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Public Finances in EMU – 2008

THE ROLE OF QUALITY OF PUBLIC FINANCES IN THE EU GOVERNANCE FRAMEWORK

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I. INTRODUCTION

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.

Despite this progress, EU Member States are still facing a number of major challenges that leave little room for complacency on fiscal policies. First and foremost, potential GDP growth is still constrained in many Member States, reflecting an inefficient use of resources, including by the public sector. At the same time, the current economic juncture with strong inflationary pressures is reducing the room for manoeuvre in the conduct of policies. Second, 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. And third, 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.

To address these challenges a comprehensive fiscal policy approach that raises the quality of public finances and supports long-term economic growth is called for. Policy action can be more growth-friendly and competitiveness-enhancing through measures that help raise the efficiency of expenditure and revenue systems. Such a broad-based approach would, by creating new fiscal space, directly contribute to further fiscal consolidation and mitigate the debt sustainability challenge. At the same time, these measures can have an indirect impact on budgetary balances through their effect on economic growth and employment.

From the viewpoint of EU economic surveillance, stronger focus on the quality of public finances opens up a promising avenue to better link the different instruments of economic governance, specifically the Stability and Growth Pact (SGP) and the Lisbon Strategy for Growth and Jobs. This would respond to a demand first expressed in the March 2005 Council report on the reform of the SGP and underlying successive conclusions of the European Council and the Ecofin Council pertaining to specific aspects of the quality of public finances. Most recently, the Commission Communication *EMU@10: successes and challenges after 10 years of Economic and Monetary Union* [1] called for a deeper and broader approach to fiscal and economic surveillance, with greater focus on quality of public finances and its links to growth, as one key element *inter alia* for the smooth functioning of EMU. The present Communication discusses areas of public finances where improving quality would make it possible to tap the potential synergies across the main instruments of EU economic policy coordination.

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1 COM(2008) 238 final, 7.5.2008.

II. Current implementation of fiscal surveillance

After nearly a decade of experience with the EU fiscal framework, including the recent episodes of fiscal consolidation, a number of lessons can be drawn. These are particularly relevant given the large degree of uncertainty attached to current economic prospects.

II.1 Lessons from past experience

The experience accumulated after the 2005 reform of the Pact is, on balance, positive.

The *dissuasive arm of the SGP*, 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. Hence, in spring 2006, no less than twelve Member States were subject to the excessive deficit procedure. The Council recommendations and decisions issued for countries in excessive deficit typically asked for ambitious fiscal corrections, equal or even bigger in size than those under the “old” Pact. The required adjustment period was extended when appropriate, but this was necessary only in rare cases. Two-and-a-half years on, the number of Member States subject to the excessive deficit procedure is nearing zero as fiscal improvements have generally been in line with or even exceeded the recommendations by the Council, reflecting not only favourable economic conditions in 2006 and 2007 but also significant consolidation efforts.

The implementation of the *preventive arm of the SGP*, which requires Member States to adjust their budgets until sustainable fiscal positions are achieved, has improved. The preventive arm is built around medium-term budgetary plans laid down by Member States in the annual updates of the stability and convergence programmes (SCPs), which are key components in the implementation of the EU fiscal surveillance framework. The preventive part of the SGP has contributed to achieving in 2007 the best budgetary results in decades, with many Member States being close to balance or in surplus. However, in a few countries little progress has been made toward medium-term budgetary objectives. More generally, a number of points as regards the experience with the preventive arm should be noted. [2]

- Over time many Member States have not fully implemented their medium-term budgetary strategies. Most fiscal plans envisaged more or less ambitious restraints of government expenditure combined with a reduction of the tax burden, but two thirds of the planned budget balance improvements were not reached and three quarters of government expenditure targets were overshot. Moreover, fiscal corrections were often postponed, turning the medium-term budgetary objectives into moving targets rather than anchoring fiscal policy.

- Nevertheless, a number of success factors for better adherence to medium-term plans and stronger fiscal positions have emerged. The Commission analysis shows that countries with sound fiscal governance, in particular strong national fiscal rules and medium-term fiscal frameworks, had better budgetary outcomes and tended to stick more closely to

[2] Analytical work underpinning these conclusions was presented in the European Commission’s 2006 and 2007 *Public finances in EMU* reports.

budgetary plans. This role of fiscal governance has been explicitly recognised in the reformed SGP and in successive Council conclusions. Moreover, fiscal adjustments that laid the emphasis on expenditure cuts, other than investment, had a higher chance to be lasting than those with a focus on revenue increases.

- As regards structural reforms, the view that they may conflict with fiscal consolidation is still widespread but such a perception is unwarranted. Evidence, including the recent progress under the Strategy for Growth and Jobs, suggests that structural reforms can be an integral part of successful medium-term fiscal consolidations and hence be conducive to making a fiscal correction last. Moreover, to the extent that structural reforms, while beneficial to long-term sustainability, entail budgetary costs in the short run, the revised SGP allows this to be taken into account when assessing progress towards the medium-term budgetary objectives (MTOs).

II.2 Risks attached to the short-term outlook

Against the backdrop of weakening short-run economic prospects for the euro area and the EU, a number of risks in the assessment of the 2007 public finances and their outlook for 2008-09 have emerged. While most observers concur that the European economies are relatively well placed to withstand the fallout from the credit crisis and the surge in commodity prices, there is also agreement that the euro area and the EU as a whole will not be immune to the US economic slowdown and the inflationary context. This view is evidenced by the downward revisions of EU economic growth forecasts for 2008 and 2009 to 2.0% for 2008 and 1.8% for 2009 in the Commission services' spring 2008 forecast. Consequently, caution is called for in two areas of EU public finances:

- The use of revenue windfalls to raise government expenditures or to lower tax rates risks turning into a serious constraint in the coming years. While the jury is still out on the actual drivers of the tax buoyancy in 2006 and 2007, experience suggests that a significant part of it may be short-lived. Specifically, the favourable asset price cycle and the boom in corporate profits, which gave rise to extra revenues in the past two years, have come or are coming to a close. As growth abates, a reversal in the tax content of GDP would strain the budgetary situation of Member States, which have used revenue windfalls to cover expenditure slippages and plan on further expenditure growth. It would also reduce their capacity to let automatic stabilisers play. Recent expenditure overruns have been contrary to the policy advice in the Council opinions on the 2006 updated SCPs and, for the euro-area countries, the commitments made in spring 2007, notably "*to implement their 2007 budget as planned, avoiding expenditure overruns and using unexpected extra revenues for deficit and debt reduction*". [3]

- There is also a risk that medium-term growth prospects have been overestimated as the EU seems to have reached the peak of an economic cycle. Output gap estimates for 2007 suggest that the euro area and the EU as a whole were operating only marginally above potential. However, this stands in contrast to many other business cycle indicators, such as the rate of capacity utilisation in the manufacturing industry, which indicated that the EU was in fact operating clearly above potential (i.e. in "good times"). A similar

[3] Eurogroup spring orientation debate on budgetary policies: Orientations for fiscal policies in euro area Member States, 20 April 2007.

constellation was observed at the end of the 1990s, when fiscal policy makers failed to appreciate the exceptionally favourable phase of the cycle.

Overall, the remaining shortcomings in adhering to medium-term budgetary plans and the risks to the public finance outlook call for a continued effort to further strengthening the implementation of the EU fiscal surveillance framework, notably by increasing the attention to the quality of public finances.

III. Quality of public finances as an instrument to improve fiscal and economic surveillance

Past experiences and current economic risks strengthen the case for a greater focus on quality of public finances in budgetary and economic surveillance. Quality of public finances can be viewed as a framework with multiple dimensions. It goes beyond low deficits and debt levels, which remain its linchpin, but also comprises all fiscal arrangements and institutions that contribute to an efficient allocation of resources and support achieving macroeconomic goals, in particular long-term economic growth, and would facilitate reaching other objectives such as equity and social cohesion. These dimensions of quality of public finances include the composition and efficiency of public expenditure, the structure and efficiency of revenue systems, fiscal governance, the size of governments, and those public finances policies that affect the functioning of markets and the overall business environment.

Better quality of public finances can contribute to addressing the EU's fiscal policy challenges via two mutually reinforcing channels: (i) directly, by raising expenditure and revenue efficiency, i.e. by better using public resources; and (ii) indirectly, by reducing the cost for society and lowering distortions, fostering long-term economic prospects and strengthening the ability to adjust to shocks. The main transmission channels from the various dimensions of quality of public finances and broad policy lessons for the EU are summarised below. [4]

- For a given spending envelope, public finances can contribute to economic growth and sustainability through the *composition and efficiency and effectiveness of public expenditure*. Both theoretical and empirical research indicates that growth can be supported when public expenditure is oriented towards investment, underlining also the point that fiscal consolidation based on investment cuts, as evidenced in some periods in some Member States, can be problematic in the long run. The impact on growth is largely driven by public investment in human capital (through education and health spending), technical progress (R&D spending) and public infrastructure. These are key areas of European regional and cohesion policies. However, evidence also shows that the link between the amount of spending in these areas and economic growth is not automatic, but depends largely on the ability to achieve the envisaged outcomes (e.g. higher educational attainment, more private investment in R&D) and overcoming existing market failures without creating new distortions. In this context, respect of State aid rules can be instrumental. Currently, empirical estimates of efficiency of public education and health spending indicate great differences across Member States, with ample room to either

[4] For a more detailed analysis see the report *Public finances in EMU – 2008.*

economise on the use of public resources or improve outcomes. The first option would allow the much-needed fiscal space to be created for other demands, for example from ageing populations, or for tax cuts. The second option could contribute to growth through higher labour productivity.

- The *structure and efficiency of revenue systems* can also be a factor for long-run growth, in particular with increased competition for mobile tax bases and factors of production placing additional constraints on public policies. The tax structure affects the growth potential through its impacts on labour supply and demand, incentives for investment, risk taking and human capital formation. While lowering distortions through a reduction in the overall tax burden is always desirable, it would have to go hand-in-hand with expenditure reforms. An important further policy option is therefore to adapt tax structures in a revenue-neutral manner. For example, easing the tax burden on labour by shifting it to a wider tax base, such as VAT, could foster employment and growth. In model simulations by the Commission services for the euro area, a 1% tax shift of GDP from labour taxation to consumption taxation is estimated to raise real GDP by about 0.2% and employment by about 0.25% in the long run. The impacts depend strongly on institutional and structural factors, such as the indexation of transfer payments and the response of wages. In addition to widening the tax base and lowering the tax rate, efficiency-enhancing tax reforms should make tax systems simpler and more transparent, and link them better with benefit systems. As a result of a tax shift from labour to consumption taxation, the difference in income between wage earners and the inactive population typically increases. These consequences in terms of redistribution and equity should be properly addressed.

- Good *fiscal governance* can enhance all dimensions of public finances. In addition to the earlier highlighted role that national fiscal rules and medium-term budgetary frameworks play in strengthening budgetary performance, fiscal governance can also contribute to fostering expenditure efficiency, better target public expenditure and support public finance reforms. Reflecting these opportunities, most Member States are already in the process of collecting more information on the performance of public spending with the objective of putting less emphasis on input-oriented management of public resources and more stress on results-orientation. The practical implementation is very complex, however, and advances differ greatly across countries. At the same time, much room for improvement is left as regards the conduct of Member States’ policies over time, as the frequent deviations from SCPs have shown. Putting in place stronger medium-term budgetary frameworks offers a chance to overcome political economy considerations in both the design and implementation of fiscal policy. This could contribute to broadening the focus of discussions from the overall spending envelope to other aspects such as the allocation of spending, including on growth-enhancing items, and the structure and efficiency of revenue systems. Thus, strong fiscal governance can not only help keep the overall size of the public deficit in check, but is also a framework in support of a broad reform agenda in other areas of quality of public finances, ultimately affecting outcomes in terms of efficiency and size of the government sector.

- The *size of governments* tends to matter for economic growth, because it is closely linked to other dimensions of quality of public finances. When public finances areas are in good shape, maintaining relatively large public sectors and satisfactory economic growth can go hand in hand. However, a broad set of empirical studies, including some preliminary analysis by the Commission services, finds that public sectors can become a drag on the economy if they are characterised by high tax burdens, high public consumption and inefficient public spending and administrations. Problems are compounded by large deficits and debts.

- Public finances, through budgetary and non-budgetary items, can also *impact the functioning of markets and the business environment*. In addition to the above-mentioned roles of efficient public expenditure and revenue systems, public finances also play a particular role through their impact on wage setting (e.g. public sector wages), labour market participation and mobility (e.g. benefits systems), and, more generally, the business environment (e.g. through the provision of a well-functioning judicial system and public infrastructure). However, public finances are only one element in ensuring the smooth functioning of labour, product and services markets obviously and need to be accompanied by an efficient regulatory and legal framework. The Commission services' preliminary analysis suggests that total factor productivity and skilled labour contribution to GDP growth are the greatest beneficiaries in economies with lower regulatory burdens. These two growth components, in turn, have played a prominent role in EU growth over the past two decades, thereby contributing to the sustainability of public finances.

Bringing together all elements of the quality of public finances would make it possible to tap the potential synergies across the main instruments of EU economic policy coordination, specifically the SGP and the Strategy for Growth and Jobs. Explicitly or implicitly, the quality of public finances plays an important role in the implementation of both mechanisms. As regards the former, the quality of public finances is acknowledged in the reform of the Pact as deserving attention in the SCPs, and lack of progress in the area is viewed as a source of weakness in implementing the preventive arm. As regards the Strategy for Growth and Jobs, quality of public finances is the explicit subject of one of the Integrated Guidelines that Member States are expected to follow in their reform programmes, but a comprehensive review of progress in this area has been lacking so far.[5] Consequently, a more systematic and comprehensive focus on the quality of public finances can foster the achievement of the goals of the SGP and the Lisbon Strategy: sustainability of public finances and economic growth.

IV. Greater focus on the quality of public finances in EU fiscal governance

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.

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[5] Integrated Guideline No 3 of the Lisbon Strategy states: "*To promote a growth- and employment-orientated and efficient allocation of resources, Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives, and ensure the overall coherence of reform packages*".

IV.1 Gauging the quality of public finances: more systematic reporting by Member States and building up a set of indicators

By analogy with the "traditional" part of the SGP, analysing Member States' quality of public finances requires a solid and reliable set of information and indicators. In their annual updates of the SCPs, Member States are expected to present not only the projected path of major fiscal policy variables but also information on a number of elements related to the quality of public finances, e.g. on tax reforms, value-for-money initiatives and changes in national fiscal governance. However, a review of the current reporting practices, based on the 2006/07 and 2007/08 vintages of the SCPs, points to large differences across EU Member States and significant deviations from the formal provisions[6] that set out the reporting requirements. This has also complicated the collection and tracking of comparable data on quality of public finances across Member States.

Gauging the quality of public finance will benefit from:

- 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.

IV.2 Greater attention to efficiency and effectiveness of public spending

The importance of efficiency and effectiveness of public spending is linked to the idea that the quality of public finances can simultaneously serve the sustainability of public finances and economic growth. It receives further confirmation by empirical evidence highlighting that, while the relationship between the level of government spending and growth is not straightforward, a link becomes more evident between outcomes of public finance spending (e.g. on education, health) and economic performance. 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.

IV.3 More efficient government revenue systems

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6 The full name of the Code of Conduct is "Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of stability and convergence programmes". It was endorsed by the Council in September 2005.

Government revenues are more than just the budgetary counterpart of expenditure since their structure and level impact on the efficiency of the economy, the distribution of income, and economic growth. A review of the current structure of revenue systems and the main challenges for the design of tax systems, in particular the high tax burden on labour and the consequences of increased economic integration, highlights that there is scope for shifting the tax burden from labour to other tax bases, but that these bases must be broad and stable.

In particular, an assessment of the possibility to shift the tax burden from labour to consumption leads to the following conclusions: (i) tax shifting from labour to consumption can have positive but limited effects on employment and growth. These effects are mainly due to the widening of the tax base, which makes it possible to reduce tax rates and thereby distortions. (ii) The size of the positive effects depends largely on the adjustment of benefit levels. (iii) A coordinated approach in the euro area would produce a higher positive impact on employment and growth than tax shifting measures undertaken unilaterally by any individual euro-area country, whether large or small. (iv) Potential negative impacts on equity and intergenerational distribution issues need to be addressed. (v) And when shifting taxes from labour to consumption, attention should be given to its timing and the potential inflationary impact, also in relation to the position of the economy in the cycle.

In sum, 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.

IV.4 Regular review of the quality of public finances

The focus on the quality of public finances in the EU fiscal surveillance framework as well as its relevance for the Strategy for Growth and Jobs could be strengthened through a regular review of the quality of public finances in the Member States. 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.

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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. Making progress with Member States along these lines can improve the effectiveness of EU economic policy coordination by helping to tap the potential synergies of its main instruments.