

**BUDGET
PERSPECTIVES
2005**

Tim Callan

Aedín Doris

Daniel McCoy (eds.)

Shane Garrett, Catherine Mathieu,

Anne Nolan, Brian Nolan,

Henri Sterdyniak

*Copies of this paper may be obtained from The Economic and Social Research Institute
(Limited Company No. 18269). Registered Office: 4 Burlington Road, Dublin 4.*

www.esri.ie

Price €20.00

(Special rate for students, €10.00)

Tim Callan and Brian Nolan are Research Professors, Daniel McCoy is a Senior Research Officer, Anne Nolan is a Post-Doctoral Fellow and Shane Garrett is a Research Assistant at The Economic and Social Research Institute. Catherine Mathieu is a Senior Research Fellow at the OFCE (Observatoire Français des Conjonctures Economiques). Henri Sterdyniak is a Senior Research Fellow at the OFCE and Professor of Economics at the Université de Paris IX-Dauphine.

These papers have been accepted for publication by the Institute, which does not itself take institutional policy positions. Accordingly, the authors are solely responsible for the content and the views expressed.

**BUDGET
PERSPECTIVES
2005**

Tim Callan

Aedín Doris

Daniel McCoy (eds.)

**Shane Garrett, Anne Nolan,
Brian Nolan, Catherine Mathieu,
Henri Sterdyniak**

© THE ECONOMIC AND SOCIAL RESEARCH INSTITUTE
DUBLIN, 2004

ISBN 0 7070 0229 X

ACKNOWLEDGEMENTS

The papers included here have benefited substantially from comments and suggestions offered by ESRI staff, FFS members and by the Director, Brendan Whelan. We are very grateful to our colleagues for their valuable input in this regard. We thank Eleanor Bannerton and Daphne McNamara Lancha for organising the administration of the Conference. Thanks are also due to Mary Cleary, Regina Moore and Deirdre Whitaker for their invaluable help in bringing this paper to publication.

CONTENTS

	<i>Page</i>
<i>Acknowledgements</i>	iv
OPENING ADDRESS <i>Brendan Whelan</i>	1
 <i>Chapter</i>	
1 IN SEARCH OF AN APPROPRIATE EUROPEAN FISCAL FRAMEWORK <i>Catherine Mathieu and Henri Sterdyniak</i>	4
2 RELATIVE INCOME POVERTY: LEARNING FROM THE BEST- PERFORMING COUNTRIES <i>Tim Callan and Brian Nolan</i>	54
3 IRELAND'S HEALTH CARE SYSTEM: SOME ISSUES AND CHALLENGES <i>Anne Nolan and Brian Nolan</i>	70

OPENING ADDRESS

Brendan Whelan

Director, The Economic and Social Research Institute

WELCOME

I would like to welcome you all to this, the seventh *Budget Perspectives* Conference, which is co-hosted by the Economic and Social Research Institute and the Foundation for Fiscal Studies. The objective of these conferences is to set the scene for the national debate on budgetary priorities by presenting a number of papers on topics relating to taxation and public expenditure. I should, of course, remind everyone that the views expressed are strictly those of the individual authors; neither the ESRI nor the FFS takes corporate or institutional positions in relation to any of the issues raised.

The economic context in which the 2005 Budget is being constructed is quite different from that facing the Minister last year. At that time, the international economic situation had been quite depressed, with very slow growth in world trade and interest rates at historic lows. Inflation in Ireland was running at a higher level than in other EU countries and tax revenues had been quite weak. As the economy faces into 2005, most of these negative trends have been reversed. The international economy is expanding and the Irish growth rate has improved appreciably. Tax revenues have become much more buoyant and have been further boosted by a number of special factors. The pace of inflation has moderated with the Irish rate now below that prevailing in some of our EU partners.

This situation gives the Minister more room for manoeuvre in devising the budgetary strategy. While remaining prudent by continuing to target an overall position of broad fiscal balance, it should be possible to introduce some changes in the patterns of taxation and expenditure. The papers presented at today's conference, and the ensuing debate, will, I hope, help to clarify what those changes might be and how they could be implemented.

**A Macro-
economic
Perspective**

The conference opens with a presentation by Daniel McCoy and Shane Garrett, summarising some of the key trends identified in the recent *Quarterly Economic Commentary*. They project that growth will be around its long-run potential level of 5 per cent this year and

next (for both GDP and GNP), that inflation will average over 2 per cent and that the General Government Balance will remain in modest surplus, comfortably within the requirements of the *Stability and Growth Pact*. Employment is expected to continue to grow and unemployment to stay at historically low levels. The authors also take up in their presentation a number of policy themes addressed in recent editions of the *QEC* such as the possible macro-economic effects of the Special Savings Investment Accounts and the increasingly significant role of house building in the economy.

An Appropriate Fiscal Framework for the Eurozone

One of the great benefits of the *Budget Perspectives* Conferences is that they give us the opportunity to hear the views of experts from outside the country. This year we very fortunate to have with us a distinguished speaker from the *Observatoire Français des Conjonctures Économiques*, Dr Catherine Mathieu. Her paper, which is co-authored with Henri Sterdyniak, reviews the development of the *Stability and Growth Pact*, assesses the difficulties which have arisen with it and suggests an agenda for reform. The paper evaluates the wide range of reforms that have been proposed by academics and others, including the “golden rule”, new committees and institutions and the role of ageing and pension provision in the debate. The authors’ own solution emphasises the need for a relatively light regulatory touch. They suggest that surveillance at EU level should bear only on issues which have the potential to lead to negative externalities between countries in the monetary union, especially by ensuring that inflation within each country stays in line with a specified inflation target for the eurozone as a whole. This morning Catherine will only have time to present the main points of this comprehensive paper; the full version in the published volume repays further careful study.

Relative Income Poverty Risk in Ireland

In the third presentation, Tim Callan and Brian Nolan examine why relative income poverty rates in Ireland have remained high compared with many other EU countries. They begin by presenting the basic facts of the situation and look at a variety of possible explanations for the observed patterns. They conclude that differences in demographic factors, such as age structure, the pattern of labour force participation and household composition do not generally account for differences between Ireland and better performing countries such as Denmark and the Netherlands. The most likely explanation appears to lie in the different tax and welfare structures of these countries which involve substantially higher costs in the form of higher taxation. This conclusion raises important strategic choices in relation to economic incentives, labour market behaviour and economic growth.

**Issues in Relation
to Ireland's
Health Care
System**

The final presentation of the morning, by Anne Nolan and Brian Nolan, examines three key aspects of Ireland's health care system. It begins by taking an overall view and benchmarks the Irish system against that in 21 other countries. In general they characterise the performance of the health care system as disappointing. They also show that the most striking feature of Ireland's health spending is how rapidly it has increased in absolute terms in recent years. The second part of the paper considers the use of general practitioner services by persons at different income levels, in particular those with and without entitlement to free GP services. They find a marked difference between the utilisation rates of the two groups and consider the implications for policy. The last section of the paper examines the complex mix of public and private health care operating in Ireland and how it interacts with the market for health insurance. Almost half of the Irish population now pays for private health cover and the authors address the issues to which this gives rise in relation to equity and incentives.

Final Comment

It is clear from this brief outline that this morning's papers cover a very wide terrain. There will be scope for a short period of discussion after each paper and time for a somewhat more extended interaction after the final paper. I hope that as many as possible of you will participate.

IN SEARCH OF AN APPROPRIATE EUROPEAN FISCAL FRAMEWORK

Catherine Mathieu and Henri Sterdyniak***

1. Introduction

The implementation of the Stability and Growth Pact (SGP) illustrates how simple policy rules may not be enforceable if they lack sound economic rationale. The 3 per cent of GDP deficit rule embedded in the SGP has been breached in a growing number of EU-15 countries since the initiation of the economic downturn in late 2000. With six of the ten new Member States in the same position, as many as twelve of the twenty-five Member States were subject to an Excessive Deficit Procedure (EDP) in September 2004.

Since the early days of the SGP, the provisions inherited from the Maastricht Treaty had been criticised by a number of economists and policy-makers arguing that the procedures of fiscal surveillance were not providing a satisfactory framework of economic policy co-ordination in the European Union. The implementation of the SGP had started in a favourable situation of rapid growth. But the need for reforming the SGP has become more and more obvious since the economic downturn of late 2000. In November 2003, when the Ecofin Council did not endorse the European Commission recommendations requesting France and Germany to take new budgetary measures to bring their deficit below 3 per cent of GDP, the SGP seemed almost dead and the EU fiscal policy framework under high uncertainties. Ten months later, the SGP is still alive, at least on paper, but a new framework seems

* OFCE (Observatoire français des conjonctures économiques) – 69, quai d’Orsay – 75340 Paris cedex 07 – France; e-mail: catherine.mathieu@ofce.sciences-po.fr.

**OFCE and CERPEM-CREFED Université de Paris IX-Dauphine; e-mail: sterdyniak@ofce.sciences-po.fr.

more than ever necessary in an enlarging Union. On 3 September 2004, the Commission expressed ‘ideas’ depicted by Joachim Almunia as ‘an evolution rather than a reform of the SGP’ (European Commission, 2004b). On 10 September, the Ecofin Council opened the door to a possible reform of the Pact. This paper presents a critical assessment of the debate.

Section 2 recalls the fiscal policy framework in the euro area and addresses its weaknesses. Section 3 provides an assessment of the first six years of existence of the SGP. Section 4 is devoted to the reforms proposed by the Commission. Section 5 discusses proposals made by economists to improve the European fiscal policy framework. Section 6 concludes.

2. The Existing Fiscal Policy Framework

Before the launch of the economic and monetary union (EMU), two views had been proposed on the conduct of fiscal policies. In one view, the EMU should allow each Member State to choose and run domestic fiscal policy in full independence. Independent fiscal policy is a prerequisite in a monetary union since monetary policy, conducted at the area aggregate level, becomes ineffective in the event of asymmetric shocks. The exchange rate can no more be used as an instrument of economic policy. Price and wage adjustments, as well as labour mobility, only play a minor role in Europe. But fiscal policy gains strength in a monetary union as it will not be counteracted by interest rate rises or exchange rate responses.

According to another view, if each country was allowed to conduct fiscal policy without any binding rule, all countries would run excessively expansionary policies because they do not have to care anymore about their external current account balance or about speculation on exchange rate and interest rate markets. Last, a country implementing an expansionary fiscal policy alone will not be strongly affected by the central bank’s rise in interest rate.

The single currency strengthens the interdependence between participating countries through two new channels. First, each country becomes potentially affected by inflation in partner countries as it will lead to a rise in the European Central Bank’s (ECB) single interest rate. If euro area countries still had the possibility to conduct domestic fiscal policy as they wish, this would come into contradiction with having given the ECB a price stability remit (see Box 1). Second, a country unable to ensure sustainable public finances would put at risk the financial stability of the monetary union, which could provoke a rise in long-term interest rates. It should, however, be recalled that a Member State facing financial difficulty is not allowed to ask for the help of the ECB or of any partner countries, which limits the risks of contagion through higher interest rates.

Box 1: On the Compatibility Between a Single Monetary Policy and Independent National Fiscal Policies

The functioning of each Member State economy may be summarised as follows: $y_i = d_i + g_i - \sigma r$ and $\pi_i = \pi_i^0 + \alpha y_i$ where y_i is the level of output in the country i (as deviation from potential output); π_i , inflation rate in the country i , expressed as deviation from the central bank's inflation target); π_i^0 , initial inflation (as deviation from the target) or a price shock; d_i an indicator of private demand and g_i an indicator of public demand (assumed to be equal to the public deficit); r : the single interest rate. It is not possible that each country uses fiscal policy with a view to maintaining full employment, while monetary policy uses the interest rate to keep the aggregate inflation of the area at the desired level. If π_i^0 stands on average above the central bank's inflation target, fiscal and monetary policies will be incompatible. The central bank would raise the interest rate to cut inflation whereas national governments would raise public deficits to maintain full employment. This would lead to a permanent increase in the interest rate and public deficits (Capoen, Sterdyniak and Villa, 1994).

How can this interdependence be managed? A framework for a permanent co-ordination of fiscal policies and monetary policy could have been designed. However, it is difficult to imagine how urgent decisions could have been conditional on negotiations, with no final agreement certain of being reached; an agreement would have been imposed on all countries and would have been a direct constraint on fiscal policies, which is politically difficult. So it was decided to impose constraints on national fiscal policies through the SGP. These constraints are not totally rigid. National policies kept some room for manoeuvre which could compensate for the fact that the rules were not perfectly adapted. But the institutional logic is such that constraints are getting stronger over time: national authorities are becoming progressively entangled in a 'spider web'.

2.1 THE INSTITUTIONAL FISCAL FRAMEWORK

The monitoring of fiscal discipline is based on four elements: criteria inherited from the Maastricht Treaty: the 3 per cent of GDP deficit threshold and the 60 per cent reference value for the ratio of government debt to GDP; an institutional framework to implement fiscal surveillance: the Stability and Growth Pact and a co-ordination process for economic policy: the Broad Economic Policy Guidelines (BEPGs).

What is the objective of this framework? If it is to avoid a country generating negative externalities on partner countries, then the rules should bear directly on these externalities, on the level of domestic inflation or the default risk of public finances. If the objective is economic policy co-ordination, then the ECB and the

Member States should discuss and define in an open process the policies to be implemented in Europe in view of the different national situations. If the objective is to run a common economic policy, then a democratically elected economic government of Europe should be settled. No clear choice has been made between these three possibilities.

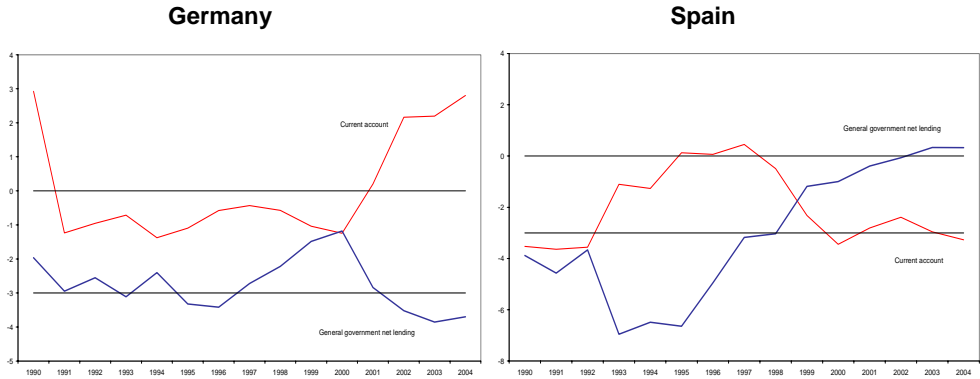
2.2 THE RATIONALE FOR THE 3 PER CENT OF GDP REFERENCE VALUE

The 3 per cent ceiling for deficits is the absolute reference in the current fiscal framework because it is the only criterion which may lead to sanctions. However, it has no economic rationale. Why 3 per cent? The reasons given are awkward. A deficit of 3 per cent of GDP would stabilise the debt level at 60 per cent of GDP under a nominal GDP growth of 5 per cent. But in that case the reference should apply to the cyclically-adjusted balance or to the average borrowing over an economic cycle. Then comes the question: why 60 per cent? The 3 per cent figure would be close to the share of public investment in EU GDP. But, there again, the reasoning can apply only to cyclically-adjusted deficits. The level of the deficit would need to be compared with the observed level of public investment, so that a country implementing public investment programmes would be entitled to a higher deficit.

A country hit by a specific fall in domestic private demand may need a higher than 3 per cent of GDP deficit. *A priori*, this does not raise inflation in the area. Such a deficit could even benefit partner countries since it will prevent the fall in domestic demand which would otherwise negatively affect partner countries' output. In 2003, the public deficit reached 3.9 per cent of GDP in Germany, but inflation was low (1.0 per cent) and the current account in surplus (2.2 per cent of GDP). It is difficult to claim that the German public deficit generates negative spill-over effects in the rest of the area. If there is to be a negative externality, it would be rather that the low level of German demand impeded partners' exports to Germany and thereby negatively affects GDP growth in these countries. Conversely, the current budgetary procedures do not prevent excessive inflation to emerge in a Member State, which will induce excessively high interest rates in the area and may have a negative impact on partner countries. Inflation was growing at an annual rate of 5.1 per cent in the Netherlands in 2001 while government borrowing was in balance. Germany does not fulfil the deficit criterion but runs a significant current account surplus, whereas Spain has a 0 per cent of GDP deficit, but runs a current account deficit (see Figure 1). Inflation or current account deficits may be more dangerous in terms of negative externalities than

public deficits. Why do surveillance procedures control public balance and not external accounts?

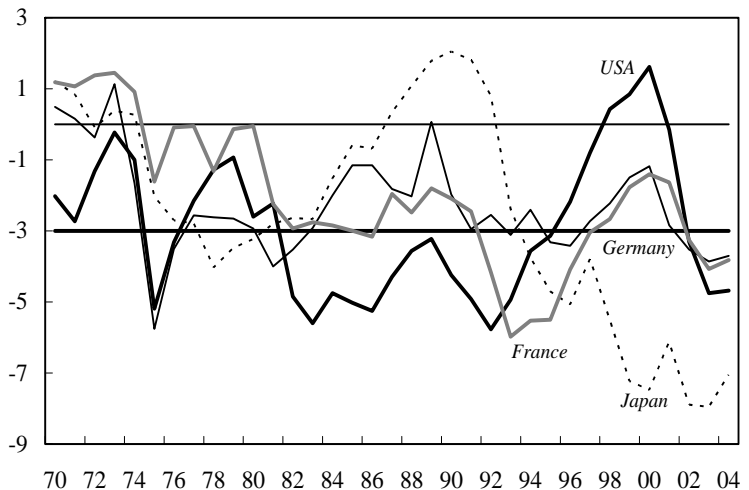
Figure 1: Government Net Lending and Current Accounts (as a Percentage of GDP)



Source: OECD Economic Outlook No. 75, June (2004).

In the past, deficits have been higher than 3 per cent of GDP quite often in industrial countries (see Figure 2) and were then judged necessary to support activity. It could be different now only if monetary policy was more growth-oriented than in the past. But this is not the ECB’s remit. Besides a single monetary policy cannot fit all different national cyclical positions (see Table 1) and cannot react to country-specific cyclical downturns. Hence, euro area countries should be given greater room for budgetary manoeuvre, since they can no longer use the exchange rate and interest rates.

**Figure 2: General Government Net Lending
As a percentage of GDP**



Note: Excluding proceeds relative to UMTS licences in the euro area.
Source: OECD Economic Outlook No. 75, June (2004).

The 3 per cent of GDP requests governments either to strongly reduce cyclically-adjusted borrowing, so that some ‘cyclical room for manoeuvre’ becomes available, or to maintain some cyclically-adjusted deficit and then lose any cyclical room for manoeuvre. Some authors (Artis and Buti, 2000, or Barrell, 2001) evaluate the level of structural deficit needed in each country to prevent public deficits from rising above 3 per cent of GDP in downturns. But such deficits are not optimal, since they are conditional on the arbitrary 3 per cent ceiling.

If we consider that there may be a negative output gap of 3 per cent of GDP in euro area economies and that a 1 per cent fall in GDP generates a 0.5 per cent of GDP rise in public deficits, then deficits of 1.5 per cent of GDP could be allowed in normal times. Let d , the level of public deficit as a share of GDP, b , the level of public debt as a share of GDP, g , nominal output growth. In equilibrium: $b = d / g$. If, as in Germany, g equals 3 per cent, b will converge towards 50 per cent if d equals 1.5 per cent on average. If, as for new members of the Union, g equals 7, b will converge towards 21 per cent. The 3 per cent limit has different consequences in terms of public debt depending on output growth. These consequences have not been explicitly taken into account in the existing fiscal framework. As pointed out by Fitz Gerald *et al.* (2004), the recent enlargement of the Union makes the issue more critical as the new Member States have higher nominal GDP growth potentials than the EU-15 average.

If Member States want to have safety margins to avoid breaching the 3 per cent ceiling in downturns, they need to run restrictive fiscal policies in ‘good times’. But the provisions of the SGP only apply in situations where deficits breach the 3 per cent ceiling, and hence are most likely to operate in downturns, i.e., when running pro-cyclical restrictive policies will add to the weakness of output growth. The Commission wishes to be entitled to react in ‘good times’ (see Section 4). But it is then difficult to define appropriate policies because of the uncertainties on the level of the output gap and on the optimal level of public deficit.

Growth and inflation still differ significantly among euro area economies (see Table 1); output gaps based on OECD estimates fluctuate from -4 per cent of potential GDP in Portugal or Ireland to 0 in Spain for 2004. Under these estimates, the ‘neutral’ interest rate given by a Taylor rule varies at mid-2004 from 1.0 in Germany to 5.7 in Spain and Greece. So the ECB’s interest rate set at 2 per cent is too high for Germany and the Netherlands whereas it is, although at various degrees, too low for the rest of the euro area.

Table 1: Interest Rates, GDP Growth and Inflation Forecasts, June 2004

Country	GDP growth, per cent	Consumer prices, per cent	Differential ⁽¹⁾	Output gap	Interest rate target ⁽²⁾
Germany	1.7	1.4	-1.1	-3.3	1.0
France	2.1	1.9	-2.0	-2.1	3.0
Italy	1.5	2.1	-1.7	-2.7	2.5
Spain	2.9	2.6	-3.5	-0.1	5.7
Netherlands	1.6	1.3	-0.9	-2.9	1.8
Belgium	2.1	1.7	-1.8	-1.5	2.9
Austria	2.1	1.5	-1.6	-2.1	2.3
Finland	2.9	1.1	-2.0	-1.1	2.5
Portugal	1.7	2.2	-1.9	-4.2	3.0
Greece	3.4	3.0	-4.4	-1.3	5.8
Ireland	4.0	2.1	-4.1	-4.2	5.0
Euro area	1.9	1.8	-1.8	-2.3	2.6

(1) Differential between the short-term interest rate (2 per cent) and consumer price inflation plus real GDP growth forecasts for 2004 (as of June 2004).

(2) Defined as $r = g + \pi + 0.5(\pi - 2.0) + 0.5(y - \bar{y})$ where g : potential output growth, π inflation rate and $(y - \bar{y})$: OECD's output gap.

Sources: Consensus Economics, OECD *Economic Outlook*, No. 75, June (2004), own calculations.

There is no certainty that a single interest rate will lead a single public deficit to GDP ratio to be optimal for each country, independently of the strength of domestic private demand. Public deficits targets do not ensure that countries will fulfil the inflation target. A country with buoyant private demand may have both high inflation and a fiscal surplus. Such norms for deficits restrict the possibility for countries to run countercyclical fiscal policies. Each country of the euro area will see falls in domestic output if demand or inflation are high in partner countries (see Box 2). Conversely, the fiscal policy needed to stabilise domestic demand and to keep inflation under control, is such that an economy operating at below capacity should be entitled to run some government deficit whereas countries in a better cyclical position should run some budget surplus.

Box 2: Stabilisation Policies and Fiscal Rules

There is no evidence that different countries having the same interest rate should implement the same fiscal policy. Let us consider the model presented in Box 1. In order to reach the single inflation target, each country has to target a level of output such as: $y_i = -\pi_i^0 / \alpha$. The central bank, considering the aggregated situation of the area, will set the interest rate as: $r = (\sum d_i + \sum \pi_i^0 / \alpha) / n\sigma$; i.e. at the level that allows reaching the inflation target with government budget in balance (n being the number of countries assumed to be of similar size). It follows that each country should be allowed to run a public deficit of:

$g_i = -d_i - \pi_i^0 / \alpha + (\Sigma d_i + \Sigma \pi_i^0 / \alpha) / n$. National deficits will differ so as to take account of different national cyclical positions and to equalise inflation rates. *Ex post* the level of output in each country will only depend on domestic factors.

Conversely, let us assume that each country is requested to keep its deficit at $g_i = 0$. Under the central bank's interest rate rule, domestic output levels are: $y_i = d_i - (\Sigma d_i + \Sigma \pi_i^0 / \alpha) / n$. This level is not compatible with the inflation target. Each country must let domestic output fluctuations depend on internal demand and so will implement a sub-optimal policy. The country is negatively affected by rising demand or inflation in partner countries.

The Treaty establishing the European Community mentions the necessity for Member States to maintain their debt to GDP ratios below a reference level (60 per cent), unless the ratio is 'diminishing and approaching the reference level at a satisfactory pace'. In practice, the debt limit has not been considered since 1997, since several Member States with debt largely above 60 per cent of GDP (Italy, Belgium and Greece) were allowed to join the monetary union. However, the debt ratio is the relevant criterion to assess fiscal sustainability although it is difficult to define the level above which default risk emerges (public debt reached 138 per cent of GDP in Belgium in 1993 without any default risk emerging) and the optimal debt level.

2.3 THE RATIONALE FOR MEDIUM-TERM BUDGETARY POSITIONS IN BALANCE

The SGP requires euro area countries to present a stability programme at the end of each year. This programme must provide a macroeconomic projection and a budgetary plan for the current and the three following years. It has to target a budgetary position 'close to balance or in surplus' in the medium run. So, the 3 per cent and the 60 per cent limits both turn out to be zero in practice.

The rationale for a medium-term balanced budget has no clear economic justification. A country where private savings are spontaneously too low (high) may need some budget surplus (deficit). It is also reasonable to finance public investment through government borrowing and therefore some public deficit may be justified. The justification given by the Commission is that budgetary positions in balance will allow policies to react to normal cyclical fluctuations without breaching the 3 per cent of GDP limit (itself arbitrary).

In a situation of relatively low private demand, running a government budget in balance may require such a low level of interest rate that the objective will be out of reach. From 1970 to 2002, the budget was in surplus in the US only from 1998 to 2000 (3 years out of 33); in the UK in 1970, 1971, 1988, 1989 and from

1998 to 2001 (8 years). This never happened in the euro area; in Germany in 1970, 1973, 1989 (3 years), in France from 1970 to 1974, in 1977 and 1980 (6 years). The Pact intends to impose as a permanent reference a situation that occurred only rarely in the past.

A deficit kept permanently at 0 per cent of GDP would lead nominal public debt to be stable and constantly declining as a percentage of GDP down to 0. But savers, in particular pension funds, need to own public assets, because these are long term, liquid and safe assets. If savers wish to own interest-bearing financial assets while private companies are reluctant to borrow, 0 per cent of GDP public deficits and debts may require low long-term interest rates, below GDP growth, which would not be optimal. If demand for bonds exceeds supply, a country that controls its domestic interest rate may cut it. But in a country not having control of interest rates, higher public deficits and debts are needed. Paradoxically, the independence of the central bank is a major cause for higher public deficits (Creel and Sterdyniak, 1995). The stability of a debt to GDP ratio at 40 per cent for instance would be a more reasonable medium-term objective. With nominal GDP rising by 4.5 per cent per year, it would allow a cyclically-adjusted deficit of 1.8 per cent of GDP.

2.4 THE STABILITY AND GROWTH PACT AND ECONOMIC POLICY CO-ORDINATION

The procedure of the stability programmes implies that governments are able to make reliable forecasts on a four-year horizon, and to commit themselves to implementing a fiscal policy in line with this projection. Governments are likely to be tempted to present an optimistic forecast, showing strong and sustained output growth bringing government borrowing into balance in a four-year time horizon. But what shall be done if GDP growth turns out to be lower than forecast? If a depressive shock occurs, should countries keep their fiscal policy stance unchanged? Should they stick to the forecasted deficits (meaning in practice tightening their policies) or should they rather maintain announced public spending and taxation (meaning accepting rising deficits)? Forecasting economic activity without errors is impossible in practice, even on a 1-year horizon. Hence, the procedure of an annual submission of stability programmes generates permanent tensions between governments wishing to keep the possibility to adapt fiscal policy to the current circumstances and the Commission claiming for a strict fulfilment of the stability programmes.

Fortunately, the horizon for budgetary positions to be in balance is a medium term one. This could have left room for a soft interpretation of the provisions of the Pact, where the medium run

target would have been indicative. The objective started to be more binding when a given year was chosen for government borrowing to be in balance (2002, then 2004, then 2006) independently of the cyclical situation.

If the procedure were strictly followed, it would put a strong constraint on fiscal policy in the countries where fiscal deficits remain. For example, general government borrowing reached 3.3 per cent of GDP in France in 2002. The fulfilment of the commitment made in Seville in 2002 to reach a balanced budgetary position in 2004 would have required the French government to cut borrowing by 1.6 per cent of GDP both in 2003 and in 2004: a contractionary policy should have been run these two years, independently of the economic situation. The lower output growth, the stronger the budgetary effort. Fiscal policy is necessarily procyclical in the path towards equilibrium.

In theory, stability programmes put strong constraints on fiscal policies. In practice, coalitions have happened to emerge in the Council not to vote the Commission recommendations.¹ Member States are not compelled to follow the recommendation as long as their deficit remains below 3 per cent of GDP. This is the 'bad example' shown by France in September 2002 when the government refused to present a stability programme showing a budgetary position in balance in 2004, and not even in 2006.

The procedure is not economic policy co-ordination, but a forced convergence toward *a priori* defined norms of public finance. The Commission does not set a target of economic growth in Europe and does not define a strategy to reach it. Monetary authorities do not take part in the process. The cyclical position of the European economy, global or country-specific, is only partly taken into consideration. National stability programmes are evaluated separately, without analysing the impact they will have on partner countries. With the view that discretionary fiscal policy must be avoided and that automatic stabilisers may be allowed to run only in countries where budgetary positions are in balance, whereas efforts should be intensified in the countries where it is not the case, it is difficult anyway to see what co-ordination the Commission could organise.

A satisfactory co-ordination process would consist in examining precisely the economic situation of the area as a whole in terms of inflation and output growth in order to set the appropriate level of interest rates, before analysing a comparison of the national situations in detail so as to set adequate national fiscal policies (see Box 3).

¹ The State concerned takes part in the vote, contrarily to votes on the EDP.

2.5 THE LIMITS OF THE BROAD ECONOMIC POLICY GUIDELINES (BEPGs)

The procedure of BEPGs is not much reported in the press and in public opinion. How could Member States accept to bind their policies to comply with decisions made by technocratic committees without any democratic debate? The BEPGs refer mainly to structural policies. In line with the Lisbon strategy, they focus on 'making Europe the most competitive and dynamic knowledge-based economy by the year 2010'. They focus more on the need to cut deficits than to support activity, advocating a preference for lower tax and public expenditure. In our view this should remain a national choice: each country should remain free to choose the organisation of its pension, health or education systems.

Box 3: An illustrative Example of Co-ordination

Six countries of the same size are assumed to form the area (see Table A). Column 1 shows the *ex ante* demand level, column 2 the level of inflation (both in deviation from the objective). The strategy chosen is that any gap between actual inflation and the objective should be reduced by half during the period. The desirable situation may then be calculated (columns 3 and 4). The average impulse needed in terms of output (+0.5) is provided by monetary policy (column 5). The fiscal policy answer adapted to each domestic situation is shown in column 6: countries A, C and D must run an expansionary fiscal policy. Countries B and F, where inflation is too high, need to run a restrictive fiscal policy and to accept a negative output gap.

Table A: An Example of Economic Policy Co-ordination

	Initial situation		Targeted situation		Impulse	
	Demand	Inflation	Output	Inflation	Monetary	Fiscal
A	-2	0	0	0	0.5	1.5
B	-1	2	-1	1	0.5	-0.5
C	-1	-1	0.5	-0.5	0.5	1.0
D	-1	0	0	0	0.5	0.5
E	0	-1	0.5	-0.5	0.5	0.0
F	1.5	1	-0.5	0.5	0.5	-2.5

* Monetary policy: $r = -0.5$

Note: In each country, production is determined by: $y_i = d_i + g_i - r$; inflation by: $\pi_i = \pi_i^0 + y_i$.

National fiscal policies are under the control of three Community procedures suffering questionable economic rationale and insufficient democratic legitimacy. Public finance criteria become objectives to be fulfilled by Member States independently of any economic rationale. A deficit higher than 3 per cent of GDP in one country therefore becomes harmful, not because of negative spillovers, but rather that it endangers the credibility of the Commission's surveillance process.

From 1977 to 1992, public debts rose from 30.5 to 60.5 per cent of GDP in the euro area. The cumulated increase reached 60 percentage points in Belgium, 70 percentage points in Greece, 50 percentage points in Italy. This led virtuous countries like Germany to ask for the introduction of a mechanism that would protect themselves from less virtuous countries. Besides national and European technocracies, financial and business leading circles wanted to use the creation of EMU as an opportunity to modify the conduct of fiscal policies in Europe, to stop and even reverse the increase of public spending and debts. So they advocated for rigid and enforceable rules to control national governments, accused to have, for electoral reasons, expansionist and extravagant biases. In this context, the existing fiscal framework cannot be justified by purely economical reasons. The Commission set a four pillar strategy – the 3 per cent limit, the medium-term budgetary position in balance, cuts in public spending and the avoidance of discretionary fiscal policies – to impose a liberal strategy: to deprive the national governments of any freedom of action; to ask them to undertake structural reform. The conflict between national governments and European institutions was ineluctable when these constraints would appear too rigid, i.e. in the first downturn.

3. The Stability and Growth Pact: An Assessment

The lack of fiscal discipline is not the original sin of the European Union Member States. Net public debt was only 20 per cent of GDP in 1979, before the surge in real interest rates; 36 per cent in 1989, before the Maastricht Treaty. In the 1990s public debt levels rose mainly due to real interest rates being kept at excessive levels as compared to real output growth. Public deficits had widened to 5.8 per cent of GDP in 1993. Member states had to run expansionary fiscal policies in face of the weakness of private demand and of the restrictive stance of monetary policy. In 1996 and 1997 the candidate countries to the euro area ran restrictive fiscal policies to meet the Maastricht criteria, which led to a surplus of 2.9 per cent of GDP of the euro area structural primary balance in 1997 (see Figure 3). After the launch of the euro, the area structural primary balance surplus declined to 1.2 per cent of GDP in 2002 and remained close to that level since then.

3.1 1997-2000: FAVOURABLE ECONOMIC CONDITIONS

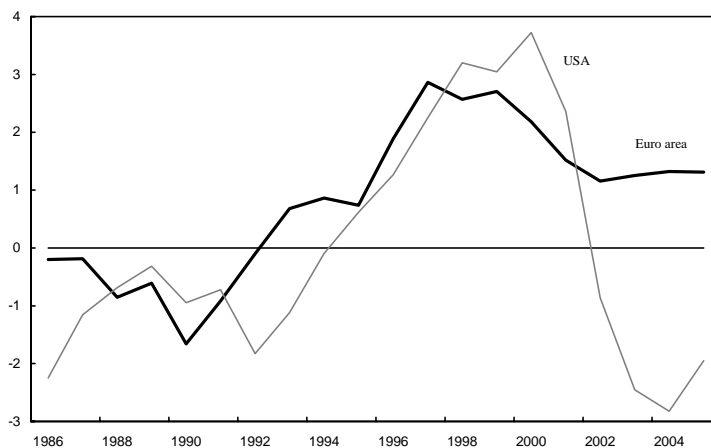
European economies grew at a rapid pace from 1997 to 2000. The euro area public deficit shrunk from -2.6 per cent of GDP in 1997 to -1.0 in 2000 (excluding one-off proceeds relative to UMTS licences). Lower interest payments explained 1 percentage point of the reduction, the effects of the economic cycle 1.3 percentage points, whereas discretionary measures increased the deficit by 0.7

percentage point (see Table 2). The cyclical improvement allowed public balances to move away from the excessive deficits threshold. Owing to faster than anticipated output growth (see Table 3), Member States easily fulfilled the objectives of their stability programmes. At the end of 2000, governments could announce that government borrowing would be in balance in 2004, albeit implementing fiscal reforms that were deteriorating public balances. In the stability programmes' updates of late 2000, the euro area public deficit was anticipated to be cut by 0.7 per cent of GDP between 2000 and 2003 due to lower interest payments (0.3 percentage points) and a positive cyclical effect (1 percentage point), while a positive fiscal impulse of 0.6 percentage points was expected.

The European authorities (the Commission and the ECB) deplored that Member States did not use the cyclical upturn to bring more rapidly their deficits close to balance. Three reasons may be given in favour of the chosen fiscal policy stance. First, Europe should target an unemployment rate of 5 per cent – well below the Commission's estimate of an equilibrium unemployment rate at 9.3 per cent – which would require output to grow by at least 3 per cent per year over five years, instead of 2.3 per cent as implicitly stated by the Commission. If this objective for unemployment is credible, there was a negative output gap of around 3.5 per cent in 2000 and a cyclically-adjusted budget surplus of 0.7 per cent of GDP. No restrictive fiscal policy was therefore needed. Output growth would bring budgetary positions back in balance. Second, a cyclically-adjusted deficit of 2.7 per cent of GDP stabilises public debt at 60 per cent of GDP in an economy growing at an annual rate of 4.5 per cent in nominal terms. A deficit of 1.5 per cent of GDP allows for some decline in the debt to GDP ratio. The euro area considered as a whole had therefore significant budgetary room for manoeuvre (of around 2 per cent). Last, a country with high unemployment, rapid GDP growth and no inflationary pressures may wish to see the continuation of this economic cycle for as long as possible. The government may prefer to implement necessary fiscal reforms (like tax cuts or lower social contributions) rather than slow growth with a restrictive fiscal policy, especially as there is no certainty that budgetary efforts would be offset by monetary loosening.

Figure 3: Euro Area and US Cyclically-Adjusted Primary Government Balance

Per Cent of Potential GDP


Table 2: General Government Balances in the Euro Area

	Percentage of GDP							
	1997	1998	1999	2000	2001	2002	2003	2004
General government balance ⁽¹⁾	-2.6	-2.3	-1.3	-1.0	-1.7	-2.3	-2.7	-2.8
Cyclical component ⁽²⁾	-0.9/-0.4	-0.5/-0.1	-0.1/0.3	0.4/0.9	0.3/0.8	-0.3/0.1	-0.9/-0.6	-1.1/-0.6
Interest payments	4.6	4.4	3.9	3.6	3.5	3.2	3.1	3.0
Cyclically-adjusted primary balance	2.9	2.6	2.7	2.2	1.5	1.2	1.3	1.3

Notes: (1) Excluding proceeds relative to UMTS licences. (2) OECD *Economic Outlook*, No. 75, June (2004). In Italics, numbers of the Commission, Spring (2004) *Economic Forecasts*.

Sources: European Commission, OECD.

Table 3: Euro Area GDP Growth and General Government Balances According to the Stability Programmes

	GDP growth assumptions (per cent)							General government balance (per cent of GDP)						
	J99	J00	J01	J02	J03	J04	Actual	J99	J00	J01	J02	J03	J04	Actual
98	2.8						2.9	-2.1	-1.9					-2.3
99	2.5	2.2					2.8	-1.7	-1.4	-1.2				-1.3
00	2.6	2.8	3.3				3.5	-1.5	-1.1	-0.7	-0.8			-1.0
01	2.6	2.5	3.1	1.7	1.5		1.6	-1.0	-0.8	-0.6	-1.2	-1.6		-1.7
02		2.5	2.9	1.9	1.0		0.9		-0.6	-0.3	-0.9	-2.2		-2.3
03		2.5	2.8	2.6	2.1	0.6	0.4		-0.2	0.0	-0.5	-1.8	-2.7	-2.7
04			2.8	2.6	2.6	1.9	1.7*			0.4	0.1	-1.1	-2.4	-2.7*
05				2.6	2.6	2.5	2.3*				0.3	-0.6	-1.8	-2.6*
06					2.6	2.5						-0.2	-1.3	
07						2.5							-0.9	

* European Commission, Spring (2004) *Economic Forecasts*.

Sources: European Commission, Stability programmes, authors' calculations.

3.2 2001-2004: THE DIFFICULT YEARS

Public deficits rose gradually under the effect of the economic slowdown in 2001 and 2002. Fiscal reforms or public spending programmes launched in 2000 contributed to raise public deficits in some countries (Germany, the Netherlands and Ireland). Deficits started to rise again in almost all euro area Member States. Expansionary fiscal policies were all the more needed to support activity that monetary policy was not very active. There was a slightly positive fiscal impulse in the area: 0.7 percentage points in 2001 (mainly due to Germany) and 0.3 in 2002. The updates of the stability programmes presented in early 2002 were still counting on a significant economic upturn in 2002. All countries with the exception of France and Ireland were maintaining the objective of balanced or in surplus budgets in 2004. Euro area public deficits were expected to be cut by 1.3 per cent of GDP between 2001 and 2004, with lower interest payments contributing to 0.3 percentage points and discretionary measures to 1 percentage point: governments were committing themselves to run restrictive budgetary policies, independently of the economic situation.

In 2002, two alternative views were proposed. According to some governments, particularly the French, it was important both to support activity in the downturn, in the absence of inflationary pressures and to fulfil electoral promises of tax cuts. In the view of European authorities, the credibility of the SGP procedures was weakened by actual deficits well above the targets presented in the stability programmes and by some governments unwilling to introduce the corrective measures needed to reach their targets for deficits in 2004. But the warnings of the European authorities were inappropriate given the economic situation and therefore were hardly listened to. The euro area deficit reached 2.3 per cent of GDP in 2002 instead of 0.9 per cent as anticipated in the stability programmes released earlier that year (see Table 3). However, the deficit was modest in comparison with past similar circumstances: 4.9 per cent of GDP in 1986 and 4.3 per cent in 1996.

The early 2003 updates of stability programmes expected a negative fiscal impulse of 0.5 per cent of GDP each year in 2003 and 2004 and of about 0.3 per cent of GDP each year in 2005 and 2006 for the euro area. This was particularly worrying as growth prospects were uncertain, especially for 2003. Deficits were expected to shrink from 2.2 per cent of GDP in 2002 to 0.1 per cent of GDP in 2006, with cyclical improvement contributing to 0.35 percentage points, lower interest payments to 0.25 percentage points and budgetary efforts to 1.6 percentage points. Germany, Portugal, Italy and the Netherlands endorsed significant restrictive budgetary measures in 2003, but France postponed them to 2004.

Almost all countries said they would reach the close-to-balance target in 2006. However, this was conditional on an annual 3 per cent real GDP growth in Italy. Germany anticipated a negative fiscal impulse of 1 per cent of GDP per year during four years. The French deficit was expected to remain around 1 per cent of GDP in 2006, after three years of an annual negative fiscal impulse of 0.4 per cent of GDP. Growth turned out to be significantly lower than expected in the euro area in 2003 (0.5 per cent against 2.1 per cent) and public deficits reached 2.7 per cent of GDP (against 1.9 per cent). Several countries (Germany, Italy, the Netherlands) did not implement the fiscal consolidation they had announced.

Table 4: Stability Programmes, Early 2004

	2002	2003	2004	2005	2006	2007
Real GDP growth, per cent						
Germany	0.2	-0.1	1.7	2.3	2.3	2.3
France	1.2	0.5	1.7	2.5	2.5	2.5
Italy	0.4	0.5	1.9	2.2	2.5	2.6
Spain	2.0	2.3	3.0	3.0	3.0	3.0
The Netherlands	0.2	0.0	1.0	2.5	2.5	2.5
Belgium	0.7	0.9	1.8	2.8	2.5	2.1
Austria	1.4	0.9	1.9	2.5	2.5	2.4
Finland	2.2	1.4	2.7	2.5	2.4	2.4
Portugal	0.4	-0.7	1.0	2.5	2.8	3.0
Greece	3.8	4.0	4.2	4.0	3.8	3.8*
Ireland	6.9	2.2	3.3	4.7	5.2	5.2*
Euro area	0.6	0.6	1.9	2.5	2.5	2.5
General government balance, per cent of GDP						
Germany	-3.5	-4.0	-3.3	-2.5	-2.0	-1.5
France	-3.1	-4.0	-3.6	-2.9	-2.2	-1.5
Italy	-2.3	-2.5	-2.2	-1.5	-0.7	-0.1*
Spain	0.1	0.5	0.0	0.1	0.2	0.3
The Netherlands	-1.6	-2.3	-2.3	-1.6	-0.9	-0.6
Belgium	0.1	0.2	0.0	0.0	0.0	0.3
Austria	-0.1	-1.3	-0.7	-1.5	-1.1	-0.4
Finland	4.2	2.3	1.7	2.1	2.1	2.2
Portugal	-2.7	-2.9	-2.8	-2.2	-1.6	-1.1
Greece	-1.2	-1.4	-1.2	-0.5	0.0	0.5
Ireland	-0.2	-0.4	-1.1	-1.4	-1.1	-1.0
Euro area	-2.2	-2.7	-2.4	-1.8	-1.3	-0.8
Fiscal impulse, per cent of GDP						
Germany	0.1	-0.4	-0.7	-0.5	-0.2	-0.2
France	1.0	0.1	-0.8	-0.7	-0.6	-0.7
Italy	-0.3	0.2	-0.1	-0.5	-0.4	-0.1*
Spain	-0.5	-0.4	0.6	0.0	-0.3	0.0
The Netherlands	0.8	-0.3	-0.4	-0.6	-0.6	-0.2
Belgium	0.0	-0.2	0.6	0.5	0.3	-0.2
Austria	0.2	0.8	-0.7	1.0	-0.2	-0.6
Finland	1.4	1.4	0.9	-0.2	0.0	-0.1
Portugal	-2.5	-1.6	-0.9	-0.8	-0.6	-0.4
Greece	1.0	1.3	0.5	-0.1	-0.1	-0.1*
Ireland	2.1	-1.2	-0.2	0.2	-0.2	0.0*
Euro area	0.3	-0.1	-0.3	-0.5	-0.3	-0.2

* Own assumptions.

Sources: *Stability programmes*, Fifth updates, end 2003/early 2004. Own calculations.

The early 2004 Updates of the Stability Programmes anticipated negative fiscal impulses in 2004, 2005 and 2006 (see Table 4). The German, French, Dutch, Portuguese and Italian programmes indicate restrictive fiscal policies of up to an annual 0.8 per cent of GDP in 2004 and 2005, which would not be sufficient to bring the deficits back to 0 in 2007 according to four of the programmes and is also likely to be the case for Italy. Only five countries look 'virtuous' in terms of deficits: Finland, Spain, Belgium, Ireland and Austria. Belgium and Austria have, however, a debt above the 60 per cent limit. From 2003 to 2007, the euro area public deficit is expected to decline by 1.7 percentage points, 1.3 points resulting from restrictive fiscal policy and 0.4 from the reduction of the cyclical part of the deficit.

Table 5: Public Balances in 2004

Per Cent of GDP	Fiscal Impulse 2003		Fiscal Impulse 2004		Public Balance	Structural Public Balance	
	J03	Actual	J04	OECD	OECD	OECD	EC
Germany	-1.2	-0.4	-0.7	-0.4	-3.7	-2.0	-2.9
France	-0.2	0.1	-0.8	-0.5	-3.8	-2.9	-3.4
Italy	-0.3	0.2	-0.1	0.5	-3.1	-1.9	-2.6
Spain	-0.1	-0.4	0.6	0.1	0.3	0.4	0.6
Netherlands	-0.3	-0.3	-0.4	-0.4	-3.1	-1.1	-1.7
Belgium	0.5	-0.2	0.6	0.9	-0.7	0.8	0.0
Austria	0.5	0.8	-0.7	-0.2	-1.3	-0.7	-0.9
Finland	1.2	1.4	0.9	0.9	1.6	2.3	2.1
Portugal	-1.2	-1.6	-0.9	0.7	-3.2	-2.1	-2.1
Greece	0.3	1.3	0.5	0.4	-3.8	-3.8	-4.1
Ireland	-1.1	-1.2	-0.2	0.3	-0.5	-0.7	-0.3
Euro area	-0.6	-0.1	-0.3	0.0	-2.8	-1.6	-2.2

Sources: Stability Programmes, end 2002 and 2003 updates, European Commission, Public Finances in EMU 2004; OECD *Economic Outlook* No. 75.

If we compare the commitments made in the latest updates of the programmes with June 2004 OECD forecasts, it seems once again that most countries will not implement the planned budgetary effort in 2004 (see Table 5). Thus, it is very likely that deficits will still exceed the 3 per cent limit in six euro area countries in 2004: Germany, France, Italy, the Netherlands, Greece and Portugal. The United Kingdom deficit will come very close to the limit (2.9 per cent according to the OECD).

From 1997 to 2002, the structural primary balance of the euro area declined from 2.9 per cent of GDP to 1.3 per cent and has stayed at this level since then. The Commission did not succeed in having Member States pursuing fiscal efforts after 1997: countries suffered from 'fiscal tiredness'. The European procedures seem to have had little impact on national policies. However, there is no certainty that a higher surplus is required on economic grounds.

3.3 THE EXCESSIVE DEFICIT PROCEDURE: IMPLEMENTATION AND IMPEDIMENTS

The widening of public deficits in a context of decelerating activity led the Commission to initiate the excessive deficit procedure (EDP) for a growing number of Member States. In November 2002, the Commission submitted a recommendation to the Council to initiate the EDP against Portugal (for year 2001) and Germany (for 2002) and recommended the sending of an early warning to France (for 2003). The Council adopted these recommendations on 21 January 2003. In April 2003, the Commission sent a recommendation to the Council to launch an EDP against France (for year 2002). This recommendation was adopted by the Council on 3 June 2003: the French government, which planned a deficit of 3.4 per cent of GDP for 2003, was asked to reduce it below 3.0 in 2004, then to reduce the structural deficit by at least 0.5 percentage points a year. Denmark and the Netherlands voted against this recommendation because it did not oblige France to implement restrictive measures in 2003 and allowed the public deficit to exceed the 3 per cent limit during two consecutive years (2002 and 2003) without fines.

The crisis erupted at the Council meeting of 25 November 2003. It was then clear that deficits would exceed the 3 per cent limit in 2004 for the third consecutive year in France and Germany. The two “sinners” refused to undertake restrictive fiscal policies in “bad times” and to implement the significant cuts needed to bring government deficits below the 3 per cent limit (implying a cut of 1 per cent of GDP in 2004). For the Commission and for several Member States (Spain, Finland, Austria and the Netherlands) strongly committed to the SGP, this was not acceptable because this was destroying the credibility of the Pact. The Commission submitted a recommendation to the Council asking France to present before the end of 2003 a budgetary programme including a reduction of 1 per cent of GDP of its structural deficit in 2004 and of 0.5 per cent in 2005. France would have to present in each quarter the situation of its public finances to the European authorities. This recommendation did not achieve the qualified majority. It obtained 30 votes (Belgium, Greece, Spain, the Netherlands, Austria and Finland), while there were 30 votes against (Germany, Italy, Portugal, Luxembourg and Ireland).² The Council adopted a less stringent conclusion accepted by the French government (Spain, Finland, Austria and the Netherlands voting against): France will have to reduce its structural deficit by 0.8 percentage points in 2004 and by 0.6 in 2005, so that the deficit falls below 3 per cent of GDP in 2005; thereafter the structural deficit

² The State concerned does not take part in the vote.

will have to be cut by an annual 0.5 percentage points until the close-to-balance target is reached. The EDP was held in abeyance and no fines imposed. Similarly, the Commission recommendation on Germany (a reduction in the structural deficit of 0.8 per cent of GDP in 2004 and 0.5 per cent in 2005 and quarterly reports) was not adopted by the Council, which required instead a reduction of 0.6 per cent of GDP in 2004 and 0.4 per cent in 2005.

The Commission considered that the non-adoption by the Council of its recommendations was not in conformity with the commitment made by the Member States when signing the SGP: procedures and fines are automatic; Member States have the obligation to adopt the Commission recommendations if the conditions are met. So the Commission brought an action before the Court of Justice of the European Communities. According to the majority of the Member States, the Council is entitled to take the economic situation into consideration. The paradox is that these countries did not suggest any reform of the SGP; they still – at least officially – agree on the principle of cutting public deficits notwithstanding the economic situation and do not try to improve economic policy co-ordination in Europe. The votes expressed in the November Council gave the unpleasant feeling to small Member States that there are two kinds of countries in the EU: the smaller ones, which have to obey the rules and the larger ones which may decide not to obey. But fiscal policy is needed more in larger countries than in smaller ones, as the latter may more easily use fiscal (like Ireland) or wages (like the Netherlands) competition, benefit from European subsidies (Ireland, Spain) or from low real interest rates, as compared to their GDP growth rates (Spain, Ireland, Greece).

In the first quarter of 2004, the Council examined Member States' Stability Programmes and noted, although deploring it, that the German and French Programmes were not fully conforming to the Pact. In May, the Council did not launch an early warning procedure against Italy, contrary to the Commission recommendation, which might be considered at the Commission as "*un renvoi d'ascenseur*" from France and Germany following the Italian vote of 25 November. Government borrowing is expected to reach 3.2 per cent in Italy this year under the Commission estimates (instead of 2.2 in Italy's Stability Programme) and 4.0 per cent in 2005, with public debt at 106 per cent of GDP. In June, the Council agreed to launch the EDP against the Netherlands. The Commission proposed, at the end of June, to launch the EDP against the Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia, and Greece. So, five of the twelve euro zone countries and six of the ten new acceding countries are subject to the EDP. But, following the Commission recommendations, the Council of 5 July 2004 allowed some delay to five of the new members before

bringing their deficits below 3 per cent: 2006 for Malta, 2007 for Poland and Slovakia, 2008 for the Czech Republic and Hungary, due to ‘special circumstances’ (‘structural adjustment in the context of their recent accession to the EU’).

Table 6: Member States Under the Excessive Deficit Procedure, June 2004

In 2004	Government balance, per cent of GDP	Government debt, per cent of GDP	Inflation, per cent	Current account, per cent of GDP
Greece	-3.2*	102.8	3.4*	-6.4*
Czech Republic	-5.9*	40.6	2.8	-6.8*
Cyprus	-4.6*	74.6*	2.2	-3.7*
Hungary	-4.9*	58.7	6.9*	-5.4*
Malta	-5.9*	73.9*	1.8	-4.3*
Poland	-6.0*	49.1	2.3	-2.3*
Slovakia	-4.1*	45.1	8.2*	-2.5*
Netherlands	-3.5*	56.3	2.0	3.8
United Kingdom	-2.8	40.1	1.6	-2.1*
France	-3.7	64.6*	1.9	0.9
Germany	-3.6*	65.6*	1.3	2.9
Portugal	-3.4*	60.7*	2.0	-3.9*
EU-15	-2.6	64.2	1.8	0.6
EU-25	-2.7	63.4	1.8	0.2

Source: European Commission, Public finances in EMU 2004 for government variables, Spring Forecasts otherwise.

On 13 July 2004, the Court of justice did not condemn the non-adoption by the Council of the Commission recommendations against France and Germany. According to the Court, the Council has a discretion in the implementation of the EDP. So, the logic of the Pact, which was to sanction automatically deficits above 3 per cent of GDP, is broken. But the Court stated also that the Council cannot hold the EDP in abeyance and cannot modify the recommendations for correcting an excessive deficit without an initiative from the Commission. So, the Council’s conclusions of 25 November were annulled. The EDP appears to require an agreement between the Commission and a qualified majority in the Council. Without this agreement, the procedure comes to a standstill.

4. The Reforms Proposed by the European Commission

In July 2001, the Ecofin Council adopted the first reform of the procedures (European Commission, 2002a). The objective was to provide a ‘more effective surveillance’. Countries shall present their annual stability programme before 1 December. The assumptions for the world economy outside the European Union shall be provided by the Commission. Domestic policies have to be in line with the BEPGs. The medium-term target must fulfil the rule of balanced budgets. But it also has to enable a rapid decline in the

debt to GDP ratio and to provide room for manoeuvre for future ageing-related expenditure. The stability programmes will have to incorporate a projection of the impact of ageing populations on public finance sustainability. Member States will be asked to commit themselves to undertake in the course of the year the correcting measures necessary to reach the targets set in their plans. Member States have to bring cyclically-adjusted public deficit into balance and then to maintain a structural position in balance or in surplus.

The reference to ageing populations is a way of putting permanent pressure on countries so that they reduce the burden of old-age pensions public spending or run budget surpluses to guarantee the future funding of pensions. But no country intends to finance the future rise in pension spending through a permanent public deficit, which would be impossible anyway. If a country is willing to finance the future increase in social expenditure through higher social contributions, there will be no impact on partner countries. Besides it is difficult to imagine how countries can fulfil the objectives of their programmes when GDP growth turns out to be much lower than expected. Should pro-cyclical policies be run? *If it was applied, the text would deprive the national governments of any freedom; they would only be allowed to let automatic stabilizers play.* This limitation is not in the Treaty. In spite of its important implications, the text was adopted by the Ecofin Council without any public and open debate.

On 18 October 2002, Romano Prodi, EC President, said: 'I know very well that the Stability Pact is stupid, like all decisions that are rigid'.³ Romano Prodi proposed (*A stronger, better Stability and Growth Pact*, 21 October) that economic policy co-ordination should be in the hands of a 'strong authority' which 'can both apply the rules strictly to prevent behaviour that is off-course and adapt the rules to changing circumstances. By its very nature, the Commission is therefore naturally suited to this steering role'. So Romano Prodi proposed the adoption of less rigid rules as the counterpart of stronger powers given to the Commission, although he did not set out how the Commission would implement these powers.

On 21 November 2002, the European Commission (2002b) presented a set of measures to 'strengthen the co-ordination of budgetary policies':

- (1) The 'close-to-balance or in surplus' requirement of the SGP should be interpreted in terms of cyclically-adjusted budget balances, as estimated by the Commission.
- (2) National structural deficits will have to be cut by at least 0.5 per cent of GDP per year, even more rapidly in countries having a high deficit or debt, or 'favourable growth conditions'. Once the close-to-balance or in surplus

³ "Je sais très bien que le Pacte de stabilité est stupide, comme toutes les décisions qui sont rigides", *Le Monde*, 18 October (2002).

requirement is reached, automatic stabilisers will be allowed to run but expansionary discretionary budgetary policies will not.

- (3) To avoid the occurrence of expansionary fiscal policies in times of favourable growth, countries must run budget surpluses when they have a positive output gap.
- (4) The Commission wishes to give its authorisation for a 'small temporary deterioration in the underlying budget position' to the countries which undertake structural reforms in line with the Lisbon strategy. But these countries must have a debt well below 60 per cent of GDP and a low level of implicit debt on public pensions; they must keep a safety margin to avoid breaching the 3 per cent reference value.
- (5) 'The sustainability of public finances should become a core policy objective'. The Commission wants to give more importance to the debt criterion of the EDP. Countries with debts above 60 per cent of GDP will have to present a debt reduction strategy in their stability programme.
- (6) 'Member States should reaffirm their political commitments to the SGP'. They should endorse a resolution to strengthen fiscal policy co-ordination, including the commitment to cut structural deficits by at least 0.5 per cent of GDP a year, to reduce significantly debt levels when they are higher than 60 per cent of GDP, to facilitate the implementation of the enforcement procedures of the Pact.
- (7) The Commission wants to take account of the 'quality of the public finances'. It wants to make sure that countries will reduce government borrowing through expenditure cuts and not through higher taxation, and that public spending will be productive. The Commission intends to strengthen its surveillance of Member States, to carry out country studies and to make them public.
- (8) The Commission wants 'more effective enforcement procedures' of the Pact: the early-warning mechanism should be activated more rapidly and more automatically; the Commission would issue early-warnings directly to Member States without a Council's vote; warnings would possibly be sent to the countries undertaking expansionary policies in good times; the EDP could be launched against countries where insufficient efforts to bring public debts below 60 per cent of GDP are made.
- (9) The Commission wants to have 'a better communication through openness and transparency'. Hence it will publish in July each year a report giving an assessment of national budgetary developments and general orientations of fiscal

policies. Member States will have take account of the Commission's report in the preparation of their budgets.

The Commission accepted that the assessment of the medium-term target (but not the 3 per cent of GDP limit) be made in terms of cyclically-adjusted budget balances. But these are difficult to estimate, since they depend on the measurement of potential output. The Commission estimates potential output with a production function (Denis, Mc Morrow and Röger, 2002). Capital is taken as exogenous: capital growth decelerates in economic downturns which lowers potential output. Labour force is measured as the product of the population of working age, the participation rate and the complement to one of the non-accelerating inflation rate of unemployment (NAIRU). The participation rate is also considered as exogenous, whereas it fluctuates in practice in line with the economic situation: a rise in unemployment will discourage a part of potentially active workers to search for a job. Last, the NAIRU is measured as a moving average of the actual unemployment rate. Hence potential output growth under this definition tends to reproduce past growth: euro area potential output is estimated to have grown by an annual 2.1 per cent in 1981-1982, 2.8 per cent in 1989-1990, 2 per cent in 1993-1994 and 2.5 per cent in 2000-2001. The output gap is underestimated in recessions while the structural deficit overestimated. Past slow growth will necessarily lower current potential output. For instance, the Commission estimated that there was a positive output gap of 0.3 per cent in France in 2002 despite an unemployment rate of 8.7 per cent in its Spring 2003 Economic Forecasts. If output growth has been stronger than 2.3 per cent a year in 2003-2004 in France, the Commission would have called for a restrictive policy to be implemented.

Table 7: How Large was the French Output Gap in 2003?

According to...	Per cent of potential GDP
French Ministry of the Economy	-2.7
OECD	-2.4
EC	-0.7
IMF	-2.1

Reasoning in terms of cyclically-adjusted deficits leaves room for automatic stabilisers to work: in bad times public deficits may rise under the effect of lower fiscal receipts induced by weaker activity. A country will not be asked to raise taxes in downturns. Fiscal policy should not go beyond automatic stabilisers in the Commission's view. But this has no economic rationale. If fiscal policy is thought to be totally ineffective, because households are Ricardian and they will anticipate future rises in taxation, then any attempt to run an expansionary policy will fail to boost activity. There will be no rise in inflation and no negative impact on partner

countries. In that case co-ordination is useless. If, on the contrary, fiscal policy is thought to have an effect on activity, then fiscal policy co-ordination is useful and there is no reason why fiscal policy should be limited to automatic stabilisers. Discretionary fiscal policy may be useful to strengthen or to reduce the effects of automatic stabilisers. If a given country is hit by an adverse demand shock, the single monetary policy will not be very proactive. A positive fiscal impulse will be needed in order to stabilise domestic output (see Box 4). The US government has run deliberately discretionary expansionary fiscal policies to boost activity in 2002 and 2003, which added to the expansionary monetary policy stance. There is no reason why such policies should be forbidden in Europe. Last, the size of automatic stabilisers varies according to the budget structure (level of the tax to GDP ratio and tax rate progression, weight of unemployment allowances), which *is a priori* unrelated to stabilisation needs. The only rationale of the Commission's view is the fear that if governments kept their budgetary powers, they would run over-expansionary policies permanently. Buti and van den Noord (2004), for instance, think that the difficulties of the SGP 'have little to do with its intrinsic quality', but reflects fiscal behaviour affected by electoral motives. But they do not explain why EMU governments should abandon fiscal activism while the US or Japanese governments continue to use it. They say that 'the fiscal philosophy of EMU's budgetary rules is to bring deficit close to balance and then let automatic stabilisers play freely'. The French, German or Italian governments do not share this philosophy. One may regret that these governments do not clearly express their disapproval instead of signing texts which they do not intend to follow.

The Commission wishes to play a stronger role in the definition and control of national public finances. But this is not in the Treaty and would have no democratic legitimacy. Until now, the Commission has focused on the levels of public deficits and debts at the expense of unemployment targets or growth prospects. The Commission does not clearly say if it would use strengthened powers to ensure the fulfilment of arbitrary fiscal rules or to implement economic policy co-ordination with a view to support growth in Europe. Is it reasonable to give more weight to the Commission? As Paul de Grauwe wrote (*Financial Times*, 22 July 2002): 'Seen from this political perspective, the Stability Pact is a vote of no confidence of the European authorities in the strength of the democratic institutions in the member countries. It is quite surprising that EU-countries have allowed this to happen, and that they have accepted to be subjected to control by the European institutions that even the IMF does not impose on banana republics.'

Box 4: How to Stabilise Output, Government Borrowing and Public Debt: Some Simple Arithmetic

Let us consider a simple model: $y = g + d + c(1-t)y$; where g is a public spending shock, d : a private spending shock, c : propensity to consume (equal to 0.5), t : tax rate, equal to 0.5. GDP level is 100; ρ , debt to GDP ratio, is 50 per cent. A fall in private spending (column 1) will lead to a rise in the public deficit and in the debt to GDP ratio *ex post* despite the effect of automatic stabilisers. A rise in public expenditure (column 2), hence of the so-called structural deficit, is necessary to stabilise fully activity. Trying to stabilise government borrowing (column 3) induces a large fall in activity. Moreover, cuts in public expenditure lead to a rise in the debt to GDP ratio because of the fall in activity. It is therefore impossible to bring the debt to GDP ratio down to its initial level through lower public spending. This is true since $\rho > (1-c)(1-t)$.

	Impact of a fall in private demand			
	d = -1	g = 0	g = 1	g = -2
y		-1.33	0	-4
Government borrowing		-0.66	-1	0
Debt to GDP ratio, in per cent		51.3	51	52.1

The Ecofin Council of 7 March 2003 and the European Council of 20-21 March finally adopted a text very close to the Commission proposal. This decision was adopted without public debate on the respective roles of European and national institutions, on a fiscal policy framework based on fiscal targets and not on output growth targets.

The European Constitution adopted by the intergovernmental conference in June 2004, does not introduce major reforms on fiscal policy. The article III-71 allows the Commission to address a direct warning to a Member State if its policy is not consistent with the BEPGs. The article III-76 keeps the EDP almost unchanged. It states that the Commission proposes (instead of recommends) the existence of an excessive deficit (unanimity, excluding the vote of the Member State concerned, is needed to modify or to reject the proposal) but the Council makes a recommendation (upon a Commission recommendation) to bring that situation to an end within a given period (the qualified majority can accept, refuse, make proposals). The Commission wanted to be entitled to make a proposal which would have strengthened its role, but Germany, Italy, Poland and Greece refused. A separate Protocol recognises the existence of the Eurogroup but its meetings remain informal; the Eurogroup will elect a President for 2.5 years, but the Constitution does not give him any official role. A Joint Declaration reaffirms

...the commitment of the Member countries to the SGP as the framework for the co-ordination of budgetary policy and to a rules-based system. The Member States should use periods of economic recovery to improve their budgetary policy. The objective is to achieve a budgetary surplus in good times. The Member States look forward to possible proposals of the Commission to strengthening and clarifying the implementation of the SGP. Improved economic policy co-ordination could support the objective to raise growth potential.

The declaration does not explain why ten countries did not fulfil the 3 per cent limit of the SGP in 2004, what is meant by “economic policy co-ordination”, how “good times” periods are characterised and it does not give evidence that a “budgetary surplus” is needed in good times.

At the end of June 2004 (EC, 2004a) and in early September (EC, 2004b), the Commission made new proposals to reform economic governance in EMU. The Commission proposed a few changes in the SGP, but still without questioning the Treaty: the 3 and 60 per cent limits must remain the “centrepiece of multilateral surveillance”. The Commission continues to confuse fiscal policies co-ordination with the fulfilment of arbitrary public finance targets. Moreover, the ‘shy’ attempt made by the Commission in September 2004 to reform the SGP has been immediately criticised by several countries (among them the Netherlands and Austria), and by the Bundesbank, in favour of a strict implementation of the existing framework. Large countries show a certain degree of indifference as they wish to keep their autonomy and hence are not very much in favour of a well-designed Pact they would have to fulfil. The Commission (EC, 2004b) made seven proposals⁴:

(1) An evolution rather than a reform of the Stability and Growth Pact.

- (a) The Commission wishes to ‘place more focus on debt and sustainability in the surveillance of budgetary positions’; to clarify the definition of ‘a satisfactory pace’ of debt reduction and to take in account the implicit debt due to the ageing population to evaluate the level of explicit debt. *This means some countries will be in permanence subject to an EDP (Belgium, Italy and Greece), which will generate permanent tensions among European countries. Countries with ‘pay-as-you-go’ pensions systems (France, Germany, Italy) will also be placed under stricter surveillance. No figure is provided with this proposal, which is designed to facilitate the adhesion of the UK and of the new Member States to the euro area.*
- (b) The Commission proposes to better take into account different economic and debt situations when setting the medium-term objective for each member state.

⁴ At the time of writing, the proposals made on 7 September remain vague.

The Commission recognises that the uniform medium-term objective of “close to balance or in surplus” ‘does not appear appropriate and lacks economic rationale given the increasing economic diversification in an EU of 25 Member States’. It proposes to allow for small deficits in countries with low debt ratios and/or high potential growth rates and to maintain the ‘close to balance or in surplus’ objective only for countries with high public debts. But it recalls that countries running a deficit have a great risk of breaching the 3 per cent reference value in slowdowns.

(c) The Commission agrees to extend the ‘exceptional circumstances’ criteria for a prolonged period of sluggish growth. *This is a step towards taking account of the output gap before blaming a country for breaching the 3 per cent limit.*

(d) The Commission wants to consider “economic circumstances and developments in the implementation of the EDP”.

A less rapid adjustment may be required from countries breaching the 3 per cent limit because of a protracted period of slow growth or from countries with a low level of public debt. The Commission expects this will encourage countries to make more efforts to reduce their debts.

(e) The Commission wants to ‘ensure earlier action to correct inadequate budgetary developments’, meaning countries would be required to run surpluses in good times. *This raises again the issues of the identification of ‘good times’ periods and the economic relevance of running a budget in balance.*

(2) Co-ordinating budgetary policies.

The Commission would like BEPGs to have a stronger influence on national fiscal and economic policies. It wished to send early warnings to oblige countries to follow its recommendations, and has been given this power by the Constitution.

The Commission suggests that fiscal policies should be discussed at the euro area level in the first half of the year: BEPGs would then be adopted and Member States would have to present their Stability Programmes in line. In the second half of the year, each Member State would vote their budget in line with the decisions made at the Community level in the first half of the year. This would allow the Commission to influence national budgets *ex ante*, instead of making a judgement *ex post*. *National Parliaments would see their power of decision significantly reduced: they would have to vote on a budget according to guidelines agreed at the Community level six months earlier. This would entail a significant loss of democracy.*

(3) Improving enforcement.

The Commission underlines the need for ‘quality, reliability and timeliness of fiscal national statistics’. It advocates for tougher

surveillance by Eurostat. *The main difficulty is that the definition of public deficit is partly arbitrary, which opens the door for creative accounting.*

The Commission (2004a) points out that the assessment of underlying budgetary positions is affected by the quantification of the cyclical component and one-off measures. It also asks for better information on long-term sustainability through a better evaluation of implicit liabilities (pensions, health care and education). *But these two objectives are difficult to fulfil. First, it is difficult to provide a reliable estimate of the output gap. Second, social implicit debt depends among other things on the possibility to increase old workers' employment rates, on medical progress, etc...*

The Commission expects that the effectiveness of peer pressure will discourage Member States from not complying with their legal obligations and would increase 'reputation costs'. *But the pressure would be ineffective if these obligations lack economic rationale.*

The Commission (2004a) calls for the introduction of national institutions warranting sustainable public finances. For instance, it recalls the proposal made by several academics to set up national Fiscal Policy Committees, where independent experts would assess and comment upon the sustainability of Member States' budgetary positions. *But debates on fiscal policy already take place at the national level between the government, the Parliament and economists. What would be the advantage of setting such Fiscal policy Committees? How would their members be appointed? By nature, fiscal policy always has to make trade-offs between several objectives: would it be advisable to look only at sustainability?*

The Commission has realised that it is difficult to request governments to implement restrictive fiscal policies in order to fulfil uniform and arbitrary rules. It tries to improve the existing rules albeit maintaining the 3 per cent and 60 per cent limits of the Treaty. But it refuses to accept the introduction of a "public finances golden rule". It does not say clearly if the new functioning of the rule will focus only on public finance targets or also on growth and inflation objectives. The Commission seems to have abandoned its previous request for countries to reach and maintain structural balances 'close to balance or in surplus', but it does not clearly define a new objective. Thus its proposals tend to become less and less clear over time. The negotiations between the Commission and the Council will determine the implement of the fiscal policy framework. Perhaps this is the best solution, a sort of 'vanishing of the Pact'.

The Statement made by the ministers of economy and finance on 10 September 2004 shows the hesitations of the Member States. The ministers say they do not want 'a watering down of the Pact, but rather a strengthening, clarification and better implementation'. The twelve Members States which are now under an EDP do not say how they can reconcile this statement with their domestic fiscal

policy. The Treaty should not be changed. Changes in regulations should be minimal. The Council accepts:

- to strengthen the preventive part of the Pact, with better discipline in “good times”, peer pressure at the early stage of budgetary deviations, more transparent growth and budgetary figures (as in the item 1.e of the Commission’s communication (2004b),
- to enhance the focus on debt and sustainability, with a better control of the countries where the debt ratio is above 60 per cent and of the countries where the future costs of ageing are high (item 1.a),
- to have more indulgence in the implementation of the EDP, for countries that did not reach their objectives due to lower growth than anticipated (a part of item 1.d).

The Council refuses items 1.b) (the redefinition of the medium term objective); 1.c) (redefinition of exceptional circumstances); 1.d) (more flexibility in the EDP); 2) (reform of the calendar procedure) and 3) (a better enforcement). We may think that some countries are less flexible than the Commission and refuse the death of the SGP; that some countries fear to infuriate the ECB with a too substantial reform; that some countries prefer an unsatisfactory Pact (with the possibility not comply to it) than a well-designed one (with a stronger obligation to comply to it).

This debate takes place at a time when public deficits cannot be said to have generated any of the generally expected negative externalities and macroeconomic unbalances: the euro area public deficit is estimated to have stood at around 2.7 per cent of GDP in 2003 and 2.2 per cent in cyclically-adjusted terms according to the Commission (with a surplus of 1.2 excluding interest payments), while there was an current account surplus of 0.5 per cent of GDP, inflation stood at 2 per cent and real long-term interest rates at 1.9 per cent, slightly below real GDP growth. Another point is that financial markets have sent no signal, either through a rise in long-term interest rates or through a fall in the euro exchange rate, as an increasing number of countries breached the 3 per cent of GDP rule, although these rules are supposed officially to be reassuring.

**5.
Reforms
Suggested By
Academics**

The need to reform the SGP has generated significant and still growing literature. Most authors focus on setting optimal rules in a national framework, but is it the task of European institutions to define optimal national policies? Some other authors try to define rules which would ensure some implicit co-ordination or would prevent negative externalities. Some others try to improve the institutional framework to ensure that rules will be met.

5.1 SOME INTERNAL ADJUSTMENT ONLY

According to Buti, Eijffinger and Franco (2003) the mechanisms of the SGP work relatively well. They make five suggestions to achieve ‘stronger discipline and higher flexibility’.

- *Country-by-country medium-term targets.* Countries with a relatively low level of (explicit and implicit) public debt would be allowed to have a medium-term deficit target in the range of 1 to 1.5 per cent of GDP. With a medium-run deficit target of 1.5 per cent of GDP, the debt to GDP ratio could remain close from 30 per cent (with a 5 per cent nominal GDP growth). With this proposal, a more realistic long-run debt objective becomes possible.
- *Improving transparency.* The authors ask countries, or Eurostat, to publish real ‘structural balances’, i.e. corrected from exceptional and one-off measures (UMTS licences, leasing or securitisation operations, one-off taxes...).
- *Tackling ‘misbehaviour’ in good times.* The authors want to prevent countries from stopping fiscal consolidation efforts during high-growth periods, as was the case in 1998-2000. They suggest that early-warning procedures could be launched against countries which have not sufficiently reduced their structural deficit (even if they have cut their public deficit). But this procedure requires an agreement on the level of potential output and on the optimal level of deficit.
- *A ‘Rainy-day fund’.* Countries would put some money in a specific fund in good times, and would withdraw these resources in bad times. This proposal looks somehow awkward because such purely financial operations have no impact on government borrowing in national accounts. There is no difference between using receipts for debt reduction and allocating them to a fund. Thus the authors suggest a change in national accounts methodology, so that transfers to the fund would raise public deficits and that withdrawals would reduce public deficits. For instance, a government running a surplus of 1 per cent of GDP in 2000 could transfer it to the fund. If there was a public deficit of 3.5 per cent of GDP in 2002, the government would have the possibility to bring it down to 2.5 per cent with a 1 per cent withdrawal from the fund. But national accounts methodology must be based on economic logic and not on political arrangements. Policy-makers have to improve economic policy rules but they should not be allowed to change the instrument of measure.
- *A non-partisan implementation of the rules.* The authors suggest that the Commission should be given more power to deliver

early-warnings, to determine the existence of excessive deficits, to decide on sanctions. Such a reform seems inappropriate to us, as long as fiscal rules are not better designed. A soft implementation of the SGP remains necessary.

5.2 THE GOLDEN RULE FOR PUBLIC FINANCES

It has been shown for a long time that it is economically desirable for public investment, which will be used over several years, to be financed over a similar period of time.⁵ Independently of stabilisation consideration, government budgets should be split into a current budget – including public capital stock depreciation related spending – which should be in balance and an investment budget, which would be financed through borrowing. The British government adopted such a rule, the so-called ‘golden rule for public finances’, in 1998.

Several economists (Modigliani *et al.*, 1998, Creel *et al.*, 2002, among others) have proposed to import this rule into the euro area: the structural current government balance, i.e., excluding public investment, should be permanently in balance or in surplus. Their proposal differs from the British rule in two respects. In the UK, the current budget has to be in balance over a cycle: government borrowing may rise under the effects of both automatic stabilisers and discretionary measures in times of economic downturn as long as this rise will be offset by surpluses in good times. This is not the case in the above mentioned proposals. The UK golden rule refers to net public investment, while Creel *et al.* (2002) seem to advocate for a rule on gross investment.

Let us assume that a country wishes to maintain public debt at the level of public capital stock.⁶ Public debt in real terms is determined by: $D = D_{-1}(1 + r - \pi) - s_p$, where s_p is primary budget surplus. Public sector capital stock is determined by: $K = K_{-1} + I - \delta K_{-1}$. $D = K$ implies that budget surplus: $s = s_p - rD_{-1} = -(I - \delta K_{-1} + \pi D_{-1})$. The correct interpretation of the golden rule is therefore that the cyclically-adjusted borrowing, net of net public investment and of debt depreciation, should be at least in balance.

According to the golden rule, borrowing may finance public investment, which is important in particular for countries where significant investment is needed. Buitier and Grafe (2003) highlight

⁵ This view was developed at the end of the 19th century by Lorenz von Stein in Germany and by Leroy-Beaulieu (1891) and Jèze (1896) in France. It can also be found for instance in Musgrave (1939) or Eisner (1989).

⁶ Blanchard and Giavazzi (2002) also look for a condition that would assure that public debt remains equal to public capital stock. But they make the assumption that there is no inflation. Hence they forget debt depreciation.

the case of the new members of the EU. Under this rule, countries will not have to cut public investment to improve government borrowing. Lowering public investment is harmful in terms of potential output growth if endogenous growth theory has some relevance. But the rule opens the Pandora's box on the definition of public investment: should the definition of national accounts be the reference, or should all spending in preparation for the future, like education or research be also taken into account, as proposed by Fitoussi (2002)? The rule also introduces a risk that governments increase public investment for short-term stabilisation purposes only.

Balassone and Franco (2001) reject this rule in the name of the difficulties of measure. The rule implies that statisticians are able to estimate the cyclical part of government borrowing (therefore the output gap and its impact on public finances), public investment and public capital stock depreciation, in other words four questionable measures. But is not it better to use a fair rule, estimated with a low degree of precision than to follow a wrong rule, estimated with precision?

A more fundamental criticism is that this rule defines the neutrality of fiscal policy, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equals public investment). But a government may choose not to be neutral. It may wish to implement an expansionary fiscal policy in times of subdued activity or to run a restrictive policy in a period of high inflation. It may wish to implement structural measures if it thinks that saving is too high *ex ante* (which would necessitate a too low interest rate) or too low⁷ (in the light of demographic changes). The proposed rule confuses a criterion of neutrality with a norm for economic policy. As with the existing rule, there is no certainty that the fiscal policy needed to reach a satisfying level of activity in a country which does not control the interest rate matches the golden rule.

As shown in Table 8, the four indicators give different results for public deficits. For instance, Italy's structural deficit amounted to 2.1 per cent of GDP in 2002, but turned into a surplus of 0.4 per cent in terms of structural balance net of gross investment. There was a structural deficit of 0.8 per cent excluding net public investment, which turned into a surplus of 2.5 per cent excluding debt depreciation.

⁷ This is developed in Kellermann (2004).

Table 8: Four Indicators for Government Borrowing in 2002

Percentage of GDP

	Cyclically-adjusted balance (CAB) ⁽¹⁾	Gross public investment (PI) ⁽²⁾	Public capital depreciation	Public debt depreciation (DD)	CAB + gross PI	CAB + net PI	CAB + net PI + DD
Germany	-2.8	1.7	1.7	1.0	-0.9	-2.8	-1.8
France	-3.2	3.2	2.3	1.4	0.0	-2.3	-0.9
Italy	-2.1	2.5	1.3	3.3	0.4	-0.8	2.5
UK	-1.4	1.1	0.8	1.3	-0.3	-1.1	0.2

(1) According to the European Commission. (2) Public investment refers to general government investment.

Sources: OECD *Economic Outlook* No. 75, June (2004); OECD, *National Accounts*, Volume II – (1989-2001), (2003).

Let us consider a country where there is a 3 per cent of GDP output gap in the trough of the cycle and where the elasticity of government borrowing to GDP is 0.5. Public debt amounts to 50 per cent of GDP, inflation to 2 per cent and gross public investment represents 3 per cent of GDP with a depreciation of 2 per cent. In comparison with the existing rule, a rule under which countries would have to keep their structural current budget in balance (excluding gross public investment), gives a supplementary margin of 3 per cent of GDP on average over the cycle (see Table 9), but is not justified from an economic point of view. A rule based on structural balance excluding public net investment provides only a 1 per cent of GDP supplementary margin on average. In the trough of the cycle, this rule is more restrictive than the existing one. If debt depreciation is taken into account, the improvement is very small as compared to the current rule in cyclical troughs (0.5 per cent of GDP) but significant on average (2 per cent of GDP).

Table 9: A Comparison of Four Fiscal Rules

Percentage of GDP

Government borrowing needed	SGP	CAB+GPI	CAB+NPI	CAB+NPI+DD
• On average over a cycle	0	-3	-1	-2
• In the trough of the cycle	-3	-4.5	-2.5	-3.5

Should a rule better than the SGP rule be proposed? Fiscal rules based on government balance will never account for the fact that public finances are only tools to support activity or to regulate the savings/investment equilibrium. Any proposal for a European fiscal rule, under the control of the Commission, neglects the fact that the surveillance of public finances in EMU should aim at avoiding that a country generates negative spill-over effects in partner countries rather than trying to define optimal national fiscal policies.

5.3 A PERMANENT BALANCE RULE

In a similar approach, Buiters and Grafe (2003) and Buiters (2003) propose a permanent balance rule. The tax rate would be set in

permanence as: $t = g^p + (r^p - \pi^p - n^p)b$, where g^p is the permanent level of primary public spending in per cent of GDP, in other words the stable level of spending in per cent of GDP which would have the same discounted value than anticipated public spending; r^p , π^p and n^p are respectively the permanent (i.e., on average over a cycle) interest rate, inflation rate and output growth; b is the debt to GDP ratio. With this *a priori* constant tax rate, anticipated public spending would be financed while public debt would be stabilised. The stability of the tax rate is optimal since it minimises the distortions arising from taxation.

In the short run, the budget balance would be: $d = g - g^p - (r - (r^p - \pi^p - n^p)b)$. A country could raise public spending transitorily, as long as its tax policy is such that no risk of default of the public debt arises. This rule leaves room for active economic policy in the short term. It would also allow countries with relatively higher real output growth and inflation (Southern or Central and Eastern European countries) to run a higher public deficit. A country having to increase public investment transitorily would be able to finance it through borrowing. An advantage of this rule is also that countries have to take future prospects into consideration. For example, a country where pensions spending will increase in the future should start to raise taxes now.

This rule would be very difficult to implement in practice. How can the permanent level of public spending be calculated? A country may decide to run a certain level of deficit today, saying that public spending will be cut tomorrow. As is recognised in Buiters and Grafe (2003), the level of public debt is undetermined under the permanent balance rule. A country with nominal output rising by an annual 4 per cent, with an interest rate of 6 per cent and a permanent level of public spending of 40 per cent of GDP may choose to fulfil the rule with a public debt of 0 per cent of GDP (i.e. with a balanced budget and a tax rate of 40 per cent of GDP), or with a 50 per cent of GDP debt (i.e. with a 2 per cent of GDP government borrowing and a tax rate of 41 per cent), or with a debt of 100 per cent of GDP (a 4 per cent of GDP deficit and a tax rate of 42 per cent). The rule does not say how fiscal policy should react to a demand shock. Besides, if public spending in year t benefits mostly the generation of year t , it is difficult to see why public spending should be paid by former generations. If the increases in old-age pensions spending benefit those generations who will live longer, they cannot justify a rise in contributions paid by former generations. Buiters and Grafe raise the relevant issue of the intergenerational equity of public spending, but this cannot be ensured by an automatic rule. Each category of spending is specific. Last, as recognised by the authors, the rule sets an optimal fiscal rule at the national level. But it does not aim at defining surveillance criteria or a fiscal policy co-ordination strategy in EMU.

5.4 A PUBLIC EXPENDITURE RULE AND ACCOUNTING FOR THE QUALITY OF PUBLIC SPENDING

Brunila (2002), among others⁸, proposed to add a complementary rule setting limits to public expenditure (excluding interest payments and unemployment allowances). This type of rule would be easy to implement and to control since the level of public spending is more easily controlled by governments than tax receipts. Member States would set a target for the medium-run growth of public expenditure and let receipts fluctuate with the economic cycle. This is the policy the French government had decided to run at the end of the 1990s. Countries with excessive structural government borrowing would have to cut the share of public spending in GDP. This proposal is in line with the Commission's view, according to which Member States should cut public expenses instead of increasing the fiscal burden.

This proposal suffers from two weaknesses. First, automatic stabilisers are allowed to work, but discretionary policies are not, which has no economic justification. Second, the appropriate level of public expenditure should be decided at the national level at the present stage of European integration. It is a social choice and no *macroeconomic* constraint should prevent a country from raising domestic public spending – pensions, health or unemployment – as long as it is financed by taxation.

Several economists, like Buti and Giudice (2002), propose that the Pact takes the quality of public spending into account. Thus a country would be entitled to a higher deficit if domestic public investment is high, if it embarks on restructuring its public finances or if it undertakes tax cuts programmes. Conversely, countries would be blamed if they cut government borrowing through tax rises instead of lower public spending. This proposal introduces a new arbitrary condition. Should European authorities be entitled to reward countries that way? In our view, each country should remain responsible for the quality of its fiscal policy.

5.5 FISCAL POLICY COMMITTEES

Wyplosz (2002) proposed to establish a Fiscal Policy Committee of independent experts in each Member State. This Committee would be given the mandate of ensuring debt sustainability. Hence their task would be the regulation of budgetary policy. The Committee would set the level of government borrowing, while public spending and receipts would remain under the control of national governments and parliaments. After the ECB's independence, this would be a new step towards leaving economic policy entirely under

⁸ Brück and Zwiener (2004) show that an expenditure target leads to better stabilisation than a deficit target.

the responsibility of a technocracy. The Committee would have to care for long-run public debt sustainability, while the objective of output stabilisation will come in second. Unfortunately, Wyplosz has difficulty in defining debt sustainability. Two possible definitions are given: balanced budget over the economic cycle (which means zero public debt in the long run), stabilisation of the debt to GDP ratio in the medium run (i.e. excluding cyclical effects), but Wyplosz reckons that it is impossible to set an optimal level for this ratio. The equilibrium ratio may change according to real interest rate levels or to demographic evolution. Wyplosz does not discuss the feasibility of his proposal. Changing economic circumstances lead observed budgets to differ from planned budgets. The Committee would have to control government policies in permanence and possibly ask for changes in taxation. Would this be acceptable for national governments? In an economic downturn, what would be the Committee's trade-off between the objectives of output stabilisation and debt stabilisation? More fundamentally, should macroeconomic strategy be decided without democratic debate?

Fatás *et al.* (2003) make a similar proposal: a Sustainability Council, an independent panel of experts, would assess at the European level national fiscal policies according to sustainability criteria. Their judgement would be made public, with a view to enforcing fiscal discipline through public opinion and financial markets. The problem is that sustainability is a vague concept, which makes sense as a long-term constraint only, so it will be difficult to use it to provide a judgement on the fiscal policy run during a year. It would require judgements on the level of the output gap, on optimal debt level and on the need of discretionary fiscal measures. Why would these experts be more qualified than others to have an opinion on such difficult and political problems? What would be the influence of these experts (possibly Fatás, Hughes Hallett, Sibert, Strauch and von Hagen) in the general public or in markets? Could these experts' judgements replace governments' responsibilities? For instance, in 2001, some European countries chose to support demand with a view to reducing unemployment rather than lowering public debt; in 2004, some countries chose to run higher than expected deficits rather than depress output further: can experts claim that these policies are not sustainable? Why would citizens be asked to vote for political parties' representatives if fiscal decisions are in fact made by independent, non-elected experts?

5.6 APPROPRIATE NATIONAL INSTITUTIONS

Calmfors *et al.* (2003) propose that Member States shall be obliged to adapt national fiscal policy procedures to a common framework,

which would guarantee that ‘good decisions’ are made at the national level, independently of the European level. They design two possible schemes:

- Each Member State would have to adopt a “law on fiscal policy”, which would set precisely the objectives for public deficits, debts and stabilisation. This law would indicate the instruments to be used for cyclical purposes. This law would guarantee *ex ante* national budgetary policies in conformity with European requirements. Is it realistic to maintain *a priori* fiscal policy in a very constraining framework, especially when fiscal policy is the only domestic policy tool available? It is an illusion to believe that a law voted at some point will be a commitment for a future government, elected with another majority and facing another position of the economic cycle, some years later.
- Each country would have to implement a ‘fiscal policy committee’, as advocated by Wyplosz (2002). This committee would be in charge of maintaining public debt sustainability and output stabilisation, either by setting the level of government balance, or by setting itself the level of some taxes. This proposal reflects the view of those who think that democratically elected governments should be deprived of their authority, and that this responsibility should be given to a group of experts or technocrats.

Wren-Lewis (2003) proposes to let the Subsidiarity Principle play its role. Each country would be free to establish its own fiscal rules provided they ensure long-term sustainability. The Commission would have to verify first that the rules ensure sustainability, then that the policy follows effectively the rule. Wren-Lewis does not specify what kind of rules will be accepted. Will the Commission agree on a rule setting public deficits at the level which maintains domestic inflation at 2 per cent?

Eichengreen (2003) considers that the SGP numerical indicators (the 3 and 60 per cent limits, the “close to balance or in surplus” objective) are arbitrary. He does not believe in the importance of fiscal spillovers, but fears instead that chronic deficits can lead to unsustainable debts. He proposes to avoid this risk with the help of structural reforms. An independent committee would be established and would grade each country according to a set of structural criteria. The author gives three examples: centralisation on spending decisions, limited future pension liabilities, adequate labour market institutions. Countries obtaining 3 “As” will not be subject to the SGP procedures, because, according to Eichengreen, they would have no reason to run too expansionary fiscal policies. In practice these countries would currently be Ireland, Finland, Luxembourg and the UK. But each country would have a new incentive to

implement structural reforms. It is, however, difficult to imagine how Member States could agree to delegate some of the powers of their labour, social and political institutions to foreign experts. It is hard to imagine how in Continental Europe, countries very attached to the European social model, would accept a reform aimed at destroying this model.

5.7 SURVEILLANCE OF PUBLIC DEBTS

Pisani-Ferry (2002) proposed that fiscal discipline should focus on debts rather than deficits, since it is an excessively high level of debt that may threaten the sustainability of public finances. He proposed to take off-balance sheet liabilities (like old-age pensions) in the assessment of public debt levels. But in that case, anticipated receipts should be considered too, like social contributions. The proposal opens the door to a never-ending process. But it is true that the notion of 'public debt' is basically ambiguous. The Treaty refers to an accounting definition of gross public debt, which has no economic meaning: public debt can be reduced through privatisation receipts, leasing operations on public infrastructures, etc.

Pisani-Ferry suggests that countries may opt for a 'Debt Sustainability Pact'. On a voluntary basis, countries could make public their off-balance debts; they would commit themselves to maintaining the debt to GDP ratio below 50 per cent and to a target for the debt to GDP ratio over a 5 year horizon. Hence, they would not be subject to the excessive deficit procedure based on public deficits. The proposal suffers from several weaknesses. The notion of 'off-balance debts' is unclear. The 50 per cent figure is arbitrary and has the only characteristic of being below 60 per cent. The proposal does not give a definition of the medium-term commitment: debt reduction or stabilisation? It does not mention how cyclical effects should be considered: the debt to GDP ratio deteriorates automatically in times of subdued activity because of rising government borrowing and of output stagnation. How should this be taken into account (see Box 4)? This proposal deals with the negative spill-over effects of debt but it does not account for the negative spill-over effects of inflation. A country with a low level of debt would be able to run excessively expansionary and inflationary fiscal policies. Partner countries and the Commission would be unable to stop it before the debt ratio reaches 50 per cent of GDP. Piloting fiscal policies with a debt rule is even less precise than with a deficit rule.

The idea of a sustainability pact can also be found in Cœuré and Pisani-Ferry (2003). Each country would have to publish a 'comprehensive balance sheet of the public sector' (including off-balance elements), to prepare long-term plans providing evidence of

future public sustainability and to infer from these plans an operational target for the gross debt to GDP ratio. This target would depend on public sector assets and liabilities. A fiscal rule would then be announced by the government, which would ensure that the actual debt to GDP ratio would converge to the objective. This rule would have to be approved by the Commission and the Council, which would be responsible for its monitoring. It is not easy to understand how this complicated procedure based on a large number of long-term assumptions may be implemented in practice. It is also difficult to understand why euro area countries should be subject to such a procedure, contrary to the US, the UK, Japan, Russia, etc. It is difficult to see why there is a specific risk for debt sustainability in the euro area. The proposed procedure would put excessive pressure on future public health and old-age pensions spending while these types of spending can be financed provided that citizens are willing to pay for them. Besides, the proposal does not deal with short-term fiscal policies. Would a country be entitled to higher deficits in 2004 if it has announced the implementation of a reform due to lower public pensions after 2010?

5.8 LOWERING PUBLIC DEBT

Gros (2003) also thinks that the Stability and Growth Pact should put emphasis on debt levels rather than deficits, debt being the major risk to public finance sustainability. He proposes to add a new element to the excessive deficit procedure, by setting a minimal speed for debt reduction in countries where debt levels stand largely above the 60 per cent of GDP threshold. In practice, these countries would be requested to cut the differential between their debt ratio and the reference ratio by 5 per cent each year. Thus a country with a 100 per cent of GDP debt would have to bring it down the following year to 98 per cent of GDP.

This proposal does not address the issue of compatibility between *a priori* set targets for public finances, and the necessity to reach short-term and medium-term macroeconomic equilibrium. If we let b , the level of public debt as a share of GDP, g : nominal output growth. The proposed rule requires that the deficit, d is such that $d < 3\% + b_{-1}(g - 5\%)$. The rule is similar with the 3 per cent of GDP reference when nominal growth equals 5 per cent; while it is less (more) strict under higher (smaller) growth. The rule is therefore highly pro-cyclical. It is less strict than the close-to-balance or in surplus target for deficits: a country having a 100 per cent of GDP debt ratio will be allowed to run a deficit of 3 per cent of GDP under the assumption of a 5 per cent nominal growth.

Calmfors *et al.* (2003) think the EMU should provide an opportunity to strengthen fiscal discipline. Saying that the major risk is debt sustainability, they suggest that the limit for deficits

should depend on public debt levels. Thus, the limit would be 0.5 per cent of GDP for countries where debt stands above 105 per cent of GDP, 1 per cent for countries where debt stands around 100 per cent of GDP, 3 per cent for countries where debt is close to 60 per cent, 4 per cent for countries where debt is 40 per cent, etc. This would be an incentive for Member States to reduce public debt so as to get more cyclical room for manoeuvre. The proposal raises constraints on highly indebted countries: Italy, Belgium and Greece. But for Italy and Belgium the opportunity of the constraint can be questioned since the level of public debt has a counterpart in a high households' saving ratio. The constraint comes in addition to the objective of a medium run budget in balance, which implies a continuing decrease in the public debt to GDP ratio. The proposal follows a weird logic according to which a country having no control on its domestic interest rate may set arbitrarily the domestic debt level. Let us consider a country with an initial debt to GDP ratio of 60 per cent. In order to cut this level down to 40 per cent, the government may decide to run a restrictive fiscal policy of 2 per cent of GDP during 10 years. This will not lead to a significant cut in the ECB's interest rate but is almost certain to strongly dampen activity, with a questionable usefulness.

These two proposals seem to forget that the 3 per cent limit and the objective of 0 for public deficits already puts strong pressure on highly-indebted countries. With a nominal growth of 4 per cent and an interest rate of 5 per cent, a country with a debt equal to 100 per cent of GDP already needs to run a primary surplus of 4 per cent of GDP to reach a 1 per cent of GDP deficit and this implies its debt ratio declines by 3 percentage points each year. It is difficult to ask for more.

The Commission (2004 a) recognises that it is impossible to define an optimal level of public debt. This level varies according to demographic or economic factors, but the Report maintains that 60 per cent is an appropriate limit. It plans to differentiate the medium-term targets for public balances according to the level of debt. A country with a low level of debt will be allowed to run some deficit; a country with a high level of debt will be required to run a surplus to converge more rapidly towards a low level. For instance, the limit for the deficit may be: $d = 0.5\% - 2\%(b_{-1} - 0.6)$. A country where the debt to GDP ratio is 60 per cent will have a public deficit limit of 0.5 per cent of GDP. A country where the debt ratio is 40 per cent will have a deficit limit of 1.3 per cent; a 100 per cent of GDP debt ratio will require a government surplus of 0.3 per cent of GDP. In the equilibrium, with a 5 per cent nominal GDP growth rate, the debt ratio will converge towards 24.3 per cent of GDP and the deficit towards 1.2 per cent of GDP. This rule has three drawbacks. First, what if the implicit target level is not the equilibrium one? Second, it assumes that highly indebted countries

will undertake strongly restrictive fiscal policies. Third, it is hard to control a stock variable (debt/GDP ratio) using a target which is a flow variable (structural deficits). But this rule has the advantage of showing that the equilibrium target currently in place in the SGP is too strict.

De Grauwe (2004) proposes a two-level strategy. First, each country will have to define a target for its debt ratio (below 60 per cent). The target should be lower if the country has large unfunded pension liabilities. This ratio implies a specific target for public deficits (for instance, if the target debt ratio is 40 per cent and projected nominal growth of GDP is 4 per cent, the public deficit target must be 1.6 per cent). So, the country will be free to allow automatic stabilisers to work (and also to undertake discretionary fiscal policies), but the counterpart will be to run fiscal surpluses in good times. The 3 per cent ceiling would disappear. The rule has the advantage of being more flexible than the SGP. The level of the debt ratio can be chosen by the Member States. But it remains arbitrary. What will happen for instance if a country having chosen a 40 per cent target sees the debt ratio reaching 50 per cent after a long period of weak activity? Will this country decide to move its target at 50 per cent or will it be obliged to undertake long and painful restrictive fiscal policies to bring the ratio back to the arbitrary level of 40 per cent?

5.9 TACKLING THE ISSUE OF AGEING POPULATIONS

Old-age related public spending – on pensions and health – will increase under the effects of ageing populations in the EU in the near future. Yet this issue is tackled very differently among Member States (see Table 10). In some countries private funded systems prevail and public pensions will be little affected. Some countries in anticipation are postponing significantly the retirement age or cutting significantly the level of pensions (like France or Italy).

Table 10: Net Increases in Age Related Public Expenditure (from 2005 to 2050, as a Percentage of GDP)

Austria	1.5
Belgium	4.5
Denmark*	5.4–2.5=2.9
Germany*	5.1–0.9=4.1
Greece	11.5
Finland	5.0
France	2.1
Ireland	4.5
Italy	1.3
Netherlands*	6.7–3.8=3.8
Portugal	1.3
Spain	6.0
Sweden*	6.3–0.4=5.9
United Kingdom	2.3

*Some countries anticipate an increase in fiscal receipts.

Source: European Commission, *Public Finances in EMU* (2004).

Some economists (among them Pisani-Ferry (2002) and Oksanen (2004)) suggest that each country should evaluate the implicit debt level of its public pensions systems and make it public in addition to financial debt. This raises three difficulties. First, what should the implicit debt include? Why not include also public education spending entitled to new-born children and the supplement of taxes these will have to pay later? Second, the estimated level of implicit debt relies on many assumptions on future retirement age and pensions levels. It may be strongly reduced, effectively or fictively, if the country says in advance that the level of pensions will be lowered or that the retirement age will be postponed (as France did in 2003). Last, the issue is not to aggregate financial public debt and implicit social debt but to see if fiscal policy is sustainable and optimal. If households benefit from a high level of social spending, well managed and useful, they may accept a high level of contributions. The burden could even be less heavy than having to pay insurance premiums to private companies with low efficiency or low reliability in health or retirement areas

Many economists (like Delbecq, 2003 and Oksanen, 2004) and the Commission think that the SGP framework is justified by the future rise in pensions spending: public debt has to be significantly reduced now to ensure the future payments of old-age pensions. This is necessary for intergenerational equity reasons (all generations sharing the tax burden) as well as economic efficiency (avoiding imposing a too heavy tax burden on future generations).

Let us consider an economy growing at 4 per cent in nominal terms, with an interest rate at 6 per cent, pensions spending rising by 4 per cent of GDP in 40 years. This economy may choose between two opposite strategies (see Table 11):

- A ‘pay-as-you-go’ strategy (PAYG) would raise contributions in line with benefits in order to maintain a stable public debt. Contributions would then rise by 4 per cent of GDP in 40 years.
- A ‘tax-to-GDP stability’ strategy (TS) would increase contributions now in order to keep the tax-to-GDP ratio unchanged. Contributions would need to be raised immediately by 2.9 per cent of GDP. A surplus of 0.9 per cent of GDP is needed today and may be reduced to 0.2 per cent of GDP in the long run. Then public debt will be negative and contributions will be 1.1 per cent of GDP lower than in the PAYG strategy. The SGP would therefore be useful to impose the best strategy.

Table 11: Two Opposite Strategies to Tackle the Issue of Ageing Populations

	Public debt		Government balance		Primary government balance excluding pensions	
	2005	2045	2005	2045	2005	2045
PAYG	50	50	-2	-2	1	5
TS	50	-6	0.9	0.2	3.9	3.9
TS*	50	24	-0.5	-1.0	2.5	2.5
PAYG	0	0	0	0	0	4.0
TS	0	-61	2.8	2.4	2.8	2.8
PAYG	100	100	-4	-4	2	6
TS	100	48	-1	-1.9	5	5

* A 2 per cent of GDP rise in pensions spending.

However, four objections may be raised. A strong rise in EU tax-to-GDP ratios would depress output and there is no certainty that monetary policy would be loosened enough to compensate for this effect. The objective of the SGP is to facilitate fiscal policy co-ordination and to avoid negative externalities, not to set optimal fiscal policies for each country. The TS strategy is not in line with the SGP: countries with low initial debt levels would have to accumulate surpluses (see Table 11), while countries with high debt levels would be allowed to run deficits: debt ratios would not converge. Last, pension policies have remained at the national level: a country may choose to raise social contributions according to a certain path (it is normal that the youngest pay more as they will live longer); a country may choose not to raise social contributions but postpone the retirement age. The public balance which will stabilise the tax-to-GDP ratio will be 0.9 per cent of GDP (if the country expects a rise of 4 per cent of GDP in pension spending); -0.5 (for a 2 per cent of GDP rise); -2.0 with no rise. Ageing populations raise important issues on fiscal strategies, but these cannot be solved in the SGP only.

Some economists (Bishop, 2003) note that ageing populations and the shrinking of pension payments offered by pay-as-you go pension systems should be an incentive for workers to raise their savings and to hold larger amounts of a long-term safe asset such as public debt. Under this approach real interest rates would decrease and once they get close to the GDP growth rate, economic efficiency would require a rise in government deficit and debt. This is very unlikely to be allowed in the SGP.

5.10 A BETTER CO-ORDINATION OF FISCAL POLICIES

The establishment of an elected economic government for Europe could be envisaged with responsibility for monetary and fiscal decisions (Fitoussi, 2002). But this is currently a utopia. Democratic debate has remained at the national level; business cycles as well as institutions still differ from one country to another; it is impossible

to imagine a common government which will decide specific measures for each country: raising taxes in Hungary and Poland, decreasing them in Austria, raising retirement pension in Ireland, etc.

The conduct of fiscal policies could be given to the European Commission. But we would face the same problem (how to deal with diversity?) plus the fact that the Commission has no democratic legitimacy. Strengthening the power of the Commission implies that all Member States agree on some fiscal policy rules (for instance, keeping their structural government balance at zero), which is not the case now.

Fiscal policies could be placed under the responsibility of the 'Ecofin Council of the euro area', but this would mean giving excessive power to the ministers for economics and finance, at the expense of other ministers and of national parliaments. It is difficult to imagine that the French government would ask for its partners' approval before introducing the 35-hour working week or that the German government would submit its fiscal reform to its partners. Would this group of ministers be entitled to decide on the different reforms of pensions systems to be implemented in the Member States?

A less ambitious solution would be to give the Eurogroup the responsibility of fiscal co-ordination in the euro area (see for instance, Begg and Shelkle, 2004). French Finance Minister Dominique Strauss-Kahn had proposed at the Ecofin Council in Dresden in April 1999 that the Eurogroup should first discuss and set the desired policy for the euro area, before setting the global objective for the area. The global target would be broken down into national targets in a second step. The proposal did not say if the ECB would participate in the co-ordination process. If the ECB and Member States agreed on explicit co-ordination to control inflation and activity, then the outcome could be similar to the ideal example described in Box 3. Interest rates would assure a satisfying level of aggregate activity; government balances would assure a satisfying level of national activity. If the ECB did not participate in the co-ordination process and if co-ordination targeted only government balances, then no improvement could be expected as compared to the existing situation. It is difficult to understand how the aggregate public deficit target would be defined and 'shared' between Member States.

In an intermediate solution, the Eurogroup could have two objectives. The first would be to verify that no country runs excessive inflation, a too high external balance deficit or a level of public debt raising doubts on its solvability. Explicit rules on public deficits would be forgotten. The second objective would be to try to co-ordinate fiscal policies. An explicit co-ordination with the ECB would be better, but this is probably unrealistic today. So, in some

circumstances, a common macroeconomic strategy could be adopted. However, such co-ordination has two pitfalls. It requires unanimity between Member States (which may be difficult to reach in practice). It may exacerbate conflicts between fiscal and monetary policies. If all Member States need a higher level of demand, the best solution is to cut interest rates. If the ECB does not agree, the risk is higher deficits and higher interest rates, which is not optimal. In the event of differences in domestic economic situations in the EU, then a co-ordination without rules is difficult.

5.11 COPING WITH NEGATIVE EXTERNALITIES: OUR PROPOSAL

Given the current level of European political integration, countries and governments must keep their prerogative on national fiscal policy, as long as it does not affect the macroeconomic position of the area. The surveillance of economic policies should consist in avoidance of any national fiscal policy negatively affecting the rest of the area. That is why we think binding rules should bear directly on externalities.

Thus, the rule should be that each country may be allowed to define its domestic fiscal policy, as long as it does not affect the macroeconomic equilibrium of the area, in other words as long as domestic inflation stays in line with the inflation target of the area.⁹ If there was an inflation target of between 1.5 per cent and 3.5 per cent in the area, one could imagine that Northern countries would be given a target within 1 and 3 per cent, while ‘Southern’ countries (more precisely the countries on a catching-up process) would have a target between 2 and 4 per cent. In such a system, a country hit by a negative demand shock would be able to counterbalance it through a transitorily more expansionary policy. Conversely, a country hit by a supply shock (inflationary pressures) would have to undertake restrictive measures.

The European authorities – the Commission and the Ecofin Council of the euro area – would have the responsibility to check that inflation remains at the level set in each country, and possibly to accept some deviations and adjustment periods, in the event of specific or common shocks. The European authorities could also have the responsibility to check that domestic public debts do not put the sustainability of public finances at risk, or that no country runs an excessively large current account deficit relative to the

⁹ Bofinger (2003) expresses a similar view. He shows that there is no link in Europe between public deficits and inflation and that, due to the common interest rate, inflationary countries enjoy higher output growth than low inflationary countries.

current account balance of the area.¹⁰ The crucial point is that surveillance can bear only on issues potentially leading to negative externalities between countries in the monetary union.

Box 5: Compatibility between Monetary Policy and Fiscal Policies

Let us consider the model of Box 1 and 2. In order to reach the inflation target, it is necessary that: $\Sigma g_i - n\sigma r = -\Sigma \pi_i^0 / \alpha - \Sigma d_i$ at the level of the area. This is compatible with a situation of high interest rates and high public deficits or with a situation of low interest rates and low public deficits. A process where monetary policy and fiscal policies are fully compatible has to be found. The optimal medium-run strategy is that the central bank sets an interest rate target, r^{obj} , equal to nominal output growth, i.e., the lowest rate compatible with economic efficiency. Fiscal policies would be responsible for reaching the inflation target. Each country would have to target the following level of production: $y_i = -\pi_i^0 / \alpha$, and consequently their public deficit would be $g_i = -d_i - \pi_i^0 / \alpha + \sigma r^{obj}$.

However, this organisation does not define the respective roles of monetary policy and fiscal policies considered as a whole. A satisfying level of global demand, compatible with the desired inflation-production trade-off may be obtained through a combination of high interest rates and public deficits, or a combination of low interest rates and public deficits (see Box 5). The second combination will induce higher private investment and therefore will be preferable in terms of medium run output growth. The compatibility between monetary policy and fiscal policies has to be planned. In our view, the best rule is the following: monetary and fiscal policies should set a common medium-term objective aiming at the convergence of real interest rates with output growth, meaning the lower interest rate be consistent with economic efficiency. If the long-term real interest rate is higher than output growth, this means that investment is too weak: monetary policy should cut interest rates and should be accompanied by restrictive fiscal policies in the countries where the cut in interest rates would raise inflation excessively. But as long as the real interest rate equals output growth, a country cannot be blamed for running some public deficit if this is necessary to support domestic activity. National fiscal policies should be in charge of managing the inflation-production trade-off in each country, under the constraint of a medium-run inflation, while monetary policy should target the interest rate.

¹⁰ The argument is also developed in Bénassy (2003), who proposes a rule taking account both of public deficits and current accounts.

6. Conclusions

The Pact aimed at ensuring that national governments would implement sound economic policies and hence requested binding fiscal rules to be met (3 per cent of GDP threshold for deficits, 60 per cent of GDP threshold for debts, medium-term objective of close to balance or in surplus government balances). The economic downturn of 2001-2004 gave evidence that the SGP framework could initiate tensions in Europe, particularly between the European Commission and the big Member States which require more active fiscal policies than smaller States. These tensions are all the more useless as the negative spillovers that could potentially arise from excessively expansionary fiscal policies have not emerged. The existing fiscal rules lack economic rationale and therefore governments are reluctant to meet them and to support them publicly.

There is currently no consensus in Europe on the appropriate macroeconomic strategy that should be adopted: some believe in the virtue of structural reforms and fiscal consolidation while some others still believe in the efficiency of active macroeconomic policies. European authorities have difficulty in imposing their vision of the conduct of sound economic policies on governments who hold a different view.

Close to balance budgetary positions should not be the main objective of the fiscal framework today. Growth has been low in the EU over the last four years, exchange rates and equity markets have been very volatile, a number of short-term uncertainties have surrounded activity.

Domestic stabilisation fiscal policies should be allowed. Each country should remain responsible for its domestic macroeconomic strategy. Placing fiscal policies under the control of committees of independent experts would result in a loss of democracy. The Eurogroup should aim at avoiding the emergence of negative spillovers from countries running excessive inflation, balance of payments current account deficits or default risks. The Eurogroup could also implement explicit fiscal policy co-ordination, if Member States were able to reach a common agreement.

REFERENCES

- ARTIS, M.J. and M. BUTI, 2000. "Close to balance or in surplus – A policy maker's guide to the implementation of the Stability and Growth Pact", *Journal of Common Market Studies*, Vol. 38, No. 4.
- BALASSONE, F. and D. FRANCO, 2001. "The SGP and the Golden rule", in A. Brunila, M. Buti and D. Franco (eds.), *The Stability and Growth Pact*, Palgrave.
- BARRELL, R., 2001. "The role of automatic stabilisers in the SGP framework", *mimeo*, NIESR, November.
- BEGG, I. and W. SCHELKLE, 2004. "The pact is dead: long live the pact", *National Institute Economic Review*, No. 189, July.
- BENASSY, A., 2003. "Pacte de Stabilité, deux objectifs, deux règles", *La Lettre du CEPII*, No 224, June.
- BISHOP, G., 2003. "Sustaining growth for future generations: the Stability Pact in perspective", *Challenge Europe*, No. 10.
- BLANCHARD, O. and F. GIAVAZZI, 2004. "Reforms that can be done: improving the SGP through a proper accounting of public investment", *CEPR Discussion Papers*, No. 4220, February.
- BOFINGER, P., 2003. "The Stability and Growth Pact neglects the policy mix between fiscal and monetary policy", *Intereconomics*, January/February.
- BRÜCK, T. and R. ZWIENER, 2004. "Fiscal Policy Rules for Stabilisation and Growth: A Simulation Analysis of Deficit and Expenditure Target in a Monetary Zone", *mimeo*, First EUROFRAME Conference *Fiscal Policies in the European Union*, Paris, 4 June.
- BRUNILA, A., 2002. "Fiscal policy: co-ordination, discipline and stabilization", *mimeo*, *Meeting of the Group of Economic Advisers of the EC*, 16 April.
- BUITER, W. H., 2003. "How to reform the Stability and Growth Pact", *mimeo*, EBRD, 13 January.
- BUITER, W. H. and C. GRAFE, 2003. "Patching up the Pact, Some suggestions for enhancing fiscal sustainability and macroeconomic stability in an enlarged European Union", *CEPR Discussion Paper*, No. 3496, August.
- BUTI, M., S. EIJJFINGER, and D. FRANCO, 2003. "Revisiting the Stability and Growth Pact: grand design or internal adjustment?", *European Economy, Economic Papers*, No. 180, January.
- BUTI, M. and G. GIUDICE, 2002. "Maastricht's fiscal rules at ten: an assessment", *Journal of Common Market Studies*, Vol. 40.
- BUTI, M. and P. Van Den NOORD, 2004. "Fiscal Policy in EMU: Rules, discretion and political incentives", *European Economy, Economic Papers*, No. 206, July.
- CALMFORS, L., G. CORSETTI, J. FLEMMING, S. HONKAPOHJA, J. KAY, W. LEIBFRTZ, G. SAINT-PAUL, H.-W. SINN, and X. VIVES, 2003. *EEAG Report on the European Economy*, Ifo Institute for Economic Research, February.

- CAPOEN, F., H. STERDYNIK and P. VILLA, 1994. "Indépendance des Banques centrales, politique monétaire et budgétaire: une approche stratégique", *Revue de l'OFCE*, No. 50, July.
- CŒURE, B. and J. PISANI-FERRY, 2003. "A sustainability pact for the eurozone", *mimeo*, 10 February.
- CREEL, J., T. LATREILLE, and J. Le CACHEUX, 2002. "Le Pacte de stabilité et les politiques budgétaires dans l'Union européenne", *Revue de l'OFCE*, Hors série, March.
- CREEL, J. and H. STERDYNIK, 1995. "Les déficits publics en Europe: causes, conséquences ou remèdes à la crise?", *Revue de l'OFCE*, No. 54, July.
- DELBECQUE, B., 2003. "Le Pacte de stabilité européen: une nécessité à court et à long terme", *Regards Économiques*, June.
- DENIS, C., K. Mc MORROW, and W. RÖGER, 2002. "Production function approach to calculating potential growth and output gaps – estimates for EU Member States and the US", *European Economy, Economic Papers*, No. 176, September.
- De GRAUWE, P., 2004, "Towards an intelligent Stability and Growth Pact", *mimeo*, Euro50 meeting, Brussels, May.
- EICHENGREEN, B., 2003. "Institutions for fiscal stability", *Working Paper PEIF-14*, October.
- EISNER, R., 1989. "Budget deficits: rhetoric and reality", *The Journal of Economic Perspectives*, Volume 3, No. 2, Spring.
- EUROPEAN COMMISSION, 2002a. "Public finances in EMU", *European Economy*, No. 3/2002.
- EUROPEAN COMMISSION, 2002b. "Strengthening the co-ordination of budgetary policies", *Communication to the Council and the European Parliament*, 21 November.
- EUROPEAN COMMISSION, 2004a. "Public finances in EMU", *European Economy*, No. 3.
- EUROPEAN COMMISSION, 2004b. "Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact", *Communication to the Council and the European Parliament*, COM(2004) 581 final, 3 September.
- FATÁS, A., A. HUGHES HALLETT, A. SIBERT, R. STRAUCH, and J. Von HAGEN, 2003. *MEI 13 Stability and Growth in Europe: Towards a Better Pact*, CEPR.
- FITOUSSI, J.-P., 2002. *La règle et le choix*, Paris: Le Seuil.
- FITZ GERALD, J., A. BERGIN, J. CULLEN, and D. McCOY, 2004: "Stability and Growth Pact: How much co-ordination in an expanding Union?", *mimeo*, First EUROFRAME Conference *Fiscal Policies in the European Union*, Paris, 4, June.
- GROS, D., 2003. "A stability pact for public debt?", *CEPS Policy Brief*, No. 30, Brussels, January.
- JÈZE, G. and M. BOUCARD, 1896. *Cours de la science des finances et de la législation financière*, Paris: V. Giard et E. Brière.
- KELLERMANN, K. 2004. "Allocative inefficiency of debt financing of public investment – an ignored aspect of 'the golden rule of public sector borrowing'", *mimeo*, First EUROFRAME Conference *Fiscal Policies in the European Union*, Paris, 4, June.
- LEROY-BEAULIEU, P., 1891. *Traité de la science des finances*, Paris: Guillaumin et C^{ie}.

- MODIGLIANI, F., J.-P. FITOUSSI, B. MORO, D. SNOWER, R. SOLOW, A. STEINHERR, and P. SYLOS LABINI, 1998. 'An economist's manifesto on unemployment in the European Union', *BNL Quarterly Review*, No. 206, September.
- MUSGRAVE, R., 1939. 'The nature of the budgetary balance and the case for a capital budget', *American Economic Review*, Vol. 29.
- OKSANEN, H., 2004. "Population Ageing, Pension Reforms and Public Finance Targets", *mimeo*, First EUROFRAME Conference *Fiscal Policies in the European Union*, Paris, 4, June.
- PISANI-FERRY, J., 2002. Fiscal discipline and policy co-ordination in the eurozone: assessment and proposals, *mimeo*, May.
- VON STEIN, L., 1985. *Lehrbuch der Finanzwissenschaft*, Leipzig, F.A. Brockhaus.
- WREN-LEWIS, S., 2003. "Changing the rules", *New Economy*.
- WYPLOSZ, C., 2002. 'Fiscal discipline in EMU: rules or institutions?', *mimeo*, *Meeting of the Group of Economic Advisers of the EC*, 16 April.

RELATIVE INCOME POVERTY RISK: WHAT IRELAND CAN LEARN FROM THE BEST-PERFORMING COUNTRIES

Tim Callan and Brian Nolan

1.
Introduction

While Ireland's income per head has converged rapidly with the EU average, the numbers falling below relative income thresholds such as 50 per cent or 60 per cent of median income here remains high compared with many other EU countries. Why is this, and what can Ireland learn from the experience of EU countries which have sustained much lower percentages below such thresholds? Such questions are important to Ireland's engagement with the Lisbon strategy adopted by the European Union in 2000, which *inter alia* set the goal of making a decisive impact on the eradication of poverty and social exclusion by 2010. To help achieve this what is termed the "open method of coordination" is being employed, whereby member states are to identify and exchange information on best practice by reference to an agreed set of indicators of social inclusion. These indicators, adopted at the Laeken European Council meeting in December 2001, include the numbers falling below various proportions of median income.

Falling below such relative income thresholds is not enough in itself to constitute being in poverty. A range of studies for Ireland and other EU countries has shown that only some of those towards the bottom of the income distribution display high levels of deprivation, are experiencing what would commonly be thought of

as poverty in their society.¹ For this reason the official Irish National Anti-Poverty Strategy targets focus on a measure of poverty (developed at the ESRI) which incorporates both being below such income thresholds and experiencing rather basic forms of deprivation – termed “consistent poverty” (see for example Whelan *et al.*, 2003). However, those falling below relative income thresholds are certainly at an enhanced risk of poverty. This is reflected in the EU’s Laeken indicators regarding them as measures of “the risk of poverty” rather than of poverty *per se* (see Box). Countries which have the lowest percentage of their populations falling below such relative income thresholds also appear to have been relatively successful in promoting social inclusion on a range of other dimensions, so it is worth trying to learn from their experiences.

The paper is structured as follows. Section 2 reports on how Irish relative income poverty rates compare with those of other EU countries, including comparisons for the elderly and children as well as the total population. Section 3 looks at possible explanations for the gap between Irish poverty risk rates and those in the best performing countries. For example, are higher Irish rates due to the demographic factors, with groups which usually have above-average rates being particularly prevalent in Ireland? Or to what extent do differences in the tax and benefit systems contribute to explaining the gap? Section 4 turns to policies on child income support, documenting recent shifts in policy. We re-examine how Irish child income supports compare with EU countries where child income poverty is low, and consider how the impact of recent policy shifts can be assessed. The main conclusions are drawn together in Section 5.

Measuring Progress towards Social Inclusion – The Laeken Indicators

In December 2001, the European Council held at Laeken in Belgium adopted a set of commonly agreed and defined indicators of social inclusion, which will in the future play a central role in monitoring the performance of the Member States in promoting social inclusion (see Atkinson *et al.*, 2002, 2004 for a discussion). These indicators are intended to allow the Member States and the Commission to monitor progress towards the goal set by the European Council of Lisbon of making a decisive impact on the eradication of poverty by 2010. They were developed by the Social Protection Committee and its Indicators Sub-Group, which recommended that a specific set of Primary and Secondary Indicators be employed. The first of the Primary Indicators is the percentage falling below 60 per cent of median income in the country in question. The Indicators Sub-Group emphasised that this was to be seen as a measure of people who are “at risk of being

¹ See for example Nolan and Whelan (1996); Layte, Maître, Nolan and Whelan (2002); Whelan, Layte and Maître (forthcoming).

poor”, not a measure of poverty – and for that reason it is labelled the “low income rate”.

It is complemented by other Primary indicators also based on this relative income threshold. One measures the depth of the shortfall for those below the 60 per cent threshold. Another measures low income persistence, that is the number of people below 60 per cent of median income who had also been below that income line for at least two of the previous three years.

The Secondary indicators also include the numbers below alternative relative income thresholds, set at 40 per cent, 50 per cent and 70 per cent of the median. They do in addition include a “low income rate” where the income threshold is anchored at a moment in time and indexed to price increases rather than to median income as with the purely relative lines. However, in tracking low income the dominant focus in the agreed social inclusion indicators is clearly on relative income thresholds. Since performance *vis-à-vis* those thresholds is going to receive a great deal of attention at EU level, it is all the more important to understand the factors underlying Ireland’s ranking in terms of this “low income” or relative income poverty rate.

2. Where Does Ireland Stand?

So where does Ireland rank in terms of the rate of relative income poverty risk? The obvious place to start in answering this question is with the figures produced by Eurostat from the European Community Household Panel Survey, recently presented among the agreed indicators of social inclusion in the Joint Report on Social Inclusion (2004). We reproduce in Table 1 the figures shown there for percentage falling below 60 per cent of median income in each of the EU Member States, for 1995 and every two years thereafter to 2001.

Table 1: Percentage of Persons below 60 Per Cent of Median Equivalised Income, Modified OECD Scale, 1995, 1997, 1999, 2001

Percentage of persons below 60 per cent of median							
Country	1995	Country	1997	Country	1999	Country	2001
Sweden	n.a.	Sweden	8	Sweden	8	Sweden	9
Finland	n.a.	Finland	8	Denmark	10	Denmark	10
Denmark	10	Denmark	10	Germany	11	Germany	11
Netherlands	11	Netherlands	10	Netherlands	11	Netherlands	11
Luxembourg	12	Luxembourg	11	Finland	11	Finland	11
Austria	13	Germany	12	Austria	12	Luxembourg	12
Germany	15	Austria	13	Luxembourg	13	Austria	12
France	15	Belgium	14	Belgium	13	Belgium	13
Belgium	16	France	15	France	15	France	15
Spain	19	UK	18	Italy	18	UK	17
Ireland	19	Italy	19	UK	19	Spain	19
UK	20	Ireland	19	Spain	19	Italy	19
Italy	20	Spain	20	Ireland	19	Greece	20
Greece	22	Greece	21	Greece	21	Portugal	20
Portugal	23	Portugal	22	Portugal	21	Ireland	21
EU15	17	EU15	16	EU15	15	EU15	15

Source: *Joint Report on Social Inclusion* (2004), Statistical Annex, Table 1.

Countries are ranked by the relative income poverty rate (60 per cent of median equivalised income) for each year, and the countries with the lowest rates (including ties for 3rd place) are highlighted in bold at the top of the table. Denmark and the Netherlands have been consistently among the countries with the lowest relative income poverty risk rates over the period, and it is these countries which are the main comparators in our later analysis. The group also includes Sweden, which has had the lowest rate for all the years for which it is included, Finland, and, in more recent years, Germany. Relative income poverty rates for this group were between 8 and 11 per cent over the period, well below the EU average.

Ireland's relative income poverty rate (also in bold in Table 1) has been above the EU average of 15 to 17 per cent throughout. In the mid-1990s the Irish rate of 19 per cent was close to that in the UK, Spain and Italy, with somewhat higher rates in Greece and Portugal. By 2001 a rise in the Irish rate to 21 per cent, combined with falls in the Greek and Portuguese rates made Ireland the country with the highest relative income poverty risk rate in the EU-15.

The picture has been rather different at lower cut-offs. In 1997, for example, at 40 per cent of median equivalised income, the Irish relative income poverty rate of 2 per cent was the lowest in the EU and the Irish poverty rate of 10 per cent at half of median income was below the EU average. But by 2001 (Table 2), Ireland has the highest proportions of persons falling below relative income poverty cut-offs at 50 per cent, 60 per cent and 70 per cent of median income. At the lowest, 40 per cent cut-off, the proportion of persons falling below the cut-off was the same (5 per cent) in Ireland as the EU average.

Table 2: Ranking of EU-15 Countries by Extent of Relative Income Poverty at Alternative Income Cut-offs, 2001

Percentage of persons living in households with disposable income per adult equivalent below							
Country	40 per cent of median	Country	50 per cent of median	Country	60 per cent of median	Country	70 per cent of median
Belgium	2	Belgium	6	Sweden	10	Sweden	18
Denmark	2	Germany	6	Denmark	11	Denmark	19
Finland	2	Luxembourg	6	Germany	11	Germany	19
Germany	3	Netherlands	6	Netherlands	11	Netherlands	19
Luxembourg	3	Austria	6	Finland	11	Austria	19
Austria	3	Finland	6	Luxembourg	12	Finland	20
Sweden	3	Sweden	6	Austria	12	Belgium	21
France	4	Denmark	7	Belgium	13	Luxembourg	21
Netherlands	4	France	9	France	15	France	23
Ireland	5	UK	11	UK	17	UK	26
UK	5	Spain	13	Spain	19	Spain	27
Portugal	6	Italy	13	Italy	19	Italy	27
Spain	7	Portugal	13	Greece	20	Greece	28
Greece	8	Greece	14	Portugal	20	Portugal	28
Italy	8	Ireland	15	Ireland	21	Ireland	29
EU-15 average	5		9		15		23

Source: *Joint Report on Social Inclusion (2004)*, Statistical Annex.

Table 3 gives relative income poverty risk rates in 2001 for different age groupings: under 16s, over 16s (including the elderly) and the elderly defined as over 65s. Interestingly, while Denmark and the Netherlands have the same overall rate of income poverty, they have quite different rates for children and the elderly – neither is close to best performance in both fields.² This distinction is held by Sweden, which has poverty risk rates close to the best for children, adults and the elderly. Denmark has the best results on children, with only 5 per cent of children living in households below 60 per cent of median equivalised income. Ireland's rate is 26 per cent, one of the highest in the EU.

The lowest rate of relative income poverty for the elderly is in the Netherlands, where only 4 per cent of elderly individuals live in households below the cut-off income. The EU-average rate is 15 per cent, but the rate in Ireland is 44 per cent – substantially higher than in any other country. This raises questions about the causes of poverty among the elderly and the best means of tackling poverty among older persons, which are worthy of a substantial study in themselves, but cannot be tackled here.

Table 3: Relative Income Poverty Rates (60 per cent of median equivalised income) by Age Category, EU-15, 2001

Age	Less than 16 years	Country	16 years and over	Country	65 years and over	Country	Total
Denmark	5	Netherlands	10	Netherlands	4	Sweden	10
Finland	6	Sweden	11	Luxembourg	7	Denmark	11
Sweden	10	Germany	11	Sweden	9	Finland	11
Belgium	12	Luxembourg	11	Germany	12	Germany	11
Austria	13	Denmark	12	Italy	17	Netherlands	11
Germany	14	Austria	12	France	19	Austria	12
Netherlands	16	Finland	13	Spain	22	Luxembourg	12
Greece	18	Belgium	14	Finland	23	Belgium	13
France	18	France	15	Austria	24	France	15
Luxembourg	18	UK	15	UK	24	UK	17
UK	24	Italy	18	Belgium	26	Italy	19
Italy	25	Spain	18	Denmark	29	Spain	19
Spain	26	Portugal	18	Portugal	30	Greece	20
Ireland	26	Ireland	20	Greece	33	Portugal	20
Portugal	27	Greece	21	Ireland	44	Ireland	21
EU-15	19	EU-15	15	EU-15	19	EU-15	15

Note: Modified OECD equivalence scale (1 for first adult, 0.5 for other adults, 0.3 for children).

Source: *Joint Report on Social Inclusion* (2004), Statistical Annex.

² Some questions have been raised about the accuracy of the figure for relative income poverty for the elderly in Denmark, but this is unlikely to affect the interpretation given here.

3. Why is Relative Income Poverty So High in Ireland?

DEMOGRAPHIC STRUCTURE, LABOUR MARKET AND HOUSEHOLD COMPOSITION

Biewen and Jenkins (2002) point out that when a low poverty rate is observed in a particular country, this may arise:

- (a) because relatively few individuals in this country have characteristics usually associated with poverty (e.g., unemployment, illness or lone parenthood) or
- (b) because, although there are many individuals with characteristics linked to a high risk of poverty, the risk in that country, given those characteristics, is itself low relative to the risk in other countries.

It is possible to distinguish between these possibilities using comparative analysis of harmonised household survey data for different countries and focusing on the numbers falling below relative income poverty lines. Callan *et al.* (2004) use European Community Household Panel data for 5 countries: the Netherlands, Ireland, Germany, the UK and Portugal to explore the significance of structural differences in the labour market, demographic profile and household composition for the extent of relative income poverty. The method employed is straightforward. The question asked is, in effect, what the relative income poverty rate in these countries would be if they all had the same unemployment rate, or the same age structure, or the same household structure, and nothing else changed. To derive those results, actual survey data are simply reweighted to shrink or expand the size of the group in question, without changing any of their circumstances or the situation of the rest of the sample – most importantly, their incomes.

An overall conclusion from these simulation exercises is that differences in age profiles, patterns of labour force participation, and household composition across the countries examined do not in themselves appear to play the major role in explaining the substantial variation observed in relative income poverty rates. Thus for Ireland,³ with 20 per cent of households below 60 per cent of median equivalised income compared with only 12 per cent in the Netherlands, simulating the impact of imposing the Dutch age, labour force or household composition structures did not close that gap – indeed it sometimes widened it. This reflects, among other things, a fundamental and often under-appreciated feature of relative income thresholds themselves: in effect, reducing the proportion in high-poverty-risk groups does not necessarily reduce the overall poverty rate as measured by such thresholds, because the standard against which poverty is being assessed is also affected. The simulations thus displayed a much stronger influence of imposing the Dutch structures on the composition of the group

³ These figures are on a household basis and thus differ slightly from those in Section 2.

found below relative income thresholds than on the size of that group. This is still very important for understanding the factors producing income poverty risk and designing strategic responses, but it does not explain very much of the persistent gap that is observed between relative income poverty rates in the countries concerned.

This result need not necessarily hold if the set of countries studied were expanded or changed, but it is worth noting that it is entirely consistent with the results from a similar exercise carried out with data from the Luxembourg Income study. Rainwater and Smeeding (1997) employ a similar simulation method based on reweighting the survey samples. Their analysis covers the Netherlands, Belgium, Denmark, France, Germany, the UK, Australia and the USA and arrives at similar findings to those discussed above. Rainwater and Smeeding conclude that social protection and the way household income is built up or “packaged” have far stronger effects on income poverty (and income inequality) than demographic factors such as age or household composition. Focusing on the Netherlands, they conclude that:

It is the Dutch income package, not its demography, which produces low rates of poverty.

Biewen and Jenkins (2002), using somewhat different methods also obtain similar findings: most of the poverty difference between the US and Britain, and between the US and Germany was accounted for by higher US risks of poverty for any given set of personal characteristics. This was partly offset by a more favourable distribution of household characteristics in the US, principally a higher employment rate.

It is also worth noting the potential impact of another factor often mentioned as complicating cross-country comparisons of income poverty and income inequality, namely housing costs and home ownership. Measuring cash income does not take into account the fact that some households own their house and have paid off their mortgages, whereas others face high housing costs – so two households on the same income might have rather different spending power. While this complicates comparisons across households within countries, it also could affect comparisons across countries with very different rates of home ownership. Since Ireland has a very high rate of home ownership, this could be particularly important in assessing our comparative position. This has been investigated in two recent studies, one focusing on the analysis of poverty in Ireland (Fahey, Nolan and Maître 2004a) and the other on housing costs and income poverty across EU countries (Fahey, Nolan and Maître 2004b). These found that while the types of household found below relative income poverty lines might indeed be affected by using income after housing costs are subtracted, the impact on the overall scale of relative income poverty was modest.

EARNINGS INEQUALITY

Earnings constitute the predominant component of market income in most industrialised countries and have, in consequence, a major

influence on disposable income. We know that there is considerable diversity across countries in the dispersion of individual earnings (Atkinson *et al.*, 1995) and that within countries earnings dispersion can change quite sharply over time. Earlier work (Nolan *et al.*, 2000) on earnings inequality in Ireland has found that it was already quite high in 1987 relative to a range of countries, and rose sharply in subsequent years. This lends further weight to the notion that it may be useful to investigate the potential impact of earnings inequality on differences in relative income poverty between Ireland and other countries.

Callan *et al.* (2004) investigate this issue again using a fairly straightforward technique. The question asked is what would happen in each country if earnings were distributed completely equally? i.e., if each wage earner received exactly the same total earnings – irrespective of occupation, qualifications, industry, sex, marital status or hours worked. This would equalise wage earnings as between all those currently earning a wage – inequalities in income would still arise between persons who were employed, unemployed or out of the labour force. Equalisation of wages has downstream implications in terms of income tax liabilities and social welfare entitlements. For this reason, investigation of the impact of this hypothesis requires the use of a tax-benefit model. Callan *et al.* (2004) make use of the EUROMOD tax-benefit model to explore the impact of “wage equalisation” – or conversely, the inequality in wages – on measures of poverty in Denmark, Portugal, the UK and Ireland. As the head count is a poverty measure which can be particularly sensitive to small changes for individuals located in the neighbourhood of the income poverty line, two additional measures were also used: a “poverty gap” which takes into account how far individuals fall below the poverty line, and a “weighted poverty gap” which takes into account the distribution of such income shortfalls.

For all three poverty measures, the results show that wage equalisation leads to substantial *proportionate* reductions in income poverty in Denmark, the UK and Portugal. Ireland is the exception – wage equalisation has a rather limited impact, no matter which measure of relative income poverty is used. As a result, it seems that differences in earnings inequality between Ireland and, say, Denmark are not likely to play a large role in explaining the difference in relative income poverty between the two countries. Even if Irish earnings inequality were to be eliminated completely it would have rather limited impact, while a lesser impact could be expected if the reduction in inequality was simply to the Danish level.

WELFARE BENEFITS AND TAX SYSTEMS

To what extent can inter-country differences in relative income poverty rates be attributed to differences in tax/transfer systems? Aggregate measures indicate that social expenditure forms a low

proportion of national income in Ireland, much lower than in the EU countries with the lowest relative poverty rates.⁴ Aggregate level comparisons of “welfare effort” and relative income poverty rates suggest that there is a relationship. Data for 1999 suggest that an extra percentage point on social security as a proportion of GDP is associated, on average, with a reduction of 0.4 percentage points in the proportion of persons falling below 60 per cent of median income.

There is, however, a more direct way to examine the possible impact of differences in tax and welfare structures on inter-country differences in relative income poverty. This involves using a tax-benefit model which can examine the first-round impact of simulating a “foreign country” policy as well as its own domestic policies to arrive at a more precise estimate of how much policy differences contribute to the explanation of differences in poverty rates. Callan *et al.* (2004) use *SWITCH*, the ESRI tax benefit model, in conjunction with information on Danish policies generated in the construction of EUROMOD, a tax-benefit model for Europe, to undertake such an analysis. The year for which the comparison was undertaken was 1998.

The impact of welfare benefits on relative income poverty depends crucially on how benefit payment rates relate to the poverty line, which is in turn related to average incomes. For this reason, we focus on benefit payment rates in Ireland and in Denmark in relation to national average earnings. When “importing” the Danish policy into the Irish setting, we ensure that the payment rate provides the same proportion of average earnings as in the original Danish setting.

A further key difference is that a greater proportion of the Danish population is covered for key social insurance schemes than in Ireland. If eligibility depended on contributions then past employment history and contribution record would be critical. But for some of the biggest social insurance schemes in Denmark – including pensions – eligibility is linked to *residence*, so that how much is paid in pension depends on the length of stay in the country, not on former income or contribution record. In order to capture this difference, we simulate a “Danish-style” system in Ireland under which the payment rates for non-contributory and contributory Old Age Pensions are the same, and scaled to provide the same level of income in relation to average earnings as the Danish pension.

As might be expected, there is a substantial cost associated with moving to Danish-style payment rates and coverage. The net cost (after tax revenue from increased payments) is of the order of €2,400 million per annum. To arrive at a consistent scenario for evaluation of the impact of such a policy, we examine a situation in

⁴ The adjustments suggested by Lawlor and McCarthy (2003) would not alter this conclusion.

which the standard and top rates of income tax are raised by 11 percentage points each (i.e., from 24 to 35 per cent, and from 46 to 57 per cent). Clearly, such substantial changes in welfare payments and tax rates would have significant implications for labour market behaviour (see Callan *et al.* (2003) for estimates of likely behavioural responses to tax/transfer policy changes), and we return to this critical issue below. Nevertheless, it is of interest to explore the potential first-round impact of this change to tax and welfare policies on relative income poverty, before any consequent changes in behaviour.

The simulation results show substantial falls in the Irish income poverty rate at 60 per cent of median income, the application of the Danish structure/support levels reducing the rate by 7 percentage points. There is little or no impact on poverty at the lower cut-offs. This means, loosely speaking, that differences in social protection could account for about two-thirds of the difference in actual relative poverty rates between the two countries with the 60 per cent threshold, which tends to be taken as the “headline” social inclusion indicator at EU level. This simulation takes into account the need to increase taxes, but does not take account of behavioural responses in the labour market.

What are the broader lessons to be drawn from this analysis? Atkinson has pointed out that:

Social investment in improving labour market skills and employability, or an ‘active welfare state’, is an important part of anti-poverty policy, but is not a complete substitute for social spending (Atkinson, 2000).

Thus, for anti-poverty policy to make progress requires enhanced education and employment opportunities and improved income supports. Both elements are necessary – neither is sufficient on its own to ensure success in combating relative income poverty.

The success of countries such as Denmark and the Netherlands in keeping relative poverty at low levels over a sustained period depends crucially on both of these factors: a high employment rate and a comprehensive welfare system ensuring that those without income from employment have an adequate income. Each of these factors is necessary, but neither on its own can be regarded as sufficient to keep relative poverty at a low level. Since the mid-1980s Ireland has made the transition from a labour market with relatively low participation rates and high unemployment to one with high employment and low unemployment. This represents a major achievement, and one of the two key elements identified above as distinguishing countries with low relative poverty rates such as Denmark and the Netherlands from others. Over this period, however, relative income poverty in Ireland has remained higher than the EU average. Comparison with “best practice”, in the EU countries who do best on this indicator, suggests that achieving low rates of relative income poverty risk would require a more comprehensive safety net and higher rates of welfare payment. In considering this issue further it will be necessary to clarify how Scandinavian countries and the Netherlands have managed to

combine high replacement rates with high employment rates, and to be aware of current trends and issues in the management and development of these systems.

4. Child Income Support Policy

EVOLUTION OVER TIME AND IN INTERNATIONAL CONTEXT

We have seen that Ireland continues to have a high rate of relative income poverty risk for children, despite dramatic economic growth, and child income support policy has been high on the policy agenda here for a number of years, so it is worth focusing in on this topic here. Concern about child poverty and about work disincentives associated with income support for children – as well as about the costs of childcare – were among the factors behind a major shift in Irish child income support policy from the mid-1990s. Table 4 sets out the evolution of payment rates for Child Benefit and for “child dependant additions” – that is extra payments for social welfare recipients with children, now termed “qualified child additions”. Much of the change occurred during the three years 1999 to 2002. Over this period, child benefit was almost trebled in nominal terms and more than doubled as a proportion of the average industrial wage. Over the full period, the total nominal expenditure on Child Benefit (CB), Child Dependant Additions (CDAs) and Family Income Supplement (FIS) more than trebled and the share of Child Benefit in the overall child income support package rose to about 80 per cent.

Table 4: Rates of Payment for Child Benefit and Child Dependant Addition, 1997-2004

	1997	1998	1999	2000	2001	2002	2003	2004
	€per week							
Child benefit (1st or 2nd child)	8.78	9.22	10.09	12.43	19.75	27.10	28.94	30.32
Child benefit (3rd or higher order child)	11.41	12.29	13.46	16.38	25.16	33.94	36.24	38.09
CDA for most schemes	16.76	16.76	16.76	16.76	16.76	16.80	16.80	16.80
CDA for One-parent Family Payment	19.30	19.30	19.30	19.30	19.30	19.30	19.30	19.30
CDA for Widow's Contributory Pension	21.59	21.59	21.59	21.59	21.59	21.60	21.60	21.60

Table 5: Rates of Payment for Child Income Supports as Percentage of Average Industrial Wage, 1997-2004

	1997	1998	1999	2000	2001	2002	2003	2004
	Percentage of average industrial wage							
Child benefit (1st or 2nd child)	2.4	2.4	2.5	2.9	4.2	5.4	5.4	5.4
Child benefit (3rd or higher order child)	3.1	3.2	3.3	3.8	5.3	6.8	6.7	6.8
CDA for most schemes	4.5	4.3	4.1	3.8	3.6	3.3	3.1	3.0
CDA for One-parent Family Payment	5.2	5.0	4.7	4.4	4.1	3.8	3.6	3.4
CDA for Widow's Contributory Pension	5.8	5.6	5.3	4.9	4.6	4.3	4.0	3.8

How then does Irish child income support policy, after this major shift, compare with that of low-poverty countries such as Denmark? This needs to be investigated in depth but Table 6 below gives some interesting preliminary indications, looking at benefit payment rates as a proportion of the average industrial wage in Ireland and Denmark. It shows that in 1998 Irish child benefit rates were somewhat lower than the corresponding Danish rates – this was particularly for young children where the Danish rates were highest. Total child income support for those receiving child dependant additions varied across schemes both in Denmark and in Ireland. For those in receipt of the lowest child dependant addition the Irish rates were higher, but those on the highest payments did better in Denmark. Turning to Irish rates in 2004, we see that the substantial increase in Child Benefit has had a major impact, bringing our overall child income support above the levels paid in Denmark in 1998. Those receiving Child Benefit only, not CDAs, will have seen the most pronounced increase in support. However, over this particular period even those also on CDAs – which were frozen in nominal terms – saw their overall child income support package increase as a proportion of average industrial earnings.

Table 6: Rates of Payment for Child Income Supports as Percentage of Average Industrial Wage, 1997-2004

	Ireland 1998	Denmark 1998	Ireland 2004
Child benefit (1st or 2nd child)	2.4	2.9 - 4.1	5.4
Child benefit + min CDA	6.7	4.6 - 5.8	8.4
Child benefit + max CDA	8.0	7.9 - 9.1	9.2

While more detailed comparisons are needed, results from a 22-country study by Bradshaw and Finch (2002)⁵ confirm the impression that, at least in terms of cash benefits and taxes, the Irish system of child income support is now one of the more generous in relation to average wages. So the persistently high percentage of children – and of the population as a whole – falling below relative income poverty thresholds in Ireland does not seem to be attributable to relatively low levels of child income support *per se*, certainly after recent increases. We look in more detail in the next section at the impact these increases may have had on the numbers – adults and children – falling below relative income thresholds.

⁵ The USA, Canada, Japan, Australia, New Zealand, Norway and Israel are included as well as the EU-15.

IMPACT OF RECENT RESTRUCTURING OF CHILD INCOME SUPPORT

What was the impact of this expansion and refocusing of child income support on the overall extent of relative income poverty risk? In order to explore this question we focus in particular on the period between 1999 and 2002, which saw the biggest changes. Child Benefit was increased very significantly, CDA rates were frozen, and rates of Child Benefit exceeded the main CDA rates for the first time.

A key issue in assessing the impact of these policy changes is establishing the appropriate counterfactual – what would have happened if these policy changes had not taken place? There is no single answer to this question, but we consider two counterfactuals:

- (a) Child benefit and CDAs could have been increased in line with average wages, with the money saved being spent in other ways outside the tax and benefit system e.g., infrastructure, retiring debt.
- (b) Child benefit and CDAs could have been increased in line with average wages, with the money saved instead being used for income tax reductions. (Our analyses for previous Budget Perspectives conferences of shifts in tax and welfare policy showed that resources over and above those needed for wage indexation of the tax and welfare systems tended to go to income tax reductions before 1999.)

Table 7: Relative Income Poverty: Impact of Increased Child Benefit Versus "Indexed" Child Income Support Levels 1999-2002

	Child Benefit and CDAs indexed to wage growth since 1999	Actual 2002 policy
Median income	€301.53	€308.24
Relative income cut-offs	% of individuals below cut-off	
< 50 % of median	12.5	12.7
< 60 % of median	22.0	20.9

Table 7 shows that relative to indexing child income support rates to wage growth, the impact of the actual 2002 policy was to reduce relative income poverty at 60 per cent of median income by about 1 percentage point and have little impact at 50 per cent of the median.

Table 8: Relative Income Poverty: Impact of Increased Child Benefit versus "Indexed" Child Income Support and Increased Personal Tax Credit 1999-2002

	Personal Tax Credit Increased, Child Benefit and CDAs indexed to wage growth	Actual 2002 policy
Median income	€307.47	€308.24
Relative income cut-offs	% of individuals below cut-off	
< 50 %	13.5	12.7
< 60 %	22.4	20.9

Table 8 shows that a somewhat stronger impact is found when comparing 2002 policy with an alternative involving additional tax cuts, with relative income poverty rates falling by about 1-1.5 percentage points.

In evaluating these effects, which may seem modest, it must be remembered that they refer to the overall number of below relative income thresholds, and that many of the households affected do not include children. It must be emphasised that the benchmark adopted has assumed Child Benefit would have been increased in line with wages anyway, so only the impact of the additional increases over and above that are being assessed. In fact, Child Benefit has in the past often been left unchanged in nominal terms for lengthy periods, and a comparison against such a benchmark would of course show larger effects.

5. Conclusions

While average income per head has risen dramatically in Ireland over the last decade, the numbers falling below relative income poverty thresholds (such as 50 per cent or 60 per cent of median income) remain well above the EU average. All those falling below such relative income thresholds are not poor: as the EU's agreed Social Inclusion Indicators put it they are best seen as "at risk of poverty". Consistent with the emphasis in the EU's Social Inclusion Strategy on member states learning from one another, we have focused on what can be learned from a comparison of Ireland with EU countries which have sustained much lower percentages below such thresholds, notably The Netherlands and Denmark.

Simulation approaches demonstrate that differences in the age profile (including the proportion of older people), the pattern of labour force participation (including unemployment), and household composition (including the frequency of lone parenthood) do not generally play the major role in the cross-country variation in the percentage "at risk of poverty". It also seems that differences in earnings inequality between Ireland and, say, Denmark do not play a large role in explaining the difference in relative income poverty between the two countries. Differences in tax and welfare rates and structures are more important: tax-benefit model simulations applying Danish welfare structures and support levels (relative to average income) to Ireland finds this substantially reduces income poverty risk. There is of course a substantial extra cost associated with Danish-style payment rates and coverage – if funded fully from income tax, the standard and top rates of income tax would each have to be raised by 11 percentage points, with major implications for incentives and behaviour.

Child income support has been the focus of particular attention in Ireland, and the orientation of policy shifted dramatically towards universal rather than means-tested payment for a time. From 1999 to 2002 Child Benefit more than doubled as a proportion of the average industrial wage, and the overall child income support package caught up on that payable in Denmark at the start of the period. Certainly by 2002 the high percentage falling below relative

income poverty thresholds does not seem to reflect low levels of child income support *per se*, but the overall support provided by social protection and the context in which it is provided.

Successful anti-poverty policy requires both enhanced education and employment opportunities and improved income supports – neither is enough on its own. Countries such as Denmark and the Netherlands have sustained both high employment and a comprehensive welfare system ensuring that those without income from employment have an adequate income. Over the last decade Ireland has successfully made the transition to high employment and low unemployment rates. The experience of other EU countries suggests that achieving low rates of relative income poverty risk would in addition require a more comprehensive safety net and higher rates of welfare payment relative to average incomes. Such higher spending would of course have to be financed via higher taxation, and the implications for economic incentives, behaviour and growth are critically important to the strategic choices to be made.

REFERENCES

- ATKINSON, A.B., 2000. “A European Social Agenda: Poverty Benchmarking and Social Transfers”, EUROMOD Working Paper No. EM3/00.
- ATKINSON, A.B., L. RAINWATER and T. SMEEDING, 1995. *Income Distribution in OECD Countries*, Social Policy Studies No. 18, Paris: OECD.
- ATKINSON, A.B., B. CANTILLON, E. MARLIER and B. NOLAN, 2002. *Social Indicators: the EU and Social Inclusion*, Oxford: Oxford University Press.
- ATKINSON, A.B., B. CANTILLON, E. MARLIER and B. NOLAN, 2004. “Indicators and Targets for Social Inclusion in the European Union”, *Journal of Common Market Studies*, Vol. 42, No. 1, pp. 47-75.
- BIEWEN, M. and S. JENKINS, 2002. “Accounting for Poverty Differences Between the United States, Great Britain and Germany”, ISER Working Paper No. 2002-14.
- BRADSHAW, J. and N. FINCH, 2002. “A Comparison of Child Benefit Packages in 22 Countries,” Social Policy Research Unit: University of York.
- CALLAN, T., R. LAYTE, A. VAN SOEST and J. WALSH, 2003. *Benefits and Labour Market Responses: New Evidence for Ireland*, Policy Research Series Paper No. 48, Dublin: The Economic and Social Research Institute.
- CALLAN, T., M. KEENEY, B. NOLAN and B. MAÎTRE, 2004. *Why is Relative Income Poverty So High in Ireland?*, Policy Research Series Paper No. 53, Dublin: The Economic and Social Research Institute.
- EUROPEAN COMMISSION, 2004. *Joint Report on Social Inclusion*, Luxembourg: Office for Official Publications of the European Communities.
- FAHEY, T., B. NOLAN and B. MAÎTRE, 2004a. *Housing, Poverty and Wealth in Ireland*, Dublin: Institute for Public Administration/Combat Poverty Agency.
- FAHEY, T., B. NOLAN and B. MAÎTRE, 2004b. “Housing Expenditures and Income Poverty in EU Countries”, *Journal of Social Policy*, Vol. 33, No. 3, pp. 437-454.

- LAWLOR, J. and C. McCARTHY, 2003. "Browsing Onwards: Irish Public Spending in Perspective", *Irish Banking Review*, Autumn.
- NOLAN, B. and C.T. WHELAN, 1996. *Resources, Deprivation and Poverty*, Oxford: Clarendon Press.
- LAYTE, R., B. MAÎTRE, B. NOLAN and C. T. WHELAN, 2001. "Persistent and Consistent Poverty: An Analysis of the First Two Waves of the ECHP", *Review of Income and Wealth*, Series 47, No. 4, pp. 427-50.
- NOLAN, B., B. MAÎTRE, D. O'NEILL and O. SWEETMAN, 2000. *The Distribution of Income in Ireland*, Dublin: Oak Tree Press.
- RAINWATER, L. and T. SMEEDING, 1997. "Demography or Income Packaging: What Explains the Income Distribution in the Netherlands?" LIS Working Paper 169, Luxembourg: CEPS.
- WHELAN, C.T., R. LAYTE, B. MAÎTRE, B. GANNON, B. NOLAN, D. WATSON, J. WILLIAMS, 2003. *Monitoring Poverty Trends in Ireland: Results from the 2001 Living in Ireland Survey*, Policy Research Series Paper No. 51, Dublin: The Economic and Social Research Institute.
- WHELAN, C.T., R. LAYTE, B. MAÎTRE, "Understanding the mismatch between income poverty and deprivation: a dynamic comparative analysis", *European Sociological Review*, forthcoming.

IRELAND'S HEALTH CARE SYSTEM: SOME ISSUES AND CHALLENGES

Anne Nolan and Brian Nolan¹

1. Introduction

A variety of recent reports and strategy documents have highlighted the intimidating range of challenges facing Ireland's health system as it seeks to improve its performance. In this short paper we cannot deal with these in any comprehensive fashion, but instead focus on three specific issues. First, we illustrate the value of trying to benchmark performance against other countries, as well as some of the difficulties that arise in such an exercise. Second, with primary care a central focus of official strategies we look at the use of general practitioner services by people at different income levels and in particular by those with and without entitlement to free GP care. Finally, we discuss the complex web of issues in relation to both equity and efficiency that arise from the unique role which private health insurance plays in the Irish healthcare system.

2. Benchmarking Ireland's Performance

How well is Ireland's health care system functioning? Media attention tends to highlight waiting lists for acute hospital care and waiting times and conditions in A&E. These are real concerns, but the broader perspective gained by benchmarking performance against other countries can be particularly valuable, in this as in other areas. To provide this perspective we can draw on recent comparative compilations of data by the OECD and Eurostat and the methodology employed in a recent benchmarking exercise by the

¹ We are grateful to ESRI colleagues and to Donal de Buitléir and Miriam Hederman-O'Brien for comments on an earlier draft, and to the Health Research Board for funding the collaborative research programme on the Provision and Use of Health Services, Health Inequalities, and Health and Social Gain on which the paper draws.

Conference Board of Canada (see Conference Board of Canada, 2004).

The Conference Board adopts an interesting approach to benchmarking which distinguishes three dimensions: health status, non-medical factors and health outcomes. In each of these, the performance of OECD countries is assessed and each is awarded a gold, silver or bronze medal. “Gold medal” performance means the country is in the top one-third of the range on the indicator in question, “silver medal” performance means it is in the middle third and “bronze medal” means it is in the bottom one-third of the range. Note that this is not equivalent to being in the top one-third of countries on the indicator in question; indeed, if there was a big enough gap between the best and next-best performer, there might be only one country in the top one-third of the range of scores. That is precisely the appeal of this approach; it is based on how close to or far away from the best performers each country is, rather than simply on where they rank on each indicator. Based on their medal performance, countries are then ranked on each dimension and in aggregate across them, by assigning different values to gold, silver and bronze medal performance respectively.

Unfortunately, the results presented by the Conference Board itself, although they do include Ireland, could be misleading because they fail to take into account that some of the indicators employed were missing for some countries. So here we apply their method, but re-analyse the data taking this failing into account, i.e., instead of assigning a zero score to a country with missing information on an indicator, we exclude that indicator altogether from the analysis.² In addition, the Conference Board analysis covers 24 OECD countries, including Mexico and South Korea. In certain instances, including Mexico and South Korea widens the range of values on the indicators and has a significant impact on the results. We prefer to confine attention to 22 OECD countries in Europe, North America, Australasia and Japan, using data from 2001.³

We look first at health status. Table 1 shows how the 22 OECD countries included in the analysis were ranked on the basis of four health status indicators: life expectancy for men and for women, infant mortality and low birth weight rates. We see that for these indicators Ireland has one gold medal and three bronze medals. Ireland performs poorly on life expectancy at birth for both men and

² Due to missing information for some countries, in the “health status” category we exclude disability-free life expectancy for men and women and self-reported health status while for the “non-medical factors” category, we exclude body weight and immunisation rates for influenza.

³ We follow the Conference Board in not including five OECD countries (Czech Republic, Hungary, Poland, Slovak Republic and Turkey) for reasons to do with data availability and reliability, and Luxembourg on the basis of its size. In some instances, where data for 2001 are unavailable, data for earlier years are used instead. All data were obtained from the OECD *Health Data* for 2003.

women, which is in the bottom one-third of countries. Ireland also scores poorly on infant mortality, where again it is in the bottom one-third of the range. In contrast, Ireland is among the best performers in terms of the proportion of babies born with low birth weight.

A ranking of countries on this dimension can then be derived by aggregating across the indicators assigning a value of two for each gold medal, one for each silver medal and zero for each bronze medal. Ireland ranks joint 14th out of 22 countries on this basis. Health status indicators are of course affected by a wide range of factors other than health care, notably socio-economic and environmental conditions. None the less, the ultimate aim of health care is indeed to improve population health.

Table 1: Comparative Performance of OECD Countries on Health Status Indicators

Rank	Country	Gold	Silver	Bronze	Weighted Medal Count*
1	Iceland	3	1		7
1	Sweden	3	1		7
3	Norway	2	2		6
3	Japan	3		1	6
5	Finland	2	1	1	5
5	Canada	1	3		5
5	Italy	1	3		5
5	Switzerland	1	3		5
5	Australia	1	3		5
5	France	1	3		5
5	Spain	1	3		5
12	Netherlands	1	2	1	4
12	Austria		4		4
14	Ireland	1		3	2
14	Belgium		2	2	2
14	Denmark		2	2	2
14	Germany		2	2	2
14	New Zealand		2	2	2
14	UK		2	2	2
20	Portugal		1	3	1
20	Greece		1	3	1
22	US			4	0

* Gold = 2; Silver = 1; Bronze = 0

Source: OECD *Health Data* (2003), Conference Board of Canada (2004).

In terms of the range of other factors influencing health status, the Conference Board also look at what they term “non-medical factors”, namely indicators relating to tobacco consumption, alcohol consumption, road traffic accidents, sulphur oxide emissions and immunisation rates. The results in Table 2 show that Ireland has one gold medal, two silver medals and two bronze medals on these indicators. Ireland does well on road traffic injuries, is in the middle range in terms of sulphur oxide emissions and the percentage of the adult population smoking daily but scores in the bottom range for alcohol consumption and childhood immunisations. Once again this leaves Ireland ranking low down, in joint last place with Japan.

Table 2: Comparative Performance of OECD Countries on Non-Medical Factors

Rank	Country	Gold	Silver	Bronze	Weighted Medal Count*
1	Sweden	5			10
2	Iceland	4	1		9
3	Denmark	3	2		8
3	Finland	3	2		8
3	France	3	2		8
3	Norway	4		1	8
7	Belgium	2	3		7
7	Germany	2	3		7
7	Netherlands	3	1	1	7
7	New Zealand	2	3		7
7	Switzerland	3	1	1	7
12	Australia	2	2	1	6
12	Italy	1	4		6
12	Portugal	2	2	1	6
12	UK	1	4		6
16	Austria	1	3	1	5
16	Canada	2	1	2	5
16	Greece	1	3	1	5
16	Spain	2	1	2	5
16	US	2	1	2	5
21	Ireland	1	2	2	4
21	Japan	2		3	4

* Gold = 2; Silver = 1; Bronze = 0.

Source: OECD *Health Data* (2003), Conference Board of Canada (2004).

We focus next on key health outcomes, which one might expect to be affected by health care programmes and clinical interventions. The indicators employed relate to leading causes of mortality and premature mortality, namely cancer, heart attack, strokes and suicide. They measure mortality standardised for age for men and for women relating to lung cancer, heart attack and stroke, together with potential years of life lost through lung cancer for men and for women, female breast cancer and male suicide. Lower rates on these measures can be attributed both to lower incidence (which in turn relates *inter alia* to health-related behaviours) and to treatment. Once again, as Table 3 shows, Ireland performs very poorly, ranking joint second last of the OECD countries included. While Ireland receives four gold medals (for male and female mortality rates from strokes and for male and female potential years of life lost due to lung cancer), Ireland scores particularly poorly on male and female mortality from heart attack (the highest rates in the OECD) and for potential years of life lost due to female breast cancer.

One can then aggregate across the three dimensions and arrive at an overall score, simply by adding up the number of medals of each type and then deriving the weighted medal count. This should be seen as only an illustrative exercise, since it implicitly makes the strong assumption that we would want to treat each of the indicators in each of the dimensions as equally important, but may none the less be interesting. Table 4 shows that on this basis Ireland ranks second last of the 22 countries covered, ahead of only the USA.

Table 3: Comparative Performance of OECD Countries on Health Outcome Indicators

Rank	Country	Gold	Silver	Bronze	Weighted Medal Count*
1	Switzerland	9	1		19
2	Italy	7	3		17
2	Japan	8	1	1	17
2	Spain	8	1	1	17
5	Austria	6	4		16
5	Sweden	6	4		16
5	Australia	5	5		15
5	France	6	3	1	15
5	Norway	6	3	1	15
10	Germany	4	6		14
10	Portugal	6	2	2	14
12	Finland	6	1	3	13
12	Greece	5	3	2	13
14	New Zealand	4	4	2	12
14	UK	4	4	2	12
16	Belgium	5	1	4	11
16	Canada	2	7	1	11
16	Ireland	4	3	3	11
16	Netherlands	3	5	2	11
16	US	2	7	1	11
21	Denmark	3	4	3	10
21	Iceland	3	4	3	10

* Gold = 2; Silver = 1; Bronze = 0

Source: OECD Health Data (2003), Conference Board of Canada (2004).

Table 4: Comparative Performance of OECD Countries on Health Status Indicators, Non-Medical Factors and Health Outcome Indicators

Rank	Country	Gold	Silver	Bronze	Weighted Medal Count*
1	Sweden	14	5	0	33
2	Switzerland	13	5	1	31
3	Norway	12	5	2	29
4	France	10	8	1	28
4	Italy	9	10	0	28
6	Japan	13	1	5	27
6	Spain	11	5	3	27
8	Australia	8	10	1	26
8	Finland	11	4	4	26
8	Iceland	10	6	3	26
11	Austria	7	11	1	25
12	Germany	6	11	2	23
13	Netherlands	7	8	4	22
14	Canada	5	11	3	21
14	New Zealand	6	9	4	21
14	Portugal	8	5	6	21
17	Belgium	7	6	6	20
17	Denmark	6	8	5	20
17	UK	5	10	4	20
20	Greece	6	7	6	19
21	Ireland	6	5	8	17
22	US	4	8	7	16

* Gold = 2; Silver = 1; Bronze = 0

Source: OECD Health Data (2003), Conference Board of Canada (2004).

So the performance of Ireland's health-care system in comparative perspective is disappointing. What about the financial resources being

devoted to health care? Table 5 looks at overall health spending in 2002 as a proportion of GDP, the conventional way of comparing expenditure across countries. In comparison with the 22 OECD countries we are including here, we see that Ireland is the lowest spender (jointly with Finland), with 7.3 per cent of GDP devoted to health care compared with an average of 9 per cent. However, as has been regularly pointed out, the use of GDP as the reference point may be misleading in the Irish case, since repatriation of profits abroad is both very high and variable from one year to the next. Expressing health expenditure as a proportion of GNP instead makes very little difference to any of the other countries covered but increases the Irish health spending share markedly, to 9 per cent – about the average.

Table 5: Financial Resources Devoted to Health Care, OECD Countries, 2001

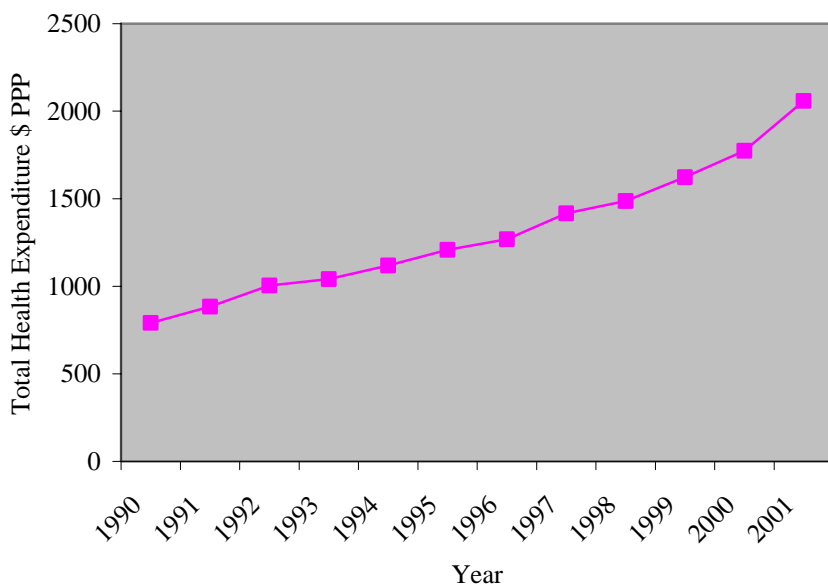
Country	Total Health Expenditure as a % of GDP	Total Health Expenditure as a % of GNP	Total Health Expenditure per Capita in \$ PPP
Australia	9.1	9.4	2,504
Austria	7.7	7.8	2,220
Belgium	9.1	8.9	2,515
Canada	9.6	9.9	2,931
Denmark	8.8	9.0	2,580
Finland	7.3	7.3	1,943
France	9.7	9.7	2,736
Germany	10.9	10.9	2,817
Greece	9.5	9.5	1,814
Iceland	9.9	10.1	2,807
Ireland	7.3	9.0	2,367
Italy	8.5	8.5	2,166
Japan	7.8	7.7	2,077
Netherlands	9.1	9.3	2,643
New Zealand	8.5	8.4	1,857
Norway	8.7	8.6	3,083
Portugal	9.3	9.5	1,702
Spain	7.6	7.7	1,646
Sweden	9.2	9.3	2,517
Switzerland	11.2	10.4	3,445
UK	7.7	7.6	2,160
US	14.6	14.5	5,267
OECD 22 Average	9.1	9.2	2,536

Source: OECD *Health Data* (2004) (for total health expenditure and GDP) and European Commission, AMECO Macro-Economic Database 2004 (for GNP).

However, the most striking feature of Ireland's health spending is how rapidly it has been increasing in *absolute* terms in recent years. Whatever about relative to rapidly increasing GNP, health spending has risen very rapidly indeed in nominal terms – from €2.2 billion to €9.4 billion between 1990 and 2002. Even when adjusted for the increases in relevant prices, health spending has risen markedly in purchasing power terms. Figure 1 charts Irish total health expenditure per capita in purchasing power terms from 1990 to 2002, as calculated by the OECD, and by the end of the period the level of spending was

3 times higher than in 1990. This depends of course on the reliability of the adjustment made for the change in prices of the goods and services involved (holding “quality” constant), which is notoriously difficult to capture in the health care area. It is also worth noting that despite its rapid rate of increase, the level of spending per capita in purchasing power terms in Ireland had still not reached the average for these 22 OECD countries by 2002.

Figure 1: Ireland’s Total Health Expenditure Per Capita Expressed in \$ PPP, 1990-2002



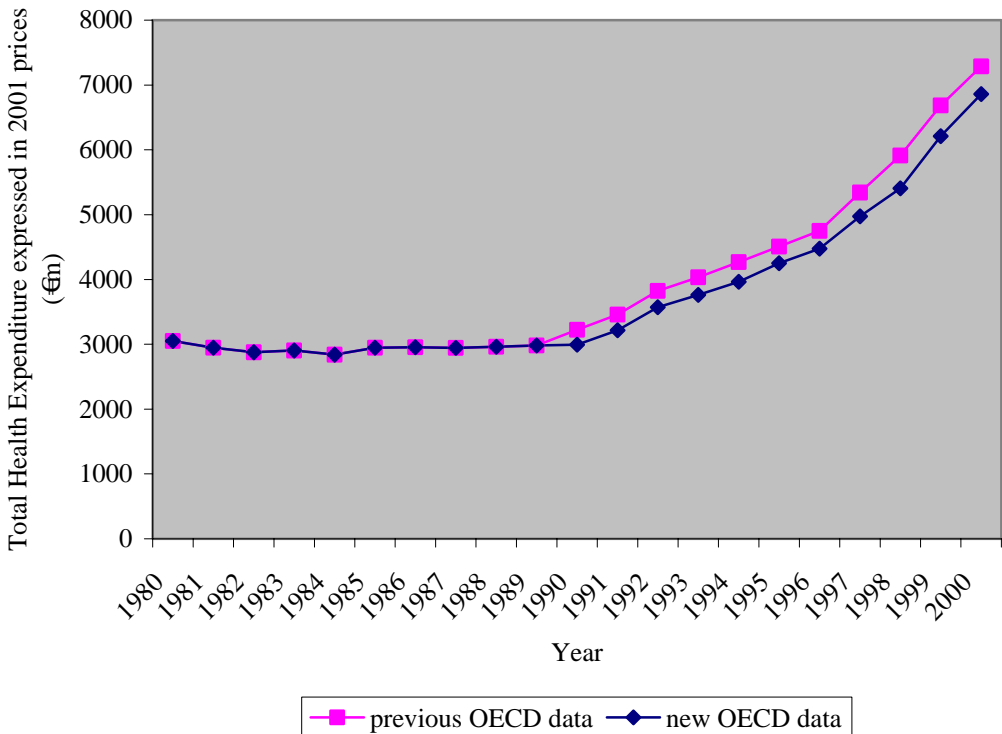
Source: OECD Health Data (2004).

It is also worth entering an important caveat in relation to the comparative perspective on Ireland’s health spending. This is illustrated by the comparison of the trend in health spending shown in Figure 2 labelled “2003 OECD data” with the line labelled “2002 OECD data”. The latter shows the figures published in 2002 by the OECD in their databank and in “Health At a Glance”, the source on which comparisons of this sort for OECD countries now rely. We can see that this shows substantially higher levels of health spending for Ireland than the set produced in 2003. This is because, in compiling their 2003 set of data, the OECD with the help of the Department of Health and Children re-examined the nature of the spending involved, and decided to exclude certain sub-heads of Irish public health spending which relate to what would in other countries probably be counted as social services or social transfers. Consequently, the percentage of GNP accounted for by health spending in Ireland for 2000 fell from 7.8 per cent using the 2002 data

to 7.4 per cent using the 2003 data. (The most recent OECD figures, published in mid-2004, are on the same basis as the 2003 figures – see also the discussion in Wren (2004)).

The point is not that this reclassification was inappropriate, but rather that there is no guarantee that spending in other countries is delimited in exactly the same way. What is being counted as health spending may not be harmonised across countries to the extent one would want, despite the best efforts of the OECD. In relation to the hazards of comparative analysis it is also worth noting that the recently-produced OECD figures only carry this re-categorisation of health spending in the Irish case back to 1990, so the unsuspecting user of their data will get a misleading picture of the increase in health spending over time if the base year used is earlier than that.

Figure 2: Total Health Expenditure in Ireland, 1990-2001, in OECD Database 2002 Versus 2003



Source: OECD Health Data (2002), (2003).

3. Use of GP Services by Income Level and Medical Card Status

As we noted in the introduction to this paper, primary care has become a central focus of official health strategy as Ireland, like many other countries, seeks to shift the emphasis from expensive hospital-based health care to primary curative and preventative interventions. General practitioners play the central role in primary care, and one of the most distinctive features of the Irish health care system is the pricing of GP services. For those who have medical card cover – generally because they fall below the specified income threshold – GP visits are free. For the rest of the population, GP visits must be paid for out of pocket on a fee per service basis; usually the patient has to bear that full cost (i.e., it is not reimbursed even where they have health insurance). GPs are free to set the charge to meet their full costs and provide them with an income and the majority of GPs provide services to both sets of patients – medical cardholders and non-medical cardholders. In many other OECD countries, by contrast, primary care is either free or heavily subsidised, by one means or another, for most or all of the population.

This pricing structure in the Irish context gives rise to a number of concerns, so it is useful to look at the empirical evidence about the use of general practitioner services by people at different income levels, and in particular by those with and without entitlement to free GP care due to the medical card system. Once again it is helpful to start with a comparative perspective. Using data from the European Community Household Panel Survey for representative samples of the populations of most of the “old” EU 15 countries, we can derive GP visiting rates for adults by position in the income distribution.⁴ Table 6 shows for 2001 the average number of GP visits in the previous year for adults (aged 16+) in the bottom one-tenth (decile) of the income distribution in their country, the next one-tenth and so on up to the top one-tenth, as well as the overall average. (This ranking is on the basis of household income adjusted for the size and composition of the household using what are termed “equivalence scales”.)

We see first that the overall average visiting rate in Ireland, of 3.6 visits per person per year, is about the middle of the range across these countries. That range is in fact rather wide, running from almost 5 in Austria, Belgium and Italy down to less than 2 in Greece, reflecting *inter alia* the different roles played by general practitioners in different healthcare systems. The Irish average is slightly higher than the UK, where the GP role is similar.

Looking now at the way the frequency of GP visiting varies across the income distribution, we see that in almost all countries visiting rates are higher towards the bottom of the distribution and lower towards

⁴ Sweden did not participate in the survey, and some other countries (Germany, France) participated but did not have exactly the data we are focusing on here for 2001.

the top (Finland being the exception with a very flat pattern across the deciles). However, the gap between top and bottom varies a good deal. In Ireland, visiting rates are about twice as high towards the bottom compared with the top, whereas in most of the other countries that ratio is rather lower, at approximately 1.5. Where Ireland also stands out, none the less, is in the very sharp fall in the visiting rate as one goes from the second to the third decile – when the average number of visits drops from 6.6 to 3.6. No other country sees such a sharp decline; the obvious question to ask is whether this could reflect the impact of medical card entitlement on the cost of a GP visit to patients. (The visiting rate in the Irish case also jumps up again in the sixth decile and then down in the eighth, but the gap between the second and third decile is considerably wider.)

Table 6: GP Visiting Rates for Adults 16+ by Income Decile, EU Countries, 2001

Country	Bottom 10%	2	3	4	5	6	7	8	9	Top 10%	All
Austria	5.8	6.4	5.1	4.8	5.0	4.7	3.7	4.1	4.3	3.8	4.7
Belgium	7.6	6.9	6.2	4.8	5.0	4.7	3.8	3.5	3.5	3.6	4.9
Denmark	3.4	3.6	3.6	4.1	2.8	2.7	2.1	2.0	2.3	2.0	2.9
Finland	1.8	2.6	2.4	2.4	2.0	1.9	2.0	1.9	2.3	1.8	2.1
Greece	2.5	2.4	2.1	1.9	2.1	1.8	1.6	1.4	1.6	1.2	1.9
Ireland	4.8	6.6	3.6	3.0	3.1	4.1	3.7	2.3	2.6	2.4	3.6
Italy	5.0	5.7	5.0	5.6	5.8	4.9	4.3	4.3	4.3	3.9	4.9
Netherlands	3.4	3.2	3.2	3.1	2.8	2.9	2.6	2.3	2.4	2.4	2.8
Portugal	3.8	3.6	4.1	2.8	3.0	3.0	3.0	2.6	2.5	2.6	3.1
Spain	4.5	5.6	4.2	4.4	4.3	3.6	4.0	3.5	3.0	1.9	3.9
UK	3.8	4.4	3.7	3.4	3.3	3.2	2.9	2.7	2.8	2.5	3.2

Source: European Community Household Panel Survey (2001).

Note: Data are unavailable for France, Germany and Sweden.

The first point to note is that people in the various deciles differ not only in terms of income but also in terms of other characteristics that may well influence their use of health services, most obviously their age. The incomes of older people are particularly concentrated in Ireland, with a high proportion on low (but not the lowest) incomes. Therefore, the difference in visiting rates between the second and third deciles could partly reflect the fact that far more people in the second decile are older. In addition the Irish situation in 2001, the year to which these figures relate, is complicated by the fact that medical card entitlement was extended to all those aged 70 years or over in the latter part of the year. It is therefore useful to look in Table 7 at visiting rates across the various countries for those aged between 16 and 69 years only.

This shows that the overall average visiting rate for Ireland is once again in the middle of the range across these countries and slightly above that in the UK. The differential between the top and bottom of the income distribution is narrower than when the elderly were included, but is still substantial and particularly marked in the Irish case. Furthermore, although the drop in visiting rate comparing the second and the third deciles is now smaller, from 5.5 to 3.1, it is still very large and unusual both in a comparative context and in terms of

the pattern across other deciles in Ireland. So these figures certainly suggest that it is worth investigating in some depth whether the distinctive features of the “pricing system” for GP visits in Ireland has implications for use of the services.

Table 7: GP Visiting Rates for Adults Aged 16-69 Years by Income Decile, EU Countries, 2001

Country	Bottom 10 per cent	Country	3	4	5	6	7	8	9	Top 10 per cent	All
Austria	4.3	5.1	4.2	4.5	4.1	3.9	3.2	3.8	3.6	3.3	3.9
Belgium	6.0	5.2	5.0	4.2	4.2	4.2	3.2	3.3	3.3	3.2	4.1
Denmark	2.6	2.2	3.6	4.2	2.6	2.7	2.1	1.8	2.3	1.9	2.6
Finland	1.8	2.3	2.3	2.4	2.0	1.9	2.0	1.9	2.3	1.9	2.1
Greece	1.7	1.7	1.5	1.4	1.6	1.3	1.3	1.2	1.2	1.1	1.4
Ireland	4.2	5.5	3.1	2.9	2.7	4.0	3.6	2.3	2.4	2.3	3.2
Italy	4.3	4.4	3.7	4.2	4.5	4.2	3.5	3.9	3.7	3.6	4.0
Netherlands	3.4	3.0	2.8	2.8	2.4	2.8	2.4	2.1	2.3	2.2	2.6
Portugal	3.2	3.1	3.4	2.5	2.8	2.6	2.7	2.4	2.3	2.3	2.7
Spain	4.0	4.3	3.5	3.6	3.7	2.9	3.6	3.2	2.8	1.7	3.3
UK	3.7	4.2	3.6	3.2	3.1	3.0	2.8	2.6	2.7	2.4	3.0

Source: European Community Household Panel (2001).

Notes: Data are unavailable for France, Germany and Sweden.

We have pursued this using micro-data from the Living in Ireland Survey, the Irish element of the European Community Household Panel. Estimation of an econometric model of GP visiting behaviour using Irish data for 2001 allows us to relate the reported number of visits by each adult to a range of characteristics including their age, gender, education, household income and medical card status. Valuably, we were also able to control to some extent for differences in health status, which is particularly important since those on low incomes are distinctive not just in having medical card cover, but are also likely to have poorer health and a greater need for health care than the rest of the population. While the measures of health status available to us in the survey are crude, they do allow us to go some way towards taking such differences in needs into account.

Cross-sectional analysis described in detail in Nolan and Nolan (2003) and Madden, Nolan and Nolan (2004) find that medical card entitlement has a highly statistically significant and substantial influence on the number of GP visits an individual reports. Having controlled for all the other characteristics mentioned, including health status, those with medical card cover have on average about 1.6 more visits each year than those with similar characteristics but without a medical card. Even if the health status indicators available to us understate the difference in needs between those with and without medical cards, it seems likely that the different financial incentives they face also play a role in producing this very substantial gap.

It is also important to investigate whether this effect is more pronounced in the income ranges above but still quite close to the medical card threshold. There has been a great deal of concern expressed about the position of families just above the threshold, who would be brought within medical card entitlement by raising the threshold as the government are committed to doing at some point.

For this paper we tested whether proximity to the threshold makes a marked difference to visiting rates by introducing a set of interaction terms between income decile and the variable in our model capturing medical card status. These interaction terms do not turn out to be statistically significant. These results suggest, on the face of it, that the key difference in terms of GP visiting rates in Ireland is simply between those with and without medical cards.

While the analysis to date has been cross-sectional, we have also begun to exploit in this context the longitudinal nature of the Living in Ireland Survey data, i.e., the fact that it sought to interview the same individuals from one year to the next. This means we can follow people from 1995 up to 2001 and identify those who moved from having medical card cover to not having cover and vice versa, and investigate whether their GP visiting rates changed. Visiting rates do fall on average when medical card cover is lost and rise when medical card cover is “gained”, but this could be for a variety of reasons including changes in health and thus the need for care.⁵ The next stage in the analysis is to estimate econometric models controlling for, among other things, changes in reported health status and see the extent to which changes in visiting rates not associated with such variation in need are identified.

How should one react to the fact that medical card holders visit the GP more often than those without cover, even when we control for measured differences in health status? Does this mean that medical cardholders “overconsume” or non-medical cardholders “underconsume” GP services, or indeed both? Deciding on an appropriate benchmark against which to make such a judgement is difficult, since we do not know the “right” level of visiting from a medical, much less a cost-effectiveness point of view. International comparisons reveal countries with higher average levels of visiting towards the bottom of the income distribution than Ireland, and ones with similar (though not lower) rates towards the top. What we can say is that, given the gap between those with and without medical cards, it is unlikely that both are optimal – again, from a medical or cost-effectiveness point of view.

If we regard the present situation as distorted, then, the next issue is best how to address that distortion. From an incentives perspective, one can look at both supply and demand sides, providers and patients. Focusing on providers, it seems plausible that providers paid on a fee-for-service basis to treat patients facing zero price would be particularly likely to induce demand; this was indeed a key rationale behind the change in the reimbursement system for GMS GPs in the late 1980s, following on the research by Tussing (1985). However, when we estimated the cross-sectional models mentioned earlier for

⁵ It would hardly be surprising if visiting fell when someone moved from being out of work due to illness or disability into work, or rose when the opposite occurred, but the pattern described remains when we exclude such cases.

1987, 1995 and 2000, this did not reveal any narrowing of the gap between medical card holders and others after the change to a capitation reimbursement system (see Madden, Nolan and Nolan, 2004).

Turning to the patient side of the equation, the issue of charging for health care and its impact on utilisation and efficiency is a perennial and much-debated one in the health economics literature (see Nolan (1993) for a discussion). The key question is not now whether charges affect utilisation – the accumulating evidence is that they do, and our findings to date are consistent with that pattern. Rather, the critical question is whether charges reduce “necessary” as well as “unnecessary” visits, and by its nature that is very difficult to assess. Perhaps the most important point to stress in this context is the uncertainty inherent in making that distinction for the patient *ex post*. It is difficult for experts to make an assessment of the value of a specific visit after the event; it is even more difficult for a “layman” to do so when deciding whether to visit, since the motive for visiting a doctor is often to see if medical intervention is needed because the individual simply does not have the knowledge to make that judgement. This uncertainty, identified as critically important to the economics of health care as long ago as Arrow (1963), means that charges inevitably discourage “necessary” as well as “unnecessary” visits. This of course applies to the current substantial charges facing Irish patients without medical cards, as well as to any charges that might be levied on medical card patients.

4. Health Insurance

Over the past decade or so the context in which Ireland’s complex mix of public and private health care operates has changed radically, as the numbers purchasing health insurance soared and the nature of the insurance market has changed in response to EU regulations. This has widened the divide between those with and without health insurance, and called into question the public-private structure on which Ireland has relied for many years. Almost half the Irish population now pay for private health insurance, one of the highest levels of coverage in the OECD. This is despite the fact that hospital care is covered by private health insurance and everyone has entitlement to public hospital care from the state. The insured can avail of “private” health care, but much of this private care is actually delivered in public hospitals. The resulting two-tier system is now widely regarded as problematic from an equity perspective, but there are also serious efficiency issues arising from the incentive structures embedded in this particularly close intertwining of public and private. It is worth dwelling briefly on how this situation has come about. For many years those towards the top of the income distribution in Ireland have been encouraged to take out “private” health insurance. In the late 1950s the Voluntary Health Insurance Board (VHI) was

established as a monopoly state-backed not-for-profit health insurer to cater for the top 15 per cent or so of the income distribution, who did not (then) have entitlement to public hospital care from the state. This state-backed insurer operated community rating and income tax relief was available on premia paid. This structure was designed, *inter alia*, to ensure that the entire population had access to hospital care while satisfying the demands of medical consultants that their private practice not be undermined. Those towards the top of the distribution were in effect encouraged to take out “private” insurance, while the cost of in-patient care for the rest of the population was fully covered by the state.

To complicate the picture – and it is a crucial difference between Ireland and many other countries – not only was “private” insurance provided for many years by what was to all intents and purposes an arm of the State, much of the “private” care it covers was and is delivered in public hospitals. Medical consultants retained the right to treat their private patients in public hospitals, and about half of all private hospital care is in fact delivered in those hospitals. Most patients receiving private care – in a public or private hospital – have insurance, and the insurer reimburses both medical consultant and hospital. However, for many years public hospitals only charged for the “hotel” facilities associated with being in a private room. In addition, most medical consultants are contracted to care for public patients in public hospitals on a salaried basis, while maintaining the scope to treat private patients on a fee-for-service basis. The public and private systems in Ireland, rather than being distinct, have had what has accurately been described as a symbiotic relationship (Barrington, 1987; see also Wren, 2003).

From the 1950s to the late 1970s or early 1980s, this public-private mix supported by “private” health insurance functioned in roughly the way it was designed to do, with a monopoly insurer covering private care for the well-off and in effect “topping up” the public system. There have been fundamental changes in the health insurance landscape since then. The first is the dramatic rise in the percentage of the population buying health insurance. This jumped up from about 20 per cent to 30 per cent in the late 1970s, jumped once again in 1987 to 35 per cent, rose steadily through the 1990s and by now is very close to half the population. This occurred despite the fact that full entitlement to public hospital care (subject to some charges levied on all those without medical card cover) was extended to the top part of the income distribution in the early 1990s.

So health insurance in Ireland, having been the preserve of the better-off for many years, now covers half the population. Quite why this increase in the numbers buying health insurance has occurred is not well understood. The scale of economic growth and increasing real household incomes in Ireland during the 1990s – the “Celtic Tiger” – has clearly made it possible for more people, but this does not explain

why they want or feel the need to have health insurance cover. The upward trend in numbers insured has also proved remarkably resilient in the face of significant annual premium increases and a diminution in income tax relief as tax rates fell and relief was scaled back to the standard rather than the purchaser's marginal tax rate. Econometric time-series analysis also suggests that the evolution of income and price still leave much of the increase in demand to be explained (Harmon and Nolan, 2001), so it is also important to explore what people think they are buying when they buy insurance, and the alternative they face or believe they face without it.

Attitudinal surveys (see for example, Watson and Williams (2001), Health Insurance Authority (2003)) suggest that concern about waiting times for public hospital care is uppermost in people's minds, that quality of care has also come to be seen as a significant issue, and that having a private room or other "hotel" aspects are not seen as an important reason for buying private insurance. Waiting times for public hospitals are widely perceived to be long, both by those with and without insurance. So what people essentially believe they are buying is the assurance that they can access hospital care when they need it, without undue waiting and with care from a medical consultant of their choice.

It seems plausible then that perceptions of access to public hospitals combined with perceptions of the quality of public versus private care are key drivers underpinning demand for health insurance. The role of media coverage in influencing such perceptions merits examination, but there are indeed long waits for certain types of public hospital treatment that are by-passed by those with insurance. In one of the attitudinal surveys, for example, almost half the respondents said they personally knew someone who recently had a lengthy wait for public hospital treatment – so they were not simply reacting to media reports.

This two-tier hospital system is now widely regarded as problematic from an equity perspective. Indeed, the issue of equity of access to hospital care for public versus private patients has become a very high profile one politically and equity as a goal has been highlighted in the official Health Strategy produced after lengthy consultation in 2001. The focus of policy has been on regulating access to public hospitals, on the proportion of private versus public beds in them, on the charges for private care in public hospitals and on reducing waiting times for public patients. However, in our view this focus misses some deep-seated structural problems, in respect to both equity and efficiency, which the recent upsurge in numbers insured has not created but has certainly exacerbated.

Dealing first with equity, a number of different layers to the argument may be usefully distinguished in assessing the fairness of the current system. Where separate and distinct public and private healthcare systems operate side-by-side and private health insurance provides

cover for the latter, then a likely outcome is that those with insurance – who are most often on higher incomes – will have more rapid access to health care. Views may, and do, differ about whether this is equitable, both within and across societies. However, the role of the state in subsidising health insurance or private health care, directly or indirectly, adds a further dimension: some who see differential access as fair if the full cost is being paid by those “going privately” might question its fairness if the taxpayer is in effect covering part of the cost. A further, and even more complex, dimension arises when – as in the Irish case – much of the private care to which those with insurance gain access is actually being delivered in public hospitals. In that situation, the financial flows underpinning the system are more difficult to disentangle but the two-tier nature of access by those with versus without insurance is more striking.

So what is distinctive about the Irish case is that the *public* hospital system has come to be seen very widely as a two-tier one, offering the better-off more rapid access; the fact that they are in effect subsidised by the taxpayer in doing so is less widely debated but well understood by analysts. Subsidisation comes through tax breaks on insurance premia and below-cost charges for private care in public hospitals; recently this charge has been raised significantly but still represents an implicit subsidy to private care in public hospitals (Nolan and Wiley, 2001). The clarity of the distinction between private versus public beds in those hospitals and how to ensure that private patients do not obtain preferential access through public beds have also been the focus of particular attention from policy makers.

Even if private care in public hospitals covered its full cost or even generated a surplus to cross-subsidise care of public patients, an equity concern would arise about two-speed access to those hospitals. The main argument advanced for retention of private care in public hospitals is that this allows the most able medical specialists to be available to care for public patients. There has been no attempt to assess the scale of the purported benefits to the public system, nor whether the benefits of close interaction with private care are outweighed by the costs.

These costs include not only the direct and indirect subsidisation already mentioned, but also the distortionary impact of the incentives for medical consultants and hospital managers associated with the inter-mingling of public and private care. Most medical consultants employed to treat public patients, and paid a salary for doing so, also have private patients for whom they are paid on a fee-per-service basis. While consultants are committed to a specified number of hours per week caring for public patients there is no effective monitoring and the incentive they face to concentrate more of their attention on private patients – even if it is by working very long hours over and above their public commitment – may clearly be to the detriment of public patients. (Unlike private patients, many public

patients will be treated by more junior doctors.) Public hospital managers also face an incentive to maximise revenue from private patients in any given year, since this is one of the few sources of additional revenue available to them.

Some of these incentive issues might still feature, though they would probably be less pronounced, if private care was delivered only in private hospitals – if for example consultants still had a mix of private and public patients and were in effect incentivised to prioritise the former. Equity concerns could still be raised about faster access to such private hospitals, especially if the state subsidises them not only indirectly by favourable tax treatment of insurance premia and via training of staff in the public system, but also by direct tax breaks to encourage building private facilities as have recently been introduced by the Irish government. However, both efficiency and equity concerns are undoubtedly heightened by Ireland's peculiarly intimate public-private mix.

Health insurance underpins Ireland's public/private mix. The major change in the landscape in that respect came in response to the EU's 1992 Third Non-Life Insurance Directive, designed to stimulate competition in insurance. The Irish government enacted legislation opening up the health insurance market, and BUPA Ireland commenced operation in 1997. The way that market operates is tightly regulated: Ireland obtained approval from the EU to continue to require all insurers to apply open enrolment, community rating and lifetime cover, as enshrined in the 1994 Health Insurance Act and the 1996 Health Insurance Regulations. In 2001 the Health Insurance Authority was set up to oversee and regulate the market. Among its responsibilities is the implementation of a risk equalisation scheme in order to support community rating. This has proved particularly controversial and no transfer of funds across insurers has yet taken place. The VHI continues to dominate the market, with about 95 per cent of subscribers and although its status has been debated it remains a not-for-profit body whose board is appointed by the Minister for Health, requiring official approval for changes in premium levels.

The highly regulated nature of the private health insurance market in Ireland is distinctive. Open enrolment, community rating and lifetime cover are enshrined as core principles, reflecting the role which public policy has traditionally assigned to insurance in the health care system. These restrictions have not been much debated and appear widely supported, but their rationale is in fact open to question. The logic that applied when public policy saw insurance financing hospital care for the well-off cannot simply carry over to what is now a very different situation. Indeed, it is far from clear where policy now sees insurance fitting in and going, in a situation where everyone is entitled to avail of public care on the same basis but half choose to buy insurance.

Implementation of the risk equalisation scheme in order to support community rating, on the other hand, has proved controversial – at least between the two insurers who would be affected. A vigorous debate between them has continued as to the justification for such a scheme and the need for a transfer and no transfer of funds across insurers has yet taken place. This uncertainty may be acting as a deterrent to the entry of further insurers to compete in the Irish market.

None the less, the entry of BUPA and potential entry of further insurers is a fundamental change in the health insurance market. The fact that the VHI, though still dominating the market, faces real competition from BUPA and the potential for entry by more competitors has clearly affected behaviour in the market. This is most obvious in the range of new insurance products which continue to appear and the efforts to market them. Despite competition, however, the cost of insurance has continued to rise.

As well as the supply side, the prospects for the demand for health insurance are also uncertain. Even if it were to plateau at about the current level, the dynamic effects of recent growth in the numbers purchasing health insurance still have to work their way through. It is not clear, from a financial or broader public policy perspective, whether a 50/50 split between those with and without insurance, is inherently unstable. From a public policy perspective, it is hard to see why the number taking out private insurance should in itself be a target variable. If, however, public policy gave priority to effectively improving access to, and quality of, care for public patients in public hospitals this might have a significant impact on demand for private insurance, given the apparent importance of perceptions of the public system in promoting that demand.

While health has of course become an extremely high-profile and politically sensitive topic, health insurance itself has not come centre-stage in the public debate – which has focused on waiting times for public hospital care and the location of those hospitals. Some alternative structures involving “insurance for all”, either via social insurance or subsidised private insurance, have been put forward but this discussion has not as yet progressed very far. The slogan that “everyone should be a private patient” amply illustrates that having 50 per cent of the population with insurance alters the context for such a debate. However, it will clearly be difficult to move forward when “insurance for all” means very different things to different groups advocating it – and clarity about who would gain and lose is notably lacking. In sum, recent Irish experience shows that a structure designed to take advantage of possible benefits for the public system of close interaction with private care can create perverse incentives and potentially undermine that public system. The numbers currently with health insurance can also be expected to fundamentally influence the political economy of structural reform.

5. Summary and Conclusions

This paper began by illustrating the value of benchmarking the performance of Ireland's health-care system against other countries. This showed that performance, as reflected in a variety of indicators, to be disappointing. Some of the difficulties in such a benchmarking exercise were seen when we looking at a key indicator, namely the level of health spending. This has risen very rapidly indeed in nominal terms in recent years, outpacing even the exceptional scale of economic growth. However, in purchasing power terms and as a percentage of GNP it was only at the UK level – which the British government considers too low compared with other EU countries – by 2002. Re-classification of some spending by the Department of Health by the OECD in 2003 also significantly reduced their estimate of Ireland's health spending, a process which may not be applied uniformly across countries.

With primary care a central focus of official strategies we then investigated the use of general practitioner services by people at different income levels, in particular those with and without entitlement to free GP care. Having controlled for other characteristics, including health status, those with medical card cover were found to have on average about 1.6 more visits each year than those with similar characteristics but without a medical card. Even if the health status indicators available to us understate the difference in needs between those with and without medical cards, it seems likely that the different financial incentives they face also play a role in producing this very substantial gap. The current substantial charges facing Irish patients without medical cards in all probability discourage some “necessary” as well as “unnecessary” GP visits, and this would also apply to introducing charges for medical card patients, essentially because of the uncertainty about drawing this distinction – particularly for the layman in deciding whether to visit.

Finally, we identified some key issues in relation to both equity and efficiency arising from the unique role which private health care and health insurance plays in the Irish health care system. The public hospital system facilitates the better-off in obtaining more rapid access to care, and incentives for medical consultants and hospital managers are distorted by the inter-mingling of public and private care. Health insurance underpins this public/private mix in a highly regulated market. Open enrolment, community rating and lifetime cover reflects the role which public policy has traditionally assigned to insurance, but the logic that applied when insurance financed hospital care for the top 15 per cent now needs to be re-examined. A structure designed to take advantage of possible benefits for the public system of close interaction with private care has created perverse incentives and come to be seen as inequitable in terms of access and utilisation, and could potentially undermine that public system. However, the

numbers now having health insurance also fundamentally influence the political economy of structural reform.

REFERENCES

- ARROW, K., 1963. "Uncertainty and the welfare economics of medical care", *American Economic Review*, Vol. 53, pp. 941-970.
- BARRINGTON, R., 1987. *Health, Medicine and Politics in Ireland: 1900-1970*. Dublin: Institute of Public Administration.
- CONFERENCE BOARD OF CANADA, 2004. *Understanding Health Care Cost Drivers and Escalators*. Ottawa: The Conference Board of Canada.
- HARMON, C. and B. NOLAN, 2001. "Health Insurance and Health Services Utilisation in Ireland", *Health Economics*, Vol. 10, No. 2, pp. 135-46.
- HEALTH INSURANCE AUTHORITY, 2003. *The Private Health Insurance Market in Ireland*. Dublin: Health Insurance Authority.
- MADDEN, D., A. NOLAN and B. NOLAN, 2004. "GP Reimbursement and Visiting Behaviour in Ireland", mimeo, Dublin: The Economic and Social Research Institute.
- NOLAN, B., 1993. *Charging for Public Health Services in Ireland: Why and How?* Policy Research Series Paper No. 19, Dublin: The Economic and Social Research Institute.
- NOLAN, A. and B. NOLAN, 2003. "A Cross-Sectional Analysis of the Utilisation of GP Services in Ireland: 1987-2001". Working Paper No.1 of Research Programme on *Health Services, Health Inequalities and Health and Social Gain*. ESRI, ISSC and University of Ulster.
- NOLAN, B. and M. WILEY, 2001. *Private Practice in Irish Public Hospitals*. General Research Series Paper No. 175, Dublin: The Economic and Social Research Institute.
- TUSSING, A. D., 1985. *Irish Medical Care Resources: An Economic Analysis*. General Research Series Paper No. 126. Dublin: Economic and Social Research Institute.
- WATSON, D. and J. WILLIAMS, 2001. *Perceptions of the Quality of Care in the Public and Private Sectors in Ireland*. Report to the Centre for Insurance Studies, Graduate School of Business, Dublin: University College.
- WREN, M.-A., 2003. *Unhealthy State – Anatomy of a Sick Society*, Dublin: New Island.
- WREN, M.-A., 2004. "Health Spending and the Black Hole", in *Quarterly Economic Commentary*, Autumn, Dublin: The Economic and Social Research Institute.

