Overview of EU public finances

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The global economy is experiencing its deepest recession since the Second World War. Along with other negative consequences, this has resulted into a sharp deterioration in the state of public finances. Most European governments are now facing similar problems: on one hand, a steep drop in tax and other revenues, and, on the other hand, rising public expenditure caused by automatic stabilizers and by one-time measures designed to stabilize the financial sector and to kick-start the economy, or at least to mitigate the effects of the economic crisis. Due to several factors, it is difficult for governments to set and time "exit strategies" for unwinding the unprecedented damage to public finances. There is the persistent uncertainty about the start and extent of the expected economic recovery, which in turn is related to the continuing pressure on public finances. The unstable situation in capital markets along with the acute problem of ageing populations will in the near future put public expenditure under additional pressure. These factors are also contributing to differences in expert opinions on the timing and pace of the necessary consolidation of public finances.

Pre-crisis developments

Public finance developments in the EU up to 2008 can be divided into three stages:

- In 1997, the Stability and Growth Pact entered into force, as an agreement of EU Member States designed to achieve and maintain fiscal discipline in the Member States. The setting of rules for an autonomous fiscal policy indeed led to the strengthening of fiscal discipline in subsequent years, which gradually fed through to the more efficient use of public resources at the EU level, peaking at a surplus in 2000.
- From 2001, the EU saw a slowdown in economic growth (largely due to the business cycle of the largest Member States). The recession was also reflected in a turnaround in the development of public finances in the EU. As economic growth declined, the general government deficits of EU countries rose. The deficit at the EU aggregate level increased for three years and in 2003 exceeded even the Maastricht reference value of 3% of GDP.
- In 2004, again as a result of a shift in the business cycle in EU countries, public finances underwent another change in development, entering a four-year phase of consolidation which culminated in 2007 when the deficit fell to 0.8% of GDP. The countries included in the monetary union recorded an even lower deficit of 0.6% of GDP.

The global economic crisis and its effect on EU public finances

The latest phase in the development of EU public finances, which began in 2008, is also expected to last around three to four years and has also been determined by a change in the economic environment. In reaction to the eruption of the global financial and economic crisis, governments adopted costly financial market stabilization measures. As a way of fighting the recession, the governments of EU Member States agreed on a joint coordinated reaction by adopting the *European Recovery Plan* (ERP). The ERP is based on the following two key pillars:

The 1st pillar is a major injection of purchasing power into the domestic economy, implemented through a fiscal impulse amounting to 1.5% of GDP and in accordance with obligations under the Stability and Growth Pact.

The 2nd pillar rests on direct and immediate action to reinforce the EU's competitiveness in the long term. The plan includes a set of measures to support "smart" investment: investing in energy efficiency; investing in clean technologies to boost sectors like construction and automobiles in the low-carbon markets of the future; and investing in infrastructure and inter-connection to promote efficiency and innovation.

Since the fundamental principle of the ERP is solidarity and social justice, the ERP must be geared to, or compatible with, the objective of assisting those groups who are hardest hit by the crisis, with particular emphasis on maintaining employment.

Both financial sector support measures and anti-crisis measures represent a heavy burden on public budgets. The EU general government deficit deteriorated from 0.8% of GDP in 2007 to 2.0% of GDP in 2008. For euro area countries, the deficit increased by a larger margin still, from 0.6% of GDP in 2007 to 2.0% of GDP in 2008.

In 2008, eleven countries reported a general government deficit exceeding the reference value of 3% of GDP, including, in the euro area, Ireland, Greece, France, Spain and Malta, and, outside the euro area, Lithuania, Latvia, Hungary, Poland, Romania and the United Kingdom. The deficit rose most sharply in Ireland, which went from having a surplus of 0.2% in 2007 to a deficit of 7.2% in 2008 – a difference of 7.4 percentage points. Despite the global crisis, the consolidation of public finances continued in five countries: Bulgaria, Germany, Hungary, the Netherlands and Austria.

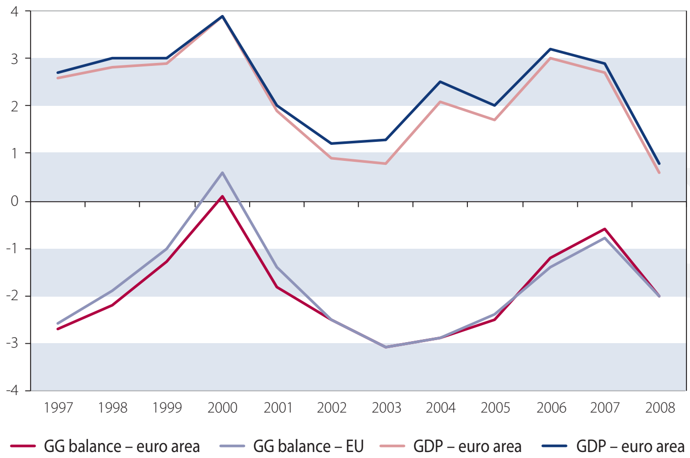
In the euro area, government debt rose from 66.2% of GDP in 2007 to 69.3% of GDP in 2008, and in the European Union as a whole it increased from 58.7% to 61.5% for the same years.

In 2007, eight countries failed to meet the Maastricht debt criterion: Belgium, Germany, Greece, France, Italy, Hungary, Malta and Portugal. In 2008, the reference value of 60% of GDP was exceeded also by Austria, which reported a debt of 62.6% of GDP (from 59.4% in 2007). Ireland recorded the largest increase in government debt – a rise of 19.1 percentage points, to 44.1% of GDP in 2008. By contrast, seven countries reported a government debt in 2008 that was lower than in 2007. They were Bulgaria, Cyprus, Lithuania, Slovenia, Slovakia, Finland and Sweden, with Cyprus recording the largest drop of 11.2 percentage points, down in 48.4% of GDP in 2008.

Excessive deficit procedure (EDP)

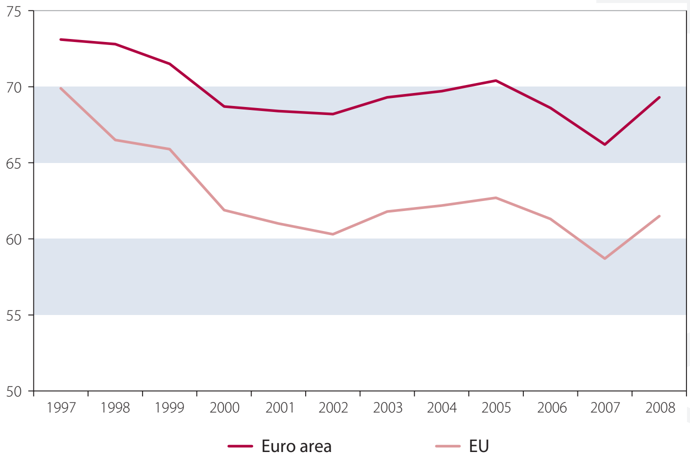
At the end of 2007, six countries were subject to the excessive deficit procedure, including two countries in the euro area (Italy and Portugal) and four outside the euro area (Poland, Slovakia, the Czech Republic, and Hungary). In the first half of 2008, the procedure was terminated for all countries – except for Hungary (which was given until 2009 to correct the excess deficit) – since their fi-

Chart 1 General government balance (as a % of GDP) and GDP in the EU and euro area



Source: Eurostat.

Chart 2 Government debt in the EU and euro area (in % of GDP)



Source: Eurostat.

Table 1 Overview of general government balances in euro area countries

General government deficit (-) / surplus (+) in the euro area (in % of GDP)									
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Belgium	0.0	0.5	0.0	-0.1	-0.3	-2.7	0.3	-0.2	-1.2
Germany	1.3	-2.8	-3.7	-4.0	-3.8	-3.3	-1.5	-0.2	0.0
Ireland	4.8	0.9	-0.4	0.4	1.4	1.7	3.0	0.2	-7.2
Greece	-3.7	-4.5	-4.8	-5.7	-7.5	-5.1	-2.8	-3.6	-7.7
Spain	-1.0	-0.6	-0.5	-0.2	-0.3	1.0	2.0	2.2	-4.1
France	-1.5	-1.5	-3.1	-4.1	-3.6	-2.9	-2.3	-2.7	-3.4
Italy	-0.8	-3.1	-2.9	-3.5	-3.5	-4.3	-3.3	-1.5	-2.7
Cyprus	-2.3	-2.2	-4.4	-6.5	-4.1	-2.4	-1.2	3.4	0.9
Luxembourg	6.0	6.1	2.1	0.5	-1.1	0.0	1.4	3.6	2.5
Malta	-6.2	-6.4	-5.5	-9.9	-4.7	-2.9	-2.6	-2.2	-4.7
Netherlands	2.0	-0.2	-2.1	-3.1	-1.7	-0.3	0.6	0.3	0.7
Austria	-1.7	0.0	-0.7	-1.4	-4.4	-1.6	-1.6	-0.5	-0.4
Portugal	-2.9	-4.3	-2.8	-2.9	-3.4	-6.1	-3.9	-2.6	-2.7
Slovenia	-3.7	-4.0	-2.5	-2.7	-2.2	-1.4	-1.3	0.5	-1.8
Slovakia	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.5	-1.9	-2.3
Finland	6.9	5.0	4.1	2.6	2.4	2.8	4.0	5.2	4.5

Source: Eurostat.

Table 2 Overview of excessive deficit procedures closed

EDP in the past		
	EC report (pursuant to Article 104(3) of the Treaty)	Council decision to abrogate the EDP
Poland	12 May 2004	8 July 2008
Portugal	22 June 2005	3 June 2008
Italy	7 June 2005	3 June 2008
Czech Republic	12 May 2004	3 June 2008
Slovakia	12 May 2004	3 June 2008
Cyprus	12 May 2004	11 June 2006
Malta	12 May 2004	16 May 2007
United Kingdom	21 September 2005	12 September 2007
Greece	19 May 2004	16 May 2007
Netherlands	28 April 2004	7 June 2005
Germany	19 November 2002	16 May 2007
France	2 April 2003	31 January 2007
Portugal	24 September 2002	11 May 2004

Source: http://ec.europa.eu/economy_finance/.
Note: Council – the EU's Economic and Financial Affairs Council (ECOFIN).

Table 3 Overview of current excessive deficit procedures

Countries subject to the excessive deficit procedure (EDP) as at 2 December 2009			
	EC report (pursuant to Article 104(3) of the Treaty)	Council decision on existence of an excessive deficit	Deadline for correction
Belgium	7 October 2009	2 December 2009	2012
Czech Republic	7 October 2009	2 December 2009	2013
Germany	7 October 2009	2 December 2009	2013
Italy	7 October 2009	2 December 2009	2012
Netherlands	7 October 2009	2 December 2009	2013
Austria	7 October 2009	2 December 2009	2013
Portugal	7 October 2009	2 December 2009	2013
Slovenia	7 October 2009	2 December 2009	2013
Slovakia	7 October 2009	2 December 2009	2013
Poland	13 May 2009	7 July 2009	2012
Romania	13 May 2009	7 July 2009	2011
Lithuania	13 May 2009	7 July 2009	2011
Malta	13 May 2009	7 July 2009	2010
France	18 February 2009	27 April 2009	2012
Latvia	18 February 2009	7 July 2009	2012
Ireland	18 February 2009	27 April 2009	2013
Greece	18 February 2009	27 April 2009	2010
Spain	18 February 2009	27 April 2009	2012
United Kingdom	11 June 2008	8 July 2008	2013/2014
Hungary	12 May 2004	5 July 2004	2011

Source: http://ec.europa.eu/economy_finance/.

nal general government budget deficits for 2007 were below 3% of GDP.

In summer 2008, the Council (ECOFIN) decided that the United Kingdom had an excessive deficit, and in April 2009 it did the same for Ireland, Spain, France and Greece. Greece was given until 2010 to correct its deficit, Spain and France until 2012, and Ireland until 2013. In the case of the United Kingdom, the Council revised the deadline for correction, to 2013/2014. Latvia and Malta, despite their higher budget deficits, were not originally considered for the excessive deficit procedure, given that, in the case of Latvia, a new government had just taken office, and, in the case of Malta, the budget excess was deemed to be small and temporary. In February, however, the EDP was initiated for Latvia, and in June, on the basis of the EC's April notification, the EDP was initiated also for Lithuania, Malta, Poland and Romania. Malta has until 2010 to correct its deficit, Latvia until 2011, and Romania and Poland until 2012. In the case of Hungary, the EC took into account its exceptional situation (characterized largely by a deep recession and fragile financial system) and decided to extend the correction deadline under the EDP, from 2009 to 2011. On 11 November 2009, the EC published a report in which it proposed initiating the EDP for Belgium, the Czech Republic, Germany, Italy, the Netherlands, Austria, Portugal, Slovenia and Slovakia. Belgium and Germany were to be given until 2012 to correct their budgets, and the other countries until 2013. On 2 December 2009, the Council adopted the EC's recommendations, and, as a result, a total of 20 countries were subject to the excessive deficit procedure as at the end of 2009.

Chart 3 Expected general government deficits in the euro area according to the EC's Autumn Forecast

Source: Economic Forecast, DG ECFIN; Eurostat.

Expected developments

Expected developments in EU public finances are addressed by several institutions in forecasts and publications. For the purposes of implementing the EU's fiscal policy, however, the relevant forecasts are mainly those of the European System of Central Banks (Working Group on Public Finance), the European Commission (Directorate-General for Economic and Financial Affairs – DG ECFIN), the International Monetary Fund (IMF), the OECD, and the forecasts of individual countries published in the form of convergence programmes and stability programmes. Given that the Eurosystem's forecast (the Public Finance Report) is not published, this article is based on the DG ECFIN's forecasts, which, like the Eurosystem's forecasts, are published twice a year (in spring and autumn) and are complemented by a twice yearly "Interim Forecast".

According to this year's Autumn Forecast, the euro area's deficit will rise to 6.4% of GDP in 2009, from 2% of GDP in 2008, and it will continue climbing to 6.9% of GDP in 2010. No consolidation is expected until 2011, when the deficit is projected to decline by a modest 0.4 p.p., to 6.5% of GDP. As for the European Union as a whole, its deficit for this year is expected to be 6.9% of GDP, rising to 7.5% in 2010, and there should then follow a period of moderate consolidation. That the EU deficit is projected to be higher than the euro area's deficit is largely due to the double-digit deficits projected for the United Kingdom, including 13.8% of GDP in 2010.

The largest general government deficits for 2009 are expected to be reported by Greece, at 12.7% of GDP, and Ireland, at 12.5% of GDP. In 2010, too, the Irish deficit is expected to be the highest in the EU-27, at 14.7% of GDP, and in 2011 it should stabilize. Double-digit budget gaps over the projection period (2009–2011) are also forecast for Latvia, the United Kingdom, Spain and Greece. By contrast, five countries (Luxembourg, Finland, Bulgaria, Denmark and Sweden) are expected to maintain their budget deficit at below the 3% reference value, while a sixth, Estonia, is projected to report a deficit of 3.0% of GDP. All countries except for Bulgaria are projected to exceed the threshold in 2010. The EC expects that in 2011, as in 2010, not one euro area country will meet the Maastricht public finance criterion. Across the EU-27, only Bulgaria and Sweden are projected to meet this criterion in 2011, and Estonia is expected to return to a deficit of 3% of GDP.

Gross public debt in the euro area will, according to the EC's expectations, increase by 8.9 percentage points from last year's figure, to 78.2% of GDP, and will maintain a rising tendency in 2010 (84% of GDP) and 2011 (88.2% of GDP). The EU's gross debt for 2009 is projected to be 73% of GDP, rising to 79.3% of GDP in 2010 and to 83.7% of GDP in 2011. This upward tendency is expected to continue in subsequent years, too.

In the context of the business cycle, it is generally the case that forecasts are revised upwards in "good times", i.e. during booms, but that during "bad times", i.e. recessions, each forecast is more pessimistic than the last. The current economic crisis provides a good example of this phenomenon. For a complete picture, it is best to start by comparing the EC's Spring Forecast with its previous Autumn Forecast. In the Spring Forecast, the deficit projected for the euro area in 2009 was 3.5 p.p. higher than in the previous Autumn Forecast, and likewise the projection for the EU's 2009 deficit was 3.7 p.p. higher in 2009 Spring Forecast than in the 2008 Autumn Forecast. A similar pattern can be seen in expectations for 2010, too, where the deficit forecasts for the euro area and European Union rise by, respectively 4.5 p.p. and 4.7 p.p.

In the case of individual countries, the change in the deficit forecast for 2009 ranged, in the euro

Table 4 Comparison of the spring 2009 and autumn 2008 forecasts for general government balances

	Spring 2009			Autumn 2008			Spring 2009 – Autumn 2008		
In % of GDP	2008	2009	2010	2008	2009	2010	2008	2009	2010
Euro area	-1.9	-5.3	-6.5	-1.3	-1.8	-2.0	-0.6	-3.5	-4.5
EU	-2.3	-6.0	-7.3	-1.6	-2.3	-2.6	-0.7	-3.7	-4.7

Source: Economic Forecasts, DG for Economic and Financial Affairs; NBS's own calculations.

Table 5 Comparison of the current (autumn) forecast with the previous (spring) forecast

	Spring 2009				Autumn 2008			Spring 2009 – Autumn 2008			
In % of GDP	2008	2009	2010	2011	2008	2009	2010	2008	2009	2010	2011
Euro area	-2.0	-6.4	-6.9	-6.5	-1.9	-5.3	-6.5	-0.1	-1.1	-0.4	-
EU	-2.0	-6.9	-7.5	-6.9	-2.3	-6.0	-7.3	0.3	-0.9	-0.2	-

Source: Economic Forecasts, DG for Economic and Financial Affairs; NBS's own calculations.

Table 6 Comparison of general government balances before and during the economic crisis

General government balances in the European Union; % of GDP			
	2007	2009	2009 – 2007
Belgium	-0.2	-5.9	-5.7
Germany	-0.2	-3.4	-3.2
Ireland	0.2	-12.5	-12.7
Greece	-3.6	-12.7	-9.1
Spain	2.2	-11.2	-13.4
France	-2.7	-8.3	-5.6
Italy	-1.5	-5.3	-3.8
Cyprus	3.4	-3.5	-6.9
Luxembourg	3.6	-2.2	-5.8
Malta	-2.2	-4.5	-2.3
Netherlands	0.3	-4.7	-5.0
Austria	-0.5	-4.3	-3.8
Portugal	-2.6	-8.0	-5.4
Slovenia	0.5	-6.3	-6.8
Slovakia	-1.9	-6.3	-4.4
Finland	5.2	-2.8	-8.0
Bulgaria	0.1	-0.8	-0.9
Czech Republic	-0.6	-6.6	-6.0
Denmark	4.5	-2.0	-6.5
Estonia	2.7	-3.0	-5.7
Latvia	-0.4	-9.0	-8.6
Lithuania	-1.0	-9.8	-8.8
Hungary	-4.9	-4.1	0.8
Poland	-1.9	-6.4	-4.5
Romania	-2.5	-7.8	-5.3
Sweden	3.8	-2.1	-5.9
United Kingdom	-2.7	-12.1	-9.4

Source: 2007 Eurostat; 2009 Economic Forecasts, DG for Economic and Financial Affairs; NBS's own calculations.

area, from -0.9 p.p. (Malta) to -5.7 p.p. (Spain), and, in the rest of the EU-27, from -0.1 p.p. (Hungary) to -5.9 p.p. (United Kingdom). Among euro area countries and among the rest of the EU-27, the largest deteriorations in the EC's 2010 estimates were recorded for, respectively Ireland (a difference of 8.4 p.p.) and the United Kingdom (7.3 p.p.). By contrast, the forecasts that are expected to have changed the least are, as in 2009, those for Malta and Hungary, their deterioration being, respectively, 0.7 and 0.6 percentage points.

As for the 2009 Autumn Forecast, the outlook for government deficits has continued to worsen, albeit more moderately (since the most pessimistic expectations had already been incorporated into the Spring Forecast). The deterioration from the spring figures is most noticeable in the forecasts for 2009 (1.1 p.p. in the euro area and 0.9 p.p. in the EU), as a result of the actual figures for the first three quarters of 2009. The differences on a country-by-country basis are similar, i.e. projected deficit increases ranging from 2.6 p.p. (Spain) to 0.3 p.p. (Bulgaria) were recorded by countries mainly in 2009. Greece is an exception, since it is the only country to have its budget deficit for 2008 revised considerably upwards, by 2.7 p.p. to 7.7% of GDP, the reason being that previous forecasts did not incorporate the crisis-induced increase in its public expenditure. The EC expects the deficit forecasts for Greece in coming years to again show the largest differences from the previous forecast, i.e. a difference of 7.6 p.p. in 2009 and 6.5 p.p. in 2010. In the case of Spain, the Czech Republic and Romania, the EC still expects an adjustment of more than 2 p.p., but for Latvia, Germany and Sweden it is predicting an improvement on the figures in the 2009 Spring Forecast. The outlook for Latvia has improved by as much as 2.1 p.p. largely due to the adjusted general government budget of October 2009, which the Latvian government approved as a prerequisite for borrowing funds from the EU and IMF. The budget features considerable cuts in old-age pensions and salaries of state employees and an increase in income tax, all of which had to be adopted in order to keep the deficit within 10% of GDP. In 2010, the Commission predicts an improvement in the general government deficit not only of these countries, but also of Ireland and the United Kingdom, though the 0.9% reduction estimated in both cases will make only a slight difference to their projected double-digit budget gaps.

The effect of the crisis on the development of public finances has undoubtedly been severe. Certain differences have, of course, appeared from one country to another, according to the particular impact of both the economic and financial crisis. The differences lie in the original fiscal deficits recorded before the crisis and in how the "good times" were used.

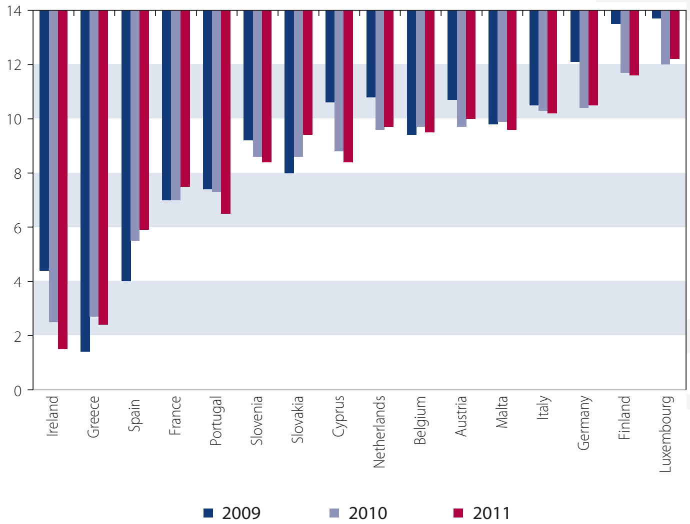
Cyclically adjusted balance (CAB)

In addition to the current deficit of general government budgets, another indicator that is used is the so-called cyclically adjusted balance (CAB), i.e. the general government balance adjusted for the effect of the business cycle. Where real GDP is at the level of its potential, then the CAB is equal to the current, nominal general government balance, since in this case the cyclical component has a zero value. According to the EC, the euro area's CAB for 2009 will be worse than that for

Chart 4 Comparison of general government balances before and during the economic crisis (in % of GDP)

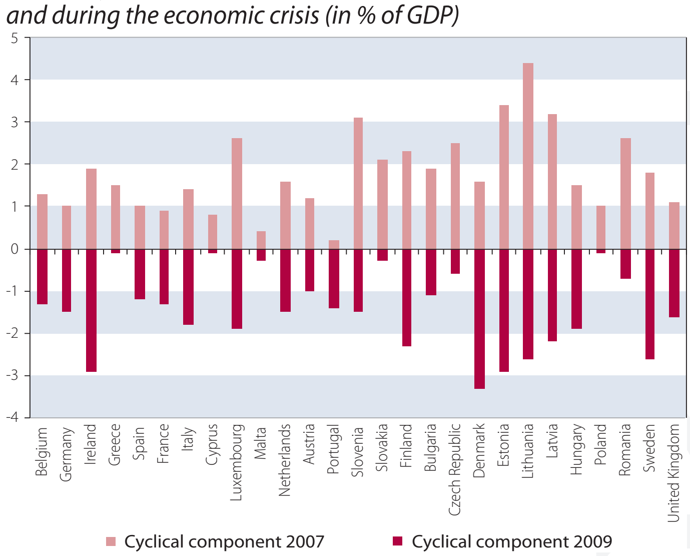
Source: Economic Forecast, DG for Economic and Financial Affairs.

Chart 5 Cyclically adjusted general government deficits of euro area countries, according to the autumn forecast (in % of GDP)



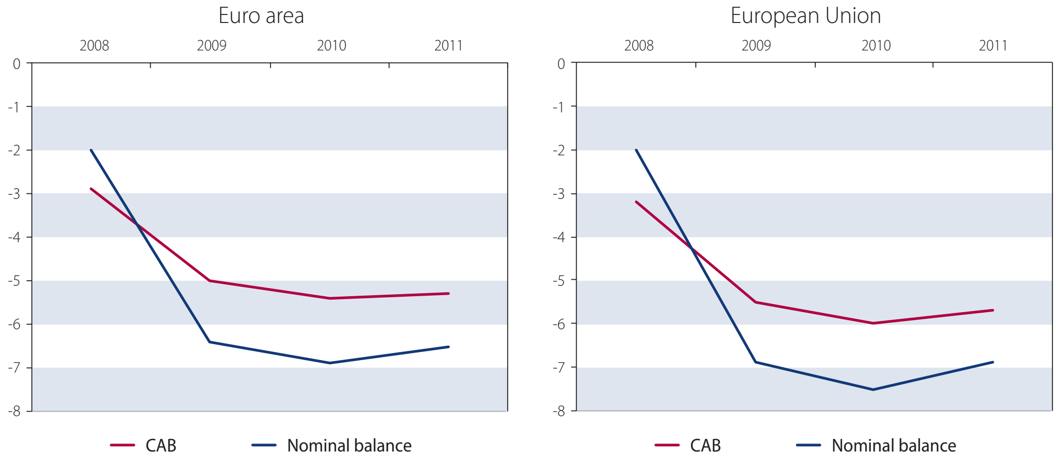
Source: Economic Forecast, DG for Economic and Financial Affairs.

Chart 6 Cyclical components of general government deficits before and during the economic crisis (in % of GDP)



Source: Economic Forecast, DG for Economic and Financial Affairs; NBS's own calculations.

Charts 7 and 8 Comparison of the cyclically adjusted balance and nominal balance



Source: Economic Forecast, DG for Economic and Financial Affairs.

the previous year by around 2 p.p. From -2.9% in 2008, the CAB is expected to be -5% in 2009 and -5.4% in 2010. No structural consolidation is projected until 2011, and then only a very slight improvement of 0.1 p.p., to -5.3% of GDP. As for the EU-27, which recorded a CAB of -3.2% in 2008, the EC forecasts its CAB to be -5.5% in 2009 and -6% in 2010. Here, too, a moderate consolidation is projected in 2011, when the CAB is forecast to be -5.7% of GDP.

The comparison of the cyclically adjusted deficits and the nominal general government deficits shows that the general government deficit of every EU Member State was positively affected by the cycle, while exactly the opposite is the case over the projection horizon (2009–2011). The EC expects that with the exception of Malta (which has only a very small, positive cyclical component of 0.1% of GDP), all countries of the EU-27 (including the euro area) will see their general government balance for 2011 adversely affected by the cycle.

Conclusion

In the current forecasts of the ECB, EC and other institutions, as well as the forecasts of the Member States themselves, the fiscal policies of EU countries are based on the fact that that the global economy is experiencing its deepest recession since the Second World War. As a consequence, the condition of public finances has deteriorated sharply as all countries face similar problems: a sharp decline in tax revenues and other budget revenues, alongside a huge rise in expenditure caused by automatic stabilizers as well as by one-time measures designed to kick-start the economy, or at least to mitigate the effects of the current crisis. Taking the examples of the most troubled economies, the principal reasons for their high budget deficits and public debts can be clearly illustrated, and consideration can be given to what measures are most crucial to the restoration of public finances. In the case of Ireland (which has a double-digit budget deficit despite taking consolidation measures since the middle of 2008, including the raising of certain taxes and contributions), budget revenues have continued to fall and general government expenditure has risen. Another negative factor is the climbing costs for managing a level of public debt that, in the projection horizon, is expected to reach 96% of GDP. There is a prevailing view that the condition of public finances in Ireland stems from a failure to address the issue of sustainable public expenditure growth when revenues were rising sharply. For the future, it would be advisable to support fiscal discipline with a framework programme that ensures both sounder management of public finances and a broadening of the tax base to make it less sensitive to the volatility of economic activity. In the case of Greece, the EC even in its Spring Forecast expected the budget gaps for 2010 and 2011 to be, respectively, 5.1% of GDP and 5.7% of GDP, but because these projections did not incorporate rising expenditure and falling revenues, the projections for Greece's deficit had to be revised in the Autumn Forecast and now stand at double digits over the whole projection horizon. The example of Greece serves as a pertinent illustration of the failure to comply with the requirements of European institutions for transparency and consistency in submitted data. The consequence is a history of regular upward revisions to the general government budget deficits. Because of the considerable degree of uncertainty in the data notified by the Greek authorities, Eurostat, in its news release[1], expressed reservations on the data submitted by Greece for 2008. In the example of the United Kingdom, which also has a double-digit budget deficit, we can see the effect of stimulation measures introduced by the government (particularly in support for financial institutions), which are expected to exacerbate the overall government deficit by one quarter. For the purpose of containing fiscal expenditure in the future, it would therefore be desirable to lay down clear rules for the provision of assistance to individual financial

1 *Eurostat News Release 149/2009 of 22 October 2009.*

institutions. In addition, it is recommended that the United Kingdom make greater efforts to consolidate public finances, so that by taking steps that are less dependent on macroeconomic developments, it can achieve sustainable public finances. Bulgaria, by contrast, is the only EU-27 country that has maintained its budget deficit at below 1% of GDP, and it expects that figure to worsen only slightly (by 0.4 p.p.) next year. Here too, however, despite the relatively positive results, there are persistent risks of a deterioration in economic developments. Considering also that Bulgaria has elections looming, this country, too, faces the risk of declining efficiency in public expenditure. Fiscal policy should focus on maintaining macroeconomic stability and on increasing confidence among foreign investors. Above all, and it would be advisable for every country, it would be appropriate to focus on raising the efficiency of its public expenditure.