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Towards budget discipline: an economic assessment of the possibilities for reducing national deficits in the run-up to EMU

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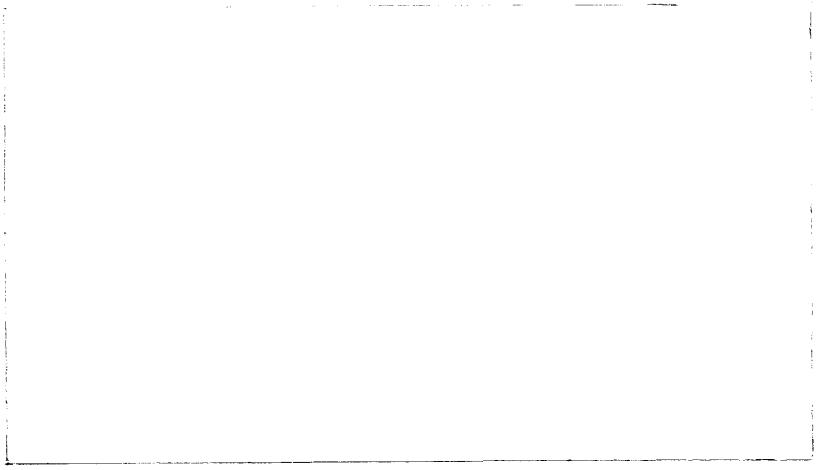

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0. Executive summary

0.1 Background of study

In the 1990s Member States of the European Community will meet with the challenge to prepare their economies for the arrival of a truely Common Market. As Member States progress towards the completion of the Common Market, policymakers concerned have become acutely aware of the urgent need that their various countries be able to compete in terms of - notably - relative cost levels, effective tax levels, and the mix of provisions offered by the public sector.

As from July 1, 1990 the European Community has embarked upon Stage I of the European Economic and Monetary Union (EMU). During Stage I a high degree of convergence of economic policies and performance is strived for. Regarding public finances, the convergence aimed at implies greater budgetary discipline in a number of Member States, in that excessive deficits have to be avoided.

More specifically, at its Maastricht meeting of December 10, 1991 the European Council set reference values for both the general government deficit as well as general government debt. With some qualifications, net borrowing of general government should not exceed 3 percent of Gross Domestic Product (GDP) at market prices. Total gross debt at nominal value outstanding at the end of the year should amount to no more than 60 percent of GDP.

At the end of 1991, the public finances of only three Member States - i.e. France, Luxembourg and the United Kingdom - fully respected these reference values. The remaining Member States will have to increase taxes and/or cut public spending to a various degree, in order to (gradually) bring their deficit-to-GDP ratio and/or debt-to-GDP ratio down to or below the reference levels agreed upon.

0.2 Aim of study

This study aims to analyse the flexibility of national government revenue and expenditure instruments in the context of economic and monetary union, while not taking a particular view on the optimal size of the public sector. Moreover, the analysis assumes a status quo on tax harmonization in the EC (e.g. that the 1989 proposal for a minimum withholding tax of

15% will not be accepted). Building upon relevant theoretical notions and taking into account historical experience since the early 1980s, the study intends to provide an empirical basis on which policy recommendations could be formulated to Member States, as regards their options in achieving and maintaining sustainable budgetary positions in the successive stages of EMU.

On the revenue side, possible constraints from tax competition - as partly induced by the internal market, and further strengthened by growing integration of goods and services markets as well as enhanced cross border mobility of assets, enterprises, workers and consumers - may in some Member States seriously limit the scope for future tax increases. Emerging tax competition could hamper the tax intake at a time when a number of Member States need to undertake painful efforts to redress imbalances in their public finances, in order to bring down their excessive public debt-to-GDP ratio towards the Community average.

On the expenditure side, the study classifies spending items by major functional category. Separate country studies discuss the scope for reducing outlays, given legal, institutional and political factors typical of the Member State concerned. The study also considers the merits of alternative ways to cut back public spending, given - for example - the level of public investment and present defense spending.

Recent theoretical and empirical literature examines the variation in political and institutional arrangements which may affect outcomes of the national policy formation process. Building upon this literature, the study also examines how cross-country differences in public sector size and debt accumulation among Member States during the 1980s can be explained.

0.3 Summary of main results

First, the study reviews trends in taxes and public spending in all Member States of the European Community. By 1990, not withstanding tax reductions during the second half of the 1980s, in almost every Member State the tax take out of GDP exceeded the 1980-tax level. Also, during the 1980s national tax levels have somewhat converged. On the other hand, the already large variation in national tax mixes has further increased. Broadly speaking, tax competition has been a factor in bringing down the (top) rate of the personal income tax, in reducing corporate income tax rates, and in harmonising the standard rate of the value added tax to some degree.

After a marked expansion in the 1970s, public spending levels in most Member States

tended more or less to stabilize over the 1980s, most southern States being the exception here, in part because they started from lower spending levels.

The growth of government debt in Member States of the European Community is positively related to the frequency of government changes, implying that countries with less stable governments may have greater difficulty to satisfy the Maastricht criteria for fiscal policy. In themselves, however, these budgetary criteria might constitute an important external incentive to policymakers concerned, which may compensate for the lack of internal political stability.

The study also finds evidence that improved budgetary procedures might strengthen attempts to pursue stable fiscal policies, since the growth of government debt is negatively correlated with sound budgetary procedures. It was also found that in countries with left-wing governments the share of public spending in total output generally tends to grow faster.

The study offers a detailed analysis of budgetary policies pursued in five Member States: Belgium, Denmark, Ireland, Italy and the Netherlands. These countries have been selected, because:

- they all face the challenge to substantially redirect present tax and spending policies, in order to attain the reference values for government debt and (hence) deficit which have been laid down in Maastricht (Denmark being the sole exception here);
- three have a track record of rather successfully attacking major budgetary problems (Belgium, and notably Italy being the exceptions here).

Tabel 0.1 outlines the profile of selected Member States. Levels of public spending are above the EC-average (48.6 percent of GDP), except in Ireland. Projected deficits in 1992 exceed the Maastricht target, except in Denmark. In all cases, the debt ratio exceeds the Maastricht target, notably in Italy (106 percent of GDP) and in Belgium (128 percent of GDP). Table 0.1 serves to illustrate the need for (thorough) budgetary adjustments in Italy, Belgium, Ireland and the Netherlands, in that order.

In addition to several usual macroeconomic indicators, table 0.1 includes three items indicative of problems that national governments will meet in trying to attain budgetary targets previously set. The redress of public finances is complicated because of demographic trends in all countries (except in Ireland), notably so in Italy. The same country has also by far the highest score on the political instability index. Political instability is assumed to increase, the higher the total number of government changes between 1981 and 1989. The minimum value for the scale used is 2. In practice one would expect no more than, say, 10 government changes per decade. Together with Belgium (22) and Ireland (33), Italy (31)

ranks lowest on the quality index of budgetary procedures, which for EC Member States varies between 22 (Belgium) and 61 (France).

Evidently, those Member States where strong adjustment is most in order, are unfortunately also most handicapped by demographic and politico-institutional factors to redress their public finances.

Given profiles of the five Member States, the study charts policy options available to each of them to take corrective action against excessive deficits in the run-up to the third stage of the EMU. Two matrices identify, country by country, various options to increase taxes and/or to cut back public outlays respectively. All in all, ten revenue options are considered, which have been ranked in table 0.2 according to the sensitivity of their base to tax competition. To facilitate the analysis, outlays are broken down into ten separate expenditure categories (table 0.3).

The columns in both tables summarize policy options which are explained and discussed in much greater detail in the final paragraph of each country chapter. Detailed tables in Chapters 7-11 confront tax and spending options with crucial factors determining the degree of control that a particular government can exercise over individual items, and over tax and spending levels as a whole. Political factors, institutional set-up, budgetary rules and procedures, possible impacts of tax competition and other relevant factors are - whenever possible - included in our discussion.

Based on these detailed analyses we have tentatively pencilled in plusses and minuses in tables 0.2 and 0.3, so as to summarize future general government budget flexibility. More detailed discussions by major tax and expenditure category may be found in the country chapters.

The scope of our study and a lack of sufficiently detailed data explain that in most cases no item-by-item discussion is offered. Nevertheless, the data collected allows for a clear picture of overall policy options available to national governments to bring their public finances in line with the Maastricht criteria.

Table 0.2 considers the potential contribution of various revenue sources to budget consolidation.

Given the mobility of private assets and increasing tax competition, in the absence of fiscal coordination or harmonization taxes on portfolio income of individuals offer little or no revenue potential. Increased taxation of corporate profits, especially by broadening the tax base and eliminating special, reduced rates, may contribute to redress budgetary imbalances in Belgium, Italy and Ireland respectively.

A broader VAT-base (Ireland) or an improved administration of VAT (Italy) can produce additional revenue. Italy and Belgium may increase the rates of a number of excise duties. A more effective administration would substantially raise revenue from social security contributions in Italy.

Taxes on individual income, taxes on property and various non-tax revenues may all potentially contribute to improve the budget position of most Member States considered here, notably through a policy mix including broadening tax bases, setting higher rates, attacking tax fraud, and the successful privatization of public enterprises.

Table 0.3 considers the potential contribution to budget consolidation by reducing various spending categories.

In most of the selected countries, outlays relating to general public services can be reduced by increasing efficiency; in some Member States, notably in Italy, public sector wage restraint may contribute to budget consolidation. Defense spending shows some downward flexibility, resulting from 'peace dividends'.

Outlays relating to public order and safety offer a mixed picture. While in a few countries some reduction can be achieved as a result of wage restraint, in other countries there clearly is a need for higher outlays due to additional demand.

Educational spending may fall somewhat as a result of demographic change. Health expenditure, for the same reason, tends to increase. However, in some countries wages in the health sector could be moderated and incentives to restrict demand might be introduced or strengthened.

In most Member States social security and welfare outlays, being quantitatively the single most important functional spending category, show some downward flexibility, although demographic trends call for additional expenditure. Downward flexibility may result from policies that reduce volume and/or benefit rates. The flexibility of this expenditure category is strongly correlated with the growth performance of national economies and general wage trends. Since the growth rate of the economy is positively correlated with private sector wage restraint, this is a very important policy variable. The same holds true for the participation rate, which is especially low in Belgium and the Netherlands. An increase in the participation rate can turn benefit recipients into net contributors to public sector financing, which makes the knife cut both ways.

Cuts in outlays for housing and community amenities can contribute to downward budget flexibility in Italy and the Netherlands. Spending on recreational, cultural and religious affairs is in itself only a small category, characterized by generally little downward flexibility.

Spending on economic services offers more scope for spending cuts, since some Member

States provide for rather substantial amounts of state aid and business subsidies, which can not easily be defended in an open market.

The spending category 'other functions' mainly consists of interest payments on general government debt. This is an inflexible item by definition. The interest-to-GDP ratio only reacts very slowly to deficit reduction schemes and is heavily dependent on changes in the real interest rate, which in itself is no policy instrument. Moreover, countries where the urgency to reduce outlays is most manifest, are exactly those with the highest interest payments-to-GDP ratio (Belgium and Italy).

From the preceding analysis it follows that options to cut public outlays will in many respects closely conform to policies that were initiated during the 1980s. However, some trends should be reversed. In the past decade, public investment declined in the majority of EC countries. Given new priorities (cleaning up the environment and improving infrastructure) by now the bottom line for public investment might well have been reached. Transfers to families and industry are a prime target for further reductions in public outlays. In the 1980s benefit levels were cut in most Member States already, but a marked rise in the number of benefit recipients ('volume') in some countries outweighted the effect of cuts in benefit levels ('price'), resulting in higher spending relative to GDP. In countries with declining public spending (relative to GDP) most cuts were targeted against typical welfare programs, such as housing subsidies, health care and government outlays for education. Generally, expenditure for defence slightly fell, whereas outlays for internal safety (police) increased somewhat.

Table 0.4 summarizes the revenue and expenditure flexibility of the five EC Member States reviewed in tables 0.2 and 0.3. Italy and Denmark are most flexible in terms of reducing outlays. The Netherlands and Denmark have hardly any option to increase tax revenue. Italy, on the other hand, might consider to raise its taxes.

0.4 Outline of study

The study is organised as follows. Part I describes in some detail the methodology used here, while Part II provides a broad overview of trends in public finances of all Member States during the 1980s and of progress as to sustainable fiscal policy achieved thus far. Next, Part III seeks to explain national spending and revenue trends of the 1980s as the combined result of a set of both macroeconomic, political and institutional variables.

Results of the analyses in Parts II and III respectively may be useful in assessing the room of manoeuvre for policymakers who are trying to bring budget deficits and the public debt of their country in line with targets set in the Maastricht Treaty.

Finally, Part IV comprises of five country studies. Results from these case studies have already been summarized in tables 0.2 and 0.3, respectively.

Table 0.1 Profiles of five EC Member States, 1992

	Outlays[a]	Deficit[a]	Debt[a]	GDP growth[b] 1992-1993	Inflation[b] 1992-1993	Interest rate 1991	Change dependency ratio 90s[c]	Political instability index[d]	Budgetary Procedures Index[e]
Belgium	50.8	6.3	127.8	2.5	2.9	9.3	2.1	5	22
Denmark	57.1	1.1	61.7	2.5	2.2	10.1	-0.9	4	49
Ireland	41.9	3.5	95.2	2.8	3.5	9.2	-9.4	5	33
Italy	54.1	10.1	105.8	1.8	4.8	12.9	4.0	8	31
Netherlands	56.4	4.9	79.9	1.7	3.5	8.9	0.9	5	54
EC average	48.6	4.5	61.0	2.0	4.1	10.4	2.8	-	-

[a] Percent of GDP.

[b] Estimate.

[c] Differences in percent shares between 1990 and 2000; percentage of working age population.

[d] Total number of government changes between 1981-1989.

[e] Based on Von Hagen (1992). A higher number indicates better procedures.

Source: EC and OECD

Table 0.2 Potential contribution to budget consolidation of revenue categories in five EC Member States[a]

	1. Taxes on portfolio income of individuals	2. Taxes on corporate profits	3. Taxes on goods & services		4. Taxes on use of labour			5. Taxes on income of individuals	6. Taxes on property	7. Non-tax revenues
			3.1 VAT	3.2 Excise duties	4.1 Social security contributions employees	4.2 Social security contributions employers	4.3 Social security contributions self-employed			
Belgium	--	+	-	+	0	0	0	+	++	+
Denmark	--	-	-	--	--	--	0	-	+	+
Ireland	-	+	+	-	-	-	0	0	++	+
Italy	--	+	+	+	++	++	0	+	++	++
Netherlands	--	0	0	-	--	--	0	+	+	+

[a] Plusses indicate a positive contribution to budget consolidation (higher revenue, smaller deficit). Minuses indicate a negative contribition to budget consolidation (lower revenue, higher deficit). The number of signs (one or two) indicates the relative degree of flexibility of each tax instrument in terms of its ratio to GDP.

Table 0.3 Potential contribution to budget consolidation of expenditure categories in five EC Member States[a]

	1. General public services	2. Defense	3. Public order and safety	4. Education	5. Health	6. Social security and welfare	7. Housing and commun. amenities	8. Recreat., cult. & rel. affairs	9. Economic services	10. Other functions
Belgium	+	+	0	+	+	+	0	0	+	0
8Denmark	+	+	0	+	-	++	+	+	+	0
Ireland	+	+	+	+	+	0	0	0	-	0
Italy	+	++	+	++	+	+	+	+	++	0
Netherlands	0	+	-	-	-	++	+	0	0	0

[a] Plusses indicate a positive contribution to budget consolidation (lower expenditure, smaller deficit). Minuses indicate a negative contribution to budget consolidation (higher expenditure, higher deficit). The number of signs (one or two) indicates the relative degree of flexibility of each expenditure category in terms of its ratio to GDP.

Table 0.4 Fiscal policy structures (1992) and flexibility of expenditure and revenue instruments

	Expenditure				Revenue		
	Current (exclusive interest payments)	Interest payments	Expenditure flexibility index[a]		Current receipts	Revenue flexibility index[b]	
	% GDP	% GDP	Weighted	Unweighted	% GDP	Weighted	Unweighted
Belgium	39.7	10.9	+0.7	+0.6	44.3	+0.4	+0.4
Denmark	49.5	7.3	+1.1	+0.7	55.3	-0.7	-0.6
Ireland	36.3	8.3	+0.2	+0.4	40.4	+0.1	+0.2
Italy	43.2	10.6	+1.1	+1.2	44.4	+1.7	+1.0
Netherlands	50.4	6.2	+0.6	+0.1	52.5	-0.3	-0.2
EC average[c]	42.4	5.0	n.a.	n.a.	43.3	n.a.	n.a.

[a] The unweighted expenditure flexibility index is calculated by simply adding the number of 'plusses' and 'minusses' from the individual country summary tables regarding the contribution to budget consolidation, and dividing the outcome by the total number of entries (12). As the maximum score for each entry can be a double 'plus' or 'minus', the index varies between +2 and -2. To calculate the weighted flexibility index, the 'plusses' and 'minusses' from the summary tables are weighted by the shares of the functional expenditure categories in total outlays as indicated (between brackets) in the individual country tables. Once again the index has a maximum value of +2 and a minimum value of -2.

[b] The flexibility index for revenues is calculated analogously to the expenditure index and has the same upper and lower limits.

[c] EUR12; 1990.

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PART I

INTRODUCTION TO STUDY

1. Introduction: take off for EMU

In the 1990s Member States of the European Community will meet with the challenge to prepare their economies for the arrival of a truely Common Market. As Member States progress towards the completion of the Common Market, policymakers concerned have become acutely aware of the urgent need that their various countries be able to compete in terms of - notably - relative costs levels, effective tax levels and the mix of provisions offered by the public sector.

As from July 1, 1990 the European Community has embarked upon Stage I of the European Economic and Monetary Union (EMU). During Stage I a high degree of convergence of economic policies and performance is strived for. Regarding public finances, the convergence aimed at implies greater budgetary discipline in that excessive deficits have to be avoided.[1] Excessive deficits may threaten a common monetary policy.

At its meeting in Maastricht at December 10, 1991 the European Council agreed that the European Commission shall monitor the development of the budgetary situation and the stock of government debt in all Member States. Compliance with targets of budgetary discipline will be judged according to two criteria:

- the ratio of general government deficit to Gross Domestic Product (GDP);
- the ratio of general government debt to GDP.

The *Protocol on the excessive-deficit procedure* specifies both reference values. With some qualifications, net borrowing of general government should not exceed 3 percent of GDP at market prices. Total gross debt at nominal value outstanding at the end of the year should amount to no more than 60 percent of GDP.

If a Member State does not fulfill the requirements under one of these criteria, the Commission shall prepare a report. It was also agreed upon that such report will take into account whether the government deficit exceeds public investment expenditure, and all other relevant factors, including the medium term economic and budgetary position of the Member State concerned.

If the Council agrees with the Commission that some Member State has an excessive deficit, the Council shall make recommendations to that Member State so as to bring that

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[1] Apart from the absence of excessive deficits, budgetary discipline also implies no monetary and compulsory financing of government budget deficits, and no bailing-out.

situation to an end within a given time period. This peer group pressure should move Member States to redress their budgetary policy whenever deemed necessary, which in turn will facilitate the passage to the final stage of EMU, since absence of excessive government deficits is one of the four criteria on which the Council shall assess whether a Member State fulfills the necessary conditions for adoption of the single currency.

By the end of 1991, the public finances of only three Member States - i.e. France, Luxembourg and the United Kingdom - fully respected the reference values. The remaining Member States will have to increase taxes and/or cut public spending to a various degree, in order to (gradually) bring their deficit-to-GDP ratio and/or debt-to-GDP ratio down to or below the reference levels agreed upon in Maastricht.

2. Aim, scope and methodology of study

2.1 Aim and scope of study

This study aims to analyse the flexibility of national government revenue and expenditure instruments in the context of economic and monetary union, while not taking a particular view on the optimal size of the public sector. Moreover, the analysis assumes a status quo on tax harmonization in the EC (e.g. that the 1989 proposal for a minimum withholding tax of 15% will not be accepted). Building upon relevant theoretical notions and taking into account historical experience since the early 1980s, the study provides an empirical basis on which policy recommendations could be formulated to Member States, as regards their options in achieving and maintaining sustainable budgetary positions in the successive stages of EMU.

To this end, the study first provides a broad review of trends in the public finances of all Member States and of progress as to sustainable fiscal policy achieved thus far (chapter 3). Next, chapters 4 and 5 offer a detailed analysis of government outlays and revenues, respectively.

Recent theoretical and empirical literature examines the variation in political and institutional arrangements which may affect outcomes of the national policy formation process. Building upon this literature, chapter 6 examines how cross-country differences in public sector size and debt accumulation among Member States during the 1980s can be explained.

Results of this analysis may be useful in assessing the room of manoeuvre for policymakers who try to bring budget deficits and the public debt in line with targets set in Maastricht.

Separate country studies (chapters 7-11) discuss the scope for increasing tax revenues and/or reducing outlays, given economic, legal, institutional and political factors typical of the Member State concerned. The study also considers the merits of alternative ways to cut back public spending, given - for example - the level of public investment and present defense spending.

2.2 A note on budget flexibility

In years to come, most Member States will have to adjust their public finances in order to comply with reference values for their public debt and deficit, as specified by the Maastricht Treaty. To assess the task ahead, it is important to establish the flexibility of general government budgets in terms of legal, socio-economic and political constraints. The term budget flexibility refers to options available to policymakers to manipulate the budget deficit or surplus. The flexibility of tax instruments and outlays by category is looked into, so as to determine the scope for policy action to redress annual deficits and the debt-to-GDP ratio in Member States concerned.

Tax systems still differ considerably between Member States of the Community. The free circulation of capital, goods and individuals may invoke tax competition among Member States. The most direct way of tax competition is through differences in tax rates. Tax competition also occurs, at similar tax rates, through variation in the definition of the tax base. Even with similar tax rates and definition of the tax base, tax-competition can still occur through differences in enforcement. The flexibility of the revenue side of the budget may be limited because of possible constraints from tax competition. Tax competition - as partly induced by the internal market, and further strengthened by growing integration of goods and services markets as well as enhanced cross border mobility of assets, enterprises, workers and consumers - may in some Member States seriously limit the scope for future tax increases. Emerging tax competition could hamper the tax intake at a time when a number of Member States need to undertake painful efforts to redress imbalances in their public finances, in order to bring down their public debt-to-GDP ratio towards the Community

average.

The flexibility of public spending will depend on, inter alia, commitments made in the past (interest due, transfer payments to international organisations, multi-year investment projects), institutional arrangements (automatic cost-of-living adjustment of transfers to households, linkage of public wages to private sector salaries), and the number of 'open-ended' programs (with no cap on spending). Also, government stability, the effectiveness of rules to draw up and control the annual budget, and political preferences may importantly contribute to the relative degree of flexibility of the expenditure side of the budget. Due to a lack of data, in this study spending items are not classified according to their degree of flexibility, but by major functional category.

Overall budget flexibility can be characterised by a singular property, i.e. automatic or built-in flexibility and discretionary flexibility. Since we are especially interested in policy options to reduce budget deficits, we will concentrate on the upward flexibility of tax revenues and the downward flexibility of outlays.

The built-in flexibility of budget items indicates the "automatic" change in receipts and expenditures when government programmes remain unchanged. With regard to the revenue side of the budget this implies constant tax bases and tax rates. Normally, the built-in flexibility of receipts is positive, as a result of growing incomes in combination with an on average slightly progressive tax structure. Applied to the expenditure side of the budget, built-in flexibility is defined as the change in outlays, keeping constant both existing eligibility criteria and indexation mechanisms of income maintenance programmes, and the setting of government wages as well.

Apart from an automatic reaction to changes in national income and employment, the built-in flexibility of outlays can be the result of demografic, social or culfural changes.

Discretionary flexibility indicates possibilities to change government receipts and expenditures by discretionary policy action. With regard to the revenue side of the budget such actions may include changes in the tax mix (through revised tax rates and/or changing the tax base of separate taxes) which, inter alia, can also lead to changes in the built-in flexibility of receipts. Analogously, policy actions can also change the built-in flexibility of expenditures, when coverage and benefit ratio's are affected.

Normally, it takes time to implement discretionary policy changes, therefore it will be clear that discretionary flexibility increases rapidly with time. Discretionary flexibility is

especially limited by third party contracts (e.g. interest payments) and, moreover, by political and economic considerations.

2.3 Methodology and data

As has been pointed out in chapter 1, the excessive deficit criterion relates to general government, which includes central government, state, regional and local authorities and the social security system. General government covers most of public sector activity; it is also the sector for which the most comparative data are available. Throughout this study we will therefore focus on general government.

The analysis of fiscal policy in the past is primarily confined to the period 1981-1990 and three subperiods thereof, i.e.: 1981-1983, 1984-1986 and 1987-1989. These sample periods have been selected on the basis of two criteria:

- the business cycle; and
- general trends in public finance.

As is well known, the government budget is sensitive to cyclical fluctuations and it is therefore important to select periods which are from a cyclical point of view as homogeneous as possible. By 1984 the level of economic activity in the Community had definitely picked up, after some years of sluggish economic performance. Over the years 1987-1989 fiscal consolidation policies were helped by higher than average GDP growth rates.

The data used in the analysis has mainly been collected and published by the EC Directorate-General for Economic and Financial Affairs. However, sometimes data provided by the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) are used. The OECD provides detailed statistics on government revenues of Member States which are employed throughout chapters 3 and 5. OECD National Accounts and IMF's Government Finance Statistics contain useful information as to the functional classification of government outlays. These data are used in chapters 3 and 4.

PART II

TRENDS IN TAXES AND PUBLIC SPENDING

3. Trends in public finances of EC Member States

Introduction

Over the last three decades public finances in Member States of the European Community underwent major changes. Three fairly distinct phases may be identified:[1]

1. The phase of balanced expansion of the public sector. During the 1960s, in the Community general government expenditure as a proportion of GDP rose rapidly everywhere, with tax receipts and other public revenues expanding more or less at the same pace. The main driving force behind higher government spending levels was the expansion of social protection schemes, reflecting both more generous individual benefits and an extension of programme coverage as well. The balanced expansion of the public sector reflected a widely shared belief in the effectiveness of government involvement in the economy, and political preferences to redistribute personal incomes.

2. The phase of strongly deteriorating budgetary positions. During the 1970s and the early 1980s the public expenditure ratio increased further in all Member States. Although the level of taxes and social security contributions also rose sharply, revenues did not keep up with additional spending. Consequently, net borrowing grew rapidly, especially so during the second half of the 1970s. After 1975 the government debt ratio started to rise sharply, following its earlier gradual decline between 1960 and 1975. The contraction in economic growth and rising unemployment contributed to the worsening of budgetary positions.

3. The phase of corrective steps towards more sound public finances. During the 1980s a fundamental reorientation of fiscal policy dominated the agenda of policymakers in most Member States. This policy reorientation was inspired by growing concern about possible adverse effects of too large a public sector, about the sustainability of budgetary positions in many countries and about the increasing inflexibility of budgets due to the expansion of the relative share of interest payments and current transfers.[2]

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[1] Public finances and fiscal policy in the Community, *European Economy*, No. 42, November 1989, 137-160.

[2] Budgetary policies in Stage I of EMU, *European Economy*, No. 46, December 1990, 163-178.

Also, awareness grew that budgetary policies should be steadily pursued and be framed in a medium-term perspective. Now, the three major objectives of fiscal policy became[3]:

a. Containing the growth of public debt

The rapid expansion of public debt implies increasing budgetary inflexibility as a result of higher debt-servicing and greater vulnerability to changes in interest rates. Moreover, there exists widespread concern that government budget deficits might put upward pressure on interest rates, which may hamper privare investment and economic growth. Such pressures were enhanced by the restrictive monetary policy stance after 1979.

b. Reducing the share of public outlays

The objective to cut back general government spending was motivated by two considerations. First, a leaner government budget would allow for smaller tax wedges, which might encourage moderate wage trends, thus restoring business profitability. Larger retained earnings would produce resources needed for an expansion of private investment and thus improve perspectives for private sector employment. Such was the second consideration of policymakers.

c. Changing the structure of public revenue and expenditure

A major goal of the tax reforms which took place in many countries was to broaden the tax base and to lower marginal tax rates, generally with the restriction that such reform measures should be broadly neutral in their impact on total tax revenue. On the expenditure side of the budget a reduction of especially subsidies and transfer payments became a major policy target.

The growth of public debt

The record so far with respect to containing the growth of public debt is clearly mixed. Two groups of countries may be distinguished here (figure 3.1):[4]

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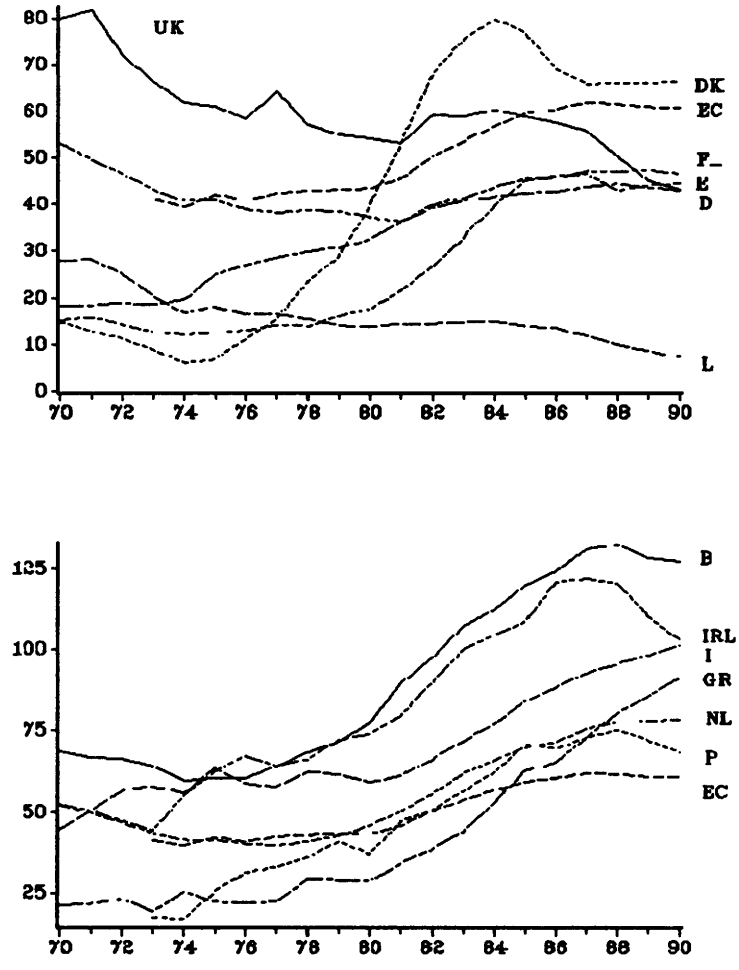
[3] Public finances and fiscal policy in the Community, *European Economy*, No. 42, November 1989, 137-160.

[4] It should be noted that not all data refer to consolidated gross debt of general government, valued in nominal terms on a calender year basis. In Belgium, the Netherlands and Luxembourg the debt of social security funds is excluded; data for Portugal are for central government only, while figures for Italy also include the debt of public enterprises. In France and the UK debt is valued at market prices. Debt has not been consolidated

- Member States with public debt below or very close to the EC average (1990): Denmark, the United Kingdom, Spain, Germany, France and Luxemburg.
- Member States with public debt above the EC average (1990): Belgium, Ireland, Italy, the Netherlands, Greece and Portugal.

Figure 3.1 General government gross debt (% GDP), 1970-1990



Source: EC, *Tables on Public Finance*

for Denmark, Greece, Spain, France and Luxembourg, while in Denmark and Spain short-term liabilities are not included.

Table 3.1 Government deficits in the Community, 1981-1990 [a]

	1981-1983 level	1984-1986 level	1987-1989- level	1981-1989 [b] change (% point) [c]	1990 level
		Net borrowing (% GDP)			
Luxembourg	-0.8	4.1	2.8	4.7	4.7
United Kingdom	-2.8	-3.1	0.3	4.6	-0.7
Denmark	-7.7	-0.9	0.8	2.8	-1.5
France	-2.6	-2.8	-1.6	-1.2	-1.7
Germany	-3.1	-1.4	-1.2	3.0	-1.9
Ireland	-13.0	-10.7	-5.9	9.2	-3.6
Spain	-4.7	-6.1	-3.1	-0.1	-4.0
Netherlands	-6.3	-5.7	-5.7	-1.2	-5.3
Belgium	-11.7	-8.9	-6.9	2.5	-5.7
Portugal	-9.6	-9.8	-5.2	5.9	-5.8
Italy	-11.1	-11.9	-10.7	-1.5	-10.7
Greece	-9.0	-12.1	-15.0	-7.3	-20.4
Community	-5.2	-4.9	-3.3	1.2	-4.1
		Primary balance (% GDP)			
Denmark	-1.3	8.5	8.7	6.2	5.7
Luxembourg	0.2	5.1	3.7	4.6	5.4
Belgium	-2.8	1.8	3.7	6.9	5.2
Ireland	-4.4	-0.9	3.5	11.7	4.8
United Kingdom	2.1	1.7	4.2	3.4	2.7
Portugal	-3.9	-1.7	2.4	7.9	2.4
France	-0.4	0.0	1.2	0.1	1.4
Germany	-0.4	1.6	1.5	3.8	0.7
Netherlands	-1.2	0.5	0.4	1.0	0.6
Spain	-3.6	-3.0	0.4	2.5	-0.5
Italy	-4.2	-3.8	-2.3	2.0	-1.0
Greece	-5.9	-7.0	-7.2	-2.3	-8.4
Community	-1.1	0.0	1.3	2.7	0.9

[a] Countries are ranked according to deficits in 1990.

[b] For Portugal and Greece cumulative change over 1982-1989.

[c] + indicates improvement of budgetary situation.

Source: EC, *Tables on Public Finance*

Table 3.1 (in conjunction with figure 3.1) shows the progress achieved with respect to the reduction of budget deficits. Table 3.1 demonstrates that many countries have succeeded in reducing their deficit position in the second half of the 1980s. Indeed, the primary balance of most countries (i.e. deficits, net of interest payments) turned positive again. However, in 1990-1991 budgetary policies in the Community relaxed. Notably, due to the detoriation of the German budgetary position following unification, and to a lesser extent as a consequence of slower economic growth, net borrowing in the Community shot up again from 2.9 percent of GDP in 1989 to 4.6 percent in 1991.

Regardless of progress achieved thusfar, budgetary problems persist in at least six countries. In Italy and Greece the public debt-to-GDP ratio is rapidly rising and nearing (Greece) or breaching (Italy) the 100 percent threshold. In both countries net borrowing in proportion to GDP is expected to stay at unsustainable high levels. In Belgium, Ireland, the Netherlands and Portugal public indebtedness remains at high to very high levels. In Belgium and Ireland public debt exceeds GDP, but in the latter country net borrowing has been reduced considerably, followed by a steep decline in the debt-to-GDP ratio. In Belgium the debt ratio has been stabilized at by far the highest ratio in the Community (almost 130 percent of GDP). In the Netherlands the debt ratio has also been stabilised, however with the debt ratio significantly above the EC average. In Portugal the public debt ratio is declining, but it is also still above the EC average. Denmark, Germany, Spain, France, Luxembourg and the United Kingdom all have reasonably sound budgetary positions, although in recent years net borrowing has increased considerably. In Germany this was a consequence of high government outlays related to the unification process.

Figure 3.2 breaks down the cumulative change in government net borrowing over the years 1981-1989 into its cyclical component (vertical axis) and a residual, which may be interpreted as the discretionary component (horizontal axis).[5] Countries to the right (left) of the vertical axis took 'discretionary' measures to reduce (increase) the deficit. Countries above (below) the horizontal axis experienced a cyclically related decrease (increase) in the deficit. Substantial discretionary improvements of the budgetary position have been achieved in Ireland, and, to a lesser extent, in Denmark, Belgium, Germany, the Netherlands and the United Kingdom.

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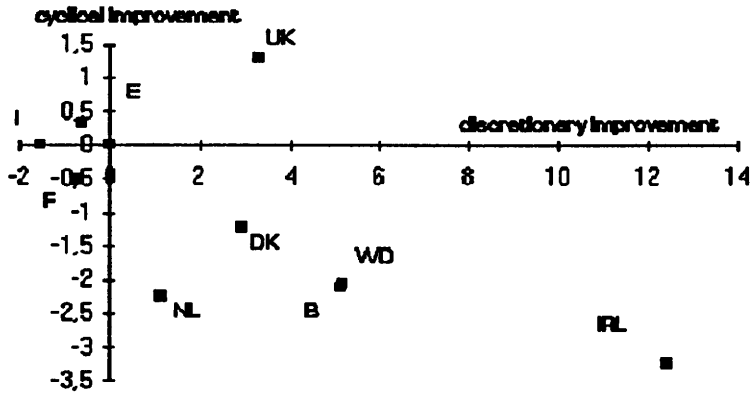
[5] The data on the cyclically adjusted deficit were provided by the OECD. In constructing figure 3.2 the OECD data on government budget deficits have also been used, so as to enable comparison with the cyclically adjusted deficit.

Figure 3.2 Fiscal stance over the period (% GDP), 1981-1989



Source: data provided by OECD

An interesting question is whether progress achieved so far has mainly been caused by reducing outlays or increasing revenues. Figure 3.3a shows that during the period 1981-1983 deficits increased in the majority of EC Member States, because expenditure growth exceeded revenue growth. Germany, Greece, Ireland, Luxembourg and Portugal trimmed the government budget deficit. It is noteworthy, that at that time some of the countries which are currently classified as having an excessive deficit were able to reduce net borrowing.

Figure 3.3a Changes in government spending and revenues (percent points), 1981-1983

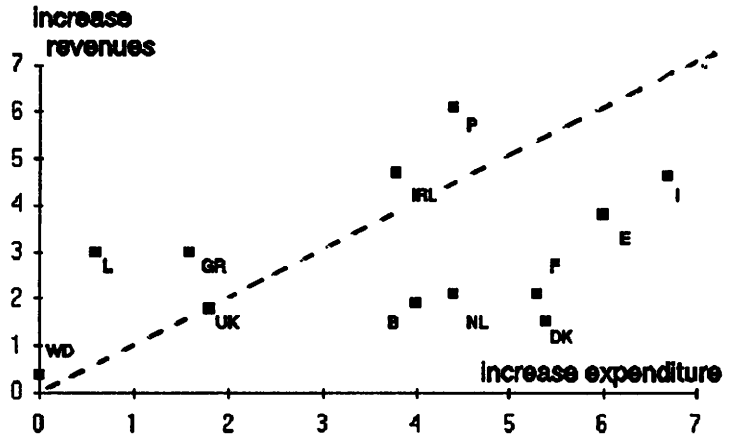
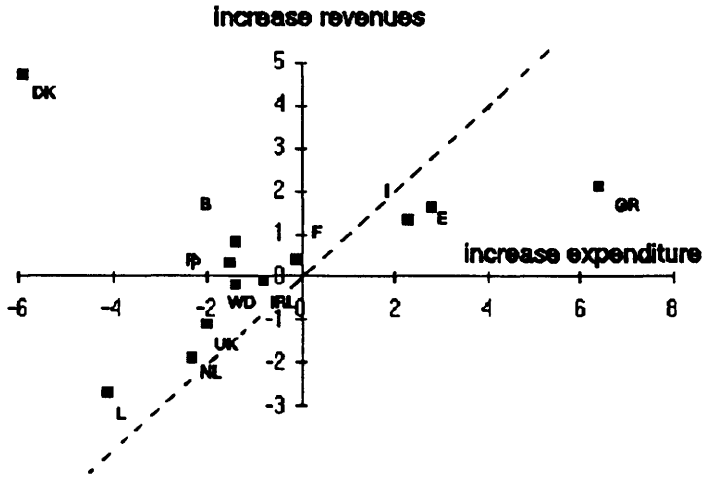
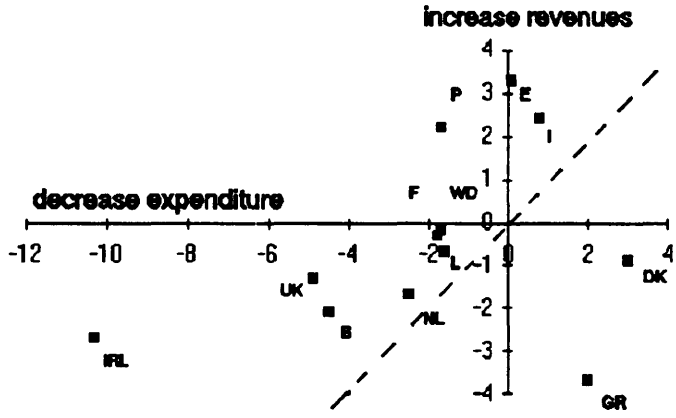


Figure 3.3b Changes in government spending and revenues (percent points), 1984-1986



Over the years 1984-1986 government net borrowing increased sharply in Greece and, to a lesser extent, in Italy and Spain. This was because expenditure growth exceeding revenue growth. The budgetary position in Denmark and, to a lesser extent, in Portugal, improved substantially, due to higher receipts and reduced outlays. In Belgium the position of the budget was also eased somewhat through higher revenue and lower spending levels. Despite lower receipts, Germany, Ireland, the Netherlands, Luxembourg and the United Kingdom were also able to improve upon their budget situation.

Figure 3.3c Changes in government spending and revenues (percent points), 1987-1989

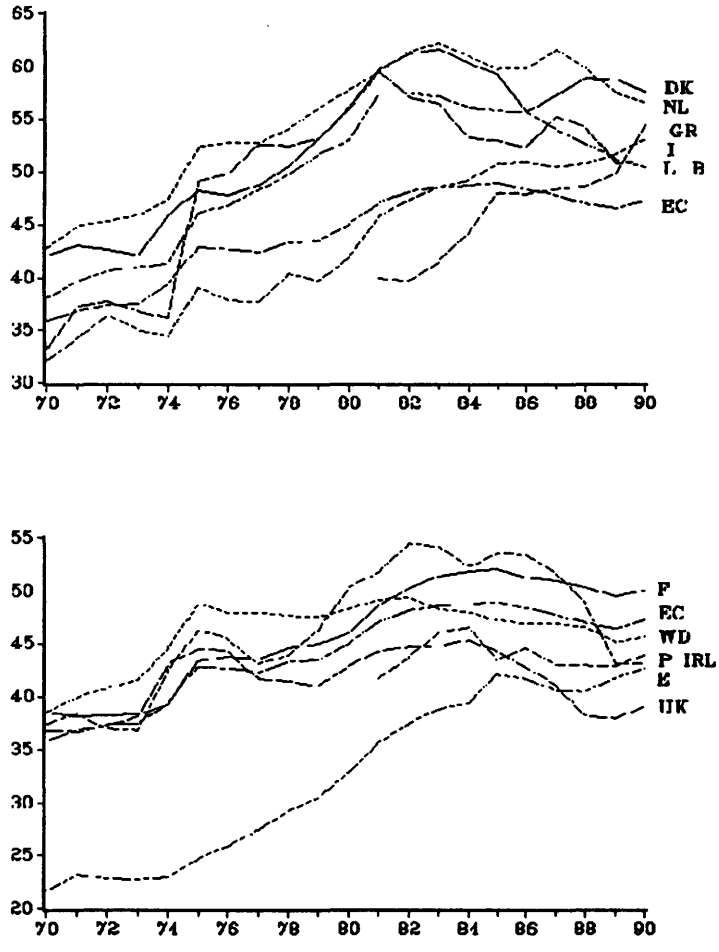


Over the years 1987-1989 most Member States were successful in bringing down government spending levels, often in conjunction with a somewhat reduced tax-take out of GDP. Ireland substantially improved upon its budgetary situation, despite an almost 3 percent point cut of its tax level, while in Portugal revenues were raised and outlays reduced. In Denmark government net borrowing increased as a result of lower receipts and higher spending. The same factors contributed to a higher deficit in Greece. In Spain the deficit was reduced by raising revenues and in Italy revenue increases exceeded spending growth.

Share of public outlays

The record with respect to reducing the share of public outlays in GDP is highly mixed (figure 3.4).

Figure 3.4 Total government expenditure (%GDP), 1970-1990



Source: EC, *Tables on Public Finance*

In a large number of countries total government expenditure expressed as a percentage of GDP decreased in the second half of the 1980s. However, Greece, Spain and Italy further expanded their public sector during the whole decade. In Portugal government spending remained around 45 percent of GDP.

Tax reform

Over the past decade, tax reform became a major policy issue in most OECD member countries. Broad interest in options to reform national tax systems originated in growing concern that taxes not only imposed large costs on society by distorting economic decisions, but also that taxes were unnecessarily complex and unfair (Hagemann et al., 1988). Undoubtedly, the prospect of fiercer tax competition has also motivated policymakers in some countries to critically inspect their tax systems. Fear among policymakers of increased tax competition may in part explain why in the 1980s many countries lowered the rates of the personal and the corporate income tax.

As national economies within the EC become more closely integrated, and with formal restrictions on capital transactions removed, it may be presumed that overall tax levels and rates of major taxes will tend to gradually converge, since the removal of all kind of barriers to trade and factor movements will intensify competition, which may in turn enhance rivalry in taxation.

Seen in broad perspective, tax reform efforts in a number of EC Member States seem to have concentrated on two major sources of government revenue: the personal income tax and the value added tax. In addition, in some EC countries the corporate income tax was fundamentally overhauled. Only a few countries also scrutinised the role and rates of social security contributions.

In line with the approach taken by the authorities in the USA (Tax Reform Act of 1986), most of the EC countries sought to broaden the tax base of the personal income tax, while at the same time reducing the level and flattening the structure of rates. In several Member States, lower income tax rates were also achieved by increasing the share of other taxes in national tax mixes. Such revisions were largely the result of a un-coordinated policy process, since up till now the Commission has not declared the harmonisation or coordination of the personal income tax (and social security contributions) to be an urgent target for Community policies.

Likewise, a number of Member States have reduced the rate of the corporate income tax, in many cases by as much as ten points or even more. Again, such rate reductions reflect in part a 'spontaneous' adjustment of national tax systems, in order to level effective tax rates on the use of capital. To recoup resulting losses to the budget, the tax base was often expanded, mainly by reigning in tax incentives for private investment.

The creation of a single integrated market, free of restrictions on the movement of goods, requires that product taxes are closely coordinated. To that end, in the 1980s Greece, Portugal and Spain have introduced the value added tax. In itself, this move constituted a major reform. By now, the tax base of VAT is nearly fully harmonised across Member States. During the past decade VAT-rates were slightly increased, reflecting growing budgetary needs. In October 1992, the Council adopted measures introducing a minimum VAT rate of 15% as from 1 January 1993, also imposing minimum excise rates.

Taxing and spending: levels and mixes

During the 1980s general government spending levels in Member States of the European Community did not converge. In 1981 the 'spread' between spending levels amounted to 15.5 percent points of GDP, to increase to 18.5 points by 1990. A closer look at government outlays reveals their widely varying mix among Member States. Some common trends may be discerned, however. The share of interest payments grew in nearly all States, whereas the share of public investment dropped. Transfers dominate government outlays in most or all Member States. Interestingly enough, the spread in the part of GDP that Member States (re)distribute through transfer payments has slightly contracted, from 17.4 percent points (1980) to 15.1 points. Transfers expanded markedly in the 1970s, and it seems unavoidable that this spending category bears the brunt of necessary budgetary adjustments.

The area of taxation offers a rather diverse picture. In the course of the 1980s the spread in tax levels of Member States has been reduced somewhat. On the other hand, successive changes of the tax legislation seem to have increased the already existing variation of national tax mixes. The relatively limited share of the personal income tax in the Dutch and French tax mix fell even further, whereas Member States that already heavily relied upon consumption taxes expanded the role of such taxes in the national tax mix. Chapters 4 and 5 will discuss trends in spending and taxation, respectively, in greater detail.

(3)

4. Analysis of government expenditure, 1980-1989

In this chapter government outlays are disaggregated so as to examine the change of major spending categories during the 1980s. Two classifications of government outlays are considered: a breakdown by economic classification and, as far as possible, a breakdown by function.

4.1 Economic classification

Five categories of government outlays are distinguished here:

1. current transfers;
2. interest payments on government debt;
3. government consumption;
4. net capital transfers;
5. gross fixed capital formation.

Table 4.1 details the development of government expenditures over the period 1981-1989 and in 1990. Trends in current transfers differ in the various Member States. In six countries (Denmark, Greece, Spain, France, Italy and the Netherlands) current transfers rose during the 1980s, whereas in the remaining Member States this category of spending was cut back. It is noteworthy, that three out of four Member States where current transfers already absorbed the largest share of GDP (the Netherlands, Denmark and France) belong to the group of countries with rising transfer spending.

Government consumption has increased over the years 1981-1989 in Greece, Spain, Italy and Portugal. It may be noted, that Greece has already one of the highest government consumption ratios in the Community.

Table 4.1 Government expenditure, economic classification, 1981-1990 [a]

	current transfers		consumption		interest payments		capital transfers		capital formation	
	1981-1989 change	1990 level	1981-1989 change	1990 level	1981-1989 change	1990 level	1981-1989 change	1990 level	1981-1989 change	1990 level
Denmark	1.9	23.5	-1.6	24.8	3.5	7.2	0.1	0.2	-1.4	1.9
Netherlands	1.4	31.9	-2.6	14.9	2.2	5.9	-0.5	1.6	-0.9	2.3
Greece	5.3	17.1	4.1	21.4	5.8	12.0	0.7	0.9	-0.5	3.1
Italy	3.7	21.2	2.1	17.4	3.6	9.7	0.1	1.4	0.1	3.5
Luxembourg	-2.0	27.4	-0.7	16.4	0.0	0.7	-0.5	0.7	-1.7	5.9
Belgium	-0.9	21.8	-3.1	15.3	4.5	10.9	-0.1	0.8	-2.2	1.6
France	2.3	25.1	0.0	18.1	1.3	3.1	-0.2	0.4	0.0	3.4
Germany	-0.4	21.4	-1.4	18.3	0.8	2.6	-0.7	1.0	-1.3	2.3
Portugal	-0.1	15.3	1.5	16.3	4.0	8.2	0.4	1.3	-1.0	3.0
Ireland	-0.1	16.4	-4.5	16.1	2.5	8.4	-1.2	0.2	-4.0	1.9
Spain	1.9	18.0	1.8	15.1	2.6	3.5	0.1	1.1	2.5	5.0
United Kingdom	-1.3	13.0	-1.9	19.6	-1.0	3.3	-0.4	0.9	-0.7	2.3
EC	1.0	20.6	-0.3	17.9	1.6	5.0	-0.3	1.0	-0.2	3.0

[a] Countries are ranked according to total spending in 1990.

Source: EC, *Tables on Public Finance*

Interest payments on government debt have increased in all Member States, with the exceptions of Luxembourg and the UK. Note, however, the considerable differences in the growth of interest payments, largely depending, of course, on the rise of the debt-to-GDP ratio. In Greece and Italy, for instance, interest payments ballooned by 5.7 percent points and 3.6 points, respectively, whereas in Germany this category of government spending rose by only 0.8 percent points.

Net capital transfers have been reduced in many Member States. It is often maintained that in periods of fiscal consolidation capital formation outlays are among the first items to be cut, often quite drastically so, given that they are perceived by policymakers as the least rigid component of total outlays. The experience of the European Community corroborates this view. Only in Spain and, to lesser extent, Italy capital expenditures increased over the years 1981-1989. In some countries the fall of government investment has been so drastic that it might prove necessary to increase this category of government spending in the near future ('catch-up').

4.2 Functional classification

For the analysis of trends in outlays by various functional groups, seven expenditure categories are distinguished. Following Saunders and Klau (1985) these categories are grouped into four separate policy areas: the traditional domain, the welfare state, the mixed economy and other functions.

The traditional domain
- general public services, public order and safety;
- defense;

The welfare state
- education;
- health;
- social security, welfare and housing (including community amenities, recreational, cultural and religious affairs);

The mixed economy
- economic services (including fuel, energy, agriculture, fishing, mining, hunting, manufacturing, construction, transportation and communication);

Other functions.

Figure 4.1 charts trends in outlays by function for most Member States. Unfortunately not every year of the past decade could be included. Since as many years have been taken into account as our data bases[6] permit, the period covered varies among countries. All figures used are expressed as a percentage of GDP and changes therefore refer to percent points. Lack of data compelled us to exclude Greece. Figures for the Netherlands and Ireland refer to consolidated central government instead of general government.

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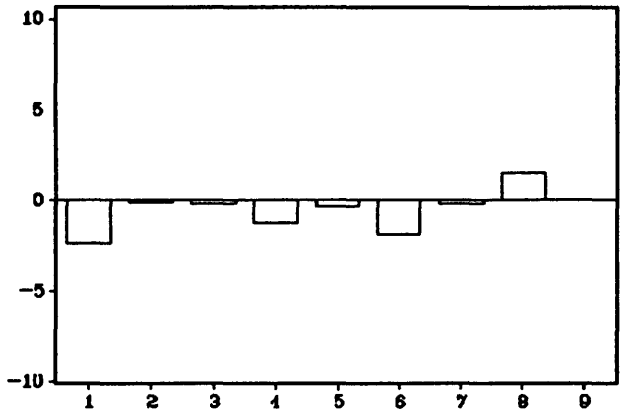
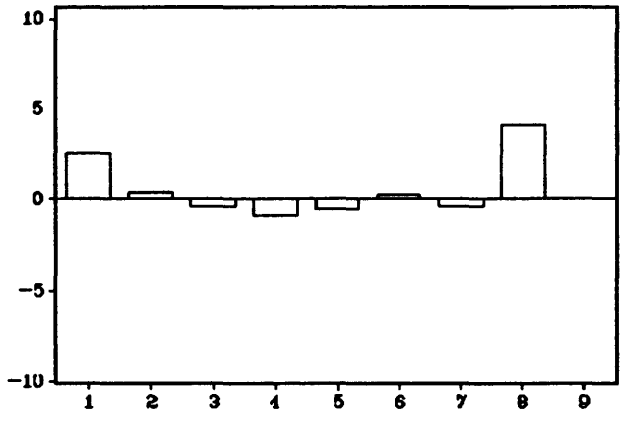
[6] OECD National Accounts, except the figures for the Netherlands and Ireland which are from IMF Government Finance Statistics Yearbook; figures for Spain are based on Eurostat.

Figure 4.1 Cumulative change in government expenditure, functional classification (percent point of GDP)

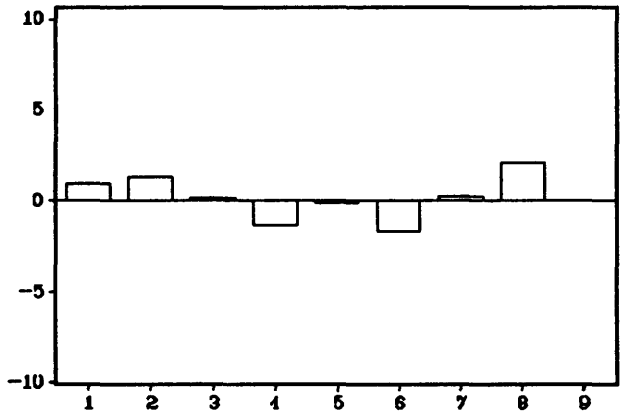
Belgium, cumulative change, 1983-1986



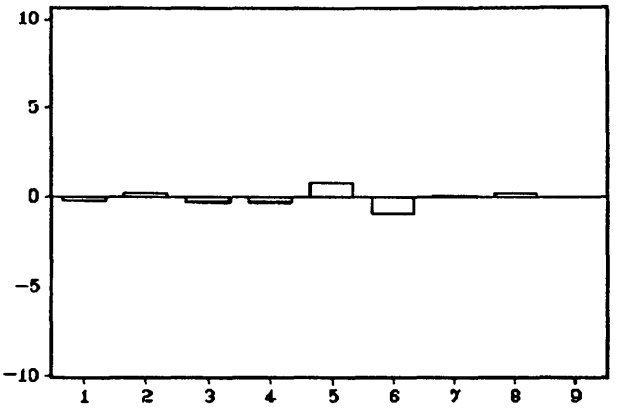
Denmark, cumulative change, 1981-1988



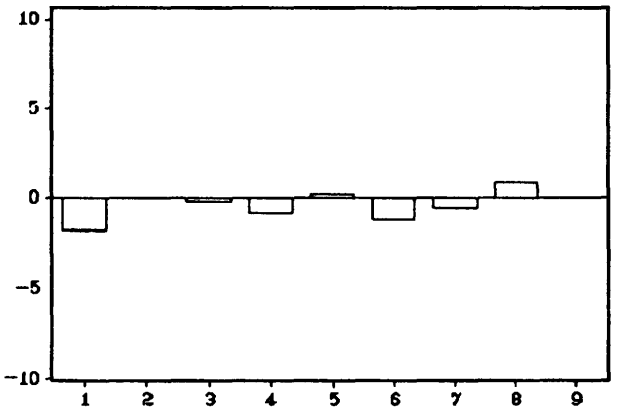
Spain, cumulative change, 1981-1986



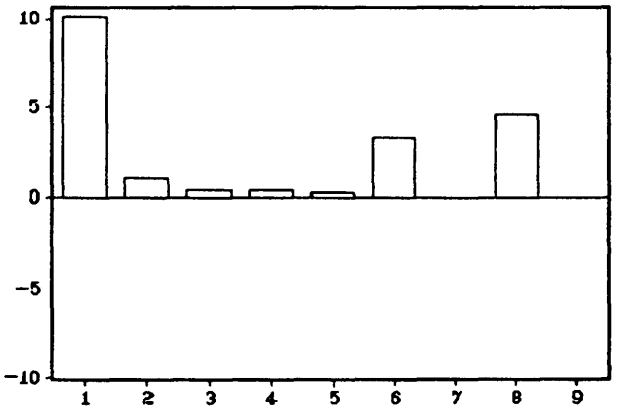
France, cumulative change, 1984-1987



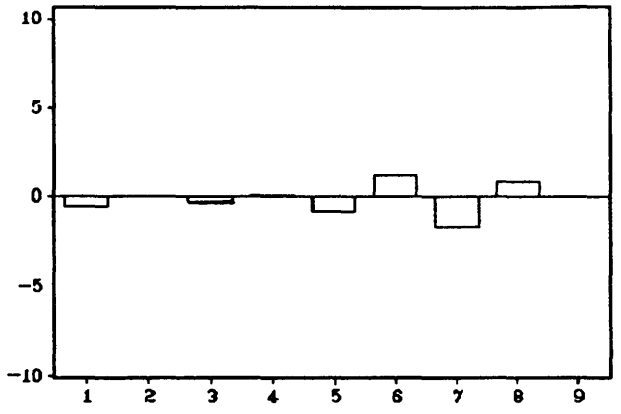
Germany, cumulative change, 1981-1988



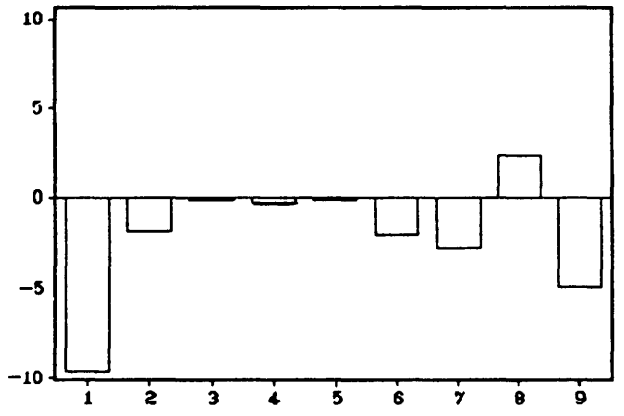
Italy, cumulative change, 1981-1989



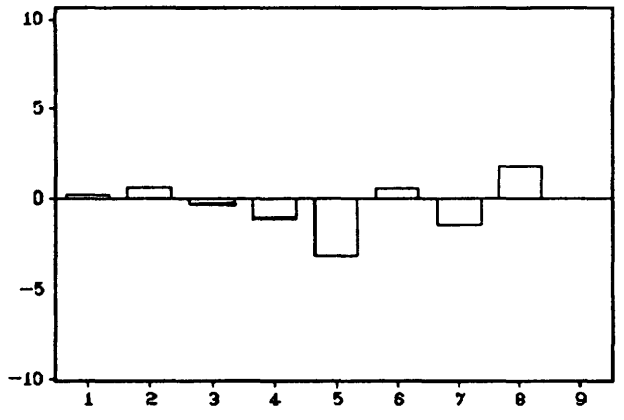
Ireland, cumulative change, 1983-1987



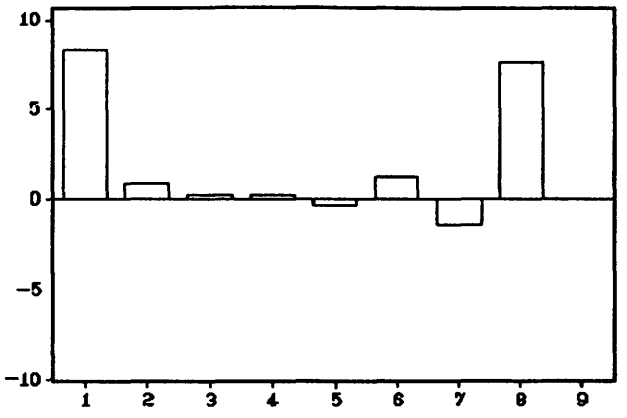
Luxembourg, cumulative change, 1981-1986



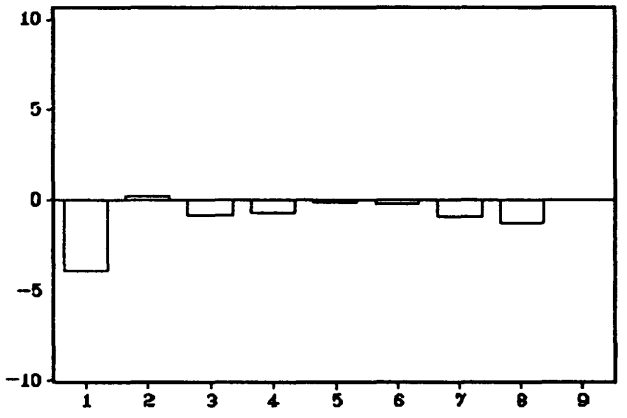
Netherlands, cumulative change, 1981-1989



Portugal, cumulative change, 1981-1986



United Kingdom, cumulative change, 1981-1989



Legend:

1. Total government expenditure
2. Government services, public order and safety
3. Defense
4. Education
5. Health
6. Social security, welfare and housing
7. Economic services
8. Other functions (incl. interest payments)
9. Correction

General trends

In Denmark, Italy, the Netherlands, Spain and Portugal total government spending increased in the period considered here. Especially Italy (+10.1) and Portugal (+8.3) showed a marked growth of outlays. In the other Member States government spending was reduced. It is interesting to see which functional spending categories bore the brunt of these reductions. In countries with rising spending levels the increase of outlays can largely be attributed to the category 'other functions', which includes interest payments on government debt.

In countries with decreasing spending levels expenditures relating to the welfare state (especially education and social security, welfare and housing) and to the mixed economy were cut back relatively most. Expenditures relating to the welfare state form exactly the category which showed the biggest expansion in the seventies.[7] Apparently, governments in the 1980s tried to roll back the expenditure trends of the 1970s. Due to the high share of welfare spending in total outlays, relatively small budget cuts in this area lead to a substantial reduction of the share of total government spending in GDP.

This result of decreasing welfare state spending in many EC Member States is perhaps surprising, given the findings of a recent OECD study by Oxley and Martin (1991). For a set of eleven OECD countries, of which only four countries are included in our sample, these authors conclude that "excluding debt interest payments, the main increase in the spending ratio, as in the 1970s, has been in the area of 'welfare state' activities.." (Oxley and Martin 1991, p. 161).

In the EC Member States spending in the traditional domain generally showed very little dynamics. A slight increase in expenditures on general public services, public order and safety was compensated for by a small decrease in defense spending.

Development of separate functional categories

In the traditional domain, expenditures on general public services, public order and safety only increased by about 1 percent point in Portugal, Italy and Spain. In the Netherlands this increase was somewhat smaller. Other countries show a small decrease, generally less than 0.5 points. Defense expenditures mostly decreased. Only in Spain, Italy and Portugal there was a very limited increase.

Of the welfare state expenditure categories spending on education was generally on a downward trend; in Germany and the UK a little less than 1 percent point, in the Netherlands, Belgium and Spain slightly more. Health expenditures decreased in eight out of the

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[7] See: Saunders and Klau (1985), p. 49.

eleven countries from our sample. The Netherlands (-3.1), Ireland (-0.8), Denmark (-0.5) and Portugal (-0.4) showed the biggest drop in health spending. On the other hand, health spending went up in France, Germany and Italy. Expenditures on social security, welfare and housing decreased in six countries. In Belgium, Spain and Luxembourg the decrease was about 2 percent point.

The single category distinguished here among the expenditures relating to the mixed economy, 'economic services', generally showed a decline, rather substantially so in Luxembourg (-2.8), Portugal (-1.4), the UK (-0.9), the Netherlands (-1.4) and Ireland (-1.7). Denmark showed a more moderate trend (-0,6).

'Other expenditures' increased in most countries, the most extremely so in Portugal (+5.2), Italy (+2.8), Denmark (+2.8), Spain (+2.1), Belgium (+1.5) and the Netherlands (+1.4).

5. Analysis of tax receipts, 1980-1989

In this chapter government receipts are disaggregated so as to examine which revenue categories have changed during the 1980s.[8] Efforts to reduce tax rates and the wedge not withstanding, in the 1980s total tax revenue as percentage of GDP increased in the EC area as a whole by 3.5 percent points (unweighted average). A breakdown by subperiod (table 5.1) shows that tax rises were largely concentrated in the years 1981-1983 (2.9 percent points). In the late 1980s the average tax level in the EC even declined ever so slightly (by -0.2 points). During this subperiod the tax level fell markedly in Greece (-3.8), Belgium (-2.8), Ireland (-1.5) and the United Kingdom (-1.1).

Over the period as a whole, Spain (10.6), Italy (7.6), Portugal (6.4), Greece (4.8), Denmark (4.4) and Ireland (3.6) all witnessed an above average increase of their tax-to-GDP ratio. France (2.1), Luxembourg (1.4) and the United Kingdom (1.2) saw a smaller rise of the tax-take out of GDP. In the Netherlands (0.2), Germany (0.1), and Belgium (-0.1) the tax ratio more or less stabilised. In fact, by 1989 no single Member State had succeeded in reducing its tax-to-GDP ratio to below the 1980-level.

Table 5.1 also shows EC Member States at the end of the 1980s to move in two 'tax convoys', with Denmark way ahead. In the first convoy national tax levels are typically in the 42-46 percent of GDP range. Countries in the second convoy are characterised by tax levels in the 33-38 percent of GDP range. In the 1980s some convergence of tax levels has materialised, since the rise of tax levels in all countries of the first convoy was clearly below the EC average. Only Denmark speeded ahead, in a forceful effort to drastically curb its deficit. All southern Member States are in the second convoy, and their tax levels haven clearly been catching up. In this group, Germany and the United Kingdom experienced an only (very) moderate hike of the tax-to-GDP level.

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[8] Since the *Revenue Statistics* of the OECD provide the most detailed figures on taxes our analysis is based upon OECD data.

Table 5.1 Change of tax levels (percent points of GDP), 1981-1989 [a]

	tax level 1989	change of tax level (percent points of GDP)		
	(% of GDP)	1981-89	1981-83	1984-86	1987-89
Denmark	49.9	4.4	1.0	4.3	-0.9
First convoy:					
Netherlands	46.0	0.2	0.9	-0.9	0.2
Belgium	44.3	-0.1	2.0	0.7	-2.8
France	43.8	2.1	1.9	0.4	-0.2
Luxembourg	42.4	1.4	3.9	-2.6	0.1
EC average	39.9	3.5	2.9	0.8	-0.2
Second convoy:					
Germany	38.1	0.1	-0.7	0.3	0.5
Italy	37.8	7.6	5.6	0.3	1.7
Ireland	37.6	3.6	4.3	0.8	-1.5
United Kingdom	36.5	1.2	2.1	0.2	-1.1
Portugal	35.1	6.4	4.2	0.5	1.7
Spain	34.4	10.6	3.8	3.0	3.8
Greece	33.2	4.8	5.5	3.1	-3.8

[a] Countries are ranked by declining tax-to-GDP ratio.

Source: OECD

The tax structure of any country may be characterised by the tax mix by sector of government, or by the relative share of various types of tax. Besides total tax levels, table 5.2 displays the tax mix by type of tax for all EC Member States. Following the OECD classification of taxes, all national taxes have been grouped into one of six categories:

1. taxes on income and profits, including capital gains (1000);
2. social security contributions (2000);
3. taxes on payroll and workforce (3000);
4. taxes on property (4000);
5. taxes on goods and services (5000);
6. other taxes (6000).

In table 5.2 social security contributions and payroll taxes have been lumped together. Taxes under code 6000 have been omitted from the table, as they are relatively unimportant in

revenue terms.

In 1989 countries clearly had different tax profiles. In France (44 percent of total tax revenue), the Netherlands (41), Germany (36) and Spain (35) social security contributions and payroll taxes are the single most important source of government revenue. Receipts from this source vary strongly among Member States, reflecting both varying degrees of coverage and generosity of programs, and different methods of financing social security transfers as well.

In Denmark (60 percent), Luxembourg (41 percent), the United Kingdom (39 percent), Belgium (38 percent), and Italy (37 percent) income and profit taxes head the list of national revenue sources, whereas Greece (45 percent), Portugal (45 percent) and Ireland (44 percent) rely mainly on taxes on goods and services.

Reading the columns of table 5.2, the spread in the share of income and profit taxes is 43 points, ranging from 60 percent in Denmark to only 17 percent in France and 18 percent in Greece. Social security contributions show a spread in the same order of magnitude (41 points), their share ranging from 44 percent in France to only 3 percent in Denmark.

After lumping together all taxes on income, profits and wages (codes 1000-3000), to correct for the varying degree to which social security transfers are financed through separate contributions, the spread of these taxes across Member States is considerably narrowed. Still, a wide gap remains between Belgium, Germany, Italy and the Netherlands (70-72 percent of total tax revenues) on the one hand, and Ireland, Greece and Portugal (51-52 percent) on the other hand. Of course, consumption taxes (code 5000) dominate the tax mix of the latter Member States.

The share of property taxes (code 4000) also varies considerably, from 2-3 percent (Italy, Portugal, Belgium, Germany and Greece) to 13 percent in the United Kingdom.

Table 5.2 Tax mix of Member States (tax shares in % of total tax), 1989

	tax level	total	1000	2/3000	4000	5000
Denmark	49.9	100	60	3	4	33
Netherlands	46.0	100	29	41	4	26
Belgium	44.3	100	38	34	3	26
France	43.8	100 [a]	17	44	7	29
Luxembourg	42.4	100	41	26	8	24
Germany	38.1	100	35	36	3	26
Italy	37.8	100	37	34	2	27
Ireland	37.6	100	35	16	5	44
United Kingdom	36.5	100	39	18	13	31
Portugal	35.1	100	26	26	2	45
Spain	34.4	100	33	35	4	29
Greece	33.2	100	18	33	3	45
Memorandum item:						
EC average [b]	39.9	100				

[a] France gathers 3% from 'other taxes' not included here.

[b] Unweighted.

Source: OECD

Table 5.3 Change of tax mix (change in percent points of GDP), 1981-1989

	tax level 1989 (% of GDP)	income (1100)	profits (1200)	social (2/3000)	property (4000)	consumption (5100)
Denmark	49.9	2.5	0.6	0.7	-0.4	-0.4
Netherlands	46.0	-2.3	0.5	1.5	0.1	0.2
Belgium	44.3	-2.0	0.5	1.6	0.2	-0.3
France	43.8	-0.2	0.3	1.3	0.7	-0.4
Luxembourg	42.4	-1.1	0.7	-1.2	1.2	1.5
Germany	38.1	-0.1	0.0	0.6	0.0	-0.4
Italy	37.8	3.1	1.4	1.0	-0.2	0.6
Ireland	37.6	1.0	-0.2	0.9	0.0	3.1
United Kingdom	36.5	-0.9	1.5	-1.0	0.4	1.1
Portugal	35.1	n.a.	n.a.	0.0	0.1	2.5
Spain	34.4	3.1	1.8	0.2	0.2	3.4
Greece	33.2	0.0	0.4	0.9	-0.2	4.7

Source: OECD

Although the 1980s witnessed an increase of aggregate tax levels in all Member States (by 3.5 percent points on average), the share of separate taxes showed a somewhat more dynamic pattern, as may be illustrated by table 5.3.

Revenue from the personal income tax fell in the Netherlands (by -2.3 percent points), Belgium (-2.0), Luxembourg (-1.1) and the United Kingdom (-0.8). On the other hand, Spain and Italy (3.1), and Denmark (2.5) recorded a relatively significant increase in revenue from the personal income tax.

Although the rate of the corporation income tax was reduced in most EC Member States, revenue from this source grew in all jurisdictions (Ireland excepted), sometimes markedly so, at least in relative terms.

Social security contributions demonstrated more variation, increasing most in Belgium (1.6) and the Netherlands (1.5), and falling most in Luxembourg (-1.2) and the United Kingdom (-1.0). The share of property taxes notably went up in France (1.2) and Luxembourg (0.7), to drop in only three Member States.

Finally, proceeds from taxes on consumption showed a slow but persistent upward trend in some Member States, and were reduced in some other countries. Revenue from general consumption taxes strongly increased in Member States that introduced VAT only in the 1980s, i.e. Greece (4.9), Spain (3.4) and Portugal (2.5). Revenue from VAT also rose quite substantially in Ireland (3.1) and the United Kingdom (1.1). Variation in VAT-revenues in the original founding Member States remained between -0.4 (France, Germany) and 0.6 (Italy), Luxembourg (1.5) being an outlyer here.

Table 5.3 serves to illustrate the impression that in the 1980s changes in tax shares sometimes tended to enlarge the already existing variation in national tax mixes. For example, the rather limited role of the personal income tax in the Dutch and French tax mix was further reduced, whereas some countries with a high share of regressive taxes increased consumption taxes most.

Under conditions favoring possibly increasing tax competition, especially tax rates require close attention. Table 5.4 displays rates of selected taxes of EC Member States (at 1991/1992 levels). The information in table 5.4 should be interpreted cautiously, since a number of caveats apply. For example, the impact of local income taxes (Belgium, Denmark) and temporary tax increases (Germany) has been omitted. Moreover, the corporate income tax rate may differ for retained earnings and profits paid out to shareholders respectively (Germany, France). Only the standard rate of value added tax has been included in table 5.4. Excise rates (expressed in ECU; rounded) are approximate, because a certain variation by product characteristics has been neglected. In short, tax rates presented in table 5.4 are primarily intended to illustrate relative country positions in a general way, and should be interpreted accordingly.

The spread in the top rate of the personal income tax (1992 data) amounts to twenty percent points, Denmark, Portugal and the United Kingdom (all 40%) and the Netherlands (60%) being located at both extremes of the tax spectre. The gap between national corporate income tax rates (1991 data) is thirteen points. Here Luxemburg (33%), Greece (46%) and Germany (50%, aplies to retained earnings only) take extreme positions. The spread of the standard rate of the value added tax is still twelve points (Spain 13%, Denmark 25%). However, as from January 1993 all Member States will have to observe a minimum rate of 15%, reducing the spread to ten points at most. Rates of selected excises taxes show wide variation.

The spread in present rates, as is illustrated in table 5.4, stresses the scope for increased harmonization of tax rates. Harmonization may result from market pressures or political effort.

(4)

Table 5.4 Selected tax rates in EC Member States, 1991/1992

	Belgium	Denmark	Germany	Greece	Spain	France	Ireland	Italy	Luxembourg	Netherlands	Portugal	UK
Personal income tax (top rate) (%) [1992]	55	40	53	50	56	56,8	52	51	50	60	40	40
Corporate income tax (%) [1991]	39	38	36/50	46	35	34/42	43	36	33	35	36	34
Value Added Tax standard rate (%) [1992]	19,5	25	14	18	13	18,6	21	19	15	17,5	17	17,5
Excises (ECU)[a] [1992]												
- Ethyl alcohol and spirits (hl)	1513	1802	1251	171	561	1122	2616	745	905	1384	675	2779
- Beer (hl)	16	68	7	9	4	3	113	22	5	20	12	78
- Petrol (unleaded) (1,000 l)	338	286	402	202	390	407	362	551	242	423	467	329
- Cigarettes [b]	69	147	82	35	17	55	103	55	44	54	42	118

[a] Rounded.

[b] Total tax yield per 1,000 cigarettes of most popular price category.

Source: International Bureau of Fiscal Documentation, European Tax Handbook (ed. 1992);

OECD, Taxing Profits in a Global Economy (1991, p. 71); Commission of the European Communities (excises)

PART III

IMPACT OF POLITICAL AND INSTITUTIONAL FACTORS

6. Impact of political and institutional factors on fiscal policy in the 1980s

6.1 Introduction

Previous chapters have documented considerable cross-country differences in the EC as to both the size of the public sector and the public debt-to-GDP ratio of Member States. This chapter in turn examines which factors may help to explain such cross-country variation.

Explaining the size of the public sector has been an important issue on the public finance research agenda, ever since Wagner (1883) published his 'Law of Increasing State Activity'. According to Wagner the demand for increases in the scope of public sector activity was to be considered as a natural consequence of higher living standards which accompany economic industrialisation. There are surprisingly few studies which attempt to explain country variation in the share of government expenditure in GDP. Wagner's law has received almost no empirical support from cross-section studies (Saunders and Klau (1985)). More recent analyses of public expenditure growth have focused on supply-side influences. The 'plateau theory' of Peacock and Wiseman (1961) and the 'unbalanced productivity growth' model of Baumol (1967) are well-known examples.

In explaining public sector growth, the public choice approach focuses on the role of voting behaviour and decision-making in mixed economies. Much of this literature attempts to show an inherent bias towards overproduction of public sector goods. This bias towards excessive government size may be a consequence of voter coalitions (Buchanan and Tullock (1962)), bureaucratic behaviour (Niskanen (1971)) or it may be the result of the impact of public employee voting patterns. According to the public choice approach modern democracies also have a bias towards deficit financing of government expenditure. As Tollison and Wagner argue: "there exists a bias towards the use of deficit finance, because deficit finance can increase a governing party's support over what it would be with tax finance. In the absence of borrowing and inflation as methods of finance, a governing party can increase expenditures only by increasing taxes. While increased expenditures increase political support for the governing party, increased taxation reduces it... Deficit finance, however, allows the governing party to offer some combination of lower taxes and higher expenditures" (Tollison and Wagner, 1987, 376-377).

In recent theoretical and empirical research the variation in political and institutional arrangements which may affect the process of national policy formation is hypothesized to explain cross-country differences with respect to fiscal policies pursued. A first class of models investigates how the political system affects the behaviour of policy-makers (see Grilli

et al. (1991)). According to these models two features of the political system are especially relevant: instability (i.e. the chance that policymakers will be thrown out of office) and polarization (i.e. how strong is the disagreement between alternating governments). For instance, Persson and Svensson (1989) have shown that a conservative government, which favours a low level of government spending but knows that it will probably be replaced by a government that prefers higher spending levels, will borrow more than when it was certain to stay in office. For a two party system, Alesina and Tabellini (1990) show that public debt is positively correlated with the degree of polarization between alternating governments, with the time between government changes, and with the chance that a government will not be re-elected. Basically, these models imply that more unstable and polarized political systems behave more myopically and have, therefore, higher public debt-to-GDP ratios. Indeed, Grilli et al. (1991) found a strong negative correlation between debt accumulation and the frequency of government changes in their sample of eighteen OECD countries.[1] Saunders and Klau (1985) report that the number of elections, reflecting opportunities for competitive fiscal bidding by political parties, is significantly positive in their cross-country regression which tries to explain the growth of the public sector.

A second class of models focusses on disagreement between various decision makers (see e.g. Alesina and Drazen (1991)). The greater the conflict, the more difficult it will be to enact on deficit reduction measures. It is likely, that such policy conflicts are more important in countries with coalition governments. Game theory suggests that cooperation is harder when the number of players is large. In this view, coalition governments will have a hard time closing budget deficits after adverse shocks, since individual parties in the coalition will each veto spending cuts or tax increases that would impinge on their constituencies (see also Corsetti and Roubini (1991)). Roubini and Sachs (1989a) and Corsetti and Roubini (1991) found that their index of political power dispersion, which measures the type of government in power, helps explain government debt growth in their sample of fifteen OECD countries: large coalition governments have higher deficits, other things being equal, than do one-party, majoritarian governments. Edin and Ohlson (1991) argue, however, that the political cohesion variable used by Roubini and Sachs captures the effects of minority governments, rather than majority coalition governments. Roubini and Sachs (1989b) also stress that coalition governments will have a bias towards higher levels of government spending relative

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[1] There is also some evidence concerning developing countries. See Cukierman et al. (1989), Edwards and Tabellini (1991), Roubini (1991) and De Haan and Siermann (1992). All these studies conclude that the number of government changes help explain cross-country variation in fiscal policy.

to majority-party governments, as various parties in government make logrolling agreements so as to ensure higher outlays benefitting their individual constituencies. They report evidence in support of this view.

A third class of models, which antedates the models outlined above, focuses on ideological differences (see e.g. Hibbs (1977) and Frey and Schneider (1978)). It is often maintained that left-wing governments aim for a higher share of government spending in total output, and are perhaps even more willing to accept rising government budget deficits, than do right-wing governments. Cameron (1985) and Roubini and Sachs (1989b) found some support for this hypothesis, but De Haan and Zelhorst (1992) conclude that government debt growth in Germany is not influenced by the 'political colour' of government.

Finally, some authors have argued that budgeting procedures, i.e. the rules according to which budgets are drafted by the government, amended and passed by the parliament, and implemented by the government may have important consequences for the sustainability of fiscal policy (see e.g. Von Hagen (1991) (1992)). According to Von Hagen a budgeting procedure enabling a government to commit itself to fiscal discipline is an essential condition for fiscal stability. Indeed, Von Hagen (1992), using data from the European Community countries during the 1980s and characterizations obtained from an assesment of national budget procedures, has found strong empirical support for the view that a budgetary process that gives the prime minister or the finance minister a dominant position over spending ministers, that limits the amendment power of parliament, and that leaves little room for changes in the budget during its implementation, is conducive to fiscal discipline.

In this section we will build upon the literature indicated above and examine whether cross-country differences in debt accumulation and public sector size can be explained using, inter alia, the following variables:[2]

- the number of government changes;
- the share of cabinet portfolios held by social democratic and other leftist parties;
- the Roubini and Sachs political power dispersion index;
- a variant of the Von Hagen budgetary process variable.

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[2] The position of the central bank, i.e. whether it is autonomous or not, may also be of relevance. In the present study we do not take up this line of inquiry. In a previous paper we have shown that countries with an independent central bank generally have lower budget deficits. See De Haan and Sturm (1992).

6.2 The data

We describe three main features of the political systems of EC Member States: (a) the type of government; (b) the stability of governments; and (c) the share of cabinet portfolios held by social democratic and other leftist parties.

Various authors have argued that the kind of government (coalition, majority government or minority government) may influence both government debt accumulation (Grilli et al. (1991)) and the level of government spending (Roubini and Sachs (1989b)). To capture possible effects of divided versus single party governments, and following Roubini and Sachs (1989a,b), we have constructed an index of power dispersion (POL) which measures the size of the governing coalition, ranging from 0 (smallest coalition) to 3 (minority government)[3]:

Index 0 one-party majority parliamentary government;
1 coalition parliamentary government with two-to-three coalition partners;
2 coalition parliamentary government with four or more coalition partners;
3 minority government.

Our second variable CHANGE traces the frequency of government changes. A government change occurs after each election and if a change takes place with respect to the parties participating in the governing coalition.[4] For example, when the social democrats left the three-party coalition in the Netherlands in 1982 and the remaining parties formed a minority government, we consider this event to constitute a change of government. After the elections took place, a new centre-right government was formed, and this event we consider as another change of government.

Our third variable is the share of cabinet portfolios held by social democratic and other leftist parties (LEFT). This variable is constructed following the approach outlined by Cameron (1985). The total number of months that left-wing politicians held cabinet portfolios is divided by the total number of cabinet members, multiplied by twelve. For their sample of fourteen industrial countries Roubini and Sachs (1989b) concluded that this

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[3] Note, however, that for some countries some minor differences exist between our index and the power dispersion index as presented by Roubini and Sachs (1988). The Roubini and Sachs index for the Netherlands for the period 1983-85 (2) is, for instance, clearly wrong as the government coalition consisted of two parties during that period. See the Appendix for further details.

[4] This variable intends to measure the chance of being thrown out of office and therefore all elections are included even if the government is re-elected.

variable helps explain cross-country differences in government spending.[5] The Appendix contains detailed information on our political variables.

Our final institutional variable is based upon the work of Von Hagen (1992). On the basis of an assessment of national budgeting procedures, Von Hagen has constructed a number of budgetary process indexes. He distinguishes various characteristics which are grouped under five large items: the structure of negotiations within government; the structure of parliamentary process; the informativeness of the budget draft; the flexibility of the budget execution and the existence of long-term planning constraints. For each characteristic numbers ranging from zero to four are used to describe its quality, with a low number indicating a quality conducive to little fiscal discipline. In case of missing information a number equal to the average of the available numbers for the other characteristics of the same item is assigned. In our empirical analysis we will use an index (BUDGET), which is based upon the characteristics distinguished by Von Hagen.[6]

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[5] Roubini and Sachs (1989b) have used Cameron's (1985) variable in their regressions on the growth of government spending. Note, however, that Cameron's period of observation (1965-81) is rather different from the one used by Roubini and Sachs (1973-85), which raises considerable doubt as regards the value of their results.

[6] With respect to the structure of negotiations the following characteristics distinguished by Von Hagen are included in BUDGET: a) existence of general constraints (like golden rule); b) agenda setting for budget negotiations; c) scope of budget norms in the setting of the agenda and d) the way cabinet members are involved in the negotiations. Concerning the structure of the parliamentary process the following characteristics are included: a) possibility of amendments; b) whether it is required that they are offsetting; c) whether all expenditure is passed in one vote and d) whether there is an initial global vote on budget size. With respect to the informativeness of the budget the following characteristics are taken into account: a) are special funds included?; b) are government loans to non-government entities included in the budget? Concerning flexibility of budget execution the following characteristics are included: a) minister of finance can block expenditures; b) spending ministries are subject to cash limits; c) disbursement approval required from minister of finance; d) are transfers of expenditures between chapters allowed?; e) changes in budget law during execution and f) carry-over of unused funds to next year. As to longterm planning constraints the following characteristics are covered: a) multi-annual target; b) length of planning horizon; c) the nature of the forecasts and d) the degree of commitment implied by the forecasts. Three characteristics that Von Hagen distinguishes have been omitted in constructing BUDGET: 1) whether parliamentary amendments can cause the fall of the government, because Von Hagen himself indicates that this issue does not unambiguously strengthen the budgetary process; 2) the assessment of budget transparency, and 3) the link of the budget draft to the national accounts, since that information is of little use from the viewpoint of fiscal discipline.

6.3 Explaining government debt growth in the EC

This section presents the estimation results of a pooled time-series regression in which the growth of the debt-to-GDP ratio is the dependent variable. Our basic model is borrowed from Roubini and Sachs (1989a). As these authors have pointed out, the specification of their model is consistent both with elements of optimizing approaches to budget deficits (such as the tax smoothing model of Barro (1979)) and with traditional Keynesian models of fiscal deficits as well. Indeed, both theories imply that budget deficits are countercyclical. Suppressing time indices the estimated equation is:

$$(1) \qquad DBY = a_0 + a_1\, DBYL + a_2\, DUB + a_3\, DRB + a_4\, DGR + a_5\, P + v$$

where the dependent variable (DBY) is the change in the public debt-to-GDP ratio and the explanatory variables are: the lagged change in the debt-ratio (DBYL), the change in the unemployment rate (DUB), the change in debt-servicing costs (DRB)[7] and the change in the GDP growth rate (DGR), and our political variables (P).[8] Finally, v denotes the error term.

The lagged deficit is included to allow for slow adjustment of budget deficits. The adverse shocks of slow growth and high unemployment resulted in increasing deficits; a process which was aggrevated by the rise in real interest rates, which significantly and often unexpectedly raised most governments' costs of debt servicing. See Roubini and Sachs (1989a) for a further discussion of the model.

Table 6.1 contains our estimation results. The first row of table 6.1 presents the outcomes of the basic Roubini and Sachs model. All coefficients have the right sign and most of them are significantly different from zero. Row 2 of table 6.1 shows the outcomes when power

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[7] This variable is defined as $d(i - p - n)BY_{t-1}$, where i denotes interest payments on government debt divided by government debt, p is the rate of inflation and n is the GDP growth rate. Our variable is very similar to the one used by Roubini and Sachs (1989a). We have also experimented using actual interest payments in nominal terms, expressed as a percentage of GDP instead of DRB. This approach yielded very similar results (not shown).

[8] In contrast to Roubini and Sachs we have used data on gross government debt, which are more reliable than those on net debt. Our interest rate variable also differs from the one used by Roubini and Sachs. In our regressions this variable consists of the change in total interest payments on gross debt, expressed as a percentage of GDP. We have also experimented with the interest rate variable proposed by Roubini and Sachs, and variants thereof, but this does not affect our conclusions regarding the influence of political factors.

dispersion index POL is added as an explanatory variable. In sharp contrast to the results reported by Roubini and Sachs (1989a,b), we find that the coefficient of POL is not significantly different from zero. As Edin and Ohlin (1991) have pointed out, the construction of POL places a very restrictive form on its effects. Why should the increase of public debt under a minority government be three times as large as under a two-party majority coalition? Row 3 of table 6.1 therefore reports the results when POL is replaced by a dummy variable for each 'political class'. In contrast to the results reported by Edin and Ohlin (1991), the coefficient of the POL3 dummy (minority governments) is not significantly different from zero. Closer inspection of fiscal policy in individual countries indeed suggests that minority governments are often able to reduce budget deficits, as the Danish experience clearly demonstrates. The coefficients of POL1 and POL2 are also not significantly different from zero.

Next, we have examined whether the number of government changes may help explain cross-country variation in the growth of public debt. Row 4 of table 6.1 presents the outcomes adding CHANGE as explanatory variable. It is very interesting, that the frequency of government changes apparently does matter. This result is in accordance with the conclusions of Grilli et al. (1991). Our conclusion does not change when the constant term is replaced by country dummies (not shown). We have also experimented with a variable which has the value of one only in case of substantial government change and is zero otherwise.[9] The coefficient of this variable is not significantly different from zero (row 5 of table 6.1), which is also in accordance with the results of Grilli et al. (1991).

The next variable included in the model is LEFT (row 6 of table 6.1). It follows that the coefficient of this variable is not significantly different from zero, which is in accordance with the results De Haan and Zelhorst (1992) found for Germany.

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[9] When a government is not replaced after elections this dummy has the value of one. Similarly, when the same coalition of political parties remains in power after some political crisis, this dummy is also one.

Table 6.1 Explaining cross-country differences in public debt growth in the EC, 1981-1989 [a)]

	DBYL	DUB	DRB	DGR	POL	POL1	POL2	POL3	CHANGE	LEFT	BUDGET	R^2(adj)
(1)	0.59	1.19	0.24	-0.33								0.52
	(7.7)	(4.5)	(1.2)	(1.6)								
(2)	0.60	1.19	0.24	-0.34	-0.14							0.51
	(7.5)	(4.5)	(1.2)	(1.6)	(0.4)							
(3)	0.57	1.24	0.25	-0.29		-0.16	0.79	-0.78				0.52
	(7.0)	(4.6)	(1.2)	(1.4)		(0.2)	(0.7)	(0.7)				
(4)	0.59	1.12	0.25	-0.33					1.19			0.54
	(7.8)	(4.3)	(1.2)	(1.6)					(2.4)			
(5)	0.58	1.13	0.26	-0.35					0.86			0.52
	(7.5)	(4.2)	(1.3)	(1.7)					(1.2)			
(6)	0.58	1.15	0.25	-0.31						1.13		0.52
	(7.5)	(4.3)	(1.2)	(1.5)						(1.5)		
(7)	0.56	1.22	0.25	-0.31							-0.03	0.52
	(7.1)	(4.6)	(1.2)	(1.5)							(1.5)	
(8)	0.48	1.25	0.27	-0.21							-0.06	0.54
	(5.4)	(4.8)	(1.4)	(1.0)							(2.4)	

[a)] Absolute values of t-statistics in parentheses. A constant is included in all regressions.

Finally, we have added the variable BUDGET to our model. The outcomes are shown in row 7 of table 6.1. Although the coefficient of BUDGET has the 'right' sign, it is not very significant. So at first sight there is only limited support for the view that budgetary procedures matter. Closer inspection of the data suggests, however, that the inclusion of Luxembourg severely influences the outcome. Luxembourg not only has the lowest value for BUDGET, but also the lowest government deficit of all EC Member Countries.[10] Reestimating the model with a dummy included for Luxembourg reinforces this impression (row 8 of table 6.1): the coefficient of BUDGET is now significantly different from zero. Note, however, that the significance of the coefficient of the economic growth variable is reduced. Although maybe not a sufficient condition for stable fiscal policy, there are strong indications that budgetary procedures are relevant in explaining cross-country differences in fiscal

[10] This low value of BUDGET for Luxembourg does not seem to be influenced so much by the budgetary process as well as by the absence of information on the elements on which the index is based.

policies actually pursued.[11]

6.4 Explaining government spending in the EC

This section reports the estimation results of a model to explain the change in the share of total government spending in GDP (DGY). Apart from our political variables POL, CHANGE and LEFT, the explanatory variables in our basic model are: (1) DGYL, the lagged dependent variable; (2) the change in the unemployment rate (DUB); and (3) the change in the GDP growth rate (DGR). A very similar set of explanatory variables has been used by Roubini and Sachs (1989b). Row 1 of table 6.2 shows the estimation outcomes for the basic model in which LEFT is included as a political variable. Previous studies (Cameron (1978), Roubini and Sachs (1989b)) concluded that the political orientation of governments may help explain cross-country differences in public sector size.[12] All variables have the expected sign and are significantly different from zero. Row 2 of table 6.2 reports the results when POL is added as an explanatory variable. Its coefficient is not significantly different from zero. This conclusion is also reached when POL is the only political variable in the regression (not shown). As follows from row 3 of table 6.2 it also does not make much of a difference if POL is replaced by dummies for each different 'political class'. Row 4 of table 6.2 yields the conclusion that, in contrast to the results for government debt accumulation, the coefficient of the frequency of government changes is not significantly different from zero. The same conclusion is reached with respect to the impact of the number of significant government changes and the strength of the budgetary process (not shown).

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[11] This conclusion is also reached when the basic model is estimated adding four interaction variables, constructed by multiplying the explanatory variables by the variable BUDGET. The motivation for this approach is to examine whether budgetary institutions determine the strength of the effects of other variables on the deficit. Our estimation results (not shown) suggest that the budgetary procedures variable is especially important for the effect of the interest payments variable.

[12] Solano (1983) did not find support for the view that the number of seats of leftist parties in the central legislature may account for cross-country variation in government spending.

Table 6.2 Determinants of the change in the ratio of government spending to GDP in EC Member Countries, 1981-1989 [a)]

	DGYL	DUB	DGR	LEFT	POL	POL1	POL2	POL3	CHANGE	R^2(adj)
(1)	0.25	0.50	-0.38	0.94						0.49
	(2.8)	(4.0)	(5.5)	(2.8)						
(2)	0.24	0.49	-0.38	1.07	0.15					0.49
	(2.6)	(3.9)	(5.4)	(3.0)	(1.1)					
(3)	0.22	0.49	-0.38	1.16		-0.46	0.11	0.15		0.49
	(2.5)	(3.9)	(5.4)	(3.2)		(1.3)	(0.2)	(0.3)		
(4)	0.23	0.50	-0.38	0.96					0.21	0.49
	(2.6)	(4.0)	(5.5)	(2.8)					(0.9)	

	DGYL	DUB	DGR	LEFT	TRADE	POP	PCY	R^2(adj)
(5)	0.24	0.50	-0.38	0.79	-0.005			0.50
	(2.7)	(4.0)	(5.5)	(2.3)	(1.8)			
(6)	0.24	0.56	-0.38	0.99		-0.04		0.49
	(2.8)	(4.4)	(5.5)	(2.9)		(1.7)		
(7)	0.25	0.50	-0.38	0.90			-0.001	0.48
	(2.8)	(4.0)	(5.5)	(2.5)			(0.4)	

[a)] Absolute values of t-statistics in parentheses. A constant is included in all regressions.

Finally, we have experimented with a number of other explanatory variables which have frequently been used in the literature explaining government growth, to examine whether our conclusions are dependent upon the variables included in our basic model.[13] The first variable is TRADE, which is defined as the total share of export and imports in GDP. Cameron (1978) was the first to propose this variable. His argument is that a highly open economy is more susceptible to fluctuations in effective demand, leading strong labour unions to press governments to take appropriate countermeasures, the ultimate effect being a larger government sector. Like Cameron (1978), Saunders and Klau (1985) found support for this point of view. However, as follows from row 5 of table 6.2, in our regressions the coefficient of TRADE has the 'wrong' sign. The significance of LEFT is somewhat reduced.

[13] See Lybeck (1988) for a review of the state of the art. Lybeck describes twelve theories on the growth of government and attempts to clarify what support the various theories have received from recent studies. Some variables which have been found in this literature to add explanatory power are not included in our regressions. Although it is, for instance, found that federal systems have lower spending levels we have not included a dummy to capture this effect by lack of sufficient federal countries in our sample of countries.

The second variable included is POP, the percentage of the population under 15 and aged 65 and over. As explained by Lybeck (1988), this variable is often included to test the version of Wagner's Law which rests upon the transformation of the traditional society into the industrialized society. Like most previous studies (see e.g. Saunders and Klau (1985) and Solano (1983)), we find no support for this hypothesis (row 6 of table 6.2).

The third variable is per capita income (PCY). The rationale for this variable follos from a second interpreation of Wagner's Law (see Lybeck (1988)) in which the public sector's share of total resources has risen, because many goods and services traditionally produced by the government have a high income elasticity of demand, so that higher per capita income implies more government. Like Saunders and Klau (1985), but unlike Solano (1983), we find that the coefficient of PCY is not significant (row 7 of table 6.2).[14] The coefficients and significance levels of the variables in our basic model hardly change.

6.5 Conclusions

The Maastricht Treaty spells out a prohibition on excessive deficits based on criteria for public debt and deficit, and details procedures and penalties to deal with violations of this prohibition so as to induce EC Member States to pursue sustainable fiscal policies. All other things being equal, a violation of the criteria is more likely to occur if the basic reason for missing sustainable fiscal policies is to be found in a weak political and institutional setting of fiscal policy. In recent theoretical and empirical research political and institutional aspects, which may affect the process of policy formation, are scrutinised to explain cross-country differences with respect to fiscal policies pursued. In this chapter we have built upon this literature to examine how cross-country differences in debt accumulation and public sector size of Member States of the European Community during the 1980s can be explained. It is concluded that government debt growth is positively correlated with the frequency of government changes. This implies that countries with unstable governments may have more difficulties to satisfy the Maastricht criteria for fiscal policy. On the other hand, the introduction of these budgetary criteria may constitute an important external incentive to

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[14] Ram (1987) has examined this version of Wagner's Law for a sample of 115 countries for the period 1960-80 and found that in 43 cases the share of government in GDP increases as per capita income increases. For the period 1950-80 24 out of 63 countries exhibit significantly positive relations. This result is, however, compatible with our conclusions, since the analysis of Ram is confined to a different sample period.

policymakers concerned, which may compensate for the lack of internal political stability. We also find evidence that improved budgetary procedures may strengthen attempts to pursue stable fiscal policies. A final conclusion is that in countries having left-wing governments the share of government spending in total output generally tends to grow faster.

Appendix to section 6

This appendix provides detailed statistics underlying our estimates presented in sections 6.3 and 6.4. The source is: Keesing Archives, various years. The data on BUDGET are based upon Von Hagen (1992). See the main text for a further explanation.

		1981	1982	1983	1984	1985	1986	1987	1988	1989
Belgium	POL	2	2	2	2	2	2	2	2	2
	CHANGE	1	1	0	0	1	0	1	1	0
	LEFT	0.45	0	0	0	0	0	0	0.32	0.47
	BUDGET					21.53				
Denmark	POL	3	3	3	3	3	3	3	3	3
	CHANGE	1	1	0	1	0	0	0	1	0
	LEFT	1.00	0.67	0	0	0	0	0	0	0
	BUDGET					48.73				
France	POL	1	1	1	1	1	1	1	1	1
	CHANGE	2	0	1	1	0	1	0	1	0
	LEFT	0.59	1.00	1.00	1.00	1.00	0.25	0	0.67	1.00
	BUDGET					61.20				
Germany	POL	1	1	1	1	1	1	1	1	1
	CHANGE	0	1	1	0	0	0	1	0	0
	LEFT	0.76	0.57	0	0	0	0	0	0	0
	BUDGET					53.60				
Greece	POL	1	1	1	1	1	1	1	1	3
	CHANGE	1	0	0	0	1	0	0	0	2
	LEFT	0.17	1.00	1.00	1.00	1.00	1.00	1.00	1.00	0.61
	BUDGET					25.60				
Ireland	POL	3	3	1	1	1	1	3	3	1
	CHANGE	1	2	0	0	0	0	1	0	1
	LEFT	0.13	0.04	0.27	0.27	0.27	0.27	0.02	0	0
	BUDGET					33.00				
Italy	POL	2	2	2	2	2	2	2	2	2
	CHANGE	1	1	1	0	0	1	2	1	1
	LEFT	0.26	0.25	0.25	0.20	0.20	0.20	0.18	0.26	0.28
	BUDGET					30.66				
Luxembourg	POL	1	1	1	1	1	1	1	1	1
	CHANGE	0	0	0	1	0	0	0	0	1
	LEFT	0	0	0	0.15	0.44	0.44	0.44	0.44	0.45
	BUDGET					(15.00) [a]				
Netherlands	POL	1	3	1	1	1	1	1	1	1
	CHANGE	1	1	1	0	0	1	0	0	1
	LEFT	0.38	0	0	0	0	0	0	0	0.04
	BUDGET					53.66				
Portugal	POL	1	1	1	1	1	3	3	1	1
	CHANGE	2	0	1	0	1	0	1	0	0
	LEFT	0	0	0.26	0.53	0.35	0	0	0	0
	BUDGET					34.66				
Spain	POL	3	3	1	1	1	1	1	1	1
	CHANGE	1	1	0	0	0	1	0	0	1
	LEFT	0	0.17	1.00	1.00	1.00	1.00	1.00	1.00	1.00
	BUDGET					28.80				
UK	POL	0	0	0	0	0	0	0	0	0
	CHANGE	0	0	1	0	0	0	1	0	0
	LEFT	0	0	0	0	0	0	0	0	0
	BUDGET					59.40				

[a] The low value of BUDGET for Luxembourg is due to partial lack of information

PART IV

FIVE COUNTRY (CASE) STUDIES

7. Belgium

7.1. Introduction

During the first half of the 1980s the Belgian economy was in serious trouble. Macroeconomic performance was characterized by sluggish real growth of national income, a rising unemployment rate, high inflation, a substantial (although decreasing) current account deficit and a very high government deficit (see tables 7.1 and 7.2). This situation gradually improved in the second half of the 1980s when economic growth picked up, to exceed the EC average both in 1988 and 1989.

Unemployment peaked at 13.2 percent in both 1983 and 1984, to drop in later years to the still high level of 8.7 percent in 1989. Employment creation mainly resulted from increased private sector activity. The labour force grew only moderately as a result of demographic developments and the introduction of early retirement schemes. However, the sharp growth in the number of unfilled vacancies through geographical and occupational mismatches between demand and supply, and the rising share of long-term unemployed still indicate major labour market imbalances.

Inflation gradually decreased to 6 percent in the mid 1980s, falling sharply in 1986 to less than 1 percent, mainly as a consequence of external factors in combination with a strong exchange rate. By the end of the 1980s the inflation rate accelerated somewhat, to stay well below the EC average. Inflation picked up in spite of wage restraint, as a result of a substantial improvement of profit margins combined with external factors (dollar and energy prices), rising government prices and the introduction of higher excise duties.

The interest rate remained high over the 1980s. The real interest mainly remained in the 5-7% range, substantially above the real GDP growth rate.

Nominal unit labour costs fell sharply in the beginning of the 1980s to roughly stabilize in later years.

The current account of the balance of payments has improved significantly in the 1980s. The high deficits of around 4 percent of GDP in 1980-1982 turned into small deficits of less than 1 percent in 1983 and 1984, following the 1982 devaluation of the Belgian franc. Ever since 1985 the current balance has been in surplus, averaging more than 1 percent of GDP in the second half of the 1980s. Initially, this turning point was passed because of weak domestic demand, soon complemented and later on substituted by improving terms of trade and increased export market shares.

The dependency ratio (individuals aged 0-14 and 65+ divided by individuals aged 15-64) fell in the 1980s by about three percent points. At the same time, as from 1983, the participation rate of men dropped by four points, while the participation rate of women increased by the same number.

In 1991 the economy softened appreciably, in line with the experience of most other OECD countries. The GDP growth rate fell back to 1.5 percent, after an average growth of about 4 percent as from 1988. Domestic demand weakened and growing exports simply could not fully compensate for the drop in domestic demand. As a result, unemployment rose (for the first time since 1984) and the general government deficit increased substantially, reversing a trend set after the mid 1980s. Inflation declined further, helped by lower energy prices. The interest rate declined as a result of the apparently successful hard currency policy which reduced the interest rate differential with Germany.

For 1992 and 1993 a modest recovery is expected, with economic growth possibly increasing to 2.3 percent in 1993, depending on a more favorable international climate. Unemployment is expected to stabilize at 9.7 percent and inflation is projected to decrease gradually to 3 percent in 1993. The latest OECD projections (different from the figures in table 7.1) show a further reduction of the general government deficit from 6 percent of GDP in 1991 to 5.5 percent in 1992 and 5 percent in 1993.[1]

The new government has announced a package of corrective measures to reduce government debt. Effective measures are required in the short run, as the success of longer term plans may be in doubt given elections coming up in 1994. The coalition Agreement from March 1992 makes the commitment to spread the deficit reducing measures evenly over the spending and the revenue side of the budget. The socialist vice-president recently pleaded for a special temporal tax levy on income and profits.

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[1] OECD *Economic Outlook* 51, June 1992, pp. 90 and 91. According to the latest (October 1992) forecasts the international economic recovery is more hesitant than expected, which will result in lower economic growth and higher deficits.

Table 7.1 Main economic indicators, 1980-1993

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP growth	4.2	-0.9	1.5	0.4	2.0	0.8	1.6	2.3	4.9	3.8	3.7	1.5	1.6	2.3
Unemployment	7.9	10.2	11.9	13.2	13.2	12.3	11.6	11.3	10.3	9.3	8.7	9.3	9.7	9.6
Inflation	6.2	8.7	7.9	7.0	6.0	6.0	0.7	1.5	0.8	3.4	3.5	3.3	2.9	2.9
Interest rate	12.2	13.8	13.4	11.8	12.0	10.6	7.9	7.8	7.9	8.7	10.1	9.3		
Nominal unit labour costs[a)]	100	91.2	80.8	79.0	78.1	79.5	84.3	85.7	81.8	79.9	83.4	81.7		
Current account (% GDP)	-4.3	-3.8	-3.7	-0.8	-0.6	0.3	2.1	1.4	1.5	1.1	1.0	1.0	1.1	
Dependency ratio	52.4	51.5	50.8	49.7	48.6	48.6	48.4	48.4	48.6	48.8	49.3			
Participation rate men	78.9	78.1	77.7	76.8	75.6	74.5	73.6	73.0	72.2	72.4	72.7			
Participation rate women	47.0	47.7	48.3	48.7	48.9	49.3	49.9	50.6	51.2	51.6	52.4			

a) Relative to 19 industrial countries, double export weights (USD 1980=100)

Source: OECD and EC[2]

Table 7.2. General government budget indicators, 1980-1993

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current receipts	43.9	44.7	46.5	45.8	47.1	47.3	46.6	46.9	45.8	44.5	44.7	44.5	44.3	44.1
Total expenditures	53.1	57.5	57.5	57.1	56.1	55.8	55.7	54.0	52.7	51.2	50.4	50.9	50.6	50.0
Net borrowing	-9.2	-12.8	-11.0	-11.3	-9.0	-8.5	-9.1	-7.1	-6.9	-6.7	-5.7	-6.4	-6.3	-5.9
Gross public debt	77.3	89.7	97.4	107.3	112.6	119.8	124	131	132.4	128.4	127.3	129.4	129.6	128.9

Source: EC[3]

[2] GDP growth, unemployment and inflation data are taken from OECD, *Economic Outlook* 51, June 1992, pp. 91, 175, 185 and 193; interest rate, labour costs and current account are from *European Economy* 50, December 1991, table 48, pp. 247, 256 and 260.

[3] Current receipts, total expenditures and net lending are derived from *European Economy* 50, December 1991, pp. 264, 265, and 266. Gross debt is from *Tables on Public Finance*, January 1992, table 21B.

7.2 General outline of economic policy in the 1980s

Until the late 1970s, economic policy was more aimed at limiting the damage done by various structural imbalances typical of the Belgian economy, than at remedies to improve the functioning of the Belgian economy. Imbalances were mainly attributed to insufficient demand, instead of to excessive wage increases. Government sought to uphold household incomes. Relatively generous social welfare mechanisms were introduced, and many public sector jobs created. A steep increase in income tax revenues and social security contributions could not prevent a rapid deterioration of the government deficit and debt position and had harmful consequences for business profitability. Moreover, the policy of maintaining a stable nominal exchange rate resulted in an increasing interest rate differential with third countries and an appreciable increase of the real effective exchange rate. This in turn aggravated Belgium's competitiveness problems and further burdened the public sector budget.

The policy response to the vicious circle of loss of competitiveness, rising unemployment and growing government deficits was to devaluate the franc (by 8.5 percent) and to freeze real wages. As from 1984, priority has been given to fiscal consolidation. A program adopted in 1984 provided for the introduction of an additional 2% levy on wages and transfers for each of the years 1984-1986. A new program in 1986 turned attention to the expenditure side of the budget and substantially reduced outlays. At the same time incentives for part-time work were expanded and work-sharing was organised to alleviate the negative employment effects of corrective measures taken. This policy caused a steady decline of the purchasing power of average wages (-10 percent) between 1981 and 1985. Wage restraint in combination with the deteriorated terms of trade made company profits pick up rapidly between 1981 and 1986. Companies gross operating surplus in 1986 was back at the level before the first oil shock. Since the investment ratio only improved slightly, the private saving surplus widened to over 10 percent of GNP in 1986. As a result of the accompanying narrowing of the public sector deficit, the current account of the balance of payments sharply improved to show a big surplus in 1986 (2.1 percent of GDP). This surplus was more than offset by a sharp upturn in capital outflows, so that the public sector was obliged to continue borrowing abroad.

The costs of adjustment policies pursued in terms of economic output foregone seem to have been relatively modest, relative to the scale of the actions taken. The openness of the Belgian economy reduced negative multiplier effects of budgetary restraint. An active labor market policy moderated unemployment effects (early retirement, labor cost reduction and especially work-sharing agreements).

Helped by high GDP growth in 1988 and 1989, the gross public debt-to-GDP ratio started to decline somewhat as from 1989.

7.3 Detailed analysis of government spending

The share of public spending rose from 38 percent of GDP in 1970 to 57.5 percent in 1981 and 1982. Then the relative spending level started to fall to stabilise slightly above 50 percent of GDP in the early 1990s, in spite of steeply rising interest payments on government debt (table 7.5). The volume of government investment strongly contracted from 3.9 percent of GDP in 1980 to 1.6 percent in 1991 and the growth of public consumption slowed sharply (table 7.5). Real public sector wages declined and the growth of government employment was reduced substantially, although it still remained positive. The share of government employment in total employment increased by 1 percent point over the 1980s. The rise in relative government wages in 1980-1984 turned into a decline in the years 1985-1990 (table 7.3).

Table 7.3 Employment in the public sector (x 1,000), 1980-1990

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Government employment	701	707	714	707	715	727	747	725	736	737	735
2. as % of total employment	18.9	19.5	19.9	19.9	20.2	20.4	20.8	20.1	20.2	19.9	19.5
3. Growth of government real wages			-0.2[a]					-0.1[b]			
4. Growth of relative government wages			0.4[a]					-0.2[b]			

[a] Average for the period 1980-1984.

[b] Average for the period 1985-1990.

Source: OECD[4]

[4] Lines 1 and 2 are taken from OECD, *National Accounts 1977-1989*, table 15, p. 346; lines 3 and 4 from Oxley and Martin (1991); line 5 from OECD, *Labour Force Statistics 1968-1988*, *Employment Outlook*, July 1991 and *Quarterly Labour Force Studies 1991-4*; lines 6 and 7 from OECD, *Employment Outlook*, July 1991, p. 256.

Table 7.4 General government spending (% GDP), 1980-1987

Outlays	1980	1981	1982	1983	1984	1985	1986	1987
1. General public services	2.80	2.99	3.02	2.79	1.77	1.73	1.63	1.57
2. Defense	2.82	3.01	2.84	2.83	2.48	2.65	2.62	2.49
3. Public order and safety	na	na	na	na	0.80	0.79	0.80	0.81
4. Education	7.49	7.91	7.64	7.31	6.72	6.64	6.60	6.26
5. Health	0.82	0.93	0.91	0.83	1.43	1.30	1.05	0.91
6. Social security and welfare	21.04	22.89	22.46	22.97	20.79	20.93	20.45	21.27
7. Housing and comm. amenities	1.25	0.90	0.96	0.26	2.53	2.31	1.56	1.29
8. Recreational, cultural and religious affairs	0.37	0.47	0.42	0.41	0.96	0.83	0.60	0.51
9. Economic services	7.96	8.44	7.80	8.07	8.87	7.55	5.83	4.38
10. Other functions	5.31	7.49	8.81	10.12	11.61	11.70	12.17	11.62
11. Total outlays	49.87	55.02	54.85	55.60	54.94	54.05	53.30	51.12

Source: IMF, *Government Finance Statistics Yearbook 1991*, p. 149

Table 7.5 General government spending in Belgium, economic classification (% GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Government consumption	18.6	19.5	18.9	18.4	17.9	17.9	17.7	17.1	16.2	15.5	15.3	15.4	15.4
compensation of employees	13.7	14.3	14.0	13.5	13.1	13.1	12.9	12.3	11.6	11.2	11.1	11.2	11.2
Current transfers	23.5	25.5	25.2	25.7	25.1	24.3	23.9	24.0	23.3	22.6	21.8	22.2	22.0
transfers to households	21.3	23.1	22.9	23.3	22.8	22.3	21.9	21.9	21.0	20.3	20.0	20.2	20.1
Interest payments	6.1	8.0	9.3	9.5	10.0	10.8	11.4	10.7	10.3	10.6	10.9	10.9	10.9
Capital transfers	0.9	0.8	0.6	0.6	0.6	0.6	0.6	0.3	0.9	0.8	0.8	0.8	0.7
Government investment	3.9	3.8	3.5	3.0	2.6	2.2	2.0	1.8	1.9	1.7	1.6	1.6	1.6
Total expenditure	53.1	57.5	57.5	57.1	56.1	55.8	55.7	54.0	52.7	51.2	50.4	50.9	50.6

Source: EC, *Tables on Public Finance*

Table 7.6 Detailed analysis of social welfare expenditure (% GDP), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Health	9.17	9.49	9.48	9.77	9.44	9.17	9.39	9.38	8.98	8.81
1a Sickness	5.79	6.02	5.98	6.12	5.91	5.69	5.99	6.12	5.83	5.85
1b Invalidity, disability	2.54	2.62	2.70	2.90	2.79	2.80	2.76	2.64	2.57	2.41
1c Occupational accidents and diseases	0.85	0.85	0.80	0.75	0.74	0.69	0.65	0.62	0.59	0.55
2. Pension schemes	11.02	11.89	12.02	12.12	12.11	11.62	11.95	11.73	11.43	10.92
2a Old age	7.58	8.27	8.41	8.75	8.54	8.13	8.51	8.42	8.26	7.93
2b Survivors	3.44	3.62	3.60	3.37	3.57	3.49	3.44	3.32	3.17	2.99
3. Maternity and family	3.01	3.15	3.10	2.94	2.72	2.72	2.64	2.55	2.40	2.25
3a Maternity	0.16	0.16	0.16	0.16	0.16	0.16	0.15	0.14	0.14	0.13
3b Family	2.85	2.99	2.93	2.78	2.55	2.56	2.49	2.41	2.27	2.13
4. Unemployment	3.09	3.73	3.65	3.79	3.79	3.71	3.74	3.39	3.11	2.88
4a Placement, vocational guidance, resettlement	0.65	0.62	0.55	0.53	0.64	0.75	0.86	0.55	0.50	0.46
4b Unemployment	2.44	3.12	3.10	3.26	3.15	2.96	2.89	2.84	2.62	2.42
5. Housing and miscellaneous	0.25	0.27	0.42	0.44	0.42	0.41	0.36	0.34	0.32	0.29
5a Housing	na	na	na	na	na	na	na	na	na	na
5b Miscellaneous	0.25	0.27	0.42	0.44	0.42	0.41	0.36	0.34	0.32	0.29
6. Total	26.54	28.53	28.67	29.35	28.47	27.96	28.08	27.40	26.25	25.15

Source: EC, *Social Protection Expenditure and Receipts 1980-1989*, 1991

Transfer payments showed somewhat less flexibility. Subsidies to business declined as a percent of GDP only after 1986. Social security benefits fell from over 29 percent of GDP in 1983 to about 25 percent in 1989. All main spending items in table 7.6, which breaks down social welfare expenditure, contracted in relative terms. Spending on health, pension schemes and unemployment went down by 1 percent point each.

Per capita purchasing power of retirement and survivors' pensions fell more than per capita real wages in both the private and the public sector. The replacement ratio of unemployment benefits dropped sharply. Demographic trends led to reduced outlays for family allowances. From 1985-1987 the rise of the consumer price index stayed behind the GDP deflator (relative price effect) causing an automatic reduction of spending ratios.

The social security system, which is managed by the government and the social partners on a consultative basis, is to a large extent responsible for Belgiums public debt problem. Although primarily financed by contributions, the social security funds received large subsidies from central government, which in turn financed its deficit by borrowing. These subsidies from central government rose from 3 percent of GDP in 1970 to 8.4 percent in 1982 and by 1989 still amounted to 4.7 percent of GDP. At that time transfers constituted

more than half of all non-interest public spending. The Belgian government was one of the few to accommodate a strong growth of public transfers to households until the beginning of the 1980s. Ever since that time the growth of transfers in Belgium has been checked by the growth of employment, and by policy efforts to restrain public spending. The growth of benefits in general was curbed by three index skips between 1983 and 1987.

Moreover, statutory unemployment and early-retirement benefits were trimmed at the beginning of the 1980s. Benefits for individuals living together were reduced and provisions and options regarding early retirement were tightened.

Outlays related to old age pensions were succesfully restrained by several measures, which was one of the causes of the erosion of the purchasing power of pensions.

Government actions to restrain the growth of health care spending have met with less success, although the introduction of the benefit principle (user fees) probably has reduced the growth of some medical demand components, at least as far as demand can be determined by the consumer. From 1982 on government also tried to curb the growth of health care supply. The number of hospital beds in the 1980s annually decreased with 1.5 percent. However, the number of doctors per 1000 inhabitants increased with 3.6 percent a year, and their absolute number in 1989 was relatively very high (Belgium 3.3; the Netherlands 2.4; France 2.6 and Germany 3.0).[5]

Interest payments increased from 6.1 percent of GDP in 1980 to 10.6 percent in 1989, about double the EC average. Accumulated interest payments of the 1980s are responsible for more than half of the actual debt. Small wonder, that authorities try to reduce the debt-to-GDP ratio. Nevertheless, it is evident that the current dual-target strategy (explained in section 7.5) - although a prerequisite for fiscal consolidation - is not sufficient in itself to guarantee a substantial reduction of the debt-to-GDP ratio.[6]

Gross fixed capital formation has been severely cut in the 1980s, from 3.9 percent of GDP in 1980 to 1.6 percent in 1989. By now the public investment level is lower than in Germany (2.4) and the Netherlands (2.3), and much lower than in France (3.4) where the general government investment share was remarkably stable over the 1980s.

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[5] OECD, *Economic Surveys*, 1991, p. 79.

[6] OECD, *Economic Surveys*, 1991, p. 89.

7.4 Detailed analysis of government revenues

Table 7.7 shows that the share of public receipts in GDP increased from 43.5 percent of GDP in 1980 to 47.6 percent in 1985, somewhat declining to 44.3 percent in 1989. The 4.1 percent point rise in the first half of the 1980s, was mostly (for 2.5 percent points) explained by higher social security contributions. The remainder of the revenue increase stemmed from taxes on corporate profits and taxes on income of individuals.

The total tax take out of GDP (44.3 percent) in 1989 was almost one point above the EC average. In 1990 total current receipts in Belgium came to 44.7 percent of GDP (table 7.2), whereas the EUR12 average then stood at 43.3 percent of GDP.

The composition of the Belgian tax mix (in 1989) deviates from the EC average in two respects. Social security contributions (15.1 against 11.3 percent) and taxes on income of individuals (13.6 against 10.4 percent) are much higher than the EC average. Revenues from taxes on goods and services and on property remain somewhat below the European 'standard'.

The withholding tax on income from savings was raised to 25% in 1984. In March 1990 the withholding tax on interest (not on dividends) charged on new issues of financial assets (bonds and certificates of deposit) and on bank deposits was lowered to 10% to make Belgian-franc investments more attractive (particularly for residents).

Taxes on corporate profits bring in 3.0 percent of GDP, which corresponds with the EC average. The statutory rate of the corporation income tax is 39% (1991). This is well below the German level (58.5% for retained profits and 36.5% on distributed profits) but higher than the French (34% for retained profits and 42% for distributed profits) and the Dutch tax rate (35%) for corporations. However, it should be noted that the effective tax rate is most probably much lower, due to avoidance possibilities and a badly functioning tax administration.[7] Much base erosion is explained by exemptions and deductions introduced in the 1980s, primarily to promote employment creation, investment and regional development, and to alleviate double taxation.[8] There is evidence that - taking tax allowances into account - the tax treatment of the corporate sector in Belgium in 1983 was by far the most favourable in

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[7] OECD *Economic Surveys*, 1991, p. 65.

[8] OECD, *Economic Surveys*, 1991, pp. 66 - 70.

the OECD area.[9] The December 1988 tax reform included some base-broadening measures.

Taxes on goods and services, expressed as a percent of GDP, are 1.3 percent points below the EC average. This can be attributed to low excise duties which (in 1989) were 1.6 points below the average EC level. It is striking, that the relative share of taxes on goods and services has not been enlarged during the 1980s. Probably government was afraid to stimulate inflation, which is quite obvious in a system with complete indexation of wages, salaries and transfers. The standard VAT rate of 17/19% is close to the French and Dutch level but 3-5 points above the German rate and even 5-7 points above the standard rate in Luxembourg. Excise duties are rather different from those in neighbouring countries. Luxembourg has substantially lower rates on alcohol, wine and fuel. The December 1988 tax reform included increases in excise duties (and induced VAT increases) in anticipation of EC tax harmonisation.

Taxes bearing on the use of labor are high (in terms of GDP ratio) when compared to the EC average, especially social security contributions of employers. But in comparison to France and the Netherlands these taxes are still about four percent points lower and only slightly higher than German rates.

Taxes on income of individuals in 1989 (GDP ratio) ranked three percent points above the EC average, and these taxes also account for a greater share than in neighbouring countries (Germany 11.2, the Netherlands 9.7 and France 5.2 percent of GDP).

The top rate of 59.9% (55% plus 4.9%, at most, in local income tax) is not much different from that in neighbouring countries, but the effective average burden - measured as a percent of taxable income - is extremely high (32 percent). This high average burden partly results from the absence of any automatic inflation adjustment mechanism of tax brackets in the first half of the 1980s. Tax burdens as a percent of income are less extreme, due to a myriad of artfully exploited tax expenditures and an inadequate tax administration. The Belgian tax system is very complex. The tax reform legislated in December 1988 granted large income tax reductions covering a wide range of changes (including an extension of indexation) and a reduction in both the number of tax brackets (from thirteen to seven) and of marginal tax rates. The lowering of marginal tax rates (the top rate was lowered from 72% to 55%) and a revised tax treatment of couples were meant to positively affect work incentives. At the same time additional revenue was raised by a variety of base-broadening moves (including the corporate income tax and some increases in excise duties), in order to make the tax reform neutral in revenue terms.

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[9] OECD, *Economic Surveys*, 1988, p. 22.

Property taxes are fairly modest compared to the situation in other Member States.

Table 7.7 Breakdown of taxes according to the degree of mobility of the tax base (% of GDP)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Taxes on corporate profits	2.5	2.3	2.7	2.6	2.8	3.0	3.1	3.1	3.2	3.0
2. Taxes on goods and services	11.4	11.7	11.8	11.9	11.6	11.7	11.4	11.8	11.6	11.3
2.1 VAT	7.3	7.7	7.5	7.5	7.4	7.5	7.2	7.4	7.4	7.2
2.2 Excise duties	3.4	3.3	3.6	3.6	3.4	3.3	3.3	3.5	3.3	3.2
2.3 Other taxes	0.7	0.7	0.7	0.8	0.8	0.9	0.9	0.9	0.9	0.9
3. Taxes bearing on use of labour	13.2	13.5	13.6	14.1	14.9	15.7	15.9	16.0	15.5	15.1
3.1 Soc. sec. contr. employees	3.8	4.1	4.6	5.0	5.2	5.2	5.3	5.2	4.9	4.7
3.2 Soc. sec. contr. employers	8.4	8.3	7.7	8.0	8.5	9.2	9.4	9.6	9.4	9.3
3.3 Soc. sec. contr. self-empl.	1.0	1.2	1.2	1.2	1.2	1.3	1.2	1.2	1.2	1.1
3.4 Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4. Taxes on income of individuals	15.3	15.4	16.4	15.7	16.0	16.2	15.8	15.4	14.7	13.6
5. Taxes on property	1.0	0.9	0.8	0.8	0.8	0.8	0.9	1.0	1.1	1.2
6. Miscellaneous	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
7. Total tax revenue	43.5	43.9	45.4	45.3	46.3	47.6	47.1	47.2	46.1	44.3

Source: OECD, *Revenue Statistics of OECD Member Countries 1965-1990*, Paris 1991

7.5 Budgetary process

Organisation

Belgium is a unitary state. At the central (state) level the nation comprises of three Communities (Francophone, Flemish and Germanophone) and Regions (Flemish, Walloon and Brussels). Provinces and municipalities constitute the lower levels of government, together with the social security organisations. Parliament has two Chambers. Every four years direct parliamentary elections are held. Usually, coalition governments are formed, which operate on the basis of a coalition Agreement including detailed budgetary guidelines relating to the budget deficit, the tax burden and public debt. Both the minister of Finance (entrusted with financial and tax policy) and the minister of the Budget (accountable for expenditure policies) are involved in budgetary matters.

Central government has, as from 1980, transferred many of its tasks and responsibilities to Communities and Regions in order to transform Belgium into a more federal type of state.

Total expenditures involved, represent over 30 percent of the Treasury's 1989 budget. Following these reforms (in 1989) the financing of Communities and Regions has been fundamentally restructured.[10] Although this federalisation process probably has many budgetary implications, it is difficult to assess its exact impacts. The newly created financial relationships are very complex because of the multiplicity of authorities (the three Regions and three linguistic Communities do not have the same geographic boundaries). Central government transfers to local entities are adding to the inflexibility of the central government budget. Moreover, the new financing system puts no limits to local deficits. Fortunately, the resource transfers involved are calculated on a relatively restrictive basis (during a transition period transfers are kept constant in real terms) and it can be hoped that broader local responsibilities resulting from the federalisation will lead to greater economic efficiency. Nevertheless, there is a real danger that the regional devolution in Belgium will slow down the process of budgetary consolidation.

Social security contributions and rates of benefits are determined by central government.

Budgetary rules and procedures

In 1988 a 'dual target' (national government; excluding social security and local government) budget strategy was formulated for 1990 and beyond. The strategy included to have no real non-interest expenditure increase and no increase in the nominal deficit.

Although their introduction has been planned, Belgium as yet has no multi-annual budget plans or projections. There are no reserve funds; special funds are almost all included in the budget. No specific policy exists in case of expenditure overruns, except that supplementary budget laws are required. The minister of Finance monitors the implementation of the budget. Regions and Communities are allowed to borrow on domestic financial markets in Belgian Francs. Regional and local government have a 55 percent share in total government spending (excluding interest payments).

In 1990 several budgetary reforms have been announced.[11] Zero base budgetting is introduced on a broader scale in order to increase downward pressure on spending, a large number of off-budget accounts is to be eliminated, and public services will be screened for efficiency.

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[10] OECD, *Economic Surveys*, 1989, pp. 63-64.

[11] OECD, *Economic Surveys*, 1991, p. 51.

7.6 Flexibility of fiscal policy

Policies pursued in the recent past have resulted in remarkable budgetary adjustments. Table 7.1 illustrated that the deficit has been reduced from 12.8 percent of GDP in 1981 to 6.7 percent in 1989. But this is only part of the story, because the deficit reduction was realised in a period with fastly rising interest payments. In the period under review the interest-to-GDP ratio increased by 2.6 percent points.[12] So the reduction of the primary deficit over that period has even been about 9 percent, which is equivalent to trimming public outlays by 1 percent point a year. In practice - taking political, technical and other relevant factors into account and compared with other countries - this appears to be the highest feasible figure, especially when extended over such a prolonged period. Of course, the realization of deficit targets in 1988 and 1989 was helped by unexpectedly high GDP growth rather than by strict consolidation efforts. On a cyclically-adjusted basis, the deficit reduction has been somewhat less impressive and further moves to reduce the deficit in the next few years (with substantially reduced GDP growth) will be very difficult to achieve indeed. Moreover, many of the recently attained budget cuts had a one-off character (revenue anticipations, spending delays, and sale of assets[13]) not entailing any fundamental consolidation, thus hampering future consolidation efforts ('backlash' effect). Finally, it might be noted that the elasticity of revenues with respect to GDP has fallen in recent years.

This section lists factors influencing the flexibility of revenue and spending items by main category. The results are summarized in tables 7.8 and 7.9 respectively.

Scope to increase tax revenues

Generally speaking, in the Belgian case it is difficult to find much opportunity to raise tax rates, consistent with EC harmonisation, which does not seriously endanger competitiveness and which will also substantially increase revenue. Nevertheless there are some suggestions.

Taxes on portfolio income of individuals have recently (March 1990) been reduced to make savings denominated in Belgian francs more attractive. Although no EC directives could be agreed upon in this area, increased tax competition may eventually lead to a

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[12] The Belgian case has clearly demonstrated the 'snowball effect' caused by the internal dynamics of interest accumulation. If the primary balance is negative, the public debt-to-GDP ratio will keep rising if the average interest rate exceeds GDP growth.

[13] Note that such measures do not affect the deficit according to the Maastricht Treaty, which is not on a cash basis and which excludes the proceeds from asset sales.

complete abolition of withholding taxes on income from savings. For the time being, Belgium should not consider to further take the lead in this area.

Broadening the corporate income tax base, reducing high marginal rates and closing of loopholes will probably have beneficial revenue effects, since the corporate tax system is plagued by substantial tax evasion. Even with some increase in effective tax rates, the tax treatment of the corporate sector in Belgium will remain relatively favourable.

Harmonisation of the value added tax has required elimination of both top rates (25% and 33.3% respectively) which in revenue terms implies a budgetary loss equal to 0.25 percent of GDP. As the standard rate (19%) is rather high compared with rates in neighbouring countries (especially Luxembourg), there is no case to increase rates here. On the other hand, the continuing need to consolidate the budget makes a VAT rate reduction hardly feasible.

Although recent reforms have narrowed the gap, Belgium has low excise-tax rates measured by EC standards. EC harmonisation will imply increases in rates on some mineral oil products and beer, but will also lead to cuts in rates on other alcoholic beverages. Full harmonisation of indirect taxes will also swell revenue by the amounts that are now lost to Luxembourg, due to the latter country's low rates.

The room of manoeuvre to change the level and rates of social security contributions greatly depends on successes achieved in curbing social security spending. Since social partners and the government have agreed to freeze the central government subsidy to the employees' social security system in nominal terms until the end of 1995, higher contributions are to be expected. The relatively high tax wedge for private sector workers is an argument against any increase in contributions, and forms an additional argument to scale down benefit levels.

As is the case with the corporate income tax, increased personal income tax revenues could be attained by tax reform aimed at broadening the tax base, combined with reducing marginal rates, and closing of loopholes.

Taxes on property may offer a final option to increase revenue. Such taxes have some advantages in an environment which is more and more prone to tax competition.

It is not clear, if there is much room for privatisation which could lead to one-off increases in non-tax revenue. Application of the benefit principle can also produce some additional revenue.

Scope to reduce expenditure

As it seems difficult to increase tax revenues sufficiently for a successful continuation of present and past consolidation efforts, in the Belgian case substantial expenditure reductions must be considered to be the only way to further redress unbalanced public finances. Since investment spending has already been cut drastically, the burden will have to fall on current outlays, especially transfers (social security, subsidies to business). Although there may also be some options to reduce government employment (especially at the Ministry of Defence), which could reduce salary payments, it may also be necessary to offer better pay at least to part of the civil service in order to attract better qualified civil servants.

In Belgium the costs of tax collection as a percent of tax receipts are very high when compared to the situation in other countries. Especially the complexity and lack of transparancy of corporate and individual income taxation may explain present high administrative costs. Tax reform may thus induce some reduction of outlays in the field of general public services.

Defense spending is not higher than is the case in other countries. Reductions in line with recent international trends seem to be feasible.

Although the pressure on education expenditure will subside somewhat as a result of demographic developments, no substantial gains are to be expected here.

Demand and supply of health care could be made more sensitive to the financial implications of health-care consumption. Introduction of financial incentives to consumers could reduce demand. Supply could be regulated by extending the system of block appropriations and by limiting the number of doctors and hospital beds.

Demographic trends and equity arguments restrict the scope to limit the growth of pension benefits. Ageing is expected to induce a 1 percent annual increase of retirement-pensions in real terms. But there are several other factors that will boost (unfunded) pension payments such as the maturation of pension schemes, drift related to the trend growth in real incomes and an increase in the number of female individuals qualifying for a pension. Furthermore, much depends on the real increase in pensions per capita that will be granted. Savings could be realised by increasing the number of years that are required for women in order to qualify for full pension from 40 to 45, i.e. the same number as for men. It will be much easier to realize savings by cutting unemployment insurance and early retirement schemes. Various income-maintenance schemes for unemployed were set up to limit labour supply, and benefits have increasingly come to be disbursed regardless of the availability of unemployed for the labor market. In 1989 nearly a quarter of all recipients of unemployment

benefits withdrew from the labour market in return for a benefit. It may be useful to consider a reorientation of these programs in order to encourage beneficiaries to make themselves available to the labour market again. A further reason for winding down programmes which aim to reduce labour supply, is the expected shrinking of the labour force in the medium and long term due to demographic change. In 1987 participation rates in Belgium were much lower than in its main partner countries.[13] It would thus be wise policy to eliminate early retirement incentives.

Government aid to the private sector (3.2 percent of GDP) is about one point above the EC average. This is mainly due to significant subsidies to retirement and medical insurance programmes in the railroad and coal-mining sectors. The closing of the last two coal mines, scheduled to take place in 1992, will reduce outlays.

Since the volume of government debt is given in the short run, total interest payments depend on the interest rate actually paid on that debt. Interest payments are volatile and thus a risk to the budget since about a quarter of total debt has a maturity of less than one year. Moreover, about one fifth of the debt is in foreign currency which makes for strong dependency on international interest rate movements. Fortunately, the hard currency option of monetary authorities together with increased credibility of consolidation efforts have led to a narrowing of the interest rate differential with Germany, which - other things equal - reduces the overall interest bill for the government. The reduction of the withholding tax on interest income from savings denominated in Belgians francs positively affected capital market supply and hence also contributed to lower interest rates. Reforms of the money market which have been in progress since 1989, by creating greater competition, can lead to lower interest rates on Treasury certificates.

On the other hand the possible regionalisation of the Belgian debt burden resulting from further federalisation might push up interest rates, because of the lower rating of regional debt on international capital markets.

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[13] OECD, *Economic Surveys*, 1991, p. 84.

Table 7.8 Contribution to budget consolidation of revenue categories in Belgium[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. Taxes on portfolio income of individuals				tax competition	--
2. Taxes on corporate profits	enforcement; base		rates		+ (3.0)
3. Taxes on goods & services 3.1 VAT				top rates	- (7.2)
3.2 Excise duties	rates				+ (3.2)
3.3 Other taxes					0 (0.9)
4. Taxes on use of labour 4.1 Social sec. contr. employees		GDP growth	GDP growth; wedge		0 (4.7)
4.2 Social security contr. employers		GDP growth	GDP growth;wedge		0 (9.3)
4.3 Social security contr. selfemployed					0 (1.1)
4.4 Other taxes					0 (0.0)
5. Taxes on income of individuals	enforcement; base		elasticity	rates	+ (13.6)
6. Taxes on property	rates; base				++ (1.2)
7. Miscellaneous taxes					0 (-)
8. Non-tax revenues		benefit principle			+ (1.3)

[a] Budget consolidation resulting from discretionary measures is printed in bold type.
[b] A plus indicates upward flexibility (higher revenues, lower deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.
[c] A minus indicates downward flexibility (lower revenues, higher deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.
[d] The share of the various revenue categories as a percent of GDP (1989) is shown in parentheses.

Table 7.9 Contribution to budget consolidation of functional expenditure categories in Belgium[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. General public services	**administrative cost**				+ (1.6)
2. Defense		**overall**			+ (2.5)
3. Public order and safety		**overall**	**capital formation**		0 (0.8)
4. Education		demography; **overall**			+ (6.3)
5. Health		**supply; incentives**	ageing		+ (0.9)
6. Social security and welfare	**income maintenance; early retirement**		demography		+ (21.3)
7. Housing and community amenities					0 (1.3)
8. Recreational, cultural and religious affairs					0 (0.5)
9. Economic services	**business subsidies**		**capital formation**		+ (4.4)
10. Other functions	interest rates; GDP growth	**hard currency; competition**	**regionalisation**	interest rates; GDP growth	0 (11.6)

[a] Budget consolidation resulting from discretionary measures is printed in **bold** type.
[b] A plus indicates downward flexibility (less expenditure, smaller deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures. The single or double plus sign indicates the relative degree of flexibility.
[c] A minus indicates upward flexibility (more expenditure, higher deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures. The single or double minus sign indicates the relative degree of flexibility.
[d] The share of the various spending categories as a percent of GDP (1987) is shown in parentheses.

Table 7.10 Major revenue-increasing measures in Belgium, 1980-1989[a]

	Taxes on portfolio income of individuals[b]	Taxes on corporate profits	VAT	Excise duties	Social security contributions employees	Social security contributions employers	Taxes on income of individuals	Taxes on property	Non-tax revenues
1980	evasion; avoidance	special tax on exceptional profits	surtax on luxury goods	motor vehicles; alcohol; fuels; cigars	pension contributions public sector; base	base	solidarity contribution public service		
1981			rates; base	alcohol; fuels					radio/tv advertising
1982			rates	petrol; cigarettes; oil products	pension contributions; rates	solidarity levy self-employed	tax surcharge high incomes; base; special contribution		
1983	withholding tax; evasion				sickness	solidarity levy civil service	special contribution; base		various charges
1984		exceptional profits	base				special contribution; base		
1985							rates		
1986									
1987									various
1988									
1989				petrol; gasoil; beer					

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, revenue-increasing measures with a general character like combatting of tax evasion and avoidance, are indicated in the first column.

Table 7.11 Major expenditure cuts in Belgium, 1980-1989[a]

	General public services[b]	Defense	Public order and safety	Education	Health	Social security and welfare	Housing and community amenities	Recreational, cultural and religious affairs	Economic services	Other functions
1980	staff; wages					pensions; unemployment				
1981	wages; global expenditure limits			efficiency		pensions; family allowances				
1982	staff; wages			subsidies; operating costs	fees	unemployment; family allowances				
1983	postponed payment; wages				fees					
1984	wages			teachers (work longer)		pensions; unemployment; fraud				
1985						benefits				
1986	general cuts									
1987	general cuts									
1988				general cuts		general cuts			general	
1989										

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, expenditure cuts with a general character like wage restraints and general spending caps, are indicated in the first column.

8. Denmark

8.1 Introduction

In the early 1980s Denmark witnessed a steep climb of the government debt-to-GDP ratio. From almost 40 percent of GDP in 1980 government debt rose to a top of almost 80 percent in 1984, to decline to 66.7 percent of GDP in 1991. In tandem, the share of government spending in GDP increased to peak in 1983 (table 8.2). This development initially implied a continuation of trends from the 1970s. Looking back upon that decade, virtually all components of public spending expanded. Transfer payments showed the strongest growth (from 14.9 percent of GDP in 1970 to 22.6 percent in 1980). Public sector employment also increased rapidly. From 1967, when the first labour market survey was undertaken, to 1979 public sector employment doubled, increasing its share in the total labour force from 16 to 27 percent. In fact, public employment grew by 30.000-35.000 persons annually. The number of pension recipients and unemployed also increased sharply. Moreover, legislation ensured that real incomes of transfer recipients stayed in line with those of wage earners. In addition to indexation - where only pensioners received full compensation - living standards of benefit recipients have been protected by clauses linking certain transfers directly to trends in wages. The replacement ratio of an unemployed relative to that of an industrial worker increased from 40 in 1960 to 66 in 1980. Similar schemes existed for public sector employees, but despite the link of public wages to average wage drift, public sector wages did not keep up with private sector wages late in the 1970s. During 1975-80 real disposable income of public employees decreased on average by 3.3 percent; on the other hand wage earners saw their income during this period increase by 5.0 percent.

8.2 General outline of economic policy in the 1980s

The most important factor behind the rapidly deteriorating situation of the public finances in Denmark at the beginning of the 1980s was the second oil shock, which caused a severe downturn in 1980/81 with rapidly rising unemployment and inflation rates (table 8.1). Due to its strong dependence on imported energy, Denmark was relatively more affected by the rise in oil prices than the average EC country. It was against the background of persistent large

current external deficits, causing a high level of external debt, in combination with a relatively narrow industrial base (due to the decline of gross investment), a rapidly rising government deficit and a rather rigid institutional setting[14] that the government taking office in September 1982 proposed a new medium-term stabilization programme. The new strategy consisted of the following elements:

1. income policy aiming at improved competitiveness through wage guidelines;
2. tight fiscal policy (expenditure cuts and revenue raising measures);
3. stabilising the exchange rate and liberalisation of capital controls;
4. flexible monetary policy aimed at narrowing interest differentials;
5. structural policies directed at reducing rigidities in the economy and promoting savings and technological innovation.

Table 8.1 Main economic indicators, 1980-1993

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP growth	-0.4	-0.9	3.0	2.5	4.4	4.3	3.6	0.3	0.5	1.2	2.1	2.0	2.5	3.1
Unemployment	7.0	9.2	9.8	10.4	10.1	9.0	7.8	7.8	8.5	9.2	9.5	10.3	10.2	9.6
Inflation	10.7	12.0	10.3	6.7	6.4	4.3	2.9	4.6	4.9	5.1	2.5	2.7	2.7	2.8
Interest rate					14.1	11.6	10.5	11.9	10.6	10.2	11.0	10.1		
Nominal unit labour costs (1980=100)	100	91.2	80.8	79.0	78.1	79.5	84.3	85.4	81.8	79.9	83.4	81.7		
Current account (% of GDP)	-3.7	-3.2	-4.0	-2.1	-3.0	-4.6	-5.4	-2.9	-1.1	-0.8	1.2			
Dependency ratio	35.3	34.8	34.4	34.0	33.7	33.5	33.4	33.1	32.9	32.8				
Participation rate:														
- men	89.0	88.3	88.0	87.6	86.7	87.4	88.4	88.2	89.8	89.5	89.6			
- women	71.4	71.8	72.6	74.2	73.8	74.5	76.5	76.8	77.6	77.3	78.4			

Source: OECD

[14] Wage increases had been running at two-digit figures throughout the 1970s, influenced by the indexation system and labour market rigidities like high minimum wages, resistance to tax increases, and high unemployment benefits.

This is not to say that previous governments had not tried to improve the external and fiscal outlook of the Danish economy. For a long time, economic policy has been aimed at restoring external and internal balances. Measures taken included a devaluation of the Kroner in September 1979, and a further unilateral devaluation in November of that same year. In December 1979 parliament agreed on a modification of the wage indexation scheme, in that the direct energy components were removed from the wage-regulating price-index. Further measures of this package included freezing most prices and rents, a hike of direct personal taxes, and an increase in the tax rate on corporate profits from 37% to 40%.

In May 1980 parliament enacted another economic package, which included, inter alia, a rise of the general VAT-rate from 20¼% to 22%, a direct-tax hike of Kr. 1 billion, a Kr. 1 billion increase in various excise taxes and a Kr. 8 billion (4½ percent) cut in public outlays (especially government investment dropped in 1980/81). The May 1981 economic policy package included: a continuation of employment creation programmes in 1982-83, new job creation plans and a further Kr. 2 billion increase in excise taxes in 1982. Despite these measures, the deficit ballooned due to strong automatic stabilizers on both the expenditure (unemployment benefits) and the revenue side of the budget. However, a large part of the deficit was of a non-cyclical nature due to the rapid growth of public employment[15] (table 8.3 and figure 8.1), the fact that budgetary outlays were more affected by inflation than public sector receipts, the large debt servicing burden, and the generosity of social schemes. The deterioration of the public sector's financial balance can primarily be attributed to an increase in the central government deficit. Until 1982 local government ran only small deficits and the social security funds even mounted surplusses.

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[15] Labour supply increased very rapidly in Denmark due to demographic factors and an increasing participation rate of women. The participation rate of the population aged 15-64 is among the highest in the Community (table 8.1). The increase in female employment at the beginning of the 1980s can primarily be attributed to the public sector. The rising tax burden and the increased risk of unemployment may have reinforced the trend towards two bread-winners per familiy (OECD, *Economic Surveys*, 1982, p. 27).

Table 8.2 General government budget (% GDP), 1980-1991

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current receipts	52.9	52.9	52.0	54.4	56.2	57.3	59.1	59.7	59.5	58.2	56.1	55.9
Total expenditure	56.2	59.8	61.2	61.6	60.3	59.3	55.7	57.3	59.0	58.7	57.6	57.5
Net borrowing	-3.3	-6.9	-9.1	-7.2	-4.1	-2.0	3.4	2.4	0.5	-0.5	-1.5	-1.7
Gross public debt	39.9	53.3	68.1	75.5	79.8	76.8	69.0	65.8	66.1	65.6	66.4	66.7

Source: EC, *Tables on Public Finance*

The mix of measures taken by the Government which took office in September 1982 included: suspension of indexation until 1985, a maximum of four percent for pay increases in the public sector, abolishment of linking public wages and benefits to market wages, freezing of the maximum amount of unemployment and sickness benefits, introduction of a tax on wealth of pension schemes[16] and higher social security contributions.

Table 8.3 Employment in the public sector, 1980-1990

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Government employment (* 1000)	691	719	746	753	747	752	758	763	770	776	
2. As % of total employment	28.3	29.8	30.8	31.0	30.2	29.7	29.2	29.1	29.4	30.2	30.5
3. Growth of government real wages	-6.4	-2.5	0.5	-2.0	-2.2			0.5 [a)]			
4. Relative growth of government wages	-1.7	-1.8	1.2	0.8	0.7			-0.8 [a)]			

[a)] Average for the period 1985-1990.

Source: OECD

[16] In 1984 replaced by taxing the yield of pension funds, exceeding 3.5 percent in real terms.

Figure 8.1 Cyclically adjusted primary balance (% GDP), 1980-1992

Source: OECD

Through credibility and wealth effects the new policy has no doubt contributed to the economic recovery in subsequent years.[17] Price and wage inflation dropped sharply. Also the interest rate fell considerably in 1983, due to lower international interest rates, less exchange rate uncertainty, reduced inflationary expectations and the improvement of the current account. As a consequence of better export performance and higher private consumption and residential construction, reflecting increased consumer confidence, output growth picked up (table 8.1). The growth process took on a self-sustaining character early during the recovery.

The situation of the public finances improved remarkably fast. The annual growth of nominal government expenditure slowed down to 5.5 percent in the period 1983-86. The share of total government expenditure in GDP declined by 6.1 percent points in these years. The brunt of the adjustment on the expenditure side has fallen on government consumption and on public investment. Section 8.3 presents a more detailed analysis of trends in government spending. The main contribution to the improved budgetary outlook, however,

[17] The credibility of the new hard currency regime was evident in falling interest differentials vis-a-vis the Dmark. Lower interest rates reinforced optimistic expectations on the part of investors and consumers. See: EC, *Country study on Denmark*, 1991, for further details.

came from the revenue side of the budget, following a strong growth of the tax base and swollen tax rates. Section 8.4 presents a more detailed analysis of government revenues.

A major deficiency of the economic recovery was, however, the failure of the current account deficit to fall as envisaged by the 1982 recovery programme (table 8.1). After some improvement in 1983 the current account performed poorly in 1984-86, reaching a record deficit of over 5 percent of GDP. In part this development reflected the success of policies pursued: imports increased due to higher private investment and consumption. However, it also demonstrated inherent structural weaknesses of the Danish economy, i.e. a relatively small size of the tradeable goods sector, and a low and falling national savings ratio. Over the period 1980-84 Denmark has been exporting to slowly growing markets both in terms of country destination and in terms of products. At the end of 1985 it became clear that, due to high capacity-utilisation rates and bottlenecks at the labour market, the room for an additional export drive was limited and that the brunt of external adjustment would have to be borne by domestic demand.

In view of the poor performance of the current account the authorities, therefore, took additional restrictive measures. Public investment programmes were cut back further so as to relieve pressure on the building sector. In March 1986 energy taxes and some other indirect taxes were raised. The full-year revenue effect of the package was estimated at Kr. 10 billion. In May an agreement was reached with local governments to freeze the level of their real current spending in 1987/88 at the average level of the two preceeding years. In October 1986 the so called 'Potato diet' was introduced, designed to reduce private consumption. The measures included, inter alia, higher indirect taxes (increase of energy taxes[18] and higher stamp duties) and a 20% tax on interest expenses for consumer loans (with the exception of loans related to housing, business and education). These measures were important as Danish tax rules strongly favoured credit-financed consumption.[19] At the end of 1986 the government policy brought the expansion of domestic demand to a halt and imports fell accordingly.

A comprehensive tax reform was introduced early in 1987. Its aim was to reduce inconsistencies in the tax system and to encourage private savings. The reform also

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[18] The increase in energy taxes prevented lower oil prices to reach Danish consumers. However, higher energy taxes also contributed to push up consumer prices (table 8.1).

[19] Interest on loans for business purposes, home purchases (both principal and secondary residence) and for consumption and other purposes are fully deductable.

broadened the tax base.

The deceleration of demand through fiscal measures came too late to prevent labour market pressures from spilling over into wage rises, which together with an appreciation of the effective exchange rate reduced international competitiveness of the Danish economy. The current account of the balance of payments improved considerably due to stagnant economic growth. The export performance was, however, much worse than originally projected in the 1982 medium-term scenarios.

The restrictive fiscal stance was continued in 1987. However, spending increased due to higher child benefits, high pay increases of civil servants (seven percent) and local governments breaking through their expenditure ceilings, while shortening of working hours translated into a rise in personnel (table 8.3). Public investment also expanded due to, inter alia, higher spending on environmental protection.

In 1988 economic growth picked up, led by growing exports. The current account improved substantially: in 1990 it showed a surplus for the first time since 1963. The government has stated that the recent swing into current-account surplus does not warrant an easing of policies and that it will aim at keeping the current account in surplus. There is a good economic reason for this: as a result of past external deficits, Denmark's foreign debt level is one of the highest in the OECD area.

By 1988 the government surplus shrank and in 1989 it turned into a deficit due to automatic stabilizers and expansionary public policies (higher income transfers, reform of educational grants and a change in the system of social security contributions). In the budget for 1989 is was agreed that wealth taxation would be reduced by stepwise bringing down the rate from 2.2% to 1.5% in 1989, to 1.2% in 1990 and to 1% in 1991. In 1990 the tax on consumer interest payments was abolished. The corporate income tax rate has been reduced from 50% to 40% and in 1991 to 38%.

Although the 1990 Budget aimed at a lower deficit, it turned out that the central government deficit increased in 1990, since revenues fell well short of expectations. This deterioration was not offset in other areas of the general government budget and was largely caused by non-cyclical factors. The 1991 Fiscal Budget included the following measures:

- reduction of excise taxes;
- increased benefits to families with children;
- more financial assistance for housing in the private sector;
- higher taxes on tobacco;
- reduced outlays for benefits to jobless persons in the first week of unemployment;

- reduction of State employment by 6300 labour years, of which 4100 were to go as a result of privatisation;
- reduction of State subsidisation of employers' contributions to unemployment insurance.

Some initial proposals were, however, not part of the final budget, including the abolition of the 20% interest tax, the introduction of a tax on diesel fuel and a substantial reduction in housing subsidies.

8.3 Detailed analysis of government spending

Total outlays (excluding interest payments) have fallen in real terms in the period 1983-86 as the combined effect of booming economic activity and strong efforts to reduce public spending. Apart from relatively low wage increases, a new expenditure control system was introduced and ad hoc measures aimed at curbing local government spending were implemented (section 8.5). However, in 1987 when GDP growth was very limited and salaries of public employees were raised significantly, public spending relative to GDP rose again. This development continued in 1988. From 1989 to 1991 the share of government spending in GDP has slightly declined again.

During the period 1983-86 the share of government spending in GDP was considerably reduced. Budget cuts affected all major expenditure components, except interest payments.

As explained in the previous section, government final consumption expenditure bore a considerable part of the burden of fiscal adjustment. The upper part of table 8.5 presents a detailed analysis of government final consumption outlays for the period 1980-89 using ten different functional categories. Over 1983-1986 all categories of consumption have been cut. The cumulative reduction amounted to fifteen percent points. Outlays for defense (-23 percent), education (-18 percent), housing (-64 percent) and economic services (-20 percent) were cut above average. During 1987-89 consumption spending rose by 7 percent. Spending on general public services (10 percent), social security and welfare (10 percent), recreational, cultural and religious affairs (10 percent), and housing (21 percent) increased above average.

Table 8.4 Volume of recipients of unemployment, early retirement and disability benefits (1000 persons), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Unemployed	194	231	239	258	235	198	186	187	236	234
Early retirement and disability	788	807	819	837	878	893	905	916	933	945

Source: Statistical Office

Over the years 1983-86 the cumulative change in transfers amounted to +0.52 percent point. The categories that were responsible for this growth in outlays were interest payments (increase of 47 percent) and general public services (increase of 20 percent). Also note the strong reduction of transfers for social security and welfare in the period 1983-86 (cumulative: -2.4 percent points) and the subsequent rise in 1987-89 (by sixteen percent). Strong increases ocurred also in education (42 percent) and economic services (fifteen percent), whereas transfer spending on other functions (interest payments) decreased by fifteen percent during 1987-1989. The recent increase of spending on social security and welfare is at least partly caused by the rise in the number ('volume') of beneficiaries (table 8.4).

The average reduction of capital expenditure during 1983-86 amounted to 38 percent. Strong reductions took place in spending on economic services and education. Capital expenditure increased slightly in the period 1987-89 (by two percent), capital spending on housing rising most.

Table 8.5 General government spending (% GDP), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
I. Final consumption expenditure:										
1. General public services	2.03	2.16	2.20	2.14	2.03	1.98	1.91	2.03	2.11	2.11
2. Defense	2.53	2.58	2.52	2.47	2.30	2.09	1.94	2.02	2.13	2.03
3. Public order and safety	0.98	1.04	1.06	1.05	1.01	1.00	0.99	0.99	1.01	1.01
4. Education	6.03	6.26	6.31	6.06	5.70	5.47	5.16	5.42	5.53	5.43
5. Health	5.49	5.52	5.56	5.33	4.98	4.89	4.71	4.90	5.00	4.92
6. Social security and welfare	5.34	5.71	5.86	5.68	5.36	5.44	5.35	5.76	5.88	5.89
7. Housing and community amenities	0.36	0.39	0.39	0.35	0.35	0.33	0.14	0.15	0.16	0.17
8. Recreation, culture, religious affairs	1.00	1.05	1.05	1.01	0.97	0.97	0.91	0.93	1.02	1.00
9. Economic services	2.09	2.24	2.47	2.53	2.39	2.27	1.99	2.11	2.04	2.07
10. Other functions	0.78	0.80	0.81	0.79	0.77	0.80	0.81	0.86	0.88	0.91
11. Total final consumption	26.65	27.75	28.22	27.42	25.86	25.24	23.91	25.18	25.75	25.53
II. Transfers and property income:										
1. General public services	1.70	1.66	1.78	1.81	1.83	1.92	2.14	2.15	2.27	2.28
2. Defense	0.01	0.01	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.02
3. Public order and safety	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
4. Education	0.69	0.76	0.78	0.81	0.81	0.79	0.76	0.81	0.93	1.09
5. Health	0.04	0.05	0.04	0.04	0.05	0.04	0.04	0.04	0.04	0.04
6. Social security and welfare	15.92	16.97	17.06	16.78	16.14	15.46	14.66	15.34	16.34	17.07
7. Housing and community amenities	0.44	0.43	0.47	0.44	0.41	0.41	0.40	0.41	0.44	0.44
8. Recreation, culture, religious affairs	0.29	0.30	0.31	0.30	0.29	0.27	0.24	0.25	0.26	0.26
9. Economic services	2.50	2.38	2.71	2.75	2.69	2.38	2.43	2.54	2.85	2.80
10. Other functions	3.90	5.23	5.96	8.03	9.55	9.84	8.79	8.25	7.97	7.47
11. Total	25.47	27.80	29.14	31.0	31.79	31.15	29.5	29.82	31.13	31.47
- of which subsidies:	3.11	3.00	3.17	3.27	3.29	2.99	3.01	3.14	3.46	3.41
III. Capital expenditure:										
1. General public services	0.45	0.42	0.40	0.31	0.29	0.35	0.26	0.19	0.20	0.17
2. Defense	0.01	0.01	0.01	0.01	0.01	0.02	0.01	0.02	0.01	0.02
3. Public order and safety	0.05	0.06	0.06	0.06	0.05	0.05	0.06	0.06	0.05	0.05
4. Education	1.13	0.83	0.71	0.56	0.54	0.48	0.44	0.49	0.48	0.43
5. Health	0.30	0.28	0.25	0.23	0.25	0.27	0.25	0.25	0.28	0.26
6. Social security and welfare	0.29	0.44	0.40	0.29	0.30	0.38	0.25	0.30	0.32	0.27
7. Housing and community amenities	0.53	0.51	0.40	0.40	0.19	0.19	0.13	0.15	0.29	0.27
8. Recreation, culture, religious affairs	0.39	0.37	0.31	0.24	0.27	0.28	0.22	0.22	0.25	0.27
9. Economic services	1.60	1.84	1.77	1.66	1.36	1.48	1.04	1.02	1.04	0.94
10. Total capital expenditure	4.76	4.77	4.32	3.77	3.25	3.49	2.66	2.70	2.93	2.70
- of which capital formation:	3.47	3.00	2.82	2.36	2.08	2.37	1.97	2.11	2.18	2.09

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Total expenditure:										
1. General public services	4.18	4.24	4.38	4.26	4.15	4.24	4.30	4.38	4.59	4.57
2. Defense	2.56	2.60	2.55	2.50	2.33	2.13	1.97	2.06	2.16	2.07
3. Public order and safety	1.04	1.11	1.14	1.13	1.07	1.06	1.06	1.05	1.07	1.07
4. Education	7.84	7.86	7.79	7.44	7.05	6.75	6.37	6.73	6.94	6.95
5. Health	5.84	5.84	5.85	5.61	5.28	5.20	5.00	5.20	5.32	5.22
6. Social security and welfare	21.55	23.12	23.32	22.75	21.80	21.28	20.27	21.40	22.54	23.22
7. Housing and community amenities	1.32	1.33	1.25	1.19	0.94	0.92	0.67	0.71	0.89	0.87
8. Recreation, culture, religious affairs	1.68	1.71	1.67	1.55	1.53	1.52	1.38	1.40	1.53	1.53
9. Economic services	6.18	6.46	6.95	6.94	6.43	6.12	5.46	5.67	5.94	5.81
10. Other functions	4.68	6.03	6.77	8.82	10.33	10.65	9.61	9.10	8.85	8.39
11. Total expenditure	56.87	60.31	61.68	62.19	60.91	59.87	56.07	57.70	59.81	59.71

Source: OECD, *National Accounts*

Table 8.6 presents an alternative analysis of social security spending, with a breakdown of this type of outlays by five categories: health, pension schemes, maternity and family, unemployment and housing.

Spending on sickness benefits in Denmark is not excessively high in comparison with other EC Member States and has been declining very rapidly until 1987; in 1988-89 spending on sickness has slightly increased.

Although Denmark has a high participation rate, spending on old age pensions is quite high in comparison with other EC countries.

Spending on health in Denmark is not out of line with the experience in the other four EC Countries that are analysed in the current study. As is apparent from table 8.5, spending on health declined until 1986; from 1987-1989 spending climbed again but it did not reach the peak level of the early 1980s.

Spending on unemployment is relatively high in Denmark and started rising again at the end of the decade. Unemployment benefits are generous in terms of both size and maximum duration (up to ten years). Unemployment compensation can be obtained after twelve months of paying contributions into an unemployment scheme. The employer only pays the first day of unemployment (as from mid-1993 the employer will also have to pay the second day). There is also a large element of discretion for unemployed persons to reject job offers, although the 1991 Budget limited the right to reject a 'reasonable' job offer after more than one year of unemployment.

Subsidisation of owner-occupied housing has mainly taken place via the tax system. The State subsidizes housing associations. The 1991 Budget included a temporary housing

package to limit forced sales of household property, and stimulate the housing market.

Table 8.6 Detailed analysis of social welfare expenditure (% GDP), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Health	10.01	9.76	9.73	9.16	8.53	8.49	8.37	8.37	8.85	8.98
1a Sickness	7.48	7.21	7.15	6.55	6.04	5.98	5.80	5.75	6.08	6.25
1b Invalidity, disability	2.35	2.36	2.39	2.39	2.27	2.27	2.24	2.34	2.48	2.46
1c Occupational accidents and diseases	0.18	0.18	0.19	0.22	0.21	0.24	0.33	0.27	0.29	0.28
2. Pension schemes	9.99	10.25	10.32	10.34	10.13	10.07	9.89	10.05	10.39	10.49
2a Old age	9.84	10.11	10.19	10.21	10.11	10.05	9.86	10.03	10.36	10.46
2b Survivors	0.15	0.14	0.13	0.13	0.03	0.03	0.02	0.02	0.02	0.02
3. Maternity and family	3.03	3.14	3.12	2.92	2.84	2.85	2.80	3.23	3.54	3.45
3a Maternity	0.26	0.32	0.31	0.31	0.33	0.42	0.45	0.47	0.49	0.48
3b Family	2.78	2.83	2.82	2.62	2.51	2.43	2.35	2.75	3.04	2.97
4. Unemployment	3.62	4.67	5.03	5.36	4.83	4.15	3.44	3.43	3.88	4.19
4a Placement, guidance, resettlement	0.59	0.72	0.97	1.27	1.13	0.98	0.79	0.74	0.94	1.02
4b Unemployment	3.03	3.94	4.06	4.09	3.70	3.17	2.65	2.69	2.94	3.17
5. Housing and miscellaneous	1.34	1.52	1.61	1.56	1.51	1.49	1.46	1.67	1.73	1.68
5a Housing	0.40	0.42	0.43	0.46	0.48	0.48	0.49	0.54	0.58	0.59
5b Miscellaneous	0.94	1.09	1.18	1.10	1.03	1.00	0.98	1.13	1.15	1.08
6. Total	28.00	29.33	29.82	29.34	27.84	27.05	25.97	26.75	28.39	28.79

Source: EC, *Social Protection Expenditure and Receipts*, 1991

8.4 Detailed analysis of government revenues

As has been explained in section 8.2, the revenue side of the budget has importantly contributed to the budget consolidation achieved in Denmark, notably in the period 1983-86. Total tax revenue increased from 44.5 percent of GDP in 1982 to 52.1 percent of GDP in 1988. This section considers some trends in major taxes in greater detail. Table 8.7 presents an analysis of government revenue according to the mobility of the tax base.

(7)

Table 8.7 Breakdown of taxes according to degree of mobility of the tax base (% of GDP), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Taxes on corporate profits	1.5	1.3	1.2	1.4	2.5	2.4	3.1	2.3	2.3	2.1
2. Taxes on goods and services	17.0	17.0	16.4	16.6	16.7	16.8	17.9	17.4	17.4	16.5
2.1 VAT	10.1	10.4	10.0	9.8	9.8	9.8	9.9	9.7	9.9	9.7
2.2 Excise duties	6.1	5.8	5.8	6.2	6.3	6.3	7.4	7.1	6.2	5.6
2.3 Other taxes	0.8	0.8	0.6	0.6	0.6	0.7	0.6	0.6	1.3	1.2
3. Taxes bearing on use of labour	0.8	1.0	1.3	1.8	2.0	2.7	2.0	2.6	1.4	1.8
3.1 Soc. security contributions employees	0.5	0.5	0.7	0.9	0.9	1.0	0.9	1.0	1.0	1.1
3.2 Soc. security contributions employers	0.3	0.5	0.6	0.9	0.9	1.8	1.2	1.8	0.2	0.2
3.3 Soc. security contributions self-employed	-	-	-	-	-	-	-	-	-	-
3.4 Other taxes	-	-	-	-	0.2	0.8	0.5	0.7	0.3	0.6
4. Taxes on income of individuals	23.5	23.8	23.6	24.2	23.7	24.6	24.4	25.4	26.2	26.0
5. Taxes on property	2.6	2.3	2.0	2.4	2.0	2.1	2.4	2.6	2.4	2.2
6. Miscellaneous	0.1	-0.1	0.0	0.1	0.7	0.4	1.0	1.2	1.4	1.3
7. Total tax revenue	45.5	45.3	44.5	46.5	47.6	49.0	50.8	51.5	51.1	49.9

Source: *Revenue Statistics of OECD Member Countries 1965-1989*, Paris, 1990
Revenue Statistics of OECD Member Countries 1965-1990, Paris, 1991

As regards taxes on portfolio income of individuals (not shown in table 8.7) and inter/intra company remittances, it is important to note that Denmark has a 30% withholding tax on dividends (on the first Kr 30,600 (1992); for the excess the rate amounts to 45%) and certain types of royalties. The country has an extensive network of fifty double taxation agreements, which generally reduce tax to be withheld to 0-25%. The scope for further improvement in this area seems to be limited, unless the country should decide to unilaterally reduce its withholding tax.

In 1984 revenue from the corporate income tax almost doubled in terms of GDP, as a consequence of the increased tax rate (from 40% to 50%) and the improved overall performance of the Danish economy. This tax hike was intended to offset a reduction in employers social security contributions by 2 percent point. As from 1987 employers must pay a special Labor Market Tax ("arbejdsmarkedbidrag"), which amounts to 2.5%. The tax base consists of total sales of the enterprise (exclusive of exports) less total purchases of the enterprise (exclusive of imports). In later years the corporate income tax rate has been reduced stepwise, to the present 38%.

Another source of additional revenues were the energy taxes (not seperately shown in

table 8.7), which were introduced as part of the extraordinary fiscal tightening measures of December 1985 and both March and October 1986. Energy taxation in Denmark shows an exceptional disparity in that only households are heavily taxed, which is probably motivated by considerations of international competitiveness (table 8.8).

Table 8.8 Effective rates of energy taxation in selected countries (% of energy prices in 1990)

	petrol	diesel fuel	fuel oil		electricity	
			households	industry	households	industry
Belgium	65.4	46.6	14.5	0.0	n.a.	n.a.
Denmark	**69.1**	**0.0**	**62.0**	**0.0**	**50.0**	**0.0**
Ireland	67.1	51.4	24.0	20.7	9.9	n.a.
Italy	75.0	60.5	69.7	64.0	n.a.	n.a.
Netherlands	66.0	44.5	33.3	n.a.	n.a.	n.a.

Source: OECD, *Economic Surveys*, 1991, p. 66

Rates of indirect taxes are (considerably) higher in Denmark than in most other EC Member States. The rate of the value added tax (VAT) was raised from 20.25% to 22% in 1980, to remain at that level throughout the 1980s. During the decade revenues from VAT constantly amounted to about ten percent of GDP. The financial sector is not subject to VAT and news papers are zero-rated.

Although there is as yet no formal agreement on the harmonization of VAT rates, it seems likely that from the viewpoint of fiscal harmonization Denmark can retain the present rate of 22% for the major part of private consumption. Pressure to reduce the VAT rate may especially result from the large gap with VAT rates in Germany (15% as from January 1993).

Taxes on income of individuals presently bring in slightly more than half of total tax revenues. During the 1980s the aggregate income tax burden has gradually increased by over three percent points of GDP, to peak at 26.6 percent of GDP by 1988. The basic rate of the state income tax comes to 22%, the toprate is 40%. The basic rate applies to total taxable income; on personal income exceeding Kr 231,800 (1992) an additional 12% is due; on the part of aggregate personal and capital income that exceeds Kr 162,300 a further 6% is levied. In addition to state income tax, municipal and church taxes are levied on taxable income of

individuals. These taxes vary, but the average rate is 28% of taxable income.[20] Given this combined tax rate in the 50-68% band, it seems hardly possible to push up income tax rates in Denmark any more, without possibly serious damage to the functioning of labor and capital markets.[21]

As in most other industrialised countries, the personal income tax base in Denmark is partly eroded by deductions and allowances, especially because of the unlimited deductibility of interest payments. Premiums paid for ordinary pensions are also fully deductible. The OECD has estimated that government foregoes revenues equal to 4.5 percent of GDP due to the favourable treatment of interest payments in the tax system. However, it may be noted that such base erosion (by 23 percent of income-subject-to-tax in 1987) is not out of line, when compared to base erosion in most other EC Member States. For example, in 1987 the erosion of the personal income tax base in neighbouring Germany amounted to 22 percent, in the Netherlands erosion was estimated to come to 21 percent (OECD, *Economic Surveys*, 1990, p. 42).

As a consequence of high rates and an only 'average' erosion of the tax base, by 1987 Danish taxpayers effectively paid 41 percent of their aggregate taxable income in personal income tax. This effective burden considerably exceeded the burden on German taxpayers (on average 25 percent of taxable income) and the personal income tax burden in the Netherlands (17 percent). However, it should be stressed that social security in Denmark is almost exclusively financed out of general tax revenue, whereas Germany and the Netherlands heavily rely on specific social insurance contributions to finance their social security system.

During the 1980s, property taxes brought in a constant 2.0-2.5 percent of GDP. Denmark has a wealth tax. The rate is 1.2% on that part of the taxpayer's net wealth which exceeds Kr 1,482,000 for single tax payers and twice that amount for married couples. Taxation of motorvehicles is the heaviest in the EC.

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[20] Municipal taxes are imposed at flat rates, which vary from one municipality to the other. For 1992 they vary between 22.6% and 32.1%. The church tax is also imposed at a flat rate, varying from municipality to municipality, between 0.42% and 1.63%.

[21] The aggregate burden of national and municipal income taxes on any part of the tax payer's taxable income may not exceed 68 percent. If the aggregate burden exceeds this percentage, the national income tax is reduced accordingly. Similarly, income taxes, the dividend tax and the national wealth tax taken together, may not exceed 78 percent of taxable income and dividends received.

8.5 Budgetary process

Organization

The Danish public sector consists of the State, counties, municipalities, social security funds and public enterprises. The State is responsible for the provision of public goods and for income support, which is, however, administered by the municipalities. The latter are also responsible for providing primary education, social services, recreational facilities, and the like. Counties provide health care, collective transport and secondary education. Only roughly thirty percent of revenues from taxation accrue to local governments, the remainder of their outlays being covered by reimbursements and grants from the State. There exists a considerable degree of autonomy for local governments, which are, however, required to approximately balance their budgets. The social security funds represent only a small part of the total social security system. There are five different programmes in this sector, including the unemployment insurance system, which is financed by contributions from employees and employers, as well as from the State. The public enterprises include state-owned, unincorporated enterprises, such as state railways and the postal system. They operate partially on a commercial basis, but are not free to set prices and wages on their own. The number of fully or partly stated-owned incorporated companies is small, comprising mainly of the telephone companies, the national oil and gas company and the Danish share in the Scandinavian Airline System (SAS). As the State's shareholdings are not important and state-owned unincorporated enterprises are required to apply commercial principles, privatisation has not been an important issue in Denmark. It is only in recent years that proceeds from privatisation became of some quantitative importance. In 1990 privatisation measures were estimated to bring in Kr. 5 billion.

Budgetary rules and procedures

Under and after the Danish medium-term programme embarked upon in 1982/83 the government presents each year a revised five-year target scenario, taking past developments into account. The budget process starts by setting a target for net expenditure of central government, i.e. gross spending including payments to local government minus user fees and other similar revenue, and minus the State's contribution to financing unemployment benefits. The target aimed at has in recent years been approximately constant real expenditure. The global target figure is broken down into individual net spending ceilings for each Ministry. Compliance with these ceilings is checked quarterly and spending overruns

have to be met by an increase in user fees, or cutbacks in programmes. In recent years both the State and municipalities have introduced new and raised existing charges to users of publicly provided goods and services. Apart from a reduction of general grants to local government, other measures have been taken to limit expenditure growth, such as negotiated expenditure limits ('framework') for local government. In practice these limits to expenditure growth have not been fully respected by local governments. In 1988/89 a new instrument has been introduced by limiting tax rates and thus revenues by common agreement. In both 1990 and 1991 no formal restrictions were placed on local spending, but local governments committed themselves not to raise local income tax rates, which was expected to limit their ability to increase expenditure.

In recent years spending overruns occurred, but the most important reason for the recent rise of the central government budget deficit is that revenues fell well short of expectations (table 8.9).

Table 8.9 Central government budget balance: expectations and outcomes

	1989		1990		1991
	fiscal budget	outcome	fiscal budget	outcome	fiscal budget
total income	288.4	271.9	291.5	276.0	282.6
of which:					
direct taxes	115.4	117.1	124.3	119.9	123.8
indirect taxes	147.5	142.0	151.3	141.0	145.1
total expenditure	287.2	289.6	297.5	299.2	312.1
balance	1.2	-17.7	-6.0	-23.2	-29.5

Source: OECD, *Economic Surveys*, 1991, p. 28

8.6 Recent developments

The outcome for the 1991 budget was a central government budget deficit of Kr billion 36, which is considerably more than envisaged (see table 8.9). Some important measures included in the 1992 Budget consist of an agreement with local governments to fix their level of expenditures and the removal of some duties on beer and wine as part of the EC tax harmonization effort. The VAT rate was increased to 25% at the beginning of 1992. The European Court ruled against the special labour market VAT, which implied lost tax

revenues of Kr billion 4.5 for 1992. The actual budget deficit for 1992 will probably amount to Kr billion 40 or more, instead of Kr billion 30.5 as envisaged in the 1992 budget.

The most recent (1993) budget contains proposals to cut expenditure by some Kr 7.5 billion to reduce the deficit. The number of public sector employees will be trimmed by 4,100. The government also proposed to privatize state property and to cut subsidies to enterprises and unemployment benefits. The proposed measures will result in a deficit of Kr billion 33.9. At the moment of writing is was not clear whether the minority government would succeed in getting these proposals accepted by parliament.

8.7 Fiscal policy flexibility

In this section the flexibility of the budget, i.e. the scope to reduce spending and/or increase revenues is analysed. Table 8.2 shows how the general government deficit has been reduced from its peak of 9.1 percent of GDP in 1982 to a surplus of 3.4 percent in 1986. Since then, the deficit has increased again to 1.5 percent in 1992. With respect to the deficit reference value as laid down in the Maastricht Treaty, the deficit is not 'excessive'. We conclude that the deficit as such poses hardly a problem anymore. As follows from table 8.2 gross public debt amounts to 66 percent of GDP in 1992.

Scope to increase revenues

As the overall tax burden on the Danish economy is among the highest within the EC, the scope for increasing rates of major taxes seems to be very limited. Nevertheless, we will investigate some possibilities.

The rate of the corporate income tax offers little leeway, since in the European Community rates tend to converge in the 35-40% band. The Danish rate (38%) is at about the same level as in surrounding countries (assuming that the German rate will be further reduced).

The top rate of the personal income tax (68%) already exceeds the top rate of neighbouring Germany by fifteen points. This gap will further increase if by 1995 the German top rate is reduced to 46% as is now envisaged. Indeed, there is some political pressure now to reduce Danish income tax rates. Tax facilities are favourable. Interest paid and contributions to pension saving are fully deductable from the personal income tax base. The deductability of interest on mortgages could be limited in combination with a reduction

of housing subsidies. The deductability of other interest payments could be reduced by introducing statutory limits as is the case in many other EC Member Countries.

The VAT-rate of 25% is already among the highest in the EC. Among taxes which are less important in revenue terms, some increase of property tax rates seems to be the only feasible option.

Table 8.10 summarizes the flexibility of fiscal policy with respect to government revenue.

Scope to reduce expenditure

Demographic developments have had a decisive influence on trends in public spending in the past. The number and the share in the population of smaller childeren began to drop from the late 1960s, while the number of old people and their share in total population continually rose. According to OECD estimates, demographic changes until the year 2000 are likely to be similar to those of the past twenty years (OECD, *Economic Surveys*, 1988, p. 40). This implies some downward flexibility of spending on education and family benefits, while spending on health is likely to increase. Projections by Holzmann (1988) indicate that as far as the demographic influence is concerned, the share of pension outlays in Danish national income may drop in the near future. Since spending on old age pensions is quite high in comparison with other EC Member States - taking into account the high participation rate in Denmark - there is probably also some scope to reduce benefit levels.

Transfer payments have been boosted by relatively high subsidies, which mainly benefit agricultural exports, collective transport and housing associations. Spending on economic services is also quite high and may be reduced.

Most options for budget cuts are to be found in the area of social security and welfare, notably by reducing the generosity of the system. As to unemployment benefits, for instance, generosity can be reduced both in terms of the level of the benefit and its duration.

Table 8.11 summarizes the flexibility of fiscal policy with respect to government outlays.

Table 8.10 Contribution to budget consolidation of revenue categories in Denmark[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. Taxes on portfolio income of individuals				tax competition	--
2. Taxes on corporate profits			tax competition		- (2.1)
3. Taxes on goods & services 3.1 VAT		tax base		tax competition	- (9.7)
3.2 Excise duties				tax competition	-- (5.6)
3.3 Other taxes					0 (1.2)
4. Taxes on use of labour 4.1 Social sec. contr. employees				tax wedge	-- (1.1)
4.2 Social security contr. employers				tax wedge	-- (0.2)
4.3 Social security contr. selfemployed					0 (0.1)
4.4 Other taxes					0 (0.6)
5. Taxes on income of individuals		tax base		tax wedge	- (26.0)
6. Taxes on property	tax base				+ (2.2)
7. Miscellaneous taxes					0 (1.3)
8. Non-tax revenues		privatisation			+ (7.6)

[a] Budget consolidation resulting from discretionary measures is printed in **bold** type.

[b] A plus indicates upward flexibility (higher revenues, lower deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.

[c] A minus indicates downward flexibility (lower revenues, higher deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.

[d] The share of the various revenue categories as a percentage of GDP (1989) is shown in parentheses.

Table 8.11 Contribution to budget consolidation of functional expenditure categories in Denmark[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. General public services					+ (4.6)
2. Defense					+ (2.1)
3. Public order and safety					0 (1.1)
4. Education		demography			+ (7.0)
5. Health		**incentives**		demography	- (5.2)
6. Social security and welfare		**replacement ratio;** demography; GDP growth	GDP growth		++ (23.2)
7. Housing and community amenities					+ (0.9)
8. Recreational, cultural and religious affairs					+ (1.5)
9. Economic services					+ (5.8)
10. Other functions		interest rates; GDP growth	interest rates; GDP growth		0 (8.4)

[a] Budget consolidation resulting from discretionary measures is printed in **bold** type.
[b] A plus indicates downward flexibility (less expenditure, smaller deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures. The single or double plus sign indicates the relative degree of flexibility.
[c] A minus indicates upward flexibility (more expenditure, higher deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures. The single or double minus sign indicates the relative degree of flexibility.
[d] The share of the various spending categories as a percentage of GDP (1989) is shown in parentheses.

Table 8.12 Major revenue-increasing measures in Denmark, 1980-1989[a]

	Taxes on portfolio income of individuals[b]	Taxes on corporate profits	VAT	Excise duties	Social security contributions employees	Social security contributions employers	Taxes on income of individuals	Taxes on property	Non-tax revenues
1980			rates	petrol; electricity					
1981							no full indexation	revision	
1982	interest pension funds			various			no full indexation		
1983	levy on capital stock of pension funds								
1984	levy on yields pension funds			mineral water		contributions	no full indexation		rates; fees
1985				beer; tobacco			no full indexation		fees for services
1986				beer tobacco; energy				land tax	stamp duty
1987					energy		interest payments		
1988									
1989									privatisation

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, revenue-increasing measures with a general character like combatting tax evasion and avoidance, are indicated in the first column.

Table 8.13 Major expenditure cuts in Denmark, 1980-1989[a]

	General public services[b]	Defense	Public order and safety	Education	Health	Social security and welfare	Housing and community amenities	Recreational, cultural and religious affairs	Economic services	Other functions
1980	various spending caps									
1981	various spending caps									
1982	investment; spending caps									
1983	wages; spending caps			various	various	no indexation; various cuts				
1984	wages; spending caps; local spending					child care; indexation limit; various	rent subsidies		postal revenue	
1985	investment; spending caps					indexation limit; various				
1986	spending caps; local spending					indexation limit; various				
1987	investment; spending caps									
1988	capital expenditure; caps; local spending									
1989					various					

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, expenditure cuts with a general character like wage restraints and general spending caps, are indicated in the first column.

9. Ireland

9.1 Introduction

In the early 1980s Ireland's budgetary position worsened significantly: general government's net borrowing amounted to 13.4 percent of GDP in 1981; at the time its gross debt ratio rose to 80 percent of GDP. Deficits were financed to a considerable degree through foreign borrowing.

Over the period 1960-80 the public sector has absorbed an increasing share of Ireland's national output. Rising expenditure on social programmes and higher spending on public infrastructure were the most important factors behind growing public outlays in the late 1970s. A third factor behind this growth was the Irish industrial development strategy. Falling employment in agriculture and in traditional indigenous industries, high population growth[22], and a high dependency ratio all implied the need to promote employment in the non-agricultural sector. Prospective investors have been offered a broad range of generous financial and fiscal incentives, including capital grants, training, research and development grants, and various forms of tax relief.[23]

The main sources of very steeply rising public revenues have been the proceeds from indirect taxes, from personal income tax, and from social security contributions. The rapid growth of the latter revenue category reflected both an increase in the number of insured workers and an expansion of the insurance schemes concerned. The Social Insurance schemes covering unemployment, pensions, accidents and ill-health are intended to be self-financing and participation is compulsory for all dependent employees. The State covers, however, any deficit in the insurance funds and also provides Social Assistance benefits (subject to a means test) for individuals not covered by insurance schemes.

During the 1960s and the early 1970s the policy outlined above was associated with a

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[22] The Irish birth rate during the period 1950-80 was over 20 per thousand, which far exceeded the European average. Although the birth rate has fallen since 1980, it is still significantly higher than the birth rate in other EC Member States.

[23] Apart from the strain on public finances from funding the industrialisation program, the structural transformation of Irish manufacturing to a base for export-oriented foreign-owned industries introduced another problem. Direct foreign investment created little employment in indigenous supplying industries. Foreign firms tended to import the raw materials and intermediate inputs. Despite relatively high levels of economic growth, employment increased only moderately during the 1970s. One possible explanation is that over this period labour costs have risen considerably, thus encouraging the substitution of (subsidised) capital for labour. See OECD, *Economic Surveys*, 1983, p. 40.

substantial, but stable budget deficit. From 1974 onwards, however, deficits ballooned and became associated with a substantial widening of the current external deficit.

9.2 General outline of economic policies in the 1980s

By 1981 the current account deficit had increased to almost 15 percent of GDP and inflation amounted to almost 20 percent (table 9.1), which made it unavoidable to constrain demand. It took several years before this disinflation process had run its complete course; in 1987 the rate of inflation fell to 3 percent, while the current account showed a surplus. The process of disinflation commanded a high price in terms of unemployment[24]; moreover, the government budget deficit remained at a very high level despite continued efforts to redress the public finances between 1981 and 1986. The internal dynamics of the public finances became unsustainable, as a vicious circle of accumulating debt, rising debt-servicing costs and higher borrowing was set in motion. Since 1987 government net borrowing has, however, been reduced considerably (table 9.2). The steep upward trend in the public debt-to-GDP ratio has been reversed.

The success of the second phase of the budget consolidation process can be ascribed in part to the economic circumstances under which fiscal consolidation took place.[25] Indeed, the cumulative change of the cyclically adjusted primary balance during the first phase exceeds that during the second period, implying that much of the basis for succesful stabilization in the second phase was laid in the earlier period (figure 9.1). Whereas the first phase coincided with generally weak economic trends (low growth, high real interest rates, a real appreciation of the Irish pound), the second phase of budgetary adjustment took place at an ideal point in the economic cycle: an upswing in world trade after 1986, falling interest rates and a stabilization of the real exchange rate. Initially, the recovery was exclusively export-led, but as investment and private consumption rose internal demand became the main impetus to economic growth. Simulations with the OECD's Interlink model suggest that without the external influences of a large fall in oil prices and a strong recovery of world

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[24] The increase in unemployment was actually cushioned by heavy outward migration between 1981 and 1990. Although unemployment decreased during 1988-1990, this fall is indeed as much attributable to high levels of outward migration as to employment growth. Rising unemployment went together with an increasing proportion of long-term unemployed.

[25] EC, *Ireland, Country Studies*, nr. 6, 1991.

trade, efforts at fiscal consolidation would have reduced both the volume and the price component of GDP between 1986 and 1988.[26] It should, however, be pointed out that these simulation results do not take account of improved confidence and expectational effects, which may be important. Giavazzi and Pagano (1990) found that expectations of a lower share of government spending in output stimulated private consumption; Dornbusch (1989) concludes that there is some evidence for improved expectations in the asset market.[27]

Figure 9.1 Cyclically adjusted primary balance (% GDP), 1980-1992

Source: OECD

[26] OECD, *Economic Surveys*, 1989, p. 36.

[27] Dornbusch (1989) also concludes that participation in the ERM failed to help reduce the output cost of disinflation. A similar conclusion is reached by Egebo and Englander (1992), who found evidence for policy credibility effects in financial markets but not for a shift in inflation expectations in labour or product markets after 1987. For further evidence on the credibility aspect of policy, see Kremers (1990).

Table 9.1 Main economic indicators, 1980-1993

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP growth	2.7	2.6	-0.7	-1.6	2.3	1.0	-1.2	5.0	1.4	5.0	6.6	1.3	2.5	3.3
Unemployment	7.3	9.9	11.4	14.0	15.5	17.4	17.4	17.7	16.7	15.6	13.7	15.8	16.5	16.0
Inflation	18.6	19.6	14.9	9.2	7.4	5.0	4.3	3.2	2.5	3.9	3.2	3.0	2.7	2.7
Interest rate					14.6	12.7	11.1	11.3	9.4	9.0	10.1	9.2		
Nominal unit labour costs (1980=100)	100	94.8	98.1	100.2	96.7	96.8	102.2	98.7	96.2	91.4	95.3	93.8		
Current account (% of GDP)	-11.5	-14.7	-10.6	-6.8	-6.4	-4.1	-3.1	1.4	2.3	1.8	3.0			
Dependency ratio	0.70	0.69	0.69	0.68	0.68	0.67	0.66	0.65	0.65	0.64	0.63			
Change in the relative price of public services	2.8	1.5	-1.5	-0.8	0.8	0.7	0.2	2.4	2.5	2.2	2.1			
Participation rate:														
men	87.6	87.7	87.8	87.1	86.6	85.5	85.1	84.3	83.9	82.7	82.2			
women	36.3	36.9	37.6	37.8	36.9	36.6	37.2	38.5	37.6	37.5	38.9			

Source: OECD

During the first phase of fiscal consolidation budgetary adjustment efforts focussed on increasing tax revenue, while in the second phase expenditure cuts were a prime target (see also section 9.3).

The 1980 Budget aimed at reducing the government borrowing requirement through - among other policy measures - increasing revenue from the income tax and indirect taxes. But in fact current spending overruns caused the deficit to increase. Part of these overruns were due to the government's part of the National Understanding[28] of October 1980, which implied higher public sector wage growth than envisaged, the introduction of additional social welfare payments and a commitment to sustaining employment.

In 1981 spending overruns occurred with lower revenues than expected, leading to an increase of the general budget deficit; the cyclically adjusted deficit swelled even more. The slippage occurred mainly on current expenditure. Between 1979-1982 current expenditure increased from 40 percent to 49 percent of GDP. The main factors behind this increase of outlays have been (OECD, *Economic Surveys*, 1983, pp. 19-21):

[28] This held an agreement on pay and working conditions between the Irish Congress of Trade Unions and employer organisations (including the Government).

- substantial increases in the real value of per capita transfers[29];
- large increases in public sector employment[30];
- high burden of debt service charges;
- demographic factors which have raised the demand for public services, especially health and education.

Although the supplementary Budget of July 1981, introduced by the government elected in June 1981, introduced some fairly important tax and expenditure changes (including a rise of the 10% VAT rate to 15% and sharp excise increases), they had little effect on the outcomes for 1981. After its 1982 Budget Proposals had been defeated by parliament, the government resigned. The ensuing general election led to a change of government.

Although the new Budget included several adjustments to the previous one, its overall effect on the public sector budget deficit was little different. The 1982 outturn showed a further deficit growth. The budget situation became clearly unsustainable. Foreign debt had increased to over 40 percent of GDP by 1982.[31]

In October 1982 the government's economic plan *The Way Forward* was published, proposing the complete elimination of the budget deficit by 1986. However, the minority Fianna Fail government fell at the general election in November 1982. The new Fine Gael-Labour Coalition government which took office after the elections, proposed to reduce the deficit in 1983, notably by, inter alia, the following tax measures:

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[29] Spending on old age pension increased by 27 percent in real terms between 1979 and 1982; real unemployment benefits rose 4 percent. Source: OECD, *Economic Surveys*, 1983, p. 51.

[30] In 1982 public sector employment amounted to 314,000 persons, which is 24.5 percent of the total labour force. The average annual increase over the period 1979-82 amounted to 3 percent. See OECD, *Economic Surveys*, 1983, p. 19. For later developments, see table 9.3.

[31] The economic impact of foreign borrowing differs from domestic borrowing in two respects. First, foreign borrowing temporarily provides additional resources available to the country to consume, or to invest. By the same token, servicing such borrowing subsequently implies a loss of resources, and, hence, has a deflationary impact. By contrast, domestic borrowing implies transfers between residents; the subsequent servicing of this debt implies a transfer between residents. Moreover, interest payments to residents generate tax receipts. Second, borrowing in domestic currency tends to push up interest rates and crowds out domestic investment, whereas external borrowing puts upward pressure on the exchange rate, thereby crowding out activity in those sectors most exposed to international competition.

Table 9.2 General government budget deficit (% GDP), 1980-1992

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Current receipts	37.7	38.4	40.7	42.4	42.5	42.4	42.3	42.6	43.6	39.6	39.5	40.4
Total expenditure	50.4	42.8	54.5	54.2	52.3	53.6	53.4	51.7	48.8	43.1	43.1	44.5
Net borrowing	-12.7	-13.4	-13.8	-11.8	-9.8	-11.2	-11.2	-9.1	-5.2	-3.5	-3.6	-4.1
Gross public debt	73.9	79.8	89.7	100.3	104.8	108.5	120.8	122.0	120.4	110.1	103.0	102.8

Source: EC, *Tables on Public Finance*

- a new top rate of the personal income tax (65% instead of 60%);
- non-indexation of income tax brackets for inflation;
- increases in the standard and high VAT rates by 5 percent points;
- temporary levy on income of 1%.

For the first time in a number of years, budget targets for the year were largely attained, despite a decline in real GNP of almost 2 percent. Current expenditure continued to rise as a proportion of GNP in 1983, but its annual growth rate shrank from 27 percent in 1981-82, to 12 percent. Public sector employment has been cut back since 1982, and as from that year growth of government real wages was quite moderate for a number of years (table 9.3).

Table 9.3 Employment situation in the public sector, 1982-1990

	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Government employment (* 1000)	314	313	307	303	301	296	286	270	270
2. as % of total employment	15.8	15.8	15.9	15.9	15.9	15.7	15.2	14.3	13.7
3. Growth of government real wages	-4.8	0.8	0.0	0.0	0.8	3.3	0.0	4.7	5.3
4. Growth of relative government wages [a)]	-2.7	-0.2	-2.4	-1.7	-2.4	1.7	-2.2	5.0	4.6

[a)] Compared with hourly earnings in manufacturing deflated by consumer price index.

Source: OECD

The imposition of substantial tax increases in the 1982 and 1983 Budget implied a marked tightening of fiscal policy; the cyclically adjusted primary deficit was reduced significantly (figure 9.1). The actual deficit declined less. The 1984 Budget implied distinctly less fiscal adjustment than had been achieved over the previous two years. Most of the proposed deficit reduction reflected carry-over effects of tax increases enacted in the 1983 Budget. Additional measures included the introduction of a new VAT rate of 8% on adult clothing and the increase of various excise duties on beer, wine, cigarettes and petrol. The main expenditure increases were a 7 percent rise in social welfare payments to offset the effects of inflation, and the introduction of a family income supplement.

In October 1984 the government published its national plan *Building on Reality 1985-1987.* This plan foresaw a reduction in the deficit; most of the reduction was supposed to take place towards the latter half of the period. In addition, the government pledged itself to prevent the share of national output absorbed by taxation from rising above its 1984 level. Important elements of planned spending restraint included the intention to allow only modest pay increases in the public service and a major fall in the level of public investment. It was widely agreed that the return on much public investment had been low and sometimes even negative (OECD, *Economic Surveys*, 1985, p. 28).

The 1985 Budget envisaged increased government borrowing. In order to reduce Irish/UK tax and price differentials some changes were introduced in the tax system. The top VAT rate of 35% was reduced to 23%, and the excise duty on televisions was halved. Higher indirect taxes were imposed on cigarettes and petrol. The top rate of the personal income tax was reduced from 65% to 60% (the other rates being 35% and 48%, respectively). Further measures taken included a rise of welfare payments slightly above the then expected rate of inflation, and a 6 percent pay increase for public servants.

Like the 1984 and 1985 Budgets, the 1986 Budget sought only minor fiscal adjustment. The deficit hardly decreased. Important measures of the 1986 Budget included:

- increase of personal income tax exemptions;
- further reduction of the top rate of the income tax (58%) and an increase of the standard VAT rate to 25%;
- rise of various excise taxes (on cigarettes and petrol);
- 4-5 percent higher social welfare benefits;
- 7 percent pay increase for public service workers.

Table 9.4 Social welfare indicators, 1980-1990

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Replacement ratio	73.9	78.5	83.1	78.1	76.8	76.3	74.6	75.9	65.8	62.8	n.a.
2. Real unemployment benefits (1980=100)	100.0	101.7	104.1	99.2	93.1	94.3	91.5	88.9	85.0	82.6	81.1
3. Real old age pension (1980=100)	100.0	102.9	111.8	112.5	111.7	112.3	112.7	112.6	113.0	112.1	113.0

Source: OECD

The 1985 and 1986 Budgets failed to achieve the targets set out in *Building on Reality 1985-1987*. Capital spending fell further than envisaged, but nominal targets for current expenditure were not achieved, despite a much slower than expected rise in consumer prices and despite continued tight limits on public sector employment. In real terms the overshooting was much larger. One reason for this was lower-than-expected GDP growth and higher unemployment. Another reason was the increase in real pay of government workers (table 9.3), and the rise of real transfers (table 9.4). Many improvements of the compensation of groups of civil servants were awarded by an Arbitrator who is independent of the government and whose recommendations have been heavily influenced by considerations of comparability, historic relativities and so on.[32] Although the government delayed the decision - which was protested by a one-day strike in the public services - the Arbitrator was eventually reappointed in 1986.

The *Programme for National Recovery* (PNR), announced in October 1987, set the following objectives for the period till the end of 1990:

- reduction of the Exchequer borrowing requirement to 5-7 percent of GNP to stabilize the debt-to-GNP ratio;
- achieving lower inflation and interest rates;

[32] Most public service employees fall under the jurisdiction of various Conciliation and Arbitrator Schemes. Discussions take place in a Board with employers and employees equally represented under a Chairman appointed for a fixed period by the Government. Since employers and employees are usually on opposite sides, it is the Chairman - thus popularly called the Arbitrator - who rules in the end. The Arbitrators recommendations are, however, not legally-binding.

- reform of the tax system;
- moderation of annual pay increases to a maximum of 2.5 percent.

The target for 1987 was more than achieved, not only by a reduction in capital expenditure, but also by a significant fall in the ratio of current government spending to GNP. Expenditure cuts depended heavily on a freeze of wages in the government sector, and strict limitations on public sector hiring. A number of housing grants were eliminated; hospital charges were introduced for hospital stays and tax brackets were not indexed for inflation. In 1988 the ratio of current expenditure to GNP was below target by 0.8 percentage points, due to lower-than-budgeted unemployment compensation and tighter control of welfare outlays. Likewise, capital expenditure was reduced more than envisaged in the original budget plans. However, by far the most significant deviation from the initial budget projections was the unexpectedly large increase in tax revenue. A tax amnesty, combined with improved tax collection, generated extra revenue sixteen times over original estimates. Even without this once-and-for-all surge in tax revenues, current revenue flowed richly due to the strong economic recovery.

The 1989 Budget provided for an increase of outlays, mainly due to a general rise in social welfare payments by 3 percent, and a 12 percent rise of compensation for the long-term unemployed. After four years of continued reductions, capital expenditure was also slightly increased. The 1989 Budget also brought some steps in the reform of the tax system:

- reduction of personal income tax rates;
- tax relief for household's mortgage interest payments and life insurance premiums was reduced;
- excise duties on alcoholic beverages and cigarettes were increased again;
- the standard rate of the corporate income tax was reduced from 47% to 43%.

The 1990 Budget projected a further small drop of the Exchequer borrowing requirement (EBR). In the event, the outturn proved to be slightly better than projected, thanks largely to the cyclical buoyancy of the economy. The 1991 Budget projected a further small decrease of the EBR. Higher transfers and interest rates were expected to push up general government spending by about 0.5 percent of GNP. The standard rate of the income tax was reduced to 29%; the top rate was reduced to 52%. The standard VAT rate was reduced to 21%, while the 10% VAT rate was increased to 12.5%.

9.3 Detailed analysis of government spending

Table 9.5 presents data on general government spending by economic classification for the period 1980-1991.

The fact that productivity gains tend to be lower in the government than in the private sector means that the deflator of public consumption rises faster than the consumer price index, unless wages of public servants stay behind. This so called 'relative price effect' can also be discerned in Ireland (see table 9.1). The reduction of government consumption has, to a considerable degree, been realised through reductions in public sector employment and sometimes through a moderate trend in government wages (table 9.4). A new three-year agreement has been ratified in 1991. This *Programme for Economic and Social Progress 1991-1993* (PESP) provides for an annual average wage increase of 3.5 percent up to 1993.[33] The PESP terms also apply to public sector employees.

During the first half of the 1980s government transfers increased. This rise in transfer payments reflected four main factors:[34]

- increased real per capita benefits (table 9.4);
- wider entitlement to existing schemes;
- introduction of new schemes;
- higher unemployment and a lower participation ratio of older workers have increased the number of beneficiaries.

In 1986 some 743,000 persons received welfare benefits (excluding child benefits), compared with 400,000 in 1970. By contrast, the number of persons with jobs was virtually the same in 1986 as it had been in 1970.

Interest payments have been reduced since 1985 by 2 percent points of GDP. With one of the highest public debt-to-GDP ratios in the EC, Irelands budget deficit is, however, very sensitive to interest rate movements.

Capital spending has been reduced considerably during the 1980s. Even in periods with little, if any, improvement in the overall situation of the public finances, gross capital formation has been reduced nevertheless.

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[33] Like the previous "Programme for National Recovery", the PESP has been based on a consensus among government, employers, farmers and trade unions. A key element of both programmes was a wage agreement, limiting per capita wage growth.

[34] OECD, *Economic Surveys*, 1987, pp. 63-64.

Table 9.5 General government expenditure, economic classification (% of GDP), 1980-1991

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Consumption	19.9	19.9	19.8	19.3	18.7	18.7	18.9	17.8	16.7	15.4	16.1	17.1
compensation of employees	12.9	13.3	13.3	13.1	12.9	12.7	12.8	12.4	11.6	12.2	10.8	11.5
Current transfers	16.7	17.7	19.6	20.3	19.9	20.3	20.6	20.9	20.8	16.6	16.4	17.0
transfers to households	12.7	13.7	15.7	16.3	16.2	16.7	17.3	16.8	16.3	14.5	14.1	14.6
Interest payments	6.6	7.4	9.0	9.3	9.4	10.3	9.7	9.7	9.4	9.1	8.4	8.3
Capital transfers	1.4	1.0	0.9	0.6	0.4	0.3	0.5	0.4	-0.1	0.2	0.2	0.2
Investment	5.9	5.7	5.3	4.7	4.0	4.0	3.7	2.9	2.0	1.9	1.9	1.9
Total expenditure	50.4	51.8	54.5	54.2	52.3	53.6	53.4	51.7	48.8	43.1	43.1	44.5

Source: EC, *Tables on Public Finance*

Table 9.6 presents a detailed analysis of general government spending. Government spending expressed as a percentage of GDP reached its peak in 1985, and declined ever since. Over the period 1985-89 demand and policy considerations affecting social welfare spending have often pulled in opposite directions: trends in the number of beneficiaries exerted downward influence on expenditure, higher benefit levels tended to push up outlays. The effect of both tendencies varied, however, between expenditure programmes.[35]

[35] NESC, *A Strategy for the Nineties: Economic Stability and Structural Change*, Dublin, 1990, p. 204.

Table 9.6 General government spending (% GDP), 1980-1990

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. Defense	1.9	1.8	1.8	1.7	1.6	1.6	1.6	1.5	1.4	1.3	1.4
2. Other general public services	4.1	4.5	4.4	4.5	4.4	4.5	4.9	4.4	4.7	4.0	4.0
3. Education	6.0	6.4	6.4	6.3	6.1	6.1	6.1	6.2	5.6	5.3	5.2
4. Health	8.0	7.7	7.5	7.5	7.0	7.0	6.9	6.5	5.9	5.7	5.8
5. Social security and welfare	10.2	11.0	12.8	13.5	13.4	13.6	13.9	13.4	12.4	11.4	11.3
6. Housing	3.4	3.6	3.3	3.2	2.9	3.0	3.0	3.1	2.1	1.4	1.3
7. Other social services	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.4	1.3	1.2	1.3
8. Agriculture	3.1	3.1	3.1	2.8	2.5	2.3	2.2	3.2	4.5	1.0	1.9
9. Industry	2.8	3.3	3.0	2.4	2.3	2.0	1.9	1.6	1.3	1.0	1.1
10. Transport	4.8	4.4	3.5	3.3	3.0	2.8	2.9	2.3	2.1	2.0	2.1
11. Other economic services	2.6	2.0	3.4	2.9	2.9	3.2	2.8	2.9	1.9	1.6	1.7
12. Public debt	11.7	12.0	14.3	14.7	14.6	18.3	17.1	17.2	24.5	12.2	14.8
13. Total expenditure	59.9	61.2	65.1	64.2	62.2	66.0	64.9	63.5	67.6	47.9	51.8

Source: Statistical Office, Republic of Ireland

Table 9.7 presents a more detailed analysis of social welfare expenditure. As in many other countries, costs of health services are inflated, in the absence of incentives to minimize costs. Ireland's health spending as a share of GDP is rather high. Measures taken since March 1987 to reduce outlays included closing of some older and smaller hospitals, and the imposition of charges for stays in public hospitals.

Spending on pensions in Ireland is relatively low, reflecting Irelands relatively young population. During the 1980s the real income position of pensioners improved considerably (table 9.4).

Unemployment outlays are not very much above those in many other EC Member Countries, depite the high unemployment rate (table 9.1) and the high replacement ratio (table 9.4).

Spending on housing subsidies is relatively high, but has been reduced during the seond half of the 1980s.

Table 9.7. Detailed analysis of social welfare expenditure (% GDP), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Health	8.54	8.22	8.37	8.32	8.03	8.16	8.19	7.75	7.31	6.84
1a Sickness	6.95	6.88	6.81	6.69	6.43	6.55	6.54	6.15	5.75	5.36
1b Invalidity, disability	1.48	1.25	1.44	1.52	1.48	1.49	1.53	1.47	1.44	1.36
1c Occupational accidents and diseases	0.10	0.09	0.11	0.12	0.12	0.12	0.12	0.13	0.12	0.12
2. Pension schemes	7.15	6.73	7.15	7.29	7.13	7.03	7.07	7.01	6.76	6.30
2a Old age	5.80	5.33	5.62	5.70	5.55	5.45	5.50	5.46	5.26	4.90
2b Survivors	1.35	1.40	1.53	1.59	1.58	1.57	1.57	1.55	1.51	1.41
3. Maternity and family	2.28	2.33	2.70	2.80	2.75	2.71	2.87	2.85	2.64	2.44
3a Maternity	0.62	0.61	0.58	0.54	0.54	0.50	0.49	0.49	0.41	0.39
3b Family	1.66	1.73	2.11	2.22	2.21	2.21	2.38	2.37	2.23	2.05
4. Unemployment	1.78	2.19	2.83	3.39	3.50	3.70	3.79	3.64	3.36	2.96
4a Placement, vocational guidance, resettlement	0.16	0.17	0.25	0.37	0.43	0.47	0.57	0.54	0.51	0.41
4b Unemployment	1.62	2.02	2.58	3.02	3.07	3.23	3.22	3.10	2.85	2.55
5. Housing and miscellaneous	0.96	1.06	1.13	1.24	1.21	1.34	1.31	1.26	1.28	1.09
5a Housing	0.77	0.78	0.80	0.93	0.91	1.01	0.98	0.95	0.93	0.79
5b Miscellaneous	0.19	0.27	0.33	0.31	0.30	0.33	0.33	0.31	0.34	0.31
6. Total	20.68	20.53	22.17	23.03	22.64	22.94	23.22	22.50	21.35	19.62

Source: EC, *Social Protection Expenditure and Receipts*, 1991

9.4 Detailed analysis of government revenues

Table 9.8 presents a breakdown of government revenue according to the mobility of the tax base.

With respect to taxes on portfolio income of individuals Ireland has a withholding tax (Deposit Interest Retention Tax, DIRT) of 29% on interest paid to residents; Ireland has no withholding tax for non-residents. DIRT may, however, be reduced or eliminated under the terms of its more than twenty international tax treaties. There is no withholding tax on dividends. Dividends from a company qualifying for the 10% company tax rate, are 50 percent exempt from income tax, subject to a maximum of £7,000.

Table 9.8. Breakdown of taxes according to degree of mobility of the tax base (% of GDP), 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Taxes on corporate profits	1.5	1.8	1.7	1.5	1.3	1.2	1.4	1.3	1.6	1.3
2. Taxes on goods and services	14.9	15.9	16.9	17.6	17.7	17.0	17.3	16.7	17.3	16.7
2.1 VAT	5.0	5.4	7.1	8.1	8.3	7.9	8.2	7.9	8.5	8.1
2.2 Excise duties	9.6	10.1	9.3	8.9	8.6	8.4	8.4	8.1	8.1	7.9
2.3 Other taxes	0.3	0.4	0.5	0.6	0.8	0.7	0.7	0.7	0.7	0.7
3. Taxes bearing on use of labour	5.0	4.9	5.8	6.4	6.7	5.6	5.6	5.5	5.7	5.4
3.1 Soc. sec. contributions employees	1.6	1.6	2.0	2.1	2.0	2.0	2.0	2.0	2.1	1.9
3.2 Soc. sec. contributions employers	3.2	3.2	3.5	3.6	3.6	3.6	3.6	3.5	3.5	3.3
3.3 Soc. sec. contributions self-employed	0.1	0.1	0.0	0.0	0.1	-0.9	-0.7	-0.5	-0.5	-0.3
3.4 Other taxes	0.1	0.0	0.3	0.7	1.0	0.9	0.7	0.5	0.6	0.5
4. Taxes on income of individuals	10.9	11.0	11.0	11.3	12.0	12.0	12.8	13.6	14.3	11.9
5. Taxes on property	1.8	1.6	1.4	1.5	1.5	1.5	1.5	1.7	1.7	1.8
6. Miscellaneous	-0.1	0.0	0.0	0.0	-0.1	0.9	0.5	0.5	0.6	0.5
7. Total tax revenue	34.0	35.2	36.8	38.3	39.1	38.2	39.1	39.3	41.2	37.6

Source: OECD, *Revenue Statistics of OECD Member Countries 1965-1989*, Paris 1990
OECD, *Revenue Statistics of OECD Member Countries 1965-1990*, Paris 1991

Revenue from taxes on corporate profits in Ireland is, when compared to the EC average, rather low, reflecting the policy to attract foreign investors. As from 1 April 1991 the company tax rate has been reduced from 43% to 40%. This is quite high in comparison with the corporation income tax rate in the UK of 33%, but it is broadly in line with the average European rate. For the manufacturing sector as well as for qualifying service activities the rate is, however, only 10% until December 31, 2010. This reduced rate is regarded as a vital element to attract foreign investment and it has been extended to international financial service operations in a special zone in Dublin. The 10% rate is available to most manufacturing activities.

In recent years steps have been taken to curb depreciation allowances which are completely abolished as from April 1, 1992. It was argued by the minister of Finance that "the elimination of 100 percent accelerated capital allowances will remove the bias in favour of capital intensity rather than employment" (Budget 1990, p. 41). However, the reduction in capital depreciation allowances has not been extended to companies in the international financial services centre, the Shannon customs-free airport, nor to the special building incentives in designated areas for urban renewal.

In 1988 a tax was imposed on pension fund investment income on a once-off basis on the grounds that pension funds had earned 'exceptionally high returns on their investments'.

Indirect taxes on goods and services produce over forty percent of total government revenue. Excise duties are high in comparison with the EC average and also in comparison to the UK, where excise duties brought in 4.9 percent of GDP in 1988. VAT is charged at the following rates (according to the 1992 Budget):

- 0%: food, books, exports and children's clothing and footwear;
- 10%: building and hotel accommodation and newspapers;
- 12½%: domestic energy products, meals, entertainment, agricultural services;
- 16 %: fuel, electricity, telecommunication, repair and maintenance, most clothing and footwear;
- 21%: other goods and services.

As to social security contributions, various rates apply to different classes of employment. The PRSI (Pay Related Social Insurance) rate for private sector employees is 7.75% for earned income up to £19,000 and 2.25% for all other income over this amount. The employer's PRSI rate is 12.2% up to a salary limit of £20,300.

For the personal income tax two rates exist in 1992: 27% and 48%, respectively.[36] It is the intentention of the government to achieve a standard rate of personal income tax of 25% by 1993; the Programme for Economic and Social Progress envisages only one higher rate of 44%, replacing the existing higher rates. In the UK the 1991/92 top tax rate amounts to 40%.

Due to various allowances, the tax base is eroded. Allowances can be placed into four categories:

1. basic exemptions, i.e. single, married and widowed persons allowances;
2. secondary allowances and exemptions, i.e. income exempted because of the recipient's age, or physical incapacity;
3. discretionary reliefs, i.e. income exempted because of the way in which income is earned or disposed of; and
4. other allowances.

Table 9.9 provides further information on the relative importance of each category of allowances. As follows from table 9.9, exempt income in 1985/86 amounted to 76.8 percent

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[36] Income tax due on employment income is collected by means of a withholding tax on the employer known as PAYE - Pay As You Earn. A corresponding system is applied to the collection of social security taxes (Pay Related Social Insurance (PRSI). The employer is responsible for the withholding of amounts due.

of the income tax base; in 1989/90 this ratio had dropped to 68.4 percent. It is likely, that this reduction in exempted income (as a proportion of the tax base) results mainly from the buoyancy of the economy.

Table 9.9 Estimates of income exempted by category, 1981-1990

	1981/82	1985/86	1989/90
Basic	56.3	55.1	63.5
Secondary	13.4	16.0	3.7
Discretionary	9.2	12.2	14.9
Other	21.2	16.7	18.0
Total (%)	100	100	100
(£ million)	2462	4086	4703
Tax base (£ million)	3946	5321	6870

Source: National Economic and Social Council

A number of benefits-in-kind (free fuel allowance, free medical treatment) are available to those receiving welfare benefits, but not to those employed even if their income is almost as low. The overall result is that many low-paid workers find themselves in a 'welfare trap'.

Taxes on immovable property are very low, as the Residential Property Tax (RPT) base is eroded, notably due to the high levels at which exempted property values and income tresholds are set. In 1992/93 these tresholds were slightly reduced to £90,000 (property value) and £27,500 (income).

9.5 Budgetary process

The government sector in Ireland consists of the central government, local governments, and the social security system. Tax autonomy of local government is limited.

There is widespread government intervention in the private sector through an extensive array of subsidies and tax privileges. According to the EC First Survey on State Aid in the European Community, total aid to industry amounted to 5.3 percent of GDP in the period 1981-86, which is high if compared to the EC average of 3.0 percent. Aid to industry is currently cut back. The State enterprise sector is rather extensive. In addition to state provision of electricity, gas, telephone services and most transport, state companies are also involved in banking, insurance, fertilisers, petrol-refining, steel, sugar, and car ferries.

The target for budgetary policy of central government is a further reduction of the debt-to-GDP ratio. Multi-annual budget plans - from year t to t+2 or t+3 - are used, but these plans are not explicit about the evolution of expenditure and revenue. Moreover, such plans are only indicative and they are not being revised when new information on its constituent components or on the underlying assumptions becomes available. In order to increase the reliability of multi-annual budget plans, a revision procedure might be helpful, since it would allow policymakers to obtain a realistic view of the efforts needed to reach specified targets. In the most recent plan, the *Programme for Economic and Social Progress 1991-1993*, the debt-ratio is the only quantified macroeconomic target.

In terms of completeness and transparancy the Irish budget shows a good score. As to the parliamentary process, there are no restrictions on amendments by parliament.

The Ministry of Finance monitors the execution of the budget on a quarterly basis. Spending overruns require a supplementary budget law. Transfers between chapters of the budget are only allowed after approval of the minister of Finance. Carry-over of expenditure to the next year is not allowed.

9.6 Recent developments

According to the 1992 Budget the Exchequer Borrowing Requirement (EBR) amounted to 2.1 percent of GDP (in 1991), of which 0.8 percent is destined for capital investment purposes. The 1992 estimate implies a slight increase of the EBR to 2.4 percent. Public service pay is about 9 percent above the 1991 provisional outturn, due to the carryover cost of pay increases awarded in 1991, usual provision for increments and a package of measures to implement the Pay Agreement which forms part of the PESP. The minister of Finance has argued that: "Were it not for this package, I would have had to find more than £100 million extra to fund the cost of pay increases this year..... The package is absolutely essential in 1992 to enable us to keap Exchequer borrowing under control" (Budget 1992, p.16).

Social welfare spending is increased to provide full protection of benefits against inflation, while some programmes have been improved in real terms.

As to taxation, it is the government's intention to achieve a standard personal income tax rate of 25%, with a single higher rate of 44%. The 1992 Budget included the following measures in this respect:

- reduction of the standard income tax rate of 29% to 27%;

- reduction of the top rate from 52% to 48%;
- increase of personal exemptions.

Some tax base broadening measures were also announced, including the abolishment of the tax relief on life assurance. Tax reliefs for certain kinds of dividend income and for proceeds of profit-sharing schemes are also to be abolished. Fringe benefits will be taxed as from April 6, 1993. Unemployment benefits will be treated as income for tax purposes, but this change will not take place until 1993.

The 1992 Budget also proposed some changes to VAT-rates (section 9.4) and the lowering of certain excises (new cars, petrol) and the increase of others (including cigarettes). The road tax for vehicles is also raised.

9.7 Flexibility of fiscal policy

As has been explained in section 9.2, the Irish success in reducing public sector imbalances has been greatly helped by external economic developments. Although the general government deficit has been brought down considerably, the Irish public finances are still vulnerable due to the enormous overhang of public debt. Despite a substantial reduction since 1987, the public debt-to-GDP ratio still hovers around 100 percent, with a corresponding interest burden of 8-9 percent of GDP. The high debt ratio implies that the fiscal outlook is very sensitive to changes in international interest rates[37] and the growth rate of world trade. This became all to clear in 1991 when low economic growth and rising unemployment led to an increase of government's net borrowing. Policy efforts are presently aimed at reducing the debt ratio to 100 percent in terms of GNP by 1993 and to 75 percent by 2000. In terms of GDP, which in recent years has been considerably higher than GNP, these targets conform to a debt-ratio of 89 percent in 1993 and of 65 percent in 2000. Such targets pose a big challenge to policymakers. During this century a 60 percent debt ratio could not be achieved without a significant rise in the primary surplus. Nevertheless, the debt ratio will continue declining.

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[37] A number of factors combine to determine the vulnerability of the public finances to interest rate changes. The major factors are the level of the debt and its duration. The Irish position can currently be characterised as being high debt/short duration.

Scope to increase revenues

While overall tax levels in the Irish economy are not among the highest within the EC, the incidence of taxation is uneven, the main burden being borne by labour income. This is reflected in the emergence of a very substantial 'tax wedge' between gross labour cost and net wage. This large tax wedge acts as a powerful disincentive to both labour demand and labour supply. It is, therefore, desirable to reduce the high average and marginal rates of tax on earned income, as argued by the National Economic and Social Council.

Although some progress has been made both in reducing tax rates and in broadening the tax base, Irish personal income tax rates are still rather high by international standards.[38] The number of tax brackets has been reduced to two by 1992 (from six in 1983). The combination of marginal income tax rates and social insurance contributions makes for a complicated marginal rate structure, with quite high rates existing at relatively low income levels, thereby affecting a large proportion of tax payers. This is largely the cumulative result of past failures to index the income tax system for inflation.

The tax base is severely eroded by a wide range of allowances, reliefs and exemptions (see section 9.4). Taxation of imputed rent from owner-occupied houses was abolished in 1969. Tax relief for interest on loans for non-business purposes is, for instance, relatively generous. Recently, some restrictions have been introduced, with 80 percent of interest paid now being deductable, with a cap. Further broadening of the tax base seems desirable. It is noteworthy, that tax yield from farm incomes is unsatisfactory as only a minority of farmers are liable to tax. Among the options to increase tax revenues, the least distorting seems to be the introduction of a tax on residential property.

To prevent cross-border revenue losses, Irish tax rates have been brought closer to those in the United Kingdom, where the standard VAT rate now amounts to 17.5%. No further adjustment is required here. A target to increase revenue may be the abolition of zero VAT-rated consumer items. The National Economic and Social Council advises to apply a 3% rate on presently zero-rated items.

One of the reasons why the tax burden on income and expenditure is so high, is the fact that taxes on capital and corporate income tax do not produce much revenue. The base of capital taxation is seriously eroded by exemptions and reliefs. Capital gains on a wide variety of assets are tax exempt. Although a start has been made with the phasing out of accelerated depreciation provisions, the prolongation of the 10% manufacturing rate to 2010 has greatly

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[38] Tax rate reductions since 1986 have not only been financed by broadening the tax base, but also to a considerable extent by the buoyancy of tax revenues.

reduced policy options to reform corporate income taxation.

There is no comprehensive long-term policy of public sector asset privatisation. Improvement of the commercial performance of public enterprises has been emphasized by imposing stricter financial conditions on investment. Government guaranteed debt of public enterprises has fallen from 25 percent of GNP in 1986 to 17 percent in 1990.[39] The financial position of public enterprises has improved somewhat since the mid-1980s. In 1991 substantial receipts from privatisation (about 1 percent of GDP) were obtained. There seems to be some scope for further privatisation.

Table 9.10 summarizes the flexibility of fiscal policy with respect to government revenue.

Scope to reduce expenditure

During the second half of the 1980s current expenditure was considerably cut back. Much of this reduction has been accomplished through adjustment of public sector employment and wage conditions. The recent increase in current spending probably reflects catch-up effects from previous years when the relative income position of public sector employees worsened (table 9.3). However, given the sensitivity of the budget to public sector wages, continued restraint seems warranted here.

Changes in the age structure of populations have important implications for the demand for social transfers and services. The ageing of the population is likely to increase the demand for pensions and for health care, while demographic pressure on education systems, family benefits, and other services utilised mainly by young people may decrease. Ireland has a relatively young population. In 1980 the percentage of population aged 65 and over amounted to 10.7 percent, which is rather low in comparison to the OECD-average of 12.2 percent. By 1990 the share of old people in the total population had increased to 11.3 percent. According to OECD projections this will slightly decrease to 11.1 percent by 2000, while the share of population aged 0-14 (27.5 percent in 1990), is projected to decline to 23.2 percent in 2000 (OECD (1988)). Projections by Holzmann (1988) indicate that taking into account the isolated impact of demographic change, the share of pension expenditure in Irish national income will fall until 2000. Educational spending is another area where projected demographic trends should allow some savings to be made. The drop in the birth rate since 1980 and emigration of individuals in the pre-childbearing age group should allow for

[39] OECD, *Economic Surveys*, 1991, p. 59.

Expenditure overruns have to be fiatted by supplementary budget laws, but carry-over of unspent resources is allowed. The minister of Finance has certain powers to phase payments appropriations throughout the year. There are usually rather big differences between original budget targets and final outturns.[53] It is remarkable, that there is no self-correcting mechanism in case of budgetary overruns.

10.6 Recent developments

A sad tradition of missed budgetary targets continued in 1991. Estimated current expenditure was higher than originally planned for and revenues fell short of projections. The main objectives of the Italian *Programme of Economic Convergence (1992-1994)* are to reduce both the rate of inflation and the budget deficit. The main instruments are an incomes policy, primarily directed at wages of public sector employees, and a substantial privatisation plan. Other measures relate to a revision of the pension system and the funding of local government. Regarding the pension system it is important to realize that central government transfers to social security funds in 1990 amounted to 6.7 percent of GDP, which is equal to about two thirds of the general government deficit.

The 1992 Budget Bill set the target for the state-sector borrowing requirement at 127,800 billion Lire, implying a corrective manoeuver of 55,500 billion Lire. Of this amount 30,500 billion Lire will be found by increasing revenue (including 9,000 billion Lire privatisations) and 25,000 billion Lire from spending cuts.

Higher revenue is sought through broadening the tax base of income taxes by way of a reduction of tax facilities, stricter enforcement to counter tax erosion and higher taxation in specific areas, that have thus far enjoyed particularly favourable tax treatment.

Spending cuts have to be realized through containment of public sector salaries (by limiting wage increases and personnel), reduced transfers to the National Institute for Social Security, to the Regions, to local government and to local public health administrations, and by lower capital transfers to public enterprises and local government.

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[53] For an illustration see OECD *Economic Surveys*, 1989, p. 78.

The medium term objectives are to reduce the state sector deficit from 10 percent in 1991 to 5.5 percent of GNP in 1994 and to reverse the upward trend of the public debt-to-GDP ratio as from 1994.

Structural policies are aimed at privatisation of public enterprises; reduction of state aid (in the period 1986-1988 total aid has already been reduced by approximately 1 percent of GDP) to 3 percent of GDP; reforming public sector employment; reform of the pension system and changing local government finances.

In 1992 the incoming government announced plans for unprecedented large spending cuts with substantial reductions in spending relating to pensions and health care. These plans immediately provoked massive strikes with pleas for a different distribution of fiscal adjustments, for instance by eliminating massive tax evasion by the self-employed.

Expenditure pressures in the 1990s

Expenditure pressures may be expected in several policy areas.

Compensation of employees (1989: 12.1 percent of GDP). The decline of relative government wages in the 1980s will produce 'catch-up' effects in the 1990s, which have already materialized.

Social security and welfare (1989: 16.2 percent of GDP). Since these expenditures showed a very substantial growth in the 1980s, at a time when the dependency ratio actually declined (6.6 percent) such outlays will be very difficult to control in the 1990s when the dependency ratio is expected to rise by 4 percent.

Interest payments (1989: 9 percent of GDP). Since no change is projected in net borrowing and the debt is expected to increase (relative to GDP), in the absence of a sharp decrease in interest rates, interest payments will continue to absorb a growing amount of public resources. Moreover, reduced confidence of financial markets in Italian debt can easily lead to a relative increase in Italian interest rates. Moreover, given the very short maturity of the debt (31 months in September 1989;[54] and about 85 percent of negotiable government debt either has a maturity of less than twelve months or bears floating rates[55]) any increase of interest rates will immediately translate into higher interest payments, further worsening the financial position of the government. Treasury gross borrowing requirement

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[54] OECD, *Economic Surveys*, 1990, p. 43.

[55] OECD, *Economic Surveys*, 1989, p. 92.

was around 40 percent of GDP in 1990.[56] Moreover, it is rather alarming to note that the net Italian government borrowing requirement is roughly equal to the combined deficit of all other EC Member States.

10.7 Flexibility of fiscal policy

In the Italian case, considering the sheer magnitude of policy adjustments required to meet the fiscal criteria of EMU, it will be impossible to completely concentrate on the expenditure side of the budget. Policymakers will also have to find additional revenue, although this can easily have negative implications for convergence of Italian and EC inflation rates. The most efficient way to raise revenue is by increasing the efficiency of the tax system, by privatisation and by increased use of the benefit principle, because such policies will induce greater efficiency. Such measures will no doubt meet with resistance, because initially subsidized jobs will be lost and because of adverse income effects. Given present investment performance, spending cuts will have to spare capital expenditure, although this category of outlays is flexible in the short run.

This section scrutinizes factors influencing the degree of flexibility of revenues and spending items by category. Results are summarized in tables 10.7 and 10.8 respectively.

Scope to increase tax revenues

In the Italian case, there seems to be only limited scope to increase the rates and to broaden the base of certain taxes, so as to improve the overall budgetary position of the general government. Taxes on portfolio income of individuals may have to be lowered by discretionary rate reductions, since otherwise erosion of the tax base through tax evasion and avoidance will probably result. Italy has presently a 32.4% withholding tax on dividends, a 15% withholding tax on interest paid out and a 21% withholding tax on royalties. The country has an extensive network of 45 double taxation agreements, which generally reduce tax to be withheld to 5-15%.

Increasing the present rate of the corporate income tax (including local tax about 46%) does not seem to be advisable, given that in the European Community rates tend to converge in the 35-40% band. Nevertheless, it may be possible to tap this tax source to greater avail by way of improved enforcement, reduction of certain tax expenditures and revaluation of business assets.

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[56] Ibidem, p. 43.

Given rates and the weak relationship between the VAT tax base and macro-economic consumption, VAT revenues can almost certainly be substantially increased by improved enforcement. The rates of certain excise duties (cigarettes, distilled alcohol and wine) can be raised, since these are low compared with those in other EC countries. On wine there even is no duty at all. Harmonisation will lead to revenue losses from excise duties on mineral oil products and natural gas.

It is quite obvious, that taxes on labour use will have to be raised in order to bring them in line with total social security outlays. The gap between total outlays and revenues from social security contributions explains about two thirds of the total general government deficit. The deductability of social security payments for enterprises operating in the Mezzogiorno could be limited.

Revenues from taxes on income of individuals (presently 10 percent of GDP) are below the EC average. The top rate of the national Italian income tax (50%) lies in between the top rates of its Northern neighbours, France (56.8%) and Switzerland (11.5% plus local income taxes of 14.5-20% in major cities). The potential for broadening the personal income tax base is - judging from OECD-data - very limited, since erosion of the tax base hardly occurs. Nevertheless, revenue potential of the personal income tax could be substantially enlarged by improving enforcement of the existing legislation. There seems every reason to expect substantial revenue gains by improving the tax effort of self-employed and the liberal professions. Ever since the introduction of the indexation of the income brackets in 1990, fiscal dividend from inflation can no longer be counted on.

As taxes on property are at present relatively unimportant revenue sources, there seems to be scope for expanding their role in the Italian tax mix. This would bring the tax mix more in line with the EC average. Especially taxes on immovable property can hardly be avoided by taxpayers, which is an additional plus, given the present weak enforcement of major taxes on income and consumer spending.

Scope to increase non-tax revenue

Outstanding public debt could be reduced by privatising part of the assets of the public sector. OECD[57] estimates put the value of such assets at some 60 percent of public debt, on which the nominal yield is less than 2%. Privatisation could positively affect expectations, possibly triggering lower interest rates. Of course, there is the danger that proceeds of privatisation will be used to postpone necessary spending cuts elsewhere in the budget. One

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[57] OECD, *Economic Surveys*, 1990, p. 86.

also has to realize that proceeds from privatisation by definition do not change net borrowing - since this deficit concept excludes net investment - and that the proceeds have a once-for-all character. Such considerations indicate that privatisation cannot be a perfect substitute for other forms of budget consolidation. Meeting the EMU debt criterion solely by selling off government assets will not be appreciated by debtors and EC policymakers alike. Government debt can be reduced, but the eventual contribution of privatisation to long term budget consolidation will depend on the positive gap between lost proceeds of assets sold, and interest payments foregone on government debt redeemed. The general performance of the economy can be improved if privatisation leads to efficiency gains. The potential to increase revenue by privatisation in the short run is - for the time being - limited by the absense of a good blueprint or implementation strategy.

Other non-tax revenues can be enlarged through a greater role for the benefit principle, with user fees tied to the use of public services.

Scope to reduce outlays

As public expenditure net of interest payments is close to the EC average, observers should not be too optimistic in assessing the possibilities for spending cuts. Moreover, demographic, political and regional factors will interfere with any substantial intervention.

General public services, defense, public order and safety are provisions typically in the traditional public domain, where expenditure pressures from the demand side are almost absent. Nevertheless, in Italy some reduction of their GDP share could be achieved by wage restraint, combined with some increase in efficiency induced by a limitation of price compensation. Defense might contribute some 'peace dividend', especially by reduced procurement.

In recent decades there has been much demand pressure on welfare state expenditures which is likely to continue in the 1990s. Nevertheless, some flexibility will remain. For expenditures with a merit good character, like education and health, it must be possible to realize some efficiency gains and to profit from government wage restraint. Spending on education can be constrained in line with the expected fall of the young age dependency ratio. The substantial rise in the projected old age dependency ratio in the 1990s (4.2 percent point) will put strong upward pressure on health care spending. Some of that pressure can be taken away by increasing the role of user fees for buyers of medicine and for diagnostic activities, which will reduce demand and costs.

Over half of public spending on housing and community amenities, the third spending

category with a merit good character, consists of capital expenditure which is flexible from a technical point of view. As this expenditure component hardly showed any increase over the 1980s (capital expenditure even declined relative to GDP), there is probably little room for a downward change.

Social security and welfare spending is by far the most importatnt expenditure category identified in table 10.4, increasing by over 3 percent points during the 1980s. Social security and welfare outlays consist of a price and a volume component. The price component is flexible from a technical point of view, but as this directly affects the income (of relatively poor individuals) it will politically prove to be very difficult to bring down public outlays this way. Such political problems are aggravated by large regional differences in income levels and dependency ratio's. The volume component strongly depends on the general economic outlook which is difficult to change in the short run. Much upward pressure on spending levels is to be expected from the ageing of the population. The old age dependency ratio in the 1990s is projected to rise by 4.2 percent (from the working age population), which except for Greece is much more than in any other EC Member State, and double the European average. Public spending on pensions, which represents almost one third of current non-interest expenditure, constitutes a serious threat to any consolidation efforts. Corrective measures can be taken by raising the retirement age to European levels, by reducing maximum benefits and by adjusting indexation mechanisms.

Recreational, cultural and religious affairs are only small expenditure items in relative terms which remained essentially constant over the 1980s. Flexibility is assumed to be rather small here.

This brings us to the mixed economy items 'economic services' and 'other functions' (mainly interest payments). Spending on economic services (including transportation, communication, and state aid to industry) - after a rise in the mid 1980s - returned in 1989 to its 1980 level, in terms of GDP, as a result of declining subsidies and current transfers. The capital formation component of economic services (about one fourth) is technically flexible in the short run. However, from an economic point of view it would not be a wise policy to cut these expenditures, since they contribute to the productivity of the national economy as a whole. It is more obvious to reduce various state aids, as Italy's level is well above the EC average (Italy 3.1 versus the EC 2.2 percent of GDP in 1986-1988). Moreover, other Member States - as a result of Community policy - are also reducing financial aid to industry.

Interest payments now are in the same range as the borrowing requirement (10 percent of

GDP). The discretionary flexibility of these payments is almost nil. The automatic flexibility of the interest-to-GDP ratio is great. Interest rates are fixed exogenously and rate changes quickly translate into higher interest payments due to the short average term-to-maturity of the debt. The high debt level combined with the persistent deficit can easily create credibility problems. Since interest payments are in no way positively associated with GDP growth, the latter also strongly influences the interest-to-GDP ratio through the 'denominator effect'. As these arguments cut both ways, there can be an important automatic upward flexibility of interest spending as well as automatic downward flexibility.

Table 10.7 Contribution to budget consolidation of revenue categories in Italy[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. Taxes on portfolio income of individuals				**tax competition**	--
2. Taxes on corporate profits	**enforcement; base**			**tax competition**	+ (3.5)
3. Taxes on goods & services 3.1 VAT	**enforcement; base**		**harmonisation**		+ (5.6)
3.2 Excise duties	**rates**		**harmonisation**		+ (3.9)
3.3 Other taxes					0 (0.9)
4. Taxes on use of labour 4.1 Social sec. contr. employees	**pension contributions; deductions Mezzogiorno; enforcement**				++ (2.4)
4.2 Social security contr. employers					++ (8.7)
4.3 Social security contr. selfemployed					0 (1.2)
4.4 Other taxes					0 (0.2)
5. Taxes on income of individuals	**enforcement**	**rates; real GDP growth**	indexation		+ (10)
6. Taxes on property	**rates; base**				++ (0.9)
7. Miscellaneous taxes					(-)
8. Non-tax revenues	**privatisation; benefit principle**				++ (2.7)

[a] Budget consolidation resulting from discretionary measures is printed in **bold** type.
[b] A plus indicates upward flexibility (higher revenues, lower deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.
[c] A minus indicates downward flexibility (lower revenues, higher deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.
[d] The share of the various revenue categories as a percentage of GDP (1989) is shown in parentheses.

Table 10.8 Contribution to budget consolidation of functional expenditure categories in Italy[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. General public services	**overall (current expenditure)**	**wages; overall (capital expenditure)**			+ (4.2)
2. Defense	**procurement**	**wages**			++ (2.1)
3. Public order and safety	**overall (current expenditure)**	**wages**			+ (1.7)
4. Education	**overall (current expenditure);** demographic	**overall (capital expenditure); wages**			++ (5.2)
5. Health	**transfers; overall (current expenditure)**	**wages**		demographic	+ (5.8)
6. Social security and welfare	**overall; pensions**	GDP growth	GDP growth	demographic; political	+ (16.3)
7. Housing and community amenities	**overall (current expenditure)**	**overall (capital expenditure)**			+ (1.5)
8. Recreational, cultural and religious affairs		**overall**			+ (0.6)
9. Economic services	**overall; state aid**		**economic arguments**		++ (6.4)
10. Other functions	interest rate; GDP growth			interest rate ; GDP growth	0 (8.4)

[a] Budget consolidation resulting from discretionary measures is printed in **bold** type.
[b] A plus indicates downward flexibility (less expenditure, smaller deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures.
The single or double plus sign indicates the relative degree of flexibility.
[c] A minus indicates upward flexibility (more expenditure, higher deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures.
The single or double minus sign indicates the relative degree of flexibility.
[d] The share of the various spending categories as a percentage of GDP (1991) is shown in parentheses.

Table 10.9 Major revenue-increasing measures in Italy, 1980-1989[a]

	Taxes on portfolio income of individuals[b]	Taxes on corporate profits	VAT	Excise duties	Social security contributions employees	Social security contributions employers/self-empl.	Taxes on income of individuals	Taxes on property	Non-tax revenues
1980			structure	spirits, oil products; price oil products; motor vehicles			evasion and avoidance; advance payment		telephone; postal charges
1981									telephone
1982		rate	rates	oil products; beer; bananas; rates			base; property income		telephone; public srv.
1983	rates, base	advance payment rate		motor vehicles; price petrol	sickness	contributions	advance payment		
1984	evasion	base	rates; base	diesel; heating oil			base	buildings	telephone
1985					contributions; penalty late payment	contributions; penalty late payment	local tax rate		public services; public transport
1986	issue of public securities			petrol					
1987	stock exchange contracts	advance payment	base; evasion	price oil products; road tax; surcharge oil products	pension contributions		advance payment		
1988	tightening tax control		rate	price oil products; surtax electricity					health

1989	evasion				contributions	lower subsidy; contributions			health; public utility; administered prices

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, revenue-increasing measures with a general character like combatting tax evasion and avoidance, are indicated in the first column.

Table 10.10 Major expenditure cuts in Italy, 1980-1989[a]

	General public services[b]	Defense	Public order and safety	Education	Health	Social security and welfare	Housing and community amenities	Recreat., cult. and religious affairs	Economic services	Other
1980						family allowances				
1981	operating exp.				operating exp.					
1982										
1983	staff				general	family allowances; pensions; general				
1984	wages; efficiency				general; local facilities	family allowances				
1985						pensions; family allowances				
1986										
1987					general				public enterprices	
1988	productivity				general	pensions			railways; post off.	
1989	goods and services; local spending									

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, expenditure cuts with a general character like wage restraints and general spending caps, are indicated in the first column.

11. The Netherlands

11.1 Introduction

The Netherlands is one of the six founding members of the European Community. The Dutch economy may be characterised as being both small and extremely open. In 1991 exports and imports of goods and services constituted 58 percent and 54 percent of GDP, respectively.

Over the past decade, GDP growth reflected the worldwide recession of the early 1980s and the ensuing recovery of the international economy. On average, real GDP growth hovered around 2 percent, slightly below the EC average.

Table 11.1 provides some additional information on the performance of the Netherlands economy in the 1980s. Inflation was (far) below the average experience of most other EC Member States. All told, employment measured in constant labor years hardly increased. It took several years with strong employment growth to make up for the earlier loss of jobs during the recession years 1981-84. Unemployment, after peaking at 11.7 percent in 1983-84, gradually fell to 6.1 percent of the labour force (= 325,000) by 1991, somewhat below the present EC average. However, a statistical artefact hides the true size of unemployment, since perhaps as much as a quarter million of 'hidden' unemployed have been absorbed by public disability programs. Moreover, higher enrollment rates in tertiary education, substantial participation in newly introduced early retirement programs, and the growth of part-time jobs all served to restrict labour supply.

Both in the 1960s and the 1970s labour succeeded in shifting part of then strongly rising tax burdens onto recipients of capital income. Also, income losses due to deteriorating terms of trade have in part been made good through additional wage demands. Sharply in contrast, the economic recovery of the second half of the 1980s was preceded by a marked improvement of the share of capital in value added (from 10 to 20 percent). In tandem, overall inequality of the personal income distribution has increased somewhat. Nevertheless, by 1989 - the latest year for which such information is available - the personal income distribution in the Netherlands was flatter than in almost any other EC Member State.

Levelling of personal incomes is to an important degree the result of public programs. Indeed, "among OECD countries the Netherlands is one of those which have gone furthest in their sustained efforts to promote a tolerant, caring and supportive society through the

action of government".[58]

The rise of the welfare state has been reflected in a particularly strong growth in public spending and taxation levels after the mid 1950s. In the longer run, the expansion of the public sector is largely explained by the increase of transfer payments to private households. First, the volume of such transfers has tremendously grown. The number of benefit recipients (B) has continually outgrown the labour force (L). Between 1960 and 1986 the B/L ratio exploded from 0.36 to 0.86, to (temporarily) stabilize only in the second half of the 1980s. Second, over the years the relative price of transfers has risen. In 1960 average benefits (b) amounted to 25 percent of average wage income (w), whereas by 1980 the b/w-ratio had climbed to 0.43. By the early 1990s successive reductions of benefit levels during the previous decade had brought the b/w ratio down somewhat to 0.38.

In the 1960s and early 1970s the expansion of the public sector was greatly facilitated by relatively high rates of economic growth. The decline in national economic performance during the later 1970s and early 1980s triggered a financial 'crisis' of the Dutch welfare state. As from 1975 annual budget deficits have been large in historical terms. This was reflected in the subsequent upsweep of the general government debt-to-GDP ratio from 0.42 in the mid 1970s to 0.80 in 1992.

Table 11.1 Main economic indicators, 1980-1993

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
GDP growth	0.9	-0.7	-1.4	1.4	3.2	2.6	2.0	0.8	2.7	4.0	3.9	2.2	1.8	2.3
Unemployment	4.1	6.3	8.8	11.2	11.2	10.0	9.2	8.7	8.3	7.4	6.5	6.1	6.4	6.3
Inflation	7.0	6.3	5.3	2.8	2.1	2.2	0.3	-0.2	1.0	1.6	2.3	3.4	3.4	3.8
Interest rate	10.7	12.2	10.5	8.8	8.6	7.3	6.4	6.4	6.3	7.2	9.0	8.9	8.3	8.3
Nominal unit labour costs (1980=100)	100	90.3	92.8	90.5	83.6	81.2	85.8	89.4	87.1	82.1	82.8	80.5		
Current account (percent GDP)	-1.5	2.2	3.2	3.1	4.2	4.1	2.7	1.4	2.5	3.3	3.8	4.1	4.4	
Dependency ratio	33.4	33.0	32.5	31.9	31.5	31.3	31.1	31.3	31.0					
Participation rate:														
men	79.4	80.9	80.8	77.3	76.5	75.8	75.3	79.0	79.4	79.6	79.6			
women	35.5	37.9	39.0	40.3	40.7	40.9	41.3	48.8	50.6	51.0	53.0			

Source: miscellaneous OECD and government publications

[58] OECD, *Economic Surveys*, 1991, p. 57.

11.2 General outline of economic policy in the 1980s

When the second oil shock hit the Netherlands, both business profits and the share of capital in national income had - considering the postwar experience - reached historical lows (relative to GDP), in part as a consequence of 'excessive' wage demands in the previous decade. Because financial reserves had been drained and due to restructuring of major industry sectors (i.e. ship building), firms in 1981-1982 shed jobs at a monthly rate of 10-15,000. In just three years time unemployment shot up from 4.1 to 11.2 percent. Since transfers to strongly rising numbers of benefit recipients were at the time fully linked to contractual wages, general government spending was in fact out of control. By 1983 the government take out of GDP was over 62 percent; one year before government net borrowing had peaked at 7.1 percent of GDP (table 11.2).

Table 11.2 General government budget (% GDP), 1980-1993

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current receipts	53.7	54.0	54.4	55.8	54.7	55.1	53.9	55.0	54.7	52.2	51.3	51.8	52.5	52.4
Total expenditures	57.8	59.5	61.5	62.2	60.9	59.8	59.9	61.6	59.8	57.4	56.6	56.2	56.6	56.1
Net borrowing	-4.0	-5.5	-7.1	-6.4	-6.3	-4.8	-6.0	-6.6	-5.2	-5.2	-5.3	-4.4	-4.1	-3.7
Gross public debt	45.9	50.3	55.6	62.0	66.1	69.7	71.6	75.4	77.7	77.9	78.3	78.4	79.5	79.1

Source: EC, *Tables on Public Finance*

The Cabinet which entered office in 1982 set itself three major policy goals:

1. restoring profitability of firms to previous levels;
2. curbing public spending to reduce the deficit, holding the level of taxes and other public sector revenues more or less constant;
3. stimulating employment through increased private investment and a general reduction of working hours.

Initially, spending cuts deepened the recession. On the other hand, exports picked up and set into motion the ensuing process of economic recovery. After eight years of restraint, the process of public sector consolidation has clearly met with some success. Public outlays have

been reduced by some 5 to 6 percent points of GDP. The public deficit has been about halved (to 4.1 percent of GDP in 1992), whereas the tax-to-GDP ratio dropped a few points to about 52 percent of GDP. Improved macroeconomic performance during the second half of the 1980s, wage restraint resulting in a doubling of capital's share in national income, the recovery of business investment, impressive job growth in the private sector and prolonged efforts to effectively curb public spending, all contributed to the succesfull roll-back of the public sector. Table 11.2 summarizes these achievements by outlining trends in public outlays, current receipts and net borrowing requirement of the public sector during the 1980s. The remainder of this section considers policies pursued in greater detail.

It has often been argued that the disappointing growth performance of the Dutch economy at the end of the 1970s had its origin in the late sixties,i.e. in the early days of natural gas exploitation. High productivity growth in the energy sector was transmitted into inappropriately rapid labour income increases in the export sector through the process of national wage determination ('linking' of all wages and benefits to the trend in high productivity sectors). The subsequent loss of competitiveness and weaker international demand led to declining employment growth, higher unemployment and higher public sector spending. In 1978 a blueprint of medium term objectives and policies was presented (*'Blueprint 81'*) which aimed at improving competitiveness of the Dutch economy, halting the growth of public sector revenues as a proportion of net national income (NNI), and reducing the public sector deficit.[59]

The 1980 Budget was the second to be based on the new medium-term blueprint. In order to encourage wage moderation personal exemptions in the income tax were expanded. On the expenditure side a package of demand boosting measures in the order of Gld 2 billion, corresponding to 3/4 percent of GDP was proposed. This boost to demand could be financed from higher natural gas revenues, which were expected to produce an additional inflow of non-tax receipts and corporate taxes of Gld 2.1 billion. The 1979 policy of holding the increase of government wages and social benefits 1 percent below the rise in private sector wages was continued. Further measures included: higher indirect taxes, an only partial correction for bracket creep in the income tax due to inflation, and a reduction of investment

[59] Net national income is equal to GDP minus depreciation plus net primary income received from the rest of the world. In the Netherlands, NNI is about 10 percent lower than GDP.

subsidies for investment in buildings.[60] The 1980 Budget foresaw an unchanged general government budget deficit (5.5 percent of net national income). Economic developments were, however, much less favourable than envisaged and the deficit eventually turned out to be 2 percent point higher than the target level. As government took recourse to a statutory incomes policy to ensure that import price pressures did not translate into a further weakening of competitiveness and profitability of the industrial sector, the scope to increase taxes was limited. So the brunt of the adjustment effort had to fall on the expenditure side of the budget. Especially public sector incomes (wages and transfers) became a prime target for cutting outlays. However, rising interest payments and increasing unemployment put upward pressure on government spending. Despite increasing gas revenues the general government borrowing requirement exceeded policy norms previously set, due to lower tax revenues than envisaged and higher spending levels.[61] Thus collective claims on resources expanded further. One third of the 1979-1981 increase in general government expenditure was on social

Table 11.3 Employment in the public sector, 1980-1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Government employment (x 1000)	714	728	734	733	730	736	742	746	743	740
2. as % of total employment	14.9	15.4	15.9	16.2	16.1	16.0	15.8	15.7	15.4	15.1
3. Growth of government real wages			-0.1 [a]					1.3 [b]		
4. Growth of relative government wages			0.4 [a]					-0.7 [b]		

[a] 1979-1984.

[b] 1984-1990.

Source: OECD

[60] The Investment Account (WIR Scheme) was introduced in 1978 and extended in 1980. It provided for tax credits for various types of investment.

[61] Natural gas revenues amounted to 14 percent of central government receipts in 1980. Between 1979 and 1982 receipts from natural gas tripled. Apart from some temporary volume growth in 1979, higher gas revenues stemmed from the preceding surge in crude oil prices. Renegotiation of export contracts brought an additional once-and-for-all increase of export prices during 1981.

security. It is quite clear then, that the original aims of *Blueprint 1981* to reduce the government deficit and public sector growth have not been met. Despite improved competitiveness, output and employment growth fell also well short of expectations.[62]

The economic programme of the incoming centre-left government foresaw a reduction of the general government budget deficit to 6.5 percent of NNI in 1982 and to 5.5 percent by 1983.

Taxes and social security contributions would be kept at their 1981 levels in terms of NNI. Revenues soon turned out to be Gld 2.2 billion lower than assumed, and various revenue boosting measures were taken (almost Gld 1 billion). The government also proposed a package of measures aimed at curbing spending due to sickness (Gld 1.8 billion). In addition it presented the first part of its Employment Scheme, which was supposed to create some 25-30,000 new jobs. The Spring Memorandum brought out that revenues from natural gas and tax receipts proved to be disappointing, while expenditure was higher than envisaged; both factors resulted in a public sector borrowing requirement of over 8 percent of NNI. Disaccord on the allocation of unavoidable spending cuts brought the government down in May 1982.

An interim cabinet managed to implement only part of the restrictive policy proposals for 1983 (Gld 5.3 billion, instead of the proposed 8.5 billion). Consequently, general government budget deficit increased further to almost 10 percent of NNI. The 1983 Budget of the interim cabinet included new proposals representing the furthest reaching package of fiscal restraint, since 1979.

The new centre-right government that - after elections - came into office late in 1982 was clearly faced with unsustainable budget conditions. Continuation of public borrowing at prevailing levels would have led to an explosion of government debt and interest payments. At the time, it was felt that large deficits would put upward pressure on interest rates, thereby hindering the recovery of business investment. The government announced as its objective the reduction of the general government financial deficit to 7.4 percent of net national income by the end of its four-year term in office (in 1986). The target was modified in the course of the period to cover the State deficit alone, which was to be reduced to 5.7 percent of NNI. By now, the authorities shared the view that the size of the public sector itself was an impediment to balanced long-term growth. High tax and social security levels were thought to create potential welfare losses, distorting work, saving and spending decisions in the private sector.

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[62] OECD, *Economic Surveys*, 1981, p. 29.

The new government maintained most budget proposals of its interim predecessor. Important measures included: an increase in social security contributions, restraint of public sector incomes, reduction of the indexation for inflation of income tax brackets from 100 percent to 80 percent, and some minor tax reliefs for business.

The 1984 Budget involved important cuts in expenditure from planned levels.[63] A 3 percent cut in real wages of public sector employees and social security benefits produced half of the targeted amount. Tax revenues were also increased. The standard VAT rate was raised by 1 point to 19%, excise taxes were increased, the 1983 'temporary' income tax hike was continued and higher income tax rates were raised, while the lowest were reduced. The corporate income tax rate was reduced by five percent points, down from 48%.

The 1985 Budget also introduced spending cuts (Gld 9.3 billion), including a Gld 2.5 billion cut in social security benefits (see also section 11.3). The 1983 'temporary' income tax hike was again continued, while the corporate income tax rate was cut further by one point, to 42%. In 1985 and 1986 the level of minimum wages, social insurance benefits and child allowances was 'frozen'.

The 1986 Budget concluded that the objectives set in the 1982 programme had largely been attained. Initially, the government aimed at a reduction of the borrowing requirement of central and local government, with no increase in the 'collective burden' (total of taxes, social security contributions and certain non-tax revenues of government, expressed as a percent of NNI). In the event, public spending had fallen, while the objective of a central and local government deficit of 7.4 percent of NNI had been broadly achieved. Although in itself this was a remarkable achievement, some critical sounds might be voiced. First, the decline in the deficit is much less impressive once the social security system is taken into account. Second, by 1986 expenditures were Gld 12.6 billion higher than foreseen at the start of the plan (table 11.4). Part of this overspending occurred because certain programmes were expanded, part of it was due to slippage in a number of 'open-ended' income related programmes.

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[63] The re-current attempts of policymakers to catch up with worsening budget prospects have come to be known by the shorthand of budget 'cuts'. Certain observations seem important for any assessment:

- the cuts are made from a baseline of multi-year expenditure plans, which are based on assumptions of medium-term growth;
- the cuts are proposed to be permanent adjustments, lowering the level of multi-year plans over the entire planning horizon;
- the cuts are defined in terms of central government budget and include cuts in transfers to other levels of government.

Table 11.4 Projections and outcomes of the 1982 Programme (Gld billion)

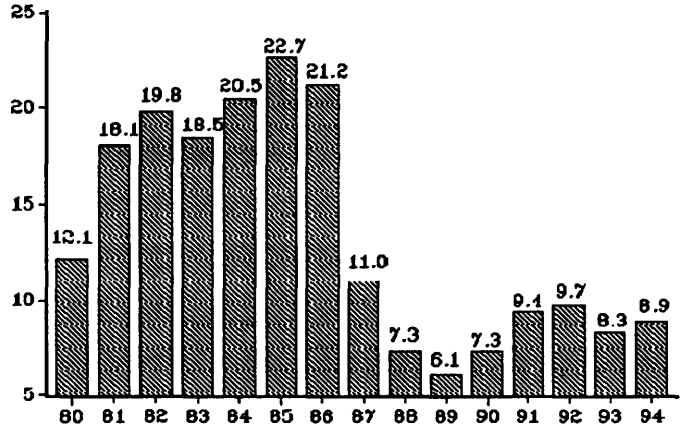
	1984	1985	1986
1982 Programme expenditure cuts	7.0	7.0	7.0
Additional cuts	4.7	2.3	1.0
Total expenditure cuts	11.7	9.3	8.0
Expenditure overruns	6.2	3.2	3.2
Net expenditure reductions	5.5	6.1	4.8

Source: OECD, *Economic Surveys*, 1986, p. 36

After the 1986 elections the centre-right coalition remained in power until mid 1989. The coalition Agreement for the 1987-1990 period, drawn up around mid-1986, aimed at reducing the central government budget deficit to 5.25 percent of NNI by 1990. Deficit reduction was to be accompanied by at least a stabilisation of the 'collective burden' and without loss of real net income for families at the minimum income level. With the benefit of hindsight it can be concluded that these objectives of fiscal policy have been met. Reduction of the deficit was hampered, however, by a marked drop in natural gas revenues accruing to the government (figure 11.1). Especially in 1987 gas revenues decreased sharply. As a consequence, the 1987 target for the central government deficit was missed, as the fall in gas revenues could only partly be offset by additional spending cuts and tax increases (one percent point higher VAT rate, higher excise taxes on energy, reduced income tax facilities for enterprises).

During the 1987-89 period spending overruns even exceeded those in 1984-86 (table 11.5), but buoyant tax revenues ensured that nonetheless deficit targets were met. Using these windfall revenues to finance spending overruns implied that the pace of consolidation was slower than what could have been achieved. Because of attractive capital market conditions, a larger part than projected of public housing loans has been repaid to central government earlier than scheduled, temporarily boasting central government non-tax revenues. Official deficit figures have been corrected for these temporary changes.

Figure 11.1 Central government natural gas revenues (Gld billion), 1980-1994



Source: *Budget Memorandum 1993*

A further important development was the governments' decision to end the system of investment subsidies, which was announced early in 1988. The Investment Account Act (WIR), which came into effect in 1978, had replaced earlier tax expenditures in the form of accelerated depreciation and an investment allowance programme. The arguments in favour of the WIR - a programem providing refundable tax credits to investors - were that it was broadly based, better suited to steer investment and that it did not discriminate against unprofitable firms. The WIR provided subsidy at a basic rate, which varied according to type of investment activity. Supplementary subsidies aimed to promote specific goals, like, e.g., helping small and medium-sized business, certain regions (abolished in 1983), and environmental improvement. As of May 1986 firms making losses were no longer entitled to subsidies granted under the WIR programme. As a compensation for the abolishment of the WIR in February 1988, the government took over employer social security contributions to finance child allowances, while reducing the corporate income tax rate from 42 to 35%.

Table 11.5 Outlays and revenues (Gld billion), 1984-1989

	1984	1985	1986	1987	1988	1989
Outlays						
Projected	163	164	169	168	168	170
Realised	163	166	171	175	172	175
Difference	0	2	2	7	4	5
Revenues						
Projected	127	135	143	139	144	147
Realised	133	143	164	160	150	151
Early redemptions	0	2	16	13	-1	0
Difference	6	6	5	8	7	4

Source: Sterks, De Haan and De Kam (1989)

Another important development to be mentioned was the reform of the personal income tax that was only fully implemented by January 1, 1990. Dutch marginal income tax rates were very high, probably reducing labour supply, particularly for married women, and encouraging the growth of the black economy. On the basis of recommendations of the Oort-commission (1986), the personal income tax system was simplified. National insurance contributions were combined with the income tax system. The tax base was broadened by some 60 percent, while tax rates were reduced (De Kam and Van Herwaarden, 1989, p. 138). The top rate, for instance, was reduced from 72% to 60%. The number of brackets was reduced from nine to three (see section 11.4 for details).

In May 1989 the government fell on disagreement over financing the National Environmental Policy Plan. According to the coalition Agreement of the centre-left government that came into office in November 1989 the central government budget deficit would be brought down further by 0.5 percent points of NNI annually in the period 1990-1994, taking it to 3.25 percent, with the 'collective burden' not exceeding 53.6 percent.

In 1989, budgetary outcomes were in part determined by a set of special factors. First, the standard rate of the VAT was reduced from 20 to 18.5%, to bring it more in line with the EC Commission's proposals and to moderate wage claims. Second, social security contributions were cut to reduce surplusses in the social security funds. Third, spending overruns occurred (see table 11.5), notably showing up in the investment subsidy scheme (WIR). Although this programme had already largely been stopped in February 1988, residual

subsidy claims still kept flowing in as applicants were allowed to spread their claims over several years. Finally, tax revenues were unexpectedly low, while the number of social security recipients rose faster than expected.

According to the 1990 Budget the target for the central government budget deficit could be met, albeit mainly because of the partial cancellation of a planned advance payment from the central government to the children's allowance Fund, to relieve cash demands in 1991. In February 1991 the Government published its Midterm Review, which confirmed that on unchanged policies the budget deficit was likely to exceed its target by a considerable margin as a result of a number of unforeseen developments (shortfall of revenues, rise in interest rate, higher than expected wage increases in the private sector)[64]. The Midterm Review contained proposals for additional expenditure cuts and revenue increases amounting to around Gld 17.5 billion in 1994, to keep the budget deficit in line with the medium term target. The proposals include cuts in subsidies (Gld 3.4 billion in 1994), reduction of disability and sickness benefits (Gld 4.8 billion) and the number of public sector workers (Gld 1.1 billion), and cuts in expenditure on defense and social welfare (Gld 3.8 billion). However, at that time a considerable part of the spending cuts was not specified.

The 1991 and 1992 Budget presented more detailed proposals on spending cuts as announced in the Midterm Review. Additional spending cuts have been announced. According to the 1993 Budget the central government budget deficit will be reduced according to schedule, while the 'collective burden' is expected to decline from 53.6 percent of NNI in 1992 to 53.0 percent in 1993.

11.3 Detailed analysis of government spending

Over the post-war period successive Dutch governments have constructed one of the most extensive social welfare systems in the EC area. Education was strongly expanded, access to medical care was improved and attempts were made to ensure that adequate housing was available to lower income groups. Over the period 1970-82, total public expenditure grew at an annual average rate of 13 percent. The rate of growth was extremely rapid in the early 1970s when authorities introduced expansionary budgets while transfer payments to the

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[64] Social benefits are conditionally linked to private sector wages, the conditionality referring to the fact that government can decide to decouple the rise of social security benefits from increases of private sector wages if the dependency ratio should exceed its 1989 level.

unemployed and the disabled rose. Afterwards, the rate of spending increases decelerated, but it remained above GDP growth. The most rapidly rising spending categories were transfer and interest payments.

After 1983 general government spending was reduced (table 11.6). Spending cuts have notably fallen on the government wage bill, transfers and public sector investment. The reduction in the wage bill largely reflected a fall in real wages. Between 1982 and 1991 real wages of civil servants lost 12 percent points against private sector wages (De Kam and Sterks, 1992, p. 121). Apart from this 'price' effect, the volume of public labor contributed to a markedly lower wage bill (relative to GDP). Up to 1979, government employment expanded faster than total labour supply, limiting unemployment, but since 1980 the growth in the number of government employees has fallen increasingly behind the growth of total employment (table 11.3).

Lower real transfers per recipient explain the reduction in government transfers. Reduced spending levels have been the result of several factors. First, the minimum wage has declined relative to average wages and as 80 percent of all benefit payments (at minimum level) are linked to net minimum wage, transfers have fallen as well. Second, for earnings-related social insurance against unemployment and disability, the benefit rate has been reduced from 80 percent of last wages to 70 percent (see below for some details). In the 1980s, the number of transfer recipients continued to rise, albeit at a slower pace.

The share of government investment in GDP is now at historically low levels. This progressive decline has initially reflected the completion of a number of large infrastructure projects (notably dykes to protect the country against its arch enemy, the sea), but in more recent years it seems that the public capital stock may well be deteriorating.

A comparison of spending levels indicates that by international standards, the Netherlands spends relatively little on government consumption. In contrast, it tends to spend considerably more on transfer payments.

Table 11.6 General government spending in the Netherlands, economic classification (% GDP), 1980-1992

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Government consumption	17.9	17.8	17.7	17.5	16.6	16.2	16.0	16.4	15.8	15.3	14.9	14.5	14.3
compensation of employees	13.0	12.7	12.6	12.2	11.5	11.1	11.0	11.2	10.7	10.2	9.9	9.7	9.6
Current transfers	30.6	31.5	33.3	34.1	33.1	32.4	32.4	33.7	33.4	32.0	31.9	32.5	32.7
transfers to households	26.3	27.4	28.9	29.4	28.1	27.3	27.1	27.5	26.9	26.1	27.0	27.1	27.5
Interest payments	3.7	4.4	5.2	5.7	6.0	6.3	6.2	6.1	6.1	5.9	5.9	5.9	6.2
Capital transfers	2.3	2.6	2.5	2.3	2.4	2.3	2.8	3.0	2.2	1.8	1.6	1.0	1.1
Government investment	3.3	3.1	2.9	2.7	2.8	2.6	2.5	2.4	2.4	2.4	2.3	2.3	2.3
Total expenditure	57.8	59.5	61.5	62.2	60.9	59.8	59.9	61.6	59.8	57.4	56.6	56.2	56.6

Source: EC, *Tables on Public Finance*

In the traditional areas of public spending - defense, public security and law and order - there have been slight reductions. The growth of education outlays also slowed. Spending levels were influenced by an important change in the student grant programme introduced in 1986, and subsequent modifications of this newly introduced programme. It consists of a basic grant and supplementary support in the form of an interest-bearing loan or an additional grant. While parental income is not taken into account for determing the basic grant, supplementary support depends on parent's income and wealth.

Public spending on health, which is largely (more than three quarters) financed through the social security system, also slightly decreased. Still, the Netherlands is one of the five biggest spenders on health-related services (both publicly and privately financed) in the OECD area. As in most 'high-spending' countries, a relatively large share of spending is devoted to the high-cost hospital care sector.[65] Up to 1983, hospitals were financed on a 'fee-for-service' basis. Under a new 'external/internal' budgeting scheme, individual hospitals are allocated a global sum for current expenditure and broadly allowed to spend it as they wish. Proposed additonal reforms to the health system on the basis of the Dekker Commission Report (1987) are currently being implemented.

Government spending on housing consists primarily of subsidies. There are two categories of housing subsidies in the rental sector: supply-related or 'object subsidies' (Gld 8 bln) and income-related or 'subject subsidies' (Gld 2 bln), that benefit low-income households which have to pay relatively high rents. Subject subsidies to renters, which are income-tested,

[65] OECD, *Economic Surveys*, 1989, p. 43.

increased rapidly after 1979. Government more or less controls rents of a large part of the housing stock. To cut back the amount of object subsidies, in recent years rents have been increased at a higher rate than inflation; where rents are low relative to quality, they are allowed to rise at a faster rate.

Table 11.7 General government spending (% GDP), 1981 - 1990

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
General public services	2.65	2.75	2.95	3.07	2.93	3.16	4.12	4.21	4.03	3.26
Defense	3.10	3.10	3.12	3.06	2.97	2.94	2.94	2.82	2.71	2.65
Public order and safety	1.28	1.32	1.32	1.29	1.27	1.29	1.35	1.28	1.10	1.18
Education	6.91	6.79	6.62	6.27	6.11	6.24	5.96	5.80	5.58	5.71
Health	6.50	6.72	6.63	6.37	6.29	6.00	6.20	6.06	6.23	6.16
Social security and welfare	20.50	21.70	22.21	21.50	20.55	20.31	20.58	19.67	19.82	20.16
Housing and Comm. Amenities	1.62	1.68	2.05	2.35	2.42	2.32	2.49	2.53	2.33	2.14
Recreational, Cultural and religious affairs	0.48	0.49	0.51	0.55	0.49	0.58	0.36	0.38	0.29	0.19
Economic services	6.19	6.30	5.97	5.98	5.58	6.02	6.39	5.25	4.40	3.88
Other functions	6.23	6.87	7.32	7.56	7.82	7.99	8.09	7.81	7.61	7.40
Total outlays	55.45	57.72	58.71	57.99	56.44	56.84	58.49	55.83	54.09	52.72

Source: IMF, *1991 Government Finance Statistics Yearbook*

The present social security system in the Netherlands consists of social insurance programmes supported by a welfare programme ('safety net'). Employee insurance is based on the principle of equivalence: premiums paid are based upon risk, with both premiums and benefits income-related, with a cap. National insurance covers all inhabitants of the Netherlands and is based upon the solidarity principle: benefits are the same for everyone who is in a similar position, but the premium due is a percent of taxable income, with a cap. In contrast to social insurances, social welfare benefits are means-tested and are again intended to benefit people who in general cannot resort to insurance benefits; thus, it forms a kind of safety net. In contrast to social security expenditure which is primarily financed by contributions from employers and employees, social welfare is financed from general revenue.

Table 11.8 Detailed analysis of social welfare expenditure (% GDP), 1980 - 1989

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1. Health	14.30	14.43	14.61	14.27	13.29	13.21	13.71	13.50	13.50	7.49
1a) Sickness	8.52	8.40	8.55	7.95	7.62	7.41	7.36	7.59	7.48	7.47
1b) Invalidity, disability	5.81	6.03	6.06	6.32	6.14	5.89	5.85	6.12	6.02	6.03
1c) Occupational accidents	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
2. Pension schemes	9.66	9.80	10.14	9.78	9.54	9.05	9.28	9.59	10.07	9.95
2a) Old age	8.25	8.38	8.69	8.36	8.18	7.74	7.98	8.27	8.72	8.60
2b) Survivors	1.41	1.41	1.45	1.42	1.36	1.30	1.30	1.33	1.36	1.35
3. Maternity and family	2.81	2.76	2.78	3.18	2.99	2.91	2.73	2.16	1.87	1.59
3a) Maternity	0.10	0.11	0.11	0.12	0.11	0.10	0.11	0.12	0.12	0.11
3b) Family	2.71	2.66	2.67	3.07	2.88	2.80	2.61	2.04	1.75	1.74
4. Unemployment	1.78	2.53	3.47	4.20	4.01	3.62	3.40	3.33	3.05	2.77
4a) Placement etc.	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a	n.a
4b) Unemployment	1.78	2.53	3.47	4.20	4.01	3.62	3.40	3.33	3.05	2.77
5. Housing and miscellaneous	0.69	0.77	0.97	0.98	0.95	0.95	0.98	1.25	1.07	1.06
5a) Housing	0.28	0.30	0.38	0.46	0.35	0.33	0.33	0.37	0.39	0.38
5b) Miscellaneous	0.41	0.48	0.59	0.52	0.60	0.63	0.66	0.88	0.68	0.69
Total	29.27	30.29	31.96	32.42	31.25	29.89	29.60	30.04	29.56	28.87

Source: EC, *Social Protection Expenditure and Receipts 1980-1989*, 1991

In the Netherlands, sickness insurance for lost work time involves relatively large amounts. In the beginning of the 1980s the number of days lost due to sickness dropped sharply, but since 1986 it has been rising again (table 11.9). Sickness benefit is payable for 52 weeks at a rate (since 1986) equal to 70 percent of average daily wages over the last year. Sickness benefit is in 99 percent of all cases topped up under collective wage agreements to 100 percent of net wage.

In comparison with most surrounding countries, disability and invalidity pensions expressed as a percent of GDP, are also high in the Netherlands. Both the number of recipients (table 11.9) and the generosity of the system explain high outlays on the disability program. The increase of the number of recipients can only partially be explained by the growth of the population of working age. It probably also reflects a general relaxation of criteria for disablement. Benefits are related to the degree of disability, which in turn

depends on reduced earnings capacity. It is generally assumed that the take-up of the disability programme includes a substantial number of 'hidden' unemployed, since benefit formulas are more generous than those of unemployment programmes. Estimates of hidden unemployment vary between 29 to 50 percent of total programme volume.[66]

Individual old age pension, consisting of 50 percent of the net minimum wage, accrues to nearly all persons aged 65 and over. Single aged have a pension equal to 70 percent of net minimum wage. Spending on old age age pensions has grown at the end of the 1980s with the rising number of retired people (table 11.9). Survivor's benefits are paid to widows younger than sixty-five and equal (as from 1986) 70 percent of net minimum wage. The system also includes age-related orphans pensions.

Child allowances are granted for children under the age of 18 and vary with the number and age of childeren.

Unemployment benefit is provided for by social insurance for nine months up to five years (depending on working history); once this benefit entitlement is exhausted transfers are received under the social welfare programme. Initially, (gross) unemployment benefits represented 80 percent of gross wages; the replacement ratio was reduced to 70 percent as from the mid 1980s.[67]

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[66] Under the new system (as from 1987) the benefit is split in two components for those with less than 80 percent disability. The disability component is based on the level of disability and the remaining is paid under the rules governing the unemployment programme if the recipient is also deemed unemployed. This change not only affected new entrants, but also those under 35 already in the programme (representing only 30 percent of the total number of benefit recipients). Tightening of the criteria for new entrants has had less effects than expected. However, of late the number of new beneficiaries classified as fully disabled has fallen somewhat.

[67] As from January 1987 some further important changes have been introduced in unemployment insurance. Under the new system, the unemployed must at least have worked 26 weeks in the year before unemployment to be entitled to unemployment benefit. If this requirement is met, the recipient receives the standard benefit of 70 percent of lastly earned gross wage for six months. If an unemployed is older than 23 and has a labour history of three years during the five years before unemployment, this standard benefit can be prolonged for a period running between 3 months to 4.5 years, depending on age. Benefits can be prolonged for one year at 70 percent of the minimum wage. Individuals who are older than 57.5 years when they became unemployed may receive this benefit until the age of 65. If an unemployed individual does not meet the 26 weeks requirement or if entitlement is exhausted, social assistance can be obtained. Unemployed youths aged 16 and 17 years are not entitled to social assistance (their parents receive child allowance) and the level of benefit is less generous for people under 23.

Table 11.9 Number of benefit recipients (1000 benefit years), 1980-1992

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Old age	1280	1306	1326	1341	1354	1781	1820	1856	1893	1927	1956	1982	2008
Survivors	168	168	169	171	172	171	169	168	166	186	187	190	191
Early retirement	11	12	14	16	20	21	24	28	34	36	38	39	40
Invalidity	718	670	621	573	529	485	439	395	349	305	201		
Disability	608	634	648	663	682	698	713	725	740	758	778	801	809
Sickness	306	288	272	260	260	257	271	280	294	316	346	353	351
Unemployment	149	221	288	270	445	476	477	537	567	559	518	504	517
Social assistance [a)]	277	283	296	297	307	208	208	213	218	221	220	220	222

[a)] Excluding unemployment.

Source: *Dutch Ministry of Social Affairs, Sociale nota 1993*

11.4 Detailed analysis of government revenues

Table 11.10 presents a detailed analysis of government revenues according to the mobility of the tax base; table 11.11 compares the Dutch tax system to that in some neighbouring countries.

With respect to taxes on portfolio income of individuals the Netherlands has a dividend withholding tax of 25%. Under the terms of nearly fifty international tax treaties this rate is generally reduced. Dividends and interest received are included in taxable income. Investment income of individuals is taxed at 38.5 to 60% (1992). As from 1987 banks have to report to the authorities all interest paid to private clients holding bank deposits. At the time, the introduction of compulsory reporting caused considerable tax flight (probably some Gld 5 billion was involved).

Revenue from taxes on corporate profits in the Netherlands is in line with revenue from this source in surrounding countries. Profits of corporations and other taxable entities are taxed at 40% on the first Dfl 250,000 of taxable profits and 35% on the excess. If a Dutch corporation owns 5 percent or more of the paid-up capital of another Dutch corporation and the shares are not held as inventory, dividends and capital gains on those shares are exempt from Dutch corporate tax ('participation exemption'). If certain additional conditions are met, these rules also apply to the participation in capital of a foreign corporation.

Table 11.10 Breakdown of taxes according to the degree of mobility of the tax base (% of GDP), 1980-1989

		1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
1.	Taxes on corporate profits	3.0	3.1	3.1	2.8	2.6	3.1	3.4	3.7	3.5	3.5
2.	Taxes on goods and services	11.6	11.2	11.0	11.3	11.4	11.5	11.9	12.6	12.5	12.0
	2.1 VAT	7.3	7.1	6.8	6.9	7.1	7.3	7.5	7.9	8.0	7.5
	2.2 Exciseduties	3.4	3.2	3.2	3.3	3.4	3.3	3.3	3.6	3.5	3.4
	2.3 Other taxes	0.9	0.9	1.0	1.1	0.9	0.9	1.1	1.1	1.0	1.1
3.	Taxes bearing on use of labour	17.4	18.0	18.9	21.0	20.0	19.9	19.6	20.7	20.6	18.9
	3.1 Soc. sec. contributions employees	7.2	7.5	8.1	9.2	8.5	8.9	8.6	9.2	9.2	8.7
	3.2 Soc. sec. contributions employers	8.2	8.1	8.0	8.3	7.9	8.0	8.1	8.4	8.3	7.5
	3.3 Soc. sec. contributions self-employed	2.0	2.4	2.8	3.5	3.6	3.0	2.9	3.1	3.1	2.7
	3.4 Other taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
4.	Taxes on income of individuals	12.0	11.1	10.8	10.0	9.4	8.7	9.3	9.5	9.9	9.7
5.	Taxes on property	1.6	1.6	1.5	1.5	1.5	1.6	1.6	1.8	1.7	1.7
6.	Miscellaneous	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.2	0.2	0.2
7.	Total tax revenue	45.8	45.2	45.4	46.7	45.0	44.9	45.8	48.5	48.4	46.0

Source: 1980-1984: OECD, *Revenue Statistics of OECD Member Countries 1965-1989*, Paris 1990
1985-1989: OECD, *Revenue Statistics of OECD Member Countries 1965-1990*, Paris 1991

The corporate income tax rate is quite similar in neighbouring countries, except for Germany which has a relatively high tax rate on retained profits (50%). Recently, proposals have been put forward to reduce the German rate to 44% as from January 1, 1994.

Indirect taxes are relatively important. Most goods and services are taxed at 17.5% value added tax as from October 1, 1992. Some services, e.g. insurance and banking, are exempt. Certain basic necessities are taxed at 6%. Although Dutch VAT-rates are not out of line with those in most neighbouring countries, the standard VAT rate in Germany (15% as from January 1, 1993) is still 2.5 percent point below the standard rate in the Netherlands.

It follows from table 11.10 that social security contributions have somewhat increased during the 1980s. Effective January 1, 1990, national insurance contributions (25.55 percent in 1992), which cover both employees and self-employed, are levied together with the wage withholding tax and personal income tax on a uniform basis. As of this date, all such taxes

are due by employees and benefit recipients. The resulting income loss for these groups has been compensated for by a 'compensation allowance' which the employer pays to the employee. Employee insurance contributions (these programmes cover only employees) are paid both by employees and employers.

It follows from table 11.10 that this source of government revenue is considerably more important in the Netherlands than in most neighbouring countries. As has been explained in the previous section, this is due to both 'volume' and 'price' of social security in the Netherlands, which are both high in comparison to those in surrounding Member States.

Table 11.11 Tax rates in some EC Member Countries

	Belgium	Germany	France	UK	Netherlands
Corporate income tax rate [a]	39%	50%	37%	34%	35%
VAT [b] reduced rate	1/6%	7%	2.1/5.5%	0%	6%
standard rate	19.5%	15%	18.6%	17.5%	17.5%
Personal income [c]					
lowest rate	25%	19%	5%	25%	38.5%
top rate	55%	53%	56.8%	40%	60%
top rate applies to income:(Dfl)	132,561	135,274	84,867	78,132	85,930
number of brackets	7	formula [d]	13	2	3
Personal examption [e]	9,961	6,329	6,194	10,863	5,225

[a] Tax rates for 1990. In the UK the 1992/93 rate amounts to 33%. Belgium has a lower rate for small business. The German tax rate on profits distributed to shareholders is 36%. The tax rate in the Netherlands amounts to 40% for profits up to Dfl 250,000. Source: OECD, Taxing Profits in a Global Economy, Paris, 1991.

[b] Expected VAT rates, as from 1 January 1993. Source: Tweede Kamer, vergaderjaar 1991-1992, 22713, nr. 3, p. 2.

[c] Rates in 1991. Source: International Bureau of Fiscal Documentation.

[d] The German personal income tax rate is based on a formula. For 1991 and 1992 an additional solidarity tax of 3,75% of total tax liability is levied.

[e] For a single individual. Calculations are based upon the average exchange rate in 1991.

The personal income tax has a personal exemption of Gld 5,225 (1992) and three rates:[68]

- 13% income tax (plus 25.55% national insurance contributions) on the first Dfl 42,966 of taxable income;
- 50% on the next Dfl 42,964; and
- 60% on the excess of taxable income.

To be taxable, income must arise from one of the following sources: profits from an enterprise or a liberal profession; income from present or past employment (including social security benefits in case of sickness, disability or unemployment, and pension benefits); income from other labour; income from immovable[69] and movable property and income from periodical payments; also capital gains are sometimes included in the tax base.[70] An exemption for dividend and interest of Dfl 1,000 (Dfl 2,000 for married couples) is granted for each of these income items. Taxpayers may claim various deductions, including interest payments (without limit) on loans and medical expenses to the extent that they exceed certain limits. Pension premiums based on a qualifying pension plan are tax exempt. Subsequent pension benefits are included in taxable income.

As follows from table 11.10 revenue from the personal income tax expressed as a percent of GDP has declined during the 1980s. Table 11.11 indicates that the top rate of the personal income tax, - not withstanding the tax reform of 1990 - is still quite high in comparison with the top rate in neighbouring countries. Note, however, that local authorities in Belgium levy additional local income taxes of 6-9% and that Germany has a solidarity tax in 1991/92. The level of taxable income from where the top rate applies is much lower in the Netherlands than it is in Belgium and Germany (table 11.11).

Taxes on immovable property vary throughout the country. Municipalities have very limited powers to levy taxes, the most important municipal tax being the tax levied on owners and tenants of immovable property.

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[68] Non-earning individuals who form a joint household may transfer their exemption to the partner earning the household income.

[69] The owner-occupier of a house must include 2.5 percent of the rental value of the house in his taxable income. Certain costs (including interest payments) related to the house may be deducted (without limit), which often results in negative taxable income. Aggregate negative income from owner-occupied housing amounts to Gld 11 billion in 1992.

[70] In general, in the Netherlands capital gains are not included in taxable income. However, capital gains realized in the course of a business and through the sale of substantial holdings of shares in one company, and certain non-speculative gains are included in taxable income.

11.5 Budgetary process

Organisation

The Netherlands is a unitary state with three levels of government: state, provincial and municipal. Provinces and municipalities (local government) spend about one third of total public outlays. Local authorities are limited in their spending through regulation and central government supervision. Spending of local authorities is controlled through 'block' and 'specific purpose' grants from central government which together finance about 90 percent of local expenditure. Local government mainly acts as an agent of central government, especially in the areas of housing, welfare benefits, police, and education. Although local government is allowed to borrow for capital expenditure, central government can restrict local borrowing.

Since 1982 there has been a continuing effort to critically reconsider the scope of central government activity. First, sales of public shareholdings in some forty firms have been made. Second, as regards State enterprises, the Post Office has been split up into three companies under a holding company fully owned by the Government; the Government Printing Office has been set up as a private company to be sold off in the future; the State Fishing Port Authority has been transferred to the private sector, while the State Mint will also be privatised.

Social insurance funds finance their outlays (30 percent of total public outlays) by special contributions. Central government controls social security spending to a large extent by determining benefit formulas and entitlements, and by annually fixing contibution rates.

Parliament has two Chambers. Since no political party has an overall majority, coalition cabinets have to be formed. Every four years the Second Chamber is directly elected. The term of the present centre-left coalition finishes by the end of 1994. Normally, parties participating in a coalition conclude so called 'coalition agreements', which contain a substantial financial paragraph regarding budgetary policy and which usually detail tax and spending priorities.

The Ministry of Finance plays a central role in budgetary matters. Ministers in the cabinet discuss and decide upon proposals regarding the extent and allocation of budgetary cuts put forward by the minister of Finance. For the minister of Finance it is important to have support of the Prime Minister in his confrontation with other spending ministers.

Budgetary rules and procedures

There are no legal constraints on budget deficits and the level of government outlays. The current coalition Agreement (which is shaped as a political commitment) identifies targets relating to both the budget deficit and the collective 'burden' (both expressed as a percent of NNI); as a result the relative level of spending is also determined.

Multi-annual budget plans or projections are published on a regular basis. Although multi-year estimates as such are not approved by Parliament, they can be considered as standing government policy. Ministers are thus under pressure to keep their spending in line with projected outlays. Revisions to the projections are made two times a year to incorporate the consequenses of changing economic conditions, without questioning initial budget targets. The multi-year plans, linked to the current year (t-1), cover a period of four years following budget year t.

Parliamentary appropriation

Annual appropriation of all central government expenditure is required. The budget is both on a cash and commitment basis. There is no prior vote on budget totals, but before discussing separate chapters of the budget, there is a general and political discussion on the budget as a whole. Only the Second Chamber has the right to amend the budget. Once enacted, the budget can only be changed by supplementary budget laws. Given the precommitments laid down in the coalition Agreement, it is common practice not to violate the targets for the government budget deficit or the collective 'burden'.

Budget execution

Rules have been formulated for in-year budget control to prevent, signal and compensate for spending overruns. According to these *Rules of Stringent Budget Policy* any expenditure overrun has in principle to be compensated for by the department where the overrun took place ('specific compensation'). In special circumstances 'general compensation' (by cutting budgets of all departments) is allowed, but only by cabinet decision. This procedure stimulates spending ministers to make realistic multi-year budget plans.

Cash limits can be imposed on departmental spending totals, to tighten up the *Rules of Stringent Budget Policy*. Prior approval by the minister of Finance can be prescribed for expenditure items and commitments, even after Parliamentary appropriation. Carry-over of approved outlays to next year's budget is not permitted. Neither is it allowed to transfer unspent funds from one article to another, without prior Parliamentary approval. Parliament

is regularly informed about progress in executing the budget.

The introduction and the gradually more effective enforcement of budgetary rules has considerably improved budgetary control. This can be concluded from budgetary practice in recent years (Sterks, 1992; De Haan, 1992).

11.6 Flexibility of fiscal policy

Table 11.2 shows that the general government deficit has been reduced by three points from 7.1 percent of GDP in 1982 to 4.1 percent in 1992. At the same time, current receipts fell by 1.9 percent points. It follows that expenditure has been cut back by 4.9 percent points. This implies an average annual reduction by 0.5 percent of GDP.

The deficit target of the present government, laid down in the coalition Agreement of 1989, is to further reduce the deficit to 3.25 percent of NNI by 1994 (about 3% of GDP). According to the most recent (1993) *Budget Memorandum*, there is all reason to expect that this target will be met. In terms of the deficit concept as laid down in the Maastricht Treaty, the deficit will amount to 2.6 percent of GDP in 1994. This figure is only slightly above the present level of general government investment. We conclude that in the Netherlands the deficit as such poses hardly a problem anymore. The only problem to comply with the EMU-criteria is the present high level of government debt. As follows from table 11.2 gross public debt kept rising from 55.6 percent of GDP in 1982 to 79.5 percent in 1992, in spite of deficit reductions realized in that period. With additional deficit reductions as laid down in the coalition Agreement the deficit-to-GDP ratio will slowly decline. If deficit reduction continues by 0.5 percent point a year the deficit will stand at 1 percent of NNI in 1998. The 60 percent debt-to-GDP target will then be met between years 2000 and 2005. To that end expenditure has to be further reduced, because the tax level is already high in relative terms. Moreover, it is desirable to reduce taxes to improve the competitive position of the Netherlands within EMU.

Besides the need to comply with EMU criteria, it is essential to reduce interest payments in order to increase the flexibility of the budget and to increase the share of productive outlays in total government spending.

Regarding the EMU debt-to-GDP criterium, the Netherlands could stress one specific feature of the national fiscal make-up which makes its high debt ratio look more acceptable. Different from the situation in other EC Member States the pensions of government

employees in the Netherlands are fully funded. This substantially reduces the amount of future liabilities of the Dutch government relative to the situation in other countries.

Scope to increase tax revenues

Given the already high revenue-to-GDP ratio in the Netherlands there is not much room to further increase taxes. Nevertheless we will investigate some possibilities.

There is no scope to raise tax rates on portfolio income of individuals. Given the high mobility of the tax base, higher rates may even produce lower revenue.

Similar arguments apply to taxes on corporate profits. The corporation income tax rate is at about the same level as in surrounding countries (assuming that the German rate will be further reduced). Although some broadening of the tax base might be envisaged, it would evidently be no wise policy to restrict present supple rules to determine taxable profit by too much.

At the moment of writing, the standard rate of VAT has just been reduced from 18.5 to 17.5%. Although this is 2.5 points above the German level, no further reductions seem to be necessary. On the other hand, to increase the VAT-rate again would detract from the consistency and the continuity of tax policy.

Taxes on the use of labour are largely earmarked to finance social security programmes. It does not make sense to use higher proceeds from these levies for deficit reduction, since this would imply that social security funds will run a surplus. Moreover, the level of taxes on labour use is very high already when compared with tax levels in other Member States (for example, about five percent points above the German level). This has resulted in relatively high marginal and average tax wedges. The scope to scale down the wedge depends on the success of trimming social security expenditure. GDP growth is an important variable here, because higher output increases the tax base as well as scales down the overall spending level (by reducing transfers to the unemployed).

Total revenue from taxes on income of individuals, expressed as a percent of GDP, is below the Belgian and German level. Nevertheless, high income earners (which are most mobile) are confronted with relatively high rates. Tax facilities in the Netherlands are favourable. Interest paid and contributions to pension saving are fully deductable from the personal income tax base. The deductability of interest on mortgages could be limited in combination with a reduction of housing subsidies. The deductability of other interest payments could be reduced by introducing statutory limits as is the case in many other EC Member States. A rather strong case is to be made for broadening the tax base by including presently untaxed private capital gains in the concept of taxable income. Progression of the

personal income tax makes revenues react more than proportionally to GDP growth. Some additional revenue might result from increased enforcement.

Local governments have room to raise their taxes on immovable property. However, this can only be a policy option when at the same time central government grants are withdrawn and central government taxes are cut. Local governments hardly contribute to the general government deficit; municipalities cannot be expected to raise tax rates to create a surplus.

Non-tax revenues can be increased by further implementation of the benefit-principle (introduction of more user charges). Non-tax revenues from the exploitation of natural gas heavily depend on the dollar-guilder exchange rate and on world crude oil prices.

Scope to reduce expenditure

After over a decade of sometimes severe cuts, it will prove to be difficult to realise substantial additional cuts. Salaries of government employees have for many years detoriated in relative terms, weakening the competitive position of government in the labour market.

General public services might be rendered more efficiently, but on the other hand environmental policy objectives ask for additional spending. Defence outlays can be further reduced, but opinions clearly differ as to the size of the 'peace dividend'. Policy options available also depend on NATO, so room for cuts should not be judged too optimistically. The growing number of (serious) crimes asks for additional spending on law and order items.

Demographic change will push up (primary) education outlays, expenditure on health and the general old age pension. The growth of health expenditure might be reduced by increased use of financial incentives to restrict supply and demand.

Undoubtedly, most possibilities for budgetary cuts are to be found in the areas of social security and welfare. Present public spending related to sickness and disability is out of line and can certainly be cut back, although upward pressures are considerable because of the ageing of the work force. The generosity of the social security system can be reduced; especially benefit levels for singles are higher than in neighbouring countries. Policy measures to increase the participation rate will work out favourably on social security spending and hence on the level and rates of social security contributions. A reduction of the minimum wage may be considered. The greying of the population leads to a built-in growth of outlays. GDP growth is an important determinant of employment opportunities and can work out both sides. Increased public spending related to the inflow of immigrants is foreseen.

Individual rent subsidies tend to rise endogenously. In line with policy options to reduce present tax facilities for owner-occupied housing, subsidies to tenants ('object' and 'subject'

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subsidies alike) can be trimmed. Public transport subsidies can be cut by increased efficiency and higher fares. The need for infrastructural investment in rail and road transport will push up investment spending.

High public debt and the relative short term to maturity makes the share of interest payments to GDP vulnerable to the interest rate and the rate of GDP growth, respectively.

Table 11.12 Contribution to budget consolidation of revenue categories in the Netherlands[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. Taxes on portfolio income of individuals			tax competition		-- (n.a)
2. Taxes on corporate profits					0 (3.5)
3. Taxes on goods & services 3.1 VAT					0 (7.5)
3.2 Excise duties			tax competition		- (3.4)
3.3 Other taxes					0 (1.1)
4. Taxes on use of labour 4.1 Social sec. contr. employees		GDP growth	GDP growth	wedge	-- (8.7)
4.2 Social security contr. employers		GDP growth	GDP growth	wedge	-- (7.5)
4.3 Social security contr. selfemployed					0 (2.7)
4.4 Other taxes					0 (0.0)
5. Taxes on income of individuals		**elasticity; enforcement facilities;capitalgains**	**top rate**	wedge	+ (9.7)
6. Taxes on property		**rates local government**			+ (1.7)
7. Miscellaneous taxes					0 (0.2)
8. Non-tax revenues		**benefit principle;** oil price; $ exchange rate	oil price; $ exchange rate		+ (6.6)

a Budget consolidation resulting from discretionary measures is printed in **bold** type.

b A plus indicates upward flexibility (higher revenues, lower deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.

c A minus indicates downward flexibility (lower revenues, higher deficit) of the revenue ratio (% GDP) resulting from relevant automatic and/or discretionary policy changes. The single and double minus signs are used to indicate the relative degree of flexibility.

d The share of the various revenue categories as a percent of GDP (1989) is shown in parentheses.

Table 11.13 Contribution to budget consolidation of functional expenditure categories in the Netherlands[a]

	++[b]	+[b]	-[c]	--[c]	total[d]
1. General public services		**overall**	clean-up of environment		0 (3,3)
2. Defense		**overall**			+ (2,7)
3. Public order and safety			**police; judicature**		- (1,2)
4. Education			demography		- (5,7)
5. Health		**incentives**		demography	- (6,2)
6. Social security and welfare	**volume (sickness, disability); generosity; fraud**	**participation rate; minimum wage;** GDP growth	demography; GDP growth	immigration	+ + (20,2)
7. Housing and community amenities	**housing subsidies**		volume rent subsidies		+ (2,1)
8. Recreational, cultural and religious affairs					0 (0,2)
9. Economic services		**subsidies to public transport**	**capital formation**		0 (3,9)
10. Other functions		interest rates; GDP growth	interest rates; GDP growth		0 (7,4)

a Budget consolidation resulting from discretionary measures is printed in **bold** type.
b A plus indicates downward flexibility (less expenditure, smaller deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures. The single or double plus sign indicates the relative degree of flexibility.
c A minus indicates upward flexibility (more expenditure, higher deficit) of the expenditure ratio (% GDP) resulting from relevant built-in-flexibility and/or discretionary measures. The single or double minus sign indicates the relative degree of flexibility.
d The share of the various spending categories as a percent of GDP (1990) is shown in parenthesis.

Table 11.14 Major revenue-increasing measures in the Netherlands, 1980-1989[a]

	Taxes on portfolio income of individuals[b]	Taxes on corporate profits	VAT	Excise duties	Social security contributions employees	Social security contributions employers	Taxes on income of individuals	Taxes on property	Non-tax revenues
1980			rate						
1981				petrol; diesel	unemployment; pensions				education; health; railway fares; etc.
1982							rates		transport
1983					rates		threshold; rates		transport
1984									
1985									
1986		accelerate payment	rates	mineral oil			accelerated payment		sale state holdings
1987	avoidance	abolish deductability of fines			health insurance fund	health insurance fund	abolish deductability of fines		
1988									
1989									

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, revenue-increasing measures with a general character like combatting tax evasion and avoidance, are indicated in the first column.

Table 11.15 Major expenditure cuts in the Netherlands, 1980-1989[a]

	General public services[b]	Defense	Public order and safety	Education	Health	Social security and welfare	Housing and community amenities	Recreation., cult. & religious affairs	Economic services	Other functions
1980	wage freeze									
1981	wages; recruitment									
1982	wages					unemployment assistance 16-17 year olds			investment support (WIR)	
1983	wages					family allowances freeze social minimum; social benefits				
1984						unemployment and invalidity benefits; freeze social minimum				
1985						freeze social minimum allowance				
1986	staff					freeze social minimum allowance				
1987	staff					freeze social minimum allowance				
1988									WIR	
1989										

[a] This table is based on the monthly summaries of principle economic policy measures in: European Economy, Supplement A 'Recent economic trends', 1980 - 1989.

[b] For simplicity, expenditure cuts with a general character like wage restraints and general spending caps, are indicated in the first column.

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