Public finances in EMU 2007 and 2008

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PURPOSE: to improve the role of quality of public finances in the EU governance framework.

CONTENT: this Communication builds on the 2005 SGP reform to suggest avenues for strengthening the focus on the quality of public finances in the surveillance of national budgetary policies. They concern the way governments formulate, implement, and assess their budgetary strategies over the medium term, and how the preventive arm of the SGP can be more effective in supporting the achievement of sustainable budgetary policies while contributing to higher growth and employment, and to a better functioning of EMU.

On the back of favourable economic conditions as well as consolidation and reform efforts, public finances have improved significantly in the EU and the euro area. Although differences remain large across countries, in 2007 the government deficit in the euro area and in the EU as a whole reached the lowest level since the early 1970s, respectively 0.6% and 0.9% of GDP. Reflecting the improvement of fiscal balances, the level of outstanding debt stayed on a clear downward path. In the EU as a whole it has already fallen to below 60% of GDP, while in the euro area it is approaching this reference value.

On the whole, the experience accumulated after the 2005 reform of the Pact is, on balance, positive. The *dissuasive arm* of the stability and growth pact, which deals with the correction of excessive deficits, has clearly delivered in spite of the concerns voiced by some that the 2005 reform of the Pact would lead to a relaxation of the rules. Violations of the 3% of GDP deficit threshold continued to result in countries being subject to the excessive deficit procedure. The implementation of the *preventive arm* of the stability and growth pact, which requires Member States to adjust their budgets until sustainable fiscal positions are achieved, has also improved.

Despite this progress, EU Member States are still facing a number of major challenges that leave little room for complacency on fiscal policies:

- potential GDP growth is still constrained in many Member States, reflecting an inefficient use of resources, including by the public sector;
- the current economic juncture with strong inflationary pressures is reducing the room for manoeuvre in the conduct of policies;
- the ongoing process of demographic ageing will weigh on the sustainability of public finances unless the consolidation process is continued and accompanied by structural reforms that reduce its budgetary cost;
- increasing exposure to global competition puts pressure on EU governments to lower the, on average, relatively high tax, administrative and regulatory burden in Europe and to improve provision of public services and goods, so as to deliver much-requested better value for money.

Considering the need for ensuring sustainability of public finances, fostering long-term economic growth and the smooth functioning of EMU, **four areas for action can be identified** to improve the focus on the quality of public finances in the EU fiscal surveillance framework and thereby also create a stronger link with the Strategy for Growth and Jobs. These draw on the broad principles laid out in the “EMU@10” Communication of May 2008.

1) Gauging the quality of public finances (more systematic reporting by Member States and building up a set of indicators): gauging the quality of public finance will benefit from:

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a more systematic and comprehensive reporting, in the context of the SCPs, on issues related to the quality of public finances and provision of regular information about structural reforms, with special reference to restructuring of public spending and tax reforms;

- the build-up of an inventory of indicators, in the context of the joint work programme of the Commission and the Economic Policy Committee, covering the different dimensions of quality of public finances across Member States and the development of a systematic approach aimed at assessing the efficiency of specific categories of public spending and gaining a better understanding of the determinants of efficiency.

2) Greater attention to efficiency and effectiveness of public spending: one promising way to enhance the efficiency and effectiveness of spending is to set up or improve institutional mechanisms aimed at establishing a stronger link between policy priorities and the allocation of resources and between resources and outcomes. Conducting budget reviews on a regular basis, including efficiency analysis, is instrumental for expenditure prioritisation. More generally, it is important that Member States move from purely input-based procedures towards procedures that take into account performance information.

3) More efficient government revenue systems: tax reforms should continue to be designed so as to foster growth and minimise distortions, while playing also their role in addressing distributional concerns. This could be achieved through simple rules and broad tax bases, avoiding loopholes, inefficient tax expenditures, special tax regimes and unnecessary exemptions.

Easing the high tax burden on labour by shifting to other tax bases, including consumption, can be an element in this strategy, but it is a limited instrument for governments to react to short-run country-specific shocks or to achieve long-run improvement of the structural conditions for increasing employment and growth in Europe.

A comprehensive strategy to revitalise European economies, including by modernising the social models, needs to rely on a comprehensive approach, using a wide set of policy instruments and a resolute implementation of structural reforms as indicated by the Strategy for Growth and Jobs.

4) Regular review of the quality of public finances: the review would draw on the information provided in the SCPs and the inventory of quality of public finances indicators. Country-specific analyses could be further included in the review, in particular on selected thematic issues. Building on a tested method of collaboration, the review could be conducted jointly by the Economic Policy Committee and the Commission.