Public finances in the Economic and Monetary Union EMU

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PURPOSE : Communication on Public finances in EMU 2005.

CONTENT : This Communication draws the main policy messages from the Public Finances in EMU-

2005 report prepared by the Commission services. The report is published yearly since 2000.

It presents an overview of recent budgetary developments in the EU, tracks the evolution in EU fiscal surveillance, and carries out analysis on fiscal policy issues of relevance for the EU wide policy debate. The following are the main points in the report:

-Large budgetary imbalances persist in some countries. After deteriorating for three consecutive years, reflecting to a large extent the economic slowdown, the euro-area general government deficit improved marginally in 2004 (from 2.8% of GDP in 2003 to 2.7% in 2004). The deficit of the EU-25 aggregate also fell (from 2.9 to 2.6% of GDP), largely as a consequence of the considerable improvement of deficits in a number of recently acceded Member States. Aggregate deficit figures mask noteworthy differences between countries. In 2004, six EU countries, including three euro-area countries, exhibited budget positions in balance or in surplus. In contrast, in four euro-area Member States (Greece, Germany, France, Italy) and seven non-euro-area countries (Czech Republic, Cyprus, Hungary, Malta, Poland, Slovakia and the UK) deficits were above the 3% of GDP reference value. While the deficit is projected to be reduced in 2005 or 2006 in a number of countries that are currently subject to the excessive deficit procedure (Germany, France, Cyprus, Malta), Italy and Portugal are expected to have deficits above the 3 % of GDP ceiling in 2005 on the basis of their current policies.

-Further action under the excessive deficit procedure: Since the summer of 2004, ten EU countries have been subject to the excessive deficit procedure (EDP). In December 2004, the Commission and the Council clarified their position regarding the EDP for Germany and France, following the Court of Justice ruling of July. Since both countries had taken measures which could plausibly result in the excessive deficit being corrected in 2005, it was decided that at that stage no further action under the

EDP was necessary. For the first time, on February 2005, the Council decided to issue a notice under Article 104(9), the last step before sanctions. This notice was addressed to Greece and contained a deadline for correcting the excessive deficit postponed by one year, i.e. until 2006, as a result of substantial revisions in deficit figures. At the occasion of the fiscal notifications of September 2004 and March 2005, the fiscal data of Greece underwent a revision of unprecedented large magnitude: deficit ratios dating back to 1997 were revised upward and the 2003 and 2004 deficits jumped, respectively, to 5.2% and 6.1% of GDP. The exceptionally large revision in the Greek government accounts came at a time when increasing emphasis was being put on improving statistical governance in the budgetary field. The Communication describes the steps taken.

-The 2005 Stability and Growth Pact reform: On 20 March 2005, the Council adopted the report

“Improving the implementation of the Stability and Growth Pact” with a view to improving the EU fiscal framework. The report updates and complements the existing legal framework of the SGP. The

report entails changes to both the preventive and corrective arms of the Pact and contains recommendations for improving fiscal and statistical governance at both the EU and the national level.

The preventive arm of the Pacthas been strengthened by ensuring that due attention is given to the fundamentals of fiscal sustainability when setting medium-term budgetary objectives. The main modifications to the corrective arm of the Pactconcern the definition of "excessive deficits" and the modalities for their correction. In particular, the new rules allow the one-year deadline for the correction of an excessive deficit to be extended by an additional year (on economic grounds) and certain steps in the EDP to be repeated (if unexpected adverse economic events occur and provided that effective action has been taken by the Member State concerned in full compliance with recommendations). The Communication goes on to detail the new agreement, discussing the "relevant factors" that the Commission and the Council can take into account when taking decisions on the EDP.

Overall, the way ahead with the implementation of SGP will be characterized by more room for economic judgement in the fiscal surveillance procedure and in the assessment of individual country cases.

-Developments in EU budgetary surveillance: The Public Finances in EMU report regularly provides analytical work aimed at improving the understanding of public finance issues in the EU and upgrading budgetary surveillance. This year the report presents, among other topics, analysis on the discrepancy between budgetary plans presented in stability and convergence programmes and results, on the determinants of debt dynamics, and on the long-term sustainability of public finances.

The Public Finance in EMU-2005 report indicates that without a medium-term budgetary consolidation a sustainable position will not be reached for most Member States. Sustainability risks are identified in ten Member States (Belgium, Czech Republic, Germany, Greece, France, Italy, Cyprus, Hungary, Malta and Slovenia).

-Structural reforms and budgetary objectives: The analysis contained in the Public Finances in EMU report considers labour and product market and pension reforms and focuses on two issues. First, which impact do reforms have on budgets in the short term? Second, is there evidence that fiscal consolidations prevent reforms? The analysis provides interesting results. The expectation that reforms are less frequent in years where a budgetary consolidation takes place does not seem to be strongly supported by the data. However, in the aftermath of reforms there is in general a slight deterioration in budget balances.

-**Fiscal challenges during convergence in the recently acceded Member States:** The report states that in the short run some of the new Member States may need to make choices: higher spending on infrastructure, training or R&D can make it harder to contain budget deficits, and tax and pension reforms introducing funded pillars recorded outside the government sector may also involve up-front budgetary costs. Part IV of the Public Finance in EMU – 2005 report discusses the main challenges for the conduct of fiscal policy the new Member States may face in the coming years. While acknowledging the differences among them, there is some scope for policy-makers in the new Member States to achieve synergies in pursuing growth and stability objectives. First, there is room to restructure existing expenditure programmes and enhance tax bases in ways that both strengthen their public finances and improve the incentives for growth, possibly already in the short term. Second, fiscal institutions could be improved upon, including through enhanced transparency of budgetary procedures and effective frameworks for multiannual budgetary planning and expenditure control. Third, well-conceived supervisory policies would improve risk management in the private sector, thereby containing government contingent liabilities, and well-designed monetary policies would steer market expectations towards stability.