EUROPEAN COMMISSION
DIRECTORATE GENERAL ECONOMIC AND FINANCIAL AFFAIRS

Budgetary policy in EMU: times to change?

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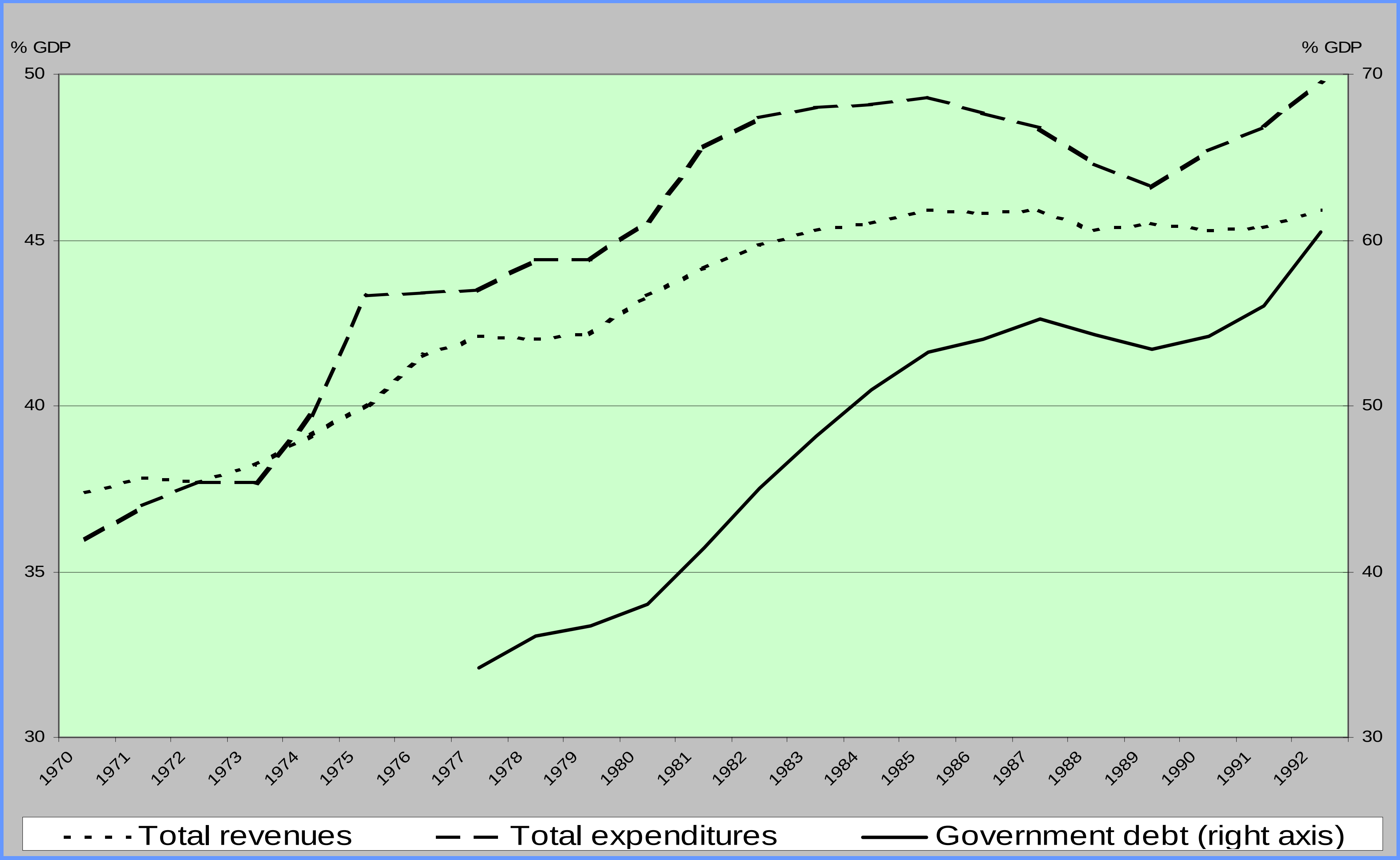
Overview of the presentation

1. Fiscal rules in the EMU. The rationale for “sound” public finances

2. Problems in their applications and proposals to improve implementation

Fiscal behavior before Maastricht



Learning from experience

Permanently high deficits → Instability

↓

Debt increasing both in bad and good times → High real interest rates; Reduced growth prospects

↓

Automatic stabilizers not able to work in bad times

(Public finances are automatically affected by the economic cycle and can smooth it)

The new common goal: “sound” public finances

1. PRICE STABILITY → Support ECB monetary policy
Lower interest rates
- Low interest payments
Longer time-horizon: more private investment

2. SMOOTHING THE CYCLE → Enough room to let automatic stabilizers play freely

3. STRUCTURAL REFORM → Room to implement reform that have a short term cost for public finances

Maastricht Treaty on budget deficit and debt

- “Member States shall avoid excessive government deficits” (Article 104).
  - **deficit** below the reference value of **3% of GDP**,
  - **debt** should not exceed the reference value of **60% of GDP**, or should be on a decreasing trend and approach the reference value at a satisfactory pace.

For many Member States, it acts as an external constraint to change fiscal behaviour

The Stability and Growth Pact (1)

Prevention

- the medium-term budgetary position must be of “close to balance or in surplus”
- “stability programmes” and “convergence programmes”.
- “significant divergences” of budgetary positions from the medium term budgetary objectives
  $\Rightarrow$ “early warning” recommendation

The Stability and Growth Pact (2)

Why “close to balance”? Is it not sufficient the 3% ceiling?

Respect of Treaty requirements

Cyclical component

Unforeseen budgetary variability including interest payments variability

Reduction of public debt below 60%

Additional policy goals

Additional room of manouvre (discretionary policies, tax reforms etc.)

Long term challenges (ageing population)

APPROPRIATE MEDIUM TERM TARGET

The Stability and Growth Pact (3)

Dissuasion

- sets up a tight timetable for the *Excessive Deficit Procedure* so as to arrive at a speedy decision on the existence of an excessive deficit.
- spells out the type and scale of sanctions in the event of persistent excessive deficit of euro-area members

A focus on stabilization and growth: comparison between EU and US policy response to slowdown

The main differences between EU economies and the US:

1) the initial budgetary situation (in terms of nominal and structural budget balances),

2) the level of the debt to GDP ratio,

3) size of future pension liabilities,

4) the cyclical sensitivity of budgets,

5) the smoothing impact of automatic stabilisers,

6) EU lower fiscal multipliers associated with discretionary measures, and

7) different institutional settings.

In EU sound public finances and automatic stabilizers seem to be the best policy

Budgetary outcomes in stage III of EMU: a mixed picture

	Actual budget balance					Cyclically-adjusted budget balance				
	1999	**2000**	**2001**	**2002**	**change**	**1999**	**2000**	**2001**	**2002**	**change**
B	-0,5	0,1	0,2	-0,1	0,4	-0,8	-1,2	-0,4	0,2	1,0
D	-1,5	-1,4	-2,8	-3,8	-2,3	-1,4	-1,9	-2,8	-3,3	-1,9
EL	-1,9	-0,8	-0,4	-1,3	0,6	-1,7	-0,9	-0,8	-1,7	0,0
E	-1,1	-0,7	-0,1	0,0	1,1	-1,5	-1,4	-0,7	-0,1	1,4
F	-1,6	-1,3	-1,5	-2,7	-1,1	-1,7	-2,0	-2,0	-2,7	-1,0
IRL	2,3	4,6	1,6	-1,0	-3,3	0,8	2,3	-0,3	-1,4	-2,2
I	-1,8	-1,8	-2,2	-2,4	-0,6	-1,6	-2,1	-2,5	-1,8	-0,2
L	3,6	5,6	6,1	0,5	-3,1	2,8	2,6	5,0	…	…
NL	0,7	1,5	0,1	-0,8	-1,5	-0,9	-0,5	-1,2	-0,6	0,3
A	-2,3	-1,9	0,2	-1,8	0,5	-2,5	-2,5	-0,1	-1,6	0,9
P	-2,4	-3,3	-4,2	-3,4	-1,0	-3,0	-4,2	-4,8	-3,0	0,0
FIN	1,9	7,0	4,9	3,6	1,7	0,4	3,8	3,5	3,7	3,3
EUR-4 (D,F,I,P)	*-1,6*	*-1,5*	*-2,3*	*-3,1*	*-1,5*	*-1,6*	*-2,0*	*-2,5*	*-2,7*	*-1,1*
EUR-8	*-0,8*	*0,4*	*0,3*	*-0,1*	*0,7*	*-1,3*	*-0,7*	*-0,4*	*-0,2*	*1,1*
EUR-12	*-1,3*	*-0,9*	*-1,5*	*-2,3*	*-1,0*	*-1,4*	*-1,6*	*-1,9*	*-2,7*	*-1,3*
DK	3,1	2,5	2,8	2,1	-1,0	2,4	1,3	2,6	2,1	-0,3
S	1,3	3,7	4,8	1,4	0,1	0,4	2,0	3,9	1,3	0,9
UK	1,1	1,6	0,7	-1,1	-2,2	0,9	1,1	0,5	-0,6	-1,5
EU-15	*-0,7*	*-0,2*	*-0,8*	*-1,9*	*-1,2*	*-0,9*	*-1,0*	*-1,2*	*-1,6*	*-0,7*

EU-4 = Deficit countries D, F, I, P

EU-8 = B, EL, E, IRL, L, NL, A, FIN

Note: Cyclically-adjusted figures are computed with the production function method.

Source: Commission services, 2002 Autumn Forecast.

Difficulties in the implementation of the Pact (1)

Lack of political ownership of the Pact on the part of several Member States:

Some countries have repeatedly missed budget targets

Member States have not played their role in applying peer pressure

Also use of creative accounting

•***Ineffective preventive and enforcement procedures***:

early warning mechanism did not work when countries deviated from agreed budgetary targets

Difficulties in the implementation of the Pact (2)

- ***Lack of focus on key policy challenges***:

  focus on procedures and short term nominal targets rather than on key challenges such as:

  ⇒The role of public finances in raising growth and employment

  ⇒Long term sustainability

- ***Problems in taking into account country specific circumstances***:

  Differences in debt levels

  Differences in investment needs

What to do?

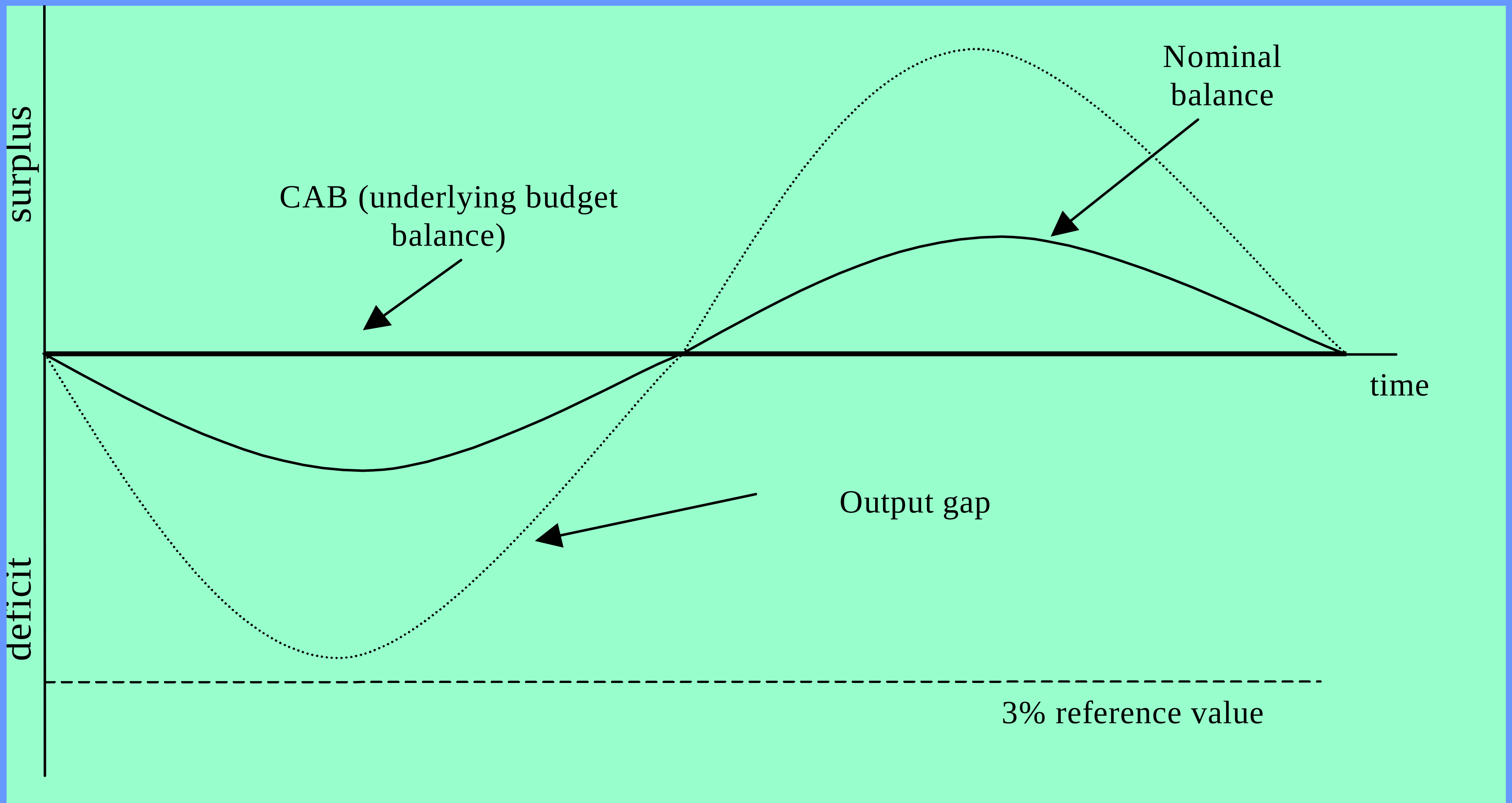
1. Nothing. The rules and procedures are fine as they are now
2. Improve implementation within the existing Treaty and SGP framework
3. Change the legislation

The Commission made a proposal to improve the implementation without changing the legal framework

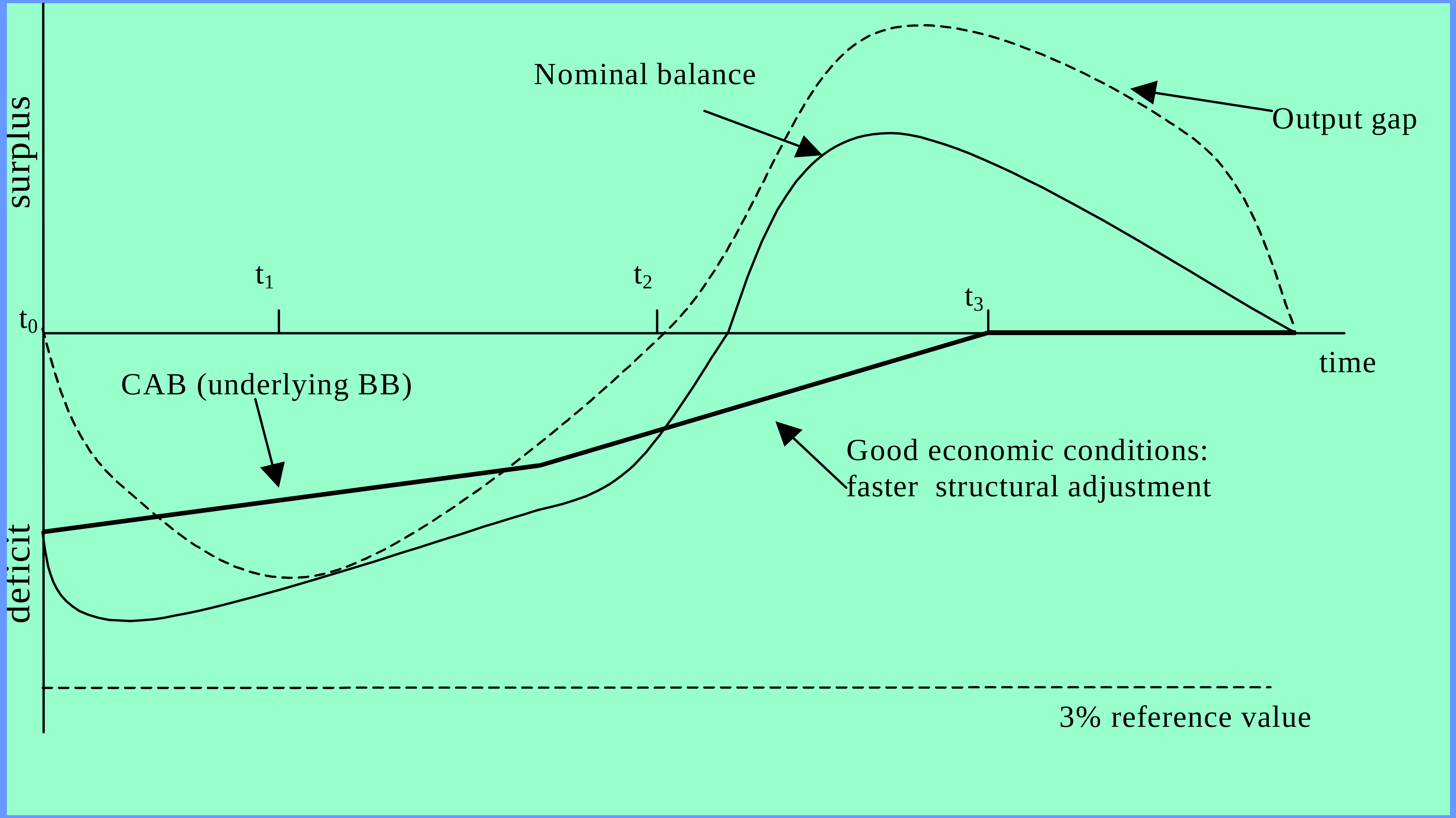
Five proposals by the Commission to strengthen the Pact

1. Budgetary targets that take account of the economic cycle
2. Transitional arrangements for countries in deficit
3. Incentive to avoid pro-cyclical policies in good times
4. Meeting the goals of the Lisbon strategy: catering for reforms that are employment and growth enhancing
5. Making sustainability a core objective

Budgetary objectives that take account of the economic cycle



Transitional arrangements for countries with underlying deficits



(3) Need to avoid pro-cyclical budget policies in good times

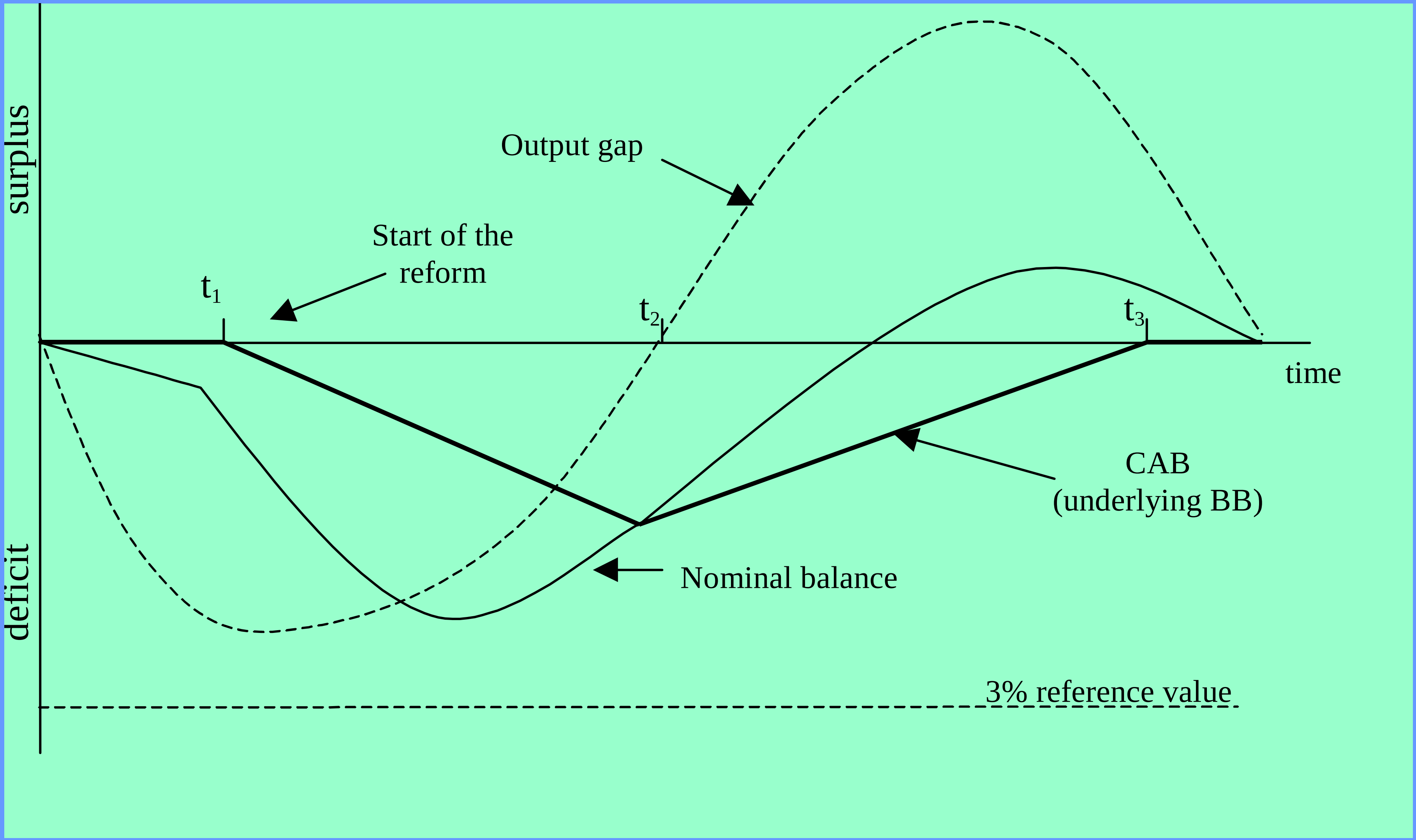
Suggestion

A pro-cyclical loosening of the budget in good times should be viewed as a violation of budgetary requirements - use of Early warning procedure

How it improves the current framework

It will help avoid a repetition of the 1999 and 2000 failure when Member States failed to consolidate during good times

The goal of the Lisbon strategy: reforms that are employment and growth enhancing



(5) Making sustainability a core budgetary objective: from short/medium term to long term targets

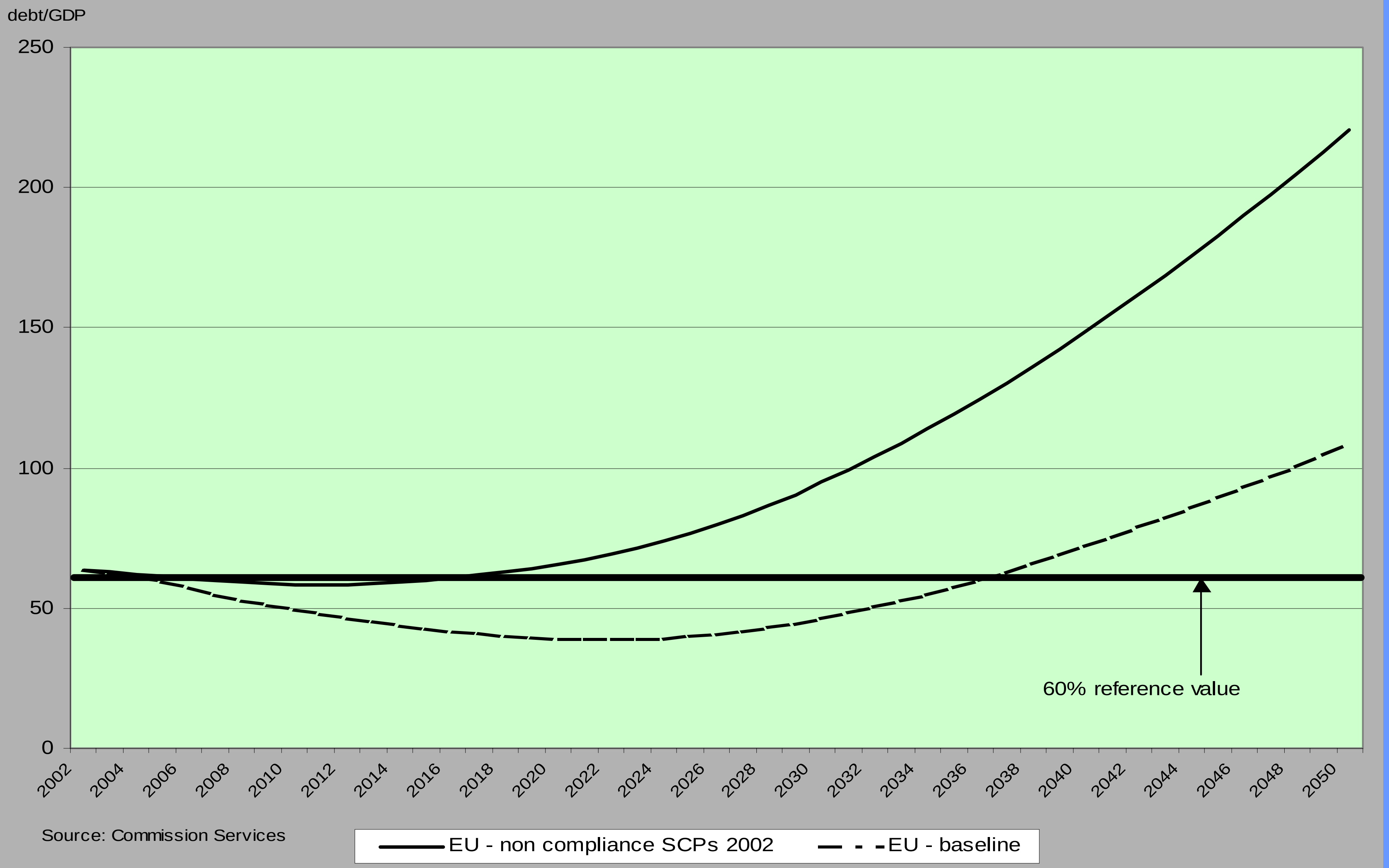
Suggestion

Medium-term budget targets are assessed against need to ensure sustainable public finances in the long run in light of ageing populations

How it improves the current framework

Extends the time horizon of budgetary surveillance beyond the 3 or 4 year time horizon of stability and convergence programmes

Debt development



Source: Commission Services

Greater attention to debt dynamic

<u>Factors to be considered in debt dynamic</u>:

1. Interest rates

2. Real GDP growth

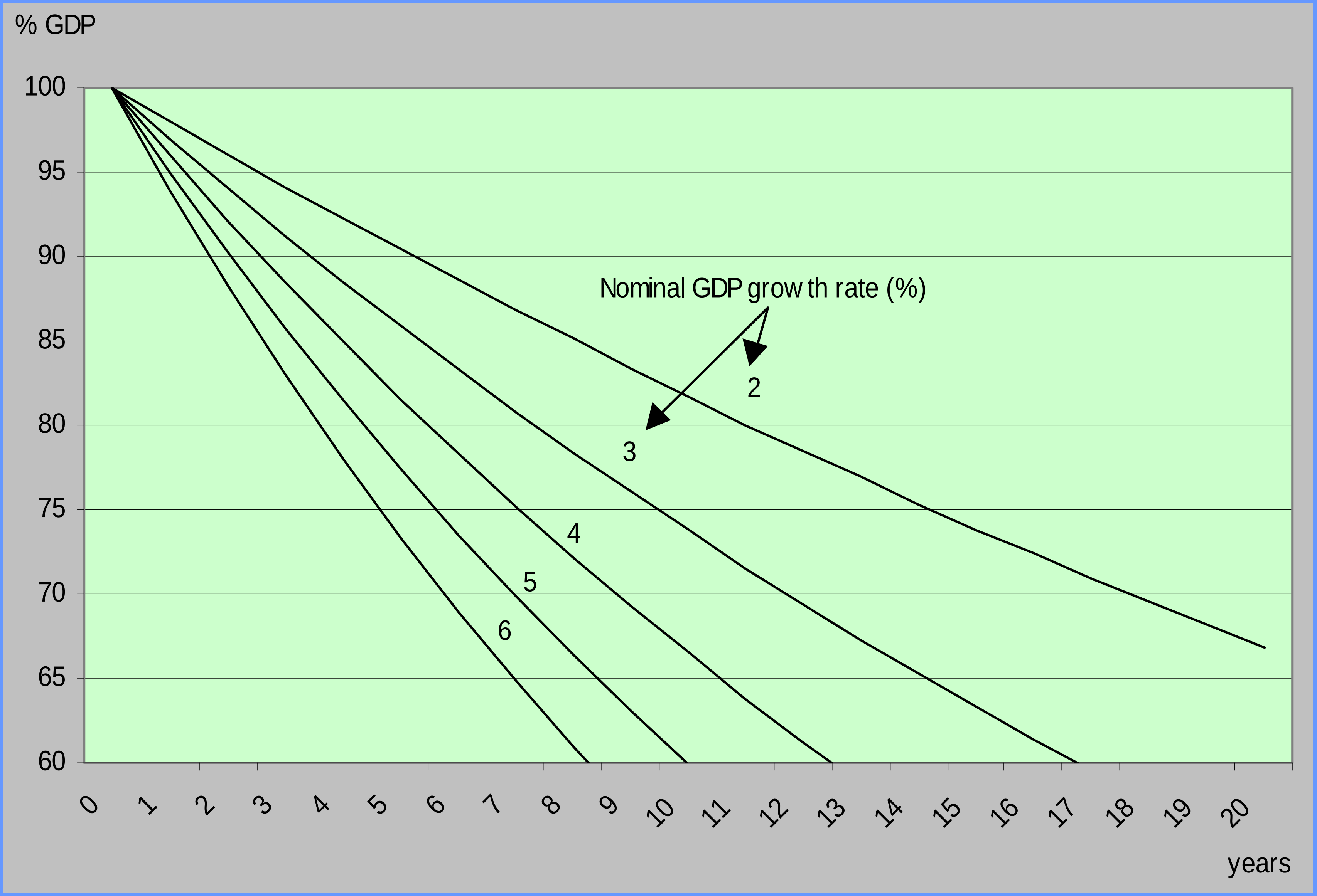
3. Inflation rate

4. Primary balance

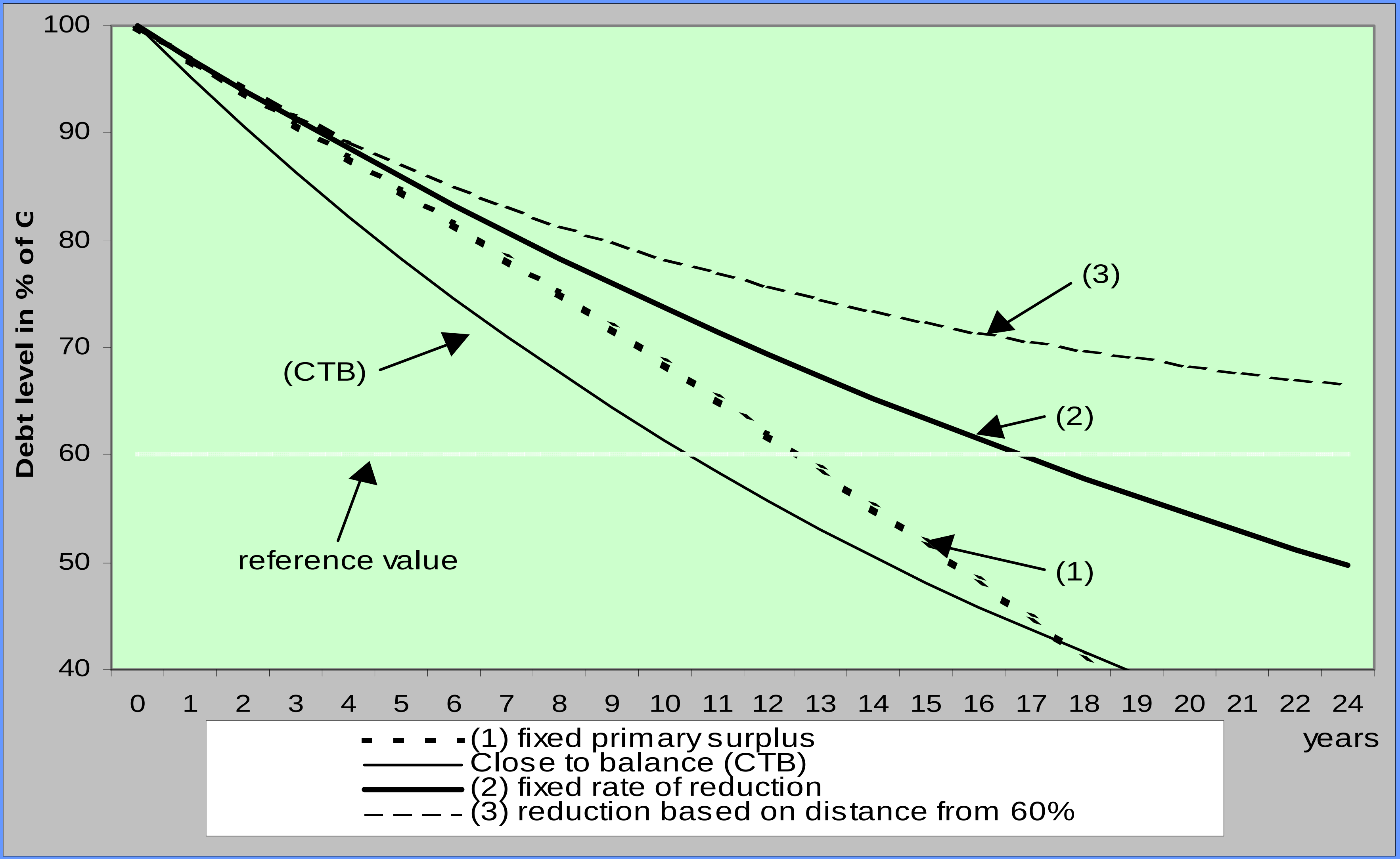
5. Stock-flows operations

Some are more under the direct control of government

The expected debt dynamic under the SGP rule



Different options to operationalise the debt criterion: a comparison



To sum up:

- There is a rationale for fiscal rules in the E(M)U
- Maastricht Treaty and the Stability and Growth Pact constitute a good framework for independent but co-ordinated fiscal policies
- Good budgetary results until the adoption of the euro, but mixed outcome since 1999
- Problems in the implementation of the Pact
- Need for some improvements, but within the budgetary framework.
- Greater attention to long term issues (growth and sustainability of public finances)

Open issues

Can we continue as it is now?

Inreasing complexity?

A more radical reform (a debt rule or a spending rule) would be better?

Need for an independent authority?

Is it better to respect the rule through creative account or not respect the rule?

How to improve the quality of public finances?