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# COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

## Public finances in EMU - 2001

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## A fast evolving debate on budgetary policy in EMU

This Communication dedicated to *Public finances in EMU* reviews Member States' budgetary performance in 2000 and assesses the short and medium-term prospects.[1] It also contains an in-depth examination of some of the most important questions in the fast evolving debate on budgetary policy at EU level. This debate is being shaped by several factors, not least a growing understanding of the challenges and constraints facing Member States in running budgetary policies in EMU. Four issues dominate the discussions on EU budgetary policy as follows:

- *the Stability and Growth Pact (SGP) target of budget positions that are "close to balance or in surplus", an important goal not yet reached in several Member States*: having achieved impressive budgetary consolidation in the run up to EMU, Member States committed themselves in the Broad Economic Policy Guidelines (BEPGs) to reach the SGP target of budget positions that are "close to balance or in surplus", as a rule, by the end of 2001. Respect of the SGP target is vital for the smooth functioning of EMU as it would safeguard the 3% of GDP deficit ceiling and allow the automatic stabilisers to operate fully in the event of an economic slowdown. With a deterioration in budget balances projected this year and mounting downside economic risks, attaining the SGP target remains an important budgetary goal for the countries that continue to have sizeable structural deficits.

- *the importance of budgetary policy delivering an appropriate policy mix both at the euro area and Member State level*: EMU is a unique policy framework in having a centralised monetary policy but decentralised budgetary policies. Member States' budgetary policy must therefore ensure an appropriate policy mix at national level, while at the same time contributing to an appropriate fiscal stance for the euro area as a whole. There is a growing awareness of the need to satisfy both of these objectives. The importance of Member States' budgetary policy in delivering the right policy mix at national level was evident several months ago when there were clear signs of overheating in several euro area Member States. In addition, a balanced policy mix at the aggregate euro level (where fiscal policies should not overburden monetary policy) is being increasingly recognised as a necessary step to tackle successfully the current economic slowdown.

- *broadening the debate on budgetary policy to include the quality and sustainability of public finances*: new priorities are coming to the fore now that most Member States have reduced

[1] This Communication is based on analysis contained in the report "Public finances in EMU – 2001" of the Directorate General for Economic and Financial Affairs. European Economy Reports N°3, 2001

their budgetary imbalances. The debate on budgetary policy at EU level needs to expand from its current focus on discipline towards a parallel emphasis on the contribution of public finances to growth and employment. The challenge facing Member States is now to sustain sound public budget positions while at the same time lowering the tax burden, restructuring public expenditure to support a knowledge-based economy and preparing for the budgetary consequences of ageing populations. Sustainable public finances also contribute to the overall strategy for sustainable development endorsed by the European Council of Gothenburg in June 2001. Budgetary surveillance at EU level needs to evolve if it is to support Member States in pursuing ambitious reform agendas that do not jeopardise the commitment to fiscal discipline.

- *better co-ordination on budgetary questions is needed:* recent events have highlighted inadequate co-ordination on budgetary questions in EMU, and consequently a failure on the part of Member States to react in a timely and consistent manner to common economic shocks/challenges. Examples of such co-ordination include how to respond to pressure to lower fuel taxes in the face of rising oil prices, what to do with windfall revenues from the sale of third generation (UMTS) mobile phone licenses, how to bring about a sustainable reduction in the tax burden, and what is the appropriate role of budgetary polices in containing overheating pressures. Faced with economic shocks/challenges of a similar nature, it is reasonable to expect that countries in a monetary union would react with policies that are consistent and which take on board the euro area implications, although the individual policy responses obviously need to be tailored to reflect country-specific circumstances. Even in cases when the policies adopted by Member States have been broadly consistent with the EU fiscal framework, lack of co-ordination has led to the impression that countries are unwilling to acknowledge the euro area implications of national policy actions, and that co-ordination only takes place after the event. Tackling the apparent shortcomings in the co-ordination of budgetary policies is a necessary and urgent task.

***Budgetary developments and prospects***

Recent budgetary policy developments and prospects present a mixed picture. On the one hand, the budget deficit of the euro area has continued to shrink to 0.7% of GDP in 2000 (net of UMTS revenues), a drop of 0.5% of GDP compared with 1999, and at the same time the tax burden is being lowered in most countries. Moreover, most of the one-off budgetary receipts from the sale of UMTS licences have, as agreed, been used to reduce debt.

On the other hand, four euro area countries (Germany, France, Italy and Portugal) are projected to have sizeable deficits in 2001. These countries have missed the opportunity of the recent favourable growth environment to meet the target of the Stability and Growth Pact, and thus they have less room for manoeuvre in the face of the current slowdown. In general, the budgetary outcome for 2000 should have been better, as some governments gave away part of the higher-than-expected "growth dividend" via tax cuts or expenditure increases. Moreover, both the actual and cyclically-adjusted budget balances of the euro are set to deteriorate slightly in 2001, marking the first reversal in budgetary consolidation since 1993. While this is largely due to welcome reductions in the tax burden, accompanying expenditure reforms have been postponed or toned down in some countries, including measures to modernise pension systems.

The downside risks are mounting with signs of decelerating growth in most countries. In this context, automatic budgetary stabilisers should be allowed to operate fully in those countries that have already achieved budget positions which respect the SGP target of "close to balance or in surplus". In contrast, the full use of automatic stabilisers may not be feasible in those Member

States that have yet to reach the SGP target, as this could lead to deficits that approach the 3% of GDP deficit ceiling.

The aggregate policy mix for the euro area has been broadly balanced in 2000 and 2001. In contrast, the policy mix at national level has not always been appropriate, as fiscal behaviour in some countries has been inconsistent with domestic cyclical and monetary conditions. In the short-term, maintaining a sound policy mix at the euro area level is essential to limit the adverse consequences of the current deceleration in growth: an undue loosening of the fiscal stance could overburden monetary policy, leading to higher-than-necessary interest rates. A particular effort is also required in those Member States experiencing signs of overheating to ensure that the fiscal stance at national level reflects the particular cyclical and monetary conditions they face.

As regards medium-term prospects, the updated stability and convergence programmes provide for a broadly neutral fiscal stance while allowing for a steady reduction in the tax burden. They also show that all Member States aim to reach the SGP target of close to balance or in surplus, but in several cases only in 2003 or 2004. This indicates that budgetary consolidation is being back-loaded towards the final years of the programmes of some countries. It is important that the SGP goal is attained in accordance with the commitments in the BEPGs, so that it does not become a goal that is continuously deferred into the future. Although some Member States have set medium-term targets that go beyond the "close to balance or in surplus" SGP target, the programmes of most Member States appear to be unambitious in light of other budgetary objectives, and especially the need to prepare for the budgetary consequences of ageing populations.

***Budgetary surveillance and institutions***

A sound budgetary performance requires effective institutions, that is efficient decision-making procedures, targets and behavioural rules. It is therefore necessary to look at how the budgetary institutions at both EU and national level are adapting to the new framework for conducting national fiscal policies in a monetary union.

A key question in the framework of budgetary surveillance in EMU is what are the appropriate medium-term targets to respect the SGP goal of close to balances or in surplus. When EMU was launched, the first step was to ensure that Member States' budgetary positions would create a sufficient safety margin so that the automatic stabilisers could operate in cyclical downturns without endangering the 3% of GDP deficit ceiling. Now that such a cyclical safety-margin has been created in most Member States, it is time to complete the transition to the SGP target of budget positions which are "close to balance or in surplus": this would build in an additional safety margin for other budgetary risks (such as unexpected shortfalls in tax revenues, expenditure overruns or interest rate shocks), and provide for a rapid reduction in the stock of public debt in high-debt countries towards the 60% of GDP reference value.

A broadly balanced budget in structural terms would be required for most countries to respect the SGP goal as it would cater for budgetary risks related to cyclical downturns as well as unexpected budgetary developments. Adherence to this goal is particularly important for high debt countries (Belgium, Greece and Italy) to ensure that debt levels fall rapidly to the 60% of GDP threshold. However, for countries which have large automatic stabilisers (the Netherlands, Finland and, outside the euro area, Denmark and Sweden), a small structural surplus of some 1% of GDP appears adequate. Overall, these suggested targets are consistent with budgetary projections outlined by Member States in their updated stability and convergence programmes.

In a recent Communication on enhancing policy co-ordination in the euro area,[2] the Commission outlined some practical suggestions on how to improve the EU budgetary surveillance within the existing legislative framework. Four suggestions warrant consideration, namely: (a) to establish a principle whereby Member States pre-inform the Commission and Council of major budgetary decisions before they are finally adopted/decided; (b) to cluster the submission of stability and convergence programmes in autumn of each year; (c) to improve the information content of the programmes; and (d) to extend their coverage to include the long-term sustainability of public finances.

National budgetary rules and procedures contribute towards meeting budgetary objectives at EU level. Member States' budgetary institutions are clearly being influenced by the need to be consistent with EU surveillance in a number of ways. A key factor is that the SGP establishes budgetary targets and commitments in the medium-term (3 to 4 years) compared with the traditional focus on an annual budget cycle at national level. Partly in response to the SGP, several Member States now use a multi-year budgeting framework or other mechanisms/guidelines to set and control public expenditure priorities in the medium-term.

EU commitments are also shaping the relationships between the different budgetary actors at national level, i.e. central government, national parliaments and State/local authorities. Several Member States have put arrangements in place to strengthen the responsibility for each level of government in meeting the target of the general government balance set down in the stability or convergence programmes. A welcome development is the so-called "internal stability pacts" which have been agreed in several Member States.

**Budgetary policy and cyclical stabilisation in EMU**

Budgetary policy and cyclical stabilisation i(and in particular the functioning of the automatic fiscal stabilisers) are central questions in the debate on fiscal policy in EMU. Analysis on these issues is important as it could serve as a basis for developing guidelines on the appropriate policy response expected from a Member State in EMU when faced with various types of economic shocks, i.e. providing a common analytical framework which could help avoid past co-ordination failures.

Given the loss of national monetary policy in EMU, budgetary policy needs to play a more significant role in smoothing the impact of country-specific shocks on real output. To this end, the norm for budgetary behaviour should be to let automatic stabilisers operate freely in both upturns and downturns, with discretionary policy being the exception rather than the rule. While this conclusion is quite uncontroversial, a number of open questions remain. Are automatic stabilisers always beneficial for the economy? How much cyclical smoothing can be expected from the working of automatic stabilisers? What kind of reforms could improve the effectiveness of automatic stabilisers?

The answers largely depend on whether the shocks hitting the economy emanate from the demand or supply side, although this distinction is not always clear-cut in practice. In the event of demand shocks, such as an acceleration of private consumption or a fall in exports, the output gap and inflation move in the same direction. Automatic fiscal stabilisers can therefore play a useful role as they cushion the impact both on output and prices. Empirical evidence shows that

[2] COM(2001)82

automatic stabilisers are particularly effective in smoothing shocks to private consumption, but less so in the event of shocks to investment or external demand.

In contrast, supply shocks (such as changes in energy prices or technological innovation) typically send output and inflation in opposite directions: for instance, a rise in the oil price results in a negative output gap and higher inflation. In this case, automatic stabilisers help smooth output, but at the cost of even higher inflation. Moreover, if the shock is permanent (i.e. it affects the level of potential activity), automatic stabilisers may be unhelpful if they delay the necessary adjustment towards the "new" level of potential output: instead what is needed is public finances conducive to flexibility in product and factor markets to enable output to converge to its new equilibrium level. In practice, the empirical evidence points to a relatively small impact of the automatic stabilisers in the case of supply shocks: they are thus unlikely to act as a major brake on the required adjustment or make it more difficult for the ECB to maintain price stability.

### *Improving the quality and sustainability of public finances*

The Stockholm European Council of March 2001, recognised the need to broaden the debate on budgetary policy at EU level from its current focus on budgetary stability towards a parallel emphasis on the contribution of public finances to growth and employment. In particular, it called for the quality and sustainability of public finances to be improved.

As outlined in the Joint Commission-Council report to the Stockholm European Council in March 2001,[3] the "quality" of public finances can contribute to economic growth and employment in many different ways. Public spending (e.g. in physical and human capital investment, research and innovation, education, social and regional transfers) can enhance employment and output potential. However, a lack of consistent and updated data, especially on the functional distribution of public spending, has so far hampered a thorough and overall analysis of these issues which need to be addressed in future reports in liaison with the benchmarking exercises of the relevant policies (e.g. education, research and innovation). A strong engagement on the part of Member States is important to remedy such statistical deficiencies

Taxation systems can also contribute to employment and growth by seeking a balanced burden-sharing across taxable sources, facilitating entrepreneurship and providing the right incentives for economic agents to work, save and invest. Efficient tax systems can also facilitate structural change in the event of permanent shocks, and can also encourage workers to stay longer in the labour force, thereby helping meet the challenges of ageing societies.

Some progress has been made in easing the fiscal burden on labour and reducing marginal tax rates. In several Member States, this has been done in the context of environmental tax reforms, where reductions in the fiscal burden on labour have been financed by new or increased taxes on pollution or resource use, which lead to the inclusion of external environmental costs in market prices. Results, however, have so far been mixed and further effort is needed since overall labour

[3] Council of the European Union (2001), "The Contribution of Public Finances to Growth and Employment: Improving Quality and Sustainability", Report of the Commission and the (ECOFIN) Council to the European Council (Stockholm 23/24 March 2001), 6997/01.

taxation remains very high by historical and international standards in some Member States. A particular effort is also needed to reduce the tax burden on low paid labour. Progress in the field of environmental taxes has been very modest to date, and this issue could be addressed in future reports.

As to benefit systems, modest progress has been made in recent years and there is still some way to go to render them more employment friendly. Recent measures have strengthened the conditionality of unemployment and social benefit schemes by revising eligibility criteria, reinforcing checks that conditionality requirements for benefits receipt are met, and improving overall management and enforcement. However, a comprehensive approach that takes the interaction between tax and benefit systems into account has often been lacking. Also the shift from passive towards active policies has been relatively limited. Without further reforms, it will be difficult for the EU to meet the ambitious employment targets established by the Lisbon and Stockholm European Councils.

The long term sustainability of public finances is of added significance in EMU. Ageing will lead to substantial falls in the size of the labour force, a doubling of the old-age dependency ratio by 2050 and a consequent sharp drop in the ratio of employed persons to inactive persons. Recent projections of the Economic Policy Committee (EPC) show that spending on public pensions could increase by between 3% and 5% of GDP in most Member States in coming decades, with very large increases projected in some countries (especially Spain, Greece and Portugal, all of whom finance public pensions on a PAYG basis). If account is taken of health and care for the elderly, the overall impact of ageing on public spending could amount to an average increase of between 5% and 8% of GDP.

This raises concerns about the long-term sustainability of public finances: failure to prepare for the budgetary costs of ageing could make it difficult for Member States to respect the SGP and could complicate the implementation of the single monetary policy by the ECB. Sustainable public finances, however, not only entail avoiding structural deficits and rising debt (i.e. respect of the SGP targets), but also keeping the tax burden at reasonable levels so that employment and growth are not hindered, and ensuring that essential non-age related public expenditures (such as education and investment) are not crowded-out by pressures for increased spending on pensions and health care.

The joint Commission-Council report to the European Council in Stockholm outlined a three-pronged strategy to address the budgetary consequences of ageing populations, namely a suitable combination of : (1) running down public debt at a faster pace; (2) measures to raise employment rates (especially amongst women and older workers); and (3) reforming pension systems to place them on a sound financial footing including greater recourse to the funding of public pensions. The overall sustainability of public finances also depends on progress being made to implement structural reforms in product, services and capital markets.

The Stockholm European Council called for the long-term sustainability of public finances to be factored into the SGP and the BEPGs.

Although the budgetary impact of ageing populations only becomes evident in the long-run, it is determined by short to medium-term policy decisions taken within the time frame of the stability and convergence programmes. An appropriate balance has to be drawn between cutting taxes and running down public debt, and implies that priority should be given to the latter in high debt countries. Current policy choices (such as the medium-term budgetary target, the pace of debt reduction and the scale and type of tax reforms) outlined in the programmes therefore need to be assessed against the commitment to place public finances on a sustainable footing. To conduct regular assessments of these nature at EU level, further work is needed in developing comparable data and indicators. Projections on the impact of ageing on public finances, along the lines of the work underway in the EPC, could be usefully updated on a regular basis, say every two or three years, and incorporated in the updates of the stability and convergence programmes.

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***The way ahead: strengthening co-ordination in budgetary issues***

For the decentralised (bottom-up) approach to budgetary policy to work, there must be real substance to economic policy coordination with a realistic account taken of the euro area dimension of national policy actions. Markets and the general public are not looking for a central fiscal authority in EMU, but instead for a tangible demonstration of the capacity to achieve a consistent budgetary policy at the euro area and national level, and a willingness on the part of euro area countries to respect agreed rules and budgetary goals. Effective policy co-ordination requires that a common and transparent analytical framework exists for analysing economic policy challenges and for devising policy responses and that adequate and timely account is taken of the implications for the euro area of national policies. Further efforts are needed to improve co-operation on budgetary policy in EMU along these lines.