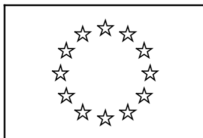

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS
International questions
Economic affairs and related issues within the pre-accession countries

"EU Accession—Developing Fiscal Policy Frameworks for Sustainable Growth"

Conference Brussels, 13-14 May 2002

SUMMARY

The European Commission, the World Bank and the IMF co-organised the above-mentioned conference on fiscal policy issues in candidate countries. It covered various economic, institutional and procedural aspects of fiscal policy in candidate countries at the current juncture as they prepare for accession and ultimately adoption of the euro.

A key aim of the conference was to provide candidate countries with an analytical framework for a successful approach to fiscal policy in the light of their future obligations as EU Member States; to engage in a dialogue on the main challenges for fiscal policy; and to exchange experience with the current Member States of the EU.

The conference was attended by representatives from all candidate countries, Member States and from international institutions working in this area. Apart from the organising institutions experts from the EBRD, ECB and OECD were also present.

OPENING ADDRESS

Commissioner Solbes opened the conference by putting it into the context of the enlargement process. Upon accession, the framework for policy-making will change, as the *acquis* on economic and budgetary policy will become binding for the new member states. A sound budgetary policy has played, and will continue to play a key role in supporting the real convergence process, containing macroeconomic imbalances and meeting the challenge of the many competing demands on candidate countries' public finances. While the tasks ahead remain difficult, integration will succeed if strong political momentum is preserved.

SESSION 1 (13 MAY, AFTERNOON)

The first session of the conference focussed on the "Public Finances in the Setting of Accession". It was chaired by Mrs. Cheryl Gray (World Bank).

In the first presentation, ***European Commission Director A. Italianer focussed on the EU macroeconomic and institutional framework from pre-accession to the adoption of the euro***. He highlighted how this will become more constraining with the reinforcement

of fiscal discipline, the integration of other economic policies and participation in the euro area but only after achieving a high degree of sustainable convergence. Having described the main economic challenges for the budgetary authorities of the candidate countries, A. Italianer outlined the EMU acquis in the fiscal field. As Member States with a derogation, the acceding countries will be subject to the excessive deficit procedure and the non-punitive parts of the Stability and Growth Path. Implementing the EU framework for multilateral fiscal surveillance in a way that facilitates appropriate policy choices will be a challenging task. The adoption of the euro implies the full application of the Stability and Growth Pact.

In the following contribution, drawing on the fiscal chapter of a book just published by the IMF entitled "Into the EU—Policy Frameworks in Central Europe", ***IMF Chief of the Central II Division of the European I Department, R. Feldman, identified the main challenges facing the transition candidates as they adopt the acquis*** and seek to foster growth and stability. Against the background of competing pressures on public finances, he emphasized the need for fiscal policy to deal with various economic stresses that can arise (for example from large external current accounts, and sizeable and potentially volatile capital inflows) to support growth that is not only strong but also sustainable. One of the key messages was that the scale of challenges and uncertainties should prompt, not discourage, a strong medium-term orientation to fiscal policy to identify tensions early on, phase in needed reforms, and set policy on a strategic course, including by garnering necessary political support. Another main point was that fiscal policy should be designed with a degree of flexibility to give policy scope to react to events, but that overall flexibility should also be combined with firm precommitment in key areas to provide a guide for structural reforms and private sector expectations. Four ways were discussed to trade-off commitment and flexibility in medium-term frameworks: using rolling frameworks that are updated every year; in cases where fiscal consolidation is typically needed, basing frameworks on prudent assumptions, with upfront understandings on how to respond both to fiscal overperformance and adverse developments; specifying a strategy for tax reform while maintaining some flexibility on phasing; and designing medium-term expenditure frameworks, with a view to protecting growth-supporting spending and identifying adjustment paths for lower priority, discretionary spending, consistent with consolidation targets for the fiscal balance. The need to move toward full SNA-type accounting was emphasized.

European Commission Economic Advisor F. Coricelli analysed the medium-term fiscal frameworks of the 2001 Pre-accession Economic Programmes (PEPs). Noting that capital expenditure levels are already fairly high, he cautioned against laying excessive stress on the need for increasing potentially unnecessary public investment spending. On the other hand, the current size of governments in Central and Eastern European candidate countries may not be excessive once other relevant factors beyond income per capita are taken into account. Qualifying the positive role played by foreign direct investment and raising doubts about the private saving behaviour implicit in most PEPs, Mr. Coricelli argued that medium-target fiscal targets should be more ambitious to reduce external vulnerability. This policy suggestion was the object of much discussion in the general discussion closing the session.

This ***discussion*** centred on the need for fiscal consolidation in candidate countries, and the uncertainty about the appropriate size of government in light of Mr. Coricelli's presentation. Some discussants questioned whether the size of government was out of line with international standards and how this squared with the call for fiscal

consolidation. It was also pointed out that the size of prospective FDI flows to the candidate countries is a key consideration in assessing the degree of external constraints to fiscal policy, as is the behaviour of private sector saving (over which there is much uncertainty).

SESSION 2 (14 MAY, MORNING)

The subject discussed in this session was "Public Expenditure Priorities on the road to EU Accession". It was chaired by Mr. Italianer (European Commission).

The following four presentations were given in this session:

Expenditure Policies Towards Accession, by B. Funck (Lead economist of the World Bank): Mr. Funck welcomed the objectives of decreasing public expenditure that most CEECs have set themselves in the context of their Pre-Accession Economic Programs but pointed out major expenditure challenges in these countries, mainly related to the banking sector restructuring, the adaptation to EU environmental and transport standards and the social system. CEECs' primary expenditure in relation to OECD countries is high, the main areas of differences identified were the larger size of the public administration (despite lower wage bill), the higher level of public transfers and subsidies and transition-related shocks (for instance the need to restructure the banking sector). Expenditure strategies for growth in the CEECs should aim at increasing the role of the private sector and productivity growth and to the reduction of the high labour taxation. Mr. Funck highlighted that there is room to reduce subsidies and transfers, for which completing bank restructuring and large privatisation deals is essential, while curbing social transfers should also become a priority. The growth-enhancing expenditure strategy in the CEECs should focus on education, transport networks, and environmental programmes, while rationalising expenditure according to country specific needs.

The UK's Policy Choices on Defining Public Expenditure Priorities, by J. Pocklington (UK Treasury): The presentation explained that the UK fiscal and budgeting framework had been reformed in response to the rapid deterioration in the budget deficit in the early 90s. The institutional framework, with a strong ministry of finance, meant the Budget process could be firmly controlled. Fiscal policy was now set in accordance with a Code for Fiscal Stability and transparent policy objectives, underpinned by two fiscal rules. The 'golden rule' allowed the government to borrow over the economic cycle only for capital investment and not current spending, while the 'sustainable investment rule' ensured public debt remained at a sustainable level. Within this framework, budgeting had been improved by setting firm three-year plans for departments. Medium term planning was also enhanced by allowing departments to roll over funds from one year to the next and through output-based budgeting with departments being set clear targets. The framework was supporting fiscal discipline and macroeconomic stability, and was allowing the government to reallocate resources to its key priorities, including health, education and transport.

Poland's View on Public Expenditure Choices, by H. Wasilewska-Trenkner (Ministry of Finance Poland): Mrs. Wasilewska-Trenkner highlighted a major policy innovation: the Polish government plans to increase expenditure annually by the level of a projected inflation rate + 1% above the inflation level. The design of the state budget will take into account the economic conditions and will not focus anymore on the deficit target

exclusively. Despite the bad growth performance of 2001, growth is seen to resume and should allow for the planned increase of expenditure without provoking inflationary pressures. Savings are expected from the restructuring of expenditure categories, focusing on areas with higher growth potential, namely infrastructure, environment and specific economic sectors. Structural funds are expected to enhance investment on those areas. The need to co-finance such projects and the corresponding pressure it puts on expenditure was highlighted in the discussions.

Estonia's Expenditure Priorities on the Road to EU Accession, by E. Pedastsaar (Ministry of Finance Estonia): The presentation highlighted some conflicting objectives in candidate countries' public finances. The need to decrease public deficits contrasts with the costs associated with transition-related reforms, the implementation of the EU acquis and the need to upgrade infrastructure. Some countries also will face higher expenditures associated with NATO membership. In the absence of room to increase the already high taxation levels, curbing expenditure seems a priority which should focus on keeping a moderate wage bill while reforming the civil service, and rationalising social services expenditure and public consumption. In this context, the high level of political commitment in Estonia was highlighted as an important component of successful reforms. Furthermore, budgetary management and procedures could play a key role in better fiscal management of the country. The speaker outlined the changes that are planned to undertake in the near future, such as the delegation of the decision-making of the use of resources to managers of agencies, and the envisaged changes of the State Budget Act. One of the amendments will establish an obligation to compose every year the budget strategy that will cover four years.

KEYNOTE SPEECH

Professor Alesina (Harvard University) presented his "Lessons from credible reforms", based on the experience of OECD countries over the past decades. He presented eight "lessons". The key message was that to be successful, reforms needed to be focused on the expenditure side (including, importantly, transfers and the government wage bill)—while overcoming the political opposition stemming from three key interest groups: retirees, labour unions, and public sector employees. On the contrary, fiscal adjustment by raising revenues has proven unsuccessful. He gave the example of Ireland's failed reform of the first half of the eighties and the later successful approach starting in the late eighties. Successful fiscal coordination typically entailed, according to him, a strong pickup of domestic demand, in particular business investment. More generally, he threw cold water on the notion that fiscal consolidation was bad for economic growth, and made the point that fiscal adjustment need not cut the benefits of the low income groups, need not be unpopular, and need not endanger the re-election of governments. Finally, Alesina expressed doubt about much-vaunted coordination between monetary and fiscal policy: in his view, this is much oversold and, potentially, poses great risks if it calls into question the independence of the central bank.

The ensuing ***discussion*** centred on the messages of some of the lessons shared by Mr. Alesina. Discussants, in particular, asked Mr. Alesina to clarify his views on policy coordination between fiscal and monetary authorities. Mr. Alesina noted that his lesson took into account the potential risk of monetary financing of public deficits, and that institutional guarantees against this would therefore help significantly to contain these risks. Furthermore, discussants wondered if his observations on desirable fiscal

consolidation measures were based on a true random sample or only on those experiences where governments perceived the political risk of consolidation as manageable. Mr. Alesina stressed that he had looked at this issue in considerable detail, basing his conclusions not only on election outcomes but also on opinion polls at different periods in time. Finally discussants raised the question of whether the experience of OECD countries would show the real risk of too much consolidation. Mr. Alesina argued that consolidation through raising revenues had proven to be ineffective.

SESSION 3 (14 MAY, AFTERNOON)

The subject discussed in this session was "the Public Finances Reform Agenda". It was chaired by Mr. Feldman (IMF).

The following three presentations were given in this session:

A. Wörgötter (OECD) presented the ongoing OECD work on recommendations for public expenditure reform in transition countries. He based his interventions on the cases of the Czech Republic, Hungary and Poland. He compared the situation in these countries with the cases of New Zealand, Switzerland and the UK, which were considered by the OECD as benchmarks for good fiscal policy management. From that his sound policy recommendations were derived: "fiscal activism" should be avoided, instead some more reliable medium-term policies should be put into place, as the potential cyclical stabilisation in small open economies was very limited. Multi-year expenditure frameworks with credible medium-term goals should be established, supported by sufficient political commitment and accompanied by ex-ante objectives and ex-post evaluation. Government accounts should be SNA consistent. And, finally the improvement of public service efficiency should be achieved by, inter alia, applying cost-benefit analyses, the use of market mechanisms and a sufficient congruence of expenditures and revenues at local level.

R. Allen (World Bank) presented the results of the OECD Sigma project, for which he had previously worked. He reviewed the acquis on budgetary policy, including rules on anti-fraud, financial control and audit and government procurement. He then pointed out that the necessary changes of fiscal policy and fiscal management have to be broad, covering a vast range of policy areas and administrative functions. He specified in more detail necessary reforms in the areas of public expenditure management, financial control, public procurement and external audit. He noted that all candidate countries are still considerably lagging in all these areas the highest EU required standards. However, with the help of international institutions, progress is being made. He identified as inherent fundamental weaknesses, endangering progress in all these areas, in civil service laws, systems and practices as well as underpaid civil servants.

M. Sweers (Dutch Ministry of Finance) gave an overview about fiscal policy rules and procedures in the Netherlands. He noted that the institutional setting of his country was characterised by the presence of coalition governments, which made changes of policies during the annual budget process or priorities in fiscal policies more difficult to reach. The budget process is, in its general orientations, shaped by the coalition agreement between the parties represented in government, whereas the annual budget process was implementing these orientations. The general orientations were shaped by the budgetary rules applying in the Netherlands. The so-called "Structural budgetary policy" introduced

in the 60s failed in the beginning of the 80s, as it delivered high deficits and debt levels. “Deficit targeting” (80s and 90s) and the “trend-based budgetary policy (since the 90s) delivered the turnaround with shrinking deficits and debt levels. The main elements of the latter were cautions economic forecasts as basis for budgetary policy, fixed real expenditure ceilings, and the rule that windfall revenues would not be spent. Although this approach was largely shared by all mainstream political parties in the Netherlands, the major criticisms of this approach were the often high revenue windfalls which led to high political spending pressure and, if resisted, to pro-cyclical tax cuts.

SESSION IV: CLOSING PANEL

The Closing Panel was chaired by Mr. Klaus Regling (Director General, European Commission). Other participants were P. Moutot (ECB), G. Szapary (National Bank of Hungary) and R. Lago (Deputy Chief Economist EBRD).

K. Regling concluded from the proceedings of the conference that fiscal policy needed to create a growth-enhancing environment, while providing sufficient space for private sector development. To attain this, a reassessment of the structure and components of budget revenues and expenditures was required and most of the reform efforts need to concentrate on the expenditure side. Governments should reduce currently high levels of mandatory expenditure and transfers to non-viable state or private enterprises. On the revenue side, tax and social security reforms should focus on growth and incentive compatibility, and should be implemented in parallel with expenditure cuts.

He then reviewed the obligations of the Stability and Growth Pact for new Member States. He pointed out that the discipline imposed by the pact will be the more restrictive, the more the new Member States aim at a prompt adoption of the euro. The adoption of the euro needs to be underpinned by serious budgetary reforms in order to ensure the sustainability of the fiscal targets. While the economic situation of some countries would support an early adoption of the euro, this was not be case for all. A differentiated approach is therefore needed. Mr. Regling pointed out that the necessary fiscal adjustment in some candidate countries is large and should probably already start taking place now. Yet in the years ahead, a sound but less stringent fiscal discipline might be the only one a country can politically afford. He finally suggested that more empirical work had to be done in order to better understand the implications of subjecting new Member States to the discipline of the Pact.

G. Szapary found the United Kingdom and Netherlands experiences with budget consolidation very interesting and useful for other countries to consider. He furthermore referred to the EC acquis on fiscal policy. He acknowledged that these provisions, from an analytical point of view are subject to manifold criticisms. However, in his view, that criticism does not change the general positive judgement about these obligations. Furthermore, these should be understood as the result of a political compromise in drafting the Maastricht Treaty. Hence, policy makers in candidate countries should not aim at changing these provisions, but should rather work towards complying with these, by the necessary fiscal adjustment, using the margins of interpretation that the Treaty would allow. That adjustment should commence as soon as possible to provide room for manoeuvre if things go wrong.

R. Lago gave an overview over the latest EBRD economic forecasts for transition countries. He noted the recent shock resilience of these countries against adverse global economic events. He stressed the importance of FDI for the development of these countries which, among other effects, would also contribute to containing the net emigration of these countries towards the west. As regards migration he sees, after accession a relatively small and declining migration trend. He finally noted that the economic "accession dividend" was, judging from the experience of the accession of Spain and Portugal, only partly due to real economic growth and to a substantial degree also due to improving terms of trade.

P. Moutot underlined the keen interest of his institution in prudent fiscal policy, at least in the euro area. He considered that the quality of fiscal policies was as relevant an issue to accession countries as it was to the euro area. Choices made in this context were often determinant for the shape and success of the convergence process from which they could not be separated. While various strategies of overall convergence and hence various fiscal rules might in principle be envisaged, it was worth stressing how important it was for policy makers to face in due time, i.e mostly early, any difficult decisions that had to be taken.

Annex: Conference programme

"EU Accession—Developing Fiscal Policy Frameworks for Sustainable Growth"

Brussels, 13-14 May 2002

Conference Programme

Afternoon 13 May 2002 – 15h00 - 17h30

Opening Address by Commissioner Pedro Solbes

Session I: Public Finances in the Setting of Accession - chaired by the World Bank

1. The macroeconomic institutional framework for accession
   by A. Italianer, Director, DG ECFIN, European Commission

2. Developing Fiscal Policy Frameworks in the Central European Countries on the Road to EU Accession: the policy setting and implementation issues
   by R. Feldman, Europe I department , IMF

Coffee break

3. The medium-term fiscal framework of the Pre-accession Economic Programmes
   by F. Coricelli, economic adviser, DG ECFIN, European Commission

4. General discussion

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Morning 14 May 2002 – 9h30 - 12h15

Session II: Public Expenditure Priorities on the road to EU Accession - chaired by the European Commission

1. Overview presentation on public expenditure policy
   by B. Funck, World Bank

2. The UK's policy choices on defining public expenditure priorities
   by J. Pocklington, UK Treasury

Coffee break

3. Poland's view on public expenditure choices
   by Mrs. H. Wasilewska-Trenkner, Ministry of Finance Poland

4. Estonia's expenditure priorities on the road to EU accession
   by E. Pedastsaar, Ministry of Finance Estonia

5. General discussion

Lunch: 12h30 – 14h00

Afternoon 14 May 2002 – 14h00 – 17h30

Keynote speech: Lessons from credible reforms
by Prof. A. Alesina, Harvard University

Session III: the Public Finances Reform Agenda - Chaired by the IMF

1. Recommendations for public expenditure reform, the case of Czech Republic, Hungary and Poland, by Andreas Wörgötter, OECD

2. Issues in public expenditure management in candidate countries
by Richard Allen, World Bank

3. Experience with public expenditure management
by M. Sweers, Ministry of Finance, the Netherlands

4. General discussion

Coffee break

Session IV: Closing Panel

Chairman Klaus Regling, Director General, European Commission
Participants: P. Moutot, ECB; G. Szapary, NBH; R. Lago, EBRD

Comments and questions