PUBLIC FINANCE IN THE EU: FROM THE MAASTRICHT CONVERGENCE CRITERIA TO THE STABILITY AND GROWTH PACT

Ing. Zora Komínková, CSc., National Bank of Slovakia

With this contribution, we open up a series of articles on public finance in the European Union, where we shall deal, without too much theoretical discussion, with the main conditions of development in the fiscal sectors of EU countries in the period of systemic preparation for the creation of monetary union in the 1990's and with the functions of fiscal policy in the euro area. With the approaching entry of Slovakia and other candidate countries into the EU and the preparation of their economies and economic mechanisms for entry into the euro area, the preparedness of the individual national fiscal sectors for performing their functions in the run-up to European integration is also becoming an increasingly important issue for these countries.

The goal of this contribution is to give a brief overview of the main developments that led to substantial changes in fiscal policy in the 90's, resulting in a mass process of consolidation in the sectors of public finance in EU countries conditioned mainly by the Maastricht process. In addition, the article presents the basic indicators and relevant terms used by European authorities in evaluating fiscal developments in the EU. In the following articles, we will deal with the factors determining the functioning of the fiscal sector in the conditions of monetary union, set out in the Stability and Growth Pact, and analyse the performance of the fiscal sector of Slovakia by international comparison and in the light of our ambition to join the euro area.

Fiscal consolidation in the EU in the 1990's

The fiscal policy pursued by EU countries in 1970 – 1980 was expansive and markedly pro-cyclical. The frequent use of discretionary measures, such as tax reduction and increase in spending, led to the suppression of automatic stabilisers. As a result, government debts increased (Fig.1). The easing of fiscal policy at a time of economic expansion necessitated a tightening of fiscal conditions at a time of slowdown in the rate of growth. As a result, fiscal policy contributed to increased fluctuations in output, instead of moderating the business cycle. The pro-cyclical behavior continued in the 90's, when deficits began to assume a sustainable level, which was in part reflected in a slowdown in the rate of economic growth. At that time, the overall budgetary position of the EU was affected significantly by the unification of Germany and, to some extent, by the impact of deep recession in several countries at the beginning of the 90's.

In 1970 – 1990, EU countries split into two groups: heavily indebted countries and countries with low debt (Tab.1). Countries of the first group recorded high structural deficits in that period (i.e. deficits adjusted for the impact of the business cycle), due partly to increased interest payments on accumulated government debt (Belgium, Greece, Ireland, Italy). The second group applied less discretionary forms of fiscal policy and regulated the budget deficit in principle on the basis of automatic stabilisers. During the comparison period (1977 – 1993), however, the debt ratio increased substantially, i.e. several times, in all EU countries (except Great Britain, where the ratio of government debt to GDP decreased).

The nineties, mainly their second half, saw dynamic fiscal consolidation, which was stimulated, apart from the real need to stop the permanent accumulation of massive government debts, by the Maastricht process and criteria for nominal convergence (Fig. 2). Fiscal consolidation in that period was determined by the 'recovery' needs of public finance sectors at the level of EU Member States and the preparations for single monetary policy with a view to mone-

Fig. 1 Accumulation of public debt, EU-15, 1997 – 2001 (in % of HDP)

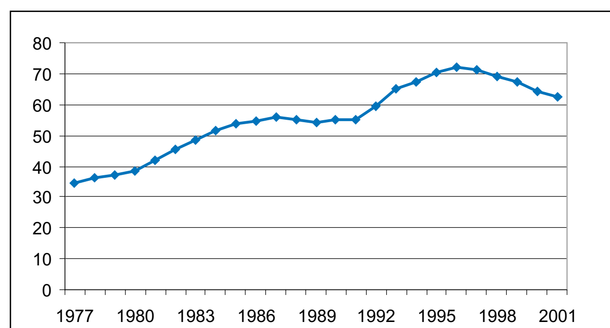
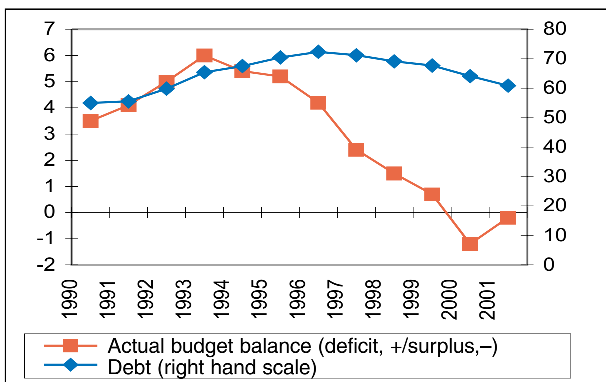


Fig. 2 Fiscal consolidation in EU-15, 1991 – 2001 (in % of HDP)



tary union. With regard to the need to reduce inflation, monetary policy was in principle cautious and was, therefore, favourable for fiscal consolidation. Subsequently, the tightening of the budgetary position was offset to some extent by the easing of monetary conditions.

The different dynamics of fiscal consolidation had a typically uneven impact on the reduction in government debts. The results achieved in individual countries from the beginning of the Maastricht process to 2001, are shown in the 2nd and 3rd columns of Table 1. The most successful country was evidently Ireland, which changed, due to a well chosen combination of monetary and fiscal policy, from a heavily indebted country (culminated in 1987, when government debt reached 118.2% of GDP) into a country with the lowest debt within the EU (excluding Luxembourg). In three countries (France, Germany, Austria), the debt ratio increased during the period under review, due to the accumulation of debts up to 1995 – 1996. In 2001, however, the ratio fluctuated below, or slightly above, the 60% limit. A marked reduction in the debt ratio was also achieved in three other heavily indebted countries (with debt above 100% of GDP), in which, however, faster debt reduction was hampered by a persistently large amount of interest payments. The increase in the debt ratio of the euro area as a whole is attributable to a marked increase in government debt in Germany.

The character of fiscal consolidation and factors responsible for the process in individual countries and the EU as a whole are summarised in Table 2. The Table shows changes in the structural balance, including the items that caused these changes (on the revenue or expenditure side of the balance). The timing and composition of budget adjustment differed by country; in principle, however, the Maastricht period consisted of two phases. Data for the group of future euro-zone members indicate that the beginning of consolidation (1992 – 1993) took place pri-

Table 1 Debt ratios in EU countries in 1977 – 2001 (in % of HDP)

Countries in order of result achieved in 2001	1977	1993	2001
Luxembourg	11.1	5.8	5.1
Ireland	62.9	98.8	34.4
United Kingdom	61.4	47.8	39.3
Finland	8.0	57.3	42.7
Denmark	14.1	78.0	43.2
Netherlands	39.9	79.1	51.8
Sweden	26.5	75.1	52.3
Portugal	31.5	61.3	53.5
France	20.8	46.1	57.1
Spain	13.3	58.6	58.0
Germany	27.3	47.2	60.0
Austria	39.9	61.9	62.3
Greece	22.0	110.2	100.4
Belgium	63.5	138.8	107.0
Italy	56.2	118.2	108.2
EU-15	34.6	65.3	62.5
EU-12	31.4	67.5	68.8

marily on the revenue side. The marked increase in structural revenues (over 3% of GDP) more than offset the continued increase in structural primary expenditures, and sufficed to reduce the total structural balance by 0.7% of GDP. The second phase (1994 – 1997) was based on the restriction of expenditure items. With structural revenues continuing to grow, the total structural balance improved by 3.3% of GDP. Since the restriction of government spending is closely connected with the commitments of government in the process of consolidation of public finance, it was an extraordinarily strong positive signal and promised more success on the road to 'non-Keynesian' forms of fiscal policy.

A strategy oriented primarily to the revenue side of the budget was applied mainly in France, Ireland, and Portugal. Tax increases prevailed also in Italy and Greece, where, however, the total size of adjustment was also affected by a reduction in structural primary expenditures. On the other hand, Denmark, Finland, Sweden, and Great Britain, i.e. countries with traditionally advanced welfare systems, applied a strategy oriented to the consolidation of expenditures. For example, Finland and Sweden reduced the ratio of structural primary expenditures to GDP by roughly 10 percentage points. These countries restricted public investment only slightly and the most of the reduction was due to a cut in current expenditures.

In other countries, as in the euro area as a whole, the consolidation of public finance was essentially a two-stage process; it was first oriented to the revenue side and then to the expenditure side of the bud-

Table 2 Character of fiscal consolidation in the 90's in the EU, excluding Luxembourg (in % of GDP)

		Consolidation period	Change in the structural balance	Change in the structural revenues	Change in the structural primary expenditures	Change in interest payments
Consolidation based on increases in revenues						
Greece		1990 – 1998	11.8	11.1	-1.0	0.3
France		1995 – 1997	3.3	2.6	-0.9	0.2
Ireland		1990 – 1994	2.3	3.0	2.5	-1.8
Italy		1991 – 1997	9.4	6.4	-3.1	0.0
Portugal		1992 – 1996	3.6	7.4	6.1	-2.3
Consolidation based on reduction in expenditures						
Denmark		1996 – 1999	5.2	0.6	-2.9	-1.7
Finland		1993 – 1999	4.0	-4.6	-9.5	1.0
Sweden		1994 – 1998	10.9	3.0	-7.5	-0.4
Great Britain		1994 – 1998	6.6	4.2	-2.8	0.5
Strategy based on 'shift' from revenues to expenditures						
Austria	Phase 1	1995 – 1996	1.3	2.3	0.8	0.2
	Phase 2	1997	2.2	-0.4	-2.3	-0.4
Belgium	Phase 1	1992 – 1993	1.7	2.9	0.5	0.7
	Phase 2	1994 – 1996	3.6	1.4	-0.2	-1.9
Germany	Phase 1	1992 – 1993	1.4	3.3	1.3	0.4
	Phase 2	1994 – 1997	1.7	1.5	-0.7	0.2
Netherlands	Phase 1	1991 – 1993	4.3	4.2	-0.4	0.2
	Phase 2	1994 – 1997	1.7	-4.5	-5.4	-0.8
Spain	Phase 1	1992 – 1993	-0.3	3.9	2.8	1.3
	Phase 2	1994 – 1997	3.5	-1.4	-4.6	-0.2
EU-11*	Phase 1	1992 – 1993	0.7	3.1	1.8	0.6
	Phase 2	1994 – 1997	3.1	0.7	-2.0	-0.4

*Excluding Luxembourg

get. A characteristic feature of the process is that (except the Netherlands) a marked improvement in the structural balance occurred in the second stage. However, it should be noted that a significant contribution to the pronounced effects of expenditure-oriented strategies was made by one-off 'cuts' in expenditures immediately before the beginning of the reference period for the evaluation of the budget convergence criterion.

After transition to the single monetary policy and introduction of the euro, the fiscal area remains under control of Member States and represents one of the most sensitive links in the successful functioning of the euro area. In the field of public finance and fiscal policy, there are still many uncertainties, caused partly by differences in national fiscal systems and partly by differences in the economic performance of individual countries (including the impact of a non-harmonised business cycle), which determine, in large measure, the fiscal requirement of their economic policies and the rate of economic growth itself.

Basic indicators of fiscal development in the EU

In evaluating the individual aspects of fiscal policy, the European Commission employs a variety of indicators (Tab. 3). The simplest indicator of budgetary performance in public finance in the current year is the primary balance, which differs from the actual balance with the deducted amount of interest paid on government debt (debt service). Underlying and cyclical budgetary positions, the total fiscal position, and the effects of fiscal policy on demand, are analysed on the basis of cyclically adjusted data on public finance.

Adjustment to the business cycle. Fluctuations in economic activity influence the revenues and expenditures of the government autonomously. During

Table 3 Survey of basic terms used in assessing the fiscal sector of the EU

Term	Definition
Maastricht reference values for public debt and deficits	Criterial ratios, 60% for debt in public finance/GDP and 3% for budget deficit/GDP, set in the Protocol annexed to the Maastricht Treaty on European Union.
Close-to-balance rule	Rule laid down in the Stability and Growth Pact, according to which the total budget balance of the Member States shall reach, in the medium term, a value close to balance or a surplus.
(Actual) budget balance	The difference between the totals of public expenditure and revenue in the given year; a positive value indicates a surplus, a negative value a deficit. Budgetary positions in the EU are monitored through the consolidated aggregates of the public sector.
Primary budget balance	Budget balance adjusted for interest payments on government debt.
Cyclically adjusted (structural) budget balance	Actual budget balance adjusted for the cyclical component of fiscal policy. The structural balance provides information on the basic trend in the budget balance with respect to the automatic effect of the business cycle on the budget.
Cyclically adjusted (structural) primary balance	Structural (cyclically adjusted) budget balance adjusted for interest payments on government debt.
Minimal benchmarks	Medium-term reference values for budget balances ensuring sufficiently safe limits for the free functioning of automatic stabilisers at periods of downturn in economic activity, without causing excessive deficits. Reference values for individual Member States are estimated at the level of the European Commission on an individual basis.
Automatic stabilisers	Various forms of tax and expenditure regimes, reacting to the business cycle and moderating its fluctuations. As a result, the budget balance has a tendency to improve in years of accelerated growth and to deteriorate at a time of slowdown in the rate of growth.
Cyclical component of fiscal policy	Part of a change in the budget balance, occurring automatically according to the cyclical conditions in the economy as a result of the reaction of public revenues and expenditures to changes in the output gap.
Discretionary component of fiscal policy ⇨ fiscal stance	Indicator of the discretionary component of fiscal policy, defined by the European Commission as a change in primary structural budget balance in comparison with the previous period. If the change is positive (negative), the fiscal position is expansive (restrictive).
Pro-cyclical fiscal policy	Fiscal position, strengthening the business cycle by increasing the structural deficit during economic expansion or reducing it during decline. The opposite is (discretionary) anti-cyclical policy, which has different effects. Neutral fiscal policy maintains the cyclically adjusted budget balance constant during the cycle and allows automatic stabilisers to act.
Excessive budget procedure	Procedure followed by the European Commission and the ECOFIN Council in monitoring the levels of national budgetary positions and public debt with the aim of assessing the risks of excessive deficit in individual Member States.
'Significant divergence'	In accordance with the Stability and Growth Pact, the ECOFIN Council is authorised to request a Member State to correct any 'substantial deviation' from the goals, set in the national programme of stability (or the convergence programme) in respect of the budget balance and the planned process of adjustment to budgetary positions sustainable in the medium term. This is an important clause pertaining to pro-cyclical fiscal policy in periods of accelerated growth.

economic expansion, the tax basis increases and unemployment falls, while during recession the course of development is reversed. As a result, tax revenues and social expenditures in connection with unemployment fluctuate in accordance with the cycle, and the budget balance automatically responds to cyclical fluctuations in the economy. The size and volatility of the cyclical component of the budget are determined by the size and volatility of cyclical fluctuations in the output and the sensitivity of government revenues and expenditures to the cycle. The cyclically adjusted budget balance expresses the size of the budget balance in the absence of cyclical fluctuations, i.e. when economic

Fig. 3 Budget balance in the EU in various definitions (in % of GDP)

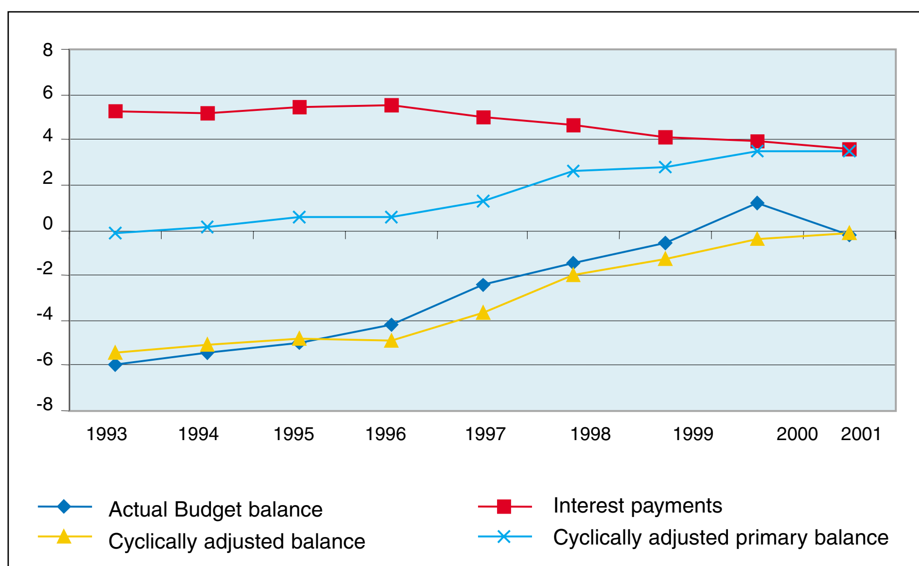
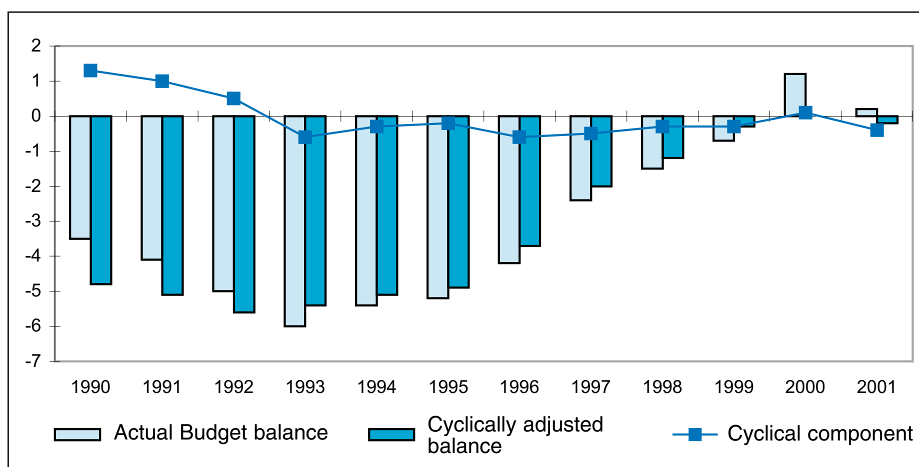


Fig. 4 Impact of the business cycle on the overall budgetary position of EU-15 (in % of GDP)



activity is at its potential or trend level. The impact of the business cycle on the total budget position of EU-15 is illustrated in Fig. 4.

Position of fiscal policy. Fiscal position expresses the orientation of fiscal policy by summarising the effects of various discretionary measures of fiscal authorities. Reduction in government spending (other than changes in the interest burden of government debt), and/or increase in taxes, improves the underlying/structural fiscal position and leads to the tightening of fiscal policy. Decisions to increase various expenditure items, and/or to reduce taxes, worsen the underlying/structural budgetary position and lead to an easing of fiscal policy in comparison with the previous period. Annual changes in discretionary policy are used for evaluating the dynamics of fiscal consolidation. The main indicator of fiscal position, as applied by the European Commission, is the cyclically adjusted primary balance. A positive change indicates a tightening in fiscal policy and a negative change is a sign of easing. The advantage of this method is that the cyclically adjusted primary balance is not affected by changes in interest payments, which are not under direct control of fiscal authorities and are, therefore, not really discretionary in nature.

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