2006, which is lower than the target of 2.1 % of GDP set in the November 2004 update of the stability programme. This is mainly due to the differences in the starting points of the projections ([2]). The stability programme update projects the general government balance to marginally improve further in 2007, to 1.9 % of GDP.

According to the spring 2005 forecast, the debt ratio will rise further in 2005 and 2006, to 57.6 and 57.9 % of GDP respectively. This is due to the still significant nominal deficit, fairly weak nominal GDP growth, and, in 2005, to the purchase of gas transport infrastructure equivalent to 0.6 % of GDP, an operation which is not reflected in the deficit.

([1]) See http://www.minfin.nl/default.asp?CMS_ITEM=MFCWDEF1AE0ADB8604FACA9E090D8745D48C1X2X59419X91.

([2]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.39

Budgetary developments 2003–07, the Netherlands

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006	
General government balance	– 3.2	– 2.3	– 2.0	– 1.6	
— Total revenues	45.8	45.5	45.8	47.6	
Of which: — current taxes	23.9	24.1	24.5	24.5	
— social contributions	15.5	15.1	15.0	16.9	
— Total expenditure	48.9	48.0	47.9	49.2	
Of which: — collective consumption	11.4	11.4	11.4	11.4	
— social transfers (2)	26.2	25.8	25.8	27.6	
— interest expenditure	2.9	2.9	2.8	2.8	
— gross fixed capital formation	3.6	3.6	3.5	3.4	
Primary balance	– 0.3	0.4	0.8	1.2	
Pm Tax burden	39.3	39.6	39.8	41.7	
Government debt	54.3	55.7	57.6	57.9	
Pm Cyclically adjusted balance	– 2.0	– 1.2	– 0.4	– 0.0	
Pm Cyclically adjusted primary balance	0.9	1.7	2.5	2.8	
Pm Real GDP (3)	367.1	372.0	375.6	383.0	
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 3.2	– 3.0	– 2.6	– 2.1	– 1.9
Primary balance	– 0.3	– 0.1	0.3	0.7	0.8
Government debt	54.1	56.3	58.1	58.6	58.3
Pm Real GDP (3)	– 0.9	1.25	1.5	2.5	2.5

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in November 2004.

Sources: Commission services and stability programme of the Netherlands.

Table V.40

Main measures in the budget for 2005, the Netherlands

Revenue measures (increases of 0.2 % of GDP)	Expenditure measures (savings of 0.3 % of GDP)
• Increase in the tax rate for the two lowest brackets of income tax	• Reduction in unemployment benefits
• Higher disability insurance premiums	• Wage freeze for civil servants
• Increases in public health insurance premiums	• Introduction of own risk in public health insurance
• New obligation to pay corporate taxes for two independent public sector agencies	• Phasing-out of subsidies on low-paid labour
	• Reductions in expenditure of ministries

Sources: Commission services and 2005 budget.

Erosion of the income tax base

The Dutch tax system allows for the deduction or exemption of certain items from taxable income. The tax reform of 2001 considerably reduced the number of exemptions, which was compensated by lowering the social security contribution and income tax rates. However, the two most important tax-deductible or tax-exempt items which were already in place before the 2001 tax reform still remain in place. They are pension premiums paid into the private pension system (tax exemption applies to both employers and employees for their respective payments, up to a certain limit, but pen-

sions paid are taxed on retirement) and payments of mortgage interest for the first house owned and occupied by the taxpayers (without an upper limit). Since the early 1990s, the combined value of tax-deductible and tax-exempt items in household income has been on an upward trend. This has led to a considerable narrowing of the tax base, as summarised in Table V.41 ([1]). In 2003, the estimated total loss in revenue on account of these two items amounted to more than 4 % of GDP, with the tax exemption of pension premiums accounting for the largest share. To put the figures in the table in perspective: in 1991, the estimated revenue loss was equivalent to slightly over 11 % of total receipts from taxes on income from employment and social security premiums.

By 1996, this share had increased to 16.5 % and, by 2003, it had reached 19.1 %. Hence, the fiscal treatment of private pension premiums and mortgage interest in the Netherlands has led to a significant narrowing of the income tax base. That said, there is a clear ratio for the tax exemption of pension premiums: since pension payments are taxed, this adds to the stability of tax revenue in an ageing society.

The amount of tax-exempt private pension premiums paid has been influenced by events in global financial markets. The fall in financial asset prices depleted the financial buffers of private pension funds managing mandatory pension savings in the so-called second pillar of the pension system (the public pension system is the first pillar; the third pillar consists of non-obligatory pension savings made by individuals, which, up to a certain threshold, may also be tax exempt if the people concerned can prove that they lack a full pension build-up under the other two pillars). The value of assets managed by pension funds fell from 114.2 % of GDP in 2001 to 98.7 % of GDP in 2003. This made it necessary for pension funds to raise their premiums, translating into further shortfalls in income tax receipts. In addition, the fall in financial buffers affected public finances in a more direct way. Net pension premiums paid by the government to the public sector pension fund (ABP) increased from 0.5 % of GDP in 2001 to 0.7 % of GDP in 2003. However, the effect of restoring financial buffers should be temporary and contribution rates might decrease again as financial markets recover.

Tax-deductible mortgage interest payments have grown particularly rapidly since the mid-1990s, in line with rising house prices, falling interest rates and the consequent ongoing rapid growth of mortgage credit to households. Another important upward impact has been the spread of mortgage products where no amortisation is paid during the period of the loan, only interest. These mortgage forms have become increasingly popular since the mid-1990s, and were developed by banks in order to let taxpayers benefit as much as possible from the tax deduction. In 2003, the total mortgage debt of Dutch households reached around 86 % of GDP. As an illustration, the tax deductions due to net mortgage interest (after allowing for the taxes levied on imputed income from

([1]) Note that the table shows net deductions of mortgage interest. This means that the (taxed) imputed income from owner-occupied housing, which is higher than in most EU Member States and which to some extent offsets the tax deductibility of mortgage interest, has been deducted.

Table V.41

Deductions of mortgage interest and exemption of pension premiums, the Netherlands

(% of GDP)

	1991–96	1997–2001	2002	2003	2004
Deduction of mortgage interest	2.2	3.2	3.5	3.7	3.8
Deduction of pension premiums	6.9	6.9	6.8	7.3	n.a.
Estimated loss in revenue:					
— due to mortgage interest	0.8	1.1	1.2	1.3	1.3
— due to deduction of pension premiums	2.7	2.8	2.7	2.9	n.a.
Total estimated loss in revenue	3.6	3.9	4.0	4.2	n.a.
Yearly loss in revenue due to narrowing of the base	0.2	0.3	0.3	0.3	n.a.

NB: Due to the denominator effect, cumulated yearly losses in revenue do not add up to the change in the total.

Sources: CPB, CBS, Netherlands Ministry of Finance and own estimates. Figures may not add up due to rounding.

house ownership) in that year amounted to 1.3 % of GDP, and can be viewed as a kind of implicit interest paid by the government on behalf of house owners with a mortgage debt. Especially middle- and higher-income groups benefit from the deductibility of mortgage interest, as there is no upper limit to the amount that can be deducted and as marginal rates are highest in the higher tax brackets.

The upward trend in the deduction of mortgage interest has been mitigated, but not halted, by several government measures taken since the late 1990s to limit deductibility. Under the new, more stringent, rules a mortgage on a second house is no longer deductible. Furthermore, taxpayers now have to prove that the mortgage is indeed used for the purchase and/or improvement of their own house, while capital gains on selling a house have to be deducted from the amount that can be financed with a tax-favoured mortgage. The high mortgage debt of Dutch households has raised concerns about their financial position should interest rates rise in the future. However, since most Dutch households still finance their mortgages against fixed long-term interest rates, the impact of higher interest rates would be spread over time and relatively limited.

The progressive ageing of the Dutch population in the next few decades will put increasing pressure on the sustainability of public finances. With ageing, the ratio of economically active to inactive persons will worsen considerably. Under current arrangements, no pension contributions for the first (public) pillar of the pension system (equivalent to an earmarked income tax) are levied on the income of those who are 65 or more. In other words, the marginal tax rate that people over 65 have to pay in the first bracket of income is relatively low, not only on their pension income, but also on other sources of income. This will be a substantial financing burden for the public part of the pension system as ageing progresses. This risks putting upward pressure on the tax rates charged to the population of working age (as a possible shortfall in first-pillar pension premiums has to be supplemented from general resources), which could be detrimental to labour supply and economic activity. Admittedly, though, the situation in the Netherlands in this respect may be considered more favourable than in some other Member States where demographic trends are more adverse. Moreover, the Dutch pension system does not depend only on the public (first) pillar, the so-called AOW, which is financed on a pay-as-you-go basis. Substantial second- and third-pillar-funded pension schemes exist with sizeable financial assets built up over the last decades. Furthermore, pension income from the second and third (private and funded) pillars of the pension system is taxed just like other sources of income. Marginal and average rates paid by those over 65 will be lower, since they do not have to pay AOW contributions. Hence, the sharp rise in the number of pensioners will also lead to the delayed taxation of the pension premiums deducted over the working lives of the people receiving them.

Several policies can be pursued to ensure the sustainability of public finances. Among them are measures to increase labour participation and enhance productivity growth. As regards fiscal policy, the achievement and maintenance of a sound fiscal position and lowering the public debt are very important. Broadening the tax base (or avoiding a further erosion) helps achieve this aim.

In this respect, stemming the marked increase in tax-deductible mortgage interest payments — or even reversing it — may be a promising avenue to explore. This may mean abolishing entirely the tax deductibility of mortgage interest payments, or, alternatively, limiting the maximal deductible amount. This can be defended on the grounds that the tax exemption for mortgage interest payments is inefficient and arguably leads to the diversion of capital from more productive uses. In any case, it may be advisable to opt for a gradual transition, in order to dampen large negative shocks to disposable income for many households and to avoid disruption in the housing market. The latter may have serious macroeconomic consequences in view of the sharp rises in house prices in recent years and the associated increase in the ratio of mortgage debt to disposable income of Dutch households. This suggests that private consumption and economic activity in the Netherlands have become increasingly sensitive to changes in net household wealth.

As regards pensions, one may consider limiting the tax deductibility of private pension premiums. However, on closer inspection, this may not be advisable. As said above, the present system for the treatment of pension savings has more desirable properties than the tax deductions of mortgage interest. Since the premiums paid are not taxed, but future pension income from the second and third pillars is, albeit at a lower average rate, the mechanism helps to spread tax revenue over time, thus mitigating the adverse effect of ageing on Dutch public finances. Nevertheless, under current arrangements, there remains a negative impact of the

narrowing of the tax base on sustainability due to the future rise in public expenditure on first-pillar pensions. This may be partly compensated by levying AOW contributions (used to finance the first, public, pillar of the pension system) on sources of income of people over 65 years of age other than their public pension. The ensuing broadening of the tax base would allow marginal tax rates to be lowered in the lowest brackets of income tax. Such a reduction in the marginal tax wedge could be positive for labour participation, and will also help limit the impact on the purchasing power of elderly people who have a relatively low pension income. Again, it seems advisable to phase this in gradually over an extended transition period, allowing future pensioners to build up additional pension rights and thus mitigate negative income effects.

18. Austria

Recent developments and medium-term prospects

The 2003 update of the stability programme targeted a general government deficit of 0.7 % of GDP for 2004.

It was missed by a considerable margin as the 2004 general government deficit turned out to be 1.3 % of GDP ([1]) in spite of the fact that the update had already taken into account the carrying-forward of parts of the 2005 tax reform.

The deviation by 0.6 percentage points cannot be attributed to negative surprises in GDP growth. Part of it can be explained by the fact that the profit of the central bank turned out to be 0.1 % of GDP lower than in the budgetary plans. However, the slippage mainly stems from the expenditure side. A major factor for this was the additional investment premium *(Investitionszuwachsprämie)*. This fiscal benefit was taken up by businesses to a much larger extent than expected by the authorities, resulting in additional expenditure of about ¼ % of GDP. In addition, expenditure targets were missed across all levels of government. At 65.2 % of GDP, the public debt ratio was 0.2 percentage points lower in 2004 than in the previous year ([2]).

The budget for 2005 was adopted on 17 November 2004. The main measure consists of the implementation of the second stage of the 2004/05 tax reform. According to the 2004 update of the stability programme, the general government deficit will amount to 1.9 % of GDP in 2005. This is in line with the Commission services' spring 2005 forecast. In the same forecast, the Commission services upheld their last autumn's prediction that the cyclically adjusted general government deficit would amount to 1.9 % of GDP in 2005 (up from an estimated 1.1 % of GDP in 2004).

Assuming no change in policy, the Commission services' spring 2005 forecast sees the general government deficit falling by a ¼ percentage point to 1.7 % of GDP in 2006. This is in line with the target presented in the update of the stability programme submitted by the Austrian authorities on 30 November 2004 ([3]). The update also foresees the deficit at 0.8 % of GDP in 2007 and a balanced budget in 2008. However, it does not specify how this consolidation is to be achieved.

According to the Commission services' spring 2005 forecast, the debt-to-GDP ratio will fall to 64.4 and 64.1 % of GDP in 2005 and 2006 respectively.

The national stability pact

The three layers of government in Austria coordinate their medium-term budgetary plans in the Revenue Sharing Act (*Finanzausgleich*), usually for a period of four years, which allocates the revenues to territorial authorities. The 1999 national stability pact (NSP) set up an enforcement mechanism on how the general government deficit was to be allocated to the different levels of government. A more detailed NSP was passed for the period 2001–04, temporarily suspending the 1999 NSP.

This 2001 NSP foresaw a consolidation path leading to a balanced budget of general government in 2002–04, for which deficit targets (so-called 'stability contributions') are allocated to the federal, state and local levels of government, flanked by a sanctioning mechanism.

([1]) According to the data received from the Austrian statistical office after the publication of the Commission services' spring 2005 forecast, the 2004 deficit was slightly lower due to unexpectedly high VAT receipts in February 2005 attributed still to the year 2004.

([2]) Note that this does not include the recalculation of 'financial intermediation services indirectly measured' (FISIM) in the GDP.

([3]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.42

Budgetary developments 2003–08, Austria

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	– 1.1	– 1.3	– 2.0	– 1.7		
— Total revenues	50.0	49.4	48.1	47.4		
Of which: — current taxes	28.3	28.0	26.9	26.4		
— social contributions	16.5	16.4	16.4	16.3		
— Total expenditure	51.2	50.7	50.1	49.2		
Of which: — collective consumption	7.2	7.0	6.9	6.8		
— social transfers (2)	29.9	29.9	29.7	29.4		
— interest expenditure	3.1	3.0	2.9	2.8		
— gross fixed capital formation	1.2	1.2	1.2	1.1		
Primary balance	2.0	1.7	0.9	1.1		
Pm Tax burden	43.5	43.2	42.1	41.6		
Government debt	65.4	65.2	64.4	64.1		
Pm Cyclically adjusted balance	– 0.8	– 1.1	– 1.9	– 1.6		
Pm Cyclically adjusted primary balance	2.3	1.9	1.1	1.2		
Pm Real GDP (3)	0.8	2.0	2.1	2.1		
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 1.1	– 1.3	– 1.9	– 1.7	– 0.8	0.0
Primary balance	– 2.1	1.9	1.2	1.3	2.2	2.9
Government debt	64.5	64.2	63.6	63.1	61.6	59.1
Pm Real GDP (3)	0..8	1.9	2.5	2.5	2.2	2.4

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in November 2004.

Sources: Commission services and stability programme of Austria.

Table V.43

Main measures in the budget for 2005, Austria

Revenue measures	Expenditure measures
• The 2004/05 tax reform (– 0.8 % of GDP). The reform's second stage in force since 1 January 2005 foresees: the personal income tax schedule reduced to four brackets, including a zero tax bracket up to an income of EUR 10 000; the corporate tax rate reduced from 34 % to 25 %; and, in addition, tax rules for holdings (domestic and foreign) simplified. • Healthcare reform (0.1 % of GDP); increase in the contribution rate and increase in the tobacco tax	• Savings in expenditure due to administrative reforms in the healthcare system (0.1 % of GDP)

Sources: Commission services and Austrian Federal Ministry of Finance.

Table V.44 shows the budget evolution during the 2001 NSP. The column 'NSP target' lists the budget balance targets in per cent of GDP given in the 2001 NSP. 'Outcome (unadj.)' shows the *ex post* budgetary outcome according to the updates of the stability programme. However, this is subject to two adjustments before compliance with the NSP target is assessed. First, the NSP is fixed in terms of ESA 95 as of October 2000, which does

not take into account the decision taken later by Eurostat that property sales are not considered as deficit reducing. Second, revised deficit targets can be negotiated between the governments in the case of an exceptional burden, in particular revenue shortfalls and expenditure increases due to a severe economic slowdown. These exceptional circumstances are not specified more precisely in the NSP. The column 'Outcome adj.' shows the budgetary outcome adjusted in such a way, according to the Austrian authorities.

The federal budget for 2003 may be illustrative. The NSP targeted the deficit at 0.75 % of GDP. The deficit according to the 2004 update of the stability programme amounted to 1.7 % of GDP. Thus, the difference between the federal deficit reported in the stability programme update and the NSP target equalled 0.95 percentage points. The actual deficit was adjusted down to 1.4 % of GDP by property sales, which are not considered as deficit reducing by a Eurostat decision taken only after October 2000, and by exceptional expenditure related to the floods of 2002.

The difference between the target of 0.75 % and the adjusted outcome now implies a shortfall from the NSP target of 0.65 percentage points.

However, the NSP foresees a further margin of tolerance. For the federal level, an (approximately) 0.25 percentage point deviation from a given year's target is acceptable and may be offset in future years. Thus, after the acceptable tolerance for 2003 the shortfall from the target is reduced to 0.4 percentage points. The notes accompanying the NSP law seem to rule out that a budgetary performance better than the target can be carried over to future years ([1]).

Thus, it may be the case that for 2003 the federal level might have exceeded the tolerable deficit by the 0.4 percentage points calculated above. A coordination committee between the different levels of government monitors compliance and would, if necessary, ask the Court of Auditors to establish a violation. Following a (non-public) report by the latter, a mediation committee would need to decide unanimously by February in the second year after the violation whether sanctions are due. The committee consists of two representatives of the federal government and two representatives of *Länder*/local governments. The latter cannot come from the state or commune that failed to comply with the pact. The NSP fixes the amount of the sanction, which takes the form of an interest-bearing deposit. If in the following year the respective target is not reached, the deposit is transferred to those governments in compliance, and reimbursed otherwise. However, the NSP does not foresee publicity of procedures and the 2004 report of the Court of Auditors is silent on the compliance.

([1]) '829 der Beilagen XXI. GP, Materialien — Regierungsvorlage Stabilitätspakt 2001–2004', available at www.parlament.gov.at. Matzinger, A., 'Finanzausgleich', in Steger, G. (ed.), *Öffentliche Haushalte in Österreich*, Vienna, 2002, pp. 51–94. Diebalek, L., W. Köhler-Töglhofer and D. Prammer, 'The Austrian internal stability pact — its effectiveness revisited', preliminary paper presented at the Workshop on Fiscal Rules, Madeira, 9 and 10 December 2004.

Table V.44

National stability pact 2001–04, budgetary targets and results, Austria

(% of GDP)

	2001			2002			2003			2004	
	NSP	outcome		NSP	outcome		NSP	outcome		NSP	outcome
Level	target	adj.	(unadj.)	target	adj.	(unadj.)	target	adj.	(unadj.)	target	(unadj.)
General government	– 1.3	0.7	(0.3)	0.0	0.4	(– 0.2)	0.0	– 0.6	(– 1.1)	0.0	(– 1.3)
Federal	– 2.05	– 0.2	(– 0.5)	– 0.75	– 0.5	(– 0.9)	– 0.75	– 1.4	(– 1.7)	– 0.75	(– 1.7)
Lower	0.78	0.9	(0.8)	0.76	0.9	(– 0.7)	0.75	0.8	(– 0.6)	0.75	(– 0.4)
Social security	n.a.	n.a.	(0.0)	n.a.	n.a.	(0.0)	n.a.	n.a.	(0.0)	n.a.	(0.0)

NB: Explanation in the text. Figures may not add up due to rounding.

Source: Austrian Federal Ministry of Finance on data by Statistics Austria.

However, compliance with the NSP seems now understood by the federal and state levels as that the required stability contribution should be respected only on average over the pact's duration. The average of the federal targets (columns 'NSP target') for the four years amounts to 1.1 % of GDP. The average of the adjusted outcomes from 2001 to 2004 (columns 'Outcome adj.' 2001–03 and 'Outcome (unadj.)' for 2004) equals 0.95 % of GDP, which would imply that, on average, the targets would have been met. In effect, this calculation implies that the better-than-required adjusted outcome in 2001 would ensure compliance, even though the federal deficit in all subsequent years exceeded the NSP target.

The 2005 NSP concluded for the years 2005–08, which is the baseline for the 2004 update of the stability programme, very much resembles the 2001 NSP. For 2005 and 2006, only the ESA accounting rules as of October 2000 continue to be applicable. However, the 2005 NSP does not foresee a tolerance margin for exceeding the deficit target by 0.25 % of GDP for the years 2005 and 2006, but only for 2007 and 2008. The recent update of the stability programme takes the targets of the 2005 NSP at face value. In particular, the 2005 NSP targets the general government budgetary position to be balanced by 2008. However, given the room for manoeuvre that the NSP seems to offer, substantial deviations may be possible before the NSP becomes binding.

In conclusion, the NSP is a useful tool aimed at involving all levels of government in the consolidation of public finances. In providing for legally enshrined budgetary commitments across various government levels, Austria may serve as a benchmark in the EU. However, there is still room for improvement in terms of clarity of the NSP rules and transparency of the procedures accompanying it. Moreover, it still remains to be seen how enforceable the pact is, once there is a case where the sanction mechanism needs to be activated.

19. Poland

Recent developments and medium-term prospects

At 4.8 % of GDP, the general government deficit in 2004 was considerably lower than targeted in the 2004 budget (5.7 % of GDP). The downward revision of the deficit resulted mainly from a better-than-expected performance by the social security subsector. A better-than-expected position of the central government due to higher revenue from corporate income tax also contributed to the positive outcome. The level of the debt ratio in 2004 at 43.6 % of GDP was considerably lower than expected in the May 2004 convergence programme (49 % of GDP). The better outcome was due to stronger-than-expected nominal GDP growth, favourable valuation effects following the appreciation of the zloty and higher-than-expected privatisation proceeds.

The most recent update of the convergence programme, submitted on 1 December 2004, foresees a general government deficit of 3.9 % of GDP in 2005 compared with 4.2 % in the May 2004 convergence programme. The budget law for 2005, approved by Parliament on 22 December 2004, confirms the target.

The budget does not contain significant tax changes, apart from an increase in excise taxes. It incorporates not only the savings measures from the public finance reform package (the so-called Hausner plan) which have been endorsed by Parliament, but also those that are still being discussed. All these measures taken together have an estimated total impact of 1.2 % of GDP in 2005. The 2005 budget does not specify or quantify the other sources of revenue that should result from the implementation of the 'widening of the taxation base' announced in the convergence programme with an expected yield of 0.35 % of GDP.

According to the Commission services' spring 2005 forecasts, the general government deficit is projected to decrease from 4.8 % of GDP in 2004 to 4.4 % in 2005 and 3.8 % in 2006 compared with respectively 3.9 and 3.2 % of GDP in the updated convergence programme. The forecast takes into account the information on the implementation of the public finance reform package provided in the updated programme. Based on the no-policy-change assumption, it includes, however, only the measures that have been approved by Parliament (estimated budgetary impact of approximately 0.75 % of GDP in 2005 and 0.6 % in 2006). The updated programme foresees a reduction in the deficit to 2.2 % of GDP in 2007. The deficit figures in both the Commission services' forecast and the updated convergence programme still include the surplus of the second-pillar funded pension funds, which is estimated at around 2 % of GDP annually in the period 2004–06, within the general government sector.

From 43.6 % of GDP in 2004, the debt-to-GDP ratio would increase to 46.8 % in 2005 and reach 47.6 % in 2006. The Polish debt figures will have to be adjusted upwards by between 3 and 6 percentage points in the period 2003–06 to reflect the March 2004 Eurostat decision on the classification of the second-pillar pension funds, which needs to be implemented by March 2007.

High share of non-flexible expenditure in the budget and the response of the authorities

One of the challenges for Poland's public finances is the relatively high share of fixed expenditure, of which legally determined expenditure constitutes a major part. This rigidity hampers the increase of investment outlays and earmarking money for co-financing structural funds. It also prevents the authorities from decreasing more quickly the tax burden on labour. The high deficit of the Social Insurance Fund (FUS) is a barrier for the decrease of the tax wedge. Eventually, the high share of fixed expenditure makes it more difficult to ensure a sustainable reduction in the general government deficit under the constraint of continuous pressure from ongoing and foreseen structural reforms and EU-related spending.

Table V.45

Budgetary developments 2003–07, Poland

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006	
General government balance (2)	– 4.5	– 4.8	– 4.4	– 3.8	
— Total revenues	44.3	43.8	44.2	44.2	
Of which: — current taxes	22.3	22.1	22.3	22.5	
— social contributions	14.1	13.1	12.9	12.7	
— Total expenditure	48.8	48.7	48.6	48.0	
Of which: — collective consumption	9.1	8.8	8.5	8.3	
— social transfers (3)	26.1	25.9	25.3	24.6	
— interest expenditure	2.9	2.6	2.6	2.5	
— gross fixed capital formation	3.4	3.4	4.2	4.7	
Primary balance	– 1.6	– 2.2	– 1.9	– 1.3	
Pm Tax burden	36.6	n.a.	n.a.	n.a.	
Government debt	45.4	43.6	46.8	47.6	
Pm Real GDP (4)	3.8	5.3	4.4	4.5	
Convergence programme (5)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance (2)	– 3.9	– 5.4	– 3.9	– 3.2	– 2.2
Primary balance	– 0.8	– 2.6	– 1.3	– 0.5	0.4
Government debt (2)	45.4	45.9	47.6	48.0	47.3
Pm Real GDP (4)	3.8	5.7	5.0	4.8	5.6

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second-pillar pension funds, these funds can continue to be classified inside the general government sector until the March 2007 EDP notification. The budgetary effect on the deficit for Poland was, according to the March 2005 EDP notification, of 1.7 % of GDP in 2003 and 2.0 % of GDP in 2004 and on the debt of 3.3 % of GDP in 2003 and 4.1 % of GDP in 2004. According to the Polish national sources, the effect on the deficit in 2005 and 2006 is expected to be of 1.9 % of GDP p.a. and on debt of 6 % of GDP p.a.
(3) In kind and other than in kind.
(4) Annual % change.
(5) Submitted in December 2004.

Sources: Commission services and convergence programme of Poland.

Table V.46

Main measures in the budget for 2005, Poland

Revenue measures	Expenditure measures
Approved by Parliament or not requiring legislative changes: • Restructuring of State-owned enterprises (railways sector, coal mining) (0.1 % of GDP) In the legislative process or rejected by Parliament: • Change in the social security contributions of the self-employed (0.17 % of GDP) • Reform of the farmers' pension scheme (KRUS) (0.10 % of GDP) Not specified in the budget law for 2005: • Widening of the taxation base (0.35 % of GDP) (Hausner plan measure, mentioned in the May and December 2004 convergence programmes)	Approved by Parliament or not requiring legislative changes: • Changes in pension indexation (0.42 % of GDP) • Changes in defence financing (0.14 % of GDP) • Changes in pre-retirement benefits (0.05 % of GDP) • Reductions in administrative costs (0.05 % of GDP) In the legislative process or rejected by Parliament: • Some changes in the social security system (e.g. employment of the disabled) (0.13 % of GDP)

Sources: Commission services and convergence programme of Poland.

The December updated convergence programme discusses the evolution of the structure of general government expenditure: non-flexible expenditure is defined as that resulting from legal provision or international agreements, *inter alia* retirement and disability pensions, unemployment benefits, housing allowances, contribution to the EU budget and debt servicing costs. Flexible expenditure includes mainly salaries, expenditures on purchases of goods and services and subsidies to companies outside the general government.

Still, before EU accession, the Polish authorities adopted the 'programme of rationalisation and reduction of public spending' (the so-called Hausner plan) designed to tackle the need for public finance restructuring and to ensure a fiscal consolidation in a sustainable manner. It was also meant to contribute to broader discussions on future economic policy and structural reforms in Poland touching upon a rationalisation of public expenditure in the fields of: (i) functioning of the State and its administration; (ii) functioning of inefficient sectors in the economy — resulting from the consequences of the ongoing restructuring in the mining, railways and health sectors; and (iii) social policy — among which are entitlement programmes including deindexation, raising the pension age, and reforming the disability pension schemes and the highly inefficient and costly farmers' social security system (KRUS).

If the Hausner plan were fully implemented, the share of non-flexible expenditure in the general government budget would decrease from 42.5 % in 2003 to 39.3 % in 2007. The modification of the indexation rule makes an important contribution to this. Indexation is not likely to take place every year, as was the case when retirement benefits were linked to the average wage increase in the economy, but only when the compounded inflation rate exceeds 5 %. Still, an important number of measures were rejected or blocked in Parliament.

The Ministry of Finance unveiled on 11 March 2005 the main ideas of a public finance management strategy for 2005–08, which introduces complementary measures to the Hausner plan and includes measures affecting the public finance management and reforming the tax system.

The strategy aims at:

- an introduction of a tax system (flat rate of 18 % for VAT and corporate and income tax) that would stimulate growth and competitiveness of the Polish economy and lead to a reduction in labour costs;
- a reform of the public finance management that would improve its efficiency, increase the share of non-legally determined (or flexible) expenditure and allow a better absorption of the EU Structural Funds;
- meeting the 3 % deficit reference value in 2007. An additional fiscal tightening comparable to that described in the December 2004 convergence programme would lead to a deficit of 2.8 % of GDP in 2007 with the second-pillar pension funds being excluded from the general government sector.

The strategy implies a strengthening of the fiscal adjustment beyond 2005 and constitutes a direct answer to the Council opinion of 17 February 2005 on Poland's 2004 December convergence programme (the updated programme contained a 2007 deficit target of 2.2 % of GDP, but with the second-pillar pension funds classified within the general government sector) ([1]).

Table V.47

Share of non-flexible (legally determined) expenditure in the general government budget, Poland

	2003	2004	2005	2006	2007
Non-flexible	42.5	40.7	40.7	39.1	39.3
Flexible	57.5	59.3	59.3	60.9	60.7

Source: Updated convergence programme, December 2004.

([1]) Not approved by the government, the strategy has not been taken into account in the Commission services' spring 2005 forecasts.

20. Portugal

Recent developments and medium-term prospects

The general government deficit for 2004 is estimated at 2.9 % of GDP ([1]). This figure is comparable to a target of 2.8 % of GDP set in the December 2003 update of the stability programme. In 2004, a deficit below 3 % of GDP was achieved through the one-off transfer to the government of pension liabilities for the employees of four State-owned enterprises in exchange for lump-sum payments worth almost 2.3 % of GDP.

Therefore, the underlying deficit was 5.2 % of GDP in 2004, which compares with a target of 4 % in the budget for 2004, with the divergence being caused by a slippage on expenditure. In 2004, the public debt stood at 61.9 % of GDP, which is above the 60 % target set in the December 2003 update of the stability programme. The deviation from the target is accounted for by an upward revision of the 2003 debt outturn by 0.6 percentage points of GDP and debt-increasing stock-flow adjustments amounting to 0.9 percentage points of GDP, against – 0.4 percentage points of GDP assumed in the 2003 update.

The budget for 2005 was presented to Parliament on 15 October and approved on 6 December 2004. The target for the 2005 general government deficit set therein is 2.8 % of GDP, which was confirmed in the December 2004 stability programme update. However, it remains to be seen whether the new government, which took office on 12 March, will: (i) stick to the targets and measures set by the former Cabinet, in particular on the envisaged implementation of revenue-raising one-off operations worth 1.4 % of GDP ([2]); and (ii) adopt new measures with a significant budgetary impact. The Commission services' spring 2005 economic forecast projects a deficit of 4.9 % of GDP. The difference with the 2005 budget is due to three factors: first, the consideration of lower revenues from one-off measures (just 0.3 % of GDP from a transfer of a pension fund to the government sector); second, lower tax proceeds in the context of significantly lower economic growth; third, a less optimistic evaluation of expenditure developments, in particular on social transfers. The cyclically adjusted balance according to the Commission services' spring 2005 economic forecast will widen to – 3.9 % of GDP. This weakening is wholly attributed to the significantly lower revenues from one-off operations, since the underlying cyclically adjusted position, i.e. excluding any of those revenues in both years, is expected to remain broadly constant (– 4.3 % of GDP in 2004 and – 4.2 % in 2005). The new government is committed to submitting a new update of its stability programme by the end of May. This will very likely provide new information on the Portuguese authorities' intentions for 2005 (and beyond) as regards budgetary targets and new policy measures. The government is also considering the submission to Parliament of a corrective budget for 2005 by early summer.

In 2006, the Commission services' spring 2005 economic forecast projects a deficit of 4.7 % of GDP on the customary no-policy-change assumption and abstracting from any one-off revenue-raising measures. This figure compares with a target deficit of 2.5 % of GDP set in the December 2004 update of the stability programme ([3]). The stability programme update foresees a further reduction in the deficit in 2007 to 1.8 % of GDP.

([1]) In releasing the data following the March 2004 EDP notification, Eurostat added that there are ongoing discussions which may lead to a subsequent revision of the data.

([2]) Three one-off measures were envisaged to raise those proceeds. The Commission services were able to take on board one of them, worth 0.3 % of GDP, in the Commission services' spring 2005 economic forecast; another measure, with an expected revenue of 0.5 % of GDP, was considered by Eurostat as a financial operation with no impact on the deficit, and, finally, the third measure (0.6 % of GDP) was not announced with a sufficient degree of detail to allow a proper assessment by the Commission services.

([3]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.48

Budgetary developments 2003–07, Portugal

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006	
General government balance	– 2.9	– 2.9	– 4.9	– 4.7	
— Total revenues	44.8	45.5	43.2	43.2	
Of which: — current taxes	24.9	24.4	24.1	24.2	
— social contributions	12.7	12.7	12.7	12.7	
— Total expenditure	47.6	48.4	48.2	47.9	
Of which: — collective consumption	8.6	8.4	8.4	8.3	
— social transfers (2)	26.8	27.8	28.3	28.5	
— interest expenditure	2.9	2.8	2.9	3.1	
— gross fixed capital formation	3.3	3.3	3.2	3.0	
Primary balance	0.0	– 0.1	– 2.0	– 1.6	
Pm Tax burden	37.1	36.7	36.4	36.5	
Government debt	60.1	61.9	66.2	68.5	
Pm Cyclically adjusted balance	– 2.2	– 2.1	– 3.9	– 3.7	
Pm Cyclically adjusted primary balance	0.7	0.8	– 1.0	– 0.7	
Pm Real GDP (3)	– 1.1	1.0	1.1	1.7	
Stability programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 2.8	– 2.9	– 2.8	– 2.5	– 1.8
Primary balance	– 0.1	– 0.1	– 0.1	– 0.6	– 1.3
Government debt	—	62.0	63.1	62.7	61.4
Pm Real GDP (3)	– 1.2	1.0	2.4	2.7	2.8

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.

Sources: Commission services and stability programme of Portugal.

Table V.49

Main measures in the budget for 2005, Portugal

Revenue measures	Expenditure measures
• Cuts in personal tax rates for most income brackets by 0.5 to 1.5 percentage points • Elimination of tax subsidies on individual saving plans, which is expected to fully compensate for the abovementioned cuts in personal income tax rates • Limit to the use of fiscal benefits by corporations with the setting of a minimum effective corporate tax rate at 60 % of the nominal tax rate of 25 % • Transfer of a pension fund to the government sector (0.3 % of GDP)	• Reduction of public investment in real terms

Sources: Commission services, 2005 budget and Portuguese Ministry of Finance.

According to the Commission services' spring 2005 economic forecast, the debt ratio will continue to increase as a consequence of the high government deficits, low nominal GDP growth, and one-off debt-increasing stock-flow adjustments as foreseen in the Portuguese stability programme of last December and as confirmed in the debt and deficit figures in the March 2005 EDP notification. It is expected to reach 66.2 and 68.5 % of GDP at the end of 2005 and 2006 respectively. Such a trajectory for public debt is well above that projected in the stability programme of Portugal of December 2004 on account of lower growth and higher deficit figures.

21. Slovenia

Recent developments and medium-term prospects

In 2004, the general government deficit fell slightly, to 1.9 % of GDP. Established within the new methodological framework, including the two extra-budgetary funds reclassified in the general government sector, the outturn was higher than the initial target (1.6 % of GDP according to the 2003 pre-accession programme). The national authorities raised the deficit forecast to 2.1 % of GDP in the middle of 2004, when the budget incurred a substantial revenue shortfall linked to the loss in VAT resources, following the dismantling of border controls after EU accession. Moreover, taxes on labour came in lower than budgeted due to the increase in the minimum threshold for payment of payroll tax, adopted in July and effective as of September.

Furthermore, in September, excise duties on fuel were set at the lowest level permitted by the EU to buffer the negative consequences of the oil price hike on inflation ([1]). However, the revenue shortfall was contained by the good economic performance — with the highest real GDP growth rate in five years — coupled with a firm determination to safeguard the deficit target. In October, when the shortfall approached the limit set in the implementation bill to the 2004 budget, the government refused claims for any further expenditure ([2]). At the end of 2004, the gross general government debt accounted for roughly 29.5 % of GDP.

The 2005 budget, adopted by Parliament in December 2003 (in accordance with Slovenia's budgetary procedure with a two-year planning horizon), is largely based on revenue measures, improving tax administration and reforming the direct tax regime. In 2004, new personal and corporate income tax legislation was adopted, coming into effect on 1 January 2005. The new personal income tax regime was estimated to reduce government revenues by 0.2 % of GDP in 2005. This was expected to be compensated by an increase in corporate income tax. On the expenditure side, the main measures concern cost-effectiveness and flexibility while additional spending commitments related to EU membership were envisaged. The change in government following the October 2004 parliamentary elections prompted the decision to amend the budget in line with the priorities of the centre-right coalition, such as the intention to reduce further the tax burden on wages while aiming to keep the fiscal targets unchanged. The March 2005 EDP notification projects the deficit to remain at 1.9 % of GDP in 2005. However, in the absence of corrective measures in a pending supplementary budget, the Commission services foresee that, taking into account the plans announced by the new government, the deficit would increase to 2.2 % of GDP.

In the medium term, the deficit is expected to decline gradually as the positive net inflow from the EU budget outweighs the negative fiscal effect of the direct tax regime reform. Under a no-policy-change assumption, the Commission services are, however, more cautious than the national authorities as regards the budgetary consolidation. At 2.1 % of GDP in 2006, the spring 2005 forecast sets the deficit slightly above 1.8 % of GDP as projected in the first update of the convergence programme, covering the period 2004–07, which was submitted in January 2005 ([3]). The programme anticipates a considerable fiscal adjustment from 2006 onwards, nar-

([1]) Adjustments in fuel excise duties are carried out every fortnight as a standard procedure to avoid inflation being excessively affected by world market price fluctuations.

([2]) As stipulated in the implementation bill to the 2004 supplementary budget, it was within the government's discretion to reduce expenditure proportionally — up to SIT 15 billion (0.25 % of GDP) — to a revenue shortfall in the course of the year, without having to propose that the budget be amended.

([3]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.50

Budgetary developments 2003–07, Slovenia

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**	
General government balance	– 2.0	– 1.9	– 2.2	– 2.1	
— Total revenues	46.2	45.8	45.4	45.1	
Of which: — current taxes	25.2	25.2	24.8	24.5	
— social contributions	15.2	14.8	14.5	14.2	
— Total expenditure	48.2	47.7	47.6	47.2	
Of which: — collective consumption	8.4	8.2	8.1	8.1	
— social transfers (2)	29.1	28.8	28.5	28.2	
— interest expenditure	2.1	1.9	1.7	1.6	
— gross fixed capital formation	2.8	2.8	2.9	2.9	
Primary balance	0.1	0.0	– 0.5	– 0.5	
Pm Tax burden	40.1	39.8	39.0	38.5	
Government debt	29.4	29.4	30.2	30.4	
Pm Real GDP (3)	2.5	4.6	3.7	4.0	
Convergence programme (4)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	– 2.0	– 2.1	– 2.1	– 1.8	– 1.1
Primary balance	0.5	0.6	0.6	0.3	– 0.3
Government debt	29.4	30.2	30.7	30.9	29.7
Pm Real GDP (3)	2.5	4.0	3.8	3.9	4.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in January 2005.

Sources: Commission services and convergence programme of Slovenia.

Table V.51

Main measures in the budget for 2005, Slovenia

Revenue measures	**Expenditure measures**
• Further harmonisation of excise duties on tobacco with the *acquis* • New personal income tax regime, introducing five tax brackets with rates ranging from 16 to 50 %, designed to disburden the lowest income classes • New corporate income tax regime, broadening the tax base and eliminating loopholes in the legislation	• Containing the rise in public wages and social benefits • Increasing the cost-effectiveness of the public administration (rationalisation of material costs)

Source: Commission services.

rowing the general government deficit to 1.1 % of GDP by 2007.

The gross general government debt is expected to increase further but will remain contained over the forecasting horizon. The Commission services' spring 2005 forecast projects the debt ratio to rise gradually to 30.4 % of GDP in 2006.

Budgetary procedure: the two-year planning horizon

In December 2001, Slovenia started adopting budgets for two consecutive years simultaneously in an effort to drive greater certainty into the planning of public finances, aiming to enhance fiscal prudence. In the first stage, the government sets out the overall expenditure framework for the next two years. Subsequently, it confirms the budget appropriations within the agreed expenditure limits. The

execution provisions are decided on for each year separately and stipulated in the accompanying budget implementation bill. Included in the bill are the specific conditions allowing the amendment of the budget as the existing budgetary procedure does not maintain expenditure ceilings fixed over the two-year horizon regardless of the changing economic circumstances.

On the whole, budgetary targets have been relatively well met. However, disappointing growth in 2002–03 led to budgets being revised in the middle of the year. For 2003, the general government deficit was much higher than initially planned. In order to limit the budgetary impact of adverse cyclical developments, the implementation bill attached to the 2004 budget introduced a novel measure. The government was given discretion to suspend new spending commitments in case of a revenue shortfall within the limits set in the bill. A revenue undershooting of up to SIT 15 billion (0.25 % of GDP) due to unfavourable economic conditions was to be compensated by a proportional reduction in expenditure in the course of the year, without introducing a supplementary budget. In case unfavourable macroeconomic conditions persisted, an up to SIT 10 billion (0.17 % of GDP) higher budget deficit was nevertheless to be accepted at the end of the year. By invoking the right to refuse claims for further expenditure as of October 2004, the government was successful in safeguarding the deficit target for 2004.

In evaluating the performance of such a budgetary setting, methodological adjustments also need to be taken into account. In the framework of the March 2004 EDP reporting, Eurostat noted an inadequate delimitation of general government and urged the Ministry of Finance to correct it in time for the September 2004 notification. On that occasion, two entities hitherto classified outside the government, the so-called extra-budgetary funds, have been included in the government accounts.

The Capital Fund helps to finance the pay-as-you-go system by managing assets to cover for the liabilities of the Pension and Disability Insurance Fund. The Restitution Fund was established for restoration of nationalised and confiscated properties to the original owners and for compensation of damages to war and post-war victims. While the inclusion of the former has not had any budgetary effect, the general government balance deteriorated due to the latter running persistent deficits since its creation in 1993. In 2002 and 2003, the Restitution Fund incurred a deficit of 0.2 % of GDP.

The methodological adjustment of the government accounting system has also involved the exclusion of certain institutions, such as pharmacies, homes for the elderly and student residences, from the general government sector. The impact on the budget, though, was negligible. This comprehensive *ex post* revision of budgetary data has increased the general government deficit for the period 2000–03 by 0.2 to 0.5 % of GDP, the most significant correction being in 2000, when the deficit was raised from 3.0 % of GDP to 3.5 % of GDP.

Table V.52

The general government deficit initial targets, revisions and outcome, Slovenia

	Initial targets (budget prepared in t – 2) ESA 95	Revised targets (supplementary budget in t – 1) ESA 95	Outcome (March 2005 notification) ESA 95
Budget for the year			
2002 ([1])	2.4°	2.6°	2.4
2003	*1.0°*	*1.9°*	*2.0*
2004	*n.a.*	*1.6*	*1.9*
2005	1.6		

([1]) The launch of the new budgetary procedure at the end of 2001 with a two-year planning horizon, setting initial targets for the 2002 and 2003 budgets.

Sources: 2002–05 budgets, 2002–04 supplementary budgets, pre-accession and convergence programmes, March 2005 EDP notification. ° Report to the July 2003 Association Committee meeting.

22. Slovakia

Recent developments and medium-term prospects

The general government deficit for 2004 was 3.3 % of GDP. This is significantly lower than the 4 % of GDP included in the budget for 2004 (and even the 3.8 % of GDP estimated in the November 2004 convergence programme). The better outturn is mostly due to spending postponements, including those related to co-payments for EU funds. The debt ratio in 2004 amounted to 43.6 % of GDP. The budget for 2005 was adopted by Parliament in December 2004 and targets a deficit of 3.8 % of GDP. This includes the revenue-decreasing and hence, *ceteris paribus*, deficit-increasing effect of the introduction of a funded pension pillar in 2005, estimated at 0.4 % of GDP at the time when the budget was passed. Both the revenue-to-GDP and expenditure-to-GDP ratios are foreseen to rise in 2005, mainly due to an assumed increased inflow of transfers from the EU on the revenue side and the associated spending (including co-financing) and the contributions to the EU budget on the expenditure side.

On the revenue side, after the major tax reforms in 2004 (unified rate of 19 % for income and value added tax) and the associated shift from direct to indirect taxation, changes to the tax legislation in 2005 are marginal. However, social contributions are significantly affected by the introduction of a funded pension pillar at the beginning of 2005. On the expenditure side, the major reform measure included in the 2005 budget is a second tranche of healthcare reforms. The budgetary target of 3.8 % of GDP is in line with the Commission services' spring 2005 forecast.

According to the Commission services' spring 2005 forecast, the general government deficit for 2006 is projected at 4.0 % of GDP on a no-policy-change basis. This is broadly in line with the target of 3.9 % of GDP set in the most recent update of the convergence programme submitted on 30 November 2004 ([1]). The programme does not foresee major reform measures in the election year 2006. It projects a major fiscal adjustment in 2007 when the deficit is planned to be reduced to the 3 % of GDP Treaty reference value.

In the Commission services' spring 2005 forecast, the debt-to-GDP ratio is predicted to increase from 43.6 % in 2004 to 44.2 % in 2005 and to 44.9 % of GDP in 2006.

Pension reform in Slovakia

Slovakia has reformed its pension system in two steps: in a first step, it introduced several changes to the parameters of the pay-as-you-go pillar (first pillar) that became effective in 2004. These parametric changes reduced the scope of entitlements and, hence, the (implicit) debt of the first pillar. They prepared the ground for the second (systemic) reform step, i.e. the introduction of a funded pension pillar (second pillar) at the beginning of 2005. Furthermore and in parallel with these reforms, the possibilities for voluntary old-age provisions (third pillar) have been expanded.

The main parametric changes to the pay-as-you-go pillar were the following: (i) an annual stepwise increase in the retirement age by nine months to 62 for both men (to be completed by 2006) and women (to be completed by 2012) from 60 for men and 53 to 57 for women (depending on the number of children); (ii) the introduction of a close link between contribution history and pension benefits; (iii) the institution of an automatic indexation mechanism for benefits, with the adjustment based half on inflation and half on the average nominal wage increase in the previous year.

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.53

Budgetary developments 2003–07, Slovakia

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006	
General government balance (2)	– 3.7	– 3.3	– 3.8	– 4.0	
— Total revenues (2)	35.4	35.1	36.1	34.8	
Of which: — current taxes	18.7	17.5	17.4	16.9	
— social contributions (2)	12.4	12.4	12.5	12.0	
— Total expenditure	39.2	38.5	39.9	38.8	
Of which: — collective consumption	11.0	10.8	10.8	10.7	
— social transfers (3)	20.3	18.4	18.0	17.7	
— interest expenditure	2.5	2.2	2.4	2.2	
— gross fixed capital formation	2.6	2.6	2.6	2.4	
Primary balance (2)	– 1.2	– 1.1	– 1.4	– 1.7	
Pm Tax burden	31.1	30.0	29.9	28.9	
Government debt	42.6	43.6	44.2	44.9	
Pm Real GDP (4)	4.5	5.5	4.9	5.2	
Convergence programme (5)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance (2)	– 3.7	– 3.8	– 3.8	– 3.9	– 3.0
Primary balance (2)	– 1.1	– 1.5	– 1.4	– 1.6	– 0.7
Government debt	42.8	43.0	44.2	45.3	45.5
Pm Real GDP (4)	4.2	5.0	4.5	5.1	5.4

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) Includes the revenue-decreasing and hence, *ceteris paribus*, deficit-increasing effect of the introduction of a funded pension pillar in 2005 (estimated at around ½ % of GDP in 2005; 1 % of GDP in 2006; and 1.1 % of GDP in 2007).
(3) In kind and other than in kind.
(4) Annual % change.
(5) Submitted in November 2004.

Sources: Commission services and convergence programme of Slovakia.

Table V.54

Main measures in the budget for 2005, Slovakia

Revenue measures	Expenditure measures
• Introduction of a funded pension pillar (second pillar) at the beginning of 2005, leading to a redirection of 9 % of gross wages away from the pay-as-you-go pillar (½ % of GDP)	• Second tranche of reforms in the healthcare system leading to an upfront increase in the GDP share of expenditures by health insurance companies of around a ½ percentage point in 2005 but a stable share thereafter. The GDP share of health insurance contributions is also expected to increase in 2005 (by 0.4 percentage points), including due to improved contribution compliance. Major reform elements are: • introduction of individual private health insurance • adjustments in the assessment base for health insurance contributions • better conditions for streamlining of the healthcare benefit package • more competition, better incentives, and harder budget constraints

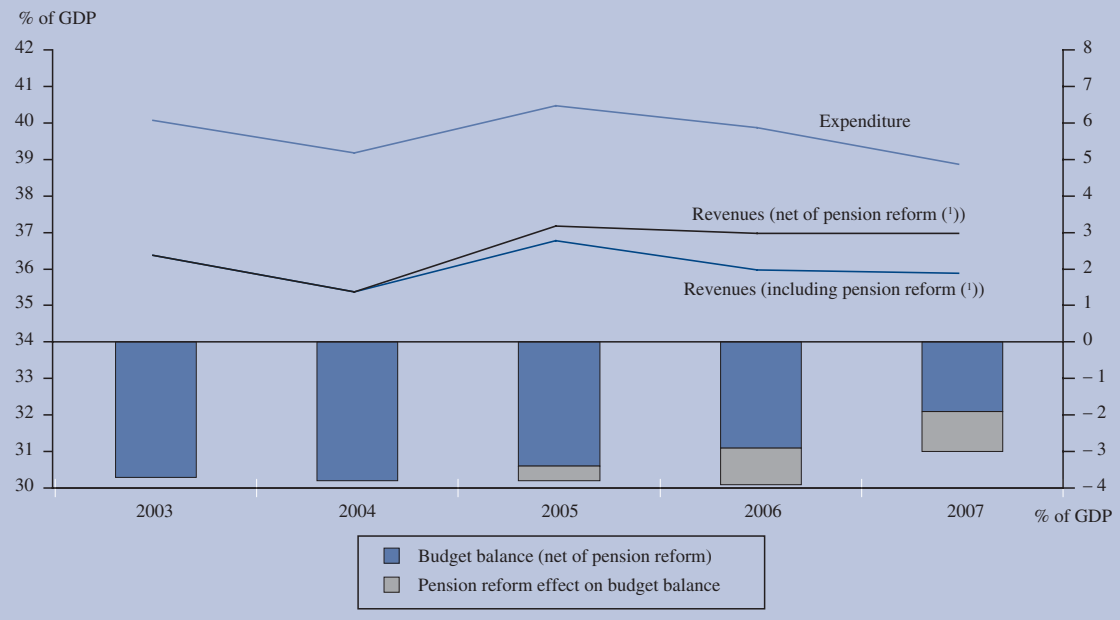
Sources: Commission services and November 2004 convergence programme of Slovakia.

The funded pension pillar introduced at the beginning of 2005 is sizeable and receives contributions by participants of 9 % of their gross wages, which are otherwise paid into the public PAYG pillar. Participation in the funded pillar is compulsory for new labour market entrants. Further pension-related social contributions, which are paid into the public pension system consist of: (i) another 9 % of gross wages for old-age pensions; (ii) 6 % for disability pensions; and (iii) 4.75 % for a reserve fund which is envisaged to cover potential shortfalls in the public pension system. Roughly three quarters of the contribution total are paid by employers.

The November 2004 convergence programme update estimates the revenue flow to the new funded pillar at 0.4 % of GDP in the first year, at 0.9 % of GDP in 2006 and at 1.1 % in 2007 (see Graph V.10). The risks attached to these estimates seem to be largely balanced. Specific uncertainties relate to the share of incumbent workers who will actually opt to switch to the new system and the exact timing of the switching (as the decision can be taken during a period spanning from the beginning of 2005 to mid-2006).

The pension reforms implemented to date considerably improve the long-term sustainability of the pension system. In addition, the reforms diversify the risk for beneficiaries and are likely to foster contribution compliance and to enhance work incentives. The introduction of a funded pillar may also have a favourable effect on financial market development. Nevertheless, sustainability considerations suggest that further reforms should be considered in the medium term. These include additional increases in the retirement age and further changes in the indexation mechanism.

Graph V.10: **Budgetary effects of the pension reform**



(1) That is, the introduction of a funded pension pillar in 2005.
Source: Commission services.

23. Finland

Recent developments and medium-term prospects

In 2004, the general government balance continued to be in surplus, at 2.1 % of GDP. This was almost a ½ percentage point higher than the target of 1.7 % set in the original 2004 budget and November 2003 update of the stability programme. The overall budgetary outturn was better than expected as central government finances posted a surplus of 0.4 % of GDP compared with a projected deficit of 0.7 %. This positive outcome derived from higher overall tax receipts and increased dividend revenues and lower interest expenditure. However, the deficit in local government finances at 0.7 % of GDP was higher than the envisaged 0.4 %, while the social security surplus at 2.4 % of GDP turned out lower than the target of 2.8 %.

Despite the positive outcome in the general government surplus, the debt ratio in 2004 was 45.1 % of GDP, while the target in the updated 2003 stability programme was 44.7 %. This higher-than-expected debt ratio follows mainly from the fact that local governments increased their borrowing, whereas central government accumulated less debt than originally planned.

The State budget for 2005 was approved by Parliament on 22 December 2004. The main measures of the budget are the income tax cuts which supplement the new centralised two-and-half-year wage agreement settled in late 2004 and the capital and corporate taxation reform. Expenditures excluding interest expenditure will go up by 1.3 % in real terms from 2004. Most of the increases derive from higher healthcare costs and increased transfers to local governments. Revenues are set to grow by 0.6 % in real terms, as the government has cut both the capital and corporate taxation, and income taxation.

The target for the general government surplus in 2005 in the biannual economic survey of the Ministry of Finance ([1]) is 1.6 % of GDP (1.8 % in the December 2004 update of the stability programme) ([2]). The Commission services' spring 2005 forecast of the general government surplus is 1.7 % of GDP ([3]) for 2005. On 17 May 2004, the government adopted the first supplementary budget for 2005. Based on current information, the budgetary projections for 2005 in the Commission services' spring forecast are still valid, but might be on the cautious side. In the first supplementary budget proposal, the government revised upwards the revenue projections by EUR 610 million (i.e. 0.4 % of GDP) for 2005 as tax receipts, dividend income and revenues from financial asset sales are foreseen to be higher than originally expected. As expenditure will be increased by EUR 160 million (i.e. 0.1 % of GDP), the central government finances should end the year better than the 0.5 % of GDP deficit presented in the original budget. In 2005, the cyclically adjusted surplus will decrease by approximately a ½ percentage point from 2004 to 1.9 % of GDP, indicating an expansionary stance in fiscal policy.

Given the no-policy-change assumption in the forecast for 2006, the general government finances are foreseen to record a surplus of 1.6 % of GDP, which is a ½ percentage point lower than the surplus target presented in the December 2004 update of the stability programme ([4]). This derives from the fact that the update of the stability programme took only partially into account the centralised two-and-half-year wage agreement settled in late 2004, which was supplemented by the government with income tax cuts worth of EUR 1.2 billion

([1]) The biannual economic survey is published in February and September.
([2]) Starting from 2003, the national accounts definition and the EDP definition of the general government balance have differed due to swap interest payments. The difference in 2004 was 0.2 percentage points, the EDP definition of general government surplus being 2.1 % of GDP and the national accounts definition 1.9 %.
([3]) EDP definition; the Ministry of Finance will continue to use the national accounts definition.
([4]) The programme, as well as its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.55

Budgetary developments 2003–08, Finland

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006
General government balance	2.5	2.1	1.7	1.6
— Total revenues	53.3	52.5	51.9	51.3
Of which: — current taxes	32.2	31.7	31.2	30.5
— social contributions	12.1	12.0	12.3	12.6
— Total expenditure	50.9	50.7	50.5	50.0
Of which: — collective consumption	7.8	7.8	7.9	7.9
— social transfers (2)	31.4	31.4	31.4	31.3
— interest expenditure	2.1	2.1	1.9	1.7
— gross fixed capital formation	3.0	2.9	2.8	2.7
Primary balance	4.5	4.0	3.3	3.1
Pm Tax burden	44.9	44.3	44.0	43.7
Government debt	45.3	45.1	44.3	43.7
Pm Cyclically adjusted balance	3.2	2.4	1.9	1.8
Pm Cyclically adjusted primary balance	5.2	4.3	3.5	3.4
Pm Real GDP (3)	2.4	3.7	3.3	2.9

Stability programme (4)	2003	2004	2005	2006	2007	2008
General government balance	2.1	2.0	1.8	2.1	2.2	2.0
Primary balance (5)	4.1	3.7	3.4	3.8	3.9	3.7
Government debt	45.6	44.6	43.4	42.5	41.7	41.1
Pm Real GDP (3)	2.0	3.2	2.8	2.4	2.2	2.0

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.
(5) The Finnish authorities provide primary balances on the basis of net interest payments rather than gross interest payments. The Commission services have recalculated the figures based on the data given in the stability programme.

Sources: Commission services and stability programme of Finland.

Table V.56

Main measures in the budget for 2005, Finland

Revenue measures	Expenditure measures
• Inflation adjustment of 2 % in the central government income tax scale and an increase in earned income deductions in municipal taxation and lowering the State income tax scale (0.3 % of GDP) • Reducing corporate income tax rate from 29 % to 26 % and capital income tax rate by 1 percentage point to 28 % (0.4 % of GDP) • Extending the domestic help credit in order to improve employment possibilities in domestic services (0.01 % of GDP)	• Increasing development cooperation spending (0.04 % of GDP) • Providing grants and subsidies for municipality mergers • Increasing funding for research and technology and financing of universities (0.04 % of GDP) • Increasing active labour market policy measures

Sources: Commission services and Finnish Ministry of Finance (budget for 2005).

(i.e. 0.8 % of GDP) for 2005–06. This has now been fully incorporated into the Commission services' spring forecast, which explains part of the discrepancy. Also, higher central government spending plans for 2006 explain the difference. Moreover, the financial position of local governments turned out to be weaker than expected in 2004 and this has had its effect on the current fiscal outlook for 2005–06. Beyond 2006, the update of the stability programme foresees the general government balance to remain in a comfortable surplus, at 2.2 % of GDP and 2.0 % for 2007 and 2008 respectively.

According to the spring 2005 forecast, the debt ratio is seen to decrease moderately from 44.3 % of GDP to 43.7 % during 2005–06. This is broadly in line with the projections in the update of the stability programme. However, based on the better-than-anticipated revenue flow, the debt ratio may be lower than projected in the Commission services' spring forecast for 2005.

Spending ceilings

Multiannual spending ceilings were first introduced into the Finnish budgetary process in 1991, but, after identified malfunction and recurrent overruns during the period 1999–2003 ([1]), the current government, which took office in June 2003, redesigned the spending ceilings and made them politically more binding. Under the new arrangement, the government at the beginning of its term agrees on the budget expenditure ceilings covering the entire four-year electoral period. The government's overall guiding premiss is that the deficit in central government finances, as measured in national accounting terms, must not exceed 2¾ % of GDP even during weak economic growth. About three quarters of the budget appropriations (i.e. 19.0 % in relation to GDP), including the supplementary budgets, are under the binding spending limits. Excluded from the ceilings are mainly cyclically fluctuating expenditure (e.g. unemployment subsidies), interest expenses on central government debt and certain items which are not deemed appropriate to tie to spending limits.

The spending limits are broken down for the ministries when preparing their annual appropriation proposals for the following year's budget. All additional spending items have to be accommodated within the ceilings. Each year, the government carries out a technical review so that ceilings are in line with the budget proposal's cost and price level and also to include changes that have been made to the structure of the budget. In 2005, these adjustments revised upwards the spending ceilings by about EUR 940 million (i.e. 0.6 % of GDP) per year between 2006 and 2007 compared with the level decided in 2003.

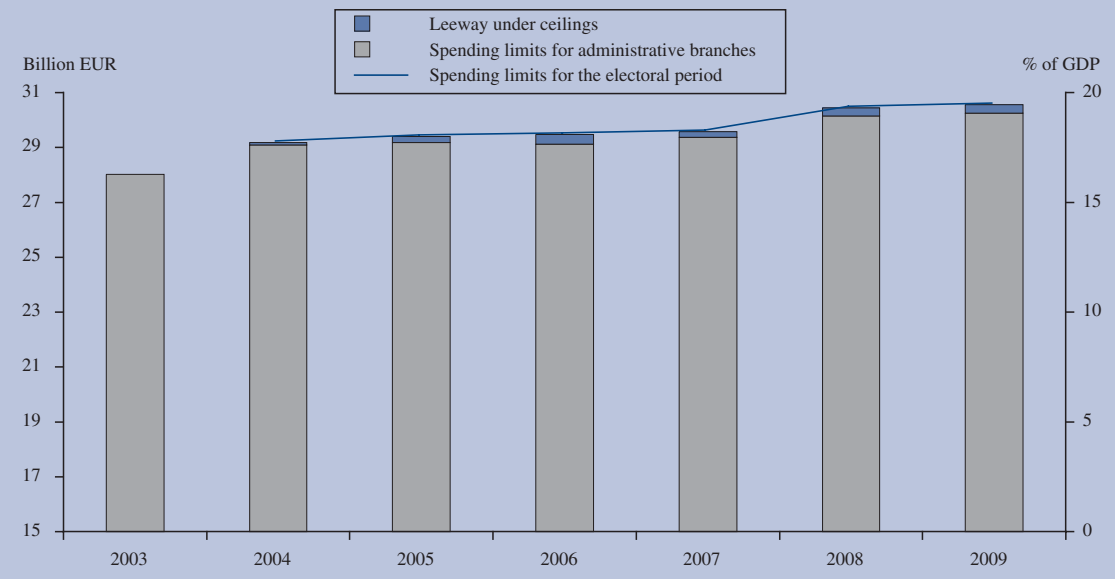
Experience so far

The spending ceilings worked well in 2004, their first year in operation, when final expenditure remained below the spending limits by EUR 84 million or 0.1 % of GDP. Also, the 2005 budget is within the ceilings, with expenditures of EUR 212 million or 0.1 % of GDP below the ceilings. This leeway will be used to cover any supplementary budgets.

According to the spending limits, total expenditure by the central government is allowed to increase by nearly 1 % a year in real terms on average in 2004–07. For the coming years, there will be testing times for the ceilings as they leave only limited scope for further expenditure increases, after spending in administrative branches in 2004 increased by 3.8 % in real terms from 2003. Also, the fact that there will be parliamentary elections in spring 2007 may exert additional pressure on the expenditure ceilings. Currently, the average leeway under the ceilings for 2006 and 2007 is EUR 280 million (i.e. 0.2 % of GDP) and beyond the current electoral period for 2008–09 the average is EUR 300 million.

([1]) See analysis of the previous expenditure frameworks in European Commission (2003a), which can be found at http://europa.eu.int/comm/economy_finance/publications/european_economy/public_finances2003_en.htm.

Graph V.11: **Budget and spending limits for the electoral period 2003–07, at the 2006 price level (billion EUR and % of GDP)**



NB: Value for 2003 is the final budget, 2004 includes original and supplementary budgets and 2005 comprises original budget. Ceilings for 2008–09 are indicatives ones, as the electoral period ends in 2007.
Source: Finnish Ministry of Finance.

24. Sweden

Recent developments and medium-term prospects

The general government recorded a surplus of 1.4 % of GDP in 2004 (1.2 % of GDP in the national accounts where the impact of swaps in the calculation of interest is excluded). This was an unexpectedly high surplus against a target of 0.4 % surplus given in the November 2003 updated convergence programme and against even the 0.7 % of GDP surplus estimated in the convergence programme submitted in November 2004. The better outcome is not surprising given the target was set using a cautious 2 % growth assumption while the growth realised, mainly due to a better export performance, was 3.5 %. However, revenues developed close to expectations in nominal terms. Instead, expenditures were lower than foreseen in the 2003 update, both in nominal terms and more prominently in shares of GDP. Lower-than-expected interest expenditure and consumption are key explanatory components. The general government debt-to-GDP ratio continued to fall and was 51.2 % of GDP in 2004.

The budget for 2005 was presented on 22 September 2004 and received parliamentary approval on 16 December 2004. The updated convergence programme for the period 2004–07, drawing fully on the draft budget, was submitted to the Commission on 18 November 2004 with a surplus target of 0.6 % of GDP for 2005. The lower surplus in 2005 as compared with the 2004 outcome mainly reflects the expansionary measures introduced in the 2005 budget, most importantly reductions in income taxes. The Commission services' spring 2005 forecast, taking into account the better-than-expected 2004 outcome, projects a slightly higher surplus of 0.8 % of GDP in 2005. On 14 April 2005, the government presented its spring budget bill with an updated surplus forecast of 0.7 % of GDP.

The Commission services' spring 2005 forecast projects the cyclically adjusted surplus to narrow by around 1 percentage point of GDP in 2005. This suggests a slightly more expansionary fiscal stance than indicated by the calculations made in the Commission's assessment of the updated programme, mainly reflecting the stronger-than-expected 2004 surplus.

Based on a no-policy-change assumption, the Commission services' spring 2005 forecast projects an unchanged surplus of 0.8 % of GDP in 2006. This is higher than the projection in the updated convergence programme of a surplus of 0.4 % of GDP, and reflects the upward revisions in the 2004 budget outcome and more favourable growth assumptions. In the spring budget bill, the government forecast a 0.6 % surplus in 2006 and 1.1 % in 2007 (compared with a 0.9 % surplus target for 2007 in the 2004 updated convergence programme).

The general government debt ratio is projected to continue to decline in 2005–06, to slightly below 50 % of GDP, though the nominal level of debt is projected to rise. The moderate pace of decline in the debt ratio reflects the 2 % of GDP surplus in the pension system being mainly invested in non-government financial assets.

Local government: the setting

Local government in Sweden consists of 290 municipalities and 20 county councils. By long tradition, they enjoy strong political and financial independence. Independent, local governments are nevertheless required by law to provide a large part of general public services. For example, municipalities are responsible for the provision of social services including childcare, and environmental and health protection, as well as primary and secondary education. The county councils mainly deal with healthcare. Municipalities and county councils share responsibility for public transport. The municipalities account for 70 % of local government expenditure while the county councils cover the remaining 30 %. Overall, local

Table V.57

Budgetary developments 2003–07, Sweden

(% of GDP)

Outturn and forecast (1)	**2003**	**2004**	**2005**	**2006**	
General government balance (2)	0.2	1.4	0.8	0.8	
— Total revenues	58.6	58.4	57.8	57.4	
Of which: — current taxes	36.0	36.3	35.8	35.5	
— social contributions	15.0	14.7	14.7	14.7	
— Total expenditure	58.4	57.0	57.0	56.6	
Of which: — collective consumption	8.2	8.0	8.0	7.9	
— social transfers (3)	38.3	37.8	37.6	37.2	
— interest expenditure	2.1	1.8	2.0	2.1	
— gross fixed capital formation	3.1	3.0	3.0	3.0	
Primary balance	2.3	3.2	2.9	2.9	
Pm Tax burden	50.8	50.7	50.1	49.8	
Government debt	52.0	51.2	50.3	49.2	
Pm Cyclically adjusted balance	1.3	1.7	0.8	0.7	
Pm Cyclically adjusted primary balance	3.4	3.5	2.9	2.8	
Pm Real GDP (4)	1.5	3.5	3.0	2.8	
Convergence programme (5)	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	0.5	0.7	0.6	0.4	0.9
Primary balance	2.7	2.8	2.8	2.7	3.3
Government debt	52.0	51.7	50.5	50.0	49.0
Pm Real GDP (4)	1.6	3.5	3.0	2.5	2.3

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second-pillar pension funds, these funds can continue to be classified inside the general government sector until the March 2007 EDP notification. This is the case in Sweden and has an estimated positive effect on the budget balance of about 1 % of GDP per year.
(3) In kind and other than in kind.
(4) Annual % change.
(5) Submitted in November 2004.

Sources: Commission services and convergence programme of Sweden.

Table V.58

Main measures in the budget for 2005, Sweden

Revenue measures	**Expenditure measures**
• Half of the fourth and last step of the income tax reform (0.3 % of GDP)	• Increase in grants to local government to support employment (volume 0.6 % of GDP)
• Abolishment of inheritance and gift taxes (0.1 % of GDP)	
• Further steps in 'green tax swap'	

Sources: Commission services and Swedish Ministry of Finance.

government is responsible for roughly 40 % of general government primary expenditures and 70 % of general government investment and consumption. More than half of the costs are for personnel and local governments employ about 25 % of employees in the economy.

For its financing, local governments have the right to levy direct tax. Tax revenues cover roughly two thirds of total revenues. They are raised through a flat-rate tax on income, i.e. salaries, unemployment and illness benefits and pensions. The average municipality tax is about 21 % and the average county council tax 10.5 % making

the average local tax about 31.5 % (this varies across local governments; in 2003, the highest local tax rate was 33.3 % while the lowest was 28.9 %).

Local governments may also raise income through fees for some services provided. However, most of the remaining revenues consist of general grants and grants directed towards a specific use (special-purpose grants). The level of the grants does not follow any indexation rule but is decided each year on a discretionary basis. As from 2005, general grants have been provided within an 'equalisation' system administered by the central government. This consists of an 'income equalisation' system and a 'cost equalisation' system. On the income side, local governments with low per capita income are compensated by central government general grants (there is also small co-financing by local governments with very high per capita income).

On the cost side, there is compensation for structural differences in the cost structure (e.g. due to differences in demography). The cost equalisation system only redistributes across local governments and there is no financial contribution from central government. The special purpose grants are mainly directed towards education and employment where those for the latter have been increased substantially in the 2005 budget.

Since 2000, budgetary developments at local level have been guided by a 'budget balance requirement'. This stipulates that budgets must be planned with revenues (taxes, fees and grants) higher than or equal to expenditures. Borrowing is allowed to finance investments but the costs to finance the loans are covered through the budget. As from 2005, a number of changes have been introduced to make the rules slightly more flexible. It is now possible to present a budget in deficit if there are 'special reasons' such as a healthy balance sheet or a particular need for large structural measures. Should a deficit materialise despite a planned surplus or balance, a consolidation rule specifies that the deficit must be compensated by surpluses in the following three years (as from 2005 — the period was two years up to 2004). There is, however, no explicit sanction mechanism in the case of non-compliance.

Budgetary problems: a procyclical bias?

Table V.59 shows the budgetary situation in local governments over the 1997–2004 period. In the 1998–2000 period, tax bases grew relatively strongly in line with overall growth and employment. At the same time, central government grants were higher than before. Backed by the healthy growth in revenues, local government activity expanded relatively strongly in volume terms. The impact on costs from the increasing activity gradually started to show on the budget balance and in 2002 the sector recorded a 0.5 % of GDP net lending deficit. Hence, in 2003, a year of weak GDP growth and falling employment in the economy as a whole, measures were taken to curb the growth in consumption while at the same time the average local tax rate was increased by 0.65 percentage points.

In 2004, the measures to curb the growth in consumption had an increased effect as mirrored by a negative local government employment growth. Even so, the average

Table V.59

Local government finances 1997–2004, Sweden

(% of GDP)

Outturn	1997	1998	1999	2000	2001	2002	2003	2004
Revenue	**22.3**	**23.6**	**23.2**	**22.4**	**22.8**	**23.2**	**23.6**	**23.3**
Taxes	15.5	15.5	15.5	15.3	15.8	16.1	16.5	16.5
Central government grants	4.3	5.5	5.3	5.0	5.0	5.1	5.0	4.8
Other	2.5	2.5	2.4	2.0	1.9	2.1	2.0	2.0
Expenditure	**22.8**	**23.4**	**23.1**	**22.2**	**23.0**	**23.7**	**23.8**	**23.3**
Consumption	18.5	19.4	19.3	18.7	19.3	20.0	20.3	20.0
Other	4.3	4.0	3.9	3.5	3.7	3.7	3.5	3.2
Net lending	**– 0.5**	**0.2**	**0.1**	**0.2**	**– 0.2**	**– 0.5**	**– 0.3**	**0.1**

Source: Swedish Ministry of Finance.

local tax rate had to be raised again, this time by an additional 0.34 %. During this period, the yearly increase in central government grants merely followed nominal GDP growth. In 2004, the sector showed a surplus again, partially explained by an increased sale of real estate. In the 2005 budget bill, the government introduced sizeable increases in transfers targeted towards supporting employment. This should limit the need for further tax increases while allowing for a positive employment growth in a context of controlled consumption growth (but lower the surplus of general government). The key financial problems of the sector as a whole therefore seem to be largely under control even though the situation remains quite disparate across local governments. About 40 % of municipalities and 60 % of county councils did not meet the balance requirement in 2004. Effectively, to recuperate the deficits realised, there is still a need for consolidation in the coming years and margins remain small.

Concluding remarks

The recent experience with the problems in the local government budgetary situation has led to some debate on the budgetary framework and the role of local government. First, the balance requirement has not been able to prevent procyclical budgetary policies. When income growth was cyclically healthy, expenditures were increased and, when the economic conditions later deteriorated, it was necessary to reduce employment and increase taxes. It is noteworthy that the local tax increases to a large extent have neutralised the government efforts to lower income taxes in order to promote incentives to work. The efforts to introduce some more flexibility in the rules can be seen as an attempt to alleviate this problem: that is, the longer time allowed for compensating for deficits and the increased possibilities to have exceptions from the balanced budget requirement. Second, the financial problems at local level quickly feed through to central level. There is arguably an implicit commitment by the central government to ensure that the provision of general public services is secured. If local governments can count on being 'bailed out', it may create a moral hazard problem ([1]). By deciding the level of grants only by discretion, the government puts pressure on local authorities to plan cautiously. The discretion also allows the government a higher degree of control and freedom to adjust measures and priorities across expenditure areas. In particular, central government expenditures must meet the nominal expenditure ceilings set by Parliament. However, the discretionary allocation of grants creates uncertainty at local level which may make effective planning more difficult. This is so even if general grants have in practice been raised to cover increases in prices and wage costs in a seemingly semi-automatic way ([2]). Third, the recent budgetary pressure has increased awareness of the medium- to longer-term budgetary challenges from the ageing of the population. Given the demographic outlook, the cost pressures from the provision of public services will to a large extent show at local level. The government's long-term survey 2003/04 ([3]) pointed to the budgetary pressures stemming from the ageing of the population. To be able to finance the higher demand for welfare services, it will be necessary to increase productivity and employment participation since the scope to increase tax rates is limited. Furthermore, a government committee on public sector responsibilities is currently studying the structure and division of responsibilities across different layers of government with a view to securing the public welfare commitment. Thus, even if the outlook for local government finances looks beneficial in the short term, the major budgetary challenges remain.

([1]) See Fischer, J., 'Swedish budget rules: praise from Brussels, pressure at home', European Commission, *Country Focus*, Volume II, issue 4.
([2]) See NIER (National Institute of Economic Research) (2004), *The Swedish economy*, December 2004.
([3]) SOU (2004), *The long-term survey of the Swedish economy*, Swedish government official report, 2004, p. 19.

25. United Kingdom

Recent developments and medium–term prospects

The outturn for the general government balance in the 2004/05 financial year ([1]) is estimated in the March 2005 budget to be a deficit of 3.0 % of GDP, a worse outturn than the 2.7 % deficit projected in the March 2004 budget (and also the 2.9 % projected in the December 2004 update of the UK convergence programme) (all figures reported here are after adjustment by the Commission services: see footnote 5 to Table V.60).

This deterioration appears to reflect both revenue growth slightly weaker than expected, in spite of robust GDP growth, and strength in current spending. On the revenue side, general government current receipts are estimated to have been GBP 3.8 billion (0.3 % of GDP) lower than expected in the 2004 budget, even though the rising price of oil led to stronger revenues from North Sea oil production. Disappointing growth of corporation tax receipts during the first half of the financial year was a significant factor in the shortfall, which the authorities suggest may have reflected a previous underestimate of the backlog in unused losses accumulated by financial companies that have depressed taxable profits in the short term, a legacy of the earlier collapse in equity markets. More recently, however, receipts of corporation tax have picked up sharply, reflecting a combination of continued strength in corporate profitability and the introduction of a number of measures designed to reduce tax avoidance. On the expenditure side, general government current expenditure is estimated to have been GBP 1.4 billion (around 0.1 % of GDP) higher than expected in the 2004 budget: central government departments appear to have made use of accumulated underspends from previous years, available to them under the UK's system of 'end year flexibility'. The authorities argue that this reflects a smoothing of expenditure given that the rate of growth in spending planned for 2004/05 had been slower than for either the preceding or following financial years. The authorities also note higher-than-expected expenditure on the UK's international commitments, including Iraq. However, this is offset by lower net investment than projected in the 2004 budget: investment is now estimated to have been some GBP 2 billion (0.2 % of GDP) less than planned in 2004/05. The debt ratio, meanwhile, is estimated to have reached 41.0 % of GDP by the end of 2004/05.

The latest budget, presented on 16 March 2005, sets out a number of discretionary policy changes which have a broadly neutral impact on the UK's fiscal position in both 2005/06 and 2006/07. The largest expenditure measure was a one-off GBP 200 contribution to all households containing someone over 65 with an obligation to pay the local government tax levied on property values ('council tax'). The biggest revenue measure was a one-off change to the payment profile of North Sea corporation tax (expected to bring in over GBP 1 billion or 0.1 % of GDP) over the coming financial year. The 2005 budget also set new estimates and projections for the public finances, updating those set in the December 2004 convergence programme update. The general government balance is now expected to improve modestly to a deficit of 2.7 % for 2005/06. In the Commission services' spring 2005 forecast, the projected outcome for calendar year 2005 is also for a modest improvement, but to a slightly less optimistic 3.0 % of GDP. This largely reflects a more conservative estimate of revenue recovery, despite forecasts for GDP growth broadly similar to the macroeconomic forecasts used by the government to forecast the public finances. Nonetheless, as measured by the change in the cyclically adjusted balance, the fiscal stance in 2005 is broadly unchanged or very slightly tighter than in 2004.

In 2006, under a no-policy-change assumption, the Commission services' spring 2005 forecast projects a further modest improvement in the general government balance,

([1]) The financial year runs from April to March.

Table V.60

Budgetary developments 2003–08/09, United Kingdom

(% of GDP)

Outturn and forecast (1)	2003	2004	2005	2006		
General government balance	– 3.4	– 3.2	– 3.0	– 2.7		
— Total revenues	40.0	40.4	40.9	41.4		
Of which: — current taxes	28.4	29.0	29.6	30.0		
— social contributions	8.0	8.1	8.1	8.1		
— Total expenditure	43.4	43.6	44.0	44.1		
Of which: — collective consumption	8.0	8.1	8.2	8.3		
— social transfers (2)	26.4	26.5	26.5	26.5		
— interest expenditure	2.1	2.1	2.1	2.1		
— gross fixed capital formation	1.7	1.8	2.0	2.1		
Primary balance	– 1.3	– 1.1	– 1.0	– 0.7		
Pm Tax burden	36.5	37.2	37.8	38.2		
Government debt	39.7	41.6	41.9	42.5		
Pm Cyclically adjusted balance	– 3.0	– 3.0	– 2.9	– 3.0		
Pm Cyclically adjusted primary balance	– 0.9	– 1.0	– 0.8	– 0.5		
Pm Real GDP (3)	2.2	3.1	2.8	2.8		
Convergence programme (4)	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**2008/09**
General government balance (5)	– 3.2	– 2.9	– 2.8	– 2.3	– 2.1	– 1.7
Primary balance (6)	– 1.2	– 0.8	– 0.7	– 0.2	– 0.1	n.a.
Government debt	39.5	40.9	41.8	42.4	42.8	42.8
Pm Real GDP (3)	2¾	3¼	3	2½	2¼	2¼

(1) Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(2) In kind and other than in kind.
(3) Annual % change.
(4) Submitted in December 2004.
(5) The UK authorities include, in their projections for the general government balance, annual receipts of around GBP 1.0 billion from the sale of UMTS licences in 2000. All figures in the table are, after adjusting for this, to bring the projections onto an EDP basis (in line with the Eurostat decision set out in News Release 81/200, 14.7.2000); this has the effect of subtracting around 0.1 percentage point from the balance (i.e. increasing the deficit) in each year.
(6) The UK authorities provide primary balances excluding net interest rather than only interest payments as done by the Commission. Figures shown above are as recalculated by the Commission services.

Sources: Commission services and convergence programme of the United Kingdom.

Table V.61

Main measures in the budget for 2005, United Kingdom

Revenue measures	Expenditure measures
• Changes to advance the payment profile of North Sea corporation tax (0.1 % of GDP in 2005/06) • Changes in property transaction tax regime ('stamp duties'): ending relief for commercial transactions in disadvantaged areas (0.03 % of GDP); doubling of the zero-rate threshold from GBP 60 000 to GBP 120 000 for residential transactions (– 0.03 % of GDP) • Specific countermeasures preventing tax avoidance through: the use of financial-product-based schemes (0.03 % of GDP); the exploitation by companies of differences within and between tax codes (0.01 % of GDP) • Deferral of the previously planned inflation-based increase in main road fuel duties to 1 September 2005 (– 0.02 % of GDP)	• Payments of GBP 200 to over-65 households to defray local government property ('council') tax charges (0.08 % of GDP) • Overseas obligations including in Iraq (0.04 % of GDP)

Sources: Commission services and 2005 budget.

to a deficit of 2.7 % of GDP, though remaining higher than the authorities' projection of 2.3 % in the 2006/07 financial year.

Thereafter, the authorities assume that the balance will continue to improve steadily, to 1.6 % of GDP by 2009/10. This is broadly in line with the profile envisaged in the December 2004 update of the UK's convergence programme ([1]).

According to the Commission services' spring 2005 forecast, the general government gross debt-to-GDP ratio is expected to rise over the forecast period, from 41.6 % of GDP in 2004 to 42.5 % in 2006.

Improving the efficiency of public services

Recent policy priorities in the UK aim to overturn a legacy of underinvestment and underprovision in public services by increasing government current and capital spending. Consequently, though remaining within the overall constraints of the UK's domestic fiscal policy rules, total general government spending rose from around 39½ % of GDP in 1999 to around 43½ % in 2004, while a reduction in debt interest costs also allowed spending to be redirected from servicing debt to public services — interest payments fell from 3.6 % of GDP to 2.1 % between 1996 and 2002, reflecting consolidation of the public finances from 1997 to 1999 and improvements to the macroeconomic framework. The rise in general government spending (plus slower growth in 2002) contributed to the general government balance deteriorating from surplus as recently as 2001 to a 3.2 % of GDP deficit in 2004.

The authorities have introduced a series of reforms to ensure public services are provided efficiently. These include the introduction of public service agreements (PSAs) which set out the outcomes each government department is committed to achieving (detailed in European Commission, 2002a), and service delivery agreements (SDAs) which outline the steps that will be taken to achieve these objectives. Building on this, and reflecting the increased pressure on the public finances, the 2003–05 BEPGs included a recommendation for the UK authorities to ensure that the public services accompanying the planned increase in spending '… are delivered efficiently and with a view to ensuring cost-effectiveness'.

The 2003 budget made achieving efficiency savings in public service delivery a key objective, savings which the government intended to redirect to increase the direct provision of public services. Potential savings were identified in a report commissioned by the government and published in July 2004, *Releasing resources to the front line: independent review of public sector efficiency* (the Gershon report ([2]). Its results and recommendations

([1]) The programme, and its assessment by the Commission and the Council, can be found at http://europa.eu.int/comm./economy_finance/about/activities/sgp/main_en.htm.

([2]) Prepared by Sir Peter Gershon, a former chief executive of the Office of Government Commerce (the government's centralised procurement agency set up in 2000).

Table V.62

Annual public service efficiency savings expected or achieved in the UK since July 2004

Department	How	Amount (% of GDP)
Health	Negotiating a new procurement deal for generic medicines	0.07 expected
	Negotiation of a new procurement deal for branded medicines	0.03
Home Office	Better use of police time, smarter procurement, improvements to the National Offender Management Service, substantial reductions in the cost of asylum	0.06
Defence	Improving defence logistics	< 0.03
Office of the Deputy Prime Minister	Reforms to the delivery of new supply, capital works, and commodity procurement and management and maintenance	> 0.02
Work and Pensions	Paying the benefits and pensions of 90 % of its customers directly into their bank accounts	< 0.02

Sources: Commission services, 2004 pre-budget report and 2005 budget.

were accepted by the government and fed directly into both the 2004 budget and the 2004 spending review which, in July 2004, set out detailed spending plans for the 2005/06 to 2007/08 financial years.

Taking its figures directly from the Gershon report, the 2004 spending review identified potential annual public sector efficiency gains of over GBP 21.5 billion (roughly 2 % of GDP) by 2007/08. This was based on departments achieving annual efficiency savings relative to their baseline expenditure ([1]) of at least 2.5 % per year over the period from 2005/06. Contributing to that end, the spending review set each government department's administration budget for 2006/07 and 2007/08 at, or below, its 2005/06 nominal level, implying a real term reduction in administration costs alone of at least 5 % over the two-year period ([2]).

The Gershon savings include a net reduction in civil service employment of 70 600 posts (roughly 13.5 % of the April 2004 total of 523 580) by 2008; 84 000 posts are to be cut, of which just under 14 000 postholders are intended to be moved to direct service provision. A further 20 000 jobs were expected to be cut by the devolved administrations of Scotland, Wales and Northern Ireland, while just over 20 000 posts were identified for relocation away from the south-east of England to lower-cost locations.

Six areas were identified as providing scope for the efficiency savings and job reductions. The first is improving the efficiency of 'back-office' facilities by such means as pooling administrative functions to eliminate job duplication amongst departments. The second is to get better value out of public procurement. The third is by improving processes associated with government transactions, including the operation of benefit payments. The fourth and fifth are by lightening the monitoring and regulation of the public and private sectors. The sixth is by increasing the time spent by staff on service delivery, including by improving sickness absence management.

The government has set out a formal process for assessing departmental progress against the targets set in the 2004 spending review. Departmental reports setting out how performance will be measured have been scrutinised by the National Audit Office (NAO) and the Audit Commission, and have been made public. Departments will be required to report formally on their progress against efficiency targets in their departmental reports, published each spring. In addition, all departments will be required to have, by December 2006, a professional finance director reporting to the head of department (the Permanent Secretary), with a seat on the departmental board.

Measures to reap the efficiency savings identified in the Gershon report were only initially understood to start from the 2005/06 financial year — i.e. April 2005 onwards. However, the December 2004 pre-budget report and the March 2005 budget claim that substantial progress has already been made, with GBP 2 billion already saved. Details of some of the biggest savings are provided in Table V.62.

Of the 84 000 civil service posts the government intends to try to eliminate by 2008, it expects 12 500 to have gone by the end of 2005. The bulk of these are being eliminated from the Department of Work and Pensions. On the relocation of posts away from south-east England, the government claims that by the end of 2004/05 it will have achieved 4 300 of the 20 000 due by the end of 2008 and that another 3 500 posts are already firmly planned for relocation.

This 'input-oriented' approach should complement the existing focus by public service agreements on outputs/results — indeed, the Treasury has a specific PSA objective of 'working with departments to help them meet their … efficiency targets amounting to [GBP] 20 billion a year by 2007/08'. Fully assessing the ultimate success of the initiative will, however, only become evident over the medium term, not least because some identified potential savings are difficult to assess *ex ante*. In addition, a successful outcome, one that is easily demonstrable to the wider public, requires clear, rigorous and accessible assessments.

([1]) Baseline expenditure is defined as the departmental expenditure limit (DEL) plus additional spending by local governments in particular policy areas for which they are responsible (e.g. education) in the 2004/05 financial year. Departments are expected to achieve a 2.5 % saving relative to that baseline in each of the three years covered by the 2004 spending review, i.e. 2005/06 through to 2007/08, implying a cumulative efficiency gain equivalent to 7.5 % of expenditure in 2004/05.

([2]) It is important to note that the spending plans set out in the 2004 spending review — and the government's fiscal rules — do not rely on the efficiency targets being met. The overall spending plans have been set consistent with the authorities' view that the spending is affordable even without the efficiency savings. Instead, if the savings are achieved, the government intends to use all the resources released for further provision of public services, leaving the overall level of expenditure unchanged.

Part VI

Resources

1. Glossary

Accession countries Countries in the process of accession to the European Union. They include Bulgaria and Romania.

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 Croatia 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 stage 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*, and 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 rules* and *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, and 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* and *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 enterprises 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, and 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 expectation 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).

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 (PAYG) pension system 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.

Procyclical 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) countercyclical 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 (PPPs) 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 identification of strategic priorities and the effective and efficient use of resources in reaching them.

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.

Recently acceded Member States Countries that became members of the EU in May 2004, i.e. the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.

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 (SSCs) Mandatory contributions paid by employers and employees to a social insurance scheme to cover 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 stage 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 balance 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 also referred to as the *cyclically adjusted budget balance*. See also *primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensures 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 Parliament	www.europarl.eu.int/
Council of the European Union	ue.eu.int/

Economics and Finance Ministries

Belgium	treasury.fgov.be/interthes	Ministère des Finances/Ministerie van Financen
Czech Republic	www.mfcr.cz	Ministry of Finance
Denmark	www.fm.dk	Ministry of Finance
Germany	www.bundesfinanzministerium.de	Bundesministerium der Finanzen
Estonia	www.fin.ee	Ministry of Finance
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
Cyprus	www.mof.gov.cy	Ministry of Finance
Latvia	www.fm.gov.lv	Ministry of Finance
Lithuania	www.finmin.lt	Ministry of Finance
Luxembourg	www.etat.lu/FI	Ministère des Finances
Hungary	www.p-m.hu	Ministry of Finance
Malta	mfea.gov.mt	Ministry of Finance and Economic Affairs
Netherlands	www.minfin.nl	Ministerie van Financien
Austria	www.bmf.gv.at	Bundesministerium für Finanzen
Poland	www.mofnet.gov.pl	Ministry of Finance
Portugal	www.min-financas.pt	Ministério das Finanças
Slovenia	sigov1.sigov.si/mf	Ministry of Finance

Slovakia	www.finance.gov.sk	Ministry of Finance
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
Romania	www.mfinante.ro	Ministry of Finance
Turkey	www.maliye.gov.tr	Ministry of Finance
Japan	www.mof.go.jp	Ministry of Finance
United States of America	www.ustreas.gov	Department of the Treasury

Central banks

European Union	www.ecb.int	European Central Bank
Belgium	www.nbb.be	Banque Nationale de Belgique/Nationale Bank van België
Czech Republic	www. cnb.cz	Czech National Bank
Denmark	www.nationalbanken.dk	Danmarks Nationalbank
Germany	www.bundesbank.de	Deutsche Bundesbank
Estonia	www.eestipank.info	Eesti Pank
Greece	www.bankofgreece.gr	Bank of Greece
Spain	www.bde.es	Banco de España
France	www.banque-france.fr	Banque de France
Ireland	www.centralbank.ie	Central Bank of Ireland
Italy	www.bancaditalia.it	Banca d'Italia
Cyprus	www.centralbank.gov.cy	Central Bank of Cyprus
Latvia	www.bank.lv	Bank of Latvia
Lithuania	www.lb.lt	Lietuvos Bankas
Luxembourg	www.bcl.lu	Banque centrale du Luxembourg
Hungary	www.mnb.hu	National Bank of Hungary
Malta	www.centralbankmalta.com	Central Bank of Malta
Netherlands	www.dnb.nl	De Nederlandsche Bank
Austria	www.oenb.co.at	Österreichische Nationalbank
Poland	www.nbp.pl	Narodowy Bank Polski
Portugal	www.bportugal.pt	Banco de Portugal
Slovenia	www.bsi.si	Bank of Slovenia

Slovakia	www.nbs.sk	National Bank of Slovakia
Finland	www.bof.fi	Suomen Pankki
Sweden	www.riksbank.com	Sveriges Riksbank
United Kingdom	www.bankofengland.co.uk	Bank of England
Bulgaria	www.bnb.bg	Bulgarian National Bank
Romania	www.bnro.ro	National Bank of Romania
Turkey	www.tcmb.gov.tr	Central Bank of the Republic of Turkey
Japan	www.boj.or.jp	Bank of Japan
United States of America	www.federalreserve.gov	Board of Governors of the Federal Reserve System

Statistical Offices

European Union	europa.eu.int/comm/eurostat	Eurostat
Belgium	www.bnb.be	National Bank of Belgium
Denmark	www.dst.dk	Danmarks Statistik
Germany	www.statistik-bund.de	Statistisches Bundesamt Deutschland
Greece	www.statistics.gr	National Statistical Service of Greece
Spain	www.ine.es	Instituto Nacional de Estadística
France	www.insee.fr	Institut National de la Statistique et des Etudes Economiques
Ireland	www.cso.ie	Central Statistics Office
Italy	petra.istat.it	Istituto nazionale di statistica
Luxembourg	statec.gouvernement.lu	Service Central de la Statistique et des Etudes Economiques
Netherlands	www.cbs.nl	Centraal Bureau voor de Statistiek
Austria	www.oestat.gv.at	Österreichisches Statistisches Zentralamt
Portugal	www.ine.pt	Instituto Nacional de Estatística
Finland	www.stat.fi	Tilastokeskus/Statistics Finland
Sweden	www.scb.se	Statistiska Centralbyrån/Statistics Sweden
United Kingdom	www.statistics.gov.uk	Office for National Statistics
Bulgaria	www.nsi.bg	National Statistical Institute
Cyprus	www.pio.gov.cy/dsr	Statistical Service
Czech Republic	www.czso.cz	Czech Statistical Office
Estonia	www.stat.ee	Statistical Office
Hungary	www.ksh.hu	Central Statistical Office
Latvia	www.csb.lv	Central Statistical Bureau
Lithuania	www.std.lt	Statistics Lithuania
Malta	www.nso.gov.mt	National Statistics Office
Poland	www.stat.gov.pl	Polish Official Statistics
Romania	www.insse.ro	National Institute of Statistics
Slovakia	www.statistics.sk	Statistical Office

Slovenia	www.sigov.si/zrs	Statistical Office
Turkey	www.die.gov.tr	State Institute of Statistics
Japan	www.stat.go.jp/english/index.htm	Statistics Bureau/Statistics Centre
United States	www.fedstats.gov/	Federal Statistical Agencies

International organisations

Bank for International Settlements	www.bis.org
ERBD	www.ebrd.com
IMF	www.imf.org
OECD	www.oecd.org
United Nations	www.un.org
World Bank	www.worldbank.org
World Trade Organisation	www.wto.org

Statistical annex

Statistical annex

List of tables

Table A.1.1

Resources and expenditure of general government

(% of GDP)

Belgium		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	12.2	13.1	12.7	12.9	12.9	13.2	13.4	13.4
2.	Current taxes on income and wealth	16.7	17.3	17.6	17.6	17.0	17.1	17.3	16.8
3.	Social contributions	16.8	16.1	16.4	16.7	16.5	16.0	15.8	15.5
4.	*Of which* actual social contributions	14.8	14.1	14.4	14.6	14.4	14.0	13.8	13.6
5.	Other current resources	3.1	2.9	3.0	2.9	2.7	2.6	2.5	2.4
6.	Total current resources	48.8	49.4	49.7	50.0	49.1	49.0	49.0	48.1
7.	Government consumption expenditure	21.4	21.1	21.7	22.3	22.8	22.9	22.9	22.8
8.	*Of which* compensation of employees	11.9	11.4	11.6	12.0	12.1	11.9	11.8	11.6
9.	Collective consumption	7.9	7.9	8.0	8.4	8.4	8.4	8.3	8.1
10.	Social benefits in kind	13.5	13.2	13.7	13.9	14.4	14.5	14.7	14.7
11.	Social transfers other than in kind	16.6	15.2	15.4	16.0	16.2	15.9	15.7	15.5
12.	Interest payments	9.3	6.7	6.5	6.0	5.4	4.7	4.5	4.2
13.	Subsidies	1.5	1.5	1.6	1.5	1.6	1.6	1.5	1.5
14.	Other current expenditure	2.0	2.0	2.0	2.1	2.3	2.2	2.2	2.2
15.	Total current expenditure	50.7	46.5	47.2	47.9	48.3	47.3	46.8	46.2
16.	Gross savings	– 2.0	2.8	2.4	2.1	0.8	1.6	2.1	1.9
17.	Capital transfers received	0.4	0.5	0.6	0.5	2.5	0.9	0.5	0.5
18.	Total resources	48.5	49.4	49.9	50.3	51.3	49.6	49.1	48.5
19.	Gross fixed capital formation	1.9	1.9	1.7	1.6	1.6	1.5	1.8	2.0
20.	Other capital expenditure	1.0	1.2	0.8	0.9	1.3	1.0	1.0	0.9
21.	Total expenditure	52.9	49.2	49.3	50.2	50.9	49.5	49.3	49.0
22.	Tax burden	46.8	47.5	47.7	48.0	47.2	47.2	47.4	46.6
23.	Net lending (+) or net borrowing (–)	– 4.4	0.2	0.6	0.1	0.4	0.1	– 0.2	– 0.6

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.2

Resources and expenditure of general government

(% of GDP)

Germany [1]		ESA 95 definitions [2]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	11.4	12.0	11.9	11.9	12.0	11.9	11.9	11.9
2.	Current taxes on income and wealth	11.1	12.5	11.1	10.8	10.6	10.2	10.1	10.2
3.	Social contributions	18.8	18.6	18.5	18.5	18.6	18.2	18.0	17.8
4.	*Of which* actual social contributions	17.7	17.6	17.5	17.4	17.5	17.2	17.0	16.8
5.	Other current resources	3.5	2.9	3.1	3.0	2.9	2.6	2.7	2.5
6.	Total current resources	44.8	46.1	44.5	44.2	44.1	42.9	42.7	42.4
7.	Government consumption expenditure	19.8	19.0	19.0	19.2	19.2	18.7	18.5	18.2
8.	*Of which* compensation of employees	9.0	8.2	8.0	8.0	7.9	7.6	7.6	7.4
9.	Collective consumption	8.4	7.9	7.9	8.0	7.9	7.7	7.5	7.3
10.	Social benefits in kind	11.4	11.1	11.1	11.3	11.3	11.0	11.0	10.9
11.	Social transfers other than in kind	18.1	18.7	18.8	19.4	19.7	19.4	19.3	18.8
12.	Interest payments	3.7	3.4	3.3	3.1	3.1	3.0	3.0	3.0
13.	Subsidies	2.1	1.7	1.6	1.5	1.4	1.3	1.2	1.2
14.	Other current expenditure	1.2	1.7	1.6	1.7	1.8	1.7	1.6	1.6
15.	Total current expenditure	44.9	44.5	44.3	45.0	45.2	44.2	43.5	42.8
16.	Gross savings	– 0.1	1.6	0.2	– 0.8	– 1.1	– 1.2	– 0.9	– 0.4
17.	Capital transfers received	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
18.	Total resources	46.1	47.1	45.5	45.1	45.0	43.8	43.6	43.4
19.	Gross fixed capital formation	2.3	1.8	1.8	1.7	1.5	1.4	1.4	1.4
20.	Other capital expenditure	1.5	– 1.1	1.7	1.6	1.6	1.5	1.5	1.4
21.	Total expenditure	49.4	45.7	48.3	48.7	48.8	47.5	47.0	46.2
22.	Tax burden	42.2	43.8	42.0	41.5	41.6	40.7	40.4	40.3
23.	Net lending (+) or net borrowing (–)	– 3.3	1.3	– 2.8	– 3.7	– 3.8	– 3.7	– 3.3	– 2.8

(1) From 1991 including former East Germany.
(2) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.3

Resources and expenditure of general government

(% of GDP)

Greece		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	13.5	15.2	14.7	15.1	14.7	14.3	14.3	14.5
2.	Current taxes on income and wealth	7.4	10.8	9.5	9.5	8.8	8.9	8.9	8.7
3.	Social contributions	12.6	14.0	14.1	15.0	15.5	16.3	16.8	17.2
4.	*Of which* actual social contributions	10.5	11.7	11.9	12.8	13.2	13.9	14.3	14.6
5.	Other current resources	4.5	3.6	4.3	3.1	2.5	2.3	2.1	2.0
6.	Total current resources	38.1	43.5	42.6	42.7	41.5	41.8	42.1	42.3
7.	Government consumption expenditure	15.3	17.7	16.8	17.6	16.4	17.1	16.9	16.4
8.	*Of which* compensation of employees	11.3	11.7	11.6	12.2	11.9	12.5	12.5	12.2
9.	Collective consumption	9.4	11.7	10.7	11.4	10.2	10.9	10.8	10.5
10.	Social benefits in kind	5.9	6.0	6.0	6.2	6.3	6.2	6.1	5.9
11.	Social transfers other than in kind	15.1	16.6	17.1	17.1	17.8	18.7	19.6	20.5
12.	Interest payments	12.7	8.2	7.3	6.3	5.8	5.8	5.5	5.5
13.	Subsidies	0.4	0.2	0.1	0.1	0.2	0.1	0.1	0.1
14.	Other current expenditure	1.3	1.1	1.1	1.2	1.7	1.7	1.6	1.6
15.	Total current expenditure	44.9	43.7	42.4	42.3	41.8	43.4	43.7	44.1
16.	Gross savings	– 6.8	– 0.2	0.2	0.3	– 0.4	– 1.4	– 1.6	– 1.8
17.	Capital transfers received	1.6	3.2	2.7	1.8	1.9	2.6	2.7	2.5
18.	Total resources	40.9	47.9	46.5	45.2	43.5	43.9	44.3	44.3
19.	Gross fixed capital formation	3.2	4.1	4.0	3.6	4.0	4.1	3.3	3.1
20.	Other capital expenditure	1.7	3.1	2.5	2.7	2.8	3.1	2.4	2.1
21.	Total expenditure	51.0	52.0	50.2	49.0	48.0	50.0	48.8	48.7
22.	Tax burden	34.4	40.6	38.9	39.5	38.7	39.2	39.7	40.0
23.	Net lending (+) or net borrowing (–)	– 10.2	– 4.1	– 3.6	– 4.1	– 5.2	– 6.1	– 4.5	– 4.4

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.4

Resources and expenditure of general government

(% of GDP)

Spain		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	10.2	11.7	11.4	11.6	12.0	12.4	12.4	12.6
2.	Current taxes on income and wealth	10.1	10.5	10.4	10.9	10.6	10.7	10.7	10.7
3.	Social contributions	13.0	13.3	13.5	13.5	13.7	13.6	13.7	13.7
4.	*Of which* actual social contributions	12.0	12.4	12.7	12.7	12.8	12.7	12.8	12.9
5.	Other current resources	4.1	3.4	3.6	3.4	3.3	3.1	3.0	3.0
6.	Total current resources	37.4	38.8	38.9	39.4	39.6	39.8	39.9	40.0
7.	Government consumption expenditure	18.1	17.7	17.6	17.7	17.9	18.3	18.5	18.7
8.	*Of which* compensation of employees	11.3	10.5	10.4	10.3	10.4	10.4	10.3	10.3
9.	Collective consumption	8.0	7.6	7.6	7.6	7.7	7.9	8.0	8.1
10.	Social benefits in kind	10.1	10.1	10.0	10.1	10.2	10.4	10.5	10.6
11.	Social transfers other than in kind	13.9	12.3	12.2	12.3	12.2	12.2	12.2	12.1
12.	Interest payments	5.2	3.3	3.2	2.8	2.5	2.2	2.1	2.0
13.	Subsidies	1.1	1.2	1.1	1.2	1.1	1.0	1.1	1.0
14.	Other current expenditure	0.9	1.2	1.2	1.3	1.5	1.5	1.5	1.5
15.	Total current expenditure	39.2	35.7	35.1	35.3	35.2	35.2	35.3	35.4
16.	Gross savings	– 1.8	3.1	3.7	4.1	4.4	4.5	4.6	4.6
17.	Capital transfers received	1.4	0.6	0.6	0.7	0.8	0.8	0.8	0.8
18.	Total resources	38.4	39.1	39.2	39.8	40.0	40.2	40.4	40.5
19.	Gross fixed capital formation	3.7	3.1	3.5	3.7	3.6	3.7	3.7	3.7
20.	Other capital expenditure	2.5	1.4	1.5	1.5	1.3	1.9	1.7	1.7
21.	Total expenditure	45.0	39.9	39.7	40.1	39.7	40.5	40.4	40.4
22.	Tax burden	34.0	36.1	35.9	36.5	36.7	37.0	37.2	37.3
23.	Net lending (+) or net borrowing (–)	– 6.6	– 0.9	– 0.5	– 0.3	0.3	– 0.3	0.0	0.1

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.5

Resources and expenditure of general government

(% of GDP)

France		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	15.4	15.5	15.0	15.1	15.1	15.5	15.5	15.4
2.	Current taxes on income and wealth	8.5	12.2	12.5	11.5	11.2	11.3	11.4	11.4
3.	Social contributions	20.5	18.2	18.2	18.2	18.5	18.2	18.4	18.4
4.	*Of which* actual social contributions	18.7	16.3	16.3	16.4	16.6	16.4	16.5	16.5
5.	Other current resources	3.7	3.5	3.6	3.5	3.5	3.6	3.6	3.6
6.	Total current resources	48.1	49.3	49.3	48.3	48.2	48.5	48.9	48.8
7.	Government consumption expenditure	23.9	23.2	23.2	23.9	24.3	24.1	24.0	23.9
8.	*Of which* compensation of employees	13.7	13.5	13.5	13.7	13.9	13.7	13.5	13.4
9.	Collective consumption	9.8	9.3	9.2	9.4	9.5	9.4	9.3	9.3
10.	Social benefits in kind	14.1	14.0	14.0	14.5	14.8	14.7	14.7	14.6
11.	Social transfers other than in kind	18.5	17.8	17.7	18.0	18.4	18.4	18.5	18.4
12.	Interest payments	3.8	3.1	3.1	3.0	2.9	2.9	2.9	3.0
13.	Subsidies	1.5	1.2	1.3	1.3	1.3	1.3	1.3	1.4
14.	Other current expenditure	1.6	1.6	1.6	1.8	1.9	2.0	2.0	2.1
15.	Total current expenditure	49.2	47.0	47.0	48.0	48.9	48.8	48.8	48.8
16.	Gross savings	– 1.1	2.3	2.2	0.3	– 0.7	– 0.3	0.0	0.0
17.	Capital transfers received	0.4	0.4	0.3	0.4	0.7	0.8	1.1	0.8
18.	Total resources	49.7	51.2	50.9	50.2	50.4	50.8	51.5	51.1
19.	Gross fixed capital formation	3.3	3.2	3.1	3.1	3.2	3.3	3.4	3.4
20.	Other capital expenditure	1.5	0.9	0.9	1.0	1.0	0.8	0.8	0.7
21.	Total expenditure	55.2	52.5	52.5	53.4	54.6	54.5	54.5	54.4
22.	Tax burden	45.2	46.5	46.2	45.3	45.2	45.4	45.7	45.6
23.	Net lending (+) or net borrowing (–)	– 5.5	– 1.4	– 1.5	– 3.2	– 4.2	– 3.7	– 3.0	– 3.4

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.6

Resources and expenditure of general government

(% of GDP)

		ESA 95 definitions (1)							
Ireland		**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
1.	Taxes on production and imports	13.5	13.2	12.0	12.2	12.7	13.2	13.1	13.0
2.	Current taxes on income and wealth	13.6	13.5	12.9	11.7	12.2	12.5	11.7	11.5
3.	Social contributions	6.8	5.7	5.8	5.8	6.0	6.2	6.2	6.1
4.	*Of which* actual social contributions	5.0	4.4	4.5	4.5	4.6	4.7	4.7	4.6
5.	Other current resources	2.8	2.1	2.2	2.1	2.0	2.1	1.8	1.7
6.	Total current resources	36.8	34.5	32.9	31.8	32.8	34.0	32.8	32.3
7.	Government consumption expenditure	16.5	14.0	14.8	15.4	15.9	16.1	16.0	15.8
8.	*Of which* compensation of employees	10.2	8.1	8.4	8.6	8.8	8.7	8.6	8.4
9.	Collective consumption	6.5	5.3	5.3	5.5	5.6	5.6	5.6	5.6
10.	Social benefits in kind	10.0	8.7	9.5	9.9	10.3	10.5	10.4	10.3
11.	Social transfers other than in kind	11.8	8.1	8.4	8.9	8.9	9.2	9.6	9.3
12.	Interest payments	5.4	2.0	1.5	1.4	1.3	1.2	1.1	1.0
13.	Subsidies	1.0	0.7	0.9	0.6	0.6	0.6	0.6	0.6
14.	Other current expenditure	2.1	2.0	2.1	2.1	2.3	2.4	2.5	2.5
15.	Total current expenditure	36.8	26.8	27.7	28.4	29.1	29.5	29.8	29.3
16.	Gross savings	0.0	7.8	5.2	3.4	3.8	4.5	3.0	3.0
17.	Capital transfers received	1.8	1.3	1.2	1.3	1.2	1.2	1.2	1.2
18.	Total resources	39.5	36.4	34.5	33.6	34.6	35.7	34.5	34.0
19.	Gross fixed capital formation	2.3	3.6	4.3	4.2	3.9	3.6	3.9	3.9
20.	Other capital expenditure	1.6	1.0	1.1	0.8	0.9	0.8	0.9	0.8
21.	Total expenditure	41.6	32.0	33.6	33.9	34.4	34.3	35.1	34.6
22.	Tax burden	35.1	33.1	31.3	30.1	31.2	32.3	31.4	31.0
23.	Net lending (+) or net borrowing (–)	– 2.1	4.4	0.9	– 0.4	0.2	1.3	– 0.6	– 0.6

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.7

Resources and expenditure of general government

(% of GDP)

Italy		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	12.1	15.0	14.5	14.7	14.4	14.4	14.6	14.5
2.	Current taxes on income and wealth	14.8	14.7	15.1	14.3	13.8	13.7	13.4	13.2
3.	Social contributions	14.8	12.7	12.6	12.8	13.0	12.9	12.9	12.9
4.	*Of which* actual social contributions	13.0	12.4	12.3	12.5	12.7	12.7	12.7	12.6
5.	Other current resources	3.1	3.0	3.3	3.2	3.1	3.3	3.2	3.1
6.	Total current resources	44.8	45.5	45.5	45.0	44.3	44.3	44.1	43.6
7.	Government consumption expenditure	17.9	18.3	18.8	19.0	19.5	19.2	19.2	18.9
8.	*Of which* compensation of employees	11.2	10.6	10.8	10.8	11.1	11.0	10.9	10.8
9.	Collective consumption	7.3	7.0	7.2	7.2	7.6	7.4	7.3	7.2
10.	Social benefits in kind	10.6	11.2	11.7	11.8	11.9	11.9	11.9	11.7
11.	Social transfers other than in kind	16.7	16.8	16.6	17.0	17.3	17.3	17.3	17.4
12.	Interest payments	11.5	6.5	6.5	5.8	5.3	5.0	4.9	5.0
13.	Subsidies	1.5	1.2	1.2	1.1	1.1	1.1	1.1	1.1
14.	Other current expenditure	1.1	1.3	1.3	1.5	1.7	1.7	1.7	1.7
15.	Total current expenditure	48.6	44.0	44.5	44.3	44.8	44.3	44.3	44.0
16.	Gross savings	– 3.8	1.4	1.0	0.6	– 0.5	– 0.1	– 0.2	– 0.4
17.	Capital transfers received	0.9	0.4	0.3	0.4	2.0	1.0	0.5	0.3
18.	Total resources	45.8	46.2	46.0	45.6	46.3	45.4	44.6	44.0
19.	Gross fixed capital formation	2.1	2.4	2.5	1.9	2.6	2.6	2.4	2.9
20.	Other capital expenditure	2.5	0.2	1.7	1.9	1.8	1.5	1.5	1.6
21.	Total expenditure	53.4	46.9	49.0	48.2	49.2	48.4	48.2	48.5
22.	Tax burden	42.3	43.0	42.8	42.2	41.5	41.4	41.2	40.8
23.	Net lending (+) or net borrowing (–)	– 7.6	– 0.6	– 3.0	– 2.6	– 2.9	– 3.0	– 3.6	– 4.6

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.8

Resources and expenditure of general government

(% of GDP)

Luxembourg		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	12.5	14.1	13.6	13.4	13.5	15.0	15.2	15.4
2.	Current taxes on income and wealth	17.5	15.4	15.5	16.0	15.7	13.9	13.5	13.3
3.	Social contributions	12.5	11.2	12.0	12.2	12.4	12.2	12.0	11.9
4.	*Of which* actual social contributions	11.2	10.3	11.1	11.4	11.5	11.3	11.2	11.1
5.	Other current resources	5.6	4.5	4.8	4.6	4.2	4.0	3.9	3.8
6.	Total current resources	48.2	45.2	45.8	46.4	45.9	45.1	44.6	44.4
7.	Government consumption expenditure	18.4	15.7	16.9	17.6	18.0	18.2	18.0	18.0
8.	*Of which* compensation of employees	9.7	7.8	8.1	8.5	8.6	8.6	8.5	8.3
9.	Collective consumption	8.0	6.5	7.0	7.3	7.3	7.2	7.1	7.1
10.	Social benefits in kind	10.4	9.2	10.0	10.3	10.6	11.0	10.9	10.9
11.	Social transfers other than in kind	16.4	13.6	14.3	15.4	16.1	15.7	15.9	16.1
12.	Interest payments	0.5	0.3	0.4	0.3	0.3	0.2	0.2	0.2
13.	Subsidies	1.8	1.6	1.6	1.6	1.7	1.7	1.7	1.7
14.	Other current expenditure	2.8	3.0	2.8	3.0	3.5	3.7	3.6	3.5
15.	Total current expenditure	39.9	34.2	36.0	37.9	39.6	39.5	39.4	39.5
16.	Gross savings	8.3	11.0	9.9	8.5	6.5	5.6	5.2	4.9
17.	Capital transfers received	0.2	0.2	0.2	0.2	0.3	0.2	0.2	0.2
18.	Total resources	47.6	44.7	45.3	46.0	45.5	44.9	44.4	44.2
19.	Gross fixed capital formation	4.6	3.8	4.4	5.1	4.9	5.0	5.1	5.1
20.	Other capital expenditure	1.5	1.0	– 0.5	1.3	1.4	1.9	1.8	1.8
21.	Total expenditure	45.0	38.5	39.1	43.7	45.1	46.0	46.0	46.0
22.	Tax burden	43.5	41.3	41.5	42.0	42.1	41.6	41.3	41.1
23.	Net lending (+) or net borrowing (–)	2.5	6.2	6.2	2.3	0.5	– 1.1	– 1.5	– 1.9

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.9

Resources and expenditure of general government

(% of GDP)

The Netherlands		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	10.7	12.1	12.6	12.6	12.7	13.1	13.4	13.3
2.	Current taxes on income and wealth	12.4	12.1	11.9	12.0	11.2	11.0	11.1	11.2
3.	Social contributions	17.2	17.1	15.3	14.9	15.5	15.1	15.0	16.9
4.	*Of which* actual social contributions	16.0	16.0	14.3	13.9	14.5	14.5	14.4	16.3
5.	Other current resources	6.0	4.8	5.3	5.0	4.9	5.0	5.1	5.0
6.	Total current resources	46.3	46.1	45.2	44.5	44.3	44.3	44.6	46.4
7.	Government consumption expenditure	24.0	22.7	23.5	24.6	25.4	25.4	25.5	26.9
8.	*Of which* compensation of employees	10.8	10.0	10.1	10.5	10.8	10.8	10.8	10.5
9.	Collective consumption	11.6	10.6	11.1	11.3	11.4	11.4	11.4	11.4
10.	Social benefits in kind	12.5	12.0	12.4	13.3	14.0	14.0	14.1	15.7
11.	Social transfers other than in kind	15.3	11.8	11.7	11.8	12.3	11.8	11.8	11.9
12.	Interest payments	5.9	3.8	3.4	3.1	2.9	2.9	2.8	2.8
13.	Subsidies	1.1	1.5	1.5	1.5	1.4	1.3	1.1	1.0
14.	Other current expenditure	1.1	1.7	1.7	1.8	1.7	1.8	1.9	1.9
15.	Total current expenditure	47.4	41.5	41.7	42.7	43.8	43.1	43.1	44.5
16.	Gross savings	– 1.1	4.6	3.5	1.7	0.5	1.1	1.5	1.9
17.	Capital transfers received	0.3	0.4	0.4	0.4	0.4	0.4	0.3	0.3
18.	Total resources	47.3	47.5	46.6	45.9	45.8	45.5	45.8	47.6
19.	Gross fixed capital formation	3.0	3.1	3.3	3.6	3.6	3.6	3.5	3.4
20.	Other capital expenditure	0.4	– 0.3	0.6	0.5	0.5	0.4	0.4	0.4
21.	Total expenditure	51.4	45.3	46.6	47.8	49.0	48.0	47.9	49.2
22.	Tax burden	41.5	42.2	40.7	40.1	40.0	39.9	40.2	42.1
23.	Net lending (+) or net borrowing (–)	– 4.2	2.2	– 0.1	– 1.9	– 3.2	– 2.5	– 2.0	– 1.6

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.10

Resources and expenditure of general government

(% of GDP)

		ESA 95 definitions (1)							
Austria		**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
1.	Taxes on production and imports	14.0	14.6	14.6	15.0	14.8	15.0	14.6	14.4
2.	Current taxes on income and wealth	11.8	13.2	15.0	14.0	13.5	13.1	12.3	12.0
3.	Social contributions	17.3	16.8	16.7	16.5	16.5	16.4	16.4	16.3
4.	*Of which* actual social contributions	15.1	14.9	14.9	14.8	14.8	14.7	14.7	14.6
5.	Other current resources	4.9	3.3	4.2	4.1	4.1	3.8	3.6	3.6
6.	Total current resources	48.1	47.9	50.6	49.5	48.8	48.2	47.0	46.3
7.	Government consumption expenditure	20.3	18.6	18.3	18.2	18.2	18.1	17.8	17.5
8.	*Of which* compensation of employees	12.6	11.0	9.8	9.7	9.7	9.4	9.3	9.1
9.	Collective consumption	8.2	7.4	7.3	7.2	7.2	7.0	6.9	6.8
10.	Social benefits in kind	12.2	11.2	10.9	11.0	11.0	11.1	10.9	10.7
11.	Social transfers other than in kind	19.5	18.6	18.7	18.6	18.9	18.8	18.8	18.7
12.	Interest payments	3.9	3.6	3.5	3.4	3.1	3.0	2.9	2.8
13.	Subsidies	2.9	2.8	3.1	3.2	3.2	2.9	2.8	2.7
14.	Other current expenditure	2.4	2.5	3.3	3.3	3.5	3.5	3.5	3.6
15.	Total current expenditure	49.0	46.1	46.8	46.5	46.9	46.3	45.8	45.3
16.	Gross savings	– 1.0	1.6	3.6	2.6	1.7	1.7	1.0	0.9
17.	Capital transfers received	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
18.	Total resources	50.9	50.5	51.7	50.8	50.0	49.4	48.1	47.4
19.	Gross fixed capital formation	3.0	1.5	1.2	1.3	1.2	1.2	1.2	1.1
20.	Other capital expenditure	2.0	2.0	2.5	2.1	2.0	2.2	2.2	1.8
21.	Total expenditure	56.7	52.0	51.4	51.0	51.2	50.7	50.1	49.2
22.	Tax burden	44.1	45.3	47.1	45.9	45.2	44.9	43.8	43.2
23.	Net lending (+) or net borrowing (–)	– 5.7	– 1.5	0.3	– 0.2	– 1.1	– 1.3	– 2.0	– 1.7

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.11

Resources and expenditure of general government

(% of GDP)

Portugal		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	13.6	14.4	14.2	15.0	15.6	15.3	15.4	15.4
2.	Current taxes on income and wealth	8.9	10.4	9.9	9.8	9.3	9.1	8.7	8.9
3.	Social contributions	11.0	11.8	12.0	12.3	12.7	12.7	12.7	12.7
4.	*Of which* actual social contributions	10.1	10.9	11.1	11.4	11.7	11.9	11.9	11.9
5.	Other current resources	4.1	3.6	3.7	4.1	3.8	4.3	4.2	4.4
6.	Total current resources	37.6	40.3	39.8	41.1	41.5	41.4	41.0	41.3
7.	Government consumption expenditure	18.6	20.5	20.9	21.2	21.2	21.4	21.4	21.0
8.	*Of which* compensation of employees	13.6	15.0	15.1	15.4	14.9	14.7	14.6	14.4
9.	Collective consumption	7.6	8.4	8.4	8.5	8.6	8.4	8.4	8.3
10.	Social benefits in kind	11.0	12.1	12.5	12.6	12.6	12.9	12.9	12.7
11.	Social transfers other than in kind	11.8	12.4	12.7	13.2	14.2	14.9	15.4	15.7
12.	Interest payments	6.3	3.2	3.2	3.0	2.9	2.8	2.9	3.1
13.	Subsidies	1.3	1.1	1.3	1.5	1.5	1.9	1.5	1.4
14.	Other current expenditure	1.6	2.4	2.5	2.5	2.8	2.7	2.6	2.6
15.	Total current expenditure	39.6	39.5	40.5	41.4	42.6	43.6	43.8	43.8
16.	Gross savings	– 2.1	0.7	– 0.7	– 0.4	– 1.2	– 2.3	– 2.8	– 2.5
17.	Capital transfers received	1.9	1.4	1.8	1.8	2.9	4.2	2.3	2.0
18.	Total resources	39.6	42.3	41.9	43.3	44.8	43.8	42.5	43.1
19.	Gross fixed capital formation	3.7	3.8	4.0	3.3	3.3	3.3	3.2	3.0
20.	Other capital expenditure	1.5	1.2	1.5	0.6	1.3	1.5	1.2	1.1
21.	Total expenditure	45.0	45.1	46.3	45.9	47.7	46.7	47.4	47.8
22.	Tax burden	34.4	37.2	36.6	37.4	38.0	37.4	37.1	37.2
23.	Net lending (+) or net borrowing (–)	– 5.5	– 2.8	– 4.4	– 2.7	– 2.9	– 2.9	– 4.9	– 4.7

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.12

Resources and expenditure of general government

(% of GDP)

Finland		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	13.6	13.7	13.4	13.7	14.2	13.9	13.8	13.6
2.	Current taxes on income and wealth	17.4	21.4	19.5	19.3	18.1	17.8	17.4	16.9
3.	Social contributions	14.8	12.3	12.6	12.3	12.1	12.0	12.3	12.6
4.	*Of which* actual social contributions	14.6	12.3	12.6	12.3	12.1	12.0	12.3	12.6
5.	Other current resources	7.3	6.2	6.4	6.2	6.0	5.9	5.8	5.7
6.	Total current resources	53.1	53.6	51.9	51.5	50.3	49.7	49.2	48.8
7.	Government consumption expenditure	22.8	20.6	21.0	21.6	22.1	22.4	22.6	22.8
8.	*Of which* compensation of employees	15.2	13.2	13.2	13.5	13.8	13.8	13.9	13.9
9.	Collective consumption	8.5	7.5	7.4	7.6	7.8	7.8	7.9	7.9
10.	Social benefits in kind	14.3	13.2	13.6	14.0	14.3	14.6	14.7	14.8
11.	Social transfers other than in kind	22.1	16.5	16.4	16.8	17.0	16.8	16.7	16.5
12.	Interest payments	4.0	2.9	2.7	2.2	2.0	1.9	1.6	1.5
13.	Subsidies	2.8	1.5	1.4	1.4	1.3	1.3	1.3	1.2
14.	Other current expenditure	2.0	2.4	2.4	2.5	2.7	2.7	2.7	2.7
15.	Total current expenditure	53.7	43.9	43.9	44.5	45.2	44.8	44.9	44.7
16.	Gross savings	– 0.7	9.7	8.0	7.0	5.0	4.4	4.1	3.9
17.	Capital transfers received	0.2	0.3	0.3	0.4	0.3	0.4	0.3	0.3
18.	Total resources	55.7	56.1	54.4	54.2	53.3	52.5	51.9	51.3
19.	Gross fixed capital formation	2.8	2.6	2.8	2.9	3.0	2.9	2.8	2.7
20.	Other capital expenditure	0.6	0.3	0.3	0.3	0.2	0.2	0.2	0.2
21.	Total expenditure	59.6	49.1	49.2	50.0	50.8	50.4	50.3	49.8
22.	Tax burden	46.5	47.9	45.9	45.6	44.6	43.9	43.7	43.4
23.	Net lending (+) or net borrowing (–)	– 3.9	7.1	5.2	4.3	2.5	2.1	1.7	1.6

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.13

Resources and expenditure of general government

(% of GDP)

Czech Republic		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	12.3	11.5	11.1	11.1	11.4	11.9	11.7	11.5
2.	Current taxes on income and wealth	9.6	8.4	8.9	9.3	9.8	9.4	8.4	8.3
3.	Social contributions	14.4	14.5	14.5	15.0	15.1	14.8	14.8	14.6
4.	*Of which* actual social contributions	14.4	14.5	14.5	10.7	15.1	14.8	14.8	14.6
5.	Other current resources	6.9	6.7	7.0	6.8	7.6	7.8	8.1	7.7
6.	Total current resources	43.1	41.2	41.5	42.3	43.8	43.9	42.9	42.1
7.	Government consumption expenditure	21.7	22.1	22.2	23.0	24.0	22.8	22.6	22.5
8.	*Of which* compensation of employees	7.3	7.2	7.5	8.0	8.3	8.2	8.1	8.1
9.	Collective consumption	10.6	11.5	11.2	11.5	12.3	11.6	11.7	12.1
10.	Social benefits in kind	11.2	10.6	10.9	11.5	11.7	11.3	10.8	10.5
11.	Social transfers other than in kind	10.7	12.3	12.1	12.5	12.3	11.9	11.9	11.4
12.	Interest payments	1.1	0.9	1.1	1.5	1.3	1.3	1.3	1.4
13.	Subsidies	2.9	2.8	2.8	2.4	2.7	3.5	2.9	3.0
14.	Other current expenditure	1.0	0.9	0.8	0.9	1.2	1.4	1.5	1.5
15.	Total current expenditure	37.4	39.0	39.0	40.3	41.6	40.9	40.1	39.9
16.	Gross savings	5.7	2.2	2.5	2.0	2.2	3.0	2.8	2.3
17.	Capital transfers received	0.5	0.2	0.3	0.1	0.2	0.0	0.2	0.2
18.	Total resources	41.0	38.5	39.1	40.2	41.6	42.7	41.8	41.0
19.	Gross fixed capital formation	5.1	2.9	3.2	3.7	4.2	3.9	3.9	3.9
20.	Other capital expenditure	14.6	3.1	5.5	5.0	9.8	2.2	3.6	2.6
21.	Total expenditure	54.4	42.1	45.0	46.9	53.3	45.7	46.3	45.1
22.	Tax burden	36.2	34.5	34.5	35.5	36.2	36.1	34.8	34.3
23.	Net lending (+) or net borrowing (–)	– 13.4	– 3.7	– 5.9	– 6.8	– 11.7	– 3.0	– 4.5	– 4.0

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.14

Resources and expenditure of general government

(% of GDP)

	Denmark	ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	16.9	17.2	17.3	17.5	17.3	17.5	17.5	17.2
2.	Current taxes on income and wealth	30.4	29.7	30.0	29.4	29.5	30.5	29.6	29.3
3.	Social contributions	2.6	3.3	3.2	2.7	2.7	2.7	2.7	2.6
4.	*Of which* actual social contributions	1.6	2.4	2.3	1.7	1.7	1.7	1.7	1.6
5.	Other current resources	6.4	5.1	5.2	5.0	5.2	5.1	4.8	4.6
6.	Total current resources	56.3	55.2	55.8	54.6	54.7	55.8	54.5	53.8
7.	Government consumption expenditure	25.8	25.3	25.9	26.3	26.6	26.5	26.2	26.0
8.	*Of which* compensation of employees	17.3	16.9	17.3	17.6	17.8	17.8	17.8	17.7
9.	Collective consumption	8.4	7.7	7.6	7.6	7.6	7.6	7.5	7.4
10.	Social benefits in kind	17.4	17.6	18.3	18.8	19.0	18.9	18.7	18.5
11.	Social transfers other than in kind	20.4	17.3	17.3	17.5	18.1	18.0	17.8	17.5
12.	Interest payments	6.0	3.5	3.2	2.8	2.5	2.3	2.2	2.0
13.	Subsidies	2.5	2.2	2.2	2.2	2.1	2.1	2.1	2.1
14.	Other current expenditure	2.2	2.6	2.6	2.6	2.5	2.5	2.5	2.5
15.	Total current expenditure	56.9	50.9	51.2	51.5	51.9	51.5	50.8	50.1
16.	Gross savings	– 0.5	4.2	4.5	2.9	2.6	4.1	3.6	3.5
17.	Capital transfers received	0.5	0.5	0.5	0.8	0.6	0.6	0.6	0.6
18.	Total resources	57.6	56.7	57.4	56.6	56.6	57.7	56.5	55.7
19.	Gross fixed capital formation	1.8	1.7	1.9	1.8	1.7	1.7	1.8	1.7
20.	Other capital expenditure	0.5	0.5	0.1	0.4	0.4	0.4	0.4	0.4
21.	Total expenditure	59.9	54.1	54.3	54.9	55.3	55.0	54.3	53.5
22.	Tax burden	50.2	50.4	50.7	49.7	49.7	50.9	49.9	49.4
23.	Net lending (+) or net borrowing (–)	– 2.3	2.6	3.2	1.7	1.2	2.8	2.1	2.2

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.15

Resources and expenditure of general government

(% of GDP)

Estonia		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	13.9	12.9	12.8	13.1	13.1	12.7	13.5	13.5
2.	Current taxes on income and wealth	10.9	8.1	7.6	7.9	8.7	8.7	7.6	6.9
3.	Social contributions	13.1	11.4	11.1	11.4	11.5	11.2	11.2	10.9
4.	*Of which* actual social contributions	13.1	11.4	11.1	11.4	11.5	11.2	11.2	10.9
5.	Other current resources	8.8	4.1	5.0	4.7	4.2	5.6	6.2	5.8
6.	Total current resources	46.6	36.5	36.5	37.1	37.5	38.2	38.5	37.2
7.	Government consumption expenditure	27.2	19.9	19.0	18.8	18.7	18.7	19.4	19.0
8.	*Of which* compensation of employees	11.7	10.8	10.2	9.9	10.2	9.9	9.8	9.7
9.	Collective consumption	11.9	9.5	9.1	9.0	8.8	8.7	9.0	8.8
10.	Social benefits in kind	15.3	10.3	9.9	9.8	9.9	10.0	10.3	10.2
11.	Social transfers other than in kind	10.0	9.8	9.5	9.2	9.6	10.2	10.6	10.5
12.	Interest payments	0.2	0.3	0.2	0.3	0.3	0.2	0.2	0.2
13.	Subsidies	0.7	1.0	1.0	0.9	0.9	1.4	1.7	1.6
14.	Other current expenditure	1.4	0.9	1.0	0.7	0.9	2.6	1.6	1.3
15.	Total current expenditure	39.5	31.9	30.7	29.9	30.3	33.1	33.4	32.6
16.	Gross savings	7.1	4.6	5.8	7.2	7.2	5.1	5.1	4.6
17.	Capital transfers received	0.0	0.3	0.0	0.2	0.3	1.6	1.7	1.6
18.	Total resources	43.9	37.7	37.2	38.0	38.9	40.9	40.8	39.2
19.	Gross fixed capital formation	5.0	3.9	4.1	4.7	3.4	3.6	4.3	4.2
20.	Other capital expenditure	1.8	1.6	1.5	1.3	1.0	1.3	1.6	1.5
21.	Total expenditure	43.4	38.2	36.9	36.6	35.8	39.1	40.0	38.7
22.	Tax burden	37.9	32.4	31.6	32.4	33.4	32.6	32.3	31.4
23.	Net lending (+) or net borrowing (–)	0.4	– 0.6	0.3	1.4	3.1	1.8	0.9	0.5

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.16

Resources and expenditure of general government

(% of GDP)

Cyprus		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	:	12.7	13.2	13.4	16.5	16.1	16.1	16.2
2.	Current taxes on income and wealth	:	11.1	11.3	11.2	9.7	9.2	9.8	9.3
3.	Social contributions	:	6.7	6.9	6.8	7.1	8.4	8.2	8.0
4.	*Of which* actual social contributions	:	6.7	6.9	6.8	7.1	8.4	8.2	8.0
5.	Other current resources	:	3.2	3.7	2.9	4.0	3.7	3.6	3.6
6.	Total current resources	:	33.7	35.1	34.4	37.3	37.4	37.7	37.2
7.	Government consumption expenditure	:	16.4	17.5	18.4	19.9	18.3	18.0	17.6
8.	*Of which* compensation of employees	:	13.8	13.5	13.9	15.7	14.8	13.8	13.0
9.	Collective consumption	:	8.4	9.6	10.1	11.0	10.1	9.9	9.7
10.	Social benefits in kind	:	8.0	7.9	8.3	9.0	8.2	8.1	7.9
11.	Social transfers other than in kind	:	9.1	9.4	10.3	11.4	11.6	11.7	11.3
12.	Interest payments	:	3.4	3.4	3.2	3.4	3.4	3.3	3.2
13.	Subsidies	:	1.4	1.4	1.1	1.2	1.1	0.8	0.6
14.	Other current expenditure	:	2.3	2.3	2.4	3.6	3.1	2.7	2.4
15.	Total current expenditure	:	32.6	34.0	35.3	39.6	37.5	36.6	35.2
16.	Gross savings	:	1.1	1.1	– 0.9	– 2.3	– 0.2	1.2	2.0
17.	Capital transfers received	:	0.1	0.1	0.0	0.1	0.3	0.0	0.1
18.	Total resources	:	35.3	36.6	36.1	39.1	39.4	39.4	38.9
19.	Gross fixed capital formation	:	3.0	3.0	3.0	3.4	3.9	3.6	3.5
20.	Other capital expenditure	:	0.6	0.5	0.6	0.7	0.5	0.5	0.5
21.	Total expenditure	:	37.7	38.9	40.6	45.4	43.6	42.3	40.7
22.	Tax burden	:	30.5	31.5	31.4	33.3	33.6	34.1	33.6
23.	Net lending (+) or net borrowing (–)	:	– 2.4	– 2.3	– 4.5	– 6.3	– 4.2	– 2.9	– 1.9

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.17

Resources and expenditure of general government

(% of GDP)

Latvia		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	13.7	11.7	11.2	10.7	11.5	11.3	11.2	11.1
2.	Current taxes on income and wealth	7.8	8.3	8.5	8.7	8.5	8.4	8.2	8.1
3.	Social contributions	12.2	10.2	9.4	9.6	9.2	8.8	8.2	7.8
4.	*Of which* actual social contributions	12.1	10.0	9.3	9.4	9.0	8.7	8.2	7.8
5.	Other current resources	6.4	7.2	7.4	5.9	6.3	6.0	5.5	5.2
6.	Total current resources	40.0	37.5	36.5	34.8	35.4	34.5	33.1	32.2
7.	Government consumption expenditure	24.4	21.0	20.6	21.1	21.8	21.5	21.1	20.7
8.	*Of which* compensation of employees	11.3	10.9	10.3	10.6	11.1	10.9	11.2	11.6
9.	Collective consumption	12.0	10.3	10.5	10.7	11.0	10.9	10.7	10.5
10.	Social benefits in kind	12.5	10.7	10.1	10.5	10.8	10.6	10.5	10.2
11.	Social transfers other than in kind	12.8	12.6	11.3	10.3	9.6	8.3	8.0	7.8
12.	Interest payments	1.3	1.0	1.0	0.8	0.8	0.8	0.8	0.8
13.	Subsidies	1.2	1.0	0.7	0.7	0.8	1.0	1.5	1.6
14.	Other current expenditure	0.1	1.7	1.9	1.1	0.8	0.9	1.2	1.2
15.	Total current expenditure	39.8	37.3	35.4	34.0	33.7	32.4	32.7	32.1
16.	Gross savings	0.2	0.3	1.1	0.8	1.7	2.1	0.5	0.2
17.	Capital transfers received	0.5	0.7	0.5	0.3	0.1	0.7	2.6	3.4
18.	Total resources	37.3	35.1	34.4	33.1	34.2	35.2	35.4	35.3
19.	Gross fixed capital formation	1.9	1.4	1.1	1.3	1.5	1.7	2.6	3.1
20.	Other capital expenditure	0.8	2.4	2.6	2.5	1.9	1.8	2.1	1.9
21.	Total expenditure	39.3	37.9	36.5	35.8	35.7	35.9	37.0	36.8
22.	Tax burden	33.7	30.3	29.1	28.9	29.1	28.5	27.7	27.3
23.	Net lending (+) or net borrowing (–)	– 2.0	– 2.8	– 2.1	– 2.7	– 1.5	– 0.8	– 1.6	– 1.5

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.18

Resources and expenditure of general government

(% of GDP)

		ESA 95 definitions (1)							
Lithuania		**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
1.	Taxes on production and imports	12.3	12.5	12.2	12.5	11.9	11.1	10.8	10.5
2.	Current taxes on income and wealth	8.8	8.5	7.9	7.5	8.1	7.9	7.7	7.6
3.	Social contributions	7.6	9.4	9.0	8.7	8.7	8.4	8.6	8.5
4.	*Of which* actual social contributions	7.6	9.4	9.0	8.7	8.6	8.4	8.6	8.5
5.	Other current resources	6.3	5.7	4.7	3.7	3.3	3.4	4.0	3.8
6.	Total current resources	34.9	36.1	33.8	32.5	31.9	30.8	31.1	30.4
7.	Government consumption expenditure	21.9	21.6	19.8	19.3	18.5	17.5	17.4	16.9
8.	*Of which* compensation of employees	10.1	12.8	11.7	11.4	11.0	11.1	11.0	10.7
9.	Collective consumption	9.9	9.5	8.0	7.7	7.6	7.3	7.3	7.0
10.	Social benefits in kind	12.0	12.1	11.8	11.6	10.8	10.2	10.1	9.9
11.	Social transfers other than in kind	8.6	10.7	10.6	9.3	9.2	9.4	9.3	8.9
12.	Interest payments	0.4	1.7	1.6	1.4	1.3	1.0	0.9	0.9
13.	Subsidies	1.1	0.8	0.9	0.8	0.8	1.2	1.5	1.5
14.	Other current expenditure	0.0	0.3	0.2	0.1	0.1	0.6	0.8	0.8
15.	Total current expenditure	32.0	35.2	33.1	31.0	29.9	29.7	30.0	29.0
16.	Gross savings	2.9	1.0	0.7	1.5	2.0	1.1	1.1	1.4
17.	Capital transfers received	0.0	0.1	0.1	0.5	0.4	1.0	1.2	1.2
18.	Total resources	34.2	35.8	33.0	32.8	32.3	31.8	32.3	31.6
19.	Gross fixed capital formation	3.4	2.4	2.2	2.8	3.0	3.2	3.4	3.4
20.	Other capital expenditure	:	1.2	0.6	0.6	1.2	1.3	1.3	1.2
21.	Total expenditure	36.1	38.4	35.0	34.3	34.2	34.3	34.8	33.6
22.	Tax burden	28.6	30.5	29.1	28.7	28.6	27.4	27.1	26.6
23.	Net lending (+) or net borrowing (–)	– 1.9	– 2.5	– 2.0	– 1.5	– 1.9	– 2.5	– 2.4	– 1.9

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.19

Resources and expenditure of general government

(% of GDP)

Hungary		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	17.9	16.4	15.7	15.2	15.8	16.3	15.7	16.0
2.	Current taxes on income and wealth	9.4	9.9	10.4	10.4	9.7	9.7	9.4	9.4
3.	Social contributions	15.6	13.9	14.0	13.9	13.5	13.6	13.5	13.4
4.	*Of which* actual social contributions	:	13.8	13.9	13.9	13.4	13.7	13.5	13.5
5.	Other current resources	:	6.0	5.7	5.7	6.6	5.5	5.3	5.2
6.	Total current resources	:	46.2	45.7	45.2	45.6	45.2	43.9	44.0
7.	Government consumption expenditure	23.6	21.3	21.8	23.4	24.2	23.7	22.7	22.3
8.	*Of which* compensation of employees	12.2	10.7	11.4	12.5	13.2	12.5	11.9	11.6
9.	Collective consumption	11.0	10.0	10.2	10.8	10.8	10.6	10.1	9.9
10.	Social benefits in kind	12.6	11.3	11.6	12.6	13.4	13.1	12.5	12.3
11.	Social transfers other than in kind	15.8	12.8	12.9	13.7	14.2	14.1	14.1	14.1
12.	Interest payments	:	5.6	4.7	4.0	4.0	4.3	3.8	3.4
13.	Subsidies	2.1	1.7	1.8	1.8	1.5	1.4	1.1	1.1
14.	Other current expenditure	:	1.7	1.7	1.8	1.7	1.3	1.8	2.3
15.	Total current expenditure	:	43.0	42.9	44.8	45.8	44.8	43.6	43.2
16.	Gross savings	:	3.1	2.7	0.4	– 0.1	0.3	0.3	0.8
17.	Capital transfers received	:	0.4	0.5	0.5	0.5	0.6	0.5	0.6
18.	Total resources	:	45.3	45.0	44.1	44.5	47.5	43.9	43.0
19.	Gross fixed capital formation	:	3.2	3.8	4.9	3.4	3.5	2.3	3.1
20.	Other capital expenditure	:	2.8	3.1	4.4	2.0	1.9	2.4	2.4
21.	Total expenditure	:	47.6	48.7	52.6	50.8	52.0	47.8	47.1
22.	Tax burden	:	40.2	40.0	39.5	39.8	:	:	:
23.	Net lending (+) or net borrowing (–)	:	– 2.4	– 3.7	– 8.5	– 6.2	– 4.5	– 3.9	– 4.1

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.20

Resources and expenditure of general government

(% of GDP)

Malta		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	:	12.9	13.4	14.2	13.4	15.3	17.2	17.2
2.	Current taxes on income and wealth	:	9.3	10.2	11.8	12.2	11.9	12.1	12.2
3.	Social contributions	:	7.7	8.5	8.4	8.3	8.3	8.6	8.7
4.	*Of which* actual social contributions	:	6.5	7.0	6.8	6.7	8.3	8.5	8.3
5.	Other current resources	:	6.3	6.6	6.5	7.4	5.4	4.4	3.9
6.	Total current resources	:	36.2	38.6	40.9	41.2	40.9	42.3	41.9
7.	Government consumption expenditure	:	19.4	20.6	21.2	21.4	21.7	21.5	20.9
8.	*Of which* compensation of employees	:	13.3	15.0	15.1	15.3	15.0	15.2	14.9
9.	Collective consumption	:	9.2	9.8	10.0	10.1	10.2	10.1	10.0
10.	Social benefits in kind	:	10.2	10.8	11.2	11.4	11.5	11.4	10.9
11.	Social transfers other than in kind	:	12.1	12.6	12.8	13.0	13.1	12.9	12.6
12.	Interest payments	:	3.8	3.7	3.9	3.8	4.1	4.3	4.3
13.	Subsidies	:	1.4	1.6	2.1	2.2	1.7	1.5	1.4
14.	Other current expenditure	:	1.9	2.2	2.2	2.3	2.4	2.5	2.8
15.	Total current expenditure	:	38.6	40.7	42.2	42.7	43.0	42.7	42.1
16.	Gross savings	:	– 2.4	– 2.1	– 1.3	– 1.5	– 2.1	– 0.3	– 0.2
17.	Capital transfers received	:	1.0	0.2	0.4	0.5	2.0	2.2	2.2
18.	Total resources	:	36.0	37.6	40.0	40.5	49.0	48.8	48.6
19.	Gross fixed capital formation	:	4.1	3.7	4.5	5.3	4.3	3.9	3.7
20.	Other capital expenditure	:	0.9	1.0	0.4	3.5	0.7	1.9	1.1
21.	Total expenditure	:	42.3	44.1	45.8	50.9	54.1	52.6	51.4
22.	Tax burden	:	29.9	32.0	34.4	33.9	35.5	37.9	38.0
23.	Net lending (+) or net borrowing (–)	:	– 6.3	– 6.4	– 5.9	– 10.5	– 5.2	– 3.9	– 2.8

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.21

Resources and expenditure of general government

(% of GDP)

Poland		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	15.8	14.8	14.4	14.7	15.1	15.1	15.4	15.6
2.	Current taxes on income and wealth	12.8	7.4	6.9	6.6	7.2	7.0	7.0	6.9
3.	Social contributions	11.7	14.0	15.3	14.7	14.1	13.1	12.9	12.7
4.	*Of which* actual social contributions	11.7	14.0	15.3	14.7	14.1	13.1	12.9	12.7
5.	Other current resources	4.9	4.1	4.1	4.0	4.3	3.6	3.9	4.1
6.	Total current resources	45.1	40.3	40.7	40.1	40.7	38.9	39.2	39.3
7.	Government consumption expenditure	19.0	18.0	18.0	18.1	17.6	16.9	16.5	16.1
8.	*Of which* compensation of employees	11.3	11.1	12.0	11.9	11.9	11.5	11.4	11.2
9.	Collective consumption	9.3	9.1	9.5	9.5	9.1	8.8	8.5	8.3
10.	Social benefits in kind	9.7	8.9	8.5	8.5	8.5	8.2	8.0	7.8
11.	Social transfers other than in kind	16.9	16.6	17.1	17.7	17.6	17.7	17.3	16.9
12.	Interest payments	5.8	3.1	3.2	2.9	2.9	2.6	2.6	2.5
13.	Subsidies	1.5	0.7	0.6	0.5	0.4	0.8	0.9	0.9
14.	Other current expenditure	1.4	0.8	1.1	0.9	1.5	2.5	2.3	2.2
15.	Total current expenditure	44.6	39.3	39.9	40.1	40.1	40.6	39.7	38.6
16.	Gross savings	0.5	1.4	0.9	– 0.7	0.5	– 1.7	– 0.4	0.9
17.	Capital transfers received	– 0.7	– 1.0	– 1.2	– 0.6	– 0.8	1.1	1.1	1.1
18.	Total resources	47.4	42.5	43.8	43.9	44.3	43.8	44.2	44.2
19.	Gross fixed capital formation	3.4	2.5	3.5	3.6	3.4	3.4	4.2	4.7
20.	Other capital expenditure	0.4	0.3	0.1	0.0	0.7	0.9	0.9	0.9
21.	Total expenditure	51.3	45.2	47.7	47.5	48.8	48.7	48.6	48.0
22.	Tax burden	40.2	36.2	36.6	36.1	36.6	35.5	35.5	35.5
23.	Net lending (+) or net borrowing (–)	– 2.3	– 1.6	– 3.9	– 3.6	– 4.5	– 4.8	– 4.4	– 3.8

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.22

Resources and expenditure of general government

(% of GDP)

Slovenia		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	:	16.5	16.2	16.5	16.8	16.7	16.4	16.1
2.	Current taxes on income and wealth	:	7.6	7.7	8.0	8.4	8.4	8.4	8.4
3.	Social contributions	:	15.1	15.4	15.2	15.2	14.8	14.5	14.2
4.	*Of which* actual social contributions	:	14.9	15.1	14.9	14.9	14.6	14.2	14.0
5.	Other current resources	:	3.7	3.9	4.0	4.0	4.0	4.3	4.6
6.	Total current resources	:	42.9	43.2	43.6	44.3	43.9	43.5	43.3
7.	Government consumption expenditure	:	19.9	20.5	20.2	20.3	19.9	19.7	19.6
8.	*Of which* compensation of employees	:	11.8	12.3	12.1	12.3	11.8	11.4	11.1
9.	Collective consumption	:	7.6	7.8	8.3	8.4	8.2	8.1	8.1
10.	Social benefits in kind	:	12.3	12.7	11.9	11.9	11.7	11.6	11.5
11.	Social transfers other than in kind	:	17.2	17.1	17.2	17.2	17.1	16.9	16.7
12.	Interest payments	:	2.4	2.4	2.3	2.1	1.9	1.7	1.6
13.	Subsidies	:	1.5	1.4	1.2	1.5	1.6	1.8	1.9
14.	Other current expenditure	:	1.2	1.1	1.3	1.3	1.5	1.7	1.8
15.	Total current expenditure	:	42.2	42.5	42.3	42.4	42.0	41.8	41.5
16.	Gross savings	:	0.8	0.7	1.4	1.9	1.9	1.7	1.8
17.	Capital transfers received	:	0.2	0.2	0.2	0.1	0.2	0.2	0.2
18.	Total resources	:	44.7	45.1	45.7	46.2	45.8	45.4	45.1
19.	Gross fixed capital formation	:	3.1	3.0	2.8	2.8	2.8	2.9	2.9
20.	Other capital expenditure	:	1.3	0.8	1.2	1.3	1.2	1.1	1.1
21.	Total expenditure	:	48.2	47.9	48.1	48.2	47.7	47.6	47.2
22.	Tax burden	:	39.2	39.3	39.7	40.4	39.9	39.2	38.7
23.	Net lending (+) or net borrowing (–)	:	– 3.5	– 2.8	– 2.4	– 2.0	– 1.9	– 2.2	– 2.1

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.23

Resources and expenditure of general government

(% of GDP)

Slovakia		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	15.6	13.0	11.8	12.0	11.5	11.8	11.8	11.5
2.	Current taxes on income and wealth	11.6	7.6	7.4	7.4	7.2	5.7	5.6	5.4
3.	Social contributions	14.4	13.8	13.7	13.6	12.4	12.4	12.5	12.0
4.	*Of which* actual social contributions	14.3	13.7	13.7	13.5	12.3	12.4	12.5	12.0
5.	Other current resources	13.8	15.1	14.3	13.8	6.0	4.8	5.7	5.5
6.	Total current resources	55.4	49.5	47.2	46.9	37.2	34.7	35.6	34.4
7.	Government consumption expenditure	20.5	19.8	20.1	20.1	19.9	19.4	19.4	19.2
8.	*Of which* compensation of employees	9.5	8.8	8.9	9.2	9.0	8.6	8.5	8.2
9.	Collective consumption	16.2	10.9	11.3	11.3	11.0	10.8	10.8	10.7
10.	Social benefits in kind	4.4	8.9	8.9	8.8	8.9	8.7	8.6	8.6
11.	Social transfers other than in kind	12.2	12.3	12.0	11.8	11.4	9.7	9.4	9.1
12.	Interest payments	2.3	4.1	4.0	3.6	2.5	2.2	2.4	2.2
13.	Subsidies	4.8	2.5	2.2	1.6	1.7	1.7	1.7	1.7
14.	Other current expenditure	8.0	10.1	9.0	10.6	2.2	2.1	3.1	2.7
15.	Total current expenditure	47.9	48.9	47.3	47.6	37.8	35.2	35.9	34.9
16.	Gross savings	7.5	0.6	– 0.1	– 0.7	– 0.6	– 0.5	– 0.3	– 0.5
17.	Capital transfers received	1.0	0.4	0.4	0.5	0.0	0.4	0.5	0.4
18.	Total resources	53.3	47.6	45.5	45.2	35.4	35.1	36.1	34.8
19.	Gross fixed capital formation	2.3	2.8	3.1	3.3	2.6	2.6	2.6	2.4
20.	Other capital expenditure	6.9	10.5	3.1	2.2	0.5	0.7	1.4	1.5
21.	Total expenditure	54.1	59.9	51.5	50.9	39.2	38.5	39.9	38.8
22.	Tax burden	41.6	34.3	32.9	33.1	31.2	:	:	:
23.	Net lending (+) or net borrowing (–)	– 0.9	– 12.3	– 6.0	– 5.7	– 3.7	– 3.3	– 3.8	– 4.0

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.24

Resources and expenditure of general government

(% of GDP)

Sweden		ESA 95 definitions (1)							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	15.6	16.4	16.5	17.0	17.1	17.0	16.8	16.6
2.	Current taxes on income and wealth	20.1	22.4	19.9	18.0	18.9	19.3	19.0	18.9
3.	Social contributions	13.7	15.0	15.4	15.3	15.0	14.7	14.7	14.7
4.	*Of which* actual social contributions	13.1	14.4	14.8	14.6	14.3	14.0	14.0	13.9
5.	Other current resources	8.2	6.0	5.1	5.0	5.0	4.9	4.8	4.7
6.	Total current resources	57.5	59.8	56.9	55.3	56.0	55.9	55.3	54.9
7.	Government consumption expenditure	27.2	26.6	27.0	27.9	28.3	27.8	27.6	27.5
8.	*Of which* compensation of employees	16.7	15.7	16.0	16.3	16.6	16.3	16.3	16.3
9.	Collective consumption	8.3	8.4	8.2	8.3	8.2	8.0	8.0	7.9
10.	Social benefits in kind	18.9	18.2	18.8	19.6	20.1	19.8	19.7	19.6
11.	Social transfers other than in kind	20.6	17.5	17.4	17.5	18.2	18.1	17.9	17.7
12.	Interest payments	6.7	4.1	3.2	3.0	2.1	1.8	2.0	2.1
13.	Subsidies	3.7	1.6	1.5	1.5	1.5	1.4	1.5	1.5
14.	Other current expenditure	2.0	2.3	2.4	2.3	2.5	2.5	2.5	2.5
15.	Total current expenditure	60.2	52.0	51.4	52.3	52.7	51.6	51.6	51.2
16.	Gross savings	– 2.6	7.7	5.5	2.7	3.0	4.1	3.7	3.6
17.	Capital transfers received	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
18.	Total resources	60.8	62.3	59.5	57.8	58.6	58.4	57.8	57.4
19.	Gross fixed capital formation	4.0	2.9	3.1	3.2	3.1	3.0	3.0	3.0
20.	Other capital expenditure	0.6	0.1	0.1	0.2	0.1	0.0	0.0	0.0
21.	Total expenditure	67.8	57.4	57.0	58.1	58.4	57.0	57.0	56.6
22.	Tax burden	50.1	54.3	52.3	50.6	51.4	51.3	50.8	50.4
23.	Net lending (+) or net borrowing (–)	– 7.0	5.0	2.5	– 0.3	0.2	1.4	0.8	0.8

(1) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.25

Resources and expenditure of general government

(% of GDP)

United Kingdom		ESA 95 definitions [1]							
		1995	2000	2001	2002	2003	2004	2005	2006
1.	Taxes on production and imports	13.1	13.6	13.3	13.3	13.2	13.4	13.3	13.2
2.	Current taxes on income and wealth	14.9	16.7	16.8	15.7	15.2	15.6	16.3	16.7
3.	Social contributions	7.5	7.6	7.6	7.4	8.0	8.1	8.1	8.1
4.	*Of which* actual social contributions	6.8	6.9	7.0	6.7	7.4	7.6	7.6	7.6
5.	Other current resources	2.9	2.5	2.7	2.4	2.3	2.2	2.2	2.2
6.	Total current resources	38.3	40.3	40.4	38.7	38.6	39.2	39.8	40.2
7.	Government consumption expenditure	19.5	18.6	19.1	20.0	20.9	21.2	21.4	21.6
8.	*Of which* compensation of employees	10.8	9.9	10.1	10.2	10.5	10.6	10.7	10.9
9.	Collective consumption	8.3	7.4	7.6	7.8	8.0	8.1	8.2	8.3
10.	Social benefits in kind	11.2	11.2	11.5	12.2	12.9	13.0	13.1	13.3
11.	Social transfers other than in kind	15.4	13.3	13.7	13.5	13.5	13.5	13.4	13.2
12.	Interest payments	3.6	2.7	2.4	2.1	2.1	2.1	2.1	2.1
13.	Subsidies	0.8	0.5	0.6	0.6	0.6	0.7	0.7	0.7
14.	Other current expenditure	1.8	2.3	2.3	2.6	2.8	2.9	3.0	2.9
15.	Total current expenditure	41.0	37.4	38.0	38.6	39.8	40.3	40.5	40.5
16.	Gross savings	– 2.7	2.9	2.4	0.0	– 1.2	– 1.1	– 0.7	– 0.3
17.	Capital transfers received	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4
18.	Total resources	39.1	41.2	41.5	40.0	40.0	40.4	40.9	41.4
19.	Gross fixed capital formation	2.2	1.3	1.4	1.4	1.7	1.8	2.0	2.1
20.	Other capital expenditure	1.2	– 1.9	0.7	0.7	0.9	0.7	0.8	0.8
21.	Total expenditure	44.9	37.4	40.9	41.7	43.4	43.6	44.0	44.1
22.	Tax burden	36.5	38.5	38.3	36.8	36.8	37.5	38.0	38.4
23.	Net lending (+) or net borrowing (–)	– 5.8	3.8	0.7	– 1.7	– 3.4	– 3.2	– 3.0	– 2.7

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.1.26

Resources and expenditure of general government

(% of GDP)

		ESA 95 definitions (2)							
Euro area (1)		**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
1.	Taxes on production and imports	12.5	13.6	13.3	13.4	13.4	13.6	13.6	13.6
2.	Current taxes on income and wealth	11.4	13.0	12.6	12.1	11.8	11.7	11.6	11.5
3.	Social contributions	17.4	16.2	16.0	16.0	16.2	15.9	15.9	15.9
4.	*Of which* actual social contributions	16.0	15.1	14.9	14.9	15.0	14.9	14.8	14.8
5.	Other current resources	3.8	3.3	3.5	3.4	3.3	3.2	3.2	3.1
6.	Total current resources (1 + 2 + 3 + 5)	45.1	46.0	45.4	45.0	44.7	44.4	44.3	44.2
7.	Government consumption expenditure (9 + 10)	20.5	19.9	20.1	20.4	20.7	20.5	20.4	20.4
8.	*Of which* compensation of employees	11.1	10.6	10.5	10.7	10.7	10.6	10.6	10.4
9.	Collective consumption	8.6	8.2	8.2	8.3	8.4	8.3	8.2	8.1
10.	Social benefits in kind	11.9	11.7	11.9	12.1	12.3	12.2	12.2	12.2
11.	Social transfers other than in kind	17.3	16.6	16.6	16.9	17.2	17.1	17.1	16.9
12.	Interest payments	5.6	4.1	4.0	3.7	3.5	3.3	3.3	3.3
13.	Subsidies	1.7	1.4	1.4	1.4	1.3	1.3	1.2	1.2
14.	Other current expenditure	1.4	1.6	1.6	1.7	1.9	1.9	1.9	1.9
15.	Total current expenditure (9 to 14)	46.5	43.7	43.7	44.1	44.5	44.1	43.9	43.6
16.	Gross savings (6 – 15)	– 1.4	2.3	1.7	0.8	0.1	0.3	0.5	0.6
17.	Capital transfers received	0.6	0.5	0.5	0.5	1.0	0.8	0.7	0.6
18.	Total resources (6 + 17)	46.5	47.2	46.5	46.1	46.3	45.7	45.6	45.4
19.	Gross fixed capital formation	2.7	2.5	2.6	2.5	2.6	2.6	2.5	2.6
20.	Other capital expenditure	1.7	0.2	1.4	1.4	1.4	1.3	1.3	1.2
21.	Total expenditure (15 + 19 + 20)	51.5	47.1	48.3	48.6	49.1	48.5	48.2	48.0
22.	Tax burden	42.2	43.3	42.5	42.0	41.8	41.6	41.5	41.4
23.	Net lending (+) or net borrowing (–) (18 – 21)	– 5.1	0.1	– 1.8	– 2.5	– 2.9	– 2.7	– 2.6	– 2.7

(1) Due to problem with availability of data, Luxembourg data are not included; from 1991 including former East Germany.
(3) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 – line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 – line 21.

Source: Commission services.

Table A.2.1

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Belgium									
1.	Net borrowing (1)	4.4	– 0.2	– 0.6	– 0.1	– 0.4	– 0.1	0.2	0.6
2.	Interest payments	9.3	6.7	6.5	6.0	5.4	4.7	4.5	4.2
3.	Implicit interest rate (2)	7.1	6.2	6.1	5.7	5.3	5.0	4.8	4.6
4.	Nominal GDP growth rate (%)	3.6	5.2	2.5	2.7	3.2	5.1	4.1	4.5
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	4.4	– 0.2	– 0.6	– 0.1	– 0.4	– 0.1	0.2	0.6
6.	Contribution of nominal GDP growth	– 4.8	– 5.7	– 2.7	– 2.9	– 3.3	– 4.9	– 3.6	– 4.1
7.	Stock-flow adjustment (3)	– 1.5	0.1	2.2	0.4	– 1.8	0.6	2.7	0.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 4.9	– 6.9	– 7.2	– 6.1	– 5.7	– 4.8	– 4.3	– 3.6
9.	Snowball effect	4.5	1.1	3.9	3.1	2.1	– 0.2	0.8	0.1
10.	Stock-flow adjustment (3)	– 1.5	0.1	2.2	0.4	– 1.8	0.6	2.7	0.4
11.	Change in gross debt (5)	– 1.9	– 5.8	– 1.1	– 2.6	– 5.4	– 4.4	– 0.7	– 3.1
12.	Level of gross debt (end of year)	134.0	109.1	108.0	105.4	100.0	95.6	94.9	91.7
Germany (*)									
1.	Net borrowing (1)	3.3	– 1.3	2.8	3.7	3.8	3.7	3.3	2.8
2.	Interest payments	3.7	3.4	3.3	3.1	3.1	3.0	3.0	3.0
3.	Implicit interest rate (2)	7.7	5.7	5.5	5.4	5.2	4.8	4.7	4.6
4.	Nominal GDP growth rate (%)	3.8	2.6	2.2	1.6	1.0	2.3	1.4	2.3
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	3.3	– 1.3	2.8	3.7	3.8	3.7	3.3	2.8
6.	Contribution of nominal GDP growth	– 1.8	– 1.5	– 1.3	– 0.9	– 0.6	– 1.4	– 0.9	– 1.5
7.	Stock-flow adjustment (3)	6.2	1.9	– 2.3	– 1.3	0.1	– 0.4	– 0.5	– 0.3
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 0.3	– 4.7	– 0.4	0.5	0.7	0.6	0.3	– 0.2
9.	Snowball effect	1.9	1.8	2.0	2.2	2.5	1.6	2.1	1.5
10.	Stock-flow adjustment (3)	6.2	1.9	– 2.3	– 1.3	0.1	– 0.4	– 0.5	– 0.3
11.	Change in gross debt (5)	7.7	– 1.0	– 0.8	1.5	3.3	1.8	2.0	0.9
12.	Level of gross debt (end of year)	57.0	60.2	59.4	60.9	64.2	66.0	68.0	68.9

(*) From 1991, including former East Germany.
(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.2

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Greece									
1.	Net borrowing (1)	10.2	4.1	3.6	4.1	5.2	6.1	4.5	4.4
2.	Interest payments	12.7	8.2	7.3	6.3	5.8	5.8	5.5	5.5
3.	Implicit interest rate (2)	13.2	7.9	6.9	5.9	5.6	5.7	5.3	5.3
4.	Nominal GDP growth rate (%)	12.1	8.0	7.9	7.9	8.3	7.7	6.3	6.5
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (1)	10.2	4.1	3.6	4.1	5.2	6.1	4.5	4.4
6.	Contribution of nominal GDP growth	– 11.6	– 8.3	– 8.3	– 8.4	– 8.6	– 7.8	– 6.5	– 6.8
7.	Stock-flow adjustment (3)	2.2	5.9	5.5	1.7	0.6	2.9	1.9	0.7
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (4)	– 2.6	– 4.0	– 3.7	– 2.2	– 0.6	0.4	– 1.0	– 1.0
9.	Snowball effect	1.1	– 0.1	– 1.1	– 2.1	– 2.9	– 2.0	– 1.0	– 1.3
10.	Stock-flow adjustment (3)	2.2	5.9	5.5	1.7	0.6	2.9	1.9	0.7
11.	Change in gross debt (5)	0.8	1.7	0.7	– 2.6	– 2.9	1.3	– 0.1	– 1.6
12.	Level of gross debt (end of year)	108.7	114.0	114.8	112.2	109.3	110.5	110.5	108.9
Spain									
1.	Net borrowing (1)	6.6							
2.	Interest payments	5.2	0.9	0.5	0.3	– 0.3	0.3	0.0	– 0.1
3.	Implicit interest rate (2)	9.2	3.3	3.2	2.8	2.5	2.2	2.1	2.0
4.	Nominal GDP growth rate (%)	7.8	5.6	5.5	5.2	4.9	4.5	4.5	4.6
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (1)	6.6	0.9	0.5	0.3	– 0.3	0.3	0.0	– 0.1
6.	Contribution of nominal GDP growth	– 4.4	– 4.7	– 4.1	– 3.7	– 3.4	– 3.5	– 3.1	– 2.8
7.	Stock-flow adjustment (3)	0.6	1.7	0.3	0.6	0.1	0.7	0.6	0.6
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (4)	1.4	– 2.4	– 2.6	– 2.6	– 2.8	– 1.9	– 2.1	– 2.1
9.	Snowball effect	0.8	– 1.4	– 0.9	– 0.9	– 0.9	– 1.3	– 1.0	– 0.8
10.	Stock-flow adjustment (3)	0.6	1.7	0.3	0.6	0.1	0.7	0.6	0.6
11.	Change in gross debt (5)	2.8	– 2.0	– 3.3	– 2.9	– 3.6	– 2.5	– 2.4	– 2.3
12.	Level of gross debt (end of year)	63.9	61.1	57.8	55.0	51.4	48.9	46.5	44.2

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.3

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
France									
1.	Net borrowing (1)	5.5	1.4	1.5	3.2	4.2	3.7	3.0	3.4
2.	Interest payments	3.8	3.1	3.1	3.0	2.9	2.9	2.9	3.0
3.	Implicit interest rate (2)	8.0	5.5	5.7	5.5	5.1	4.7	4.6	4.7
4.	Nominal GDP growth rate (%)	3.4	4.8	3.9	3.5	2.0	4.4	3.7	4.0
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	5.5	1.4	1.5	3.2	4.2	3.7	3.0	3.4
6.	Contribution of nominal GDP growth	– 1.6	– 2.7	– 2.1	– 1.9	– 1.2	– 2.7	– 2.3	– 2.5
7.	Stock-flow adjustment (3)	2.3	– 0.4	0.8	0.8	1.8	0.6	0.0	0.0
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	1.8	– 1.7	– 1.6	0.2	1.3	0.8	0.1	0.4
9.	Snowball effect	2.2	0.4	1.0	1.1	1.8	0.2	0.6	0.5
10.	Stock-flow adjustment (3)	2.3	– 0.4	0.8	0.8	1.8	0.6	0.0	0.0
11.	Change in gross debt (5)	6.2	– 1.6	0.2	2.1	4.9	1.6	0.7	0.8
12.	Level of gross debt (end of year)	54.6	56.8	57.0	59.0	63.9	65.6	66.2	67.1
Ireland									
1.	Net borrowing (1)	2.1	– 4.4	– 0.9	0.4	– 0.2	– 1.3	0.6	0.6
2.	Interest payments	5.4	2.0	1.4	1.3	1.3	1.2	1.1	1.0
3.	Implicit interest rate (2)	6.8	4.8	4.4	4.3	4.2	4.0	4.0	3.8
4.	Nominal GDP growth rate (%)	13.0	15.2	12.0	10.9	5.3	8.5	7.7	7.8
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	2.1	– 4.4	– 0.9	0.4	– 0.2	– 1.3	0.6	0.6
6.	Contribution of nominal GDP growth	– 10.3	– 6.4	– 4.1	– 3.5	– 1.6	– 2.5	– 2.2	– 2.2
7.	Stock-flow adjustment (3)	0.6	0.4	2.5	– 0.1	1.2	1.7	1.5	1.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 3.3	– 6.4	– 2.4	– 1.0	– 1.5	– 2.5	– 0.5	– 0.5
9.	Snowball effect	– 4.9	– 4.4	– 2.6	– 2.1	– 0.3	– 1.3	– 1.1	– 1.1
10.	Stock-flow adjustment (3)	0.6	0.4	2.5	– 0.1	1.2	1.7	1.5	1.4
11.	Change in gross debt (5)	– 7.6	– 10.4	– 2.5	– 3.2	– 0.6	– 2.1	– 0.1	– 0.2
12.	Level of gross debt (end of year)	82.0	38.3	35.8	32.6	32.0	29.9	29.8	29.6

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.4

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Italy									
1.	Net borrowing (1)	7.6	0.6	3.0	2.6	2.9	3.0	3.6	4.6
2.	Interest payments	11.5	6.5	6.5	5.8	5.3	5.0	4.9	5.0
3.	Implicit interest rate (2)	10.0	5.9	6.1	5.4	5.1	4.9	4.8	4.9
4.	Nominal GDP growth rate (%)	8.1	5.3	4.5	3.5	3.2	3.9	3.5	3.9
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (1)	7.6	0.6	3.0	2.6	2.9	3.0	3.6	4.6
6.	Contribution of nominal GDP growth	– 9.3	– 5.8	– 4.7	– 3.7	– 3.3	– 4.0	– 3.5	– 4.0
7.	Stock-flow adjustment (3)	1.2	0.9	1.3	– 1.5	– 1.3	0.4	– 0.3	0.1
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (4)	– 3.9	– 5.8	– 3.6	– 3.2	– 2.4	– 2.0	– 1.3	– 0.4
9.	Snowball effect	2.2	0.7	1.8	2.1	2.0	1.0	1.4	1.0
10.	Stock-flow adjustment (3)	1.2	0.9	1.3	– 1.5	– 1.3	0.4	– 0.3	0.1
11.	Change in gross debt (5)	– 0.6	– 4.3	– 0.5	– 2.6	– 1.7	– 0.5	– 0.2	0.7
12.	Level of gross debt (end of year)	124.3	111.2	110.7	108.0	106.3	105.8	105.6	106.3
Luxembourg									
1.	Net borrowing (1)	– 2.5	– 6.2	– 6.2	– 2.3	– 0.5	1.1	1.5	1.9
2.	Interest payments	0.5	0.3	0.4	0.3	0.3	0.2	0.2	0.2
3.	Implicit interest rate (2)	8.2	6.3	7.0	5.0	4.4	3.6	3.0	2.6
4.	Nominal GDP growth rate (%)	3.8	13.6	3.5	3.6	5.0	7.0	7.1	6.5
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (1)	– 2.5	– 6.2	– 6.2	– 2.3	– 0.5	1.1	1.5	1.9
6.	Contribution of nominal GDP growth	– 0.2	– 0.7	– 0.2	– 0.2	– 0.4	– 0.5	– 0.5	– 0.5
7.	Stock-flow adjustment (3)	3.2	6.4	8.1	2.8	0.5	– 0.2	– 0.8	– 1.2
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (4)	– 3.0	– 6.5	– 6.5	– 2.6	– 0.8	0.9	1.3	1.7
9.	Snowball effect	0.3	– 0.4	0.2	0.1	0.0	– 0.2	– 0.3	– 0.3
10.	Stock-flow adjustment (3)	3.2	6.4	8.1	2.8	0.5	– 0.2	– 0.8	– 1.2
11.	Change in gross debt (5)	0.4	– 0.5	1.7	0.3	– 0.4	0.4	0.3	0.2
12.	Level of gross debt (end of year)	6.7	5.5	7.2	7.5	7.1	7.5	7.8	7.9

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.5

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
The Netherlands									
1.	Net borrowing (1)	4.2	– 2.2	0.1	1.9	3.2	2.5	2.0	1.6
2.	Interest payments	5.9	3.8	3.4	3.1	2.9	2.9	2.8	2.8
3.	Implicit interest rate (2)	8.1	6.5	6.4	6.0	5.6	5.4	5.2	5.0
4.	Nominal GDP growth rate (%)	5.1	7.5	6.7	3.7	2.0	2.4	1.9	2.9
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	4.2	– 2.2	0.1	1.9	3.2	2.5	2.0	1.6
6.	Contribution of nominal GDP growth	– 3.7	– 4.4	– 3.5	– 1.9	– 1.1	– 1.3	– 1.0	– 1.6
7.	Stock-flow adjustment (3)	0.4	– 0.6	0.5	– 0.3	– 0.5	0.2	0.9	0.3
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 1.7	– 6.0	– 3.3	– 1.1	0.3	– 0.4	– 0.8	– 1.2
9.	Snowball effect	2.2	– 0.6	– 0.2	1.2	1.9	1.6	1.8	1.2
10.	Stock-flow adjustment (3)	0.4	– 0.6	0.5	– 0.3	– 0.5	0.2	0.9	0.3
11.	Change in gross debt (5)	0.8	– 7.2	– 3.0	– 0.3	1.7	1.4	1.9	0.3
12.	Level of gross debt (end of year)	77.2	55.9	52.9	52.6	54.3	55.7	57.6	57.9
Austria									
1.	Net borrowing (1)	5.8	1.5	– 0.3	0.2	1.1	1.3	2.0	1.7
2.	Interest payments	4.0	3.6	3.5	3.4	3.1	3.0	2.9	2.8
3.	Implicit interest rate (2)	6.3	5.5	5.4	5.1	4.8	4.8	4.6	4.6
4.	Nominal GDP growth rate (%)	3.9	5.2	2.5	2.5	2.3	3.9	3.8	3.6
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	5.8	1.5	– 0.3	0.2	1.1	1.3	2.0	1.7
6.	Contribution of nominal GDP growth	– 2.4	– 3.2	– 1.6	– 1.7	– 1.6	– 2.2	– 2.4	– 2.2
7.	Stock-flow adjustment (3)	1.3	1.1	2.3	1.0	– 0.7	0.7	– 0.4	0.2
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	1.9	– 2.1	– 3.8	– 3.1	– 2.0	– 1.7	– 0.9	– 1.1
9.	Snowball effect	1.4	0.3	1.9	1.6	1.5	0.7	0.5	0.6
10.	Stock-flow adjustment (3)	1.3	1.1	2.3	1.0	– 0.7	0.7	– 0.4	0.2
11.	Change in gross debt (5)	4.6	– 0.7	0.4	– 0.5	– 1.2	– 0.2	– 0.7	– 0.3
12.	Level of gross debt (end of year)	68.8	66.7	67.1	66.7	65.4	65.2	64.4	64.1

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.6

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Portugal									
1.	Net borrowing (1)	5.5	2.8	4.4	2.7	2.9	2.9	4.9	4.7
2.	Interest payments	6.3	3.2	3.2	3.0	2.9	2.8	2.9	3.1
3.	Implicit interest rate (2)	10.9	6.3	6.3	5.7	5.0	4.9	4.9	4.8
4.	Nominal GDP growth rate (%)	7.9	7.0	6.1	4.8	1.6	3.5	3.4	4.1
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	5.5	2.8	4.4	2.7	2.9	2.9	4.9	4.7
6.	Contribution of nominal GDP growth	– 4.5	– 3.5	– 3.0	– 2.6	– 0.9	– 2.0	– 2.0	– 2.6
7.	Stock-flow adjustment (3)	1.2	– 0.3	1.3	2.5	– 0.4	0.9	1.4	0.2
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 0.8	– 0.4	1.2	– 0.3	0.0	0.1	2.0	1.6
9.	Snowball effect	1.7	– 0.3	0.1	0.5	2.0	0.9	0.9	0.5
10.	Stock-flow adjustment (3)	1.2	– 0.3	1.3	2.5	– 0.4	0.9	1.4	0.2
11.	Change in gross debt (5)	2.2	– 1.0	2.6	2.6	1.6	1.9	4.3	2.3
12.	Level of gross debt (end of year)	64.3	53.3	55.9	58.5	60.1	61.9	66.2	68.5
Finland									
1.	Net borrowing (1)	3.9	– 7.1	– 5.2	– 4.3	– 2.5	– 2.1	– 1.7	– 1.6
2.	Interest payments	4.0	2.9	2.7	2.2	2.0	1.9	1.6	1.5
3.	Implicit interest rate (2)	7.5	6.6	6.4	5.2	4.8	4.4	3.8	3.6
4.	Nominal GDP growth rate (%)	8.4	8.5	4.1	3.6	2.2	4.5	4.0	4.1
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	3.9	– 7.1	– 5.2	– 4.3	– 2.5	– 2.1	– 1.7	– 1.6
6.	Contribution of nominal GDP growth	– 4.5	– 3.7	– 1.8	– 1.5	– 0.9	– 1.9	– 1.7	– 1.7
7.	Stock-flow adjustment (3)	– 0.3	8.3	6.2	4.4	6.2	3.8	2.5	2.7
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 0.1	– 10.0	– 7.9	– 6.5	– 4.5	– 4.0	– 3.3	– 3.1
9.	Snowball effect	– 0.5	– 0.8	1.0	0.7	1.1	0.0	– 0.1	– 0.2
10.	Stock-flow adjustment (3)	– 0.3	8.3	6.2	4.4	6.2	3.8	2.5	2.7
11.	Change in gross debt (5)	– 0.9	– 2.5	– 0.7	– 1.4	2.8	– 0.2	– 0.9	– 0.6
12.	Level of gross debt (end of year)	57.1	44.6	43.8	42.5	45.3	45.1	44.3	43.7

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.7

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Czech Republic									
1.	Net borrowing (1)	13.4	3.7	5.9	6.8	11.7	3.0	4.5	4.0
2.	Interest payments	1.1	0.9	1.1	1.5	1.3	1.3	1.3	1.4
3.	Implicit interest rate (2)	:	5.7	6.3	5.8	4.6	3.5	3.7	4.3
4.	Nominal GDP growth rate (%)	16.8	5.3	7.7	4.3	5.6	7.9	7.9	7.5
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	13.4	3.7	5.9	6.8	11.7	3.0	4.5	4.0
6.	Contribution of nominal GDP growth	:	– 0.8	– 1.3	– 1.1	– 1.6	– 2.8	– 2.7	– 2.5
7.	Stock-flow adjustment (3)	:	– 0.6	4.4	– 2.2	– 2.4	– 1.2	– 2.7	– 0.9
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	12.3	2.8	4.8	5.2	10.3	1.8	3.2	2.6
9.	Snowball effect	:	0.1	– 0.2	0.4	– 0.3	– 1.5	– 1.5	– 1.1
10.	Stock-flow adjustment (3)	:	– 0.6	4.4	– 2.2	– 2.4	– 1.2	– 2.7	– 0.9
11.	Change in gross debt (5)	:	2.3	9.0	3.4	7.7	– 0.9	– 1.0	0.6
12.	Level of gross debt (end of year)	:	18.2	27.2	30.7	38.3	37.4	36.4	37.0
Denmark									
1.	Net borrowing (1)	2.3	– 2.6	– 3.2	– 1.7	– 1.2	– 2.8	– 2.1	– 2.2
2.	Interest payments	6.0	3.5	3.2	2.8	2.5	2.3	2.2	2.0
3.	Implicit interest rate (2)	8.1	6.5	6.3	6.0	5.5	5.3	5.3	5.2
4.	Nominal GDP growth rate (%)	4.6	5.9	3.6	2.7	2.6	3.7	4.0	3.9
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	2.3	– 2.6	– 3.2	– 1.7	– 1.2	– 2.8	– 2.1	– 2.2
6.	Contribution of nominal GDP growth	– 3.4	– 3.2	– 1.8	– 1.2	– 1.2	– 1.6	– 1.7	– 1.5
7.	Stock-flow adjustment (3)	– 3.1	0.5	0.4	2.4	– 0.1	2.3	1.6	1.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 3.7	– 6.2	– 6.3	– 4.5	– 3.8	– 5.1	– 4.3	– 4.2
9.	Snowball effect	2.6	0.3	1.3	1.6	1.3	0.7	0.5	0.5
10.	Stock-flow adjustment (3)	– 3.1	0.5	0.4	2.4	– 0.1	2.3	1.6	1.4
11.	Change in gross debt (5)	– 4.2	– 5.4	– 4.5	– 0.5	– 2.5	– 2.0	– 2.2	– 2.3
12.	Level of gross debt (end of year)	73.2	52.3	47.8	47.2	44.7	42.7	40.5	38.2

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.8

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Estonia									
1.	Net borrowing (1)	– 0.4	0.6	– 0.3	– 1.4	– 3.1	– 1.8	– 0.9	– 0.5
2.	Interest payments	0.2	0.3	0.2	0.3	0.3	0.2	0.2	0.2
3.	Implicit interest rate (2)	:	6.0	5.9	6.7	5.2	4.7	4.6	4.9
4.	Nominal GDP growth rate (%)	37.3	13.6	12.5	12.0	7.7	9.6	9.7	9.3
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	– 0.4	0.6	– 0.3	– 1.4	– 3.1	– 1.8	– 0.9	– 0.5
6.	Contribution of nominal GDP growth	:	– 0.7	– 0.5	– 0.5	– 0.4	– 0.5	– 0.4	– 0.4
7.	Stock-flow adjustment (3)	:	– 1.2	0.5	2.8	3.5	1.9	0.6	0.5
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 0.6	0.2	– 0.5	– 1.7	– 3.3	– 2.0	– 1.1	– 0.7
9.	Snowball effect	:	– 0.4	– 0.3	– 0.2	– 0.1	– 0.2	– 0.2	– 0.2
10.	Stock-flow adjustment (3)	:	– 1.2	0.5	2.8	3.5	1.9	0.6	0.5
11.	Change in gross debt (5)	:	– 1.4	– 0.3	0.9	0.0	– 0.4	– 0.7	– 0.3
12.	Level of gross debt (end of year)	:	4.7	4.4	5.3	5.3	4.9	4.3	4.0
Cyprus									
1.	Net borrowing (1)	:	2.4	2.3	4.5	6.3	4.2	2.9	1.9
2.	Interest payments	:	3.4	3.4	3.2	3.4	3.4	3.3	3.2
3.	Implicit interest rate (2)	:	6.2	6.1	5.3	5.7	5.1	4.9	5.0
4.	Nominal GDP growth rate (%)	9.4	8.9	7.5	4.4	6.8	6.0	6.9	6.6
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	:	2.4	2.3	4.5	6.3	4.2	2.9	1.9
6.	Contribution of nominal GDP growth	:	– 4.9	– 4.2	– 2.6	– 4.2	– 4.1	– 4.5	– 4.3
7.	Stock-flow adjustment (3)	:	2.5	3.9	1.5	2.5	2.0	– 1.2	0.0
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	:	– 1.1	– 1.1	1.3	2.8	0.9	– 0.4	– 1.4
9.	Snowball effect	:	– 1.5	– 0.7	0.6	– 0.7	– 0.8	– 1.2	– 1.1
10.	Stock-flow adjustment (3)	:	2.5	3.9	1.5	2.5	2.0	– 1.2	0.0
11.	Change in gross debt (5)	:	0.0	2.0	3.3	4.6	2.1	– 2.8	– 2.5
12.	Level of gross debt (end of year)	:	59.9	61.9	65.2	69.8	71.9	69.1	66.6

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.9

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Latvia									
1.	Net borrowing (1)	2.0	2.8	2.1	2.7	1.5	0.8	1.6	1.5
2.	Interest payments	1.3	1.0	1.0	0.8	0.8	0.8	0.8	0.8
3.	Implicit interest rate (2)	:	8.7	8.2	6.0	6.4	6.3	6.3	6.1
4.	Nominal GDP growth rate (%)	14.0	10.9	10.3	10.1	11.1	16.4	11.6	11.0
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	2.0	2.8	2.1	2.7	1.5	0.8	1.6	1.5
6.	Contribution of nominal GDP growth	:	– 1.2	– 1.2	– 1.4	– 1.4	– 1.9	– 1.6	– 1.4
7.	Stock-flow adjustment (3)	:	– 1.3	1.1	– 2.2	0.2	1.2	– 0.5	0.2
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	0.8	1.8	1.1	1.9	0.7	0.0	0.8	0.7
9.	Snowball effect	:	– 0.3	– 0.2	– 0.5	– 0.6	– 1.1	– 0.8	– 0.6
10.	Stock-flow adjustment (3)	:	– 1.3	1.1	– 2.2	0.2	1.2	– 0.5	0.2
11.	Change in gross debt (5)	:	0.3	2.0	– 0.8	0.3	0.1	– 0.4	0.3
12.	Level of gross debt (end of year)	:	12.9	14.9	14.1	14.4	14.4	14.0	14.3
Lithuania									
1.	Net borrowing (1)	1.9	2.5	2.0	1.5	1.9	2.5	2.4	1.9
2.	Interest payments	0.4	1.7	1.6	1.4	1.3	1.0	0.9	0.9
3.	Implicit interest rate (2)	:	8.0	7.2	6.5	6.2	5.3	5.3	4.5
4.	Nominal GDP growth rate (%)	51.3	5.0	6.3	6.7	8.8	10.2	9.6	9.6
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	1.9	2.5	2.0	1.5	1.9	2.5	2.4	1.9
6.	Contribution of nominal GDP growth	:	– 1.1	– 1.4	– 1.5	– 1.8	– 2.0	– 1.8	– 1.9
7.	Stock-flow adjustment (3)	:	– 0.6	– 1.5	– 0.6	– 1.1	– 2.3	0.9	– 0.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	1.5	0.8	0.4	0.1	0.6	1.5	1.5	1.1
9.	Snowball effect	:	0.7	0.2	– 0.1	– 0.5	– 0.9	– 0.8	– 1.0
10.	Stock-flow adjustment (3)	:	– 0.6	– 1.5	– 0.6	– 1.1	– 2.3	0.9	– 0.4
11.	Change in gross debt (5)	:	0.8	– 0.9	– 0.5	– 1.0	– 1.8	1.5	– 0.3
12.	Level of gross debt (end of year)	:	23.8	22.9	22.4	21.4	19.7	21.2	20.9

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.10

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Hungary									
1.	Net borrowing (1)	:	2.4	3.7	8.5	6.2	4.5	3.9	4.1
2.	Interest payments	:	5.6	4.8	4.1	4.2	4.3	3.8	3.4
3.	Implicit interest rate (2)	:	10.6	9.6	8.7	8.0	8.2	7.3	6.4
4.	Nominal GDP growth rate (%)	28.6	15.6	12.7	12.7	10.9	8.9	8.9	8.1
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	:	2.4	3.7	8.5	6.2	4.5	3.9	4.1
6.	Contribution of nominal GDP growth	:	– 8.2	– 6.3	– 5.9	– 5.5	– 4.6	– 4.9	– 4.3
7.	Stock-flow adjustment (3)	:	0.4	– 0.7	0.7	0.6	0.9	1.2	0.3
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	:	– 3.2	– 1.0	4.4	2.0	0.2	0.0	0.7
9.	Snowball effect	:	– 2.6	– 1.5	– 1.9	– 1.4	– 0.4	– 1.0	– 0.9
10.	Stock-flow adjustment (3)	:	0.4	– 0.7	0.7	0.6	0.9	1.2	0.3
11.	Change in gross debt (5)	:	– 5.5	– 3.3	3.4	1.4	0.7	0.2	0.1
12.	Level of gross debt (end of year)	:	55.4	52.2	55.5	56.9	57.6	57.8	57.9
Malta									
1.	Net borrowing (1)	:	6.3	6.4	5.9	10.5	5.2	3.9	2.8
2.	Interest payments	:	3.8	3.7	3.9	3.8	4.1	4.3	4.3
3.	Implicit interest rate (2)	:	7.2	6.6	6.4	6.3	5.8	6.0	5.8
4.	Nominal GDP growth rate (%)	11.4	7.0	1.6	2.8	3.1	3.2	4.3	3.2
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	:	6.3	6.4	5.9	10.5	5.2	3.9	2.8
6.	Contribution of nominal GDP growth	:	– 3.7	– 1.7	– 1.4	– 2.0	– 2.1	– 2.5	– 2.4
7.	Stock-flow adjustment (3)	:	– 2.4	0.7	– 4.3	0.8	0.0	0.1	0.3
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	:	2.5	2.8	1.9	6.7	1.1	– 0.5	– 1.5
9.	Snowball effect	:	0.1	2.0	2.6	1.8	2.0	1.8	1.9
10.	Stock-flow adjustment (3)	:	– 2.4	0.7	– 4.3	0.8	0.0	0.1	0.3
11.	Change in gross debt (5)	:	0.2	5.5	0.2	9.2	3.1	1.5	0.7
12.	Level of gross debt (end of year)	:	57.0	62.4	62.7	71.8	75.0	76.4	77.1

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.11

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Poland									
1.	Net borrowing (1)	3.9	2.4	3.6	4.3	4.7	4.9	4.4	3.6
2.	Interest payments	5.8	2.8	2.9	3.7	3.1	2.7	2.6	2.4
3.	Implicit interest rate (2)	:	8.7	9.0	8.1	7.3	6.3	6.2	5.7
4.	Nominal GDP growth rate (%)	36.9	10.9	5.1	2.7	4.3	8.4	6.2	6.6
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	3.9	2.4	3.6	4.3	4.7	4.9	4.4	3.6
6.	Contribution of nominal GDP growth	:	– 4.0	– 1.8	– 1.0	– 1.7	– 3.5	– 2.6	– 2.9
7.	Stock-flow adjustment (3)	:	– 0.9	– 2.2	1.8	1.4	– 3.0	1.3	– 0.1
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	– 2.0	– 0.4	0.7	0.7	1.6	2.2	1.9	1.3
9.	Snowball effect	:	– 0.8	1.4	1.9	1.2	– 0.9	0.0	– 0.4
10.	Stock-flow adjustment (3)	:	– 0.9	– 2.2	1.8	1.4	– 3.0	1.3	– 0.1
11.	Change in gross debt (5)	:	– 3.2	– 0.1	4.4	4.2	– 1.7	3.2	0.7
12.	Level of gross debt (end of year)	:	36.8	36.7	41.2	45.4	43.6	46.8	47.6
Slovenia									
1.	Net borrowing (1)	:	3.5	2.8	2.4	2.0	1.9	2.2	2.1
2.	Interest payments	:	2.4	2.4	2.3	2.1	1.9	1.7	1.6
3.	Implicit interest rate (2)	:	10.7	9.9	9.3	7.8	6.8	6.2	5.6
4.	Nominal GDP growth rate (%)	15.0	9.7	12.0	11.6	8.1	7.7	6.8	6.8
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	:	3.5	2.8	2.4	2.0	1.9	2.2	2.1
6.	Contribution of nominal GDP growth	:	– 2.2	– 2.9	– 2.9	– 2.2	– 2.1	– 1.9	– 1.9
7.	Stock-flow adjustment (3)	:	1.3	0.8	1.9	0.0	0.3	0.5	0.1
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	:	1.0	0.4	0.0	– 0.1	0.0	0.5	0.5
9.	Snowball effect	:	0.2	– 0.5	– 0.6	– 0.1	– 0.3	– 0.2	– 0.3
10.	Stock-flow adjustment (3)	:	1.3	0.8	1.9	0.0	0.3	0.5	0.1
11.	Change in gross debt (5)	:	2.6	0.7	1.4	– 0.2	0.1	0.7	0.2
12.	Level of gross debt (end of year)	:	27.4	28.1	29.5	29.4	29.4	30.2	30.4

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.12

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Slovakia									
1.	Net borrowing (1)	0.9	12.3	6.0	5.7	3.7	3.3	3.8	4.0
2.	Interest payments	2.3	4.1	4.0	3.6	2.5	2.2	2.4	2.2
3.	Implicit interest rate (2)	:	9.5	8.7	8.0	6.4	5.7	5.8	5.5
4.	Nominal GDP growth rate (%)	16.3	10.7	8.1	8.8	9.3	10.3	8.0	8.0
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (1)	0.9	12.3	6.0	5.7	3.7	3.3	3.8	4.0
6.	Contribution of nominal GDP growth	:	– 4.5	– 3.7	– 3.9	– 3.7	– 4.0	– 3.2	– 3.3
7.	Stock-flow adjustment (3)	:	– 5.1	– 3.4	– 7.2	– 0.7	1.7	0.0	0.0
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (4)	– 1.5	8.2	2.0	2.1	1.2	1.1	1.4	1.7
9.	Snowball effect	:	– 0.5	0.3	– 0.3	– 1.2	– 1.8	– 0.9	– 1.0
10.	Stock-flow adjustment (3)	:	– 5.1	– 3.4	– 7.2	– 0.7	1.7	0.0	0.0
11.	Change in gross debt (5)	:	2.7	– 1.1	– 5.5	– 0.7	1.0	0.5	0.7
12.	Level of gross debt (end of year)	:	49.9	48.7	43.3	42.6	43.6	44.2	44.9
Sweden (*)									
1.	Net borrowing (1)	6.9	– 5.0	– 2.5	0.3	– 0.2	– 1.4	– 0.8	– 0.8
2.	Interest payments	6.6	4.1	3.2	3.0	2.1	1.8	2.0	2.1
3.	Implicit interest rate (2)	9.8	6.9	6.2	5.8	4.2	3.6	4.2	4.4
4.	Nominal GDP growth rate (%)	7.6	5.7	3.4	3.7	3.6	4.3	4.4	4.9
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (1)	6.9	– 5.0	– 2.5	0.3	– 0.2	– 1.4	– 0.8	– 0.8
6.	Contribution of nominal GDP growth	– 5.2	– 3.4	– 1.7	– 1.9	– 1.8	– 2.1	– 2.2	– 2.3
7.	Stock-flow adjustment (3)	– 2.0	– 1.6	5.7	– 0.2	1.6	2.8	2.1	2.1
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (4)	0.3	– 9.1	– 5.7	– 2.8	– 2.3	– 3.2	– 2.9	– 2.9
9.	Snowball effect	1.5	0.7	1.4	1.1	0.3	– 0.3	– 0.1	– 0.3
10.	Stock-flow adjustment (3)	– 2.0	– 1.6	5.7	– 0.2	1.6	2.8	2.1	2.1
11.	Change in gross debt (5)	– 0.2	– 9.9	1.5	– 1.9	– 0.4	– 0.8	– 1.0	– 1.0
12.	Level of gross debt (end of year)	73.7	52.8	54.3	52.4	52.0	51.2	50.3	49.2

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.13

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
United Kingdom									
1.	Net borrowing (1)	5.8	– 3.8	– 0.7	1.7	3.4	3.2	3.0	2.7
2.	Interest payments	3.6	2.7	2.4	2.1	2.1	2.1	2.1	2.1
3.	Implicit interest rate (2)	7.8	6.4	5.9	5.6	5.7	5.4	5.2	5.2
4.	Nominal GDP growth rate (%)	5.6	5.2	4.6	5.0	5.5	5.2	5.0	5.4
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (1)	5.8	– 3.8	– 0.7	1.7	3.4	3.2	3.0	2.7
6.	Contribution of nominal GDP growth	– 2.6	– 2.2	– 1.8	– 1.8	– 2.0	– 1.9	– 2.0	– 2.1
7.	Stock-flow adjustment (3)	– 0.1	3.1	– 0.7	– 0.3	0.0	0.6	– 0.7	– 0.1
Budgetary constraint based on the primary deficit									
8.	Primary deficit (4)	2.2	– 6.6	– 3.1	– 0.3	1.3	1.1	1.0	0.7
9.	Snowball effect	1.0	0.5	0.5	0.2	0.1	0.1	0.1	– 0.1
10.	Stock-flow adjustment (3)	– 0.1	3.1	– 0.7	– 0.3	0.0	0.6	– 0.7	– 0.1
11.	Change in gross debt (5)	3.2	– 3.0	– 3.3	– 0.4	1.4	1.9	0.4	0.5
12.	Level of gross debt (end of year)	51.8	42.0	38.8	38.3	39.7	41.6	41.9	42.5

(1) Line 1 = line 5, a minus sign means a surplus.
(2) Actual interest payments as a percentage of gross debt at the end of t–1.
(3) Line 7 = line 10.
(4) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(5) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.2.14

Contributions to the change in the general government gross debt ratio

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
EUR-12 (1)									
1.	Net borrowing (2)	5.1	– 0.1	1.8	2.5	2.9	2.7	2.6	2.7
2.	Interest payments	5.6	4.1	4.0	3.7	3.5	3.4	3.3	3.3
3.	Implicit interest rate (3)	8.5	5.8	5.9	5.4	5.1	4.9	4.7	4.7
4.	Nominal GDP growth rate (%)	4.7	4.9	4.1	3.4	2.6	4.0	3.4	3.8
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (2)	5.1	– 0.1	1.8	2.5	2.9	2.7	2.6	2.7
6.	Contribution of nominal GDP growth	– 3.1	– 3.4	– 2.8	– 2.3	– 1.8	– 2.7	– 2.3	– 2.7
7.	Stock-flow adjustment (4)	2.7	1.0	0.2	– 0.2	0.2	0.4	0.2	0.1
Budgetary constraint based on the primary deficit									
8.	Primary deficit (5)	–0.5	– 4.2	– 2.2	– 1.2	– 0.6	– 0.6	– 0.7	– 0.6
9.	Snowball effect	2.5	0.6	1.2	1.4	1.7	0.6	1.0	0.6
10.	Stock-flow adjustment (4)	2.7	1.0	0.2	– 0.2	0.2	0.4	0.2	0.1
11.	Change in gross debt (6)	4.7	– 2.5	– 0.8	– 0.1	1.3	0.4	0.5	0.1
12.	Level of gross debt (end of year)	73.8	70.6	69.8	69.7	71.0	71.5	72.0	72.1

(1) Due to problems with availability of the data, Luxembourg data are not included.
(2) Line 1 = line 5, a minus sign means a surplus.
(3) Actual interest payments as a percentage of gross debt at the end of t–1.
(4) Line 7 = line 10.
(5) Net borrowing excluding interest payments, line 8 = line 1 – line 2. A minus sign means a primary surplus.
(6) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10.

Source: Commission services.

Table A.3.1

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Belgium									
Total resources									
1.	Actual data	48.5	49.4	49.9	50.3	51.3	49.6	49.1	48.5
2.	Cyclical component	– 0.2	1.1	1.0	0.6	– 0.3	– 0.5	– 0.6	– 0.6
3.	Cyclically adjusted data	48.7	48.3	49.5	50.4	51.8	49.8	49.3	48.5
Total uses									
4.	Actual data	52.9	49.3	49.4	50.2	51.0	49.6	49.4	49.1
5.	Cyclical component	0.1	– 0.3	– 0.1	0.0	0.1	0.1	0.0	0.0
6.	Cyclically adjusted data	52.9	49.5	49.6	50.2	50.8	49.4	49.3	49.0
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 4.4	0.2	0.6	0.1	0.4	0.1	– 0.2	– 0.6
8.	Cyclical component	– 0.6	1.2	0.3	– 0.4	– 0.8	– 0.5	– 0.4	– 0.4
9.	Cyclically adjusted balance	– 3.8	– 1.0	0.1	0.5	1.2	0.6	0.3	– 0.2
	— as % of potential GDP	– 3.8	– 1.0	0.1	0.5	1.1	0.6	0.3	– 0.2
10.	GDP at 1995 market prices (annual % change)	2.4	3.9	0.7	0.9	1.3	2.7	2.2	2.3
11.	Potential GDP at 1995 market prices (annual % change)	2.2	2.4	2.1	2.0	2.0	2.2	2.1	2.2
12.	Gap between actual and potential GDP (% of potential GDP)	– 0.9	1.9	0.5	– 0.6	– 1.3	– 0.8	– 0.7	– 0.6
Germany									
Total resources									
1.	Actual data	46.1	47.1	45.5	45.1	45.0	43.8	43.6	43.4
2.	Cyclical component	0.2	0.7	0.5	0.0	– 0.6	– 0.4	– 0.6	– 0.4
3.	Cyclically adjusted data	45.9	46.3	44.9	45.1	45.6	44.2	44.2	43.8
Total uses									
4.	Actual data	49.4	45.7	48.3	48.7	48.8	47.5	47.0	46.2
5.	Cyclical component	0.0	– 0.1	0.0	0.0	0.1	0.0	0.1	0.0
6.	Cyclically adjusted data	49.5	48.3	48.3	48.7	48.8	47.5	46.9	46.1
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 3.3	1.3	– 2.8	– 3.7	– 3.8	– 3.7	– 3.3	– 2.8
8.	Cyclical component	– 0.1	0.5	0.3	– 0.1	– 0.6	– 0.4	– 0.6	– 0.5
9.	Cyclically adjusted balance	– 3.2	– 1.7	– 3.2	– 3.6	– 3.2	– 3.3	– 2.8	– 2.3
	— as % of potential GDP	– 3.2	– 1.7	– 3.2	– 3.6	– 3.2	– 3.3	– 2.7	– 2.3
10.	GDP at 1995 market prices (annual % change)	1.7	2.9	0.8	0.1	– 0.1	1.6	0.8	1.6
11.	Potential GDP at 1995 market prices (annual % change)	2.1	1.4	1.2	1.0	0.9	1.1	1.2	1.3
12.	Gap between actual and potential GDP (% of potential GDP)	– 0.3	1.0	0.7	– 0.2	– 1.2	–0.8	– 1.2	– 1.0

Source: Commission services.

Table A.3.2

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Greece									
Total resources									
1.	Actual data	40.9	47.9	46.5	45.2	43.5	43.9	44.3	44.3
2.	Cyclical component	– 0.7	0.0	0.3	0.3	0.6	0.8	0.5	0.3
3.	Cyclically adjusted data	41.6	47.9	46.3	45.0	42.9	43.1	43.8	44.0
Total uses									
4.	Actual data	51.0	52.1	50.2	49.0	48.1	49.9	48.8	48.7
5.	Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	51.0	52.0	50.7	49.0	48.0	50.0	48.8	48.7
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 10.2	– 4.1	– 3.6	– 4.1	– 5.2	– 6.1	– 4.5	– 4.4
8.	Cyclical component	– 1.2	– 0.3	0.1	0.2	0.5	1.0	0.9	0.9
9.	Cyclically adjusted balance	– 9.0	– 3.8	– 4.2	– 4.3	– 5.7	– 7.1	– 5.4	– 5.3
	— as % of potential GDP	– 8.7	– 3.8	– 4.2	– 4.3	– 5.8	– 7.3	– 5.6	– 5.5
10.	GDP at 1995 market prices (annual % change)	2.1	4.5	4.3	3.8	4.7	4.2	2.9	3.1
11.	Potential GDP at 1995 market prices (annual % change)	2.1	3.6	3.4	3.4	3.9	3.0	3.1	3.1
12.	Gap between actual and potential GDP (% of potential GDP)	– 3.1	– 0.6	0.2	0.5	1.3	2.4	2.2	2.2
Spain									
Total resources									
1.	Actual data	38.4	39.1	39.2	39.8	40.0	40.2	40.4	40.5
2.	Cyclical component	– 0.7	0.7	0.6	0.3	0.1	0.1	0.0	– 0.1
3.	Cyclically adjusted data	39.1	38.4	38.6	39.5	39.9	40.2	40.4	40.6
Total uses									
4.	Actual data	45.0	40.0	39.7	40.1	39.7	40.5	40.4	40.4
5.	Cyclical component	0.1	– 0.1	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	44.9	40.1	39.7	40.1	39.7	40.5	40.4	40.4
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 6.6	– 0.9	– 0.5	– 0.3	0.3	– 0.3	0.0	0.1
8.	Cyclical component	– 0.8	0.7	0.6	0.3	0.1	0.1	0.0	– 0.1
9.	Cyclically adjusted balance	– 5.8	– 1.7	– 1.1	– 0.6	0.2	– 0.3	0.0	0.2
	— as % of potential GDP	– 5.2	– 1.4	– 0.7	0.0	1.1	0.6	1.0	1.2
10.	GDP at 1995 market prices (annual % change)	2.8	4.4	2.8	2.2	2.5	2.7	2.7	2.7
11.	Potential GDP at 1995 market prices (annual % change)	2.8	3.1	3.1	3.0	3.0	2.9	2.9	2.9
12.	Gap between actual and potential GDP (% of potential GDP)	– 2.1	1.9	1.6	0.8	0.4	0.1	0.0	– 0.2

Source: Commission services.

Table A.3.3

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
France									
Total resources									
1.	Actual data	49.7	51.2	50.9	50.2	50.4	50.8	51.5	51.1
2.	Cyclical component	– 0.4	0.6	0.6	0.3	– 0.2	– 0.1	– 0.1	0.0
3.	Cyclically adjusted data	50.1	50.6	50.4	50.0	50.6	50.9	51.6	51.1
Total uses									
4.	Actual data	55.2	52.6	52.5	53.4	54.6	54.5	54.5	54.4
5.	Cyclical component	0.1	– 0.2	– 0.2	– 0.1	0.1	0.0	0.0	0.0
6.	Cyclically adjusted data	55.1	52.7	52.7	53.5	54.6	54.5	54.5	54.4
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 5.5	– 1.4	– 1.5	– 3.2	– 4.2	– 3.7	– 3.0	– 3.4
8.	Cyclical component	– 0.6	0.8	0.7	0.4	– 0.3	– 0.1	– 0.2	– 0.3
9.	Cyclically adjusted balance	– 4.9	– 2.2	– 2.4	– 3.6	– 4.0	– 3.6	– 2.8	– 3.1
	— as % of potential GDP	– 4.8	– 2.3	– 2.4	– 3.6	– 3.9	– 3.6	– 2.8	– 3.0
10.	GDP at 1995 market prices (annual % change)	1.7	3.8	2.1	1.2	0.5	2.5	2.0	2.2
11.	Potential GDP at 1995 market prices (annual % change)	1.8	2.3	2.3	2.1	2.1	2.2	2.3	2.4
12.	Gap between actual and potential GDP (% of potential GDP)	– 1.4	2.0	1.8	1.0	– 0.6	– 0.3	– 0.6	– 0.7
Ireland									
Total resources									
1.	Actual data	39.5	36.4	34.5	33.6	34.6	35.7	34.5	34.0
2.	Cyclical component	– 1.0	1.5	1.1	0.9	0.4	0.2	0.1	0.0
3.	Cyclically adjusted data	40.5	34.9	33.3	32.6	34.3	35.4	34.5	34.0
Total uses									
4.	Actual data	41.6	31.9	33.5	33.9	34.4	34.3	35.1	34.6
5.	Cyclical component	0.3	– 0.5	– 0.4	– 0.3	– 0.1	– 0.1	0.0	0.0
6.	Cyclically adjusted data	41.3	32.4	34.0	34.4	34.6	34.4	35.1	34.6
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 2.1	4.4	0.9	– 0.4	0.2	1.3	– 0.6	– 0.6
8.	Cyclical component	– 0.9	1.7	1.1	0.8	0.0	– 0.2	– 0.5	– 0.7
9.	Cyclically adjusted balance	– 1.2	2.7	– 0.2	– 1.4	0.2	1.6	– 0.1	0.1
	— as % of potential GDP	– 1.2	2.9	– 0.2	– 1.4	0.2	1.5	– 0.1	0.1
10.	GDP at 1995 market prices (annual % change)	9.8	9.9	6.0	6.1	3.7	5.4	4.9	5.1
11.	Potential GDP at 1995 market prices (annual % change)	7.0	8.1	7.7	7.0	6.5	6.1	5.8	5.7
12.	Gap between actual and potential GDP (% of potential GDP)	– 2.4	5.2	3.6	2.7	0.0	– 0.7	– 1.5	– 2.0

Source: Commission services.

Table A.3.4

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Italy									
Total resources									
1.	Actual data	45.8	46.2	46.0	45.6	46.3	45.4	44.6	44.0
2.	Cyclical component	– 0.1	0.5	0.7	0.3	– 0.2	– 0.2	– 0.3	– 0.1
3.	Cyclically adjusted data	45.9	45.7	45.4	45.4	46.5	45.6	44.8	44.1
Total uses									
4.	Actual data	53.4	46.9	49.0	48.4	49.3	48.5	48.2	48.5
5.	Cyclical component	0.0	– 0.1	– 0.1	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	53.4	48.1	49.0	48.2	49.2	48.4	48.2	48.5
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 7.6	– 0.6	– 3.0	– 2.6	– 2.9	– 3.0	– 3.6	– 4.6
8.	Cyclical component	0.1	0.9	0.9	0.3	– 0.3	– 0.6	– 0.7	– 0.6
9.	Cyclically adjusted balance	– 7.7	– 2.7	– 3.9	– 2.9	– 2.6	– 2.4	– 2.9	– 4.0
	— as % of potential GDP	– 7.7	– 2.8	– 3.9	– 3.0	– 2.6	– 2.4	– 2.9	– 3.9
10.	GDP at 1995 market prices (annual % change)	2.9	3.0	1.8	0.4	0.3	1.2	1.2	1.7
11.	Potential GDP at 1995 market prices (annual % change)	1.2	1.8	1.7	1.6	1.7	1.9	1.5	1.4
12.	Gap between actual and potential GDP (% of potential GDP)	0.2	2.0	2.1	0.8	– 0.6	– 1.3	– 1.6	– 1.4
Luxembourg									
Total resources									
1.	Actual data	47.6	44.7	45.3	46.0	45.5	44.9	44.4	44.2
2.	Cyclical component	– 1.6	2.2	1.1	0.3	– 0.1	0.0	0.0	0.2
3.	Cyclically adjusted data	49.2	42.5	44.2	45.6	45.7	44.9	44.4	44.0
Total uses									
4.	Actual data	45.0	38.5	39.1	43.7	45.1	46.0	46.0	46.0
5.	Cyclical component	0.7	– 1.0	– 0.5	– 0.1	0.1	0.0	0.0	– 0.1
6.	Cyclically adjusted data	44.4	39.5	39.6	43.8	45.0	46.0	46.0	46.1
Net lending (+) or net borrowing (–)									
7.	Actual balance	2.5	6.2	6.2	2.3	0.5	– 1.1	– 1.5	– 1.9
8.	Cyclical component	– 2.0	3.1	1.0	– 0.2	– 0.8	– 0.8	– 1.0	– 1.2
9.	Cyclically adjusted balance	4.6	3.1	5.2	2.5	1.3	– 0.3	– 0.6	– 0.6
	— as % of potential GDP	4.4	3.3	5.3	2.5	1.3	– 0.3	– 0.6	– 0.6
10.	GDP at 1995 market prices (annual % change)	1.4	9.0	1.5	2.5	2.9	4.2	3.8	4.0
11.	Potential GDP at 1995 market prices (annual % change)	4.8	5.4	5.4	4.5	4.0	4.1	4.2	4.4
12.	Gap between actual and potential GDP (% of potential GDP)	– 3.2	5.5	1.6	– 0.4	– 1.4	– 1.3	– 1.6	– 2.0

Source: Commission services.

Table A.3.5

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
The Netherlands									
Total resources									
1.	Actual data	47.3	47.5	46.6	45.9	45.8	45.5	45.8	47.6
2.	Cyclical component	– 0.6	1.4	1.1	0.6	– 0.3	– 0.4	– 0.6	– 0.4
3.	Cyclically adjusted data	47.9	46.1	45.5	45.3	46.1	45.9	46.5	48.1
Total uses									
4.	Actual data	51.4	45.3	46.7	47.8	49.0	48.0	47.9	49.3
5.	Cyclical component	0.4	– 1.0	– 0.8	– 0.5	0.3	0.3	0.5	0.3
6.	Cyclically adjusted data	51.0	47.0	47.4	48.3	48.8	47.7	47.4	48.9
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 4.2	2.2	– 0.1	– 1.9	– 3.2	– 2.5	– 2.0	– 1.6
8.	Cyclical component	– 0.9	2.1	1.4	0.3	– 1.3	– 1.3	– 1.7	– 1.6
9.	Cyclically adjusted balance	– 3.3	– 0.6	– 1.4	– 2.3	– 2.0	– 1.2	– 0.4	0.0
	— as % of potential GDP	– 3.2	– 0.6	– 1.5	– 2.3	– 2.0	– 1.2	– 0.4	0.0
10.	GDP at 1995 market prices (annual % change)	3.0	3.5	1.4	0.6	– 0.9	1.3	1.0	2.0
11.	Potential GDP at 1995 market prices (annual % change)	2.7	2.7	2.6	2.1	1.6	1.4	1.6	1.9
12.	Gap between actual and potential GDP (% of potential GDP)	– 1.3	3.3	2.1	0.5	– 1.9	– 1.9	– 2.5	– 2.4
Austria									
Total resources									
1.	Actual data	50.9	50.5	51.7	50.8	50.0	49.4	48.1	47.4
2.	Cyclical component	– 0.2	0.6	0.3	0.1	– 0.3	– 0.2	– 0.1	0.0
3.	Cyclically adjusted data	51.1	49.8	51.4	50.7	50.3	49.6	48.2	47.4
Total uses									
4.	Actual data	56.8	52.1	51.6	51.2	51.3	50.8	50.3	49.3
5.	Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	56.7	52.4	51.4	51.0	51.2	50.7	50.1	49.2
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 5.8	– 1.5	0.3	– 0.2	– 1.1	– 1.3	– 2.0	– 1.7
8.	Cyclical component	– 0.3	0.6	0.2	0.0	– 0.3	– 0.2	– 0.2	– 0.1
9.	Cyclically adjusted balance	– 5.4	– 2.5	0.0	– 0.3	– 0.8	– 1.1	– 1.9	– 1.6
	— as % of potential GDP	– 5.3	– 2.5	0.0	– 0.2	– 0.8	– 1.1	– 1.8	– 1.6
10.	GDP at 1995 market prices (annual % change)	1.9	3.4	0.7	1.2	0.8	2.0	2.1	2.1
11.	Potential GDP at 1995 market prices (annual % change)	2.2	2.3	2.1	1.8	1.9	1.8	1.9	1.9
12.	Gap between actual and potential GDP (% of potential GDP)	– 1.0	2.2	0.8	0.1	– 1.0	– 0.8	– 0.6	– 0.4

Source: Commission services.

Table A.3.6

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Portugal									
Total resources									
1.	Actual data	39.6	42.3	41.9	43.3	44.8	43.8	42.5	43.1
2.	Cyclical component	– 0.8	1.1	1.0	0.6	– 0.3	– 0.5	– 0.6	– 0.6
3.	Cyclically adjusted data	40.3	41.2	41.0	42.7	45.1	44.3	43.1	43.7
Total uses									
4.	Actual data	45.0	45.2	46.3	46.0	47.8	46.7	47.4	47.8
5.	Cyclical component	0.1	– 0.1	– 0.1	– 0.1	0.0	0.0	0.1	0.1
6.	Cyclically adjusted data	45.0	45.5	46.4	46.0	47.7	46.6	47.3	47.8
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 5.5	– 2.8	– 4.4	– 2.7	– 2.9	– 2.9	– 4.9	– 4.7
8.	Cyclical component	– 1.0	0.9	0.6	0.2	– 0.7	– 0.9	– 1.0	– 0.9
9.	Cyclically adjusted balance	– 4.5	– 4.0	– 5.0	– 2.9	– 2.2	– 2.1	– 3.9	– 3.7
	— as % of potential GDP	– 4.4	– 4.1	– 5.1	– 2.9	– 2.1	– 2.0	– 3.8	– 3.6
10.	GDP at 1995 market prices (annual % change)	4.3	3.4	1.7	0.4	– 1.1	1.0	1.1	1.7
11.	Potential GDP at 1995 market prices (annual % change)	2.6	2.6	2.3	1.9	1.4	1.4	1.4	1.6
12.	Gap between actual and potential GDP (% of potential GDP)	– 2.9	2.5	1.9	0.4	– 2.0	– 2.5	– 2.8	– 2.7
Finland									
Total resources									
1.	Actual data	55.7	56.1	54.4	54.2	53.3	52.5	51.9	51.3
2.	Cyclical component	– 2.5	1.9	0.8	0.3	– 0.1	0.2	0.3	0.2
3.	Cyclically adjusted data	58.2	54.3	53.6	53.9	53.3	52.3	51.7	51.1
Total uses									
4.	Actual data	59.6	49.1	49.2	50.0	50.9	50.7	50.5	50.0
5.	Cyclical component	0.9	– 0.7	– 0.3	– 0.1	0.0	– 0.1	– 0.1	– 0.1
6.	Cyclically adjusted data	58.7	49.7	49.4	50.1	50.8	50.5	50.4	49.8
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 3.9	7.1	5.2	4.3	2.5	2.1	1.7	1.6
8.	Cyclical component	– 2.7	2.3	0.5	– 0.2	– 0.7	– 0.3	– 0.2	– 0.3
9.	Cyclically adjusted balance	– 1.2	4.7	4.7	4.5	3.2	2.4	1.9	1.8
	— as % of potential GDP	– 1.2	4.9	4.7	4.5	3.1	2.4	1.9	1.8
10.	GDP at 1995 market prices (annual % change)	3.4	5.1	1.1	2.2	2.4	3.7	3.3	2.9
11.	Potential GDP at 1995 market prices (annual % change)	1.8	3.6	3.7	3.4	3.1	3.1	3.1	3.0
12.	Gap between actual and potential GDP (% of potential GDP)	– 3.8	3.5	0.8	– 0.3	– 1.1	– 0.5	– 0.3	– 0.4

Source: Commission services.

Table A.3.7

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Czech Republic									
Total resources									
1.	Actual data	41.0	38.5	39.1	40.2	41.6	42.7	41.8	41.0
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	54.4	42.1	45.0	46.9	53.2	45.7	46.3	45.0
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 13.4	– 3.7	– 5.9	– 6.8	– 11.6	– 3.0	– 4.5	– 4.0
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	5.9	3.9	2.6	1.5	3.7	4.0	4.0	4.2
11.	Potential GDP at 1995 market prices (annual % change)	:	1.5	1.7	2.2	2.8	3.1	3.2	3.2
12.	Gap between actual and potential GDP (% of potential GDP)	:	– 2.3	– 1.4	– 2.2	– 1.3	– 0.3	0.4	1.4
Denmark									
Total resources									
1.	Actual data	57.6	56.7	57.4	56.6	56.6	57.7	56.5	55.7
2.	Cyclical component	– 0.1	1.1	0.8	0.3	– 0.5	– 0.5	– 0.2	– 0.1
3.	Cyclically adjusted data	57.7	55.7	56.6	56.3	57.1	58.2	56.7	55.8
Total uses									
4.	Actual data	59.9	54.2	54.3	55.1	55.5	55.2	54.5	53.7
5.	Cyclical component	0.0	– 0.5	– 0.3	– 0.1	0.2	0.2	0.1	0.0
6.	Cyclically adjusted data	59.8	54.5	54.8	55.1	55.1	54.8	54.2	53.5
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 2.3	2.6	3.2	1.7	1.2	2.8	2.1	2.2
8.	Cyclical component	– 0.3	1.4	1.0	0.3	– 0.8	– 0.6	– 0.4	– 0.2
9.	Cyclically adjusted balance	– 1.9	1.2	1.9	1.4	2.0	3.4	2.5	2.4
	— as % of potential GDP	– 1.9	1.2	1.9	1.4	2.0	3.3	2.5	2.4
10.	GDP at 1995 market prices (annual % change)	2.8	2.8	1.6	1.0	0.4	2.0	2.3	2.1
11.	Potential GDP at 1995 market prices (annual % change)	2.1	2.2	2.1	2.0	1.8	1.8	2.0	2.0
12.	Gap between actual and potential GDP (% of potential GDP)	– 0.4	1.8	1.3	0.3	– 1.0	– 0.8	– 0.4	– 0.3

Source: Commission services.

Table A.3.8

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Estonia									
Total resources									
1.	Actual data	43.9	37.7	37.2	38.0	38.9	40.9	40.8	39.2
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	43.4	38.2	36.9	36.6	35.8	39.1	40.0	38.7
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	0.4	– 0.6	0.3	1.4	3.1	1.8	0.9	0.5
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	4.5	7.8	6.4	7.2	5.1	6.2	6.0	6.2
11.	Potential GDP at 1995 market prices (annual % change)	:	4.7	5.3	6.1	6.2	6.4	6.3	6.2
12.	Gap between actual and potential GDP (% of potential GDP)	– 7.4	– 1.2	– 0.1	1.0	0.0	– 0.2	– 0.5	– 0.5
Cyprus									
Total resources									
1.	Actual data	:	35.3	36.6	36.1	39.1	39.4	39.4	38.9
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	:	37.7	38.9	40.6	45.4	43.6	42.3	40.7
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	:	– 2.4	– 2.3	– 4.5	– 6.3	– 4.2	– 2.9	– 1.9
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	9.9	5.0	4.1	2.1	2.0	3.7	3.9	4.2
11.	Potential GDP at 1995 market prices (annual % change)	:	3.7	3.6	3.9	3.1	3.9	3.3	3.4
12.	Gap between actual and potential GDP (% of potential GDP)	1.6	1.5	1.9	0.2	– 0.9	– 1.1	– 0.6	0.2

Source: Commission services.

Table A.3.9

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Latvia									
Total resources									
1.	Actual data	37.3	35.1	34.4	33.1	34.2	35.2	35.4	35.3
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	39.3	37.9	36.5	35.8	35.7	35.9	37.0	36.8
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 2.0	– 2.8	– 2.1	– 2.7	– 1.5	– 0.8	– 1.6	– 1.5
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	– 0.9	6.9	8.0	6.4	7.5	8.5	7.2	6.9
11.	Potential GDP at 1995 market prices (annual % change)	:	5.5	6.4	6.8	6.8	7.5	8.1	8.2
12.	Gap between actual and potential GDP (% of potential GDP)	– 3.2	– 1.5	0.1	– 0.3	0.4	1.3	0.5	– 0.7
Lithuania									
Total resources									
1.	Actual data	34.2	35.8	33.0	32.8	32.3	31.8	32.3	31.6
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	36.1	38.4	35.0	34.3	34.2	34.3	34.8	33.6
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 1.9	– 2.5	– 2.0	– 1.5	– 1.9	– 2.5	– 2.4	– 1.9
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	3.3	3.9	6.4	6.8	9.7	6.7	6.4	5.9
11.	Potential GDP at 1995 market prices (annual % change)	:	3.6	4.4	5.5	6.2	6.3	6.7	6.9
12.	Gap between actual and potential GDP (% of potential GDP)	– 5.3	– 4.5	– 2.8	– 1.6	1.7	2.0	1.7	0.8

Source: Commission services.

Table A.3.10

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Hungary									
Total resources									
1.	Actual data	:	45.3	45.0	44.1	44.5	47.5	43.9	43.0
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	:	47.7	48.7	52.7	50.7	52.0	47.8	47.1
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	:	– 2.4	– 3.7	– 8.5	– 6.2	– 4.5	– 3.9	– 4.1
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	1.5	5.2	3.8	3.5	3.0	4.0	3.9	3.8
11.	Potential GDP at 1995 market prices (annual % change)	:	4.0	4.0	3.9	3.7	3.9	3.8	3.7
12.	Gap between actual and potential GDP (% of potential GDP)	2.2	0.4	0.2	– 0.2	– 0.8	– 0.7	– 0.6	– 0.5
Malta									
Total resources									
1.	Actual data	:	36.0	37.6	40.0	40.5	49.0	48.8	48.6
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	:	42.3	44.1	45.8	50.9	54.1	52.6	51.4
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	:	– 6.3	– 6.4	– 5.9	– 10.5	– 5.2	– 3.9	– 2.8
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	6.2	6.4	– 1.7	2.2	– 1.8	1.5	1.7	1.9
11.	Potential GDP at 1995 market prices (annual % change)	:	3.7	2.8	0.6	1.5	1.9	2.0	1.9
12.	Gap between actual and potential GDP (% of potential GDP)	– 2.3	4.7	0.1	1.7	– 1.6	– 2.0	– 2.2	– 2.2

Source: Commission services.

Table A.3.11

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Poland									
Total resources									
1.	Actual data	47.4	42.5	43.8	43.9	44.3	43.8	44.2	44.2
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	51.3	44.9	47.4	48.3	49.1	48.8	48.6	47.9
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 3.9	– 2.4	– 3.6	– 4.3	– 4.7	– 4.9	– 4.4	– 3.6
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	7.0	4.0	1.0	1.4	3.8	5.3	4.4	4.5
11.	Potential GDP at 1995 market prices (annual % change)	:	3.7	3.1	2.5	2.5	3.3	3.6	3.8
12.	Gap between actual and potential GDP (% of potential GDP)	– 4.2	0.0	– 2.0	– 3.1	– 1.9	0.1	0.8	1.5
Slovenia									
Total resources									
1.	Actual data	:	44.7	45.1	45.7	46.2	45.8	45.4	45.1
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	:	48.2	47.9	48.1	48.2	47.7	47.6	47.2
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	:	– 3.5	– 2.8	– 2.4	– 2.0	– 1.9	– 2.2	– 2.1
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	4.1	3.9	2.7	3.3	2.5	4.6	3.7	4.0
11.	Potential GDP at 1995 market prices (annual % change)	:	4.1	3.9	3.7	3.8	3.5	3.4	3.3
12.	Gap between actual and potential GDP (% of potential GDP)	:	1.0	– 0.2	– 0.5	– 1.7	– 0.7	– 0.4	0.2

Source: Commission services.

Table A.3.12

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
Slovakia									
Total resources									
1.	Actual data	53.3	47.6	45.5	45.2	35.4	35.1	36.1	34.8
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	54.1	59.9	51.5	50.9	39.2	38.5	39.9	38.8
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 0.9	– 12.3	– 6.0	– 5.7	– 3.7	– 3.3	– 3.8	– 4.0
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	5.8	2.0	3.8	4.6	4.5	5.5	4.9	5.2
11.	Potential GDP at 1995 market prices (annual % change)	:	2.7	3.7	4.6	4.9	3.9	3.9	4.1
12.	Gap between actual and potential GDP (% of potential GDP)	:	– 1.8	– 1.8	– 1.7	– 2.2	– 0.6	0.3	1.3
Sweden									
Total resources									
1.	Actual data	60.8	62.3	59.5	57.8	58.6	58.4	57.8	57.4
2.	Cyclical component	– 0.5	1.5	0.6	0.2	– 0.4	0.0	0.2	0.3
3.	Cyclically adjusted data	61.2	60.8	58.9	57.6	59.0	58.4	57.6	57.1
Total uses									
4.	Actual data	67.7	57.4	57.0	58.4	58.7	57.2	57.0	56.6
5.	Cyclical component	0.1	– 0.4	– 0.2	– 0.1	0.1	0.0	– 0.1	– 0.1
6.	Cyclically adjusted data	67.7	57.8	57.2	58.2	58.3	57.0	57.1	56.7
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 6.9	5.0	2.5	– 0.3	0.2	1.4	0.8	0.8
8.	Cyclical component	– 2.5	0.7	– 0.3	– 0.6	– 1.1	– 0.2	0.0	0.1
9.	Cyclically adjusted balance	– 4.5	4.2	2.9	0.3	1.3	1.7	0.8	0.7
	— as % of potential GDP	– 4.4	4.3	2.9	0.3	1.3	1.7	0.8	0.7
10.	GDP at 1995 market prices (annual % change)	4.1	4.3	1.0	2.0	1.5	3.5	3.0	2.8
11.	Potential GDP at 1995 market prices (annual % change)	2.7	2.6	2.6	2.4	2.2	2.1	2.7	2.7
12.	Gap between actual and potential GDP (% of potential GDP)	– 3.6	1.0	– 0.5	– 0.9	– 1.6	– 0.3	0.0	0.1

Source: Commission services.

Table A.3.13

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
United Kingdom									
Total resources									
1.	Actual data	39.1	41.2	41.5	40.0	40.0	40.4	40.9	41.4
2.	Cyclical component	– 0.3	0.6	0.4	0.0	– 0.1	0.1	0.1	0.2
3.	Cyclically adjusted data	39.4	40.6	41.1	39.9	40.2	40.3	40.8	41.1
Total uses									
4.	Actual data	44.9	37.4	40.9	41.7	43.4	43.6	44.0	44.1
5.	Cyclical component	0.1	– 0.1	– 0.1	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	44.9	39.8	40.9	41.7	43.3	43.6	44.0	44.1
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 5.8	3.8	0.7	– 1.7	– 3.4	– 3.2	– 3.0	– 2.7
8.	Cyclical component	– 0.2	0.6	0.4	– 0.1	– 0.4	– 0.2	– 0.1	– 0.1
9.	Cyclically adjusted balance	– 5.6	0.8	0.3	– 1.6	– 3.0	– 3.0	– 2.9	– 2.6
	— as % of potential GDP	– 5.6	0.8	0.3	– 1.6	– 2.9	– 3.0	– 2.9	– 2.6
10.	GDP at 1995 market prices (annual % change)	2.9	3.9	2.3	1.8	2.2	3.1	2.8	2.8
11.	Potential GDP at 1995 market prices (annual % change)	2.4	2.9	2.9	2.7	2.9	2.6	2.6	2.8
12.	Gap between actual and potential GDP (% of potential GDP)	– 0.4	1.3	0.8	– 0.2	– 0.8	– 0.4	– 0.3	– 0.3

Source: Commission services.

Table A.3.14

Cyclical adjustment of general government receipts, expenditures and budget balances

(% of GDP)

		ESA 95 definitions							
		1995	2000	2001	2002	2003	2004	2005	2006
EUR-12 ([1])									
Total resources									
1.	Actual data	46.5	47.2	46.5	46.1	46.3	45.7	45.6	45.4
2.	Cyclical component	– 0.2	0.7	0.6	0.2	– 0.3	– 0.2	– 0.3	– 0.2
3.	Cyclically adjusted data	46.7	46.5	45.9	45.9	46.5	45.9	45.9	45.6
Total uses									
4.	Actual data	51.5	47.2	48.3	48.6	49.1	48.5	48.2	48.1
5.	Cyclical component	0.1	– 0.2	– 0.1	– 0.1	0.0	0.0	0.1	0.0
6.	Cyclically adjusted data	51.5	48.3	48.5	48.7	49.0	48.4	48.2	48.0
Net lending (+) or net borrowing (–)									
7.	Actual balance	– 5.1	0.1	– 1.7	– 2.4	– 2.8	– 2.7	– 2.6	– 2.7
8.	Cyclical component	– 0.4	0.8	0.6	0.1	– 0.5	– 0.4	– 0.6	– 0.6
9.	Cyclically adjusted balance	– 4.6	– 1.8	– 2.4	– 2.6	– 2.4	– 2.4	– 2.1	– 2.2
	— as % of potential GDP	– 4.6	– 1.8	– 2.4	– 2.6	– 2.3	– 2.3	– 2.0	– 2.1
10.	GDP at 1995 market prices (annual % change)	2.2	3.5	1.6	0.9	0.5	2.0	1.6	2.0
11.	Potential GDP at 1995 market prices (annual % change)	2.0	2.2	2.1	1.9	1.9	1.9	1.9	2.0
12.	Gap between actual and potential GDP (% of potential GDP)	– 1.0	1.7	1.3	0.3	– 1.1	– 0.9	– 1.2	– 1.2
EU-25									
Total resources									
1.	Actual data	:	46.6	46.0	45.4	45.6	45.3	45.2	45.1
2.	Cyclical component	:	:	:	:	:	:	:	:
3.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Total uses									
4.	Actual data	:	45.8	47.3	47.7	48.5	48.0	47.8	47.6
5.	Cyclical component	:	:	:	:	:	:	:	:
6.	Cyclically adjusted data	:	:	:	:	:	:	:	:
Net lending (+) or net borrowing (–)									
7.	Actual balance	:	0.8	– 1.2	– 2.3	– 2.9	– 2.7	– 2.6	– 2.5
8.	Cyclical component	:	:	:	:	:	:	:	:
9.	Cyclically adjusted balance	:	:	:	:	:	:	:	:
	— as % of potential GDP	:	:	:	:	:	:	:	:
10.	GDP at 1995 market prices (annual % change)	2.5	3.6	1.7	1.1	0.9	2.3	1.9	2.3
11.	Potential GDP at 1995 market prices (annual % change)	:	2.4	2.3	2.1	2.1	2.1	2.1	2.2
12.	Gap between actual and potential GDP (% of potential GDP)	:	1.6	1.1	0.1	– 1.1	– 0.8	– 1.0	– 0.9

([1]) From 1991, including former East Germany. Due to problem with availability of the data, Luxembourg data are not included.

Source: Commission services.

Table A.4.1

Current tax burden; total economy

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	46.8	47.5	47.7	48.0	47.2	47.2	47.4	46.6
DE (1)	42.2	43.8	42.0	41.5	41.6	40.7	40.4	40.3
EL	34.4	40.6	38.9	39.5	38.7	39.2	39.7	40.0
ES	34.0	36.1	35.9	36.5	36.7	37.0	37.2	37.3
FR	45.2	46.5	46.2	45.3	45.2	45.4	45.7	45.6
IE	35.1	33.1	31.3	30.1	31.2	32.3	31.4	31.0
IT	42.3	43.0	42.8	42.2	41.5	41.4	41.2	40.8
LU	43.5	41.3	41.5	42.0	42.1	41.6	41.3	41.1
NL	41.5	42.2	40.7	40.1	40.0	39.9	40.2	42.1
AT	44.1	45.3	47.1	45.9	45.2	44.9	43.8	43.2
PT	34.4	37.2	36.6	37.4	38.0	37.4	37.1	37.2
FI	46.5	47.9	45.9	45.6	44.6	43.9	43.7	43.4
Euro area (2)	42.2	43.3	42.5	42.0	41.8	41.6	41.5	41.4
CZ	36.2	34.5	34.5	35.5	36.2	36.1	34.8	34.3
DK	50.2	50.4	50.7	49.7	49.7	50.9	49.9	49.4
EE	37.9	32.4	31.6	32.4	33.4	32.6	32.3	31.4
CY	:	30.5	31.5	31.4	33.3	33.6	34.1	33.6
LV	33.7	30.3	29.1	28.9	29.1	28.5	27.7	27.3
LT	28.6	30.5	29.1	28.7	28.6	27.4	27.1	26.6
HU	:	40.2	40.0	39.5	39.8	:	:	:
MT	:	29.9	32.0	34.4	33.9	35.5	37.9	38.0
PL	40.2	36.2	36.6	36.1	36.6	35.5	35.5	35.5
SI	:	39.2	39.3	39.7	40.4	39.9	39.2	38.7
SK	41.6	34.3	32.9	33.1	31.2	:	:	:
SE	50.1	54.3	52.3	50.6	51.4	51.3	50.8	50.4
UK	36.5	38.5	38.3	36.8	36.8	37.5	38.0	38.4
EU-25	:	42.6	41.9	41.2	41.1	:	:	:

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.2

Social contributions received; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	16.8	16.1	16.4	16.7	16.5	16.0	15.8	15.5
DE (1)	18.8	18.6	18.5	18.5	18.6	18.2	18.0	17.8
EL	12.6	14.0	14.1	15.0	15.5	16.3	16.8	17.2
ES	13.0	13.3	13.5	13.5	13.7	13.6	13.7	13.7
FR	20.5	18.2	18.2	18.2	18.5	18.2	18.4	18.4
IE	6.8	5.7	5.8	5.8	6.0	6.2	6.2	6.1
IT	14.8	12.7	12.6	12.8	13.0	12.9	12.9	12.9
LU	12.5	11.2	12.0	12.2	12.4	12.2	12.0	11.9
NL	17.2	17.1	15.3	14.9	15.5	15.1	15.0	16.9
AT	17.3	16.8	16.7	16.5	16.5	16.4	16.4	16.3
PT	11.0	11.8	12.0	12.3	12.7	12.7	12.7	12.7
FI	14.8	12.3	12.6	12.3	12.1	12.0	12.3	12.6
Euro area (2)	17.4	16.2	16.0	16.0	16.2	15.9	15.9	15.9
CZ	14.4	14.5	14.5	15.0	15.1	14.8	14.8	14.6
DK	2.6	3.3	3.2	2.7	2.7	2.7	2.7	2.6
EE	13.1	11.4	11.1	11.4	11.5	11.2	11.2	10.9
CY	:	6.7	6.9	6.8	7.1	8.4	8.2	8.0
LV	12.2	10.2	9.4	9.6	9.2	8.8	8.2	7.8
LT	7.6	9.4	9.0	8.7	8.7	8.4	8.6	8.5
HU	15.6	13.9	14.0	13.9	13.5	13.6	13.5	13.4
MT	:	7.7	8.5	8.4	8.3	8.3	8.6	8.7
PL	11.7	14.0	15.3	14.7	14.1	13.1	12.9	12.7
SI	:	15.1	15.4	15.2	15.2	14.8	14.5	14.2
SK	14.4	13.8	13.7	13.6	12.4	12.4	12.5	12.0
SE	13.7	15.0	15.4	15.3	15.0	14.7	14.7	14.7
UK	7.5	7.6	7.6	7.4	8.0	8.1	8.1	8.1
EU-25	:	14.3	14.2	14.2	14.4	14.2	14.2	14.2

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.3

Current taxes on income and wealth (direct taxes); general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	16.7	17.3	17.6	17.6	17	17.1	17.3	– 17.3
DE (1)	11.1	12.5	11.1	10.8	10.6	10.2	10.1	– 10.1
EL	7.4	10.8	9.5	9.5	8.8	8.9	8.9	– 8.9
ES	10.1	10.5	10.4	10.9	10.6	10.7	10.7	– 10.7
FR	8.5	12.2	12.5	11.5	11.2	11.3	11.4	– 11.4
IE	13.6	13.5	12.9	11.7	12.2	12.5	11.7	– 11.7
IT	14.8	14.7	15.1	14.3	13.8	13.7	13.4	– 13.4
LU	17.5	15.4	15.5	16	15.7	13.9	13.5	– 13.5
NL	12.4	12.1	11.9	12	11.2	11	11.1	– 11.1
AT	11.8	13.2	15	14	13.5	13.1	12.3	– 12.3
PT	8.9	10.4	9.9	9.8	9.3	9.1	8.7	– 8.7
FI	17.4	21.4	19.5	19.3	18.1	17.8	17.4	– 17.4
Euro area (2)	11.4	13	12.6	12.1	11.8	11.7	11.6	– 11.6
CZ	9.6	8.4	8.9	9.3	9.8	9.4	8.4	– 8.4
DK	30.4	29.7	30	29.4	29.5	30.5	29.6	– 29.6
EE	10.9	8.1	7.6	7.9	8.7	8.7	7.6	– 7.6
CY	:	11.1	11.3	11.2	9.7	9.2	9.8	– 9.8
LV	7.8	8.3	8.5	8.7	8.5	8.4	8.2	– 8.2
LT	8.8	8.5	7.9	7.5	8.1	7.9	7.7	– 7.7
HU	9.4	9.9	10.4	10.4	9.7	9.7	9.4	– 9.4
MT	:	9.3	10.2	11.8	12.2	11.9	12.1	– 12.1
PL	12.8	7.4	6.9	6.6	7.2	7	7	– 7
SI	:	7.6	7.7	8	8.4	8.4	8.4	– 8.4
SK	11.6	7.6	7.4	7.4	7.2	5.7	5.6	– 19
SE	20.1	22.4	19.9	18	18.9	19.3	19	– 5.6
UK	14.9	16.7	16.8	15.7	15.2	15.6	16.3	– 16.3
EU-25	:	14	13.7	13.1	12.7	12.7	12.7	– 12.7

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.4

Taxes linked to imports and production (indirect taxes); general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	12.2	13.1	12.7	12.9	12.9	13.2	13.4	13.4
DE (1)	11.4	12	11.9	11.9	12	11.9	11.9	11.9
EL	13.5	15.2	14.7	15.1	14.7	14.3	14.3	14.5
ES	10.2	11.7	11.4	11.6	12	12.4	12.4	12.6
FR	15.4	15.5	15	15.1	15.1	15.5	15.5	15.4
IE	13.5	13.2	12	12.2	12.7	13.2	13.1	13
IT	12.1	15	14.5	14.7	14.4	14.4	14.6	14.5
LU	12.5	14.1	13.6	13.4	13.5	15	15.2	15.4
NL	10.7	12.1	12.6	12.6	12.7	13.1	13.4	13.3
AT	14	14.6	14.6	15	14.8	15	14.6	14.4
PT	13.6	14.4	14.2	15	15.6	15.3	15.4	15.4
FI	13.6	13.7	13.4	13.7	14.2	13.9	13.8	13.6
Euro area (2)	12.5	13.6	13.3	13.4	13.4	13.6	13.6	13.6
CZ	12.3	11.5	11.1	11.1	11.4	11.9	11.7	11.5
DK	16.9	17.2	17.3	17.5	17.3	17.5	17.5	17.2
EE	13.9	12.9	12.8	13.1	13.1	12.7	13.5	13.5
CY	:	12.7	13.2	13.4	16.5	16.1	16.1	16.2
LV	13.7	11.7	11.2	10.7	11.5	11.3	11.2	11.1
LT	12.3	12.5	12.2	12.5	11.9	11.1	10.8	10.5
HU	17.9	16.4	15.7	15.2	15.8	16.3	15.7	16
MT	:	12.9	13.4	14.2	13.4	15.3	17.2	17.2
PL	15.8	14.8	14.4	14.7	15.1	15.1	15.4	15.6
SI	:	16.5	16.2	16.5	16.8	16.7	16.4	16.1
SK	15.6	13	11.8	12	11.5	11.8	11.8	11.5
SE	15.6	16.4	16.5	17	17.1	17	16.8	16.6
UK	13.1	13.6	13.3	13.3	13.2	13.4	13.3	13.2
EU-25	:	13.7	13.5	13.6	13.6	13.8	13.8	13.7

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.5

Other current resources; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	3.1	2.9	3.0	2.9	2.7	2.6	2.5	2.4
DE (1)	3.5	2.9	3.1	3.0	2.9	2.6	2.7	2.5
EL	4.5	3.6	4.3	3.1	2.5	2.3	2.1	2.0
ES	4.1	3.4	3.6	3.4	3.3	3.1	3.0	3.0
FR	3.7	3.5	3.6	3.5	3.5	3.6	3.6	3.6
IE	2.8	2.1	2.2	2.1	2.0	2.1	1.8	1.7
IT	3.1	3.0	3.3	3.2	3.1	3.3	3.2	3.1
LU	5.6	4.5	4.8	4.6	4.2	4.0	3.9	3.8
NL	6.0	4.8	5.3	5.0	4.9	5.0	5.1	5.0
AT	4.9	3.3	4.2	4.1	4.1	3.8	3.6	3.6
PT	4.1	3.6	3.7	4.1	3.8	4.3	4.2	4.4
FI	7.3	6.2	6.4	6.2	6.0	5.9	5.8	5.7
Euro area (2)	3.8	3.3	3.5	3.4	3.3	3.2	3.2	3.1
CZ	6.9	6.7	7.0	6.8	7.6	7.8	8.1	7.7
DK	6.4	5.1	5.2	5.0	5.2	5.1	4.8	4.6
EE	8.8	4.1	5.0	4.7	4.2	5.6	6.2	5.8
CY	:	3.2	3.7	2.9	4.0	3.7	3.6	3.6
LV	6.4	7.2	7.4	5.9	6.3	6.0	5.5	5.2
LT	6.3	5.7	4.7	3.7	3.3	3.4	4.0	3.8
HU	:	6.0	5.7	5.7	6.6	5.5	5.3	5.2
MT	:	6.3	6.6	6.5	7.4	5.4	4.4	3.9
PL	4.9	4.1	4.1	4.0	4.3	3.6	3.9	4.1
SI	:	3.7	3.9	4.0	4.0	4.0	4.3	4.6
SK	13.8	15.1	14.3	13.8	6.0	4.8	5.7	5.5
SE	8.2	6.0	5.1	5.0	5.0	4.9	4.8	4.7
UK	2.9	2.5	2.7	2.4	2.3	2.2	2.2	2.2
EU-25	:	3.4	3.6	3.4	3.3	3.2	3.2	3.2

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.6

Total current resources; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	48.8	49.4	49.7	50.0	49.1	49.0	49.0	48.1
DE (1)	44.8	46.1	44.5	44.2	44.1	42.9	42.7	42.4
EL	38.1	43.5	42.6	42.7	41.5	41.8	42.1	42.3
ES	37.4	38.8	38.9	39.4	39.6	39.8	39.9	40.0
FR	48.1	49.3	49.3	48.3	48.2	48.5	48.9	48.8
IE	36.8	34.5	32.9	31.8	32.8	34.0	32.8	32.3
IT	44.8	45.5	45.5	45.0	44.3	44.3	44.1	43.6
LU	48.2	45.2	45.8	46.4	45.9	45.1	44.6	44.4
NL	46.3	46.1	45.2	44.5	44.3	44.3	44.6	46.4
AT	48.1	47.9	50.6	49.5	48.8	48.2	47.0	46.3
PT	37.6	40.3	39.8	41.1	41.5	41.4	41.0	41.3
FI	53.1	53.6	51.9	51.5	50.3	49.7	49.2	48.8
Euro area (2)	45.1	46.0	45.4	45.0	44.7	44.4	44.3	44.2
CZ	43.1	41.2	41.5	42.3	43.8	43.9	42.9	42.1
DK	56.3	55.2	55.8	54.6	54.7	55.8	54.5	53.8
EE	46.6	36.5	36.5	37.1	37.5	38.2	38.5	37.2
CY	:	33.7	35.1	34.4	37.3	37.4	37.7	37.2
LV	40.0	37.5	36.5	34.8	35.4	34.5	33.1	32.2
LT	34.9	36.1	33.8	32.5	31.9	30.8	31.1	30.4
HU	:	46.2	45.7	45.2	45.6	45.2	43.9	44.0
MT	:	36.2	38.6	40.9	41.2	40.9	42.3	41.9
PL	45.1	40.3	40.7	40.1	40.7	38.9	39.2	39.3
SI	:	42.9	43.2	43.6	44.3	43.9	43.5	43.3
SK	55.4	49.5	47.2	46.9	37.2	34.7	35.6	34.4
SE	57.5	59.8	56.9	55.3	56.0	55.9	55.3	54.9
UK	38.3	40.3	40.4	38.7	38.6	39.2	39.8	40.2
EU-25	:	45.4	44.9	44.2	44.1	43.9	43.9	43.8

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.7

Interest payments; general government

(Percentage of GDP at market prices (excessive deficit procedure)

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	9.3	6.8	6.6	6.0	5.4	4.8	4.5	4.3
DE (1)	3.7	3.4	3.3	3.1	3.1	3.0	3.0	3.0
EL	12.7	8.2	7.2	6.4	5.8	5.6	5.5	5.5
ES	5.2	3.3	3.2	2.9	2.5	2.2	2.1	2.0
FR	3.8	3.1	3.1	3.0	3.0	2.9	2.9	3.0
IE	5.4	2.0	1.5	1.3	1.3	1.2	1.1	1.0
IT	11.5	6.5	6.5	5.9	5.4	5.1	4.9	5.0
LU	0.5	0.3	0.4	0.3	0.3	0.2	0.2	0.2
NL	5.9	3.8	3.4	3.1	2.9	2.9	2.9	2.8
AT	4.0	3.7	3.7	3.6	3.3	3.1	3.1	3.0
PT	6.3	3.3	3.2	3.1	2.9	2.9	3.0	3.1
FI	4.0	2.9	2.7	2.2	2.1	2.1	1.9	1.7
Euro area (2)	5.6	4.1	4.0	3.7	3.5	3.4	3.3	3.3
CZ	1.1	0.9	1.1	1.5	1.3	1.3	1.3	1.4
DK	6.0	3.6	3.2	2.9	2.8	2.5	2.3	2.2
EE	0.2	0.3	0.2	0.3	0.3	0.2	0.2	0.2
CY	:	3.4	3.4	3.2	3.4	3.4	3.3	3.2
LV	1.3	1.0	1.0	0.8	0.8	0.8	0.8	0.8
LT	0.4	1.7	1.6	1.4	1.3	1.0	0.9	0.9
HU	:	5.6	4.8	4.1	4.2	4.3	3.8	3.4
MT	:	3.8	3.7	3.9	3.8	4.1	4.3	4.3
PL	5.8	2.8	2.9	3.7	3.1	2.7	2.6	2.4
SI	:	2.4	2.4	2.3	2.1	1.9	1.7	1.6
SK	6.6	4.1	3.1	3.3	2.4	2.0	2.0	2.1
SE	2.3	4.1	4.0	3.6	2.5	2.2	2.4	2.2
UK	3.6	2.7	2.4	2.1	2.1	2.1	2.1	2.1
EU-25	:	3.8	3.6	3.4	3.2	3.0	3.0	3.0

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.8

Final consumption expenditure of general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	21.4	21.1	21.7	22.3	22.8	22.9	22.9	22.8
DE (1)	19.8	19.0	19.0	19.2	19.2	18.7	18.5	18.2
EL	15.3	17.7	16.8	17.6	16.4	17.1	16.9	16.4
ES	18.1	17.7	17.6	17.7	17.9	18.3	18.5	18.7
FR	23.9	23.2	23.2	23.9	24.3	24.1	24.0	23.9
IE	16.5	14.0	14.8	15.4	15.9	16.1	16.0	15.8
IT	17.9	18.3	18.8	19.0	19.5	19.2	19.2	18.9
LU	18.4	15.7	16.9	17.6	18.0	18.2	18.0	18.0
NL	24.0	22.7	23.5	24.6	25.4	25.4	25.5	26.9
AT	20.3	18.6	18.3	18.2	18.2	18.1	17.8	17.5
PT	18.6	20.5	20.9	21.2	21.2	21.4	21.4	21.0
FI	22.8	20.6	21.0	21.6	22.1	22.4	22.6	22.8
Euro area (2)	20.5	19.9	20.1	20.4	20.7	20.5	20.4	20.4
CZ	21.7	22.1	22.2	23.0	24.0	22.8	22.6	22.5
DK	25.8	25.3	25.9	26.3	26.6	26.5	26.2	26.0
EE	27.2	19.9	19.0	18.8	18.7	18.7	19.4	19.0
CY	:	16.4	17.5	18.4	19.9	18.3	18.0	17.6
LV	24.4	21.0	20.6	21.1	21.8	21.5	21.1	20.7
LT	21.9	21.6	19.8	19.3	18.5	17.5	17.4	16.9
HU	23.6	21.3	21.8	23.4	24.2	23.7	22.7	22.3
MT	:	19.4	20.6	21.2	21.4	21.7	21.5	20.9
PL	19.0	18.0	18.0	18.1	17.6	16.9	16.5	16.1
SI	:	19.9	20.5	20.2	20.3	19.9	19.7	19.6
SK	20.5	19.8	20.1	20.1	19.9	19.4	19.4	19.2
SE	27.2	26.6	27.0	27.9	28.3	27.8	27.6	27.5
UK	19.5	18.6	19.1	20.0	20.9	21.2	21.4	21.6
EU-25	:	20.0	20.2	20.7	21.0	20.9	20.8	20.8

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.9

Compensation of employees; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	11.9	11.4	11.6	12.0	12.1	11.9	11.8	11.6
DE (1)	9.0	8.2	8.0	8.0	7.9	7.6	7.6	7.4
EL	11.3	11.7	11.6	12.2	11.9	12.5	12.5	12.2
ES	11.3	10.5	10.4	10.3	10.4	10.4	10.3	10.3
FR	13.7	13.5	13.5	13.7	13.9	13.7	13.5	13.4
IE	10.2	8.1	8.4	8.6	8.8	8.7	8.6	8.4
IT	11.2	10.6	10.8	10.8	11.1	11.0	10.9	10.8
LU	9.7	7.8	8.1	8.5	8.6	8.6	8.5	8.3
NL	10.8	10.0	10.1	10.5	10.8	10.8	10.8	10.5
AT	12.6	11.0	9.8	9.7	9.7	9.4	9.3	9.1
PT	13.6	15.0	15.1	15.4	14.9	14.7	14.6	14.4
FI	15.2	13.2	13.2	13.5	13.8	13.8	13.9	13.9
Euro area (2)	11.1	10.6	10.5	10.7	10.7	10.6	10.6	10.4
CZ	7.3	7.2	7.5	8.0	8.3	8.2	8.1	8.1
DK	17.3	16.9	17.3	17.6	17.8	17.8	17.8	17.7
EE	11.7	10.8	10.2	9.9	10.2	9.9	9.8	9.7
CY	:	13.8	13.5	13.9	15.7	14.8	13.8	13.0
LV	11.3	10.9	10.3	10.6	11.1	10.9	11.2	11.6
LT	10.1	12.8	11.7	11.4	11.0	11.1	11.0	10.7
HU	12.2	10.7	11.4	12.5	13.2	12.5	11.9	11.6
MT	:	13.3	15.0	15.1	15.3	15.0	15.2	14.9
PL	11.3	11.1	12.0	11.9	11.9	11.5	11.4	11.2
SI	:	11.8	12.3	12.1	12.3	11.8	11.4	11.1
SK	9.5	8.8	8.9	9.2	9.0	8.6	8.5	8.2
SE	16.7	15.7	16.0	16.3	16.6	16.3	16.3	16.3
UK	10.8	9.9	10.1	10.2	10.5	10.6	10.7	10.9
EU-25	:	10.7	10.8	10.9	11.0	10.9	10.9	10.8

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.10

Total current expenditure; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	50.7	46.6	47.3	47.9	48.3	47.3	46.9	46.3
DE (1)	44.9	44.5	44.3	45.0	45.2	44.2	43.5	42.8
EL	44.9	43.7	42.4	42.4	41.9	43.2	43.7	44.1
ES	39.2	35.7	35.2	35.3	35.2	35.2	35.4	35.4
FR	49.2	47.0	47.0	48.0	48.9	48.8	48.8	48.8
IE	36.8	26.8	27.7	28.4	29.0	29.5	29.8	29.3
IT	48.6	44.1	44.5	44.4	44.8	44.4	44.3	44.0
LU	39.9	34.2	36.0	37.9	39.6	39.5	39.4	39.5
NL	47.4	41.5	41.7	42.7	43.8	43.1	43.1	44.5
AT	49.1	46.2	47.0	46.9	47.1	46.4	46.0	45.5
PT	39.6	39.6	40.5	41.4	42.7	43.6	43.8	43.8
FI	53.7	43.9	43.9	44.5	45.3	45.3	45.2	44.9
Euro area (2)	46.5	43.7	43.7	44.2	44.6	44.1	43.9	43.6
CZ	37.4	39.0	39.0	40.3	41.6	40.9	40.1	39.8
DK	56.9	51.0	51.3	51.7	52.1	51.7	51.0	50.3
EE	39.5	31.9	30.7	29.9	30.3	33.1	33.4	32.6
CY	:	32.6	34.0	35.3	39.6	37.5	36.6	35.2
LV	39.8	37.3	35.4	34.0	33.7	32.4	32.7	32.1
LT	32.0	35.2	33.1	31.0	29.9	29.7	30.0	29.0
HU	:	43.1	42.9	44.8	45.7	44.8	43.6	43.2
MT	:	38.6	40.7	42.2	42.7	43.0	42.7	42.1
PL	44.6	38.9	39.8	40.8	40.2	40.7	39.7	38.5
SI	:	42.2	42.5	42.3	42.4	42.0	41.8	41.5
SK	47.9	48.9	47.3	47.6	37.8	35.2	35.9	34.9
SE	60.1	52.0	51.3	52.6	53.0	51.8	51.6	51.2
UK	41.0	37.5	38.1	38.7	39.8	40.3	40.5	40.5
EU-25	:	42.8	42.9	43.4	44.0	43.6	43.4	43.2

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.11

Gross saving; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	– 2.0	2.8	2.4	2.1	0.8	1.6	2.1	1.9
DE (1)	– 0.1	1.6	0.2	– 0.8	– 1.1	– 1.2	– 0.9	– 0.4
EL	– 6.8	– 0.2	0.2	0.3	– 0.4	– 1.4	– 1.6	– 1.8
ES	– 1.8	3.1	3.7	4.1	4.4	4.5	4.6	4.6
FR	– 1.1	2.3	2.2	0.3	– 0.7	– 0.3	0.0	0.0
IE	0.0	7.8	5.2	3.4	3.8	4.5	3.0	3.0
IT	– 3.8	1.4	1.0	0.6	– 0.5	– 0.1	– 0.2	– 0.4
LU	8.3	11.0	9.9	8.5	6.5	5.6	5.2	4.9
NL	– 1.1	4.6	3.5	1.7	0.5	1.1	1.5	1.9
AT	– 1.0	1.6	3.6	2.6	1.7	1.7	1.0	0.9
PT	– 2.1	0.7	– 0.7	– 0.4	– 1.2	– 2.3	– 2.8	– 2.5
FI	– 0.7	9.7	8.0	7.0	5.0	4.4	4.1	3.9
Euro area (2)	– 1.4	2.3	1.7	0.8	0.1	0.3	0.5	0.6
CZ	5.7	2.2	2.5	2.0	2.2	3.0	2.8	2.3
DK	– 0.5	4.2	4.5	2.9	2.6	4.1	3.6	3.5
EE	7.1	4.6	5.8	7.2	7.2	5.1	5.1	4.6
CY	:	1.1	1.1	– 0.9	– 2.3	– 0.2	1.2	2.0
LV	0.2	0.3	1.1	0.8	1.7	2.1	0.5	0.2
LT	2.9	1.0	0.7	1.5	2.0	1.1	1.1	1.4
HU	:	3.1	2.7	0.4	– 0.1	0.3	0.3	0.8
MT	:	– 2.4	– 2.1	– 1.3	– 1.5	– 2.1	– 0.3	– 0.2
PL	0.5	1.4	0.9	– 0.7	0.5	– 1.7	– 0.4	0.9
SI	:	0.8	0.7	1.4	1.9	1.9	1.7	1.8
SK	7.5	0.6	– 0.1	– 0.7	– 0.6	– 0.5	– 0.3	– 0.5
SE	– 2.6	7.7	5.5	2.7	3.0	4.1	3.7	3.6
UK	– 2.7	2.9	2.4	0.0	– 1.2	– 1.1	– 0.7	– 0.3
EU-25	:	2.6	2.0	0.8	0.1	0.3	0.5	0.6

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.12

Gross fixed capital formation; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	1.9	1.9	1.7	1.6	1.6	1.5	1.8	2.0
DE (1)	2.3	1.8	1.8	1.7	1.5	1.4	1.4	1.4
EL	3.2	4.1	4.0	3.6	4.0	4.1	3.3	3.1
ES	3.7	3.1	3.5	3.7	3.6	3.7	3.7	3.7
FR	3.3	3.2	3.1	3.1	3.2	3.3	3.4	3.4
IE	2.3	3.6	4.3	4.2	3.9	3.6	3.9	3.9
IT	2.1	2.4	2.5	1.9	2.6	2.6	2.4	2.9
LU	4.6	3.8	4.4	5.1	4.9	5.0	5.1	5.1
NL	3.0	3.1	3.3	3.6	3.6	3.6	3.5	3.4
AT	3.0	1.5	1.2	1.3	1.2	1.2	1.2	1.1
PT	3.7	3.8	4.0	3.3	3.3	3.3	3.2	3.0
FI	2.8	2.6	2.8	2.9	3.0	2.9	2.8	2.7
Euro area (2)	2.7	2.5	2.6	2.5	2.6	2.6	2.5	2.6
CZ	5.1	2.9	3.2	3.7	4.2	3.9	3.9	3.9
DK	1.8	1.7	1.9	1.8	1.7	1.7	1.8	1.7
EE	5.0	3.9	4.1	4.7	3.4	3.6	4.3	4.2
CY	:	3.0	3.0	3.0	3.4	3.9	3.6	3.5
LV	1.9	1.4	1.1	1.3	1.5	1.7	2.6	3.1
LT	3.4	2.4	2.2	2.8	3.0	3.2	3.4	3.4
HU	:	3.2	3.8	4.9	3.4	3.5	2.3	3.1
MT	:	4.1	3.7	4.5	5.3	4.3	3.9	3.7
PL	3.4	2.5	3.5	3.6	3.4	3.4	4.2	4.7
SI	:	3.1	3.0	2.8	2.8	2.8	2.9	2.9
SK	2.3	2.8	3.1	3.3	2.6	2.6	2.6	2.4
SE	4.0	2.9	3.1	3.2	3.1	3.0	3.0	3.0
UK	2.2	1.3	1.4	1.4	1.7	1.8	2.0	2.1
EU-25	:	2.3	2.4	2.4	2.5	2.5	2.5	2.6

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.13

Total expenditure; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	52.9	49.3	49.4	50.2	51.0	49.6	49.4	49.1
DE (1)	49.4	45.7	48.3	48.7	48.8	47.5	47.0	46.2
EL	51.0	52.1	50.2	49.0	48.1	49.9	48.8	48.7
ES	45.0	40.0	39.7	40.1	39.7	40.5	40.4	40.4
FR	55.2	52.6	52.5	53.4	54.6	54.5	54.5	54.4
IE	41.6	31.9	33.5	33.9	34.4	34.3	35.1	34.6
IT	53.4	46.9	49.0	48.4	49.3	48.5	48.2	48.5
LU	45.0	38.5	39.1	43.7	45.1	46.0	46.0	46.0
NL	51.4	45.3	46.7	47.8	49.0	48.0	47.9	49.3
AT	56.8	52.1	51.6	51.2	51.3	50.8	50.3	49.3
PT	45.0	45.2	46.3	46.0	47.8	46.7	47.4	47.8
FI	59.6	49.1	49.2	50.0	50.9	50.7	50.5	50.0
Euro area (2)	51.5	47.2	48.3	48.6	49.1	48.5	48.2	48.1
CZ	54.4	42.1	45.0	46.9	53.2	45.7	46.3	45.0
DK	59.9	54.2	54.3	55.1	55.5	55.2	54.5	53.7
EE	43.4	38.2	36.9	36.6	35.8	39.1	40.0	38.7
CY	:	37.7	38.9	40.6	45.4	43.6	42.3	40.7
LV	39.3	37.9	36.5	35.8	35.7	35.9	37.0	36.8
LT	36.1	38.4	35.0	34.3	34.2	34.3	34.8	33.6
HU	:	47.7	48.7	52.7	50.7	52.0	47.8	47.1
MT	:	42.3	44.1	45.8	50.9	54.1	52.6	51.4
PL	51.3	44.9	47.4	48.3	49.1	48.8	48.6	47.9
SI	:	48.2	47.9	48.1	48.2	47.7	47.6	47.2
SK	54.1	59.9	51.5	50.9	39.2	38.5	39.9	38.8
SE	67.7	57.4	57.0	58.4	58.7	57.2	57.0	56.6
UK	44.9	37.4	40.9	41.7	43.4	43.6	44.0	44.1
EU-25	:	45.8	47.3	47.7	48.5	48.0	47.8	47.6

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.14

Net lending (+) or net borrowing (–); general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions [1]							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	– 4.4	0.2	0.6	0.1	0.3	0.0	– 0.2	– 0.6
DE [1]	– 3.3	1.3	– 2.8	– 3.7	– 3.8	– 3.7	– 3.3	– 2.8
EL	– 10.2	– 4.2	– 3.6	– 4.2	– 5.2	– 6.0	– 4.5	– 4.4
ES	– 6.6	– 0.9	– 0.5	– 0.3	0.3	– 0.3	0.0	0.1
FR	– 5.5	– 1.4	– 1.5	– 3.2	– 4.2	– 3.7	– 3.0	– 3.4
IE	– 2.1	4.4	1.0	– 0.3	0.2	1.3	– 0.6	– 0.6
IT	– 7.6	– 0.7	– 3.0	– 2.7	– 3.0	– 3.1	– 3.6	– 4.6
LU	2.5	6.2	6.2	2.3	0.5	– 1.1	– 1.5	– 1.9
NL	– 4.2	2.2	– 0.1	– 1.9	– 3.3	– 2.5	– 2.1	– 1.6
AT	– 5.8	– 1.7	0.1	– 0.4	– 1.3	– 1.4	– 2.2	– 1.9
PT	– 5.5	– 2.9	– 4.4	– 2.7	– 3.0	– 3.0	– 4.9	– 4.7
FI	– 3.9	7.1	5.2	4.3	2.3	1.9	1.4	1.3
Euro area [2]	– 5.1	0.1	– 1.8	– 2.5	– 2.9	– 2.8	– 2.6	– 2.7
CZ	– 13.4	– 3.7	– 5.9	– 6.8	– 11.6	– 3.0	– 4.5	– 4.0
DK	– 2.3	2.5	3.1	1.5	1.0	2.5	2.0	2.0
EE	0.4	– 0.6	0.3	1.4	3.1	1.8	0.9	0.5
CY	:	– 2.4	– 2.3	– 4.5	– 6.3	– 4.2	– 2.9	– 1.9
LV	– 2.0	– 2.8	– 2.1	– 2.7	– 1.5	– 0.8	– 1.6	– 1.5
LT	– 1.9	– 2.5	– 2.0	– 1.5	– 1.9	– 2.5	– 2.4	– 1.9
HU	:	– 2.4	– 3.7	– 8.5	– 6.2	– 4.5	– 3.9	– 4.1
MT	:	– 6.3	– 6.4	– 5.9	– 10.5	– 5.2	– 3.9	– 2.8
PL	– 3.9	– 2.4	– 3.6	– 4.3	– 4.7	– 4.9	– 4.4	– 3.6
SI	:	– 3.5	– 2.8	– 2.4	– 2.0	– 1.9	– 2.2	– 2.1
SK	– 0.9	– 12.3	– 6.0	– 5.7	– 3.7	– 3.3	– 3.8	– 4.0
SE	– 6.9	5.0	2.6	– 0.5	– 0.1	1.2	0.8	0.8
UK	– 5.8	3.8	0.7	– 1.7	– 3.3	– 3.2	– 3.0	– 2.7
EU-25	:	0.8	– 1.2	– 2.3	– 2.9	– 2.7	– 2.6	– 2.5

([1]) From 1991 including former East Germany.
([2]) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.15

Net lending (+) or net borrowing (–) excluding interest; general government

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	4.9	6.9	7.2	6.1	5.7	4.8	4.3	3.6
DE (1)	0.3	4.7	0.4	– 0.5	– 0.7	– 0.6	– 0.3	0.2
EL	2.6	4.0	3.7	2.2	0.6	– 0.4	1.0	1.0
ES	– 1.4	2.4	2.6	2.6	2.8	1.9	2.1	2.1
FR	– 1.8	1.7	1.6	– 0.2	– 1.3	– 0.8	– 0.1	– 0.4
IE	3.3	6.4	2.4	1.0	1.5	2.5	0.5	0.5
IT	3.9	5.8	3.6	3.2	2.4	2.0	1.3	0.4
LU	3.0	6.5	6.5	2.6	0.8	– 0.9	– 1.3	– 1.7
NL	1.7	6.0	3.3	1.1	– 0.3	0.4	0.8	1.2
AT	– 1.9	2.1	3.8	3.1	2.0	1.7	0.9	1.1
PT	0.8	0.4	– 1.2	0.3	0.0	– 0.1	– 2.0	– 1.6
FI	0.1	10.0	7.9	6.5	4.5	4.0	3.3	3.1
Euro area (2)	0.5	4.2	2.2	1.2	0.6	0.6	0.7	0.6
CZ	– 12.3	– 2.8	– 4.8	– 5.2	– 10.3	– 1.8	– 3.2	– 2.6
DK	3.7	6.2	6.3	4.5	3.8	5.1	4.3	4.2
EE	0.6	– 0.2	0.5	1.7	3.3	2.0	1.1	0.7
CY	:	1.1	1.1	– 1.3	– 2.8	– 0.9	0.4	1.4
LV	– 0.8	– 1.8	– 1.1	– 1.9	– 0.7	0.0	– 0.8	– 0.7
LT	– 1.5	– 0.8	– 0.4	– 0.1	– 0.6	– 1.5	– 1.5	– 1.1
HU	:	3.2	1.0	– 4.4	– 2.0	– 0.2	0.0	– 0.7
MT	:	– 2.5	– 2.8	– 1.9	– 6.7	– 1.1	0.5	1.5
PL	2.0	0.4	– 0.7	– 0.7	– 1.6	– 2.2	– 1.9	– 1.3
SI	:	– 1.0	– 0.4	0.0	0.1	0.0	– 0.5	– 0.5
SK	1.5	– 8.2	– 2.0	– 2.1	– 1.2	– 1.1	– 1.4	– 1.7
SE	– 0.3	9.1	5.7	2.8	2.3	3.2	2.9	2.9
UK	– 2.2	6.6	3.1	0.3	– 1.3	– 1.1	– 1.0	– 0.7
EU-25	:	4.6	2.4	1.0	0.3	0.4	0.4	0.4

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.16

General government consolidated gross debt

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	134.0	109.1	108.0	105.4	100.0	95.6	94.9	91.7
DE (1)	57.0	60.2	59.4	60.9	64.2	66.0	68.0	68.9
EL	108.7	114.0	114.8	112.2	109.3	110.5	110.5	108.9
ES	63.9	61.1	57.8	55.0	51.4	48.9	46.5	44.2
FR	54.6	56.8	57.0	59.0	63.9	65.6	66.2	67.1
IE	82.0	38.3	35.8	32.6	32.0	29.9	29.8	29.6
IT	124.3	111.2	110.7	108.0	106.3	105.8	105.6	106.3
LU	6.7	5.5	7.2	7.5	7.1	7.5	7.8	7.9
NL	77.2	55.9	52.9	52.6	54.3	55.7	57.6	57.9
AT	68.8	66.7	67.1	66.7	65.4	65.2	64.4	64.1
PT	64.3	53.3	55.9	58.5	60.1	61.9	66.2	68.5
FI	57.1	44.6	43.8	42.5	45.3	45.1	44.3	43.7
Euro area (2)	73.8	70.6	69.8	69.7	71.0	71.5	72.0	72.1
CZ	:	18.2	27.2	30.7	38.3	37.4	36.4	37.0
DK	73.2	52.3	47.8	47.2	44.7	42.7	40.5	38.2
EE	:	4.7	4.4	5.3	5.3	4.9	4.3	4.0
CY	:	59.9	61.9	65.2	69.8	71.9	69.1	66.6
LV	:	12.9	14.9	14.1	14.4	14.4	14.0	14.3
LT	:	23.8	22.9	22.4	21.4	19.7	21.2	20.9
HU	:	55.4	52.2	55.5	56.9	57.6	57.8	57.9
MT	:	57.0	62.4	62.7	71.8	75.0	76.4	77.1
PL	:	36.8	36.7	41.2	45.4	43.6	46.8	47.6
SI	:	27.4	28.1	29.5	29.4	29.4	30.2	30.4
SK	:	49.9	48.7	43.3	42.6	43.6	44.2	44.9
SE	73.7	52.8	54.3	52.4	52.0	51.2	50.3	49.2
UK	51.8	42.0	38.8	38.3	39.7	41.6	41.9	42.5
EU-25	:	62.9	62.2	61.7	63.3	63.8	64.1	64.2

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.4.17

Cyclically adjusted total resources of general government
Adjustment based on potential GDP

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	49.0	48.5	49.7	50.6	52.0	50.0	49.5	48.7
DE (1)	46.2	46.6	45.1	45.2	45.5	44.1	44.1	43.8
EL	42.1	48.2	46.4	45.0	43.0	42.9	43.4	43.4
ES (3)	39.1	38.4	38.6	39.5	39.9	40.2	40.4	40.6
FR	50.2	50.5	50.4	49.9	50.6	50.9	51.7	51.3
IE	40.1	35.1	33.6	33.0	34.6	35.8	34.9	34.5
IT	45.7	45.4	45.2	45.3	46.6	45.9	45.2	44.5
LU	49.0	42.6	44.6	46.1	46.1	45.4	45.1	45.0
NL	47.8	46.2	45.8	45.7	46.5	46.3	46.8	48.6
AT	51.2	49.9	51.4	50.8	50.3	49.6	48.2	47.5
PT	40.4	41.5	41.3	43.1	45.5	44.6	43.4	44.0
FI	57.7	54.4	54.0	54.4	53.8	52.8	52.1	51.5
Euro area (2)	46.8	46.6	46.0	46.0	46.7	46.1	46.1	45.8
CZ	:	:	:	:	:	:	:	:
DK	57.8	55.7	56.7	56.4	57.1	58.1	56.7	55.8
EE	:	:	:	:	:	:	:	:
CY	:	:	:	:	:	:	:	:
LV	:	:	:	:	:	:	:	:
LT	:	:	:	:	:	:	:	:
HU	:	:	:	:	:	:	:	:
MT	:	:	:	:	:	:	:	:
PL	:	:	:	:	:	:	:	:
SI	:	:	:	:	:	:	:	:
SK	:	:	:	:	:	:	:	:
SE	62.7	61.7	59.8	58.3	59.5	58.6	57.8	57.3
UK	39.2	40.7	41.2	40.0	40.3	40.5	41.1	41.5
EU-25	:	:	:	:	:	:	:	:

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.
(3) Adjustment based on trend GDP.

Source: Commission services.

Table A.4.18

Cyclically adjusted total expenditure of general government
Adjustment based on potential GDP

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	52.8	49.5	49.5	50.1	50.8	49.4	49.2	49.0
DE (1)	49.4	48.3	48.3	48.7	48.8	47.5	46.9	46.1
EL	51.0	52.0	50.7	49.0	48.0	50.0	48.8	48.7
ES (3)	44.9	40.1	39.7	40.1	39.7	40.5	40.4	40.4
FR	55.1	52.7	52.7	53.6	54.6	54.5	54.5	54.4
IE	41.4	32.4	33.9	34.3	34.4	34.3	35.0	34.4
IT	53.4	48.1	49.1	48.2	49.2	48.4	48.2	48.5
LU	44.5	39.5	39.4	43.6	44.8	45.8	45.7	45.7
NL	51.1	46.9	47.2	48.0	48.5	47.4	47.2	48.6
AT	56.7	52.4	51.4	51.0	51.2	50.7	50.1	49.2
PT	44.9	45.5	46.3	46.0	47.7	46.6	47.3	47.7
FI	58.9	49.7	49.3	49.9	50.6	50.3	50.2	49.7
Euro area (2)	51.4	48.3	48.4	48.6	49.0	48.4	48.1	47.9
CZ	:	:	:	:	:	:	:	:
DK	59.8	54.5	54.8	55.0	55.1	54.8	54.2	53.5
EE	:	:	:	:	:	:	:	:
CY	:	:	:	:	:	:	:	:
LV	:	:	:	:	:	:	:	:
LT	:	:	:	:	:	:	:	:
HU	:	:	:	:	:	:	:	:
MT	:	:	:	:	:	:	:	:
PL	:	:	:	:	:	:	:	:
SI	:	:	:	:	:	:	:	:
SK	:	:	:	:	:	:	:	:
SE	67.2	57.5	56.9	58.0	58.2	56.9	57.0	56.6
UK	44.9	39.8	40.9	41.7	43.3	43.5	44.0	44.1
EU-25	:	:	:	:	:	:	:	:

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.
(3) Adjustment based on trend GDP.

Source: Commission services.

Table A.4.19

Cyclically adjusted net lending (+) or net borrowing (–) of general government
Adjustment based on potential GDP

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions (1)							
	1995	2000	2001	2002	2003	2004	2005	2006
BE	– 3.8	– 1.0	0.1	0.5	1.2	0.6	0.3	– 0.2
DE (1)	– 3.2	– 1.7	– 3.2	– 3.6	– 3.2	– 3.3	– 2.8	– 2.3
EL	– 9.0	– 3.8	– 4.2	– 4.3	– 5.7	– 7.1	– 5.4	– 5.3
ES (3)	– 5.8	– 1.7	– 1.1	– 0.6	0.2	– 0.3	0.0	0.2
FR	– 4.9	– 2.2	– 2.4	– 3.6	– 4.0	– 3.6	– 2.8	– 3.1
IE	– 1.2	2.7	– 0.2	– 1.4	0.2	1.6	– 0.1	0.1
IT	– 7.7	– 2.7	– 3.9	– 2.9	– 2.6	– 2.4	– 2.9	– 4.0
LU	4.6	3.1	5.2	2.5	1.3	– 0.3	– 0.6	– 0.6
NL	– 3.3	– 0.6	– 1.4	– 2.3	– 2.0	– 1.2	– 0.4	0.0
AT	– 5.4	– 2.5	0.0	– 0.3	– 0.8	– 1.1	– 1.9	– 1.6
PT	– 4.5	– 4.0	– 5.0	– 2.9	– 2.2	– 2.1	– 3.9	– 3.7
FI	– 1.2	4.7	4.7	4.5	3.2	2.4	1.9	1.8
Euro area (2)	– 4.6	– 1.8	– 2.4	– 2.6	– 2.4	– 2.3	– 2.0	– 2.1
CZ	:	:	:	:	:	:	:	:
DK	– 1.9	1.2	1.9	1.4	2.0	3.4	2.5	2.4
EE	:	:	:	:	:	:	:	:
CY	:	:	:	:	:	:	:	:
LV	:	:	:	:	:	:	:	:
LT	:	:	:	:	:	:	:	:
HU	:	:	:	:	:	:	:	:
MT	:	:	:	:	:	:	:	:
PL	:	:	:	:	:	:	:	:
SI	:	:	:	:	:	:	:	:
SK	:	:	:	:	:	:	:	:
SE	– 4.5	4.2	2.9	0.3	1.3	1.7	0.8	0.7
UK	– 5.6	0.8	0.3	– 1.6	– 3.0	– 3.0	– 2.9	– 2.6
EU-25	:	:	:	:	:	:	:	:

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.
(3) Adjustment based on trend GDP.

Source: Commission services.

Table A.5.1

Gross domestic product at current market prices

(Billion EUR)

	1995	2000	2001	2002	2003	2004	2005	2006
BE	211.5	247.9	254.2	261.1	269.5	283.2	294.7	307.9
DE (1)	1 880.0	2 030.0	2 074.0	2 107.0	2 128.0	2 177.0	2 208.0	2 258.0
EL	89.9	123.2	131.3	141.7	153.5	165.3	175.7	187.1
ES	446.9	610.5	653.9	698.6	744.8	798.7	852.0	906.5
FR	1 188.0	1 420.0	1 476.0	1 527.0	1 557.0	1625.0	1 685.0	1 752.0
IE	50.7	103.1	115.4	128.0	134.8	146.2	157.4	169.7
IT	839.0	1 167.0	1 219.0	1 261.0	1 301.0	1 351.0	1 398.0	1 453.0
LU	13.8	21.3	22.0	22.8	24.0	25.6	27.5	29.2
NL	317.3	402.3	429.3	445.2	454.3	465.3	474.2	487.8
AT	183.2	210.4	215.6	221.0	226.1	235.1	243.9	252.7
PT	82.6	115.5	122.5	128.5	130.5	135.0	139.6	145.4
FI	99.2	130.1	135.5	140.3	143.3	149.7	155.8	162.1
Euro area (2)	5 389.0	6 560.0	6 826.0	7 059.0	7 243.0	7 532.0	7 784.0	8 082.0
CZ	42.3	60.4	68.0	78.4	80.1	86.3	98.4	104.1
DK	137.8	171.6	177.9	183.1	188.0	194.7	202.1	210.0
EE	2.9	5.9	6.7	7.5	8.0	8.8	9.7	10.6
CY	7.0	9.9	10.6	11.1	11.7	12.4	13.2	14.1
LV	3.7	8.4	9.2	9.8	9.9	11.1	11.9	13.3
LT	4.9	12.3	13.5	14.9	16.3	17.9	19.7	21.5
HU	34.1	50.7	57.9	68.9	73.2	80.3	90.2	97.5
MT	2.7	4.1	4.2	4.3	4.2	4.3	4.5	4.6
PL	103.9	180.6	207.1	202.5	185.2	195.2	233.7	245.5
SI	15.3	20.6	21.9	23.5	24.6	25.9	27.6	29.5
SK	14.8	21.9	23.3	25.7	29.0	33.1	37.4	40.0
SE	189.7	259.9	245.2	256.8	267.3	278.7	293.1	307.2
UK	867.0	1 560.0	1 599.0	1 660.0	1 591.0	1 706.0	1 753.0	1 838.0
EU-25	6 829.0	8 947.0	9 292.0	9 629.0	9 756.0	10 213.0	10 606.0	11 048.0

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.5.2

Gross domestic product at 1995 market prices

(Annual percentage change)

	1995	2000	2001	2002	2003	2004	2005	2006
BE	2.4	3.9	0.7	0.9	1.3	2.7	2.2	2.3
DE (1)	1.7	2.9	0.8	0.1	– 0.1	1.6	0.8	1.6
EL	2.1	4.5	4.3	3.8	4.7	4.2	2.9	3.1
ES	2.8	4.4	2.8	2.2	2.5	2.7	2.7	2.7
FR	1.7	3.8	2.1	1.2	0.5	2.5	2.0	2.2
IE	9.8	9.9	6.0	6.1	3.7	5.4	4.9	5.1
IT	2.9	3.0	1.8	0.4	0.3	1.2	1.2	1.7
LU	1.4	9.0	1.5	2.5	2.9	4.2	3.8	4.0
NL	3.0	3.5	1.4	0.6	– 0.9	1.3	1.0	2.0
AT	1.9	3.4	0.7	1.2	0.8	2.0	2.1	2.1
PT	4.3	3.4	1.7	0.4	– 1.1	1.0	1.1	1.7
FI	3.4	5.1	1.1	2.2	2.4	3.7	3.3	2.9
Euro area (2)	2.3	3.5	1.7	0.9	0.6	2.0	1.6	2.1
CZ	5.9	3.9	2.6	1.5	3.7	4.0	4.0	4.2
DK	2.8	2.8	1.6	1.0	0.4	2.0	2.3	2.1
EE	4.5	7.8	6.4	7.2	5.1	6.2	6.0	6.2
CY	9.9	5.0	4.1	2.1	2.0	3.7	3.9	4.2
LV	– 0.9	6.9	8.0	6.4	7.5	8.5	7.2	6.9
LT	3.3	3.9	6.4	6.8	9.7	6.7	6.4	5.9
HU	1.5	5.2	3.8	3.5	3.0	4.0	3.9	3.8
MT	6.2	6.4	– 1.7	2.2	– 1.8	1.5	1.7	1.9
PL	7.0	4.0	1.0	1.4	3.8	5.3	4.4	4.5
SI	4.1	3.9	2.7	3.3	2.5	4.6	3.7	4.0
SK	5.8	2.0	3.8	4.6	4.5	5.5	4.9	5.2
SE	4.1	4.3	1.0	2.0	1.5	3.5	3.0	2.8
UK	2.9	3.9	2.3	1.8	2.2	3.1	2.8	2.8
EU-25	2.5	3.6	1.8	1.1	1.0	2.4	2.0	2.3

(1) From 1991 including former East Germany.
(2) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.5.3

Potential (1) gross domestic product at 1995 market prices

(Annual percentage change)

	1995	2000	2001	2002	2003	2004	2005	2006
BE	2.2	2.4	2.1	2.0	2.0	2.2	2.1	2.2
DE (2)	2.1	1.4	1.2	1.0	0.9	1.1	1.2	1.3
EL	2.1	3.6	3.4	3.4	3.9	3.0	3.1	3.1
ES	2.8	3.1	3.1	3.0	3.0	2.9	2.9	2.8
FR	1.8	2.3	2.3	2.1	2.1	2.2	2.3	2.4
IE	7.0	8.1	7.7	7.0	6.5	6.1	5.8	5.7
IT	1.2	1.8	1.7	1.6	1.7	1.9	1.5	1.4
LU	4.8	5.4	5.4	4.5	4.0	4.1	4.2	4.4
NL	2.7	2.7	2.6	2.1	1.6	1.4	1.6	1.9
AT	2.2	2.3	2.1	1.8	1.9	1.8	1.9	1.9
PT	2.6	2.6	2.3	1.9	1.4	1.4	1.4	1.6
FI	1.8	3.6	3.7	3.4	3.1	3.1	3.1	3.0
Euro area (3)	2.0	2.2	2.1	1.9	1.9	1.9	1.9	2.0
CZ	:	1.5	1.7	2.2	2.8	3.1	3.2	3.2
DK	2.1	2.2	2.1	2.0	1.8	1.8	2.0	2.0
EE	:	4.7	5.3	6.1	6.2	6.4	6.3	6.2
CY	:	3.7	3.6	3.9	3.1	3.9	3.3	3.4
LV	:	5.5	6.4	6.8	6.8	7.5	8.1	8.2
LT	:	3.6	4.4	5.5	6.2	6.3	6.7	6.9
HU	:	4.0	4.0	3.9	3.7	3.9	3.8	3.7
MT	:	3.7	2.8	0.6	1.5	1.9	2.0	1.9
PL	:	3.7	3.1	2.5	2.5	3.3	3.6	3.8
SI	:	4.1	3.9	3.7	3.8	3.5	3.4	3.3
SK	:	2.7	3.7	4.6	4.9	3.9	3.9	4.1
SE	2.7	2.6	2.6	2.4	2.2	2.1	2.7	2.7
UK	2.4	2.9	2.9	2.7	2.9	2.6	2.6	2.8
EU-25	:	2.3	2.2	2.1	2.1	2.0	2.1	2.2

(1) For Spain, the trend GDP rather than potential GDP is taken.
(2) From 1991 including former East Germany.
(3) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

Table A.5.4

Gap between actual and potential (1) gross domestic product at 1995 market prices

(% of potential GDP)

	1995	2000	2001	2002	2003	2004	2005	2006
BE	– 0.9	1.9	0.5	– 0.6	– 1.3	– 0.8	– 0.7	– 0.6
DE (2)	– 0.3	1.0	0.7	– 0.2	– 1.2	– 0.8	– 1.2	– 1.0
EL	– 3.1	– 0.6	0.2	0.5	1.3	2.4	2.2	2.2
ES	– 2.1	1.9	1.6	0.8	0.4	0.1	0.0	– 0.2
FR	– 1.4	2.0	1.8	1.0	– 0.6	– 0.3	– 0.6	– 0.7
IE	– 2.4	5.2	3.6	2.7	0.0	– 0.7	– 1.5	– 2.0
IT	0.2	2.0	2.1	0.8	– 0.6	– 1.3	– 1.6	– 1.4
LU	– 3.2	5.5	1.6	– 0.4	– 1.4	– 1.3	– 1.6	– 2.0
NL	– 1.3	3.3	2.1	0.5	– 1.9	– 1.9	– 2.5	– 2.4
AT	– 1.0	2.2	0.8	0.1	– 1.0	– 0.8	– 0.6	– 0.4
PT	– 2.9	2.5	1.9	0.4	– 2.0	– 2.5	– 2.8	– 2.7
FI	– 3.8	3.5	0.8	– 0.3	– 1.1	– 0.5	– 0.3	– 0.4
Euro area (3)	– 1.0	1.7	1.3	0.3	– 1.1	– 0.9	– 1.2	– 1.2
CZ	:	– 2.3	– 1.4	– 2.2	– 1.3	– 0.3	0.4	1.4
DK	– 0.4	1.8	1.3	0.3	– 1.0	– 0.8	– 0.4	– 0.3
EE	– 7.4	– 1.2	– 0.1	1.0	0.0	– 0.2	– 0.5	– 0.5
CY	1.6	1.5	1.9	0.2	– 0.9	– 1.1	– 0.6	0.2
LV	– 3.2	– 1.5	0.1	– 0.3	0.4	1.3	0.5	– 0.7
LT	– 5.3	– 4.5	– 2.8	– 1.6	1.7	2.0	1.7	0.8
HU	2.2	0.4	0.2	– 0.2	– 0.8	– 0.7	– 0.6	– 0.5
MT	– 2.3	4.7	0.1	1.7	– 1.6	– 2.0	– 2.2	– 2.2
PL	– 4.2	0.0	– 2.0	– 3.1	– 1.9	0.1	0.8	1.5
SI	:	1.0	– 0.2	– 0.5	– 1.7	– 0.7	– 0.4	0.2
SK	:	– 1.8	– 1.8	– 1.7	– 2.2	– 0.6	0.3	1.3
SE	– 3.6	1.0	– 0.5	– 0.9	– 1.6	– 0.3	0.0	0.1
UK	– 0.4	1.3	0.8	– 0.2	– 0.8	– 0.4	– 0.3	– 0.3
EU-25	:	1.6	1.1	0.1	– 1.1	– 0.8	– 1.0	– 0.9

(1) For Spain, the trend GDP rather than potential GDP is taken.
(2) From 1991 including former East Germany.
(3) Excluding Luxembourg; from 1991, including former East Germany.

Source: Commission services.

List of contents of *European Economy*

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- Economic forecasts — Autumn 2003

6-2003

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1-2004

- Report on the implementation of the 2003–05 broad economic policy guidelines

2-2004

- Economic forecasts — Spring 2004

3-2004

- Public finances in EMU — 2004

4-2004

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- The EU economy: 2004 review

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