

COMMISSION OF THE EUROPEAN COMMUNITIES

COM(82) 422 final

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BUDGET DISCIPLINE AND ECONOMIC CONVERGENCE

(Communication from the Commission to the Council)

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The Commission transmits to the Council a communication concerning the management of public finance. The communication has two aims:

- to place in a more general framework the discussion which the Council will have on the 12th July next, in conformity with Article 3 of the decision of the 18th February 1974, about the fixing of quantitative guidelines for 1983 budget proposals;
 - to reinforce, and apply in a concrete fashion, the existing procedures to achieve better convergence of the Community economies.
- The Commission reserves the right to submit later to the Council communications about other important aspects of convergence.

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I. ECONOMIC DEVELOPMENT AND STRUCTURAL IMBALANCES IN THE BUDGET

In many member states the management of public sector finances is not making a sufficient contribution towards the effort of economic stabilisation and of putting the economy on a sound footing. The Commission has drawn attention to this problem on several occasions (1). It is not therefore worthwhile to embark again on an exact analysis of how this situation arose and what its effects are. Rather the Commission considers it necessary to propose a general framework for the management of public sector finances which should make it possible :

- to promote, in an important aspect, a more convergent development of the european economies, thereby strengthening the E.M.S.;
- to reaffirm that budgetary instruments will maintain, or regain, those characteristics that should enable governments to make the best use of them to benefit economic equilibrium, development and employment;
- in particular, to ensure that the budget is able to contribute to achieving priority objectives which are to re-establish competitiveness, the modernisation of economic structure, and the development, to the benefit of employment, of the productive sector;
- finally to take care that the reduction in savings due to the budget deficit does not have an adverse impact on productive activity which would accentuate, to the detriment of these activities, the effects of a monetary policy conducted within strict limits, and contribute to high interest rates.

(1) Annual Economic Report 1980-81 (COM (80) 596 final); Draft Fifth Medium-Term Economic Policy Programme (COM (81) 344 final); Annual Economic Report 1981-82 (COM (81) 596 final).

The possibility of using budgetary policy to stimulate economic activity during certain phases of the cycle is not brought into question. Nevertheless the growth and the dynamism of the economies are at present adversely affected by the structural imbalances of the public sector budgets. Correcting these structural imbalances is a necessary step towards better growth and better employment.

The present communication endeavours to define the means to enable the genuine control of public sector finances to be regained.

II. TRENDS CHARACTERISTIC OF THE PUBLIC FINANCE SITUATION

The data reproduced in the annexed table reveal a number of unfavourable trends and situations:

- the absolute and relative growth of public expenditure accelerated after the economic crisis which became apparent in the early 1970s, whereas the growth of receipts was held in check; for the Community as a whole, the share of public expenditure in gross domestic product rose from 32.1 % in 1960 to 37.7 % in 1970 to reach 49.8% in 1982; the share of compulsory levies stands at 44.8 % in 1982 as against 37.6 % in 1970 and 32.7 % in 1960;
- a group of countries (Belgium, Denmark, Greece, Ireland and Italy) has slipped into a more unbalanced position than others because each has been less successful in controlling the accelerating rate of growth of public expenditure or faced opposition to heavier taxation or parafiscal charges; in some cases the increase in the charges on public debt, particularly external debt, has played an important role in this context;
- the structure of public expenditure has become modified so that transfers to households and operating expenditure are favoured at the expense of public investment and expenditure to back up and stimulate more balanced economic development (e.g. research and development, energy saving, support for advanced technology industries); thus the ratio of public investment to the total of public expenditure fell from 10,1 % in 1960 to 6 % in 1982, whereas the ratio for current transfer increased, over the same period, from 39,4 % to 44 %.

III. THE REMEDIES

Efforts to reduce the deficits must be concentrated on the area of public expenditure: its rise must be strictly limited and its structure improved. Given the substantial body of expenditure which it is difficult to cut back and the need to ensure a certain level of social security benefits these two objectives can be attained only by redefining certain priorities and revising the rules and legislation which now mean that much public expenditure increases automatically; this could lead to falls in public consumption and transfer expenditures in real terms. The sacrifices involved in the reorganisation of the whole body of expenditure must be fairly shared out between the various social and professional groups.

There is less scope for increasing taxation, nor is it desirable to do so, notably because of the high level already reached by the compulsory tax rates. Heavier taxation leads to more evasion, is a disincentive to professional effort when the marginal rates of tax become prohibitive even on average incomes, and puts people on low incomes at a disadvantage when indirect taxes are high. It is certainly feasible to raise certain rates of contribution in order to finance higher expenditure (notably on unemployment and sickness insurance) where there is a clear link between the levy and the benefit, and the periodic revision of specific taxes could take place at shorter intervals than in the past, but such adjustments will have a limited financial impact, varying from country to country.

A lasting improvement of the public finance situation can only be achieved if backed by procedures designed to keep the exercise of budgetary powers in closer harmony with the key economic equilibria. This means, in some cases, actual reforms of the budget legislation, and in others a greater respect for the legislation which exists.

The Commission therefore requests the Council to accept the following four guidelines, voluntarily presented in schematic form, which, however, should be implemented in each Member State while, of course taking into account individual situations.

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1. Control of the budgetary aggregates :

- Reduction of the borrowing requirement. The general government borrowing requirement, as a proportion of gross domestic product, must at a minimum be stabilised, and in the majority of countries even reduced, to what extent to be stated in the annual budget guidelines;
- Reduction and reorganisation of expenditure. This sounder budget situation must stem primarily from a reduction in the growth of public expenditure, in real terms, or from an absolute cut if the magnitude of the correction demands it. The structure of public expenditure must be altered to take account of the rapid increase in certain types of expenditure which it is difficult to cut back, and the need to leave more room for the budget appropriations that help the balanced development of the productive sector;
- Changes in taxation and social security contributions. Action needs to be taken principally with regard to expenditure; changes in taxation and social security contributions must not be ruled out as means of adjustment, but can only be a secondary instrument and should in any event take account of possible repercussions on employment;
- Public utility charges and payments. The user should be made to bear a larger share of the cost of those public services which can be attributed to the individual, which means a more regular adjustment of public utility charges to increases in costs, and a wider use of payments for the services provided by the public authorities;
- Annual targets written into a multi-annual framework. In view of the changes to be made in the volumes and structures of budgets, the Member States must each year set themselves a budget target in keeping with a return to budgetary soundness in the medium term, and adhere to it strictly. The large overshoots observed for certain categories of expenditure must be offset by cuts in other sectors or by an increase in receipts.

2. Application of strict budgetary procedures :

- Budget timetable. The basic budget law should prescribe the adoption of the general budget before the start of the financial year : this implies that, where appropriate and only when the budget cannot be so adopted for reasons outside the government's control, the provisional monthly allocations should not exceed the level of the preceding year;
- Monitoring of budget implementation. Each government should take stock, at least twice a year, of the budget's implementation and introduce, without delay before Parliament, proposals amending the original budget without financing, by cash advances, expenditure subsequently submitted for Parliament's approval. If the budget's field of application varies from one year to another, the economic and financial consequences should be clearly indicated.

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3. Application of strict principles of budget management :

- Current account equilibrium. Budgetary legislation must oblige the executive authority to present budgets which are in equilibrium as regards current account operations (national accounts definitions), after a short transitional period for those countries with particularly heavy deficits. The budget will have to contain a contingency reserve large enough to cope with the marginal variations in execution without the need for a supplementary budget to be drawn up, and will have to specify the conditions in which this reserve can be used;
- The covering of additional expenditure. In the countries where the legislative authority has the right to initiate expenditure, exercise of this right must be accompanied by the compulsory presentation of proposals on the lasting (and not just the immediate) financial consequences in terms of additional funds and or expenditure cuts in other areas. Generally speaking, it would be desirable for the multi-annual financial plan to include an evaluation of the medium-term financial effects of adopting a draft or proposed law during the financial year.

4. More severe financing criteria :

- The public deficits must be financed at the lowest cost compatible with the full respect of the financial market mechanisms and of the necessary autonomy of monetary policy. This means ruling out or restricting practices such as the direct financing of the Treasury by the central bank, the monetization of public debt securities by the banking system, the use of regulatory powers to impose the subscription to public debt securities on preferential terms, the indexation of the public debt, the issue of securities with shorter-than-minimum maturities (three months), the massive use of short-term issues, the excessive floating of public loans abroad, the over-readiness to use State guarantees to back foreign borrowings abroad by public or private undertakings.

IV. TAILORING THE REMEDIES TO INDIVIDUAL CIRCUMSTANCES

Although the achievement of a sounder budget situation must be a guideline common to the Community as a whole, the emphasis on, and connection between, the measures needed must be tailored to the individual circumstances of each Member State.

- Rigorous action is necessary in those countries (Belgium, Denmark and Ireland) running a heavy deficit on both public finance and the balance of payments on current account and in those (Italy and Greece) where the reduction of inflation has been thwarted by the size of the public deficit and the method of monetary financing.

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If tangible results do not start to be recorded rapidly in 1982 and 1983, the budget position will inevitably deteriorate substantially (in particular with regard to pressure on savings, an excessive part of the budget affected by the weight of debt, levels of interest rates, growing need for external finance).

In all these countries, a sustained effort in the medium term will be necessary to achieve lasting budget soundness; it must also be accompanied by the appropriate reforms of budgetary procedures or by the stricter application of the legislation which exists.

- In three other countries (France, Luxemburg and less so in the Netherlands), the general government borrowing requirement has not reached a particularly high proportion of GDP, but it is necessary to check the upward trend seen in the last few years and which is liable to continue in 1983.

In France, the control of public finance is an indispensable component of the policy of reducing inflation and restoring external equilibrium. In the Netherlands, the budget deficit must be cut substantially because of the prospect of a fall in natural gas production and, in the short term, in order to create better conditions for investment, expansion and employment. In Luxembourg, where the budget has traditionally been in surplus, the cost of the direct measures to assist employment has become so high that ways of offsetting it must be found.

- Finally prudence with regard to public expenditure will continue to be necessary in the Federal Republic of Germany and in the United Kingdom where important efforts have been made to control the borrowing requirement and to ensure consistency with monetary policy. It would be appropriate however to avoid an excessive level of borrowing whilst at the same time giving more weight to expenditure that will contribute to strengthening the development potential of the productive sector.

V. The Commission asks the Council to retain the four guidelines set out in § III of the present communication and to arrange, for the end of the year, a discussion of a first report which the Commission will submit concerning the implementation of these guidelines.

Principal public finance aggregates (1)

	1960	1970	1975	1980	1982	1960	1970	1975	1980	1982
	1. General government expenditure, as % of GDP					2. General government receipts, as % of GDP				
B	30,5	36,5	44,7	54,2	59,7	27,6	35,2	40,4	44,8	46,9
DK	28,5	43,1	49,5	58,4	60,0	28,1	46,1	47,5	52,5	51,1
D	32,0	37,1	46,6	46,9	47,7	35,2	37,5	40,8	43,5	43,6
GR	23,8	29,1	32,5	35,6	40,2	20,0	26,8	27,4	30,2	32,3
F	34,6	38,1	42,5	46,2	51,1	35,5	39,0	40,3	46,6	48,2
IRL	26,7	38,9	47,0	53,8	59,0	25,4	35,3	35,7	41,0	44,6
I	29,9	35,6	47,7	45,9	52,1	29,1	30,6	31,6	37,8	41,0
L	29,3	32,5	48,0	56,9	58,7	32,3	35,3	49,2	55,1	57,5
NL	33,2	44,8	55,2	58,0	59,8	34,0	44,0	52,5	54,6	54,1
UK	32,6	38,3	45,8	43,9	44,6	31,6	40,8	40,9	40,4	42,7
CE	32,1	37,7	45,9	47,2	49,8	32,7	37,6	40,1	43,6	44,8
	3. Balance of current transactions of general government, as % of GDP					4. General government net lending (+) or borrowing (-), as % of GDP				
B	-0,7	2,2	-0,7	-4,6	-7,6	-2,9	-1,3	-4,3	-9,4	-12,7
DK	6,4	8,9	2,7	-2,0	-5,2	2,6	3,0	-2,0	-5,9	-4,9
D	7,4	5,9	-0,8	2,3	0,8	3,1	0,3	-5,8	-3,5	-4,0
GR	2,3	4,4	0,7	0,2	-4,0	-3,7	-2,3	-3,1	-5,4	-7,9
F	4,6	4,3	1,1	3,5	0,2	0,9	0,9	-2,2	0,5	-3,0
IRL	1,8	1,1	-6,3	-4,7	-6,1	-1,3	-3,7	-11,3	-12,8	-14,4
I	3,0	-1,1	-9,5	-3,6	-6,4	-0,8	-5,0	-16,1	-8,1	-11,1
L	7,8	6,5	7,9	8,8	9,1	3,0	2,9	4,2	-1,8	-1,3
NL	5,9	4,3	2,1	2,0	-0,1	0,8	-0,8	-2,7	-3,4	-5,6
UK	1,8	7,6	-0,4	-0,5	0,2	-1,0	2,5	-4,9	-3,5	-1,9
CE	4,2	4,6	-1,2	0,8	-1,1	0,6	-0,1	-5,9	-3,6	-4,9
	5. Public debt, as % of GDP					6. General government gross fixed capital formation, as % of GDP				
B		57	51	70		1,9	3,5	3,3	3,9	3,9
DK		18	15	43		3,3	5,0	3,8	3,3	2,6
D		18	24	31		3,2	4,1	3,4	3,9	3,2
GR		21	22	28		6,1	6,7	5,6	5,6	3,7
F		17	15	16		2,9	3,1	2,6	2,7	3,0
IRL		n.d.	76	91		2,8	3,0	4,0	6,5	7,0
I		29	58	50		3,5	2,9	3,4	3,2	3,7
L		33	25	26		4,7	2,8	5,7	9,1	8,3
NL		68	41	46		4,0	4,1	3,3	3,3	3,1
UK		86	69	57		3,3	3,8	3,5	2,4	1,7
CE		37	26	38		3,2	3,7	3,3	3,3	3,0

(1) The definitions used are national accounts definitions. Figures do not necessarily add up because of rounding.

1. expenditure : current and capital expenditure excluding loans, advances and equities;
2. receipts : direct and indirect taxes, social security contributions, other current resources and consumption of fixed capital;
3. balance of current transactions : government gross saving;
4. net lending or borrowing : balance of receipts-expenditure (2-1);
5. public debt : central government debt + debt of local authorities, excluding central bank advances.

Sources : OECD National Accounts 1960-1979. Services of the Commission 1980-1982 (1982 estimated). Bundesministerium der Finanzen for public debt.