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Public finances in EMU
2006

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Abbreviations and symbols used

Member States

BE	Belgium
CZ	Czech Republic
DK	Denmark
DE	Germany
EE	Estonia
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
CY	Cyprus
LV	Latvia
LT	Lithuania
LU	Luxembourg
HU	Hungary
MT	Malta
NL	The Netherlands
AT	Austria
PL	Poland
PT	Portugal
SI	Slovenia
SK	Slovakia
FI	Finland
SE	Sweden
UK	United Kingdom

EUR-12	European Union Member States having adopted the single currency (BE, DE, EL, ES, FR, IE, IT, LU, NL, AU, PT, FI), i.e. countries participating in the economic and monetary union without a derogation
EU-25	European Union, 25 Member States
EU-15	European Union, 15 Member States before 1 May 2004 (EUR-12 plus DK, SE and UK)
EU-10	European Union, 10 Member States that joined the EU on 1 May 2004 (CZ, EE, CY, LV, LT, HU, MT, PL, SI, SK)

Other abbreviations

EUR	euro
ECU	European currency unit
DKK	Danish krone
GBP	Pound sterling
SEK	Swedish krona
SCPs	Stability and convergence programmes
PEPs	Pre-accession economic programmes

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Executive summary

Recent budgetary developments and prospects

In 2005, the budgetary position in the euro area and the EU improved significantly. In the euro area, the government deficit fell by 0.4 percentage point and reached 2.4 percent of GDP. The deficit of the entire EU also improved by 0.3 percentage points and reached 2.3 percent of GDP in 2005. The deficit reduction in the euro area and in the EU reflects better than expected economic growth, better than expected revenues, as well as structural budgetary adjustment. It was particularly important in the countries currently subject to an excessive deficit procedure (EDP). According to the spring 2006 forecasts of the Commission services, the euro area and EU deficits would remain roughly stable in 2006 and 2007, based on the assumption of unchanged policy. After increasing in 2005 for a second consecutive year, the debt-to-GDP ratio in the EU would fall from 63.4 percent in 2005 to 62.9 percent in 2006.

Since Spring 2005, the Commission and the Council took action on six Member States currently subject to an EDP. The Commission and the Council considered that the Netherlands had corrected its excessive deficit and the Council decided to abrogate the EDP for this country in June 2005. In June 2005 the Council also adopted a decision that an excessive deficit exists in Italy and set fiscal efforts and deadlines for its correction in a recommendation under Article 104(7) of the Treaty. The same actions were taken in September 2005 for Portugal and in January 2006 for the UK. In light of the fiscal notifications of Spring 2006, the Council decided in March 2006 to address a notice in accordance with Article 104(9) to Germany, which has to correct its excessive deficit in 2007. Finally, the Commission and the Council considered that Hungary has not respected the recommendations formulated in the 104(7) recommendation. Since January 2006, twelve EU countries are subject to an excessive deficit procedure: five *euro area* Member States, the UK and six new Member States.

In the context of budgetary surveillance, the Commission also assessed the 2005 updates of the stability and convergence programmes submitted by Member States and proposed Council Opinions on these documents. In these programmes, the nominal deficit in the EU and in the euro area is projected to be reduced from 2.5 percent of GDP in 2005, to 1.4 percent of GDP in 2008. The improvement relies notably on the large budgetary consolidation projected in the Member States in EDP. According to the calculations of the Commission based on the figures of the programmes, the cyclically-adjusted budget balance (CAB) would improve in the euro area and in the EU from -2.1 percent of GDP in 2005 to -1.0 percent of GDP in 2008. In 2006 is planned only a minor improvement in the CAB, while significant structural efforts are envisaged for 2007 and 2008. Most Member States revised their debt level upwards but project a gradual improvement over the programme period.

The EU faces a major budgetary challenge in view of ageing populations over the coming decades. The assessment of this round of Stability and Convergence Programmes suggests that the increased focus on the long-term sustainability of public finances in the EU – reinforced by Ministers in the context of the reform of the Stability and Growth Pact – has contributed to incorporate longer-term concerns in the policy-making processes. The analysis of the 2005/06 updates of the stability and convergence programmes reveals that six Member States (the Czech Republic, Greece, Cyprus, Hungary, Portugal and Slovenia), face a high risk with regard to the long-term sustainability of public finances in view of the budgetary impact of ageing populations. Ten Member States (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Malta, the Netherlands and the UK) are at medium risk and the remaining nine countries (Denmark, Estonia, Latvia, Lithuania, Austria, Poland, Slovakia, Finland and Sweden) are at low risk. For a large majority of countries, achieving the planned budgetary consolidation over the medium-term would contribute substantially to reduce the sustainability chal-

lenge. However, for a number of countries structural reforms in particular in the field of pensions need to complement the budgetary efforts to ensure a sustainable fiscal position in the long term.

The EU fiscal framework one year after the reform of the Stability and Growth Pact

One year ago, the EU heads of State or Government endorsed the March 2005 Ecofin Council report containing the main directions for reforming the Stability and Growth Pact. Since then, the revised SGP has been codified in regulations. Where necessary, further clarifications on how to interpret the new text of the regulations were included in a revised Code of Conduct for the implementation of the Stability and Growth Pact. This is the case for several provisions regarding the preventive arm of the SGP, notably the modalities for the determination of the medium-term budgetary objectives (MTOs) and the criteria for the assessment of the adjustment path towards the MTOs. Section II of the report summarises the result of one year of work to codify and make operational the revised SGP. It also provides a first review of the implementation of the revised SGP.

The 2005 SGP reform introduced new concepts, definitions and principles in the preventive arm of the SGP. In order to ensure a consistent application of the rules, a number of elements were specified since spring 2005. Notably, the methodology for setting the country-specific medium-term budgetary objectives (MTOs) was clarified and, in parallel, the Commission has started work on how implicit liabilities could in future be taken into account in their determination. A number of issues related to the definition of the adjustment path towards the MTOs were also clarified, including the conditions for taking into account structural reforms in the preventive arm of the SGP.

The Commission assessment of the functioning of the preventive arm of the pact is mixed. On the positive side, differentiated medium-term budgetary objectives reflecting country-specific economic fundamentals were set in the context of the 2005 updated Stability and Convergence Programmes. In addition, Member States lived up to their commitment to base their budgetary projections on realistic macroeconomic assumptions, and the recourse to one-off measures has clearly declined. The Commission assessment of the 2005 updated stability and Convergence Programmes also pointed to some deviations from the agreed principles. Notably, the struc-

tural fiscal adjustment planned for 2006 by Member States not yet at their MTO falls short of the 0.5 percent benchmark agreed at the moment of the reform. This provides evidence that the benign economic environment is not being exploited to progress towards the MTO. In addition, in some Member States, the projected adjustment is back-loaded and not underpinned by concrete measures.

The experience with the implementation of the excessive deficit procedure is positive. The Commission reports initiating the excessive deficit procedure gave consideration to all elements that appeared relevant for an evaluation of the situation when deciding on the existence of an excessive deficit and when setting the deadline for its correction. The increased room for judgement has notably been applied to set realistic deadlines for Member States to correct their excessive deficits, while ensuring that significant fiscal efforts are made. The application of the provisions related to 'other relevant factors' in the steps leading to a decision on the existence of an excessive deficit confirmed that the SGP remains a rules-based framework: since the reform, all deficits in excess of 3 percent of GDP have been considered excessive. Finally, the SGP reform stimulated a constructive and transparent policy dialogue on the individual country cases at EU level, which contributed to a smooth and efficient operation of the Pact.

By moving the emphasis from a single indicator to a more reasoned analysis of budgetary positions, the reform of the Stability and Growth Pact has reinforced the need to strengthen the knowledge and understanding of budgetary developments in each Member State. In the past twelve months, progress was notably made on issues related to the measurement of budgetary positions and policies. The concept of one-off and temporary measures was specified and clear principles have been agreed for taking into account such measures in the context of budgetary surveillance. Progress was also made on the cyclical adjustment of budget deficits: budget sensitivities to the cycle were updated for all Member States which allowed estimating a new set of values for the country-specific minimal benchmarks. Over the last months, several developments have contributed to improving the quality of budgetary statistics: the Council amended the regulation governing the transmission of fiscal data by Member States in order to increase the operational capacity of Eurostat in assessing the quality of government statistics and to improve transparency in the data compilation and notification procedure. Following discussions on standards for the institutional set-up

of national and Community statistical authorities, on 25 May 2005 the Commission recommended that Member States recognise the European Statistics Code of Practice as a common set of standards for statistical authorities in the EU.

The quantification of the implications for government finances of population ageing has been improved. Long-term budgetary projections were updated on the basis of commonly agreed assumptions and methods for a wide range of budgetary items (pensions, health-care, long-term care, education and unemployment benefits). With regard to the analysis of public finance sustainability in the context of the assessment of the annual updates of stability and convergence programmes, some improvements were introduced in the latest assessment round. A decomposition of the sustainability indicators has been introduced, which examines whether risks to public finance sustainability mainly come from the short-term or long-term budgetary developments. Second, a new sensitivity test has been introduced, which shows the additional budgetary cost that arises from a delayed adjustment.

Analytical sections

The role of national budgetary rules and institutions in promoting sound public finances

The debate on the ways to improve fiscal policies has recently focused on the need to rebalance the incentives of policy-makers or impose constraints on the conduct of fiscal policy via the introduction of adequate fiscal rules and institutions at national level. At EU level, the Maastricht Treaty and the Stability and Growth Pact (SGP) impose budgetary obligations on Member States. In order to ensure the respect of objectives, both of them also stress the importance of national institutions for budgetary discipline. In particular, the report on the SGP reform endorsed by the European Council on 22 March 2005 states that 'national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact' and that 'national institutions could play a more prominent role in budgetary surveillance'. Section III of the report focuses on national numerical fiscal rules and independent institutions which may influence fiscal policy making. It exploits the results of surveys which review the rules and institutions in force in the 25 EU Member States in the period 1990-2005 and assesses whether these arrangements have an effect on budgetary outcomes.

It comes out from the analysis of the survey on numerical fiscal rules that the number of rules in force in EU Member States has increased continuously over the past twenty years. The characteristics of the numerical fiscal rules in place vary depending on the sub-sector to which they apply. While most of the rules applied to regional and local governments are enshrined in a legal text, rules applying to the whole of the general government sector are more frequently based on political agreements and commitments. Similarly, while rules for regional and local governments seem to have relatively strong enforcement procedures, rules applying to general and central governments generally do not envisage *ex ante* defined actions in case of non compliance. Statistical and econometric exercises suggest the existence of a link between numerical rules and budgetary outcomes. The analysis takes into account the coverage and characteristics of fiscal rules and controls for various factors that may affect government budget balance and developments in primary expenditure. It appears that an increase in the share of government finances covered by numerical fiscal rules leads, ceteris paribus, to lower deficits. In the case of expenditure rules, it appears that an increase in the coverage of government finances by expenditure rules leads to a reduction in the primary expenditure-to-GDP ratio. The analysis also suggests that the characteristics of fiscal rules matter for their influence on budgetary outcomes. Strong rules, enshrined in law or constitution and foreseeing automatic enforcement mechanisms, seem to have a larger influence on budgetary outcomes.

The survey on national fiscal institutions shows that, contrasting with the conclusion reached for fiscal rules, there is no visible tendency towards the development of 'fiscal councils' in the EU Member States. There is a large variety in the type of institutions in place. Two major categories are distinguished: (i) institutions in charge of providing forecasts or/and conducting positive analyses on fiscal policy issues; and (ii) institutions issuing normative statements and recommendations on the conduct of fiscal policy. Assessing the influence of the institutions covered by the study on fiscal policy is by nature difficult. However, combining descriptive analysis, the result of existing studies on the subject and the answers from the questionnaires, a number of tentative conclusions on the contribution of such institutions to fiscal discipline are drawn in the report. First, delegation of the forecasting activity seems to be an efficient way to address possible optimistic biases in macroeconomic projections. Second, the institutions in place seem to have a considerable impact on the public debate and the recommendations formulated are generally

followed by governments. Finally, there is a general perception that independent fiscal institutions have contributed to fiscal discipline.

Fiscal policy in good times

In spite of the unanimous view among economists and policy -makers that pro-cyclical fiscal policies should be avoided, counter-cyclical fiscal policies are far from being the norm in most countries. What is most surprising is that the available evidence seems to indicate that in most advanced countries pro-cyclicality is an issue that mostly arises in good times, when the economic activity is above potential or when growth is above trend. This is somehow puzzling, since while in bad times a trade-off could emerge between the objective of output stabilisation and that of budgetary discipline, the two objectives go hand in hand in good times. The direct consequence of a pro-cyclical behaviour of fiscal policy is an unnecessary amplification of GDP fluctuations. Furthermore, the prevalence of pro-cyclical behaviour in good times is responsible for a considerable share of debt growth in EU countries.

The analysis carried out in this years' Report reveals that episodes of pro-cyclical fiscal policy were frequent in euro-area countries in the past decades. The picture, however, is quite different depending on the period considered. While during the run-up to EMU pro-cyclicality took place mostly during bad times, after the completion of EMU budgetary corrections in bad times became less common, but there was a greater incidence of pro-cyclical policies in good times. The separate analysis of government revenues and expenditures reveals that the pro-cyclical bias is mainly related with the behaviour of expenditures, which appear to grow faster in periods of positive output gap. An explanation could be identification and implementation lags. Strong pressures to spend budgetary windfalls accruing in good times would be an aggravating factor. The analysis also shows that, although revisions in output gap estimates can be quite considerable, errors in measuring the cycle in real time can explain to some extent pro-cyclicality in bad times,

but the same does not hold for pro-cyclical behaviour in good times.

A possible response to the pro-cyclical bias of fiscal policy is setting up national-level rules and institutions that permit governments to credibly commit not to surrender to the pressures to increase spending or cut taxes in good times. Expenditure frameworks aimed at capping the growth of expenditure over a medium-term framework can address the tendency for expenditure to grow faster in good times. Revenue rules that determine *ex ante* which share of revenue windfalls will be saved or the establishment of rainy-day funds can strengthen the commitment of governments not to spend or give away via tax cuts better than expected budgetary outcomes materialising in good times. 'Fiscal councils' providing technical inputs in fiscal policy-making, including via high-quality independent macroeconomic forecasts and a thorough estimation of the budgetary impact of policy measures could permit a better working of the rules aimed at addressing the pro-cyclical bias. The analysis in the report supports the view that expenditure rules could be an effective instrument to curb the pro-cyclical bias. It is shown that the countries endowed with effective expenditure frameworks have been less inclined to run pro-cyclical expenditure policies in good times.

An institutional framework for budgetary policy at national level that strengthens the ability of governments to keep budgets under control in strong phases of the cycle would be consistent with the reformed Stability and Growth Pact, which puts enhanced emphasis on the need for countries to step up adjustment efforts in good times to achieve their medium-term budgetary objectives. Efforts to make progress on this front should not be delayed. There is mounting evidence that good times are going to be there again. Growth in the euro area is recovering and output may return above potential in a majority of countries in the near future. Member States need to avoid the mistakes of the past and be ready to make the best use of such an opportunity to combine an appropriate use of fiscal policy as a stabilisation tool with progresses towards achieving their medium-term budgetary objectives.

Part I

Current developments and prospects

Summary

In 2005, the budgetary position in the euro area and the EU improved quite significantly. In the euro area, the nominal deficit fell by 0.4 percentage points and reached 2.4 percent of GDP. The aggregate nominal deficit of the entire EU also improved by 0.3 percentage points and reached 2.3 percent of GDP in 2005. Such a relatively good budgetary performance is due to better than expected growth performance, higher than expected revenues, as well as structural budgetary adjustment. In cyclically-adjusted terms, relative to 2004, the deficit in the euro area was reduced substantially to 1.9 percent of GDP, an improvement of 0.7 percentage points. The improvement in the budgetary position was particularly important in the countries currently subject to an excessive deficit procedure. Germany, Greece and France substantially reduced their deficits. However, fiscal imbalances increased in Italy and Portugal. Outside the euro area, apart from Hungary and the UK, all the EDP countries improved their budget balances, with Cyprus and Poland bringing their budget deficits below the reference value.

According to the Spring 2006 forecasts of the Commission services, the euro area and EU deficits would remain roughly stable in 2006 and 2007, based on the assumption of unchanged policy. Projected developments in the EU and euro area deficits result from diverse budgetary performances across Member States. In 2006, the deficit is projected to reach 3 percent of GDP in France, Poland and the UK, while in Germany and the Czech Republic it is expected to be just above the reference value. The deficit would be brought below 3 percent in 2006 in Malta and Slovakia is expected to further consolidate it below this value. On the other hand, deficits in Italy, Portugal and Hungary are expected to remain significant. Among the euro-area countries with high cyclically-adjusted deficits, structural improvements over the entire projection period are expected only in Germany and Portugal. Outside the euro area, most of the countries are foreseen to see a worsening or no changes in the cyclically adjusted deficit. The most significant worsening are expected in Hungary, Czech Republic and Poland. The only countries for which improvements over the forecast period are foreseen are Cyprus, Latvia, Slovakia and the UK. Larger efforts to improve the structural budget positions would be expected as recent indicators confirm the improvement in economic conditions. This would allow to ensure sufficient room for the automatic stabilisers to operate when necessary.

The debt-GDP ratio in the euro area and the EU has increased for the second consecutive year in 2005. However, as a consequence of the positive performance of the underlying fiscal position, the dynamics in the debt-to-GDP ratio are projected to improve. The euro area debt ratio is projected to fall from 71.7 percent in 2005 to 70.5 percent in 2006 and 70.1 percent in 2007. In the EU, the debt-to-GDP ratio would fall from 63.4 percent in 2005 to 63.2 percent in 2006. The debt ratio would remain particularly high in Belgium, Greece, and in Italy. In the latter, the debt ratio would continue increasing over the projection period. The debt ratio is also projected to increase over the next two years from a relatively high level in Germany, France and Portugal.

Since spring 2005, the Commission and the Council took action on six Member States currently subject to an Excessive Deficit Procedure (EDP). The Commission and the Council considered that the Netherlands had corrected its excessive deficit and the Council decided to abrogate the excessive deficit procedure for this country in June 2005. In June 2005 the Council also adopted a decision that an excessive deficit exists in Italy and set fiscal efforts and deadlines for the correction of the excessive deficit in a recommendation under Article 104(7) of the Treaty. The same decisions and recommendations were adopted in September 2005 for Portugal and in January 2006 for the UK. In light of the fiscal notifications of Spring 2006, the Council decided in March 2006 to address a notice in accordance with Article 104(9) to Germany, which has to correct its excessive deficit in 2007. Finally, the Commission and the Council

considered that Hungary has not respected the recommendations formulated in the 104(7) recommendation. Since January 2006, twelve EU countries are subject to an excessive deficit procedure: five euro-area Member States, the UK and six new Member States.

In the context of budgetary surveillance, the Commission also assessed the 2005 updates of the stability and convergence programmes submitted by all the Member States and proposed Council opinions on these documents. The macroeconomic assumptions underlying the medium-term budgetary projections have on average been considered realistic, which is a major progress compared to previous updates. Regarding budgetary plans, the nominal deficit in the EU and in the euro area is projected to be reduced from 2.5 percent of GDP in 2005, to 1.4 percent of GDP in 2008. The improvement relies notably on the large budgetary consolidation projected in the Member States in EDP. According to the calculations of the Commission based on the figures of the programmes, the cyclically-adjusted budget balance (CAB) would improve in the euro area and in the EU from -2.1 percent of GDP in 2005 to -1.0 percent of GDP in 2008. In 2006 is planned only a minor improvement in the CAB, while significant structural efforts are backloaded to 2007 and 2008, but policy measures are often unspecified. Most Member States revised their debt level upwards but project a gradual improvement in the debt ratio over the programme period. Apart from the Czech Republic, Poland, Slovenia, Slovakia and the UK, all non-euro-area Member States are expected to have lower debt levels in 2008 than in 2005.

By the end of the programme period, only in Malta government debt is expected to stay above the 60 percent of GDP reference value.

The EU faces a major budgetary challenge in view of ageing populations over the coming decades. The assessment of this round of Stability and Convergence Programmes suggests that the increased focus on the long-term sustainability of public finances in the EU – reinforced by Ministers in the context of the reform of the Stability and Growth Pact – has contributed to incorporate longer-term concerns in the policy-making processes. The analysis of the 2005/06 updates of the stability and convergence programmes reveals that six Member States (the Czech Republic, Greece, Cyprus, Hungary, Portugal and Slovenia), face a high risk with regard to the long-term sustainability of public finances in view of the budgetary impact of ageing populations. Ten Member States (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Malta, the Netherlands and the UK) are at medium risk and the remaining nine countries (Denmark, Estonia, Latvia, Lithuania, Austria, Poland, Slovakia, Finland and Sweden) are at low risk.

For a large majority of countries, achieving the planned budgetary consolidation over the medium-term as envisaged in the programmes would contribute substantially to reduce the sustainability challenge. However, for a number of countries structural reforms in particular in the field of pensions need to complement the budgetary efforts to ensure a sustainable fiscal position in the long term.

1. Budgetary developments in the euro area and EU Member States

1.1. Short-term developments and prospects for the budget balance and public debt

In 2005, the budgetary position in the euro area improved significantly after a slight improvement in 2004 following deterioration in period 2001-2003 (see Table I.1). Compared to 2004, the nominal deficit fell by 0.4 percentage point and reached 2.4 percent of GDP. The aggregate nominal deficit of the entire EU also improved by 0.3 percentage points and reached 2.3 percent of GDP in 2005 (see Table I.2).

The aggregate outcome for the euro area as a whole results from diverse budgetary performances across Member States. In the case of Germany, France, Greece, Italy and Portugal the budgetary positions in 2005 remained weak with nominal deficits ranging from 2.9 percent of GDP in France to 6 percent of GDP in Portugal. It is, however, important to stress substantial improvement in budget balances of Greece (of 2.4 percentage points), France (0.8 percentage points) and Germany (0.4 percentage points). On the other hand budgetary situation worsened in Italy and Portugal by respectively 0.7 and 2.8 percentage points. Among the countries mentioned above, only France succeeded in bringing its deficit below the 3 percent of GDP reference value in 2005. In 2005 the nominal deficit has significantly improved in Spain and the Netherlands, respectively, by 1.2 and 1.6 percentage points Given the improved growth conditions in 2005, the Netherlands joined the group of countries that had nominal budget positions in balance or in surplus in 2004 (in 2005 – Belgium, Ireland, Spain, the Netherlands and Finland; in 2004, only Belgium, Ireland and Finland and Spain). Overall, the nominal budget balances in 2005 worsened compared to the previous year only in the case of Ireland, Italy, Luxembourg, Austria and Portugal.

Certainly, the budgetary performance also differed across the Member States outside the euro area. Relative to 2004, the budget position remained roughly unchanged or improved in a large majority of Member States with exception of Hungary and the UK, where deficits widened further. Nominal budget balances in 2005 varied from a deficit of 6.1 percent of GDP in Hungary to a surplus of 4.9 percent of GDP in Denmark. Only in the case of Hungary, Malta and the UK, the nominal deficit in 2005 was above the reference value of 3 percent of GDP while a number of countries reached a surplus budgetary position (Denmark, Estonia, Latvia and Sweden). The improvement was particularly important in Denmark, Cyprus, Malta and Poland.

Looking ahead to 2006 and 2007, the Commission Spring 2006 forecasts project that economic growth in the euro area as a whole will hover around 2 percent reaching 2.1 percent in 2006 and decline temporarily to 1.8 percent in 2007. The nominal budget balance is expected to stay at 2.4 percent of GDP in 2006 and improve slightly in 2007 (2.3 percent of GDP). Despite the improving economic situation, given the difficulties in pursuing budgetary consolidation, the aggregate nominal deficit for the entire EU is foreseen to hold stable at 2.3 percent of GDP in 2006 and decline only slightly to 2.2 percent of GDP in 2007.

At the Member State level, the surplus budgetary position in the case of Belgium is expected to deteriorate into a deficit position in 2006, while the surplus in Ireland is expected to be significantly reduced. Under a no-policy-change assumption, the deficits in both countries would continue to worsen in 2007. In contrast, Spain and Finland are expected to maintain their budgetary positions in surplus throughout the forecast period. Among the Member States outside the euro area, this is also the case of Denmark, Estonia and Sweden.

On the basis of current policies, the Commission forecast projects that the nominal deficits in Germany, Italy and Portugal will be exceeding the 3 percent of GDP reference value in 2006 while Greece is expected to reach the 3 percent of GDP reference value. While the German deficit will improve and be just above the 3 percent reference value and an improvement is expected also for the Portuguese deficit (which remains however at 5 percent of GDP), no improvement is expected for the Italian deficit. According to the Commission forecast, the budgetary situation is expected to slightly worsen in France as a deficit of 3 percent of GDP is projected. In 2007, apart from Germany all the abovementioned countries are expected to stay above the 3 percent of GDP reference value or to breach it again. In Germany, the nominal deficit is projected to remain above 3 percent of GDP in 2006 and move below the reference value in 2007. In Greece, the nominal deficit is expected to be at 3 percent of GDP in 2006 and worsen again in 2007. Although the excessive deficit procedure for Portugal was abrogated in 2004, the nominal deficit is foreseen to exceed 3 percent of GDP again in both 2005 and 2006. In Italy, although the nominal deficit is projected beyond the threshold in 2005 and will deteriorate further in 2006.

The nominal deficit is projected to stay above the reference value also in some other Member States. Despite an already very high deficit, budgetary situation in Hungary is projected to worsen in 2006 and 2007, when it is expected to reach 7 percent of GDP. Following good budgetary performance in 2005, deficit in the Czech Republic is expected to be above the reference value throughout the forecast period, while for Poland, it is expected to stay at 3 percent of GDP. In Malta, after a solid consolidation below the reference value expected for 2006, the deficit is expected to be above 3 percent of GDP again in 2007. In the UK, it is foreseen to be at 3 percent of GDP in 2006 and decline below the deficit reference value in 2007. In 2006, most of the new Member States expect the nominal deficit increase slightly or to remain unchanged. In the case of Latvia, a significant deterioration is projected for 2006, while the surplus in Estonia is expected to be reduced over the forecast period.

In cyclically-adjusted terms, relative to 2004, the deficit in the euro area was reduced substantially to 1.9 percent of GDP, an improvement of 0.7 percentage points. According to the Commission Spring 2006 forecasts, the cyclically adjusted budget balance is projected to increase slightly in 2006 and improve again slightly in 2007. Among the euro-area countries with higher cycli-cally-adjusted deficits, improvements over the entire projection period are expected only in Germany and Portugal. In Greece a significant improvement is expected in 2006, however for 2007, the cyclically-adjusted deficit should be higher again. In Italy, no improvement is foreseen in 2006 and for 2007, a widening of the cyclically-adjusted deficit is projected. No change over the forecast period is foreseen for France, the cyclically-adjusted deficit is expected to stay at 2.5 percent of GDP.

Outside the euro area, most of the countries are foreseen to see a worsening or no changes in the cyclically adjusted deficit. The most significant deteriorations are expected in Hungary, Czech Republic and Poland, where the deficits are foreseen to reach respectively 7.1 percent, 4 percent and 3.5 percent of GDP in 2007. The only countries for which improvements over the forecast period are foreseen are Cyprus, Latvia, Slovakia and the UK.

The euro area government debt-to-GDP ratio increased to 70.8 percent in 2005 (see Table I.3). According to the Commission Spring 2006 forecasts, the debt ratio is projected to decline slightly in 2006, which would be for the first time since 2002, to 70.5 percent of GDP and again in 2007 reaching 70.1 percent of GDP. Over the period 2005-2007, it is expected that the primary surplus coupled with the stock flow adjustment would more than offset the negative contribution to the change in debt ratio from interest expenditure. The aggregate debt ratio in the EU at 63.4 percent of GDP in 2005 is lower in comparison to the euro area. The EU debt ratio is projected to fall over the forecast period and to reach 62.9 percent of GDP in 2007. As it was the case with the euro area, the overall positive contribution from the primary balance and stock flow adjustment will more than offset the negative contribution from interest expenditure/growth.

Aggregate figures tend to hide different pictures across countries. In 2005, Greece and Italy continued to have debt ratios above 100 percent of GDP, and this is expected to still be the case also in 2007. Belgium managed to reduce its debt below this level already in 2003 and its debt ratio is expected to be reduced further in the future. In addition to these three countries, seven EU Member States are projected to have debt ratios above 60 percent of GDP in 2007. This includes Hungary, which is expected to breach the 60 percent of GDP reference value in 2007. Despite an overall bright picture at the euro area and EU levels the combined effect of poor growth performance and interest expenditure is nevertheless expected to significantly affect the budgetary

Table I.1

General government budgetary position — Euro area, 2001-2006 (% of GDP)

	2002[1]	2003	2004	2005	2006	2007
Total revenue (1)	45.1	45.1	44.7	45.1	45.0	44.8
Total expenditure (2)	47.6	48.1	47.5	47.5	47.4	47.1
Actual balance (3) = (1) — (2)	**– 2.5**	**– 3.0**	**– 2.8**	**– 2.4**	**– 2.4**	**– 2.3**
Interest (4)	3.5	3.3	3.1	3.0	3.0	3.0
Primary balance (5) = (3) + (4)	1.0	0.3	0.3	0.6	0.6	0.6
UTMS proceeds	0.0	0.0	0.0	0.0	0.0	0.0
Cyclically-adjusted balance (6)	**– 2.8**	**– 2.8**	**– 2.6**	**– 1.9**	**– 2.0**	**– 1.9**
Cyclically-adjusted primary balance = (6) + (4)	0.6	0.5	0.5	1.1	1.0	1.1
Change in actual balance	– 0.7	– 0.5	0.3	0.4	0.0	0.0
Due to: — Cycle	– 0.5	– 0.6	0.1	– 0.3	0.1	– 0.1
— UMTS	0.1	0.0	0.0	0.0	0.0	0.0
— Interest	0.3	0.2	0.2	0.1	0.1	0.0
— Cyclically-adjusted primary balance	– 0.5	– 0.1	0.0	0.6	– 0.1	0.1

NB: differences are due to rounding.
[1]   Including UMTS receipts. UMTS receipts as a percent of GDP would be equal in 2002 to 0.2 for IE and 0 for the euro area and EU-15.

Source: Commission Spring 2006 forecasts.

situation in Italy, Portugal and Poland, where in addition primary deficits are projected over the forecast period.

1.2. Government revenue and expenditure

The developments in the EU and euro-area budgetary positions are derived from changes in expenditure and revenue ratios. On the spending side, the euro area expenditure-to-GDP ratio in 2005 stayed at the same level as in 2004, both in nominal and cyclically-adjusted terms (see Table I.4). The reductions in interest and subsidies offset the increases in social benefits. According to the Commission Spring 2006 forecasts, the expenditure ratio is projected to decline further during the forecast period with additional reduction of collective consumption and social transfers other than in kind, while other items are foreseen to remain broadly unchanged. On the revenue side, the revenue-to-GDP ratio increased in 2005, both in nominal and cyclically-adjusted terms and it is expected to decline in the coming years.

At the Member State level, the patterns are generally similar (see Table I.5.). Only in Spain, Ireland, Italy, Portugal and the Netherlands and outside the euro area in the Czech Republic, Latvia, Poland and UK expenditure ratios are projected to increase over the 2005-07 period. In contrast, over the same period, large decreases are

expected in Germany, Greece, Austria, Denmark, Lithuania, Slovakia, Hungary, Malta, Poland and Slovenia. Revenue ratios are set to increase pronouncedly over 2005-07 in the case of the Netherlands and Portugal and outside the euro area, in the UK, whereas important reductions are foreseen in Belgium, Austria, Finland, Denmark, Hungary, Lithuania and Malta.

In the euro-area, the projected decrease in tax revenues on income and wealth, social contributions and other resources is being offset by an expected decline in expenditure on collective consumption, social benefits other than in kind and interests. Such a development reflects lessons from the past showing that tax measures resulting in a decline of tax revenues should be accompanied by expenditure cuts to avoid the worsening of the general government balances.

Nevertheless, the composition of expenditure adjustment should not constrain growth enhancing spending items such as public investment, education and R & D. This doesn't seem to be the case as expenditure on gross fixed capital formation is broadly stable at around 2.5 percent of GDP at annual level. The reduction in interest expenditure that has particularly contributed to a better allocation of available resources in past years will slowly continue.

Table I.2

Budget balances in EU Member States, 2004-2007 (% of GDP)

	Budget balance				Cyclically-adjusted budget balance				Cyclically-adjusted primary balance			
	2004	2005	2006	2007	2004	2005	2006	2007	2004	2005	2006	2007
BE	0.0	0.1	− 0.3	− 0.9	0.0	0.6	0.1	− 0.3	4.8	4.9	4.3	3.6
DE	− 3.7	− 3.3	− 3.1	− 2.5	− 3.4	− 3.0	− 3.0	− 2.3	− 0.6	− 0.2	− 0.2	0.5
EL	− 6.9	− 4.5	− 3.0	− 3.6	− 7.7	− 5.3	− 3.8	− 4.4	− 2.3	− 0.3	1.1	0.6
ES	− 0.1	1.1	0.9	0.4	0.0	1.3	1.3	1.0	2.0	3.1	3.0	2.5
FR	− 3.7	− 2.9	− 3.0	− 3.1	− 3.6	− 2.5	− 2.5	− 2.5	− 1.0	0.1	0.1	0.2
IE	1.5	1.0	0.1	− 0.4	1.4	1.5	1.1	0.8	2.6	2.7	2.3	2.0
IT	− 3.4	− 4.1	− 4.1	− 4.5	− 3.3	− 3.4	− 3.4	− 3.8	1.4	1.2	1.1	0.9
LU	− 1.1	− 1.9	− 1.8	− 1.5	− 0.5	− 1.3	− 1.3	− 1.0	− 0.3	− 1.1	− 1.1	− 0.9
NL	− 1.9	− 0.3	− 1.2	− 0.7	− 0.9	1.0	− 0.3	− 0.2	1.7	3.5	2.1	2.1
AT	− 1.1	− 1.5	− 1.9	− 1.4	− 0.8	− 1.0	− 1.7	− 1.2	2.0	1.7	1.0	1.4
PT	− 3.2	− 6.0	− 5.0	− 4.9	− 2.7	− 5.1	− 4.0	− 3.8	0.0	− 2.4	− 1.1	− 0.7
FI	2.3	2.6	2.8	2.5	2.5	3.2	3.0	2.7	4.0	4.7	4.4	4.1
EUR-12	**− 2.8**	**− 2.4**	**− 2.4**	**− 2.3**	**− 2.6**	**− 1.9**	**− 2.0**	**− 1.9**	**0.5**	**1.1**	**1.0**	**1.1**
CZ	− 2.9	− 2.6	− 3.2	− 3.4	− 2.0	− 2.5	− 3.6	− 4.0	− 0.8	− 1.4	− 2.2	− 2.6
DK	2.7	4.9	3.9	4.0	3.8	5.4	3.9	4.0	6.1	7.3	5.7	5.5
EE	1.5	1.6	1.4	0.8	1.8	1.5	1.1	0.5	2.0	1.7	1.3	0.7
CY	− 4.1	− 2.4	− 2.1	− 2.0	− 3.9	− 2.1	− 1.9	− 2.0	− 0.7	1.3	1.2	1.0
LV	− 0.9	0.2	− 1.0	− 1.0	− 0.9	− 0.2	− 1.2	− 0.8	− 0.1	0.4	− 0.6	− 0.2
LH	− 1.5	− 0.5	− 0.6	− 0.9	− 1.9	− 1.2	− 1.0	− 1.0	− 1.0	− 0.3	− 0.3	− 0.3
HU	− 5.4	− 6.1	− 6.7	− 7.0	− 5.2	− 5.8	− 6.6	− 7.1	− 1.1	− 1.9	− 2.9	− 3.5
MT	− 5.1	− 3.3	− 2.9	− 3.2	− 3.9	− 2.4	− 2.2	− 2.6	0.1	1.5	1.6	1.1
PL	− 3.9	− 2.5	− 3.0	− 3.0	− 4.2	− 2.6	− 3.3	− 3.5	− 1.6	− 0.3	− 0.8	− 0.9
SI	− 2.3	− 1.8	− 1.9	− 1.6	− 1.8	− 1.4	− 1.8	− 1.7	0.0	0.3	− 0.3	− 0.3
SK	− 3.0	− 2.9	− 2.7	− 2.1	− 2.3	− 2.4	− 2.4	− 2.1	− 0.1	− 0.7	− 0.7	− 0.4
SE	1.8	2.9	2.2	2.3	1.9	3.0	2.1	2.1	3.5	4.6	3.8	3.9
UK	− 3.3	− 3.5	− 3.0	− 2.8	− 3.5	− 3.3	− 2.7	− 2.5	− 1.5	− 1.1	− 0.7	− 0.5
EU-25	**− 2.6**	**− 2.3**	**− 2.3**	**− 2.2**	**− 2.5**	**− 1.9**	**− 1.9**	**− 1.8**	**0.3**	**0.8**	**0.7**	**0.9**

NB: Cyclically-adjusted figures are computed with the Production Function method.

Source: Commission Spring 2006 forecasts.

1.2.1. The fiscal stance and policy mix in the euro area

An appropriate policy mix can be defined as a combination of monetary and fiscal policies that ensures price stability and keeps economic activity close to its potential level. In the euro area, given that monetary policy is centralised and fiscal policies decentralised, it is of a particular importance to assess both the aggregate fiscal stance at the euro area level and national fiscal stances. Namely, the aggregate fiscal stance affects the policy mix at the euro area level and is, therefore, one of the elements to be considered by the ECB when setting the monetary policy.

Graph I.1 examines the fiscal stance (approximated by the changes in the cyclically-adjusted primary balance, CAPB) in relation to cyclical conditions (approximated by the size of the output gap) [1]. In this graph, fiscal behaviour in accordance with the SGP would be represented by movements along the horizontal axis. In other words, countries would achieve and maintain broadly

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[1] In line with the Council agreement, the output gap in this section is computed with the Production Function method. It should be noted, however, that *changes* in the output gap are equally relevant for the judgment of the stance in relation to cyclical conditions. The changes in the gap can be inferred in Graph I.1 by looking at the horizontal distance between years.

Table I.3

Composition of changes in government debt ratio in EU Member States, 2004-2007 (% of GDP)

| | Gross debt | | | | Change in gross debt 2005-07 | Change in 2005-07 due to: | | |
	2004	2005	2006	2007		Primary balance	Interest & growth contribution	Stock flow adjustment
BE	94.7	93.3	89.8	87.0	− 6.3	− 6.9	0.6	− 0.1
DE	65.5	67.7	68.9	69.2	1.5	0.0	2.8	− 1.2
EL	108.5	107.5	105.0	102.1	− 5.4	− 3.3	− 3.2	1.1
ES	46.4	43.2	40.0	37.9	− 5.2	− 4.5	− 2.2	1.5
FR	64.4	66.8	66.9	67.0	0.3	0.9	0.5	− 1.1
IE	29.4	27.6	27.2	27.0	− 0.6	− 2.1	− 1.7	3.2
IT	103.8	106.4	107.4	107.7	1.3	− 0.7	2.3	− 0.3
LU	6.6	6.2	7.9	8.2	2.0	3.0	− 0.7	− 0.3
NL	52.6	52.9	51.2	50.3	− 2.6	− 2.8	0.7	− 0.5
AT	63.6	62.9	62.4	61.6	− 1.4	− 2.0	0.2	0.4
PT	58.7	63.9	68.4	70.6	6.8	3.9	1.7	1.1
FI	44.3	41.1	39.7	38.3	− 2.8	− 8.1	− 0.4	5.7
EUR-12	**69.8**	**70.8**	**70.5**	**70.1**	**− 0.7**	**− 1.2**	**0.7**	**− 0.2**
CZ	30.6	30.5	31.5	32.4	1.9	3.9	− 0.9	− 1.1
DK	42.6	35.8	30.0	26.5	− 9.3	− 11.2	− 0.2	2.2
EE	5.4	4.8	3.6	3.0	− 1.7	− 2.6	− 0.6	1.4
CY	71.7	70.3	69.1	67.8	− 2.5	− 2.0	− 2.0	1.5
LV	14.6	11.9	11.3	10.9	− 1.1	0.9	− 2.0	0.0
LT	19.5	18.7	18.9	19.7	1.0	0.1	− 2.1	3.0
HU	57.1	58.4	59.9	62.0	3.6	6.3	− 0.4	− 2.3
MT	76.2	74.7	74.0	74.0	− 0.7	− 1.3	0.3	0.3
PL	41.9	42.5	45.5	46.7	4.2	0.9	0.4	2.8
SI	29.5	29.1	29.9	29.7	0.6	0.6	− 0.7	0.7
SK	41.6	34.5	34.3	34.7	0.2	1.3	− 2.6	1.7
SE	50.5	50.3	47.6	44.8	− 5.5	− 8.1	− 1.1	3.7
UK	40.8	42.8	44.1	44.7	1.9	1.7	0.1	0.2
EU-25	**62.4**	**63.4**	**63.2**	**62.9**	**− 0.5**	**− 0.9**	**0.5**	**− 0.1**

Source: Commission Spring 2006 Economic Forecasts.

balanced budgets over the economic cycle. Thus, changes in the output gap would not imply movements in the CAPB. However, as long as a Member State has not yet reached the medium-term target of the SGP, a restrictive fiscal stance – that is a positive change in CAPB – would be needed.

According to the Commission Spring 2006 forecasts, the euro area fiscal stance in 2005 was slightly on the side of pro-cyclical fiscal tightening. Looking ahead to 2006 and 2007, the euro area fiscal stance is projected to become again broadly neutral. Lessons from the past show that efforts to improve the underlying budget posi-

tions should be made as economic conditions improve in order to ensure sufficient room for the automatic stabilisers to operate in the next downturn.

Graph I.2 illustrates the euro area policy-mix, by plotting the fiscal stance on the vertical axis and the monetary stance (approximated by the change in the short-term real interest rates) on the horizontal axis. Against the background of a protracted slowdown in economic activity, the monetary stance tightened somewhat and became more neutral in 2004, after three consecutive years of loosening. In 2005, it remained broadly neutral, while the euro area fiscal stance was being tightened.

Table I.4

Euro area government revenue and expenditure, 2003-2007 (% of GDP)

	2003	2004	2005	2006	2007
Total revenue	**45.1**	**44.7**	**45.1**	**45.0**	**44.8**
— Cyclically-adjusted	45.3	44.9	45.5	45.4	45.2
Taxes on imports and production	13.1	13.3	13.4	13.5	13.8
Current taxes on income and wealth	11.5	11.4	11.6	11.6	11.4
Social contributions	15.8	15.6	15.6	15.6	15.3
of which actual social contributions	14.7	14.5	14.4	14.4	14.2
Other revenue	4.7	4.5	4.5	4.4	4.3
Total expenditure	**48.1**	**47.5**	**47.5**	**47.4**	**47.1**
— Cyclically-adjusted	48.1	47.4	47.4	47.3	47.1
Collective consumption	8.1	8.0	8.0	7.9	7.9
Social benefits in kind	12.3	12.2	12.3	12.3	12.3
Social benefits other than in kind	16.7	16.6	16.7	16.7	16.5
Interest	3.3	3.1	3.0	2.9	2.9
Subsidies	1.4	1.3	1.2	1.2	1.2
Gross fixed capital formation	2.5	2.4	2.4	2.5	2.5
Other expenditures	3.8	3.8	3.9	3.8	3.8

NB: Including UMTS receipts. See footnote to Table I.1.
NB: Data from the Commission October 2005 forecasts for Italy have been used in order to estimate the aggregate value for 'Collective consumptions' and for 'Social benefits in kind'.

Source: Commission Spring 2006 forecasts.

1.2.2. The fiscal stance and policy mix at the national level

The aggregate fiscal stance for the euro area results from a variety of diverse fiscal stances across Member States despite fairly similar cyclical developments, Graph I.3 shows that most EU-25 countries recorded a negative output gap in 2005 with the exception of Greece, Poland and the Baltic States.

In 2005, several EU countries ran moderately broadly neutral fiscal policies in a context of negative output gaps. Policies were, however, clearly countercyclical in the case of Portugal, Hungary, Italy and Luxemburg. It is worth mentioning that the nominal budget balances in these countries markedly worsened in the course of 2005.

The Netherlands, Cyprus and Malta ran pro-cyclical policy in 2005, reflecting consolidation efforts in order to improve the budgetary position. At the same time France also tightened its fiscal stance in order to bring the deficit below the 3 percent of GDP reference value.

As pointed out above, the overall policy-mix in the euro area in 2005 was characterised by a neutral monetary stance and tightened fiscal policy stance with most Member States experiencing an adjustment of the fiscal stance (see Graph I.4).

The real interest rate for the euro area (i.e. the short-term interest rate corrected by private consumption inflation) amounted to below 0.3 percent in 2005. However, this aggregate figure for the euro area conceals significant differences across Member States due to disparities in inflation rates across countries. The highest real interest rates were in France, Finland and Germany (1 percent, 0.9 percent and 0.9 percent, respectively), whereas in a number of countries (Belgium, Greece, Spain, Italy and Portugal) the real interest rates were negative.

Regarding 2006, the overall fiscal stance of the euro area is expected to be broadly neutral (see Graph I.5), although some pro-cyclical fiscal easing is expected, particularly in the Netherlands, Austria, Ireland, Finland and Belgium. Greece and Portugal are projected to considerably tighten their fiscal stances. Outside the euro area, Denmark, Hungary, the Czech Republic and Latvia are projected to substantially ease their fiscal stance, while the UK is expected to tighten it.

Table I.5

Total revenue and expenditure in EU Member States, 2004-2007 (% of GDP)

	Revenue				Expenditure			
	2004	**2005**	**2006**	**2007**	**2004**	**2005**	**2006**	**2007**
BE	49.4	50.1	49.3	48.5	49.5	50.1	49.7	49.5
DE	43.2	43.4	43.1	43.0	46.8	46.7	46.1	45.5
EL	42.0	41.8	41.9	41.3	48.8	46.2	44.8	44.9
ES	38.7	39.3	39.3	38.8	38.8	38.2	38.3	38.5
FR	49.6	51.0	51.0	50.7	53.2	53.9	54.1	53.8
IE	35.2	35.5	35.1	34.7	33.7	34.5	34.9	35.1
IT	44.3	44.0	44.0	43.8	47.8	48.2	48.1	48.4
LU	42.1	42.4	42.2	42.3	43.2	44.3	44.0	43.8
NL	44.5	45.4	46.5	46.4	46.6	45.7	47.7	47.1
AT	48.8	48.0	46.6	46.8	50.0	49.6	48.7	48.3
PT	43.2	41.8	43.0	43.1	46.4	47.8	48.0	48.0
FI	52.4	53.1	52.7	52.1	50.3	50.7	50.1	49.8
EUR-12	**44.7**	**45.1**	**45.0**	**44.8**	**47.5**	**47.5**	**47.4**	**47.1**
CZ	41.4	41.1	40.8	40.4	44.3	43.7	44.1	43.9
DK	57.2	57.4	54.7	53.8	54.6	52.7	50.9	50.0
EE	37.9	37.5	37.3	36.8	36.4	35.9	35.8	35.9
CY	39.7	42.3	41.8	41.8	43.8	44.7	43.9	43.8
LV	34.9	36.4	36.1	36.1	35.9	36.2	37.1	37.1
LH	31.9	33.1	32.0	30.7	33.4	33.7	32.6	31.7
HU	44.1	44.5	43.1	42.2	49.5	50.6	49.8	49.2
MT	43.4	44.2	42.4	40.2	48.5	47.5	45.3	43.4
PL	38.6	40.8	41.6	40.7	42.5	43.3	44.6	43.7
SI	45.3	45.5	45.5	45.3	47.6	47.3	47.3	47.0
SK	35.9	33.9	33.0	32.5	38.9	36.8	35.7	34.6
SE	58.3	59.1	58.2	57.7	56.7	56.4	56.1	55.6
UK	39.9	41.3	42.2	42.7	43.2	44.8	45.2	45.5
EU-25	**44.3**	**44.9**	**44.9**	**44.7**	**47.0**	**47.2**	**47.1**	**46.9**
p.m. EU-15	**44.5**	**45.1**	**45.1**	**45.0**	**47.2**	**47.4**	**47.3**	**47.2**
p.m. EU-10	**39.9**	**40.8**	**40.7**	**39.9**	**43.5**	**43.7**	**43.9**	**43.2**

NB: Including UMTS receipts. see footnote to Table I.1.

Source: Commission Spring 2005 forecasts.

Graph I.1: **Euro-area fiscal stance and cyclical conditions, 2001-2007**
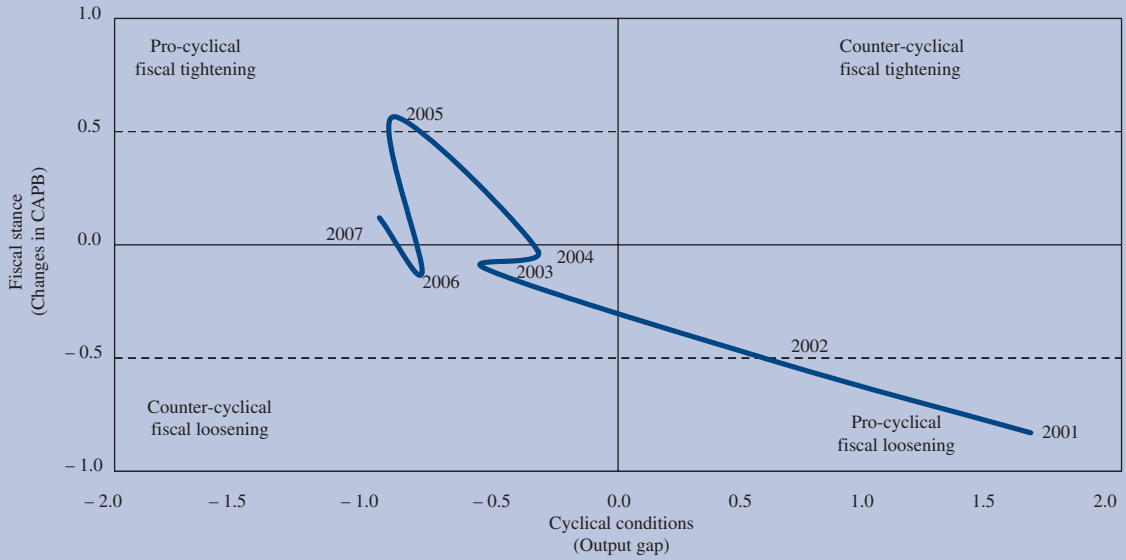
Graph I.2: **Euro-area policy-mix, 2001-2005**
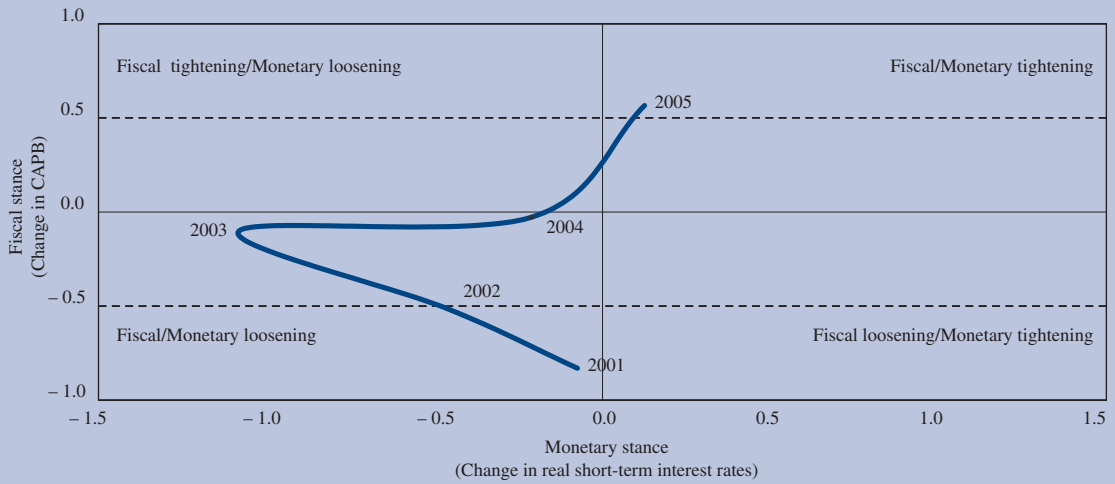
Graph I.3: **Fiscal stance and cyclical conditions in the EU-25 Member States, 2005**
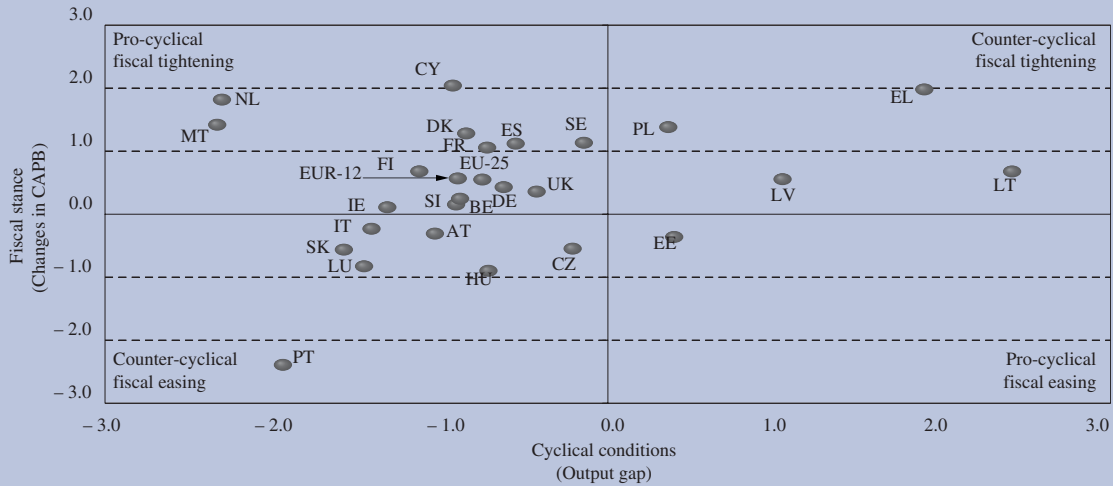
Graph I.4: **Policy-mix in the euro-area Member States, 2005**
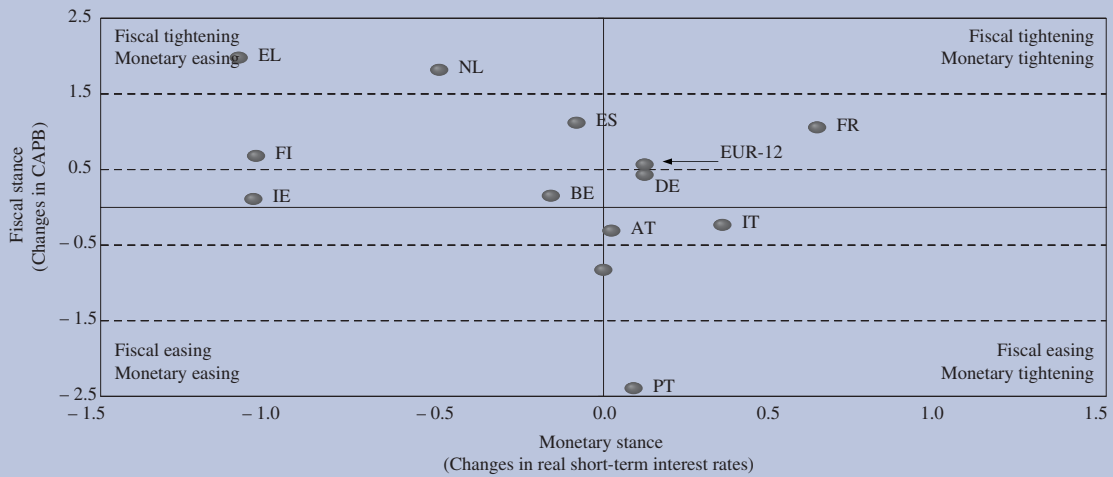
Graph I.5: **Fiscal stance and cyclical conditions in the EU-25 Member States, 2006**
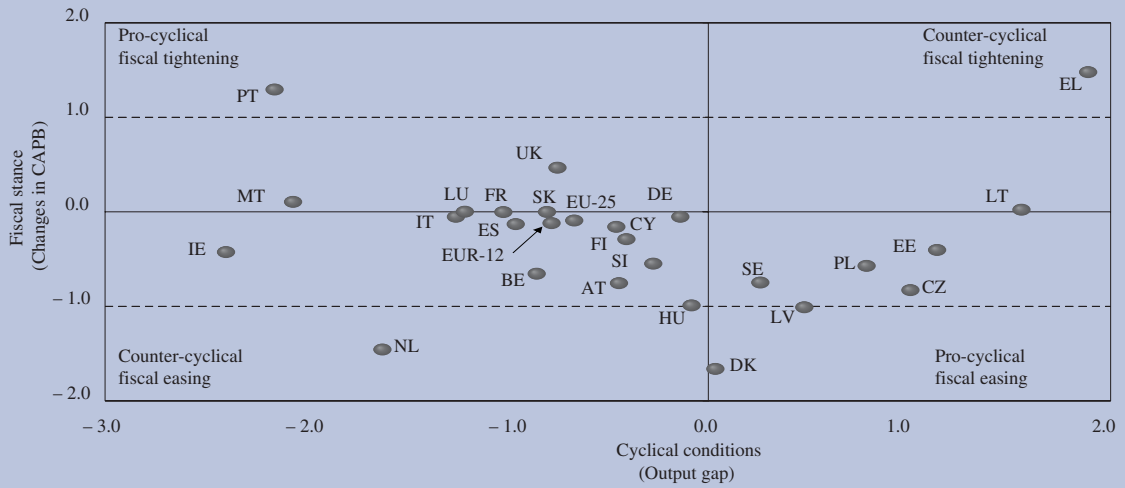
2. Implementing the Stability and Growth Pact

2.1. Introduction

The fiscal framework of EMU aims at ensuring budgetary discipline through two main requirements. These are the Treaty requirements to avoid excessive deficit positions, measured against reference values for deficits and debt of 3 percent and 60 percent of GDP respectively, and the requirement for Member States to achieve and maintain their medium-term budgetary objective (MTO). Compliance with the MTO secures fiscal discipline and the sustainability of public finances, and thus contributes to maintaining an economic environment in which monetary policy can effectively pursue price stability. It also provides the necessary room for manoeuvre to allow the automatic stabilisers to play freely without breaching the 3 percent reference value of the Treaty.

The rules-based framework of the Treaty and SGP consists of both preventive and dissuasive elements, both of which are backed up with enforcement procedures. Box I.1 makes a description of these procedures. During 2005 and the early part of 2006, the Commission and Council applied the various enforcement mechanisms of the Stability and Growth Pact (SGP) against several Member States. This section reviews the implementation of these mechanisms since spring 2005 in the EU countries.

2.2. The excessive deficit procedure since spring 2005

Since spring 2005, the Commission and the Council took action concerning six Member States in EDP. The Commission and the Council considered that the Netherlands had corrected its excessive deficit and the Council decided to abrogate the excessive deficit procedure for this country on 7 June 2005. The Council decided to address a notice in accordance with Article 104(9) to Germany, which has to correct its excessive deficit in

2007. The Council decided that Portugal, the UK and Italy were in excessive deficit and set fiscal efforts and deadlines for their correction in 104(7) recommendations. Finally, the Commission and the Council considered that Hungary has not respected the recommendations formulated in the 104(7) recommendation. Since January 2006, twelve EU countries are subject to an excessive deficit procedure: five euro-area Member States, the UK and six new Member States (¹).

2.2.1. The surveillance mechanisms in the euro-area countries

Germany and France

Summary of past events

Following evidence of government deficits above 3 percent of GDP in 2002, the Council decided in spring 2003 that excessive deficits existed in Germany and in France and adopted recommendations under Article 104(7) with a view to bringing this situation to an end by 2004. In autumn 2003, the Commission considered that the actions implemented were inadequate and recommended the Council to adopt decisions giving notice to these two countries to correct the excessive deficit by 2005.

On 25 November 2003, the Council voted on the recommended decisions but did not achieve the required majority. Instead the Council adopted conclusions addressing recommendations to Germany and France for the correction of the excessive deficit by 2005 and stating that the excessive deficit procedure was held in abeyance. The Commission brought the case before the Court of Justice of the European Communities. On 13 July 2004, the Court annulled the Council conclusions in so far as they aimed

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(¹) For documents concerning these procedures, see the section on fiscal surveillance on the website of the DG ECFIN: http://europa.eu.int/comm/ economy_finance/about/activities/sgp/procedures_en.htm.

at formally suspending the procedure and modifying the existing recommendations.

On 14 December 2004, the Commission adopted a Communication clarifying the situation of Germany and France in relation to the excessive deficit procedure. The Commission recognised that the actions of the two Member States concerned taken in the aftermath of the Council conclusions of 25 November 2003 and up to their annulment by the Court on 13 July 2004 were based on the notion that the deadline for the correction of the deficit had been effectively moved to 2005. The Commission considered that the assessment of the actions taken to correct the excessive deficit situation should refer to 2005 as the relevant deadline. In the Communication, the Commission stated that the actions taken by the German and French authorities were broadly consistent with a correction of the excessive deficit by 2005 and that no further steps were necessary under the excessive deficit procedure. The Council agreed with this position.

Germany

The German statistics office announced on 22 February 2006 that the public deficit in 2005 was 3.3 percent of GDP, down from 3.7 percent in 2004 but above the 3.0 percent reference value set in the Treaty. In addition, the deficit is expected by the German authorities to remain above the 3 percent of GDP threshold in 2006. The Commission recommended to the Council to give notice to Germany, according to Article 104(9) of the Treaty, to correct its excessive deficit by 2007. Such a notice was adopted by the Council on 14 March 2006. In this notice, the Council acknowledged that the German government that took office in November 2005 has adopted a comprehensive budgetary consolidation strategy in a context of still fragile economic recovery to bring the deficit below the 3 percent reference value by 2007.

The Commission and the Council considered that, on the basis of currently available information, the fiscal effort implied in the strategy until 2007 would be in line with the rules of the Stability and Growth Pact. Moreover, the Commission and the Council also considered that the adoption process of this strategy was well advanced, which reduces uncertainty regarding the effectiveness of the consolidation. The Council recommended in the notice that Germany corrects the excessive deficit by 2007 at the latest and ensures that the budget balance in structural terms (i.e. disregarding cyclical effects and one-off and temporary measures) improves by at least one percentage point cumulatively in 2006 and 2007. Germany shall submit to the Commission, by 14 July 2006 at the latest, a report outlining the measures taken to comply with the notice. Other reports should be submitted by 1 October 2006, 1 April 2007, 1 October 2007 and 1 April 2008, examining the progress made. The latest Commission forecast shows a deficit just above the reference value in 2006 and well below it in 2007.

France

The French deficit was reduced to just below the reference value in 2005. The deficit reduction notably reflects large

Graph I.6: **Budgetary plans, forecasts and outcomes in Germany**
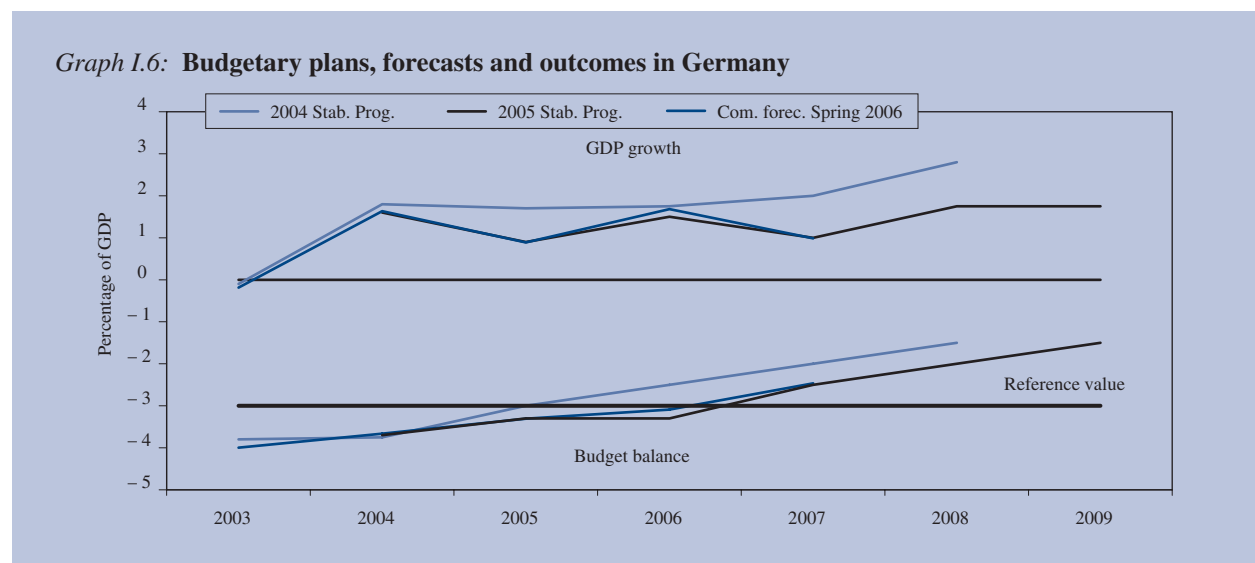
one-off revenues and statistical revisions. For 2006, the Commission projects a deficit at the reference value (including one-off revenues amounting to 0.2 percent of GDP). The no-policy change projection for 2007 shows a deficit slightly above 3 percent of GDP. Taking into account the uncertainties surrounding the deficit forecasts for 2006 and 2007, the Commission will continue in the coming months its monitoring of the budgetary developments in France and assess whether the correction of the excessive deficit is firmly established.

Portugal

The update of the stability programme submitted on 9 June 2005 by the Portuguese authorities revealed the plans for a general government deficit in excess of the 3 percent of GDP reference value of the Treaty for the years from 2005 to 2007. More specifically, after a reported deficit outturn of 2.9 percent in 2004, Portugal planned to record a government deficit of 6.2 percent of GDP for 2005, 4.8 percent in 2006, 3.9 percent in 2007 and 2.8 percent of GDP in 2008. Over the same years, the debt-to-GDP ratio was projected to increase from 61.9 percent in 2004 to a peak of 67.8 percent of GDP in 2007. On this basis, the Council decided on 20 September 2005 that Portugal has an excessive deficit.

On the same date, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2008. Specifically, Portugal was recommended to limit the deterioration of the fiscal position in 2005 and to ensure a correction of the structural deficit of some 1.5 percent of GDP in 2006 from 2005, followed by a further decrease of, at least, ¾ percent of GDP in each of the two subsequent years. At the same time, Portugal was invited to rapidly implement reforms to contain and reduce expenditure and to stand ready to adopt the additional measures which may be necessary to achieve the correction of the excessive deficit by 2008. In addition, the Portuguese authorities were recommended to ensure that the government gross debt ratio is brought onto a downward path also by avoiding debt-increasing financial transactions, and by considering carefully the possible impact on debt of major public investment projects.

The Council established the deadline of 19 March 2006 for the Portuguese government to take effective action in order to achieve the 2006 deficit target. The Commission will carry out an assessment of the efforts made by the Portuguese authorities in the coming weeks. This assessment will take into account the results of the spring 2006 Commission forecast that shows a 2006 deficit somewhat higher than recommended.

Greece

On 4 May 2004, the Greek authorities submitted a revised EDP notification showing a 2003 deficit of 3.2 percent of GDP. The Council, also taking into account developments in the debt ratio, decided that an excessive deficit exists in Greece and addressed on

Graph I.7: **Budgetary plans, forecasts and outcomes in France**

Graph I.8: **Budgetary plans, forecasts and outcomes in Portugal**
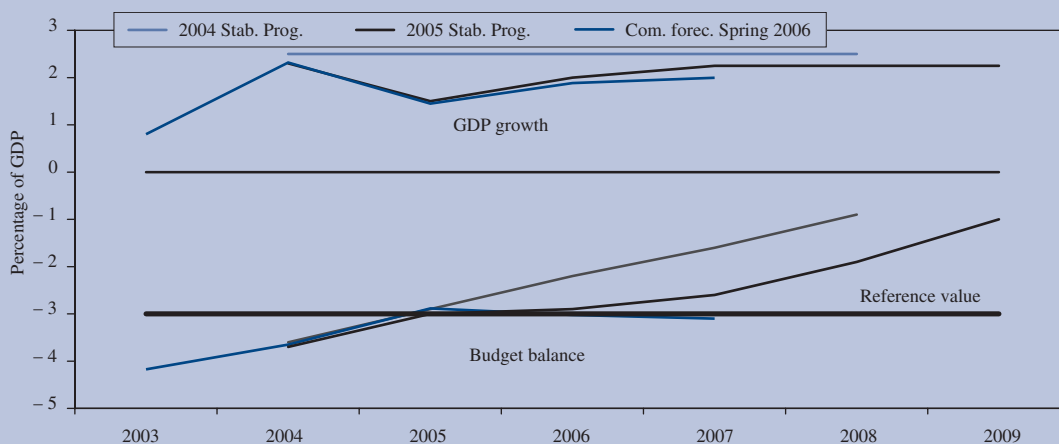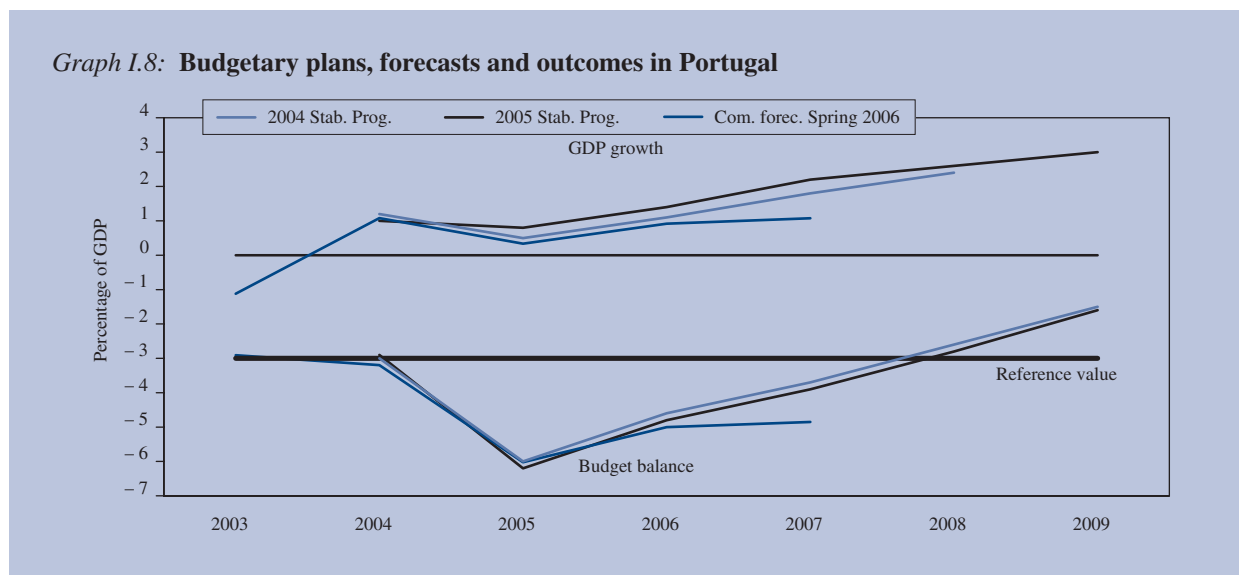
5 July 2004 a 104(7) recommendation to Greece with a view to bringing the excessive deficit situation to an end by 2005. The Council established the deadline of 5 November 2004 for Greece to take appropriate measures to this end.

Based on its autumn 2004 forecast incorporating the data revisions of the September 2004 notification and projecting the 2005 deficit at 3.6 percent of GDP, on 22 December 2004 the Commission recommended to the Council to decide under Article 104(8) that no effective action had been taken in response to its 104(7) recommendation. The Council decided accordingly on 18 January 2005. On 9 February 2005, the Commission recommended to the Council to give notice to Greece, in accordance with Article 104(9) of the Treaty, to take the necessary measures to remedy its excessive deficit situation. The Commission recommended extending the deadline for bringing the deficit below the 3.0 percent reference value by one year to 2006. When taking this decision, the Commission took into account the fact that the 2004 deficit would likely be substantially higher than expected, due to statistical revisions and to expenditure overruns associated notably with the organisation of the Olympic games. In addition, the Commission considered that GDP growth prospects for 2005 and 2006 had become less favourable, making the reduction of the deficit more difficult.

On 17 February 2005, the Council adopted a decision giving notice to Greece, in accordance with Article 104(9) of the Treaty, to take measures to remedy the sit-

uation of excessive deficit as rapidly as possible and at the latest by 2006 through (i) a rigorous implementation of the 2005 budget as approved by the Parliament; (ii) implementing in 2006 adjustment measures of a permanent nature leading to a correction in the deficit of at least 0.6 percentage point of GDP [1]. The Council decided that Greece had to submit, by 21 March 2005 at the latest, a report outlining the decisions to respect these recommendations.

In March 2005, Greece submitted a report, which was assessed in the Commission Communication of 6 April. The Commission concluded that the Greek government had taken effective action so that no further steps under the EDP were needed at that stage. Greece submitted other reports in October 2005 and April 2006. Another report examining progress made in respecting the recommendations of the notice issued under 104(9) shall be submitted by 31 October 2006. For Greece, the Spring 2006 Commission forecast shows a structural improvement in 2005 and 2006 that is in line with the Council notice under Article 104(9) but, given the upward revisions of past deficits, the deficit is at the reference value in 2006 only because of significant one-offs (0.6 percent of GDP).

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[1] The Council also recommended Greece to further pursue the efforts to identify and control factors other than net borrowing, which contribute to the change in debt levels, with a view to ensuring that the government gross debt ratio diminishes sufficiently and approaches the reference value at a satisfactory pace in line with the correction of the excessive deficit.

Graph I.9: **Budgetary plans, forecasts and outcomes in Greece**
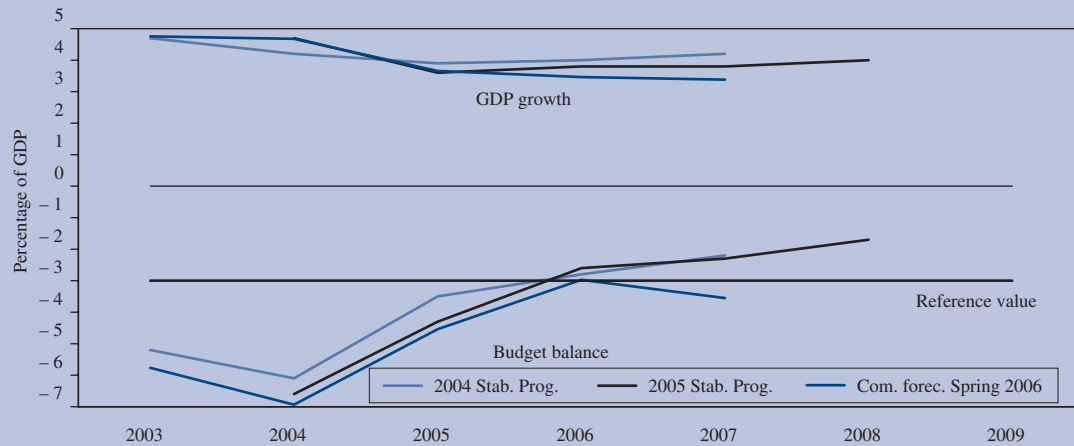
The Netherlands

In light of a reported general government deficit of 3.2 percent of GDP in 2003 and considering the risk that the deficit might remain above 3 percent of GDP in 2004, the Council placed the Netherlands in excessive deficit on 2 June 2004 and at the same time issued an Art. 104(7) recommendation for its correction. The Dutch government was recommended to put an end by 2005 at the latest to the excessive deficit. To that end, it was recommended to take action regarding corrective measures in 2005 amounting to at least half a percentage point of GDP by the deadline of 2 October 2004.

Following this recommendation, the Dutch authorities implemented an additional savings package for 2004 equivalent to 0.6 percentage point of GDP on top of the savings measures that had already been included in the 2004 budget. The corrective measures were for the largest part of a structural nature, thus having a deficit-reducing impact also in subsequent years. On 6 October 2004, the Commission considered that the Netherlands had taken effective action to correct the excessive deficit by 2005. The Council concurred to this analysis in its conclusions of 21 October 2004.

Based on data reported by the Netherlands of a deficit of 2.3 percent of GDP in 2004 and the Commission services' spring 2005 economic forecast of a deficit at 2.0 percent in 2005, the Commission recommended on 18 May to the Council to abrogate its decisions under Article (6) and (7) of paragraph 104 of the Treaty. On

7 June 2005, the Council abrogated its decision on the existence of an excessive deficit in the Netherlands.

Italy

On 23 May 2005, Eurostat released revised figures on Italian government data, showing a general government deficit of 3.1 percent of GDP in both 2003 and 2004. Over the same two years, the debt-to-GDP ratio was reported to have remained broadly stable at around 106-107 percent of GDP. On 24 May the Italian institute of statistics (ISTAT) released new public finances data for the period 2000-2004. The deficit was reported at 3.2 percent of GDP in 2003 and 2004. Considering that the deficit ratio had been above but close to 3 percent of GDP in 2003 and 2004 and that the breach of the reference value could not be considered temporary because the deficit was projected by the Commission to exceed 3 percent in 2005 and 2006, and taking into account developments in the debt ratio, the Council decided that Italy has an excessive deficit. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007.

In particular, Italy was recommended to implement with rigour the 2005 budget; reduce the structural deficit by a minimum 1.6 percent of GDP by 2007 relative to its level in 2005, with at least half of this correction taking place in 2006; and ensure that the debt-to-GDP ratio diminishes and approaches the reference value at a satisfactory pace.

Graph I.10: **Budgetary plans, forecasts and outcomes in the Netherlands**
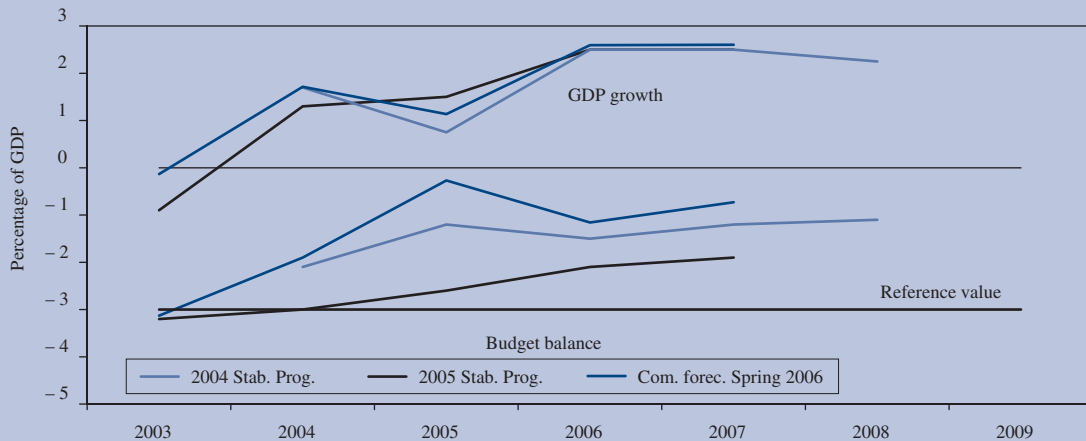
Graph I.11: **Budgetary plans, forecasts and outcomes in the Italy**
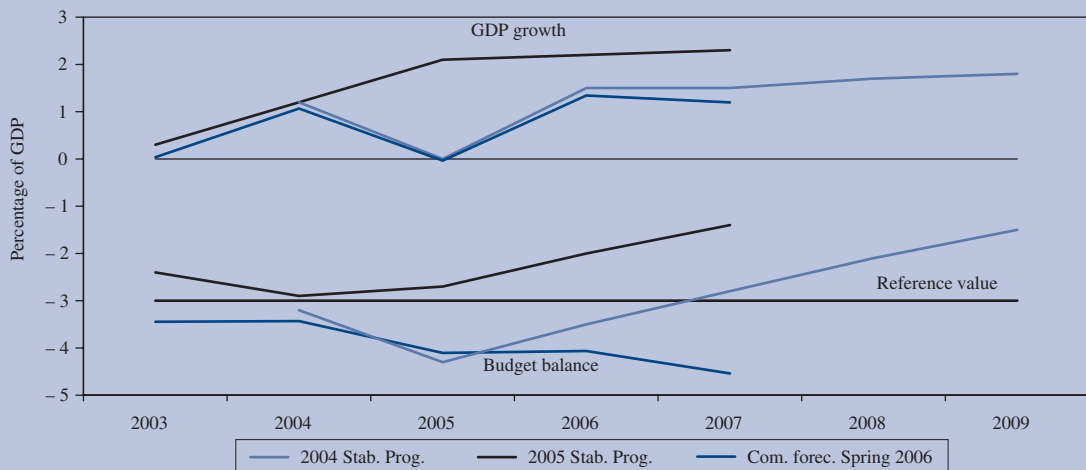
On 22 February, the Commission adopted a communication concluding that the actions taken by Italy, if fully implemented and effective, would be consistent with the Council recommendation. The Commission Communication highlighted that implementation uncertainties persist, which will require continuous monitoring. The Council agreed with this analysis. The spring 2006 Commission forecast shows that the deficit would remain unchanged at just above 4 percent of GDP in 2006 and rise further in 2007 on a no-policy change basis. This confirms the significant uncertainties surrounding the

correction of the excessive deficit by 2007 that were highlighted in the Commission communication on the action taken in response to the Council recommendation.

2.2.2. The surveillance mechanisms in the non-euro area Member States

United Kingdom

According to the data notified by the United Kingdom in August 2005, the general government deficit amounted to 3.2 percent of GDP in the 2004/05 finan-

cial year. The excess over the 3 percent of GDP reference value was not exceptional. In particular, it did not result from an unusual event outside the control of the United Kingdom authorities, nor was it the result of a severe economic downturn. The excess over the 3 percent of GDP reference value was also considered not temporary, based on the Commission services' autumn 2005 forecasts. Assuming that United Kingdom fiscal policy remained as announced, the deficit in these forecasts was expected to widen to just below 3½ percent of GDP in 2005/06 and to remain over 3 percent of GDP in 2006/07. Based on these projections, the excess over the reference value could not be considered exceptional or temporary within the meaning of the Treaty and the Stability and Growth Pact although the deficit is close to the reference value.

After the Commission services' autumn forecasts had been published, the United Kingdom announced policy decisions in the Pre-Budget Report presented to Parliament on 5 December. In net terms, these measures represented an easing of policy by 0.1 percent of GDP in the 2005/06 financial year and a tightening of policy by 0.1 percent of GDP in 2006/07. Compared to an unchanged policy scenario, the Pre-Budget Report foresaw a tightening of 0.2 percent of GDP in 2007/08. Taking into consideration these measures, the Commission's assessment remained that the deficit in 2006/07, at around 3.1 percent of GDP, was expected to exceed 3 percent of GDP. On this basis, the Council decided on 24 January 2006 that the UK had an excessive deficit.

On 24 January 2006, the Council considered that, in the case of the United Kingdom, the consideration of relevant factors did not warrant a departure from the standard deadline for correcting the excessive deficit. Therefore the Council decided that the United Kingdom authorities should put an end to the excessive deficit situation as soon as possible and by the financial year 2006/07 at the latest. To this end, the UK authorities should bring the general government deficit below 3 percent of GDP in a credible and sustainable manner and to this end ensure an improvement of the structural balance by at least 0.5 percentage points of GDP between the 2005/06 and 2006/07 financial years.

For the United Kingdom, the spring 2006 Commission forecast shows the deficit at the reference value in financial year 2006/07 and dropping below it in 2007/08.

Hungary

On 5 July 2004, the Council issued a 104(7) recommendation to the Hungarian authorities to implement the measures envisaged in the May 2004 convergence programme aiming at a correction of the excessive deficit by 2008. The Hungarian authorities were recommended to stand ready to introduce additional measures, if necessary, with a view to achieving the deficit targets for 2004 and 2005.

On 18 January 2005, the Council considered that Hungary had not taken effective action in response to its recommendation. Having joined the Community on

Graph I.12: **Budgetary plans, forecasts and outcomes in the UK**
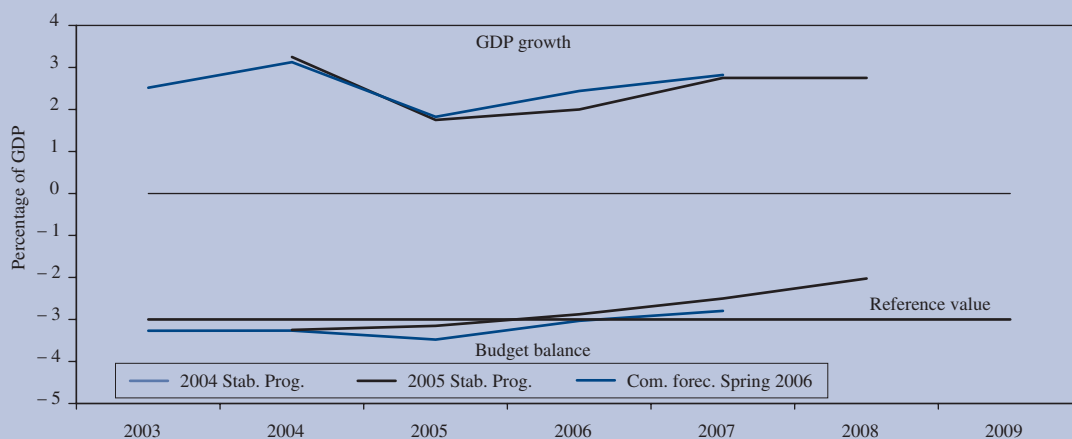
1 May 2004, Hungary is a Member State with a deroga-tion, which means that it is to avoid excessive deficits but that Articles 104(9) and Article 104(11) of the Treaty do not apply to it. The Council therefore issued on 8 March 2005 another recommendation based on Article 104(7), taking into account the information of Hungary's convergence programme update submitted in December 2004. The Council recommended the Hungarian author-ities to 'take effective action by 8 July 2005 regarding additional measures, as far as possible of a structural nature, in order to achieve the deficit target for 2005 as set in the updated convergence programme'.

On 13 July 2005, the Commission adopted a Communica-tion stating that, based on the information available at the time that the Hungarian authorities had taken effective action regarding the 2005 budget deficit within the 4-month deadline set by the Council in its new 104(7) rec-ommendations of 8 March 2005. The assessment under-lined that the achievement of the 2005 deficit target of 3.6 percent of GDP might require further action later in the year and that important adjustments and decisive action would be needed to achieve the target of 2.9 percent of GDP in 2006 of the authorities. However, in light of a substantial deterioration of the budgetary out-look in Hungary, based on a Commission recommenda-tion of 2 October 2005 incorporating the new information, the Council decided on 8 November 2005 that Hungary did not comply with the new 104(7) recommendations.

Czech Republic

On 5 July 2004 the Council decided that the Czech Republic had an excessive deficit. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be cor-rected by 2008 in a credible and sustainable manner. In particular, the Czech Republic was recommended to take effective action regarding the measures envisaged to achieve the 2005 deficit target by the deadline of 5 November 2004 and to implement with vigour the measures envisaged in the May 2004 convergence pro-gramme, in particular to cut the wage bill of central gov-ernment and to reduce spending of individual ministries. Furthermore, the Czech Republic was invited to allocate higher-than-budgeted revenues to deficit reduction, to introduce fiscal targeting based on medium-term expenditure ceilings, to design effective rules to reduce the risk of increasing indebtedness of regions and munic-ipalities, to undertake the reform of the pension and healthcare systems so as to improve the long-term sus-tainability of the public finances and to minimise the negative budgetary impact of the operations of the Czech Consolidation Agency.

On 22 December 2004, the Commission concluded that the Czech government had taken effective action regard-ing the measures envisaged to achieve the 2005 deficit target in response to the Council recommendation, and that no further steps were necessary under the excessive

Graph I.13: **Budgetary plans, forecasts and outcomes in Hungary**
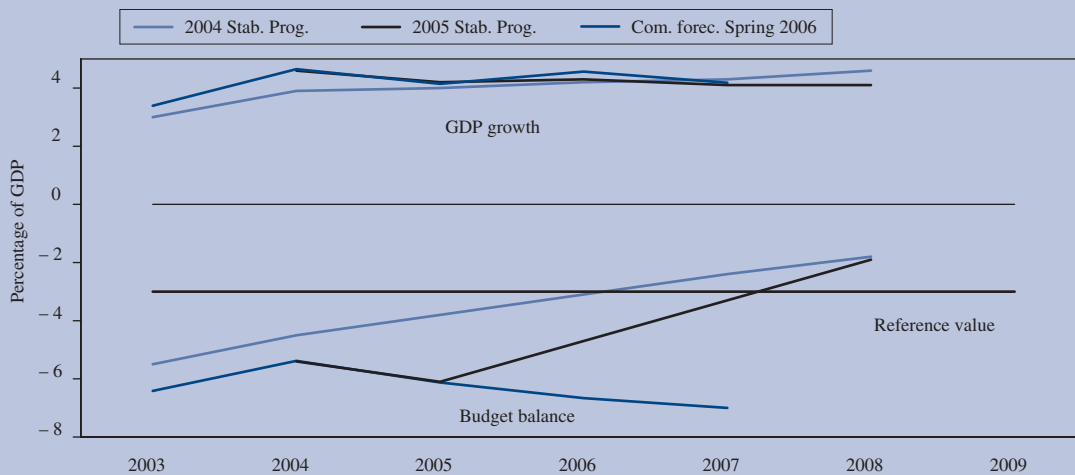
deficit procedure. The Commission spring 2006 fore-casts confirmed that the Czech Republic seems to be on track to correct the excessive deficit by 2008.

Cyprus

On 5 July 2004, the Council decided that an excessive deficit existed in Cyprus. At the same time, the Council addressed a recommendation to Cyprus under Article 104(7), requesting Cyprus to take effective action by 5 November 2004 in order to bring the deficit below 3 per-cent of GDP by 2005 in a credible and sustainable manner and to implement with vigour the measures envisaged in the May 2004 programme. Cyprus was also recom-mended, *inter alia*, to pursue the reform process in the pension and healthcare system in order to reduce the sustainability risks associated with the future evolution of age-related expenditures, together with the planned and necessary budgetary consolidation in the medium term.

A Commission communication of 22 December 2004 concluded that, on then available information and on the basis of the measures detailed in the 2005 budget, it appeared that the Cypriot government had taken effective action to achieve the 2005 deficit target, in compliance with the Council recommendation under Article 104(7). Accordingly, the Commission concluded that no further steps were necessary at that point under the excessive deficit procedure. The spring 2006 forecast of Commission services shows a deficit clearly below the reference value in 2005 (albeit thanks to a significant one-off) and

expected to fall further by 2007 on a no-policy change basis (including small one-offs in 2006 and 2007).

Malta

On 5 July 2004 the Council decided that Malta had an excessive deficit. At the same time, the Council addressed a recommendation under Article 104(7) spec-ifying that the excessive deficit had to be corrected by 2006. Malta was recommended to implement with vig-our measures, particularly those of a structural nature, aimed at rationalising and reducing expenditure. The Council also recommended that the rise in the debt ratio is brought to a halt in 2005 and reversed thereafter.

The Commission Communication to the Council of 22 December 2004 concluded that, on the basis of the measures contained in the 2005 budget, Malta appeared to have taken effective action regarding the measures to achieve the deficit targets for 2005 in response to the Council Recommendation. According to the spring 2006 forecast of Commission services, Malta seems to be on track to correct the excessive deficit by 2006.

Poland

On 5 July 2004, the Council decided that Poland had an excessive deficit. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007. In par-

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Graph I.14: **Budgetary plans, forecasts and outcomes in Czech Republic**
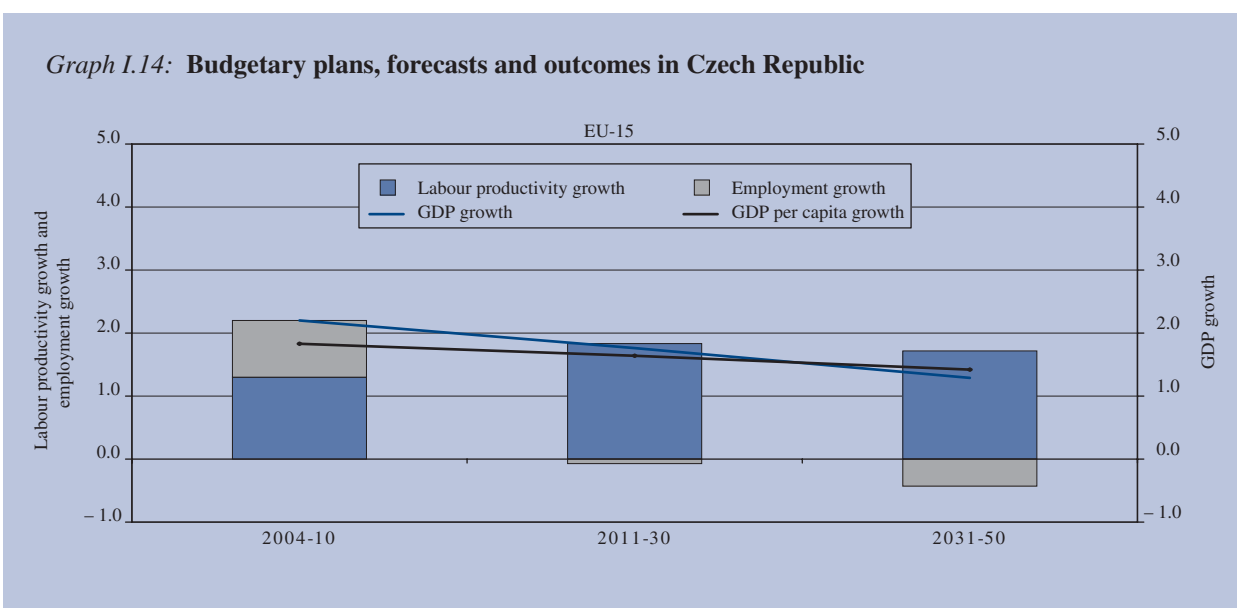
Graph I.15: **Budgetary plans, forecasts and outcomes in Cyprus**
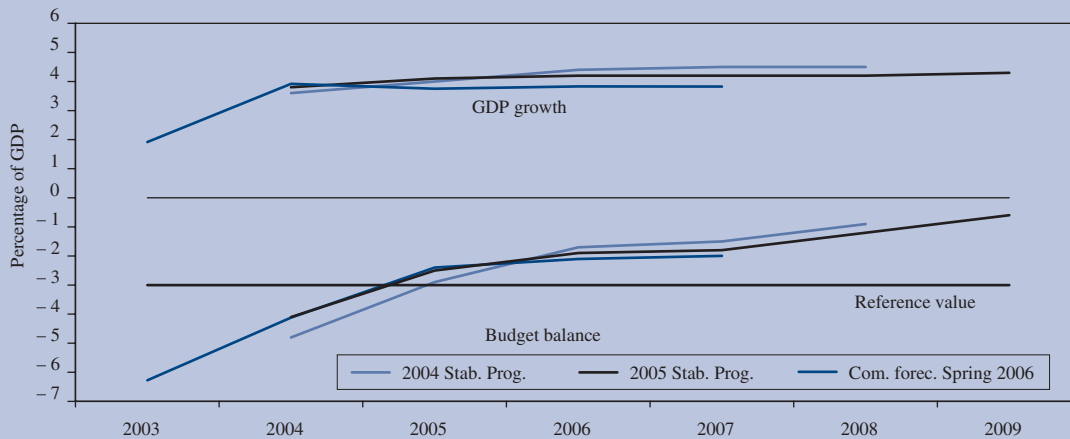
Graph I.16: **Budgetary plans, forecasts and outcomes in Malta**
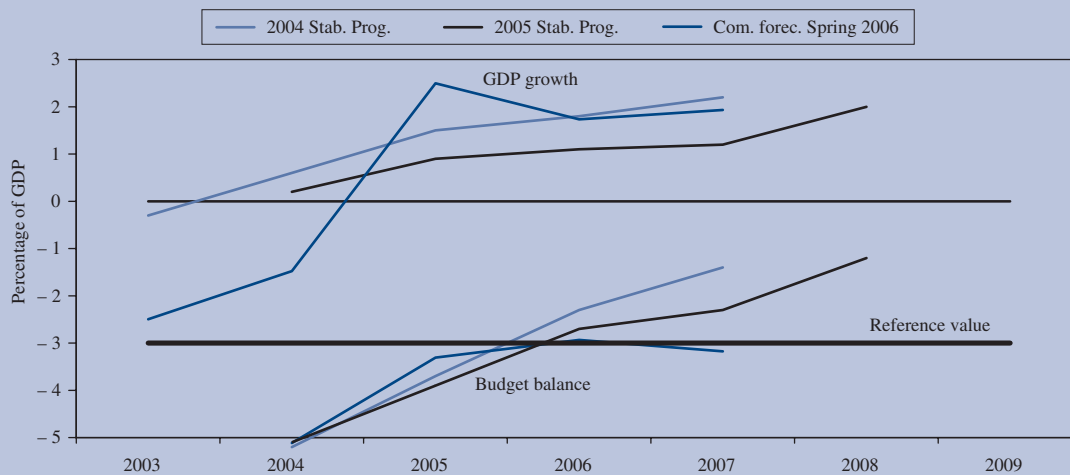
ticular, Poland was recommended to implement with vigour the measures envisaged in the convergence programme, in particular those contained in the so-called Hausner plan. This plan was proposed in 2003 and aimed at reducing public expenditure on social protection, public administration and State aid. The Polish authorities were recommended to take effective action by 5 November 2004 regarding the measures envisaged to achieve the 2005 deficit target. In addition, the Council invited the Polish authorities to allocate possible extra revenues to decrease the general government deficit.

On 22 December 2004, the Commission stated, in its communication to the Council, that the Polish government had taken effective action regarding the measures envisaged to achieve the 2005 deficit target in response to the Council recommendation. Accordingly, the Commission concluded that no further steps were necessary at that point under the excessive deficit procedure.

The spring 2006 Commission forecast for Poland shows nominal deficits – on current definitions – at the reference value for 2006-07. After the implementation (by

spring 2007) of the March 2004 Eurostat decision on the classification of funded pension schemes, the deficit figures will be revised upwards by close to 2 percent of GDP. Although the projection for 2006 is in line with the Council recommendation under Article 104(7), the budgetary target for 2007 in the most recent update of the convergence programme is not consistent with the correction of the excessive deficit by 2007.

Slovakia

On 5 July 2004 the Council decided that an excessive deficit existed in Slovakia. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007. In particular, Slovakia was recommended to take effective action by 5 November 2004 to achieve the 2005 deficit target, to implement with vigour the measures envisaged in the May 2004 programme, and to accelerate the fiscal adjustment if the implemented structural reforms result in higher growth than expected in the programme, in particular by dedicating any higher-than-budgeted revenues primarily to faster deficit reduction.

The Commission communication of 22 December 2004 concluded that, based on current information and the measures detailed in the 2005 budget, it appeared that the Slovak government had taken effective action to achieve the 2005 deficit target, by the deadline of 5 November, in response to the Council recommendation under Article 104(7) to correct the excessive deficit by 2007 at the latest. The communication concluded that no further steps were necessary at that point under the excessive deficit procedure.

The spring 2006 Commission forecast for Slovakia shows nominal deficits – on current definition – falling below the reference value in 2006-07. After the implementation (by spring 2007) of the March 2004 Eurostat decision on the classification of funded pension schemes, however, deficit figures will be revised upwards by some 1¼ percent of GDP. The projection for 2006 is in line with the Council recommendation under Article 104(7), while the no-policy change forecast for 2007 stands at 3½ percent of GDP including the impact of the Eurostat decision.

Graph I.17: **Budgetary plans, forecasts and outcomes in Poland**
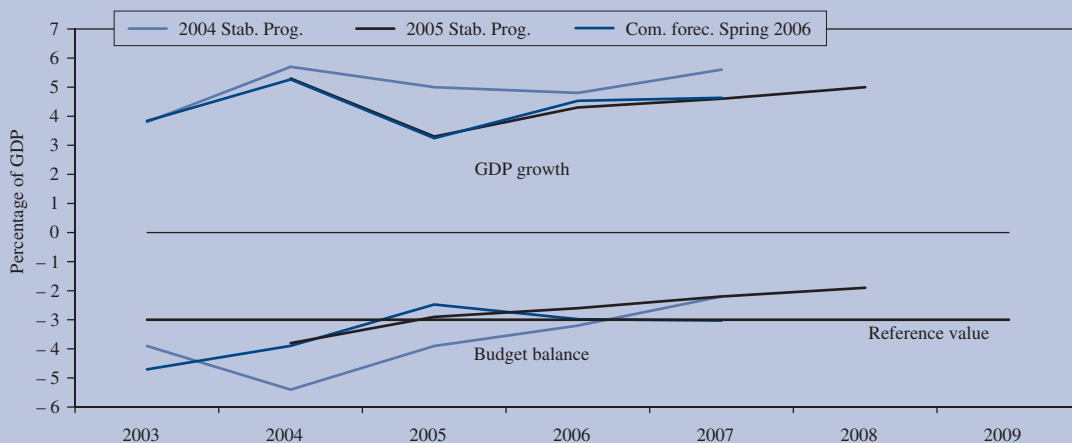
Graph I.18: **Budgetary plans, forecasts and outcomes in Slovakia**
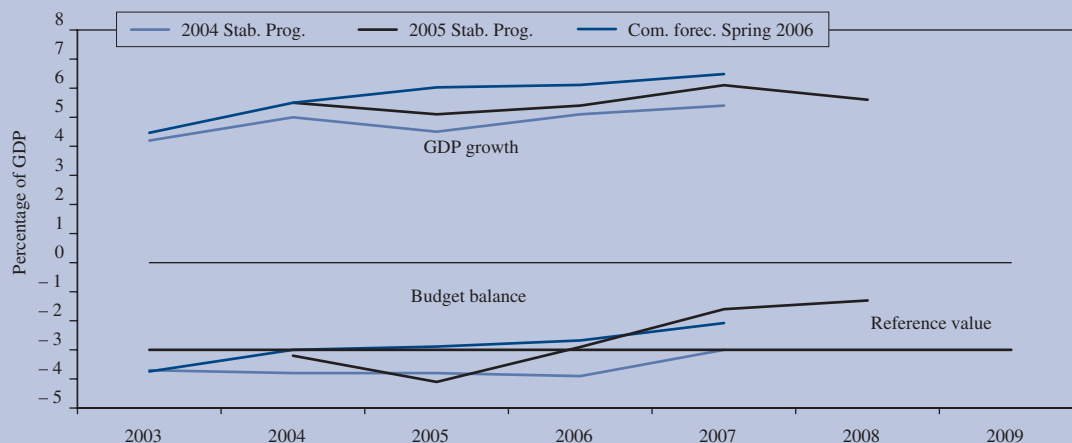
Box I.1: The enforcement mechanisms of the Stability and Growth Pact

This section provides a description of the enforcement mechanisms at the disposal of the Commission and the Council to ensure budgetary discipline in the EU. It first explains the different steps of the *excessive deficit procedure*, which is codified in Article 104 of the Treaty and Council Regulation (EC) No 1467/97, and when these steps need to be activated. In a second step, a short description of the mechanism of *early warning* is provided. This mechanism is codified in Article 99(4) of the Treaty and Articles 6(2) and 10(2) of Council Regulation (EC) No 1466/97.

The excessive deficit procedure

Article 104 of the Treaty states that Member States shall avoid excessive government deficits. In particular Member States shall comply with budgetary discipline by respecting two criteria: a deficit ratio and a debt ratio not exceeding reference values of respectively 3 percent and 60 percent of GDP. Article 104 also sets out the procedure to be followed to identify and correct situations of excessive deficit, and voting modalities in the course of the procedure. The Regulation 1467/97 of the Stability and Growth Pact (SGP) clarifies the procedure.

The first four steps of the procedure, corresponding to provisions of paragraphs 3 to 6 of Article 104, concern the identification of situations of excessive deficit. The excessive deficit procedure is triggered if the deficit of a Member State exceeds 3 percent of GDP [1]. In such a situation, the Commission adopts a report, in accordance with Article 104(3), reviewing in detail the economic and budgetary situation the Member State considered. As foreseen in Article 104(4) and Regulation 1467/97, the Economic and Financial Committee formulates an opinion on this report within two weeks. The Commission takes this opinion into account and, if it considers that an excessive deficit exists, addresses an opinion under Article 104(5) to the Council. On the basis of the Commission opinion, the Council decides on the existence of an excessive deficit under Article 104(6).

The subsequent steps of the procedure are dedicated to the correction of excessive deficits. When it decides that an excessive deficit exists, the Council addresses a recommendation to the Member State concerned in accordance with Article

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[1] Article 104(2) of the Treaty states that a deficit in excess of the 3 percent reference value that is only exceptional and temporary may not be considered excessive in case the deficit remains close to the reference value. A deficit above 3 percent of GDP may also not be considered excessive if it has declined substantially and reached a level that comes close to the reference value. The same Article provides an exception for countries having a debt ratio above 60 percent, if this ratio diminishes sufficiently and approaches the value of 60 percent of GDP at a satisfactory pace.

(Continued on the next page)

104(7). In this recommendation, the Council sets a deadline for the Member State to correct the excessive deficit and a fiscal effort to be achieved by the Member States concerned to this end (at least 0.5 percent of GDP as a benchmark). Regulation 1467(97) specifies that the deadline for the correction of the excessive deficit shall be set taking into account an overall assessment of the factors mentioned in the Article 104(3) of the Treaty.

In case action by the Member State concerned leads to the correction of the excessive deficit, the Council shall decide, in accordance with Article 104(12), to abrogate its decisions under the excessive deficit procedure. In other words, the procedure is closed. In the event the Council considers that no effective action has been taken, it may decide, as stated in Article 104(8) of the Treaty, to make public its recommendation according to 104(7). In case effective action has been taken but events outside the control of the government with large adverse consequences on the budget prevent the correction of the excessive deficit within the time limits set by the Council, the possibility exists to revise the deadline for the correction of the excessive deficit in a new 104(7) recommendation.

The steps described above apply to all EU countries. The further steps of the procedure depend on whether the Member State is a euro area Member State.

The excessive deficit procedure applies in full to euro-area Member States. For these countries, Article 104(9) stipulates that, provided the Council adopts a decision under article 104(8), it may decide to give notice to the Member State concerned to take the necessary measures to reduce the deficit. The recommendations under Article 104(9) of the Treaty shall include a deadline for the correction of the excessive deficit and a fiscal effort to be achieved by the Member States concerned to this end (at least 0.5 percent of GDP as a benchmark).

This step constitutes a move towards even closer surveillance, and is the ultimate step before the possible imposition of sanctions. If the Member State fails to comply with the recommendations, the Council may decide to impose sanctions no later than two months after notice has been given. In case of compliance with the recommendations formulated in the notice under article 104(9), the decisions taken under articles 104(6) to 104(9) are abrogated with a Council decision in accordance with article 104(12), and the procedure is closed. In case effective action has been taken but events outside the control of the government with large adverse consequences on the budget prevent the correction of the excessive deficit within the time limits set by the Council, the possibility exists to revise the deadline for the correction of the excessive deficit in a new 104(9) notice.

As already mentioned, non-euro area Member States are not exempt from the obligation to avoid excessive deficits, but the later steps of the EDP do not apply for them. When a Member States outside the euro area in a situation of an excessive deficit fails to respect the recommendations addressed under Article 104(7), it cannot be submitted to the last two steps of the excessive deficit procedure, namely notice foreseen in Article 104(9) and the imposition of sanctions foreseen in Article 104(11) [1]. Non-compliance with a recommendation under 104(7) may lead to a renewed recommendation according to Article 104(7).

The UK, Sweden, Denmark and the RAMS are in such a situation. The specific situation of the RAMS, which have the status of 'Member States with a derogation', in the sense of Article 122 of the Treaty, was detailed in the 2004 edition of this report. This report also underlined that, in addition to Council recommendations, other channels may act as complementary discipline mechanisms for these countries.

The early warning mechanism

In complement to the Excessive Deficit Procedure, the Treaty foresees in its Article 99(4) the possibility for the Council to make recommendations to Member States in case their economic policies 'are not consistent with the broad guidelines or risk jeopardising the proper functioning of EMU'. Based on this Article, Regulation 1466/97, which codifies the preventive arm of the SGP, provides the Council with the possibility to issue 'early warnings' to Member States in order to prevent the occurrence of an excessive deficit.

Early warnings are issued by the Council, upon recommendation of the Commission, in the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it.

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[1] These Member States have no voting right on decisions provided for under the two paragraphs.

Table I.6

Overview of ongoing excessive deficit procedures

	DE	FR	EL	IT	PT	UK
Commission adopts EDP-report (Art. 104.3) = start of the procedure	19.11.2002	2.4.2003	19.5.2004	7.6.2005	22.6.2005	21.9.2005
Economic and Financial Committee adopts opinion (Art. 104.4)	29.11.2002	13.4.2003	2.6.2004	20.6.2005	4.7.2005	30.9.2005
Commission adopts: • opinion on existence of excessive deficit (Art. 104.5) • recommendation for Council decision on existence of excessive deficit (Art.104.6) • recommendation for Council recommendation to end this situation (Art. 104.7)	8.1.2003	7.5.2003	24.6.2004	29.6.2005	20.7.2005	11.1.2006
Council adopts: • decision on existence of excessive deficit (Art. 104.6) • recommendation to end this situation (Art. 104.7)	21.1.2003	3.6.2003	5.7.2004	28.7.2005[1]	20.9.2005[2]	24.1.2006
• **deadline for taking effective action**	21.5.2003	3.10.2003	5.11.2004	12.1.2006	19.3.2006	24.7.2006
• **deadline for correction of excessive deficit**	**2004**	**2004**	**2005**	**2007**	**2008**	**financial year 2006/07**
Follow-up of the 104.7 Council recommendation						
Commission adopts recommendations for: **Council decision establishing no effective action** **(Art. 104.8)** **Council decision to give notice (Art. 104.9)**	**18.11.2003**	**8.10.2003** **21.10.2003**	**22.12.2004** **9.2.2005**			
Council adopts conclusions (instead of Commission recommendations for 104.8 & 104.9) • **new deadline for correction of excessive deficit** (NB: conclusions **annulled by European Court of Justice on 13.7.2004**)	25.11.2003 **2005**	25.11.2003 **2005**				
Commission adopts communication on budgetary situation **Council** adopts conclusions thereon	14.12.2004 18.1.2005	14.12.2004 18.1.2005				
Council adopts: • decision establishing no effective action (Art. 104.8) • decision to give notice (Art. 104.9) • **deadline for first report to be submitted** • **new deadline for correction of excessive deficit**			18.1.2005 17.2.2005 21.3.2005 **2006**			
Commission adopts communication on action taken				22.2.2006		
Council adopts conclusions thereon **Commission** adopts NEW recommendation for: • Council decision to give notice (Art. 104.9) **Council** adopts: • decision to give notice (Art. 104.9) • **deadline for first report to be submitted** • **new deadline for correction of excessive deficit** **Follow-up of the 104.9 Council notice** **Commission** adopts communication on action taken (cf. first report) **Council** adopts conclusions thereon	1.3.2006 14.3.2006 14.7.2006 **2007**		14.3.2006 6.4.2005 12.4.2005			

[1] Date of political agreement: 12 July (ECOFIN). Actual adoption on 28 July (written procedure).
[2] Date of political agreement: 9/10 September (informal ECOFIN). Actual adoption on 20 September (AGRI/FISH Council).

Continued from Table I.6

Overview EDP – steps to date

	CZ	CY	HU	MT	PL	SK
Commission adopts EDP-report (Art. 104.3) = start of the procedure	12.5.2004	12.5.2004	12.5.2004	12.5.2004	12.5.2004	12.5.2004
Economic and Financial Committee adopts opinion (Art. 104.4)	24.5.2004	24.5.2004	24.5.2004	24.5.2004	24.5.2004	24.5.2004
Commission adopts: • opinion on existence of excessive deficit (Art. 104.5) • recommendation for Council decision on existence of excessive deficit • recommendation for Council recommendation to end this situation	24.6.2004	24.6.2004	24.6.2004	24.6.2004	24.6.2004	24.6.2004
Council adopts: • decision on existence of excessive deficit (Art. 104.6) • recommendation to end this situation (Art. 104.7)	5.7.2004	5.7.2004	5.7.2004	5.7.2004	5.7.2004	5.7.2004
• **deadline for taking effective action**	5.11.2004	5.11.2004	5.11.2004	5.11.2004	5.11.2004	5.11.2004
• **deadline for correction of excessive deficit**	**2008**	**2005**	**2008**	**2006**	**2007**	**2007**
Follow-up of the 104.7 Council recommendation						
Commission adopts communication on action taken	22.12.2004	22.12.2004		22.12.2004	22.12.2004	22.12.2004
Council adopts conclusions thereon	18.1.2005	18.1.2005		18.1.2005	18.1.2005	18.1.2005
Commission adopts recommendation for Council decision establishing no effective action (Art. 104.8)			22.12.2004		To be decided (¹)	
Council adopts decision establishing no effective action (Art. 104.8)			18.1.2005			
Commission adopts recommendation for **new** Council recommendation to end excessive deficit situation (Art. 104.7)			16.2.2005			
Council adopts **new** recommendation to end excessive deficit situation (Art. 104.7)			8.3.2005			
• **deadline for taking effective action**			8.7.2005			
• **deadline for correction of excessive deficit**			**2008**			
Follow-up of the NEW 104.7 Council recommendation						
Commission adopts communication on action taken			13.7.2005			
Council adopts conclusions thereon			-			
Commission adopts recommendation for Council decision establishing inadequate action (Art. 104.8)			20.10.2005			
Council adopts decision establishing inadequate action (Art. 104.8)			8.11.2005			
Commission adopts recommendation for **new** Council recommendation to end excessive deficit situation (Art. 104.7)			To be decided			

(¹) As indicated in the Council opinion of 14 March 2006 on the updated convergence programme, the Commission intends to recommend further steps under the excessive deficit procedure as required by the Stability and Growth Pact.

3. Overview of the 2005 updates of the stability and convergence programmes

3.1. Introduction

The 2005-06 assessment round of Stability and Convergence Programmes was the second one including all the 25 Member States of the enlarged EU and the first one implementing the reformed Stability and Growth Pact (SGP).

While the new principles of the revised Pact were generally well followed-up, the assessment process was hampered by the non-respect of the 1 December deadline set in the 'Code of Conduct' for the submission of stability and convergence programmes. Eighteen countries submitted their programme after the deadline, sometimes several weeks so. The late submission of the programmes gave the Commission little time to prepare a thorough assessment.

The 2005 SGP reform introduced a number of changes to the preventive arm which had an impact both on the format and content of the Stability and Convergence Programmes and on the way the Commission assessment was made. For the first time, EU Member States indicated their medium-term objectives (MTO) in their Stability and Convergence Programmes. The Commission, in assessing the adjustment path towards the medium-term objective, as a result of the SGP reform, took into account, *inter alia*, whether the improvement in cyclically adjusted budget balances net of one-offs was in line with the agreed benchmark after the SGP reform, whether adjustment efforts were stronger in good times, whether structural reforms justified deviations from the adjustment path. All these matters relating to the way the Commission assessed the Programmes are discussed in Part II.2 of the report. In the present section the focus in instead on the content of Stability and Convergence Programmes.

3.2. Medium-term objectives indicated in the Stability and Convergence Programmes

In March 2005 the Council agreed that, until criteria and modalities for taking into account implicit liabilities are established, the country-specific MTOs are set taking into account the following three elements: (i) the government debt ratio; (ii) potential growth; (iii) the need to ensure a safety margin with respect to the reference value of 3 percent of GDP. Moreover, the new Pact states that the MTO for euroa-area coutries and ERMII countries shall not be below -1 percent of GDP.

As foreseen by the reformed SGP, Member States presented their MTOs in their Stability or Convergence Programme updates taking into account the results of discussions following the 2005 reform agreement and further defining modalities regarding the computation.

In some cases the MTOs were not directly specified but could be inferred from the programmes. In the case of the UK, a quantitative medium-term objective was not specified, while the programme referred to fiscal objectives under domestic rules ([1]). The table below presents the country-specific MTOs that the EU Member States set in their programmes.

As shown in the table above, some countries set MTOs that are more ambitious than the minimum required in light of the new texts of the SGP. In most cases, this reflected national strategies to ensure the sustainability of government finances through a rapid decline in the debt to GDP ratio.

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[1] This implies a medium-term path for the cyclically-adjusted deficit, consistent with stabilising the debt-to-GDP ratio at a low level and with keeping the current budget in balance or surplus on average over the economic cycle.

Table I.7

Country-specific MTOs

Country	MTO
AT	0 % of GDP
BE	0.5 % of GDP
CY	– ½ % of GDP
CZ	Around – 1 % of GDP
DE	0 % of GDP
DK	Between 1½ and 2½ % of GDP
EE	0 % of GDP
EL	0 % of GDP
ES	0 % of GDP
FI	Around 1½ % of GDP
FR	0 % of GDP
HU	Between – 0.5 and – 1 % of GDP
IE	Close to balance
IT	0 % of GDP
LT	– 1 % of GDP or below
LU	– 0.8 % of GDP
LV	Around – 1 % of GDP
MT	0 % of GDP
NL	Between – 0.5 % and 1 % of GDP
PL	– 1 % of GDP
PT	At least – 0.5 % of GDP
SE	2 % of GDP
SI	– 1 % of GDP
SK	– 0.9 % of GDP
UK	Fiscal objectives under the domestic rules

Source: Commission services.

3.3. Growth projections

The examination of the 2005 round of updates of stability and convergence programmes, covering the period up to 2009, was completed by March 2006 ([1]).

In order to make an assessment of the budgetary targets set by Member States in the 2005 updates of the programmes, it is necessary to examine the growth assumptions upon which the budgetary commitments are made. The 2005 programme updates project economic growth to recover gradually over the coming years (see Table I.8). The average GDP growth in the EU-25 is expected to pick up from 1.7 percent in 2005 to 2.3 percent in 2006, 2.4 percent in 2007 and 2.6 percent in 2008. Favourable growth pros-

pects are expected to continue in the new Member States. Growth assumptions concerning euro-area countries can be considered cautious, with growth expected to average 2.1 percent over the period 2006-2008.

In comparison with the 2004 updates of the programmes, growth projections have been revised downwards for all the years covered by the programmes (see also Part II.2 of this report on this point). The revision is particularly large concerning 2005, when growth is estimated to have reached 1.7 percent instead of 2.6 expected. For the years 2006-2008, growth projections were revised slightly downwards, and are marginally more favourable than the Commission autumn 2005 forecast. This was the case for the previous updates as well.

Contrary to previous updates of the stability programmes, growth projections for the programme period seem to be based mainly on cautious or plausible macroeconomic assumptions. This constitutes an improvement compared to the experience of the last few years, which provided evidence of an optimistic bias in the macroeconomic forecasts associated with budgetary plans. As a consequence, the growth projections for the euro area in 2006 as derived from the stability programmes is very similar to the one projected in the Commission services' spring 2006 forecast.

3.4. Budgetary plans

Based on these growth assumptions, the nominal deficit in the EU-25 and in the euro area is projected to be reduced to 2.5 percent of GDP in 2005. The improvement relies notably on the large budgetary consolidation projected in the Member States in EDP, such as Germany (1.3 percentage points over the period 2005-2008), France (1.1 percentage points over the same period) and Italy (2.2 percentage points over the same period). Significant consolidation is also expected in Greece (2.6 percentage points over the same period) and Portugal (3.4 percentage points over the same period).

In contrast, the Commission services' spring 2006 forecast projects no change in the nominal budget deficit for the euro area in 2006, which is thus expected to remain at 2.4 percent of GDP. On the basis of unchanged policies, the Commission services' spring 2006 forecast puts it at 2.3 percent of GDP. To some extent the difference between the programme targets and the spring forecast reflects the small gap between both for 2006. More significantly however, the 2007 figures in the programme

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([1]) See Table I.13 of the 2005 updates of the stability and convergence programmes.

updates embody to varying degrees as yet unspecified budgetary measures, while the Commission services' forecast extrapolates revenue and expenditure trends and only includes measures that are known in sufficient detail at the time of completion of the forecast (no-policy-change assumption). The differences are the largest in the cases of Belgium, Greece, Italy and Portugal.

Outside the euro area, substantial consolidation of public finances is foreseen in new Member States with excessive budgetary deficits. Among these, particularly strong reductions are expected in the countries with initially high deficits, such as Malta (2.7 percentage points over the next three years), Slovakia (2.8 percentage points over the same period) and Hungary (4.2 percentage points over the next four years).

According to the 2005 updates of the stability programmes the excessive deficits in Germany is expected to be corrected in 2007, while in France additional budgetary consolidation over the programme period is expected to result in a deficit of 1.9 percent of GDP in 2008. In Greece, the expected deficit is projected to be corrected this year, in Italy, next year, while in Portugal the correction is foreseen to take place in 2008, in line with their respective Council recommendations.

Outside the euro area, sizeable budgetary improvements are expected in all six Member States under the excessive deficit procedure, of which the Czech Republic, Cyprus, Poland and Slovakia have brought the deficit below the 3 percent of GDP reference value in 2005. According to the Commission services' spring 2006

Table I.8

Projections of real growth in the 2005 updates (% change from the previous year)

	2004 ([1])	2005	2006	2007	2008
BE	2.3	2.4	2.3	2.0	2.3
CZ	4.4	4.8	4.4	4.2	4.3
DK	2.0	2.4	2.4	1.1	1.6
DE	1.6	0.9	1.5	1.0	1.8
EE	7.8	6.5	6.6	6.3	6.3
EL	4.7	3.6	3.8	3.8	4.0
ES	3.1	3.4	3.3	3.2	3.2
FR	2.3 ([1])	1.5	2.0	2.3	2.3
IE	4.5	4.6	4.8	5.0	4.8
IT	1.2	0.0	1.5	1.5	1.7
CY	3.8	4.1	4.2	4.2	4.2
LV	8.5	8.4	7.5	7.0	7.0
LT	7.0	7.0	6.0	5.3	6.8
LU	4.4	4.0	4.4	4.9	4.9
HU	4.6	4.2	4.3	4.1	4.1
MT	0.2	0.9	1.1	1.2	2.0
NL	1.7	0.8	2.5	2.5	2.3
AT	2.4	1.7	1.8	2.4	2.5
PL	5.3	3.3	4.3	4.6	5.0
PT	1.2	0.5	1.1	1.8	2.4
SI	4.2	3.9	4.0	4.0	3.8
SK	5.5	5.1	5.4	6.1	5.6
FI	3.6	2.1	3.2	2.6	2.3
SE	3.6	2.4	3.1	2.8	2.3
UK ([2])	3.3	1.8	2.0	2.8	2.8
EU-12	2.1	1.4	2.1	2.0	2.3
EU-25	2.5	1.7	2.3	2.4	2.6

([1]) COM Autumn 2005 Economic Forecast. In the calculation of the euro-area and the EU averages for the year 2004, data from the Commission Autumn 2005 forecast were used for France.
([2]) Financial years ending in following March.

Source: Commission services.

forecast, however, the Czech Republic and Poland are expected to record deficits higher than 3 percent of GDP again in 2006. According to their latest convergence programme updates, Malta and the UK will have deficits below the reference value in 2006, although according to the Commission services' latest forecast this may not be the case for the latter. According to the convergence programme updates, the Czech Republic and Hungary in 2008 are expected to correct their respective excessive deficits in 2008.

Denmark, Ireland, Spain, Finland and Estonia are the only Member States that project a budgetary deterioration between 2005 and the end of the programme period, albeit from a surplus budgetary position. Updates are still more optimistic about budgetary developments in 2006 and 2007 than the Commission Spring 2006 forecasts, in particular those of Greece, Italy, Portugal and Hungary.

3.5. Composition of the budgetary adjustment

The updates of the programmes show that both revenue and expenditure ratios are expected to decline over the programme period (see Table I.10). In the euro area total receipts are expected to fall by 0.6 percentage point between 2005 and 2008, to below 45 percent of GDP by the end of the programme period. This is more than compensated by reductions in the expenditure ratio which,

over the same period, are expected to amount to approximately 1.6 percentage point of GDP. Revenue ratios are projected to decline in all Member States with the exception of Greece, the Netherlands and Portugal, where they are expected to increase. Contrary to this, outside the euro area, total receipts are foreseen to decrease in all countries except for Latvia and the UK, where they are set to rise. Particularly strong reductions in revenue are projected in Estonia, Hungary, Malta and Denmark.

Almost all Member States are set to decrease the expenditure ratio, with the exception of Ireland, Latvia, the Netherlands and the UK. Particularly strong reductions are planned by the Czech Republic, Germany, Estonia, Hungary, Malta and Slovakia.

Graph I.20 presents the contribution to the change in the budget balances from four budget components, namely primary current expenditures, interest expenditure, gross fixed capital formation and total revenues. A number of remarks can be made.

Firstly, Member States that have been under the excessive deficit procedure (EDP) project to improve budget balances substantially via cuts in primary current expenditures. However, Greece, the Netherlands, Portugal and UK foresee to increase reveneus. In the case of France, Hungary, Malta, the Netherlands, Portugal and Slovakia, the budgetary adjustment involves a decline in public investments.

Graph I.19: **Nominal budget balances in the euro area: evolution in projections from the 2000 — 2005 updates of the stability programmes (% of GDP)**

Source: Commission services.

Table I.9
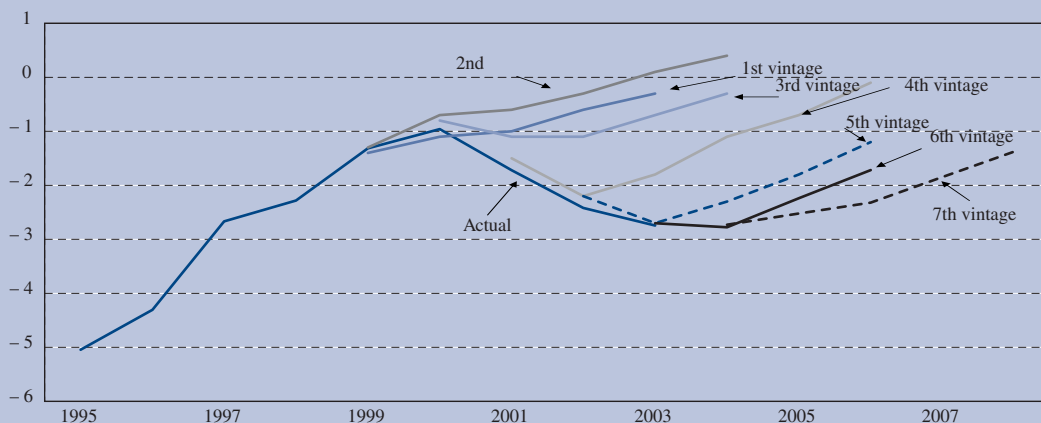
Nominal budget balances in the 2005 updates and the Commission Autumn 2005 forecasts

	2005 updates of the stability and convergence programmes					Commission Autumn 2005 forecasts [1]			Commission Spring 2006 forecasts [1]		
	2004	2005	2006	2007	2008	2005	2006	2007	2005	2006	2007
BE	0.0	0.0	0.0	0.3	0.5	0.0	− 0.3	− 0.5	0,1	− 0.3	− 0.9
CZ	− 3.0	− 4.8	− 3.8	− 3.3	− 2.7	− 3.2	− 3.7	− 3.3	− 2.6	− 3.2	− 3.4
DK	2.0	2.7	2.1	2.2	1.7	3.7	3.0	2.7	4.9	3.9	4.0
DE	− 3.7	− 3.3	− 3.3	− 2.5	− 2.0	− 3.9	− 3.7	− 3.3	− 3.3	− 3.1	− 2.5
EE	1.7	0.3	0.1	0.0	0.0	1.1	0.6	0.4	1.6	1.4	0.8
EL	− 6.6	− 4.3	− 2.6	− 2.3	− 1.7	− 3.7	− 3.8	− 3.8	− 4.5	− 3.0	− 3.6
ES	− 0.1	1.0	0.9	0.7	0.6	0.2	0.1	− 0.4	1.1	0.9	0.4
FR	− 3.7	− 3.0	− 2.9	− 2.6	− 1.9	− 3.2	− 3.5	− 3.5	− 2.9	− 3.0	− 3.1
IE	1.4	0.3	− 0.6	− 0.8	− 0.8	− 0.4	− 0.3	− 0.1	1.0	0.1	− 0.4
IT	− 3.2	− 4.3	− 3.5	− 2.8	− 2.1	− 4.3	− 4.2	− 4.6	− 4.1	− 4.1	− 4.0
CY	− 4.1	− 2.5	− 1.9	− 1.8	− 1.2	− 2.8	− 2.8	− 2.4	− 2.4	− 2.1	− 2.0
LV	− 1.0	− 1.5	− 1.5	− 1.4	− 1.3	− 1.2	− 1.5	− 1.5	0.2	− 1.0	− 1.0
LT	− 1.4	− 1.5	− 1.4	− 1.3	− 1.0	− 2.0	− 1.8	− 1.6	− 0.5	− 0.6	− 0.9
LU	− 1.2	− 2.3	− 1.8	− 1.0	− 0.2	− 2.3	− 2.0	− 2.2	− 1.9	− 1.8	− 1.5
HU	− 5.4	− 6.1	− 4.7	− 3.3	− 1.9	− 6.1	− 6.7	− 6.9	− 6.1	− 6.7	− 7.0
MT	− 5.1	− 3.9	− 2.7	− 2.3	− 1.2	− 4.2	− 3.0	− 2.5	− 3.3	− 2.9	− 3.2
NL	2.1	− 1.2	− 1.5	− 1.2	− 1.1	− 1.8	− 1.9	− 1.5	− 0.3	− 1.2	− 0.7
AT	− 1.0	− 1.9	− 1.7	− 0.8	0.0	− 1.9	− 1.8	− 1.4	− 1.5	− 1.9	− 1.4
PL	− 3.8	− 2.9	− 2.6	− 2.2	− 1.9	− 3.6	− 3.6	− 3.4	− 2.5	− 3.0	− 3.0
PT	− 3.0	− 6.0	− 4.6	− 3.7	− 2.6	− 6.0	− 5.0	− 4.8	− 6.0	− 5.0	− 4.9
SI	− 2.0	− 1.7	− 1.7	− 1.4	− 1.0	− 1.7	− 1.9	− 1.6	− 1.8	− 1.9	− 1.6
SK	− 3.2	− 4.1	− 2.9	− 1.6	− 1.3	− 4.1	− 3.0	− 2.5	− 2.9	− 2.7	− 2,.
FI	2.1	1.8	1.6	1.6	1.5	1.9	1.9	1.8	2.6	2.8	2.5
SE	1.6	1.6	0.9	1.2	1.7	1.4	0.8	1.1	2.9	2.2	2.3
UK [1]	− 3.3	− 3.2	− 2.9	− 2.5	− 2.0	− 3.4	− 3.3	− 3.0	− 3.5	− 3.0	− 2.8
EU-12	− 2.5	− 2.5	− 2.3	− 1.8	− 1.4	− 2.9	− 2.8	− 2.8	− 2.4	− 2.4	− 2.3
EU-25	− 2.5	− 2.5	− 2.3	− 1.8	− 1.4	− 2.7	− 2.7	− 2.7	− 2.3	− 2.3	− 22

[1] Financial years ending in following March, excluding the UMTS receipts.

Source: Commission services.

The decline in the new Member States implies that the budgetary adjustment arising from this item is coming to an end, particularly given their substantial investment needs to improve the infrastructure. Among countries in EDP, a significant fall in interest expenditure over the programme period is expected to contribute to an improvement in budget balance in Greece, France, Italy, Malta and Poland.

Secondly, Czech Republic, Italy, Poland and UK plan to increase the expenditure ratio (notably public investments). In the UK case this is financed by an increase in the revenue ratio, which should help reducing the deficit to closer to balance.

Thirdly, several Member States with budget close-to-balance or in surplus in 2005 (Belgium, Denmark, Estonia, Ireland, Finland and Sweden) foresee cuts in primary current expenditures as well as in taxes, thereby reducing the size of the public sector while maintaining sound budgetary positions. Finally, deterioration in the budget balance over the period is expected in Denmark, Estonia, Spain, Ireland and Finland, albeit from a position of budgetary surpluses. In Estonia and Finland the reduction in revenues is partially compensated by cuts in primary current expenditures, and in public investments.

Table I.10

Revenue and expenditure ratios in the 2005 updates

	Total revenues			Total expenditures		
	2005	**2008**	**2005-08**	**2005**	**2008**	**2005-08**
BE	49.7	48.8	− 0.9	49.7	48.3	− 1.4
CZ	41.1	40.9	− 0.2	45.9	43.6	− 2.3
DK	55.0	52.2	− 2.8	52.3	50.5	− 1.8
DE	43.4	42.5	− 0.9	46.7	44.0	− 2.7
EE	41.2	37.2	− 4.0	40.9	37.2	− 3.7
EL	41.1	41.9	0.8	45.4	n.a.	n.a.
ES	39.4	38.9	− 0.5	38.4	38.3	− 0.1
FR	50.8	50.2	− 0.6	53.8	52.1	− 1.7
IE	35.3	34.4	− 0.9	33.2	33.3	0.1
IT	44.9	44.2	− 0.7	49.2	47.5	− 1.7
CY	41.2	39.6	− 1.6	43.8	40.8	− 3.0
LV	35.3	37.4	2.1	36.8	38.7	1.9
LT	33.5	33.0	− 0.5	35.1	34.0	− 1.1
LU	44.7	44.3	− 0.4	47.0	44.5	− 2.5
HU	45.1	41.7	− 3.4	51.2	43.6	− 7.6
MT	45.7	40.9	− 4.8	49.6	42.1	− 7.5
NL	46.0	47.0	1.0	47.2	48.1	0.9
AT	47.6	46.7	− 0.9	49.5	46.7	− 2.8
PL	42.0	40.5	− 1.5	44.9	42.4	− 2.5
PT	41.4	42.5	1.1	47.4	n.a.	n.a.
SL	44.9	43.1	− 1.8	46.7	44.2	− 2.5
SK	37.8	37.2	− 0.6	41.9	38.5	− 3.4
FI	53.2	52.0	− 1.2	51.4	50.5	− 0.9
SE	58.9	57.7	− 1.2	57.3	56.0	− 1.3
UK*	38.7	40.2	1.5	41.9	42.2	0.3
EU-12	**45.3**	**44.7**	**− 0.6**	**47.8**	**46.2**	**− 1.6**
EU-25	**44.5**	**44.2**	**− 0.4**	**47.0**	**45.6**	**− 1.4**

NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes. Therefore, the net lending implied by this table may be different from the one in table 8.
([1]) Financial years ending in following March. Concerns total current revenue.

Source: Commission services.

3.6. Debt projections

The gross debt to GDP ratio in the euro area is expected to have increased to 71.0 percent of GDP in 2005 (see Table I.12). As it was the case in the previous vintages of updates, most Member States revised their debt level upwards but project a gradual improvement in the debt ratio over the programme period. However, the adjustment path is slower and the debt ratio for 2007 is projected to be 2.1 percentage point higher than the figure projected in the 2004 updates (see Graph I-21 and even higher compared to the previous updates. This is mainly due to smaller primary surpluses, although the contribution from the nominal GDP growth is expected to slightly increase given the positive growth outlook.

Table I.11 also shows that the estimated stock-flow component on average increases the debt ratio up to 2006, while from 2007 to 2008 their contribute is negative. This could stem from plans to build up financial assets (for example public pension reserve funds which are invested in non-governmental assets).

Table I.12 shows that although all seven euro area Member States with debt levels currently above the 60 percent of GDP ceiling that (Belgium, Germany, Greece, France, Italy and Austria), plan to reduce their debt levels over the programme period, only Austria expects it to be below the debt reference value by the end of it. Portugal, however, is expecting a rise in debt ratio over the same period. On the other hand, by the end of the programme

Graph I.20: **Contributions to change in budgetary position 2005-2008 (in percentage points)**
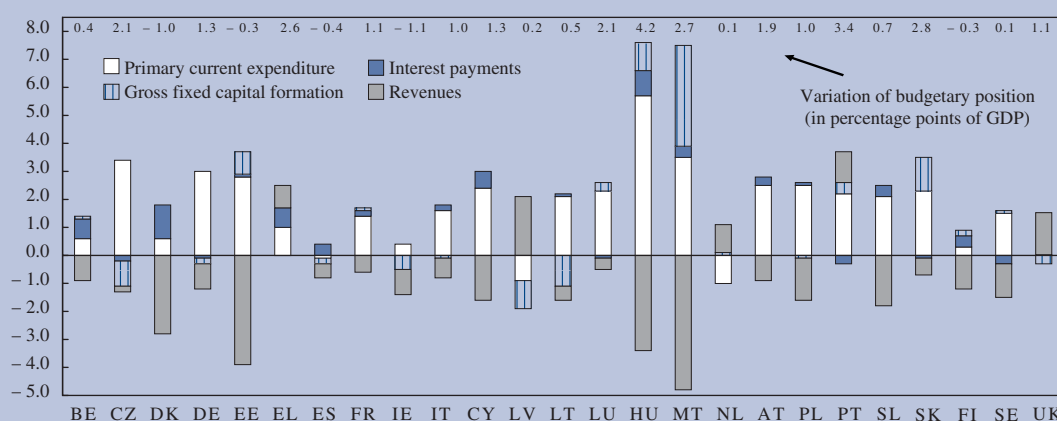
Source: 2005 updates of the stability and convergence programmes. A positive value indicates a positive contribution to the change in budgetary position. A positive value in total variation of budgetary position (value is presented on top of columns) implies an improvement of the balance.

Table I.11

Euro area – Gross debt level and changes in the 2005 updates

	2005	2006	2007	2008
Gross debt level	71.0	70.8	69.6	64.7
Change in gross debt	0.8	− 0.1	− 1.1	− 1.3
Previous updates of the programmes	70.0	69.4	68.4	67.6
Difference	1.0	1.4	1.2	− 2.9
Contributions to change in gross debt				
Primary balance	− 0.2	0.0	0.4	0.6
Interest expenditure	3.1	3.0	3.0	2.9
Nominal GDP growth	− 2.0	− 2.6	− 2.6	− 2.6
Other factors influencing the debt ratio *	0.3	0.2	− 1.0	− 1.2

NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes. * The programmes do not always contain enough information to identify directly the contribution from different factors to the development of the euro-area debt ratio. Therefore, it has been necessary in some cases to 'identify' the contribution from nominal GDP growth (GDP deflator plus real GDP growth multiplied by the debt ratio). In this way, the stock-flow adjustment is derived as a residual.

Source: Commission services.

period only Ireland and Luxembourg plan not to have their debt levels above 30 percent of GDP.

In the Member States outside the euro area, government debt is on the average significantly lower. Overall, apart from the Czech Republic, Poland, Slovenia, Slovakia and the UK, all non-euro area Member States are expected to have lower debt levels in 2008 than in 2005. By the end of the programme period only in Malta, government debt is expected to stay above the 60 percent of GDP reference value. Finally, in five countries, namely, Denmark, Estonia, Latvia, Lithuania and Slovenia, debt levels are expected to be below 30 percent of GDP at the end of the programme period.

Graph I.21: **Debt to GDP ratio in the euro area: evolution in projections from the 2000 updates to the 2005 updates of the stability programmes (% of GDP)**
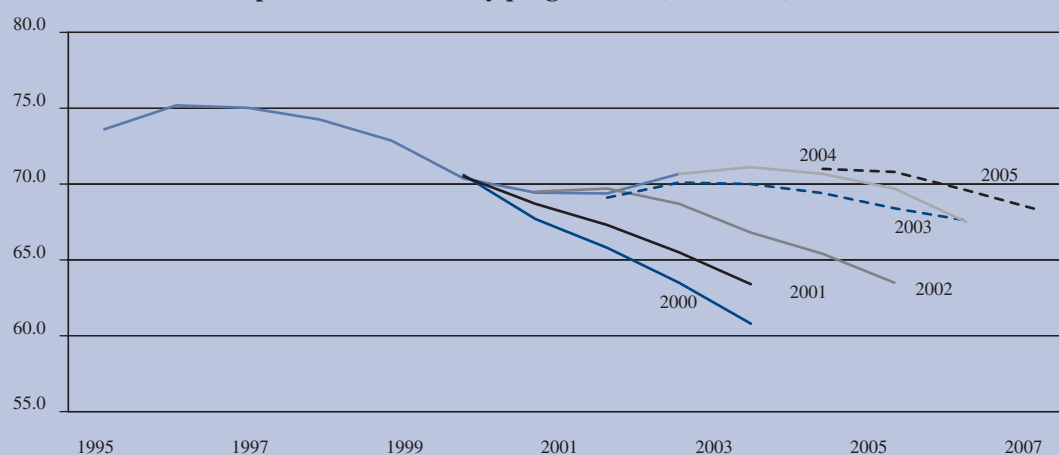
Table I.12

Debt levels in the 2005 updates (as % of GDP)

	2004	2005	2006	2007	2008
BE	94.7	94.3	90.7	87.0	83.0
CZ	36.8	37.4	37.1	37.9	37.8
DK	42.3	35.6	31.7	28.9	26.5
DE	65.7 (¹)	67.5	69.0	68.5	68.0
EE	5.4	4.6	4.4	3.3	3.0
EL	109.3	107.9	104.8	101.1	96.8
ES	46.6	43.1	40.3	38.0	36.0
FR	63.2(¹)	65.8	66.0	65.6	64.6
IE	29.4	28.0	28.0	28.2	28.3
IT	106.5	108.5	108.0	106.1	104.4
CY	71.3	70.5	67.0	64.0	56.9
LV	13.1	14.9	13.6	13.7	14.7
LT	19.5	19.2	19.9	19.8	18.9
LU	6.6	6.4	9.6	9.9	10.2
HU	57.2	57.7	58.4	57.9	56.2
MT	76.7	76.7	70.8	68.9	67.3
NL	53.1	54.4	54.5	53.9	53.1
AT	63.6	63.4	63.1	61.6	59.5
PL	41.9	42.5	45.0	45.3	45.4
PT	59.4	65.5	68.7	69.3	68.4
SL	29.5	29.0	29.6	29.8	29.4
SK	42.6	33.7	35.5	35.2	36.2
FI	44.9	42.7	41.7	41.1	40.6
SE	51.1	50.9	49.4	47.8	46.0
UK (¹)	40.5	42.7	44.1	44.7	44.7
EU-12	70.1	71.0	70.8	69.6	64.7
EU-25	62.8	63.6	63.6	62.6	61.5

(¹)   Financial years ending in following March.

Source: Commission services.

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Table I.13

Council examinations of the updated SCPs 2005

	Macroeconomic outlook	MTO?	Risks to budgetary targets	EDP correction on track? (deadline)	Safety margin provided?	MTO achieved? Adjustment path? (4)	Debt ratio sufficiently diminishing?	Long-term sustainability
BE 2005-2009	Plausible	0.5 % of GDP, identified	Worse than projected, especially in 2006-2007	N.A.(2)	Yes	From 2007 Could be strengthened in 2006	Yes	Medium risk
CZ 2005-2008	Plausible, tilted to favourable in outer year	Around – 1 % of GDP, identified	Broadly balanced	Yes (2008)	N.A. (3)	Beyond programme horizon N.A. (3)	N.A. (6)	High risk
DK 2005-2010	Cautious, in particular 2007-08	1½ — 2½ % of GDP, inferred	Better than projected	N.A.(2)	Yes	Yes, throughout programme period. No pro-cyclicality in good times	N.A. (6)	Low risk
DE 2005-2009	Plausible, tilted to slightly favourable in outer years	0 % of GDP, identified	Balanced in 2006, worse than projected from 2007	Yes (2007)	From 2008	Beyond programme horizon Broadly in line with Pact	No	Medium risk
EE 2005-2009	Markedly cautious	0 % of GDP, identified	(Significantly) better than projected	N.A.(2)	Yes	Yes, throughout programme period. Risk of pro-cyclicality in good times in 2006	N.A. (6)	Low risk
EL 2005-2008	Favourable	0 % of GDP, identified	Worse than projected	Yes (2006)	No	Beyond programme horizon. Could be strengthened in 2008	Yes	High risk
ES 2005-2008	Plausible	0 % of GDP, identified	Broadly balanced	N.A.(2)	Yes	Yes, throughout programme period. Not pro-cyclical	N.A. (6)	Medium risk
FR 2005-2009	Plausible	0 % of GDP, inferred	Worse than projected	Yes (2005)	From 2009	Beyond programme horizon Could be strengthened in 2006	No	Medium risk
IE 2005-2008	Plausible	Close to balance, identified	Better than projected	N.A.(2)	Yes	Yes, throughout programme period. In line with Pact.	N.A. (6)	Medium risk
IT 2005-2009	Plausible	0 % of GDP, identified	Worse than projected	Yes (2007)	Possibly from 2009	Beyond programme horizon In line with Pact	No	Medium risk
CY 2005-2009	Plausible until 2007, slightly favourable in outer years	– ½ % of GDP, identified	Broadly balanced	Yes (2005)	From 2008	(Almost) from 2009 Broadly in line with Pact	Yes	High risk

(Continued on the next page)

Table 1.13 (continued)

LV 2005-2008	Plausible	Around – 1 % of GDP, identified[9]	Worse than projected	N.A.[2]	Yes	Possibly not by 2008 Could be strengthened in 2006	N.A. [6]	Low risk
LT 2005-2008	Plausible (and cautious 2007)	– 1 % of GDP or below, identified	Broadly balanced	N.A.[2]	From 2007	Possibly not by 2008 Could be strengthened in 2006-2008	N.A. [6]	Low risk
LU 2005-2008	Broadly plausible, tilted to slightly favourable in outer years	– 0.8 % of GDP, identified	Worse than projected	N.A.[2]	Yes, but risk in 2007	From 2008 Could be strengthened in 2006	N.A. [6]	Medium risk
HU 2005-2008	Plausible, tilted to favourable in outer year	– 0.5 —1 % of GDP, inferred	(Much) worse than projected	No (2008)	N.A.[3]	Beyond programme horizon N.A.[3]	N.A. [6]	High risk
MT 2005-2008	Plausible, except in 2006	0 % of GDP, identified	Worse than projected	Yes (2006)	From 2007	From 2008 In line with the Pact after the EDP correction	Yes	Medium risk
NL 2005-2008	Plausible	Between – 0.5 % and — 1 % of GDP, identified	Broadly balanced	N.A.[2]	Yes	Yes, throughout programme period Could be strengthened in 2006	N.A. [6]	Medium risk
AT 2005-2008	Plausible	0 % of GDP, identified	Balanced in 2006, worse than projected in outer years	N.A.[2]	Yes	Possibly not by 2008 In line with the Pact	Yes	Low risk
PL 2005-2008	Plausible, tilted to favourable in outer year	– 1 % of GDP, identified	Worse than projected	No (2007)	N.A.[3]	Beyond programme horizon N.A.[3]	N.A. [6]	Low risk
PT 2005-2009	Favourable, especially in outer years	At least -0.5 % of GDP, identified	Worse than projected	Yes (2008)	No	Beyond programme horizon In line with the Pact after the EDP correction	Yes, if targets are achieved	High risk
SI 2005-2008	Plausible	– 1 % of GDP, inferred	Broadly balanced	N.A.[2]	Yes	From 2008 Could be strengthened, especially in 2006	N.A. [6]	High risk
SK 2005-2008	Plausible	– 0.9 of GDP, identified	Broadly balanced	Yes (2007)	No	Beyond programme horizon Could be strengthened in 2008	N.A. [6]	Low risk
FI 2005-2009	Cautious	Around 1½ % of GDP, inferred	Broadly balanced	N.A. [2]	Yes	Yes, throughout programme period In line with Pact.	N.A. [6]	Low risk
SE 2005-2008	Plausible	2 % of GDP, inferred	Better than projected	N.A.[2]	Yes	Broadly yes, except 2006-07 Risk of pro-cyclicality in good times	N.A. [6]	Low risk

Table 1.13 (continued)

| UK 2005/06 – 2010/11 | Broadly plausible, with a margin of caution towards end of period | Unknown (fiscal objectives under domestic rules) | Worse than projected, especially in short term | Deadline for taking effective action is 24 July 2006. (Financial year 2006/2007) | Possibly from 2010/11 | N.A. (7) Could be strengthened from 2007/08 (5) | N.A. (6) | Medium risk |

(1) Identified = 'explicitly identified in the programme'; Inferred = 'inferred from the programme's projections'; Unknown = 'not specified in the programme'.
(2) Not relevant because the country is not in excessive deficit.
(3) Not relevant because the country corrects the excessive deficit only at the end of the programme period
(4) Namely: for countries that are in MTO, whether pro-cyclical fiscal policies are avoided in good times, and for countries that are not yet in MTO, whether the adjustment (towards the MTO) is in line with the Pact (0.5 benchmark for euro area and ERMII countries and higher in good times).; for countries in EDP, this is assessed for the period after the correction of the excessive deficit.
(5) Not relevant because debt ratio was below 60 % in 2005.
(6) Broad economic policy guidelines; NRP=National Reform Programme.
(7) Not relevant because the MTO is unknown.

Box I.2: **Making the SGP reform take root: an increasing role for national institutions, including parliament**

Slippages of budgetary results compared with plans from SCPs were among the reasons leading to the revision of the preventive arm of the Pact in 2005. Member States' commitment to the Pact diminishing over time was partly related to insufficient involvement of national institutions, including national parliaments in the preparation and discussion of SCPs or in the discussion of EDP procedures. This conclusion was reflected in the ECOFIN report of March 2005 (Council, 2005a), which states that 'the Council invites Member States' governments to present Stability and Convergence Programmes and the Council opinions thereon to their national parliaments. National parliaments may wish to discuss the follow-up to recommendations in the context of the early warning and the excessive deficit procedures'. Recent academic work has emphasised the importance of national institutions in this domain, particularly the idea that stronger national 'ownership' can potentially increase the effectiveness of EU rules and mechanisms (see, e.g., discussion in Buti et al. (2005), Hallerberg et al. (2001) and European Commission (2005)).

Some specific recommendations are embedded in the revised Code of Conduct endorsed by the ECOFIN Council in October 2005 (Council, 2005b). The Code includes provisions that 'Each programme mentions its status in the context of national procedures, notably with respect to the national parliament. The programme also indicates whether the Council opinion on the previous programme has been presented to the national parliament'.

So far the involvement of national Parliaments with EU budgetary surveillance remains limited. The table below indicates in summary form the extent of national parliamentary involvement in EU budgetary surveillance processes, distinguishing practice in terms of the instruments involved: national Stability or Convergence Programmes, Council Opinions on these programmes and Excessive Deficit Procedures (EDPs). Two of the indicators concerning national Stability and Convergence Programmes are purely passive, those recording whether the programmes are formally submitted to Parliament (only a bare majority are) and the recording in the Programmes themselves of whether Council Opinions on the previous programme were presented to parliament (the vast majority of programmes submitted in the 2005-06 round omitted this mention, despite it being recommended in the Code of Conduct for their preparation). Among the more active indicators, no country makes its national programme as such subject to explicit parliamentary approval, although substantial content could be said to be subject to such approval in the cases of Austria and the United Kingdom.

The situation regarding parliamentary involvement between oversight of Council Opinions and EDP procedures is very similar. Only in about a quarter of Member States is there some parliamentary scrutiny, and among these about half are concerned only with the procedures related to the same Member State, with the other half of this group scrutinising procedures for all Member States. In the great majority of Member States, parliaments have not so far involved themselves in these processes on any regular footing.

Table I.14

Parliamentary oversight of EU budgetary surveillance in the 25 Member States (number of cases)

National stability/convergence programme		
Formally submitted to Parliament?	No:12	Yes:13
Subject to explicit approval of Parliament?	No: 25	Yes: 0
Indicates whether Opinion on previous programme has been presented to Parliament ([1])?	No:23	Yes: 2
Council Opinions on Member State programmes		
Formally scrutinised by Parliament?	No:18	Yes:7
If so, for all Opinions or just for own country?		All:3
		Own:4
Council EDP surveillance instruments		
Formally scrutinised by Parliament?	No:19	Yes:6
If so, for all Member States or just for own country?		All:3
		Own:3

([1])   Guideline in code of conduct

4. The long-term sustainability of public finances based on the 2005/06 updates of the stability and convergence programmes

4.1. Introduction

The projected demographic changes, with the old-age dependency ratio doubling over the coming decades in the EU, have led to growing concerns regarding the long-term sustainability of public finances. Since the launch of the euro in 1999, the Commission has sought to integrate an examination of the sustainability of public finances into the existing EU framework for the surveillance of Member States' economic and budgetary policies, in line with the conclusions of the Stockholm (March 2001) and Barcelona (March 2002) European Council meetings and the March 2003 Ecofin Council. More recently and importantly, the 22-23 March 2005 European Council put increased emphasis on long-term sustainability issues in the context of the reform of the Stability and Growth Pact.

The Commission is therefore regularly producing assessments of long-term sustainability of public finances in the context of the Stability and Growth Pact. This note presents the overview of the assessment of the long-term sustainability of the public finances based on the 2005/06 updates of Stability and Convergence Programmes (SCPs).

The assessment of long-term sustainability of public finances is a multifaceted issue and there is not a unique indicator that provides a clear response to what extent a country's public finances are sustainable in the long run. The Commission and the Council therefore assesses long term sustainability of public finances by using both quantitative indicators and qualitative information ([1]). The main quantitative indicators of public finance sustainability risks are the sustainability gaps that measure

the difference between the current and planned budgetary positions and that ensure sustainable public finances.

Greater attention has been devoted to systematically take account of qualitative features when making the assessment, which is key in enriching the interpretation of the quantitative results obtained. The main qualitative features considered in the assessment are: the current level of the debt ratio, the impact of structural reforms, the reliability of the projections and the current level of the tax burden.

4.2. The approach used to assess the long-term sustainability of public finances

There is not a unique definition of long-term sustainability of public finances. In the absence of an agreed definition in the literature, a pragmatic definition of what constitutes a sustainable public finance position is used in the assessment by the Commission and the Council, namely whether on the basis of current policies and projected budgetary trends Member States will: (i) meet the government's intertemporal budget constraint so that the discounted value of future revenues matches the discounted value of future government expenditures and the level of outstanding debt; and, (ii) continue to comply with the budgetary requirements of EMU, and in particular, the Treaty requirement to keep debt levels below the 60 percent of GDP reference value.

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[1] The EU approach to assessing sustainability is described in detail in Annex 11 of 'The impact of ageing on public expenditure: projections for the EU-25 Member States on pensions, healthcare, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006.

The assessment of this requirement is a multifaceted issue and there is not a unique indicator allowing to give a clear response on the extent of sustainability challenges a country is facing in the long run. The Commission approach, as agreed by the EPC, takes into account several factors to complement the available information on future quantitative budgetary trends.

The Commission and the Council assessed long-term sustainability of public finances using both quantitative indicators and qualitative information in order to arrive at an overall assessment of the budgetary challenge posed by ageing populations.

A complete description of the method used to assess long-term sustainability of public finances in the EU framework is given in the Annex of 'EPC and EC' (2006) (henceforth the 'Ageing report') ([1]) and in the European Commission (2005). The main improvements compared to last year's assessment, are as follows:

- A decomposition of the indicators has been introduced. It now separates the pure impact of ageing (i.e. the impact of the rise in age-related expenditure on the indicators) and the impact of the initial budgetary position (mainly the distance between the actual structural primary balance from the long-term debt-stabilizing primary balance) ([2]). It therefore enables to analyse separately the source of the risks to long-term sustainability of public finances.

- A new sensitivity test on the cost of a delay, which calculates the supplementary budgetary cost that arises if a budgetary adjustment equal to the size of the sustainability gap is made at a later stage.

4.3. The assessment of the long-term sustainability of public finances based on the 2005/06 updates

4.3.1. The data used in the analysis

In agreement with the view of the EPC, the Commission used the commonly agreed underlying assumptions —

which were finalised in November 2005 — as a reference when evaluating the projections in the programmes in the assessment of public finance sustainability ([3]). Table 1 summarises the macroeconomic assumptions underlying the long-term budgetary projections in the 2005/2006 updated stability and convergence programmes. In addition, the macroeconomic assumptions used in the common long-term projection exercise are given.

Overall, the underlying assumptions in the updates were close to the commonly agreed ones. There are however some differences that may be noted; for some countries (CY, HU and to some extent UK), labour productivity growth and real GDP growth are assumed to be higher in the SCPs than in the Ageing Report (AR), suggesting that the projections are based on more optimistic underlying assumptions.

Table I.16 presents projected budgetary changes between the last year of the programme period (usually 2008) and 2050 provided in the Stability and Convergence Programmes. In addition, the common long-term budgetary projections conducted by the EPC and the Commission are provided. Since the results of the common projections exercise were not available in time for the submission of the SCPs, the national projections were used in the assessment of public finance sustainability. This approach was agreed by the EPC in Autumn 2005.

Overall, the budgetary projections in the Stability and Convergence Programmes were close to the commonly agreed ones. As expected in view of the rising proportion of older persons in the EU over the coming decades, age-related expenditures are projected to rise significantly in the years to 2050. Especially pension but also healthcare and long-term care expenditures are of the highest concern for the long-term sustainability of public finances.

In turn, other age-related expenditures — unemployment and education — are projected to decline as a result of demographic changes in the vast majority of countries, although insufficiently to offset the increase in pension and healthcare expenditures. There are large divergences between countries with regard to pension expenditure, reflecting very diverse arrangements for public pensions. Differences in the other age-related expenditure items projections are smaller. Future pension expenditures therefore

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([1]) The Annex to the ageing report is available at: http://europa.eu.int/comm/economy_finance/epc/documents/2006/ageingannex_en.pdf.
([2]) In the case of S1, the decomposition also separates the impact of the debt position (60 percent of GDP in 2050). In particular, if the current debt/GDP ratio is below 60 percent of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

([3]) See 'The 2005 EPC projections of age-related expenditure (2004-2050) for the EU-25 Member States: underlying assumptions and projection methodologies', European Economy, Special Reports No 4, 2005.

Table I.15

Macro-economic assumptions according the national SCPs and the EPC projections

	Real GDP growth						Labour productivity growth					
	2010		2030		2050		2010		2030		2050	
	SCP	AR	SCP	AR	SCP	AR	SCP	AR	SCP	AR	SCP	AR
BE	2.2	2.7	1.5	1.3	1.6	1.5	1.3	1.7	1.8	1.7	1.8	1.7
CZ	3.6	3.6	1.9	1.9	0.8	0.8	3.4	3.4	2.7	2.7	1.7	1.7
DK	2.1	2.1	1.2	1.1	1.7	1.8	1.6	2.1	1.7	1.7	1.7	1.7
DE	2.3	2.3	0.8	0.8	1.2	1.2	1.1	1.1	1.7	1.7	1.7	1.7
EE	5.8	5.6	2.3	2.3	0.6	0.6	5.3	5.1	2.7	2.7	1.7	1.7
EL	:	2.2	:	1.0	:	1.1	:	1.3	:	1.7	:	1.7
ES	2.8	2.8	1.0	1.0	1.0	1.0	1.6	1.6	1.7	1.7	1.7	1.7
FR	2.4	2.4	1.6	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7
IE	5.2	5.2	2.1	2.1	1.6	1.6	3.8	3.8	1.7	1.7	1.7	1.7
IT	1.9	1.9	0.9	0.9	1.2	1.2	1.2	1.2	1.7	1.7	1.7	1.7
CY	4.0	4.5	3.0	2.8	3.0	1.2	3.2	2.9	3.0	2.7	3.0	1.7
LV	7.4	7.4	2.1	2.1	0.4	0.4	6.5	6.5	2.7	2.7	1.7	1.7
LT	6.4	6.1	1.9	1.9	0.4	0.4	5.3	5.1	2.7	2.7	1.7	1.7
LU	4.3	3.9	3.0	3.0	3.0	3.0	1.9	2.3	1.7	1.7	1.7	1.7
HU	4.2	3.3	3.2	2.1	2.5	1.1	3.3	3.1	3.5	2.7	3.5	1.7
MT	2.5	2.5	3.1	3.1	1.7	1.7	0.9	0.8	2.7	2.7	1.7	1.7
NL	1.8	2.1	1.4	1.3	1.8	1.7	1.8	1.7	1.8	1.7	1.8	1.7
AT	1.5	2.6	1.4	1.0	1.4	1.2	1.8	1.7	1.7	1.7	1.7	1.7
PL	5.0	5.0	2.2	2.2	0.4	0.4	3.6	3.6	2.7	2.7	1.7	1.7
PT	2.4	2.4	1.0	1.0	1.0	1.0	2.1	2.1	1.7	1.7	1.7	1.7
SI	3.7	3.6	2.0	2.0	1.1	1.1	3.1	3.1	2.7	2.7	1.7	1.7
SK	5.3	5.3	2.0	2.0	0.3	0.3	4.2	4.2	2.7	2.7	1.7	1.7
FI	2.2	2.2	1.4	1.4	1.4	1.4	1.9	1.9	1.7	1.7	1.7	1.7
SE	2.4	2.9	1.5	1.6	2.0	1.8	2.0	2.6	1.7	1.7	1.7	1.7
UK	2.0	3.0	2.0	1.3	2.0	1.3	2.0	2.4	2.0	1.7	2.0	1.7

Source: Commission services, 2005/06 updated stability and convergence programmes, 2006 Ageing report.

become crucial in terms of differentiating between the budgetary challenges that ageing populations represent in the Member States.

Looking at the 2005/06 SCPs, very high increases in age-related expenditures are projected in SI, PT, IE, CY and CZ, of 8 percent of GDP or more [1]. Relatively high increases in age-related expenditures are also projected in ES, LU, FI, NL, BE, SE, all rising by between 5 and 8 percent of GDP, while in FR, UK, SK, DK, LT the rise is projected to be between 2 percent and 5 percent of GDP. Low increases in age-related expenditures are projected in LV, AT, HU and IT; all with a total rise of less

than below 2 percent of GDP and some countries actually project a fall (PL, EE, MT).

The reasons for this large divergence across countries are primarily due to the design of the pension system in different countries, often linked to whether the pension system has been reformed in recent years or not.

For example, Sweden, France, Germany, Slovakia and Lithuania have introduced pension reforms that limit the increase in pension expenditure and the impact of reforms are even more noticeable for Poland, Estonia, Latvia, Italy and Austria. [2] By contrast, the increase in

[1] It should be noted that Greece did not include any long-term projections in their update programme and that the projected increases from last year's assessment was used for Greece, showing a very high rise of more than 11 percent of GDP in the period to 2050.

[2] Even though pension reforms limit the increase in pension expenditure, the increase in age-related expenditures in SE, FR, DE, SK is higher than 2 percent of GDP up to 2050.

Table I.16

Change in the age-related budgetary items (between last year of the programme and 2050)

	Pensions		Health care		Long-term care		Education		Unemployment benefits		Total age-related		Revenues	Other expend.
	SCPs	AR	SCPs	AR	SCPs	AR	SCPs	AR	SCPs	AR	SCPs	AR	SCPs	SCPs
BE	4.2	5.1	1.9	1.2	1.1	0.9	– 0.3	– 0.3	– 0.9	– 0.3	6.0	6.5	:	– 0.4
CZ	5.4	5.8	2.6	1.7	0.3	0.4	– 0.3	– 0.3	0.0	0.0	8.0	7.5	:	:
DK	0.4	2.7	1.1	0.8	1.1	1.1	– 0.4	– 0.1	:	0.0	2.2 (¹)	4.5	1.0	0.2
DE	2.5	2.4	1.1	1.0	:	1.0	– 0.4	– 0.5	– 0.2	– 0.3	2.9 (¹)	3.7	1.6	:
EE	– 2.6	– 2.9	– 0.3	0.8	:	:	0.0	– 0.4	0.0	0.0	– 2.9 (¹)	– 2.4	1.3	:
EL	10.3	:	1.5	1.6	:	:	0.0	– 0.1	– 0.2	– 0.1	11.6 (¹)	1.3	:	:
ES	6.9	6.8	:	2.1	:	0.3	:	– 0.2	:	– 0.3	6.9 (¹)	8.7	:	:
FR	1.9	1.9	2.4	1.5	:	:	:	– 0.2	:	– 0.2	4.3 (¹)	2.9	:	:
IE	6.1	6.1	2.7	1.8	1.0	0.6	– 0.4	– 0.5	0.0	0.0	9.4	8.0	:	– 0.1
IT	0.5	0.6	0.9	1.2	0.4	0.7	– 0.4	– 0.2	– 0.1	– 0.1	1.3	2.1	:	:
CY	7.7	12.1	1.9	1.0	:	:	– 0.1	– 1.3	:	0.1	9.5 (¹)	11.8	– 0.5	:
LV	0.1	0.1	0.6	0.8	0.1	0.3	– 0.4	– 0.4	– 0.1	0.0	0.3	0.8	– 0.7	:
LT	2.3	2.0	0.8	0.7	0.2	0.3	– 1.2	– 1.1	0.0	0.0	2.0	1.9	:	:
LU	6.5	7.7	:	1.1	:	0.6	:	– 0.8	:	– 0.1	6.5 (¹)	8.4	:	:
HU	1.7	5.9	:	0.9	:	:	:	– 0.3	:	0.0	1.7 (¹)	6.5	– 2.4	:
MT	– 1.4	– 1.2	0.5	1.7	:	0.3	– 0.7	– 0.7	– 0.2	– 0.3	– 1.8 (¹)	– 0.2	– 3.6	:
NL	3.1	3.7	3.2	1.2	:	0.6	:	– 0.1	:	0.0	6.3 (¹)	5.4	3.1	:
AT	– 0.8	– 0.9	1.2	1.4	0.7	0.9	– 0.6	– 0.7	0.0	0.0	0.5	0.7	– 0.3	:
PL	– 4.3	– 4.4	:	1.2	:	0.1	– 1.2	– 1.2	:	– 0.3	– 5.5 (¹)	– 4.6	0.4	:
PT	8.6	8.9	1.1	0.4	0.6	:	0.1	0.0	– 0.1	0.0	10.4	9.4	:	– 0.3
SI	7.3	7.2	2.9	1.4	1.0	1.1	:	0.0	:	0.0	11.2 (¹)	9.8	0.6	:
SK	2.1	2.1	1.4	1.7	:	0.5	– 0.8	– 0.8	– 0.1	– 0.2	2.5 (¹)	3.4	:	– 0.1
FI	2.7	2.7	1.8	1.3	2.4	1.6	– 0.4	– 0.4	:	– 0.1	6.5 (¹)	5.1	4.1	:
SE	1.4	1.3	1.3	1.0	2.9	1.8	– 0.1	– 0.5	– 0.2	0.0	5.3	3.6	0.5	– 1.7
UK	1.8	1.9	1.5	1.7	0.6	0.8	– 0.1	– 0.3	:	0.0	3.7 (¹)	4.2	2.2	– 0.1

NB: Projections on unemployment benefits were provided after the submission of the programmes by the Irish, Portuguese and Estonian authorities. For Cyprus, data under a no-reform scenario were not included in the programme but was provided after the submission of the programme by the Cypriot Ministry of Finance. For Belgium, projections for the period 2030-2050 were provided by the *Bureau Fédéral du Plan* after the submission of the programme. For Greece, the projections from last year's assessment were used and are given in the 'SCP' columns. Moreover, it should be noted that the total age-related expenditures according to the Ageing report does not include pension expenditure projections in the case of Greece. For Austria, the projections for healthcare, long-term care, education and unemployment benefits from last year's assessment were used and are given in the 'SCP' columns. The changes in revenues and other expenditures as a share of GDP are given for information and are taken from the SCPs for the period 2010-2050, except for the UK, where the period is 2014/15-2054/55.

The difference between the projected changes in expenditure on healthcare and long-term care are in some cases large when comparing the projections in the SCPs with those in the AR. This can be due to the differences in the assumptions made or method used. It underlines the importance of basing the analysis on comparable information in terms of underlying assumptions and methodology used.

(¹) One or several expenditure items were not available in the updated stability and convergence programmes. If the projected change in expenditure on healthcare or long-term care is missing, the increase in age-related expenditures is underestimated. If the projected change in expenditure on education or unemployment benefits is missing, the increase in age-related expenditures is in general overestimated. The change in total age-related expenditure as a share of GDP is therefore not fully comparable across the Member States.

Source: Commission services, 2005/06 updated stability and convergence programmes, 2006 Ageing Report (AR).

public expenditure is very high in countries where pension reforms have been limited (e.g. Greece, Portugal, Ireland, Cyprus, Slovenia and the Czech Republic).

The results of the common long-term budgetary projections exercise were released in February 2006, in the middle of the 2005/06 assessment round of the stability and convergence programmes. Overall, they confirm the information from the SCPs, showing a considerable rise in public spending over the coming decades as the effect of ageing takes hold. The common budgetary projections will be used in the report on the long-term sustainability of public finances that the Commission envisaged preparing for the Autumn 2006.

On the revenue side, the level of revenue/GDP ratio was kept constant at the underlying level (net off the cyclical components and one-off measures) reached in the last year of the programme period for all countries. However, as Table I.16 reveals, a number of countries include projections of changes in the revenue/GDP ratio, in some cases the projected changes are substantial.

Some countries also included other long-term expenditure projections than those covered by the common budgetary projections exercise. The changes up to 2050 in those additional projections were in general quite

small when compared to the five expenditure items covered by the common projections. [1]

4.3.2. The quantitative indicators

The quantitative indicators provide estimates of the size of budgetary adjustment that is necessary to achieve sus-

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[1] Such additional projections were given in the SCPs and their impact on the sustainability indicators, as calculated by the Commission services, were given in the respective technical assessments.

Table I.17

Results of the sustainability gap calculations

	S1 indicator, of which:								S2 indicator, of which:					
	Initial budgetary position		Debt position in 2050 [1]		Long-term change in budgetary position	Overall			Initial budgetary position		Long-term change in budgetary position	Overall	
	2005	eop	2005	eop		2005	eop		2005	eop		2005	eop
BE	– 3.3	– 3.3	0.3	0.3	3.0	0.0	0.1		– 3.3	– 3.2	4.7	1.5	1.5
CZ	2.5	1.9	– 0.3	– 0.4	2.2	4.3	3.7		2.7	2.1	4.7	7.4	6.8
DK	– 4.5	– 2.8	– 0.9	– 0.7	1.7	– 3.6	– 1.8		– 4.5	– 2.8	2.0	– 2.5	– 0.8
DE	1.2	– 0.8	0.2	0.1	1.2	2.6	0.5		1.2	– 0.8	2.0	3.3	1.3
EE	– 0.6	– 0.1	– 1.3	– 1.3	– 2.0	– 3.9	– 3.4		– 0.6	– 0.1	– 2.6	– 3.2	– 2.7
EL	0.8	– 0.8	0.6	0.6	4.8	6.2	4.6		1.2	– 0.5	7.8	8.9	7.3
ES	– 2.6	– 1.8	– 0.4	– 0.4	2.7	– 0.3	0.5		– 2.5	– 1.7	4.6	2.1	2.9
FR	1.4	– 1.3	0.1	0.0	2.3	3.8	1.0		1.4	– 1.3	3.5	4.9	2.2
IE	– 2.3	– 1.3	– 1.0	– 0.8	3.9	0.6	1.8		– 2.2	– 1.2	7.2	5.0	6.0
IT	1.0	– 1.8	0.8	0.7	0.7	2.4	– 0.5		1.0	– 1.8	1.0	2.0	– 0.8
CY	– 0.1	– 1.8	0.1	– 0.2	5.1	5.1	3.1		0.0	– 1.7	9.4	9.4	7.7
LV	1.0	0.3	– 0.8	– 0.8	– 0.4	– 0.2	– 0.9		1.2	0.5	– 0.1	1.1	0.4
LT	1.6	0.5	– 0.7	– 0.7	0.4	1.3	0.2		1.8	0.6	1.0	2.8	1.7
LU	1.3	– 0.3	– 1.8	– 1.9	2.8	2.4	0.6		1.3	– 0.4	6.5	7.8	6.1
HU	3.7	0.8	0.2	0.1	0.5	4.5	1.4		4.1	1.2	1.5	5.6	2.7
MT	0.0	– 3.8	0.4	0.2	0.0	0.4	– 3.6		0.4	– 3.4	– 1.1	– 0.7	– 4.5
NL	– 2.0	– 1.4	– 0.2	– 0.1	4.4	2.1	2.9		– 2.0	– 1.3	5.5	3.5	4.2
AT	– 0.5	– 2.0	0.0	0.0	0.6	0.1	– 1.4		– 0.5	– 2.0	0.6	0.1	– 1.5
PL	2.2	1.6	– 0.1	– 0.1	– 4.0	– 1.9	– 2.5		2.7	2.1	– 4.6	– 1.9	– 2.5
PT	3.1	– 1.1	0.2	0.1	4.4	7.7	3.4		3.3	– 0.9	7.2	10.5	6.3
SI	– 0.3	– 0.1	– 0.6	– 0.5	4.9	4.0	4.3		– 0.2	0.1	8.0	7.9	8.1
SK	2.0	1.2	– 0.4	– 0.4	0.5	2.1	1.3		2.3	1.5	1.3	3.6	2.8
FI	– 4.0	– 3.2	– 1.4	– 1.1	4.1	– 1.3	– 0.3		– 4.0	– 3.2	5.4	1.4	2.2
SE	– 3.1	– 3.4	– 0.9	– 0.7	3.2	– 0.7	– 0.8		– 3.1	– 3.4	4.6	1.5	1.2
UK	1.3	– 0.3	– 0.3	– 0.3	1.6	2.6	1.1		1.3	– 0.3	3.1	4.4	2.8

NB: 'eop' indicates the end of the programme period.
[1] In the case of S1, the decomposition also separates the impact of the debt position (60 % of GDP in 2050). In particular, if the current debt/GDP ratio is below 60 % of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

Source: Commission services.

tainable public finances over the long-term (¹). Our analysis reveals that there are large sustainability gaps in a majority of EU Member States according to the S2 indicator when considering the budgetary situation in 2005, the '2005' scenario. Assuming that the medium-term budgetary plans set out in the stability and convergence programmes are fully implemented, the 'programme' scenario, the size of the sustainability gap is usually significantly reduced. Consolidating public finances towards the MTO appears to contribute substantially to cope with the age-related budgetary challenges.

However, large sustainability gaps remains for a majority of Member States even under this assumption, suggesting that more needs to be done in most Member States.

The decomposition of the sustainability indicators introduced in the 2005/06 round of sustainability assessments provides an interesting description of where the sustainability gap mainly stem from. This decomposition distinguishes between the impact on the sustainability indicators (S1 and S2) from: (i) the *initial budgetary position* – i.e. mainly the distance between the actual structural primary balance and the long-term debt-stabilizing primary balance; and, (ii) the *long-term change in the budgetary position* – i.e. the impact of the rise in age-related expenditure on the indicators. The findings from the calculations can be summarised as follows:

- The *initial budgetary position* (the current structural primary balance and the current level of debt) is not sufficiently strong in 2005 – the '2005' scenario — to avoid unsustainable public finances even before considering the budgetary impact of ageing populations in about half of the Member States according to the S1 and S2 sustainability indicators.

- Assuming that the public finances evolve as envisaged over the period covered by the programme – the 'programme' scenario — (which usually involves a fiscal consolidation), the *initial budgetary position* at the end of the programme period would still be too weak, implying that the public finances are on an unsustainable path in about a quarter of the countries even before considering the

Table I.18

The structural primary balance and the required primary balance

	Structural primary balance		Required primary balance
	2005	**End of prog.**	
BE	4.3	4.3	5.6
CZ	− 2.1	− 1.5	5.7
DK	4.7	3.1	1.8
DE	0.0	1.9	3.4
EE	0.6	0.1	− 2.2
EL	0.4	2.0	9.2
ES	3.0	2.3	5.0
FR	− 0.6	2.0	4.1
IE	2.3	1.4	6.9
IT	0.8	3.5	2.9
CY	0.0	1.7	8.8
LV	− 1.0	− 0.3	1.0
LT	− 1.5	− 0.4	1.6
LU	− 1.3	0.4	6.6
HU	− 3.9	− 1.0	1.9
MT	0.3	4.0	− 0.9
NL	2.6	2.0	5.5
AT	1.4	2.9	1.6
PL	− 2.0	− 1.4	− 2.4
PT	− 2.2	1.9	7.8
SI	0.5	0.3	8.1
SK	− 1.8	− 1.0	2.3
FI	3.8	3.2	4.5
SE	3.2	3.6	4.7
UK	− 0.8	0.7	3.4

NB: The structural primary balance equals the cyclically-adjusted primary balance net of possible one-offs and temporary measures relative to GDP. Moreover, in the case of Hungary, Poland and Slovakia, the long-term projections of public pension expenditures as a share of GDP considered in the sustainability analysis assessment included 1st pillar pensions and excluded 2nd pillar funded defined-contribution pension schemes, the latter will be classified outside government from March 2007 onwards in accordance with Eurostat's decision of 2 March 2004. An adjustment (reduction) of government revenue as a share of GDP of the part that is attributed to the 2nd pillar funded defined-contribution schemes is therefore necessary for consistency. The updates of Hungary, Poland and Slovakia provide estimates of this revenue-reducing impact. Reducing current revenue and long-term expenditure (both related to 2nd pillar pension contributions) should be neutral or positive in terms of sustainability. The structural primary balances given in this table may therefore differ from the structural primary balance in the SCPs.

Source: Commission services, 2005/06 updated stability and convergence programmes.

budgetary impact of ageing populations according to both sustainability indicators.

- Ageing populations will result in higher public expenditure as a share of GDP over the coming dec-

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(¹) The sustainability indicators were calculated on the basis of the projected changes in the expenditure items included in the 2005/06 updates of the stability and convergence programmes reported in Table I.16. (pensions, healthcare, long-term care, education and unemployment benefits). For details, see the notes to Table I.16. In addition, they were calculated, were applicable, according to the adjusted gross debt.

Table I.19

Gross government debt (% of GDP)

		Programme scenario			2005 Scenario		
	2005	2010	2030	2050	2010	2030	2050
BE	94.3	75.3	36.1	63.5	73.4	33.6	60.2
CZ	37.4	39.6	79.0	280.2	43.2	95.7	320.3
DK	36.8	21.5	− 15.1	− 37.3	14.4	− 61.2	− 135.5
DE	67.3	65.6	57.9	99.4	73.6	116.2	232.4
EE	4.6	2.5	− 28.2	− 93.2	0.9	− 39.3	− 117.0
EL	107.9	91.0	122.0	346.0	96.9	165.2	451.3
ES	43.1	31.5	9.6	95.8	25.7	− 13.5	42.6
FR	65.8	61.1	64.2	121.2	69.2	132.8	269.9
IE	28.0	24.6	36.7	156.2	13.6	7.9	100.4
IT	108.5	99.1	51.4	30.7	108.9	127.6	208.9
CY	70.5	51.5	70.6	189.5	64.3	116.3	269.9
LV	13.1	11.7	− 0.4	11.1	13.0	14.9	49.6
LT	19.2	18.0	19.9	69.8	22.4	46.7	135.7
LU	6.4	8.9	20.9	109.7	11.5	56.1	179.1
HU	57.7	62.5	76.0	119.3	76.1	143.6	247.6
MT	76.7	60.6	− 1.8	− 106.3	80.2	92.9	79.6
NL	54.4	50.0	88.6	218.1	44.2	67.8	177.7
AT	63.4	54.9	15.0	− 21.2	58.9	54.9	67.5
PL	42.5	51.3	6.2	− 76.3	53.2	20.0	− 42.5
PT	65.5	64.4	89.2	262.5	76.3	195.4	517.4
SI	29.0	28.4	76.3	302.7	25.1	68.5	287.2
SK	33.7	35.9	48.1	130.4	38.7	66.8	176.9
FI	42.7	37.3	38.8	117.3	23.7	7.9	61.6
SE	50.9	39.0	9.6	52.0	30.3	8.0	58.8
UK	43.3	44.4	54.0	110.3	47.0	90.1	186.7

Source: Commission services, 2005/06 updated stability and convergence programmes.

ades in nearly all Member States and the size of this increase will largely depend on the projected change in pension expenditure. Indeed, there is a large dispersion across the countries in terms of the *long-term change in the budgetary position*, with a very large rise of 6 percent of GDP or more in CY, PT, SI, EL and LU according to the S2 indicator.

• The budgetary challenge posed by ageing populations can be reduced by improving and sustaining sound public finances. In a large majority – about three-quarters – of the Member States, the sustainability gap is lower in the 'programme scenario' compared with the '2005 scenario', reflecting the planned consolidation of the public finances for most countries over the programme period. However, even assuming the full implementation of the 'programme scenario', an additional adjustment of 2 percent of GDP or more would still be required in 14 countries according to the S2 indicator.

• In general, the size of the overall sustainability gap corresponds to the size of the long-term change in the budgetary position, notably for the countries with a relatively high and low sustainability gap. This is also the case with regard to the relation between the initial budgetary position and the overall sustainability gap, though it displays more variation.

As noted above, one way to cope with the budgetary implications of ageing is to run and maintain sound public finances. The size of the required budgetary position can be illustrated by the required primary balance (RPB) over the medium-term that would ensure sustainability

over the long-term, shown in Table I.18 (as calculated in the '2005' scenario). In addition, the structural primary balances in 2005 as well as at the end of the programme period are also given.

The debt/GDP ratio is projected to remain above 60 percent of GDP in the '2005' scenario over the coming decades for the EU as a whole and around 2015 it is projected to start rising considerably, revealing that the public finances are on an unsustainable path. If the medium-term budgetary plans in the programmes are implemented, the debt/GDP ratio will instead decline over the next 20 years. This trend would, however, start to reverse once the budgetary impact of ageing starts to take hold and the debt/GDP ratio will again start rising (see Graph I.22 for the EU aggregate).

This points to the importance of consolidating the public finances so as to reduce current and future debt levels. The debt/GDP ratio is above the Treaty reference value of 60 percent of GDP in 10 countries, which makes debt reduction a matter of urgency in these cases (see Table I.19). Indeed, high-debt countries need to keep large primary surpluses for an extended period of time, which may be hard to achieve in practice in view of competing budgetary pressures. They are also more vulnerable to negative interest rate and GDP growth shocks. For countries with a government debt level well above 100 percent of GDP (EL, IT) public finance consolidation is therefore of utmost importance.

4.3.3. The qualitative considerations

In order to interpret the quantitative indicators, it is necessary to take into account other factors so as to identify the main reasons behind the sustainability risks in the formulation of an overall assessment of the long-term sustainability of public finances.

The *current level of the debt/GDP ratio* is an important item in terms of risks to public finance sustainability. High-debt countries may have to sustain high primary surpluses, which might be difficult to maintain over time. Moreover, high-debt countries are more vulnerable to negative growth rate/interest rate shocks. Since the current level of gross debt has a rather limited impact on the sustainability indicators, it requires special attention in the assessment (^{1}). Those arguments notably applied to high-debt countries like Belgium and Italy, which display relatively low sustainability gaps as measured by the indicators. They also apply symmetrically to Luxembourg, being a low-debt country.

When relevant, *structural reforms* are also taken into account. Some of them have a positive impact on the long-term budgetary trends and/or the economic variables underlying such trend but their impact is uncertain and/or have not been quantified in the programmes and are therefore not incorporated in the quantitative indicators. This is particularly the case for recent pension reforms which have not yet been quantified and would be included in the calculations in next rounds.

For example, in the Netherlands a recent reform of disability schemes will reduce expenditure in the long-term. The impact of this reform is not considered in the figures provided in the Dutch stability programme because pension expenditure in the programme does not include disability schemes. It is however included in the pension projections in the Ageing report.

The *reliability of projections* may play a role, particularly when long-term assumptions/projections are considerably different from the common budgetary projections in the Ageing report, suggesting that the indicators may be over/under estimated. Some countries relied on more optimistic underlying assumptions than the commonly agreed ones (CY, HU, UK). This plays a role notably when projections displayed very different outcomes from the (at that time) forthcoming EPC results (notably Hungary). *Missing projections* were also mentioned in a number of cases (DK, DE, EL, FR, ES, LU, HU, MT, NL, PL, SK), which, when omitted, generally underestimates the budgetary impact of ageing.

The *tax ratio* could also play a role. Indeed, it may be more difficult for high tax-ratio countries to increase tax further limiting the possibilities to deal with the budgetary impact of ageing population. This could be the case for high-tax countries as Sweden and Denmark, should the need arise.

Other *long-term budgetary changes* in non-age-related expenditure and/or revenue may be taken into account in the *qualitative* assessment. Indeed, to ensure full comparability across countries, indicators are calculated on the set of items decided at EPC level. But when changes of other items are clearly explained and if the size of their

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(^{1}) The contribution of the debt to the S2 sustainability indicator for a country with a debt/GDP ratio of 100 percent and an interest/growth rate differential of 1.5 percent is in fact 1.5 percent of GDP (debt times the interest/growth rate differential).

Graph I.22: **Debt development in EU**
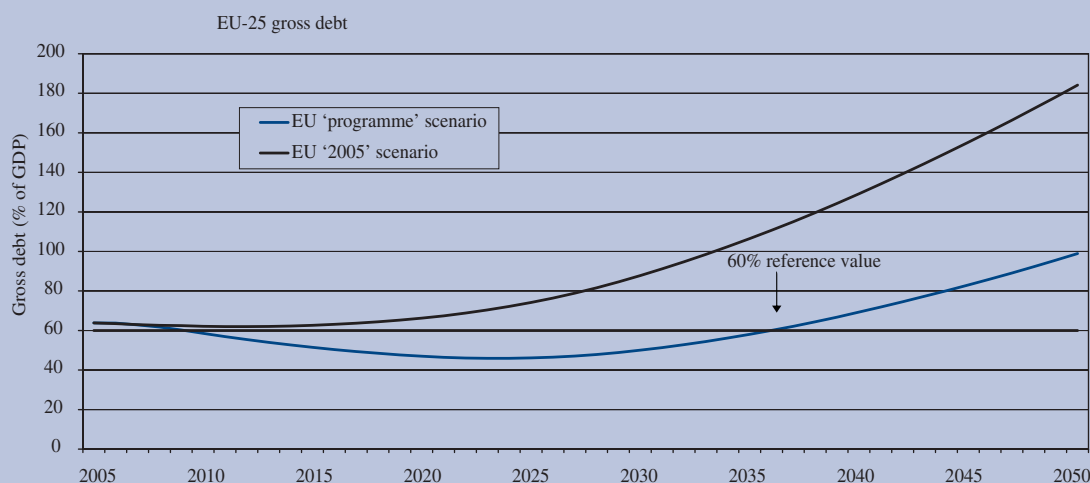
Source: Commission services.

impact seems reasonable, they would be taken into account in the overall assessment.

4.4. Main public finance sustainability challenges in Member States

The budgetary impact of ageing populations is a concern for all EU Member States. There is however a large variation in the degree of risks that they are facing and where they mainly come from. Overall, six countries were assessed to be at high risk, ten at medium risk and nine at low risk in the Council Opinions.

The assessments in the Council Opinion's were in line with the view of the Commission, with the exception of Slovakia (where the Commission's assessment of 'medium' risk was changed to 'low' risk) and the Neth-

erlands (where the Commission's assessment of 'low' risk was changed by the Council to 'medium' risk).

The reasons for the challenges to public finance sustainability are different across the Member States. This reflects a huge variety in terms of both the current and planned budgetary position over the medium-term and the projected budgetary impact of ageing over the long-term. As shown in section 1 above, it is possible to decompose the sustainability indicators (S1, S2) so that the impact of the current budgetary position and the future change (deterioration) is separated.

High-risk countries

Nearly all high-risk countries exhibit a strong increase in age-related expenditures up to 2050. The notable exception is Hungary, who projects a relatively small increase in their convergence programme. However, as shown in Table I.16 above, pension expenditure is projected to rise considerably more according to the projection in the Ageing report, pointing to a significantly higher increase in age-related expenditure than envisaged in the Hungarian convergence programme.

In addition, only Slovenia has relatively sound public finances with a level of debt slightly under 30 percent of GDP and a relatively limited structural public deficit (-1.2 percent of GDP in 2005). Indeed, three countries (EL, CY, PT) have a debt above 60 percent of GDP with structural

Table I.20

Overall classification of risks to sustainability

Risk category	Country
Low	DK, EE, LV, LT, AT, PL, SK, FI, SE
Medium	BE, DE, ES, FR, IE, IT, LU, MT, NL, UK
High	CZ, EL, CY, HU, PT, SI

Source: Commission services.

deficits close to or above 3 percent of GDP; the reduction of the level of debt appears therefore as a priority for those countries. Hungary's debt/GDP ratio is close to the Treaty threshold but its current structural deficit is very large, which implies large sustainability risks for the Hungarian public finances, even without taking account of the impact of ageing on public finances. Finally, the Czech Republic has a level of debt under 40 percent of GDP but the current structural deficit is large.

Medium-risk countries

The intermediate category consists of countries with very different characteristics. Germany and France have reformed their pension schemes so that the overall increase in public expenditure is usually limited. However their level of debt is still above the Treaty threshold and their current level of deficit, if not corrected, would result in an explosive debt before taking into account the impact of ageing.

Four countries (ES, IE, NL, and LU) should experience a relatively large increase in pension expenditure but have currently rather sound public finances. Spain and Ireland are in surplus and have a low level of debt. Luxembourg experiences a deficit but has a very low level of debt and substantial assets in the public pension fund. The Netherlands have improved their budget balance considerably in recent years.

Belgium and Italy still have high debt/GDP ratios. Yet the situation is quite different in the two countries. Belgium has been very efficient in maintaining surpluses for a number of years, which has enabled a steady reduction of its debt level; by about 14 percentage points of GDP since 2000. However, under current legislation a large rise in public expenditure is projected in Belgium.

On the other hand, Italy has considerably reformed its pension schemes, resulting in very little increase in public expenditure over the long term.

However, the current budgetary situation is not sufficiently strong to ensure a steady reduction of the consistently high debt level. Indeed, the debt/GDP ratio has been reduced by some 3 percentage points of GDP since 2000, reflecting the relatively weak budgetary position in recent years in Italy.

Although public expenditures are projected to show little change over the long-term, the pension system in Malta is currently being reviewed and reforms are envisaged, with a view to improve its financial sustainability and adequacy over the long term. Moreover, the currently high structural deficit, if not corrected, will prevent the necessary reduction of the debt/GDP ratio, currently above the 60 percent reference value. Despite a low level of debt, the UK faces a challenge in terms of public finance sustainability. Public expenditure as a share of GDP could rise faster than envisaged in the UK convergence programme, as there is possibility of insufficient provision of private pensions which could imply higher costs. In addition, the projections in the UK convergence programmes rely on more optimistic underlying assumptions than the commonly agreed ones, which results in a lower projected rise in age-related expenditure. Moreover, their current level of deficit, if not corrected, would result in an explosive debt ratio before taking into account the impact of ageing.

Low-risk countries

Low-risk countries in general have a comprehensive strategy to deal with ageing which implies a strong budg-

Table I.21

Are the overall policy conclusions different compared with last year's assessment?

This year's assessment Last year's assessment	Low risk	Medium risk	High risk
Favourable position	DK, EE, FI	LU	
Relatively favourable position	AT, LT, LV, SE,SK	IE, ES, UK, NL	
At some risks	PL	BE, FR, IT, DE MT	CY, SI, HU
At risks			PT, EL, CZ

NB: the colour of the cell indicates if there is a change in the overall assessment of the Council Opinion. A white cell means that the assessment is unchanged. A dark grey cell means that the overall assessment has changed.

Source: Commission services.

etary position (running large surpluses, reducing debt or accumulating assets) and/or a comprehensive pension reform, sometimes including a shift towards private pension schemes or both. However countries can also show very different patterns. Some countries (FI, DK, SE) are running large surpluses and are reducing debt and/or accumulating assets, which will enable them to face part of the rise in pension expenditure. Others have reformed their pension schemes and face a limited increase in pension expenditure (EE, LV, LT, AT, PL, SK, and SE).

This does not mean that these countries have no risk at all regarding long-term sustainability of the public finances. For example, the current level of debt is above 60 percent of GDP in Austria. Some countries also need further budgetary consolidation or reforms, although to a lesser degree than medium and high risk countries.

Changes compared with last year's assessment were limited

As regards sustainability of public finances, countries were divided last year in the Council Opinion's in four categories: *favourable position, relatively favourable position, at some risks, at (serious) risks*. This year, in the draft Council Opinion on the stability and convergence programmes, they have been classified in three categories: *low risk / medium risk / high risk*.

This risk categorisation involves:
- recognising that ageing population represents a budgetary challenge for all countries, albeit to varying degrees;

- providing a clear distinction between the different degrees of risks to public finance sustainability countries are facing.

For most countries (see Table I.21), the main conclusions are the same as last year and changes in the overall assessment are due to the change of the categorisation and not a change in the assessment. However, there were some changes for several countries mainly related to new information on long-term projections or sometimes to a worsening of the budgetary position.

The changes were mainly driven by new long-term projections. In particular, Poland provided budgetary projections up to 2050, which reveals that there are limited risks to public finance sustainability under current policies. For Luxembourg the increase in expenditure were revised upwards reflecting improved projections.

The projected rise in public expenditure over the long-term was revised upwards also for Ireland, Spain, the UK, Cyprus and Slovenia. In the case of Hungary, long-term projections of pension expenditure may be underestimated in their convergence programme, as evident when compared to the results of the common long-term projections.

Table I.22 provides the conclusions reached by the Ecofin Council in its Opinions on the stability and convergence programmes on the basis of the Commission's assessments.

Table I.22

Policy conclusions by the Council on the sustainability of public finances

	Are public finances sustainable?	**What are the main issues?**	**Have policy conclusions changed?**
BE	Belgium appears to be at medium risk on grounds of the projected budgetary costs of ageing populations and considering the need to sustain high primary surpluses for a prolonged period of time.	The current level of gross debt, while declining, remains well above the reference value and the steady reduction of the debt ratio foreseen in the update is necessary. The Belgian strategy of putting longer-term concerns at the heart of fiscal policy, including by reducing debt, will undoubtedly alleviate sustainability risks and the 'ageing fund law' reinforces the political commitment by setting legally binding budgetary targets. Furthermore, recent measures aimed at increasing the effective retirement age and the employment ratio should contribute positively to sustainability. However, the current budgetary position may not be sufficient to cover fully the substantial increase in expenditure due to ageing populations, underlining the importance of maintaining large primary surpluses in the coming years.	No
CZ	The Czech Republic appears to be at high risk on grounds of the projected budgetary costs of ageing populations.	While the debt ratio is currently relatively low in an EU perspective, the high deficit contributes to a rising debt ratio in the long-term projections until 2050, which increases the risk to debt sustainability. At the same time, the projected high increases of pension expenditure over the projection period are expected to put a significant burden on the public finances. A rigorous implementation of the planned consolidation of public finances over the medium term and a further strengthening of the budgetary position together with additional structural reforms to contain the increase in age-related expenditures, in particular on pensions and healthcare, appear to be of key importance in order to mitigate the risks to public finance sustainability.	No
DK	Denmark appears to be at low risk on grounds of the projected budgetary costs of an ageing population, due to its solid public finances and provided that the assumed employment increases and low government consumption growth are achieved, which requires further labour market reforms and spending restraint.	The strategy of putting sustainability concerns at the heart of fiscal policy-making, including containing pension expenditure and involving accumulation of assets, contributes positively to the long-term outlook for public finances. The currently favourable budgetary position contributes to the financing of the projected budgetary impact of an ageing population and the medium-term budgetary plans are consistent with sustainable public finances	No
DE	Germany appears to be at medium risk on grounds of the projected budgetary costs of ageing populations.	The structural reforms carried out in previous years, and in particular the pension reform, have helped to contain future rises in public expenditure. In view of the current level of government gross debt exceeding the Treaty reference value of 60 % of GDP and the currently high structural deficit, implementing rigorously a strong budgetary consolidation over the programme period is necessary so as to reduce the risks to long-term sustainability.	No

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Table I.22 (continued)

EE	Estonia appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The level of gross debt is currently very low and is projected to remain below the 60 % reference value throughout the projection period. Estonia's strategy of putting sustainability concerns at the heart of fiscal policy-making, including the pension system reform which involves the accumulation of assets, contributes positively to the outlook for the public finances. The current budgetary position in surplus contributes towards limiting the projected budgetary impact of an ageing population, and the medium-term budgetary plan of maintaining balanced budgets is consistent with low risks to public finance sustainability.	No
EL	Greece appears to be at high risk on grounds of the projected budgetary costs of ageing populations.	The debt ratio is currently the highest in the EU, and is projected to remain at very high levels throughout the projection period up to 2050. It is therefore necessary to implement rigorously the planned consolidation of public finances over the medium-term and to further strengthen the budgetary position in order to reduce risks to public finance sustainability. At the same time, the projected increase of government expenditure, notably on pensions, over the projection period is expected to put a high burden on public finances. To this end, resolutely implementing measures enacted and designing and carrying out additional structural reforms, notably on pensions, are necessary so as to reduce the risks to public finance sustainability.	No
ES	Spain appears to be at medium risk on grounds of the projected budgetary costs of ageing populations.	The currently favourable budgetary position, including the debt position and accumulation of assets in the Social Security Reserve Fund, contribute to absorb somewhat the projected increase of pension expenditures. However, the significant increase in these expenditures over the projection period suggests that the implementation of the measures within the announced social welfare reform aimed at containing the budgetary impact of ageing, notably concerning pensions could be an important element in reducing risks to the sustainability of public finances.	The updated long-term projections reveal a higher increase compared with the previous projections, pointing to higher risks for public finance sustainability over the long-term.
FR	France appears to be at medium risk on grounds of the projected budgetary costs of ageing populations.	Recent reforms, notably the 2003 pension reform, have substantially helped to contain future rise in public expenditure and their full implementation will be crucial to ensure the expected results. The current level of government gross debt is above the Treaty value of 60 % of GDP, and the currently high structural deficit, if unchanged, will prevent the necessary reduction of debt in view of the future cost of ageing. Therefore, in the absence of additional reforms, strong budgetary consolidation is needed in order to reduce the risks to long-term sustainability.	No

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Table I.22 (continued)

IE	Ireland appears to be at medium risk on grounds of the projected budgetary costs of an ageing population.	The currently sound budgetary position, in conjunction with the low debt level and the accumulation of assets in the National Pension Reserve Fund, helps partly to offset the significant rise in age-related government expenditure, notably on pensions, projected over the long term. Ireland has also recently enacted reforms to the pension system for public servants, and the authorities envisage further measures that should contribute to a more sustainable basis for the provision of public service pensions. The commitment to monitoring the adequacy of contribution rates through regular actuarial reviews is helpful. Implementing additional measures aimed at easing the budgetary impact of an ageing population over the long term would be nevertheless an important element in reducing risks to the sustainability of public finances.	The updated long-term projections reveal a higher increase compared with the previous projections, pointing to higher risks for public finance sustainability over the long-term.
IT	Italy appears to be at medium risk on grounds of the projected budgetary costs of an ageing population.	Past reforms have helped to contain future rises in public expenditure and their full implementation, notably of the 2004 pension reform, will be crucial to obtain the expected results. The currently high level of gross debt and the weak budgetary position indicate the necessity for strong consolidation of public finances over the medium-term to reduce risks to public finance sustainability	No
CY	Cyprus appears to be at high risk on grounds of the projected budgetary costs of ageing populations.	Implementing rigorously the planned consolidation of public finances over the medium term will alleviate the risks to long-term sustainability and, as recognized in the programme, substantial pension and healthcare reform measures will also be necessary to contain the projected high increase in age-related expenditure in the period up to 2050 and to reduce the risk to long-term sustainability.	The updated long-term projections reveal a higher increase compared with the previous projections, pointing to higher risks for public finance sustainability over the long-term.
LV	Latvia appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The currently very low level of gross debt is projected to remain below the 60 % reference value throughout the 2005-2050 projection period. Latvia is implementing a pension reform launched in 1996 which contributes significantly to contain the budgetary impact of ageing populations.	No
LT	Lithuania appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The level of gross debt is currently very low and is projected to remain below the 60 % of GDP reference value throughout most the projection period and a contained government deficit is planned over the programme period. Lithuania has enacted a pension reform which contributes significantly to contain the budgetary impact of ageing populations. Further changes to the pension system are envisaged by the Lithuanian authorities, aiming at increasing the replacement rates for pensioners and at the same time gradually raising the retirement age. The implementation of the latter measure would be key in ensuring the financial sustainability of the public pension system.	No

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Table I.22 (continued)

LU	Luxembourg appears to be at medium risk on grounds of the projected budgetary costs of ageing populations.	The current level of debt is certainly very low and the planned consolidation over the medium term should contribute to partly alleviating the risk to public finance sustainability. However, Luxembourg has experienced, over the last two decades, a period of exceptionally strong employment growth which will progressively translate into a similar increase in the number of pensioners and into a large increase in pension expenditure. While it contributes significantly to public finance sustainability, the current size of pension fund assets will not be sufficient and, as recognised by the programme, some changes in the pension schemes will prove necessary at some point to contain future increase in public expenditure and reduce the risk to long-term sustainability.	Yes. The updated projection of the rise in age-related expenditures point to a significant challenge with regard to public finance sustainability.
HU	Hungary appears to be at high risk on grounds of the projected budgetary costs of ageing populations.	The gross debt-to-GDP ratio is currently close to the reference value and is projected to increase in the period up to 2050. Hungary reformed its pension system in the late 1990s, aimed at contained future rises in expenditure on pensions, which helped to reduce the budgetary impact of ageing. However, increases in government expenditure on pensions could be higher than projected in the update, suggesting that a close monitoring of factors that are assumed to offset such higher expenditures as well as developments in pension and other age-related expenditures is important. Moreover, the currently high structural deficit contributes to increase sustainability risks. It is therefore necessary to carry out a large consolidation of public finances over the medium-term and to further strengthen the budgetary position in order to reduce risks to public finance sustainability.	The new common projections show a higher increase compared with the previous projections and those included in the Hungarian 2005 update, pointing to higher risks for public finance sustainability over the long-term.
MT	Malta appears to be at medium risk on grounds of the projected budgetary costs of ageing populations.	The level of gross debt is currently above the 60 % reference value and the currently high structural deficit, if unchanged, will prevent the necessary reduction of the gross debt ratio from falling below the Treaty reference value over the long term. Implementing rigorously the planned budgetary consolidation over the programme period would therefore contribute to reducing debt below the reference value, with positive consequences for risks to public finance sustainability. Changes to the pension system are envisaged by the Maltese authorities, aiming at ensuring adequacy and sustainability of the pension system. The implementation of the reform would be key in ensuring the financial sustainability of the public pension system.	No
NL	The Netherlands appears to be at medium risk on grounds of the projected budgetary costs of ageing populations.	The current level of debt is under the Treaty value of 60 % of GDP and the recent improvement of the budgetary situation in the Netherlands has helped alleviate risks to long-term sustainability. The implementation of recent reforms of the disability scheme will also contribute to curb long-term public spending. However, even fully taken into account, the projected future rise in revenue, notably due to delayed taxation of pension is not sufficient to compensate the rise in public expenditure over the long-term. Further budgetary consolidation may therefore be necessary to fully offset the impact of ageing.	No

Table I.22 (continued)

AT	Austria appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The level of debt, currently above 60 % of GDP, is projected to fall and remain below the reference value up to 2050 on the assumption that the planned budgetary consolidation is implemented. Austria's recent pension reform should contribute significantly to the containment of future increases in public expenditure. However, the structural deficit in the government finances, if not corrected, could pose a risk to public finance sustainability. Implementing the planned consolidation of public finances over the medium term is therefore instrumental for reducing the risks to public finance sustainability.	No
PL	Poland appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The level of debt is currently under the 60 % reference value and should remain so under the assumption that savings related to the implementation of the 1999 pension reform will materialise. The reform is ambitious and contributes to the solving of the ageing problem, but measures recently adopted by the government to exclude particular employment groups from the reformed pension scheme could weaken the reform's long-term outcome, particularly if further exemptions from the pension schemes were granted. The realisation of contingent liabilities as well as the currently high structural deficit may increase the debt/GDP ratio faster than planned over the medium term. Implementing rigorously the planned consolidation of public finances over the medium-term would reduce risks to long-term sustainability.	Yes. The updated projection of the change in age-related expenditures up to 2050 reveals limited risks to public finance sustainability under current policies.
PT	Portugal appears to be at high risk on grounds of the projected budgetary costs of ageing populations.	The currently high level of gross debt and the weak budgetary position indicate the necessity for implementing rigorously the planned consolidation of public finances over the medium-term and to ensure the attainment of the budgetary targets in order to reduce risks to public finance sustainability. However, the projected increases in pension and healthcare expenditures over the projection period clearly indicate the necessity of a comprehensive strategy in dealing with the challenge posed by ageing populations that goes beyond improving the currently weak budgetary position. The ongoing introduction of changes to the pension and healthcare systems should go some way in making these systems more sustainable. However, further reforms are required to curb the projected growth of age-related expenditures.	No
SI	Slovenia appears to be at high risk on grounds of the projected budgetary costs of ageing populations.	The relatively low debt ratio will contribute to limit the budgetary impact of ageing. However, Slovenia will still face a very large increase in government expenditure. Even though the 1999 pension reform has significantly alleviated future increase in expenditure, its effects have been partly offset by the modification of the indexation rule. Further changes in the pension schemes, as recognised by the programme, will prove necessary at some point to contain future increase in government expenditure and reduce the risk to long-term sustainability. If no further measures are taken to relieve the pressures of age-related expenditure, the long-term sustainability of public finances will be undermined. A careful planning and timely adoption of measures are key in this regard.	The updated long-term projections reveal a higher increase compared with the previous projections, pointing to higher risks for public finance sustainability over the long-term.

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Table I.22 (continued)

SK	With regard to the sustainability of public finances, Slovakia appears to be at low risk on grounds of the projected budgetary costs of ageing populations, subject to the sustained fiscal consolidation also beyond the programme period and the full implementation of enacted reforms, as well as other reforms of a structural nature (including a reduction of unemployment).	The level of debt is significantly under the 60 % reference value and should remain so under the assumption of unchanged policies for the coming two decades. However, the continuation of the currently high structural deficit will prevent the reduction of the debt/GDP ratio, which increases the risk to long-term sustainability. Implementing rigorously the planned consolidation of public finances over the medium-term is necessary in order to reduce risks to long-term sustainability.	No
FI	Finland appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The gross debt ratio is currently below the 60 % of GDP reference value, and is projected to remain below this value throughout most of the projection period which extends until 2050. The significant assets of social security and the currently favourable budgetary position contribute to limit the budgetary impact of ageing populations. However, in the long run, a risk to public finance sustainability could emerge, reflecting rising pension expenditure. Containing age-related expenditure over the long term, including the successful implementation of recent reform measures aimed at rising the effective retirement age, while maintaining sound budgetary positions would be key components in reducing risks to public finance sustainability.	No
SE	With regard to the sustainability of public finances, Sweden appears to be at low risk on grounds of the projected budgetary costs of ageing populations.	The level of gross debt is currently comfortably below the 60 % reference value and is projected to remain below the reference value throughout most of the programme period. The Swedish strategy of putting sustainability concerns at the heart of fiscal policy-making, including the pension system reform which contains pension expenditure and involves accumulation of assets, contributes positively to the outlook for the public finances. The currently favourable budgetary position contributes to limiting the projected budgetary impact of ageing populations while the planned consolidation towards the 2 % MTO at the end of the programme period contributes to improve sustainability.	No
UK	With regard to the sustainability of public finances, in combination with an increase in the cost of ageing, the possibility of insufficient provision of private pensions increasing fiscal costs would put the United Kingdom at medium risk, unless changes are made to improve fiscal sustainability.	Over the period until 2050, a contained rise in public pension expenditure is projected. However, higher age-related expenditure pressures cannot be excluded as there is a possibility of insufficient provision of private pensions. Pension policy is currently under review and the government's response to the November 2005 Pensions Commission report is expected in spring this year. The currently favourable debt position contributes to limit somewhat the budgetary impact of ageing populations; however, gross debt is projected to go above the 60 % of GDP reference value during the projection period to 2050 if, compared to the structural budgetary position in 2005/06, no further budgetary consolidation takes place during the programme period. Improving the structural balance of government finances over the medium term would contribute to reducing risks to public finance sustainability.	The updated long-term projections reveal a higher increase compared with the previous projections, pointing to higher risks for public finance sustainability over the long-term.

Source: Council Opinions on the 2005/06 updated stability and convergence programmes on the basis of the Commission's assessment.

Part II

Evolving budgetary surveillance

Summary

One year has passed since the EU heads of State or Government endorsed the March 2005 Ecofin Council report containing the main directions for reforming the Stability and Growth Pact. Since then, the revised SGP has been codified in regulations. Where necessary, further clarifications on how to interpret the new text of the Regulations were included in a revised Code of Conduct for the implementation of the Stability and Growth Pact. The Member States, the Commission, the Council had all to learn 'how to live with new rules'. Following the SGP reform, the information provided in Stability and Convergence Programmes by Member States needed to be enriched. New values for Member States' medium-term budgetary objectives were indicated in Stability and Convergence Programmes according to the principles spelled out in the amended SGP regulations. The implementation of the Excessive Deficit Procedure had to conform to the revised Regulations.

This part of the report summarises the result of one year of work to codify, make operational and implement the revised SGP. It also provides a first assessment on how well Member States and EU institutions adapted to the revised SGP and on how the revised SGP translated into different outcomes for what concerns the application of the Excessive Deficit Procedure.

Codification of the agreement on the SGP reform

On 20 March 2005, the EU Finance Ministers agreed on a revision of the Stability and Growth Pact, after months of intense discussions. The agreement was then endorsed by the European Council and codified in Regulations. The Commission adopted Proposals for amending Regulations 1466/97 and 1467/97 underpinning the Stability and Growth Pact on 20 April 2006. These proposals were submitted to the Council and simultaneously to the European Parliament. The amending Regulations formally entered into force on 27 July 2005. They include all the essential elements of the SGP reform.

In parallel, the Council prepared, on the basis of a proposal by the Commission services, a revised Code of Conduct which includes provisions contributing to a consistent application of the reform. This document mainly consists in definitions of concepts, clarification of procedures and provisions on some elements of the agreement reached in the Council, in particular those which were not codified in the amending Regulations. It also includes detailed provisions on the content and format of Stability and Convergence Programmes. It was endorsed by the Council on 11 October 2005.

Main developments in budgetary surveillance in the preventive arm of the SGP

The revised SGP introduced some new or revised concepts, definitions and principles in the preventive arm of the SGP. In order to ensure a coherent and consistent application of the rules, the Commission and the Member States have, in the past twelve months, further specified certain elements.

- The methodology for setting the country-specific medium-term budgetary objectives was clarified. In the revised SGP, countries are no longer required to aim for the uniform position of 'close-to-balance or in surplus' in the medium term. Rather, medium-term objectives are set taking into account country-specific economic and budgetary circumstances. The Council Report of 20 March 2005 says that, until criteria and modalities for taking into account implicit liabilities are appropriately established, MTOs are differentiated on the basis of the debt ratio and potential growth, while preserving sufficient margin below the reference value of 3 percent of GDP. Following a discussion with Member States on the basis of a document prepared by the Commission services, Member States agreed to stick to simple principles leaving sufficient leeway for setting the MTOs.

- In parallel, the Commission has started working on how implicit liabilities could be taken into account in the determination of MTOs. As foreseen by the SGP reform agreement, the Commission will report, by the end of 2006, on the progress made on this issue. A number of preliminary considerations are made in this report, aiming at illustrating the rationale for considering implicit liabilities relating to ageing in the determination of MTOs and presenting alternative broad approaches.

- Following the past failure to reach the medium-term budgetary objective of 'close to balance or in surplus', the SGP reform introduced principles for the conduct of fiscal policy in the period of convergence towards the medium-term budgetary targets. In particular, it was agreed that Member States would take active steps to reach the MTO (0.5 percent benchmark adjustment for euro area and ERM II countries) and make larger structural efforts in good times. Under certain conditions, Member States implementing structural reforms may deviate temporarily from the MTO or the adjustment path towards it. The Commission and Member States clarified a number of issues related to the definition of the adjustment path towards the MTOs and specified the conditions for taking into account structural reforms.

- The Commission assessment of the 2005 updates of Stability and Convergence Programmes suggests that Member States have, to a large extent, followed the revised rules, but also reveals some deviations from the agreement of 20 March 2005. *On the positive side*, differentiated MTOs were set for Member States that reflect country-specific fundamentals and ensure a sufficient safety margin against the 3 percent limit. Other positive elements are that the 0.5 percent benchmark adjustment is, on average over the period covered by the programmes, respected in most countries not yet at their MTO, and that the projected reduction in the deficit is generally based on realistic macroeconomic forecasts. *As regards concerns*, the adjustment planned by Member States which have not yet reached their medium-term budgetary objective (but not in EDP) falls short of the 0.5 percent adjustment in the year 2006. The benign economic environment with growth close or above potential is not being exploited to progress towards the MTO. In addition, there is, in some Member States, an unfortunate

combination of a back-loaded fiscal adjustment with a lack of specification of measures underlying the (backloaded) projected consolidation. Finally, according to the information in the programmes, the 0.5 percent benchmark is, on average, not achieved in countries with a positive output gap (the same is true for countries with a positive change in the output gap).

Main developments in budgetary surveillance in the corrective arm of the SGP

One year after the reform, the experience with the implementation of the excessive deficit procedure is overall positive. The following elements are particularly relevant.

- The Commission reports in accordance with Treaty Article 104(3) adopted since the reform contained a comprehensive assessment of 'other relevant factors'. The consideration of a wide range of factors in the initiating step of the excessive deficit procedure ensured that decisions and recommendations reflected a *comprehensive assessment* of the budgetary developments in the context of the economic conditions prevailing in the country concerned. The specific factors put forward by Member States were assessed in an objective and balanced way by the Commission. Since the SGP reform, all deficits in excess of 3 percent of GDP have been considered excessive. In all cases, deficits could not be considered close to the reference value or the excess could not be considered temporary. The application of the provisions related to 'other relevant factors' in the steps leading to a decision on the existence of an excessive deficit has confirmed that *the SGP remains a rules-based framework*.

- The revised SGP foresees that deadlines for the correction of excessive deficits should be set taking into account an overall and balanced assessment of relevant factors. Since the agreement on the revised SGP, recommendations in accordance with Article 104(7) of the Treaty were issued for three EU Member States. In all three cases, the room for judgment in the excessive deficit procedure has been applied to set realistic deadlines for Member States to correct their excessive deficits, while ensuring that significant fiscal efforts are made. The Council recommendations and notices issued since the reform always specified the required structural fiscal effort, which excludes one-off and temporary effects

on the budget balances. Finally, by introducing more room for economic judgment in the fiscal surveillance process, the SGP reform stimulated a constructive and transparent policy dialogue on the individual country cases between the Commission, the Council and Member States. This contributed to a smooth and efficient operation of the Pact.

• A focus is made in the report on a change introduced by the reform which deserves particular attention and careful implementation: the assessment of *effective action* in the excessive deficit procedure. Provisions related to effective action play a central role in the revised SGP, since the new rules foresee the possibility of repeating steps in the EDP in case a Member State has acted in compliance with the previous recommendations of the Council. Simple and transparent principles for the implementation of the concept of effective action are presented, with the view to stimulate discussion on this issue.

Progress in the measurement of budgetary positions and policies

By moving the emphasis from a single indicator to a more reasoned analysis of the budgetary position of Member States, the reform of the Stability and Growth Pact has reinforced the need to strengthen the knowledge and understanding of budgetary developments in each Member State. In the past twelve months, progress was made on a number of issues related to the measurement of budgetary positions and policies.

• The first issue concerns the identification of temporary influences, other than those stemming from the cycle, on budgetary statistics. All documents of the revised SGP refer to fiscal adjustments in cyclically-adjusted terms, *net of one-off and temporary measures*. The concept of one-off and temporary measures was specified. Common features of one-off and temporary measures were identified and there were discussions on an open and indicative list of measures to be considered in the context of the SGP. A number of clear principles have been agreed for taking into account such measures in the context of budgetary surveillance, which reduce incentives to pursue fiscal consolidation on the basis of one-off measures and, in turn, stimulate the implementation of sound consolidation measures with a sustained effect on government finances.

• Secondly, progress was made on the cyclical adjustment of budget deficits. Budget elasticities and sensitivities to the cycle were updated for the former EU-15 Member States and calculated for the first time for the new Member States. This allowed estimating a new set of values for minimal benchmarks (threshold value which ensures the respect of the 3 percent reference value under normal cyclical fluctuations) for the 25 EU Member States.

Enhanced quality of budgetary statistics

The implementation of the SGP and budgetary surveillance in broader terms has shown that the effectiveness of fiscal rules also depends on the quality of the underlying government finance statistics, and that these depend to a great extent on their governance. Over the last months, several developments have contributed to improving the quality of budgetary statistics: notably the reinforcement of the Eurostat powers and responsibility in checking the quality of fiscal data reported by Member States, the publication of budgetary statistics with an infra annual frequency, as well the establishment of minimum standards for the institutional set up of national and European statistical authorities.

New long-term budgetary projections and improvements of the analysis of the long-term sustainability of public finances

The revised SGP put greater emphasis on the sustainability of government finances. Progress was made in the past year in the quantification of the implications for government finances of population ageing. Long-term budgetary projections were updated on the basis of commonly agreed assumptions and methods for a wide range of budgetary items (pensions, healthcare, long-term care, education and unemployment benefits). With regard to the analysis of public finance sustainability in the context of the assessment of the annual updates of stability and convergence programmes, some improvements were introduced in the latest assessment round. First, a decomposition of the sustainability indicators has been introduced, which examines whether risks to public finance sustainability mainly come from the short-term or long-term budgetary developments. Second, a new sensitivity test has been introduced. It shows the supplementary budgetary cost that arises if an adjustment that ensures sustainable public finances is made in the future rather than today. In other words, it illustrates the 'cost of consolidation delay'.

1. Codification of the agreement on the SGP reform

1.1. Introduction

On 20 March 2005, the Ecofin Council reached a political agreement on a revision of the Stability and Growth Pact. The substance of the agreement is laid down in a report on 'Improving the implementation of the Stability and Growth Pact" ([1]). In this report, the Council gave consideration to enhancing the governance and the national ownership of the fiscal framework; to strengthening the economic underpinnings and the effectiveness of the SGP, both in its preventive and corrective arms; to safeguarding the sustainability of public finances in the long run; and to promoting growth. The 2005 edition of the report 'Public Finances in EMU' provided a detailed presentation of the main elements of the agreement. Table II.1 below summarises the main changes introduced by the reform.

On 22 March 2005, the European Council endorsed the Ecofin report, stating that it updates and complements the Stability and Growth Pact and invited the Commission to bring forward proposals for amending the Council Regulations (EC) No 1466/97 and No 1467/97, which underpin the SGP, in accordance with the Council report. The Commission adopted Proposals for amending the Regulations on 20 April 2005. ([2]) These proposals were submitted to the Council and simultaneously to the European Parliament. The amending Regulations were finally adopted by the Council on 27 June 2005, published in the Official Journal of the European Union on 7 July 2005 ([3]). They entered into force 20 days later.

In parallel, the Council prepared, on the basis of a contribution of the Commission services, a revised Code of Conduct including specifications on the implementation of the Stability and Growth Pact. This document includes provisions ensuring clarity and consistent application of the reform. This mainly consists in definitions of concepts, clarification of procedures and provisions on some elements of the agreement reached in the Council, in particular those which were not codified in the amending Regulations. The revised Code of Conduct also includes detailed updated provisions on the content and format of Stability and Convergence Programmes. It was endorsed by the Ecofin Council on 11 October 2005 ([4]). This section reviews the main changes introduced to the SGP Regulations and to the Code of Conduct.

1.1.1. The legislative changes to the SGP

One month after the Council agreement on the SGP reform, the Commission adopted legislative proposals for an amendment of Council Regulations 1466/97 and 1467/97 which underpin the SGP. In line with the preference expressed by the Council, the Commission proposed to limit the legislative changes to a minimum, while ensuring consistency and clarity of the legal provisions.

The Commission also decided to seize the opportunity created by the SGP reform to propose some additional amendments of a technical nature in order to smooth the process of the examination of Stability and Convergence Programmes and the application of the excessive deficit procedure. These changes essentially reflect a codifica-

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([1]) The report can be downloaded at the following address: http://register.consilium.eu.int/pdf/en/05/st07/st07423.en05.pdf.

([2]) The Commission Proposals for the amending Regulations can be downloaded at the following address: http://europa.eu.int/comm/economy_finance/publications/sgp_en.htm.

([3]) It can be downloaded at the following address: http://europa.eu.int/eur-lex/lex/johtml.do?uri=oj:l:2005:174:som:en:html.

([4]) The full title of the document is 'Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes'. It can be downloaded at the following address: http://europa.eu.int/comm/economy_finance/about/activities/sgp/codeofconduct_en.pdf.

Box II.1: **Regulations 1466/97 and 1467/97 have different legal basis and followed different revision procedures**

Council Regulation (EC) Nos 1466/97 and 1467/97 are based on different Treaty articles. Regulation 1466/97 is based on Article 99(5) of the Treaty (EC) and 1467/97 on Article 104(14). As a consequence, different procedures applied for the revision of the two Regulations.

Council Regulation 1466/97

With Article 99(5) being the relevant legal basis, changes to CR 1466/97 followed the 'cooperation procedure' as laid down in Article 252 of the Treaty. The cooperation procedure foresees two readings in the European Parliament. The following steps were followed for the adoption of the amending Regulation.

In a first step, the Commission submitted its Proposal for the amending Regulation to the Council and the European Parliament on 20 April 2005. On 3 May, the Commission Proposal was sent to the European Central Bank (ECB) for comments. On 3 June 2005, the European Central Bank reported that it does not see the need to express an opinion on the specific provisions of the revised Regulation, but endorsed the aim of improving the surveillance and coordination of economic policies so as to achieve and maintain medium-term objectives that ensure the sustainability of public finances. The ECB also considered that a rigorous and consistent implementation of the surveillance procedures would be conducive to prudent fiscal policies.

At a first reading, on 9 June 2005, the European Parliament delivered an Opinion on the Commission proposal. The Opinion was prepared by the Economic and Monetary Affairs Committee. It included amendments underlying the importance of reliable fiscal statistics (including proposals allowing the possibility for the Commission to undertake audit missions and to compare data provided by Member States with those provided by the national Central Banks and the European Central Bank). The amendments also aimed at reinforcing the monitoring of the achievement of the medium-term budgetary objectives, and giving more emphasis on government debt dynamics in the assessment of Stability and Convergence Programmes.

Then, the Council, acting by a qualified majority, adopted a Common Position, taking into account the European Parliament's Opinion. The Council decided not to include provisions reflecting the amendments adopted by the European Parliament. However, the changes adopted by the Council with respect to the Commission Proposal went in the direction of further clarifying the implementation of the preventive part of the Stability and Growth Pact (SGP), and were therefore in line with the overall thrust of the amendments tabled by the European Parliament. The changes envisaged by Parliament concerning the statistical field have been considered by the Council in the finalisation of the legal acts more directly linked to public finance statistics.

On 17 June 2005, the Commission issued a Communication on the Common Position prepared by the Council. The Commission considered that the Common Position of the Council included all the essential elements of its original proposal and reflected an overall balanced compromise. It could therefore accept all the changes made by the Council to its Proposal. On 23 June, the European Parliament adopted a resolution approving the Council's Common Position. The amending Regulation was finally adopted by the Council on 27 June 2005, published in the *Official Journal of the European Union* on 7 July 2005, and entered into force 20 days later. All official documents concerning the adoption of Regulation 1055/05 amending Regulation 1466/97 can be found at the following web address: http://www.europarl.eu.int/oeil/file.jsp?id=5245412.

Council Regulation 1467/97

Legislative changes to Council Regulation 1467/97 were submitted to the so-called 'consultation procedure'. Only one reading by the European Parliament is foreseen in this procedure.

In a first step, the Commission submitted its Proposal to the Council, which consulted the European Parliament and the ECB. On 3 June 2005, the ECB issued a report stating that it did not see a need to express an opinion on the specific provisions of the proposed regulation. In its report, the ECB reiterated that the EDP needs to be both credible and effective as a safeguard against unsustainable public finances, maintaining a strict time frame. Against this background, the ECB favoured an amendment of Council Regulation 1467/97/EC that is as limited as possible.

On 9 June 2005, the European Parliament adopted a resolution on the amending Regulation. It notably considered that there should be a clear, agreed list of which factors might be judged relevant in assessing deficits, and that the maximum deadline for correction of an excessive deficit should not exceed three years after its occurrence. The Parliament also considered that the Commission and the Council, when assessing and deciding upon the existence of an excessive deficit, should compare the figures submitted to the Commission by the Member States with the reports submitted by the national central banks to the ECB.

tion of existing practices ([1]). Overall, the amendments proposed by the Commission were limited in size and scope and reflected the compromise agreement reached in the Council.

In the weeks following the adoption by the Commission of draft amending Regulations, the European Parliament and the Council discussed and amended the legislative proposals (the main steps of the adoption process are described in Box II.1). The final versions of the amending Regulations adopted by the Council include all the essential elements of the Commission Proposal and reflect an overall balanced compromise. The main changes introduced to the legislative framework of the SGP are described below.

Legislative changes concerning the preventive arm of the SGP

The following changes were introduced in Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies:

i. *Principles for the definition and revision of country-specific medium-term budgetary objectives.* The agreement on the SGP reform foresees that medium-term budgetary objectives (MTOs) should be differentiated across countries. This principle was introduced in Article 2a of the amended Council Regulation 1466/97. This Article specifies that medium-term budgetary objectives may diverge from the requirement of a close-to-balance or in surplus position. It also says that MTOs should provide

a safety margin with respect to the 3 percent of GDP reference value, ensure rapid progress towards sustainability and allow room for budgetary manoeuvre. The same Article of the Regulation specifies that medium-term budgetary objectives can be revised when a major structural reform is implemented and in any case every four years.

ii. *The range for the MTOs of euro area and ERM II Member States.* The Council decided to insert legal provisions stating that, for euro-area and ERM II Member States, the country-specific MTOs should be specified between –1 percent of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and other temporary measures.

iii. *0.5 percent of GDP benchmark adjustment for euro-area and ERM II Member States.* The obligation for Member States of the euro area and participating to ERM II which have not achieved their MTO to pursue an annual improvement of their structural balance (cyclically-adjusted balance net of one-off and temporary measures) by 0.5 percent of GDP as a benchmark was introduced in the Articles 5 and 9 of amended Regulation 1466/97.

iv. *Larger efforts in good times.* Articles 5 and 9 of the amended Regulation specify that the Council, when assessing the adjustment path towards the MTO, should take into account whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times.

v. *Content of Stability and Convergence Programmes.* Article 3 of the revised Regulation foresees that Stability and Convergence Programmes should present a detailed and quantitative assessment of the budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, comprising a detailed cost-benefit analysis of major structural reforms which have direct long-term cost-saving effects, including by raising potential growth.

([1]) For instance, in its proposal to amend Council Regulation 1466/97 on the strengthening of the surveillance budgetary positions and the surveillance and coordination of economic policies, the Commission proposed to extend the deadline for the Council assessment of the Stability and Convergence Programmes, previously of two months after their submission, to three months. In its proposal to amend Council Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure, the Commission proposed to clarify the concept of abeyance in the excessive deficit procedure.

vi. *Provisions on structural reforms.* The SGP reform foresees that structural reforms should be taken into account when defining the adjustment path towards the medium-term budgetary objective. Articles 5 and 9 of the Regulation specify the conditions under which the implementation of structural reforms could allow a temporary deviation from the adjustment path towards the medium-term budgetary objective or from this objective.

vii. *The specific role of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar.* The Council introduced provisions specifying that Member States implementing such reforms should be allowed to deviate from the adjustment path to their medium-term budgetary objective or from the objective itself, with the deviation reflecting the net cost of the reform to the publicly managed pillar, under the condition that the deviation remains temporary and that an appropriate safety margin with respect to the deficit reference value is preserved.

Legislative changes concerning the corrective arm of the SGP

The following changes were introduced in Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure:

i. *Definition of a 'severe economic downturn' in the EDP.* Regulation 1467/97 was amended to reflect the change of the definition of a 'severe economic downturn' in the excessive deficit procedure ([1]). In the revised SGP, an economic downturn may be considered 'severe' in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth.

ii. *Specification of the nature of 'other relevant factors' in the EDP.* When reforming the SGP, the

Council specified the nature of the 'other relevant factors' mentioned in Article 104(3) of the Treaty. These factors should be taken into account in the Commission reports which launch the excessive deficit procedure. Article 2(3) of amended Regulation 1467/97 provides the list of 'other relevant factors' to be considered. The same article creates the possibility for a Member State to put forward to the Commission and the Council any factor that it considers relevant.

iii. *Role of 'other relevant factors' in the EDP.* Article 2(4) of the amended Regulation specifies that only if the general government deficit remains close to the reference value *and* its excess over the reference value is temporary, other relevant factors should be taken into account in the steps leading to the decision on the existence of an excessive deficit. Article 2(6) specifies that other relevant factors should be taken into account in the subsequent procedural steps of Article 104 of the Treaty, with the exception of decisions under Article 104 (12) of the Treaty on the abrogation of the excessive deficit procedure. In particular, other relevant factors are taken into account when setting the deadlines for the correction of the excessive deficit in the context of Council recommendations and notices in accordance with Articles 104(7) and 104(9) of the Treaty.

iv. *Systemic pension reforms.* The Council introduced legal provisions concerning the special treatment of systemic pension reforms in the excessive deficit procedure. Article 2(5) of amended Regulation 1467/97 specifies that the Commission and the Council should give due consideration to the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar in all budgetary assessments in the framework of the excessive deficit procedure. Article 2(7) specifies that, in case the deficit exceeds the reference value, while remaining close to it, and where this excess reflects the implementation of such a pension reform, the Commission and the Council should also consider the cost of the reform to the publicly managed pillar when assessing budgetary developments (see box 2 below for details on this issue).

v. *Extension of deadlines for taking action in the context of the EDP.* With a view to allowing for an appropriate assessment of all aspects, the SGP reform extended delays for the adoption of decisions and rec-

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([1]) According to Article 104 (2a) of the Treaty (and the Protocol on the Excessive Deficit Procedure) a government deficit above 3 percent of GDP is considered to be excessive unless the excess over the 3 percent is only *exceptional* and temporary and the government deficit ratio remains close to the reference value. The Council Regulation 1467/97 specifies in Art. 2 that the excess over 3 percent can be considered *exceptional* if it results (a) from an unusual event outside the control of the Member State (e.g. a natural disaster) or (b) from a severe economic downturn. In the original version of the regulation, a 'severe economic downturn' was defined as an annual fall of real GDP of at least 2 percent (Article 2(2)).

ommendations under the excessive deficit procedure, and for Member States to take effective action following Council recommendations and notices (see Table II.1. Main changes to the Stability and Growth Pact following the Council agreement of 20 March 2005). As a result, the overall maximum period of 10 months within which the Council is obliged to take a decision to impose sanctions in case a Member State participating to the euro area fails to comply with the successive decisions of the Council was effectively expanded to 16 months. These changes are codified in various Articles of amended Regulation 1467/97.

vi. *Allowing repetition of steps in the EDP.* A major innovation introduced by the 2005 SGP reform is that, in case an unexpected adverse economic event with a considerable negative impact on the budget hits a country in the course of correcting its excessive deficit, the deadline for the correction of the excessive deficit initially set by the Council following Art. 104(7) or Art. 107(9) can be revised and extended. A repetition of these steps can only be invoked under the provision that effective action has been taken by the country concerned in compliance with the initial recommendation (104(7)) or notice (104(9)). Provisions allowing repetition of steps in the EDP are inserted in Articles 3(5) and 5(2) of the Regulation.

vii. *0.5 % of GDP structural adjustment.* The amended Regulation 1467/97 specifies that the Council should always recommend an annual structural adjustment of at least 0.5 percent of GDP as a benchmark to ensure the correction of the excessive deficit.

What was not codified in the Regulations

The agreement on the SGP reform contains a number of complementary elements designed to improve fiscal and statistical governance, both at the level of the EU and in Member States. These aspects were not subject of any amendments in the two regulations considered in this section. However, as stated by the European Council on 22 March 2005, the 2005 Ecofin report is an integral part of the Stability and Growth Pact. This report contains a number of elements designed to increase the ownership of the SGP provision, clarify the respective roles and responsibilities of the various actors involved as well as measures to improve the quality and timeliness of statistical data, both at the national and the EU level. It also states that, in order to solidly re-establish the credibility of the SGP and to strengthen the enforcement of budgetary dis-

cipline, it is important that complementary measures are taken at national level to enhance the institutional settings for fiscal and statistical governance. The choice of the topics of the analytical chapters of the present report, which provide evidence of the influence of national fiscal rules and institutions on budgetary outcomes, should be seen in the context of the follow-up to the 2005 SGP reform.

1.1.2. The revised Code of Conduct

In the weeks following the 20 March 2005 Council agreement on the SGP reform, the Commission services prepared a contribution for a revised Code of Conduct for the implementation of the Stability and Growth Pact, which would substitute and extend the scope of the previous Code of Conduct. The final version of this document was endorsed by the Council on 11 October 2005, following discussions with the Member States.

At this occasion, the Council confirmed that '*the Stability and Growth Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union*'. The Council also considered that '*the revised Code of Conduct contains the guidelines for a consistent and even-handed implementation of the Stability and Growth Pact and for the content and format of the stability and convergence programmes*'.

The revised Code of Conduct includes provisions on two types of issues:

(a) *Provisions ensuring clarity and consistent application of the reform.* This mainly consists in definitions of concepts, clarification of procedures and provisions on some elements of the agreement reached in the Council, in particular those which were not codified in the amending Regulations.

(b) *An update of the existing provisions on the content and format of Stability and Convergence Programmes.* This is a code of good practice and checklist to be used by Member States in preparing stability or convergence programmes. Compared to the existing Code of Conduct, a number of additional data requirements were included.

Provisions ensuring clarity and consistent application of the SGP reform

Compared to the Council report of 20 March 2005 and the amending Regulations, the revised Code of Conduct

Table II.1

Main changes to the Stability and Growth Pact following the Council agreement of 20 March 2005

	Original	Revised
1. Changes in the preventive arm		
Medium-term objective (MTO)	All Member States (MS) have a medium-term budgetary objective (MTO) of 'close-to-balance-or-in-surplus'.	• Country-specific differentiation of MTOs according to debt and potential growth. Implicit liabilities to be taken into account at a later stage, when modalities for doing so are agreed by the Council. • MTOs for euro area and ERM II MS are set between -1 % of GDP and balance or surplus (in cyclically-adjusted terms and net of one-offs).
Adjustment path towards the MTO	No specific provisions.	• MS to take active steps to achieve the MTO. Annual minimum adjustment for MS of the euro zone or of ERM-II of 0.5 % of GDP. • The effort should be higher in 'good times', and may be more limited in 'bad times'.
Early policy advice	Early Warnings addressed by the Council, upon recommendation of the Commission.	• In addition, the Commission can issue direct 'early policy advice' to encourage MS to stick to their adjustment path. To be replaced by 'early warnings' in accordance with the Constitution once applicable.
Increasing the focus on debt and sustainability	No specific provisions.	• The debt criterion, and in particular the concept of a debt ratio 'sufficiently diminishing and approaching the reference value at a satisfactory pace' will be applied in qualitative terms.
Structural reforms	No specific provisions.	Reforms will be taken into account when defining the adjustment path to the MTO and may allow a temporary deviation from it under the following conditions: • Only major reforms (direct / indirect impact on sustainability); • Safety margin to the 3 % reference value is guaranteed; • The deficit returns to the MTO within the programme period; • Detailed information is provided in the Stability/Convergence Programmes.
2. Changes in the corrective arm		
Report under Article 104(3)	No obligation for the Commission to prepare a report if a deficit exceeds 3 %.	The Commission will always prepare a report in case there is a deficit above 3 %. The report will examine whether the exceptions in Article 104(2) apply and take into account whether the deficit exceeds government investment expenditure and all 'other relevant factors' (which are precisely defined).
Severe economic downturn	'Severe economic downturn' if fall of real GDP of at least 2 % for the preparation of report under Art. 104(3), and in decisions under 104(6) by the Council, if observations by the Member State concerned show that the downturn is exceptional in light of evidence of the abruptness of the downturn and the accumulated loss of output with respect to past trends. The MS commit not to invoke the severe economic downturn when growth is above -0.75 %.	An economic downturn may be considered 'severe' in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential growth.

(Continued on the next page)

Table II.1 (continued)

'Other relevant factors' (ORF)	No specific definition of 'ORF' and their role in the excessive deficit procedure.	• The Commission report under Art. 104(3) will take into account: — Developments in the medium-term economic position (potential growth, cyclical conditions, implementation of policies); — Developments in the medium-term budgetary position (public investment, quality of public finances, consolidation in *'good times'*, sustainability); — Any other factors, which in the opinion of the MS, are relevant in order to assess the excess over the reference value. • *'ORF'* will be considered in the steps from Article 104 (4) to (6) only if the excess over the reference value is temporary and the deficit remains close to the reference value. Any deficit above 3 % that is neither close to the reference value nor temporary will be considered excessive. • If the Council has decided that an excessive deficit exists, the ORF will also be considered in the subsequent procedural steps of Article 104 (except in Article 104(12), i.e. abrogation, and when deciding to repeat steps in the EDP).
Systemic pension reforms	No specific provisions.	• These are treated like an 'ORF', but under strict conditions also with a role in abrogation. • Consideration to the net cost of the reform will be given regressively for the initial five years after a MS has introduced the reform (or five years after 2004).
Extending deadlines for taking effective action and measures		Deadlines are extended: • for a decision under 104(6) – from 3 to 4 months after notification; • for taking effective action following 104(7) from 4 to 6 months; • for moving to 104(9) – from 1 to 2 months; • for taking action following a notice under 104(9) – from 2 to 4 months.
Minimum structural effort	No specific provision.	Countries in excessive deficit are required to achieve a annual structural effort of at least 0.5 % of GDP as a benchmark.
Initial deadline for correcting the excessive deficit	The excessive deficit has to be corrected in the year following its identification, unless there are *'special circumstances'*.	The rule remains; possible extension by one year based on 'ORF' and on the condition that minimum fiscal efforts have been taken.
Repetition of steps in the EDP	Not foreseen.	Deadlines for correcting the excessive deficit can be extended if: • effective action has been taken by the MS concerned in compliance with the initial recommendation or notice, and • unexpected adverse economic events with major unfavourable budgetary effects occur during the correction phase.

Source: Commission services

brings in a number of specifications and clarifications of the provisions inserted in Regulations. In particular, it brings important new elements on the following aspects:

i. *Specification of concepts and methods.* The Code of Conduct specifies that the reference method for the estimation of potential output is the one adopted by the Council on 12 July 2002. Assessments of the cyclical developments, as well as those of the underlying fiscal position and efforts in the context of the Stability and Growth Pact, should be based on this method.

ii. *The procedure for setting the country-specific medium-term objectives.* A consistent differentiation of MTOs across countries can only be achieved if precise modalities for setting the MTOs are discussed in the context of a common procedure. To this aim, the Code of Conduct specifies that the presentation by each Member State of its MTO in the Stability or Convergence Programme should follow a discussion in the Economic and Financial Committee. In their assessment and opinion on the programmes, the Commission and the Council would assess whether the MTOs presented by Member States are appropriate.

iii. *Definition of economic good times.* The Code of Conduct specifies the definition of good times. It states that economic 'good times' should be identified as periods where output exceeds its potential level, taking into account tax elasticities. It specifies that the change in the output gap will also play a role in the identification of good times, especially when the output gap is estimated to be close to zero. Finally, the Code specifies that the identification of periods of economic 'good times' should be made after an overall economic assessment.

iv. *Deviations from the adjustment path towards the MTO or from the MTO itself only for adopted structural reforms.* The Code clarifies the conditions under which the implementation of a structural reform may lead to a temporary deviation from the adjustment path towards the MTO or from the MTO itself. It notably specifies that only *adopted* reforms should be considered when assessing whether a structural reform can allow a deviation from the MTO or the adjustment path toward it. It also states that, in case a deviation is allowed, this should be

mentioned in the Council Opinion on the Stability or Convergence Programme.

v. *Specifications for the preparation of a Commission report under Article 104(3).* The revised Code of Conduct specifies that the indicator for assessing an '*accumulated loss of output*' in the excessive deficit procedure is the output gap. It also specifies that Member States should put forward to the Council and the Commission specific 'other relevant factors' (as a rule) within *one month* of the reporting dates established in Article 4 (2) and (3) of Regulation (EC) No 3605/93.

vi. *Clarifying the conditions for a repetition of steps in the EDP.* The Code of Conduct contains clear provisions on the conditions for a repetition of steps in the EDP. In particular, it states that a decision to repeat a recommendation or notice has to be taken *before taking into account* the other relevant factors. This decision should then be based on the assessment of whether the Member State concerned has taken effective action in response to the previous Council recommendation and whether adverse economic circumstances occurred with a significant impact on the budget.

vii. *Clarification of the concept of effective action in the excessive deficit procedure.* The Code specifies that, when assessing effective action, account should be taken of whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall would be made.

Provisions related to the content and format of Stability and Convergence Programmes

The revised Code of Conduct contains the following elements compared to the initial Code of Conduct:

i. *Status of the programme and of the measures.* Member States should mention the status of their Stability or Convergence Programme in the context of national procedures, notably with respect to the national Parliament. The programme should also indicate whether the Council Opinion on the previous programme has been presented to the national Parliament.

ii. *Specification of structural reforms and information on national fiscal rules.* The Code specifies that Member States should provide information on the measures and the structural reforms implemented (detailed quantitative cost-benefit analysis of the short-term costs and of the long-term benefits of the reforms, analysis of the projected impact of the reforms on economic growth, used methodology) and on the national budgetary rules in force.

iii. *Assessment of the sustainability of government finances.* The revised Code of Conduct specifies that the basis for the assessment of sustainability of government finances should be the common projections endorsed by the Working Group on Ageing attached to the Economic Policy Committee.

Provisions related to the data requirements of Stability and Convergence Programmes

Stability and Convergence Programmes should contain all the necessary data to assess recent economic and fiscal developments, medium-term budgetary strategies and targets, deviations from previous commitments and long-term sustainability projections. By placing emphasis on an overall assessment of Member States' public finances, the reformed Stability and Growth Pact necessitates a wider set of economic indicators than its previous version. This has been reflected in an extension of actual data – that is, statistics for the recent past – projections and targets, which according to the revised Code of Conduct, should be provided by Member States in their programmes.

Although the Stability and Convergence Programmes are a national responsibility and budgetary practices differ across countries, the Code of Conduct sets out the essential data to be provided. The transmission of complete and harmonised tables facilitates their examination by the EU institutions and their scrutiny by the public. Thus, the stability and convergence programmes should include detailed tables dealing with macroeconomic prospects (Table 1a in Annex 2 of the revised Code of Conduct), price developments (1b), labour market (1c), government revenue, expenditure and balances (2), debt developments including information of its main drivers (4), cyclical developments including potential growth, output gap and cyclically adjusted balances (5), and differences in the main variables as compared to the previous programme (6). To permit a fuller understanding of

the path of government balance, information should also be provided on one-off and temporary measures.

Member States are also invited to provide data on (1d) sectoral balances for the private sector and for the external sector, to ensure internal consistency of the medium-term projections and make more explicit the link between budgetary consolidation and the correction of any external disequilibrium that may exist. Moreover, Member States should also transmit to the Council and the Commission their external assumptions for their medium-term forecasts, such as interest and exchange rates, World and EU economic growth and oil prices (table 8). Member States are required to provide actual data for year t–1 and yearly projections until at least year t+3.

In several of these tables, data requirements are somewhat more detailed than they were in the previous Code of Conduct and a few variables, the transmission of which was optional, have now become mandatory. A case in point is the detailed government expenditure and revenue account, which has now become fully mandatory, while in the past only total revenue and expenditure, interest and balances were so. Besides detailed data on a central scenario, Member States should also provide information on alternative macroeconomic scenarios, specifying in particular how changes in economic activity and monetary conditions may affect the main budgetary targets. Moreover, Member States are also encouraged to provide data on government expenditure broken into the ten categories of the classification of government expenditure by function (COFOG) for the latest available year and for the end of the horizon covered by the programme (Table 3).

Last but not least, the revised Code of Conduct has also extended the number of variables to be provided in relation to the long-term sustainability of public finances (Table 7). These data, which should be projected until 2050, cover the government expenditure categories which are most affected by demographic changes, that is, old-age pensions, healthcare, long-term care for the elderly and education, as well as the assets set aside to cater for the ageing-related increase in expenditure. The latter should be consistent with the common long-term projections prepared by the Commission and the Ageing Working Group (AWG) attached to the Economic Policy Committee.

Box II.2: **The treatment of systemic pension reforms in the excessive deficit procedure**

In the revised SGP, the assessment of budgetary developments in the EDP should take into account the budgetary impact of the implementation of systemic pension reforms. Article 2(5) of amended Regulation (EC) No 1467/97 stipulates that 'the Commission and the Council, in all budgetary assessments in the framework of the excessive deficit procedure, shall give due consideration to the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar'. Article 2(7) states that 'in the case of Member States where the deficit exceeds the reference value, while remaining *close* to it, and where this excess reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully-funded pillar, the Commission and the Council shall also consider the cost of the reform to the publicly managed pillar when assessing developments in EDP deficit figures'.

These provisions imply that, when considering whether a deficit above 3 % of GDP is excessive, the net cost of pension reforms should be considered only if the government deficit is *close* to the reference value. In case of a deficit above 3 % of GDP but not close to it, the provisions of Article 2(7) do not apply, even if the excess of the deficit over the Treaty reference value was due to the pension reform costs.

The SGP refers to costs of reforms which establish a mandatory fully-funded pension pillar. The Code of Conduct specifies that the cost of the reform to the publicly managed pillar stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme. The introduction of a new pension pillar only creates a direct short-term cost for the government if the new pension schemes are classified outside government, for example because they have a defined-contribution nature.

Consideration should be given to the net cost of the reform on a linear degressive basis for a transitory period of five years. The Code of Conduct specifies that 'consideration to the net cost of the reform will be given for the initial five years after a Member State has introduced a fully-funded system, or five years after 2004 for Member States that have already introduced such a system. Furthermore, it will also be regressive, i.e. during a period of five years, consideration will be given to 100, 80, 60, 40 and 20 percent of the net cost of the reform to the publicly managed pillar. The net cost of the reform is measured as its direct impact on the general government deficit.' The adjustments to the deficit ratios to reflect the pension reform costs should be done in the context of the economic analysis underlying the implementation the excessive deficit procedure.

The application of the degressive scale requires two basic pieces of information: the initial year of the reform and the yearly costs of the reform. The impact of the reform starts in the year social contributions and other revenue start being diverted from government to the new pension scheme (this is not necessarily the year the reform was formally adopted). Moreover, according to the Code of Conduct, for the Member States that have already implemented reforms, the degressive scale is applied for five years starting in 2005. The cost of the reform is made up of three elements (a) the social contributions or other revenue collected by the new pension scheme which otherwise would be collected by government; (b) the interest expenditure that the government has to bear since the diversion of revenue to the new pension scheme leads to a higher deficit and an accumulation of debt, less (c) the pensions paid by the new pension scheme which otherwise would be paid by the government. The cost of the reform can be directly estimated by the difference between (i) the government deficit as compiled according to ESA95 rules and (ii) an alternative government deficit compiled as if the new pension scheme remained classified in the government sector ([1]).

The following table shows a numerical example. Line 1 shows the government deficit, compiled according to ESA95. In this example, the government deficit increases in 2005 because of the pension reform cost. Line 2 shows the government deficit if the new pension scheme was classified as government. Line 3 is the short-term cost of the pension reform for the government. It is approximated in this example by (1) – (2). Line 4 shows the degressive linear scale, from 100 % to 20 % during the first five years of the reform. The example assumes that the reform entails a cost for government from 2005 on. Line 5 shows the pension cost to be specifically considered by the Council and the Commission (i.e. (3) x (4)). No data are

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[1]   This estimate assumes that the debt issued by the government because of the pension reform equals the accumulation of assets by the pension scheme, and that the interest paid by the government because of this higher debt is similar to the income of the pension scheme assets.

Box II.2 (continued)

shown for 2005 and 2006, as the government deficit (1) for those years cannot be considered close to the Treaty reference value. Line 6 shows the government deficit adjusted by the pension reform cost to be considered in application of the SGP provision on pensions ((1) – (5)).

Numerical example on the implementation of the SGP provision on the net cost of pension reforms

(% of GDP, except line 4)	2004	2005	2006	2007	2008	2009	2010
(1) Government deficit	3.8	4.4	4.2	3.1	2.7	2.5	2.4
(2) Alternative deficit, calculated as if the new pension scheme remained classified in the government sector	3.8	3.4	3.2	2.1	1.7	1.5	1.4
(3) Cost	0.0	1.0	1.0	1.0	1.0	1.0	1.0
(4) Degressive scale	0.0	1.0	0.8	0.6	0.4	0.2	0.0
(5) Cost to be considered	-	-	-	0.6	0.4	0.2	-
(6) Adjusted government deficit to be considered in EDP	3.8	4.4	4.2	2.5	2.3	2.3	2.4

2. Making the revised Stability and Growth Pact operational – the preventive arm

2.1. Introduction

The reform of the SGP introduced some new and revised concepts, definitions and principles which leave room for judgment. In order to ensure a coherent and consistent application of the rules, the Commission and the Member States have further specified and clarified certain essential elements of the revised SGP. Work is still ongoing on some issues. This section reviews these specifications and the implementation of the new principles *in the preventive arm* of the SGP.

A first issue covered in this section concerns the methodology for setting the country-specific medium-term budgetary objectives. One of the most important changes introduced by the reform is that countries are no longer required to aim for the uniform position of 'close-to-balance or in surplus' in the medium term. Rather, medium-term objectives are set taking into account country-specific economic and budgetary circumstances, notably those related to the sustainability of government finances. This raises a number of methodological questions. Some of them, concerning the application of the principles for setting the MTOs in the short-term, were addressed by the Commission and the Member States in the context of discussions in the Economic and Financial Committee. Other issues related to the relation between sustainability considerations and the country-specific MTOs require further technical work.

A second issue is related to the adjustment path towards the medium-term budgetary objectives. In light of the experience of recurrent failures to stick to the medium-term targets under the preventive arm of the SGP, clear provisions on the adjustment path towards the MTOs were agreed. In particular, it was agreed that Member States would take active steps to reach the MTO and make larger structural efforts in good times. Under certain conditions, Member States implementing structural reforms may deviate temporarily from the MTO or the adjustment path towards it. A number of specifications were agreed concerning the definition of the adjustment path towards the MTO. This section also provides the Commission assessment of whether medium-term budgetary projections presented by Member States in their programmes were in line with the agreed principles.

2.2. Setting the medium-term budgetary objectives

In the original SGP, all Member States had to pursue the attainment of a budgetary position close-to-balance or in surplus in the medium-term. The revised SGP has changed this and foresees that medium-term budgetary objectives (MTO) may diverge from close-to-balance or in surplus and are differentiated to take into account differences in Member States economic fundamentals and risks to budgetary sustainability.

The revised SGP specifies that MTOs pursue a triple aim:

- provide a safety margin with respect to the 3 percent deficit limit;

- ensure rapid progress towards sustainability; and

- taking the first two objectives into account, allow room for budgetary manoeuvre, in particular taking into account the needs for public investment.

Additional provisions were agreed for euro-area and ERM II Member States: for these countries, the country-specific MTOs are specified within a defined range between –1 percent of GDP and balance or surplus, in cyclically-adjusted terms, net of one-off and temporary measures.

The Council considered that making the second aim mentioned above (related to the need to ensure rapid progress towards sustainability) fully operational requires further work. The Council Report of 20 March 2005 therefore says that, in a transitory phase until criteria and modalities for taking into account implicit liabilities are appropriately established, MTOs are differentiated on the basis of the *debt ratio* and *potential growth*, while preserving *sufficient margin below the reference value of -3 percent of GDP*. A new method for setting country-specific MTOs will be discussed once there will be agreement on how to take into account implicit liabilities (related to increasing expenditures in the light of ageing populations) in the definition of the medium-term budgetary objectives. By the end of 2006, the Commission will report on the progress achieved on this issue.

2.2.1. Country-specific MTOs in the current phase

In the 2005 updates of the Stability and Convergence Programmes, each Member States has, for the first time, presented its own medium-term budgetary objective. As foreseen by the revised SGP, this followed a methodological discussion with the Member States in order to ensure a consistent application of the agreed criteria for differentiation of the MTOs. This section summarises the specifications of the principles agreed with the Member States for the definition of country-specific MTOs before implicit liabilities are taken into account. It also provides an assessment of whether the MTOs presented by Member States in their Stability and Convergence Programmes were set in accordance with the agreed principles.

Setting MTOs on the basis of debt, growth and a safety margin

The following variables had to be taken into account by the Member States when presenting their country-specific MTOs:

i.   *The government debt ratio.* The revised SGP specifies that the *current* general government debt ratio is the relevant variable. When the 2005 updates of Stability and Convergence Programmes were prepared by the Member States, the latest official estimates of the gross debt ratio in the 25 Member States were those of 2004.

ii. *Potential growth.* The Code of Conduct stipulates that, for the purpose of the definition of the country-specific MTOs, '*potential growth should be assessed in a long-term perspective on the basis of the projections produced by the Working Group on Ageing attached to the Economic Policy Committee*', which are made on the basis of common and agreed assumptions. In order to make sure that country-specific MTOs are based on up-to-date information, the Commission and the Working Group on Ageing of the EPC updated growth estimates for the period 2005-2050 for all 25 Member States.

iii. *A measure of a safety margin with respect to the reference value of 3 percent of GDP.* Country-specific MTOs cannot be set at a level which does not ensure a sufficient safety margin against breaching the 3 percent ceiling. The Code of Conduct stipulates that such a safety margin is assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations. The MTO therefore cannot be set at a level which is below the so-called 'minimum benchmark' (see section 4.3.2 for a definition of the concept and calculation on this indicator). Minimum benchmarks estimates were updated by the Commission for the EU-15 Member States and calculated (for the first time) for the ten recently acceded Member States in the autumn 2005.

Table II.2. Data taken into account by Member States when setting their own medium-term budgetary objective summarises the data available when Member States had to present their country-specific MTO.

An emphasis on current debt

To ensure a consistent application of the principles established by the Council for setting the country-specific MTOs, some clarification was necessary on how to combine the information on debt, potential growth and minimal benchmarks.

One option for ensuring a consistent use of the agreed criteria for setting the country-specific MTOs would have been to define an ad hoc algorithm or function which, applied to the current debt ratio, minimal benchmarks and future potential growth, would allow deriving MTOs for all EU Member States. Such an approach would have had the advantage to take into account debt and potential growth consistently for all Member States. Instead, and considering that such a mechanistic approach would not have allowed for a sufficient room for economic judgment and leeway for Member States to

set their own medium-term budgetary objectives, Member States considered preferable to stick to the simple and transparent principles included in the Council report of 20 March 2005.

A relevant specification agreed with Member States concerns the hierarchy between the criteria taken into account for the definition of the country-specific MTOs. While the revised SGP makes clear that the MTOs should always be more ambitious than the minimal benchmarks (and therefore allow a safety margin with respect to 3 percent), the Council report of 20 March 2005 does not contain clear indications on whether the two other criteria (i.e. potential growth and the current level of government debt) should be given the same weight. Member States considered that the criterion related to debt should be given some more weight in determining the country-specific MTOs.

The main arguments were that (i) the current debt ratio is observed and does not rely on assumptions, while experience has shown that estimates for long-term potential growth can fluctuate substantially over a relatively short period of time; and (ii) that debt is the relevant indicator for assessing the risk to sustainability of government finances in the short to medium term. For this reason, it was considered reasonable that Member States with a very high debt ratio should have particularly ambitious medium-term budgetary objectives today, in order to ensure a rapid reduction in this ratio.

MTOs presented by Member States in the 2005 updated Stability and Convergence Programmes

Member States presented their MTO in the 2005 update of their Stability or Convergence Programme ([1]). Only in the case of the UK a quantitative medium-term objective (MTO) for the structural balance of the general government was not specified ([2]). The MTOs were then examined by the Commission and the Council in the context of the assessment of the Programmes. When assessing the country-specific MTOs, the Commission and the Council considered whether there was a deviation from the agreed principles.

([1]) In some cases, the MTO was not explicitly mentioned in the programme, but it could be inferred from it.

([2]) For this country, the programme refers to fiscal objectives under the domestic rules, which imply a medium-term path for the cyclically-adjusted deficit, consistent with stabilising the debt-to-GDP ratio at a low level and with keeping the current budget in balance or surplus on average over the economic cycle.

Table II.2

Data taken into account by Member States when setting their own medium-term budgetary objective

	Minimal benchmark (updated)	Debt (2004)	Potential growth (average 2005-2050)
DK	– 0.5	42.8	1.6
SE	– 0.6	51.2	2.2
FI	– 1.1	45.1	1.7
BE	– 1.1	95.5	1.7
DE	– 1.8	66	1.4
EL	– 1.3	110.5	1.4
ES	– 1.2	48.9	1.5
FR	– 1.4	65.6	1.8
IT	– 1.5	105.8	1.3
AT	– 1.5	64.2	1.5
EE	– 2.0	4.9	2.6
MT	– 1.8	75.9	2.4
IE	– 1.3	29.9	2.8
PT	– 1.1	61.9	1.5
CY	– 1.9	72.1	2.9
NL	– 1.0	55.7	1.7
HU	– 2.0	57.3	2.0
LU	– 0.8	7.5	3.1
SK	– 2.2	43.6	2.3
CZ	– 1.6	37.4	1.9
LV	– 2.1	14.3	2.8
LT	– 1.8	19.6	2.7
PL	– 1.6	43.6	2.4
SI	– 1.9	29.5	2.0
UK	– 1.4	41.6	1.9

NB: Figures for debt refer to estimates available in the autumn 2005 relative to the level of the general government gross debt ratio for the year 2004.

The figures on potential growth are based on the estimates made in the context of the projection exercise of DG ECFIN and the Ageing Working Group (baseline scenario).

The minimal benchmark estimates were updated for all Member States in the autumn 2005 (see section 4.3.2 for a detailed description of the methodology).

It came out from this examination process that Member States presented MTOs in line with the principles agreed in the revised SGP. Graph II.1 and Graph II.2 below show the relation between the debt ratio (2004 figures), potential growth and the country-specific MTOs (in case the MTOs were defined as a range, the chart shows the centre of the range).

These graphs show that Member States effectively gave a strong weight to the criterion related to the current level of the debt ratio. They also show that some countries have set targets that are more ambitious than required by

the agreed principles. In particular Denmark, Finland, Sweden and Estonia aim at relatively more demanding MTOs. Some Member States, like Italy and Greece, with high current debt ratios and potential growth prospects below the EU average could have been expected to set more ambitious MTOs. An assessment of whether the Member States currently respect their MTO is made in Part I of this report.

2.2.2. MTOs in perspective: taking into account implicit liabilities

The Council agreed on 20 March 2005 that Member States' medium-term budgetary objectives (MTOs) should, *interalia*, pursue the aim of ensuring rapid progress towards sustainability. In the 20 March 2005 Council report it is also stated that '[in the determination of MTOs] implicit liabilities (related to increasing expenditures in the light of ageing populations) should be taken into account'.

The Commission was asked to report, by the end of 2006, on progress made concerning the methodology for taking into account implicit liabilities in the definition of the MTO.

This section presents preliminary considerations on how implicit liabilities could be taken into account in the determination of MTOs. The aim is to illustrate the rationale for considering implicit liabilities related to ageing in the determination of MTOs, to overview which indicators of age-related liabilities could be used for such purpose, and to highlight alternative broad approaches that could be followed to include implicit liabilities in the determination of MTOs.

Why ageing considerations in the determination of MTOs?

Countries, by targeting appropriate values for their budget balance over the medium run, and by sticking to them, would be able to create room in their budgets which would contribute to face the looming impact of ageing. In order to define MTOs that appropriately create such a budgetary room an adequate notion of government liabilities needs to be used. The current MTOs take into account government debt, namely, government liabilities arising as a result of past explicit commitments. Such notion of government liabilities however is not sufficient to capture the stock of implicit commitments by the government to continue providing in the future services like pensions or health. Taking into account also implicit liabilities would indeed permit a better assess-

ment of which budgetary margin is needed to keep public finances sustainable in a context where age-related expenditures are expected to rise substantially.

Although creating budgetary room is key to ensure sustainability, structural reforms aimed at containing the impact of ageing on public finances are also crucial. These reforms contribute to contain the growth in age-related expenditures, thereby reducing the amount of government implicit liabilities. It is therefore necessary that MTOs that are defined on the basis of implicit liabilities could be revised regularly and in any case after the implementation of major structural reforms having an impact on age-related expenditures. To this purpose, the revised SGP states that MTOs '…can be revised when a major structural reform is implemented and in any case every four years' (Art. 2a, CR 1055/2005).

Which notion of government implicit liabilities?

The term 'implicit government liability' is often used with different meanings. In general, by implicit liabilities are meant unfunded government commitments that are not necessarily backed by law or by contractual obligations but rather grounded in strong expectations by the public [1]. Pension expenditures are the most typical example.

The concept of implicit liabilities could be *more or less forward-looking*. In a strict sense, from an accounting viewpoint, government liabilities arise from *past* events. National accountants often use the term implicit liabilities to refer to liabilities arising from commitments already taken which are however not included in standard accounting systems. This is the case for instance for accrued-to-date pension liabilities, i.e., the stock of pension rights linked to pension contributions paid already. A more forward-looking notion of implicit liability would instead include also future pension expenditures linked to contributions not paid yet. A comprehensive assessment of the public finances consequence of ageing requires a forward-looking notion of implicit liabilities.

Second, the notion of implicit liabilities could be *gross or net* of government revenues. For instance, in the case of PAYG pension systems, accumulation of deficits or of surpluses could emerge over time, depending on whether the total amount of resources arising from pension contributions fall short or exceed that of pension payments.

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[1] For a taxonomy of government liabilities see European Commission (2004) and Polachova-Brixi and Schick (2002).

Graph II.1: **MTOs and debt levels**
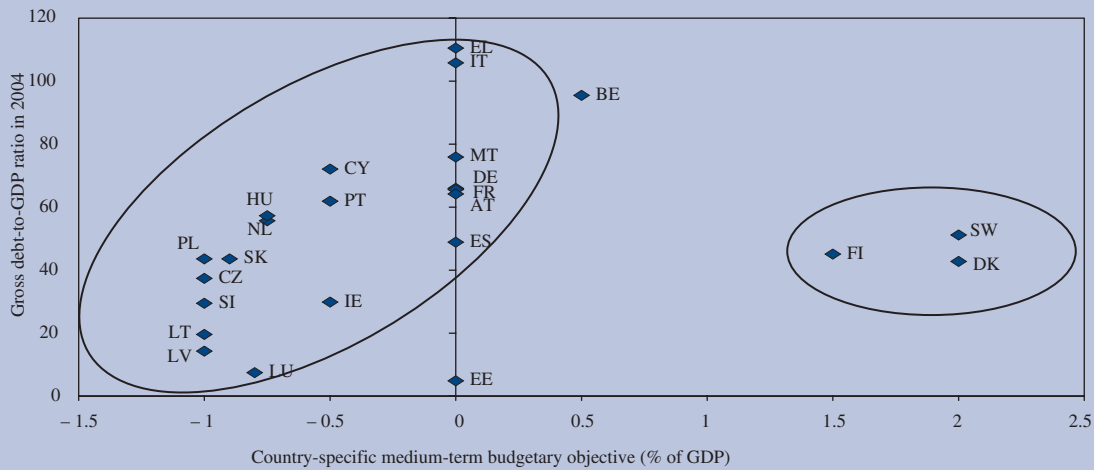
Graph II.2: **MTOs and potential growth prospects**
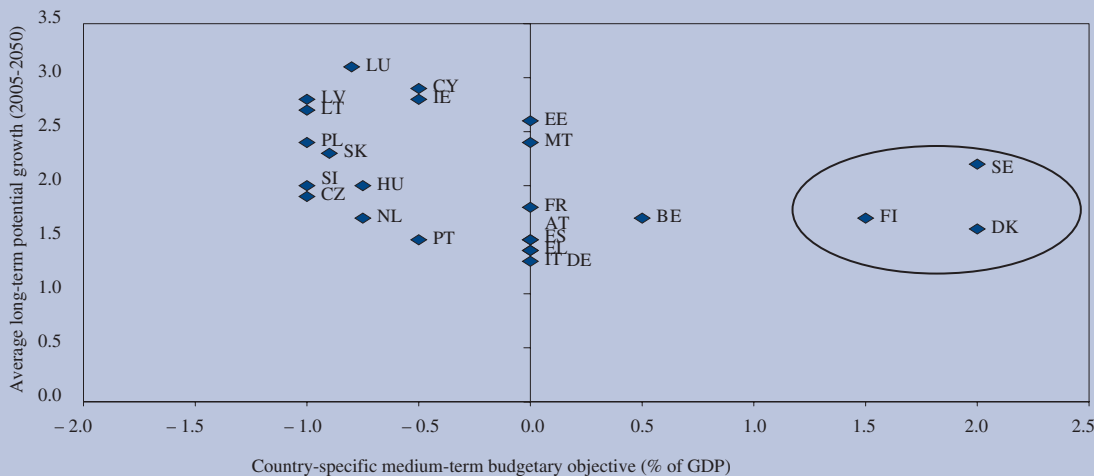
A forward-looking concept of implicit liabilities to be meaningful needs to consider not only the future implicit commitments of governments but also their entitlement to receive revenues.

Third, the notion of implicit liabilities could be *more or less broad*, i.e., it may include either a narrow or a comprehensive set of future expenditures and revenues. In particular, a broad definition of implicit liabilities could include not only the major age-related expenditures

(pensions, health, long-term care) but also other type of expenditures that are recurrent and for which there is a strong presumption that will be carried out also in the future (education expenditure, social transfers, …). A broad notion of implicit liabilities is needed for MTOs to incorporate information on the overall sustainability of public finances.

A further issue is whether to include among government implicit liabilities those liabilities that are *contingent*,

i.e., that would trigger payments only if uncertain and discrete events occur. The typical example are guarantees and insurances provided by the government to private agents (e.g., counterparts in Public-Private-Partnerships for public-purpose investments, private pension funds,…). The government in these cases may or may not have to make any actual payment, depending on whether the events that justify calling government guarantees or using government insurance schemes realise. This type of liabilities are problematic to consider, as they may never translate into an actual obligation by the government. In addition, the availability and quality of information on contingent liabilities across EU Member States is at present not fully satisfactory [1]. Progress in the statistical information on contingent liabilities is however crucial for an appropriate assessment of sustainability risks. This holds especially for the new Member States but also for some EU-15 Members (see, e.g., European Commission (2004)).

The analysis of public finance sustainability made by the Commission and the Council in the context of budgetary surveillance considers a relatively broad definition of net, non-contingent, implicit liabilities. Age-related expenditures stemming from government commitments relating to pensions, health and long-term care, unemployment benefits and education are projected on the basis of the criteria agreed within the EPC/AWG, while revenues and non-age-related expenditures as a share of GDP are assumed to remain constant (see section I.4 of this report).

Which indicators for government liabilities?

Turning to the issue of how to measure implicit liabilities a first distinction can be made between stock and flow measures of (net) government liabilities. Stock measures aim at providing a measure of the mass of outstanding net liabilities at a given point in time. Stock measures often include a comprehensive notion of government net liabilities. Flow measures aim at quantifying the budgetary position needed to dispose of enough room to absorb the future impact of ageing.

Stock measures

A first approach to obtain stock measures of implicit liabilities is to estimate the *net present value* of future

entitlements and commitments of the government weighted on current GDP. This amounts to summing up the discounted value of the future budget balances, i.e. the estimated revenues and expenditures. This indicator measures the mass of net implicit liabilities at the start of the projection period. It permits to construct comprehensive government balance sheets, which include not only current liabilities and assets, both real and financial, but also implicit liabilities [2]. Additionally, comprehensive government balance sheets could also include measures of contingent liabilities [3].

An alternative approach is to *project future debt levels*. This permits to evaluate the whole path of debt/GDP ratios and to evaluate at which points in time tensions in public finances could arise. Debt projections are a constant feature of the Commission assessment of long-term public finance sustainability within the framework of the assessment of Stability and Convergence Programmes.

Flow measures

In the Commission's practice for assessing long-term sustainability, different synthetic indicators providing a flow measure of the impact of implicit liabilities are constructed (see section I.4 of this report). The main indicator used in the sustainability assessment is the *sustainability gap* (S2). This indicator provides a measure of the permanent improvement in the unchanged-policy structural primary balance necessary to guarantee that the inter-temporal budget constraint of the government is satisfied (i.e., that the debt/GDP ratio does not grow indefinitely). In order to give a clear indication of the medium-term budgetary policy implications of achieving sustainable public finance over an infinite horizon, the S2 indicator can be expressed as a *required primary balance* (RPB). This is the unchanged-policy structural primary balance achieved over the medium term which would allow the respect of the government inter-temporal budget constraint.

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[1] See European Commission (2004), section II.4.

[2] See, e.g., Buiter, (1985) among the first analytical contributions supporting a comprehensive approach (i.e., including also implicit assets and liabilities) to the construction of government balance sheets.

[3] Since the computation of comprehensive government balance sheets requires estimates of the current stock of real and financial assets and liabilities, which are not easily available for all Member States, this approach does not feature among those commonly used by the Commission to assess the sustainability of public finances. Nevertheless, progress in the area of statistical information on government assets and liabilities could permit a better assessment of public finance sustainability including from the viewpoint of the contribution that productive government assets (e.g., infrastructure) can make to potential growth and then to government revenues.

It needs to be stressed that synthetic sustainability indicators are sensitive to the quality and availability of age-related expenditure projections and assumptions on growth and interest rates and that there are aspects that are relevant in an overall assessment of public finance sustainability that are not captured by the quantitative indicators. In order to take into account the limitations mentioned above, the quantitative sustainability analysis made by the Commission services is complemented by a qualitative assessment which covers elements such as the current debt/GDP ratio, the current level of the tax burden, the degree of reliability of age-related projections, the presence of contingent liabilities, and the overall policy scenario with particular reference to structural reforms improving sustainability (see section I.4 of this report).

Overall, although there are inevitable uncertainties related with the measurement of implicit liabilities, the information on implicit liabilities currently used in EU budgetary surveillance could be a valid starting point for taking into account implicit liabilities in the determination of MTOs.

How could a link between MTOs and implicit liabilities be made?

A first broad approach consists of determining the MTO on the basis of the *required primary balance* indicator. ([1]) As previously illustrated, this indicator measures which primary balance achieved over the medium term would be consistent with public finances sustainability at unchanged policy. Since the MTO needs to define a safety margin against a reference value for the overall budget balance (the Maastricht 3 percent deficit ceiling), the MTO needs to be gross of interest expenditures, i.e., the RPB needs to be translated into a 'required balance' (RB) which includes interest expenditures. A crucial issue relates to the *degree of frontloading* of age-related expenditures via ambitious MTOs. Medium-term objectives may be set equal to the RB, namely, ambitious enough to permit to accommodate for the impact of ageing without the need to further raise taxes or cut expenditures in the future. Following this strategy, MTOs will permit to fully frontload the impact of ageing. Alternatively, a gradual approach could be followed, such that MTOs would only partly account for the ageing impact. This partial front-loading strategy would require additional adjustment in

response to future increases in age-related expenditures and would imply a more adverse debt profile and then a higher present value of interest expenditures.

A different approach for the determination of MTOs to address the above limitations would be to take into account not only the RB but a broader set of quantitative and qualitative elements relevant to assess the public finance perspectives of a given country. One possible way would be to define groups of countries characterized by different sustainability risks, each group with MTOs incorporating a '*sustainability margin'* increasing with the degree of risk. Sustainability risks could be identified on the basis of a comprehensive assessment taking into account debt projections, synthetic sustainability indicators, available information on contingent liabilities, and qualitative elements relating to the overall current and planned policy scenario. After major structural reforms countries may enter a different risk group and be subject to a different sustainability margin. Regarding the size of the sustainability margins, it could be determined, *inter alia*, on the basis of average values of the required balance within the country group. However, comprehensive stock measures of government liabilities could also be considered, as well as qualitative elements.

2.3. The adjustment path towards the medium-term budgetary objectives

The past failure to reach the medium-term budgetary objective of 'close to balance or in surplus' was one of the main reasons for a strengthening of the preventive arm of the Stability and Growth Pact. In the context of the SGP reform, the Council notably agreed on a number of principles, including numerical benchmarks, for the definition of the appropriate adjustment path towards the country-specific medium-term budgetary objectives. In order to strengthen the growth-oriented nature of the SGP, the 2005 reform also introduced the possibility for Member States to deviate from the agreed benchmarks for the adjustment path towards the MTO or from the MTO itself, in case major structural reforms are implemented. It was also decided that due account would be taken of the needs for public investment when assessing medium-term budgetary projections.

This section recalls the main elements of the agreement on the SGP reform concerning the definition of the adjustment path towards the MTO and the conditions for allowing a deviation from the MTO or from the adjustment path towards it. It also provides a Commission

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([1]) Proposals along these lines were put forward in the debate that took place with Member States in late 2004/ early 2005 and that was preparatory to the agreement reflected in the March 2005 Council report on the SGP reform.

assessment of whether the adjustment path presented by Member States in their 2005 updated Stability and Convergence Programmes (SCPs) were designed according to the agreed principles.

2.3.1. The definition of the adjustment path towards the MTOs

The revised SGP includes a number of principles concerning the adjustment path towards the MTO:

i.   Member States that have not yet reached their MTO should take steps to achieve it over the cycle. Member States of the euro area or of ERM-II should pursue an annual adjustment in cyclically adjusted terms, net of one-offs and other temporary measures, of 0.5 percent of GDP as a benchmark.

ii.   A higher adjustment effort is required in good times; it could be more limited in bad times. Notably, Member States of the euro area or participating in ERM-II need to pursue, and achieve, an annual adjustment of their structural balance larger than 0.5 percent of GDP as a benchmark in good times.

iii. Member States should base their budgetary projections on realistic and cautious macroeconomic forecasts.

2.3.2. Deviations from the adjustment path for the implementation of structural reforms

In order to enhance the growth-oriented nature of the SGP, the 2005 SGP reform introduced the possibility to modulate the adjustment path towards the MTO for Member States which have not reached it, or to deviate temporarily from the MTO for Member states which have reached it, in case major structural reforms are implemented.

Taking into account structural reforms in the context of budgetary surveillance

With a view to preserving the rules-based nature of the system, the revised SGP includes a number of conditions to take into account structural reforms when defining the adjustment path towards the MTO or allowing a deviation from it. These conditions concern the nature and status of reforms, the budgetary situation and prospects, and the information requirements concerning the expected effects of reforms.

i.   *Only major reforms that have a verifiable positive impact on the long-term sustainability of public*

finances are taken into account. This includes reforms with direct long-term cost-saving effects and reforms raising potential growth. The reference to 'major' reforms suggests that a Member State could deviate from the adjustment path only in exceptional cases (reforms are a normal feature in EU countries). The reference to a 'verifiable' positive impact on the sustainability of government finances implies that, for a reform to be taken into account and allow a deviation from the adjustment path to the MTO or from the MTO itself, the degree of uncertainty on the impact of the reform should be low.

ii.   *Only adopted reforms are considered.* This implies that no deviation from the adjustment path towards the MTO is allowed for planned or envisaged reforms. In this respect, it was underlined in recent discussions with the Member States that 'adopted reforms' does not necessarily imply 'adoption of the reforms by the Parliament'. Depending on each country's institutional arrangements, a reform officially decided by the government (but not yet voted by the Parliament) could also be considered in case the implementation of the reforms is certain and the detailed characteristics of the reforms are already known.

iii. *A safety margin to ensure the respect of the 3 percent of GDP reference value for the deficit needs to be guaranteed.* No deviation from the adjustment path towards the MTO should be allowed for Member States which have not reached the minimum benchmark; deviations from the MTO or the adjustment path towards it should not lead to a breach of the minimum benchmark.

iv.   *The budgetary position is expected to reach the MTO within the period covered by the Stability or Convergence Programme.* The revised Code of Conduct specifies that the period under consideration for this purpose is limited to the four years following the year of presentation of the programme ([1]).

v.   *A detailed cost-benefit analysis of the reforms from the budgetary point of view would need to be provided in the Stability and Convergence Pro-*

([1]) It should be stressed that this condition does not apply in full to the specific case of systemic pension reforms. For these types of reforms, the revised SGP only specifies that the deviation should remain 'temporary', without specifying when the budgetary position is expected to return to the MTO.

grammes. The section of the Code of Conduct on the content and format of Stability and Convergence Programmes specifies that the programmes should include comprehensive information on the budgetary and economic effects of structural reforms. It is up to the Member State to provide evidence of the impact of a given major structural reform.

Magnitude of deviations

The revised SGP does not include specific provisions on the possible magnitude and timing of deviations from the adjustment path to the MTO or from the MTO itself. Only in the case of systemic pension reforms, the Council agreed that the allowed deviation from the MTO reflects the net cost of the reform to the publicly managed pillar. For other reforms, points (iii) and (iv) above de facto impose limits to the size and duration of deviations. In addition, in the case of Member States which have not yet reached their MTO, deviations from the adjustment path should never lead to a deterioration of the fiscal position, in cyclically-adjusted terms net of one-off and temporary measures.

Discussions have highlighted that, in all cases, deviations from the MTO or the adjustment path to the MTO should take due account of the uncertainties associated with the implementation of reforms. The complexity of the issue and the wide variety of possible reforms does not allow for a mechanistic approach. The expected benefits and costs of reforms, especially the indirect ones, should be assessed with caution.

2.3.3. Implementation of the agreement in the 2005 Stability and Convergence Programmes updates

This section provides an assessment by the Commission services of whether budgetary projections in the 2005 updated Stability and Convergence Programmes are in line with the principles agreed in the context of the 2005 SGP reform for the definition of the adjustment path towards the MTO. A detailed presentation of the projections made by Member States in their programmes is provided in Part I of the report.

A number of positive developments

Significant adjustments projected over the medium-term

On the positive side, it can notably be underlined that the 0.5 percent benchmark adjustment is, on average, respected in 2007 and 2008 in most countries not yet at

their MTO, including those outside the euro area and not participating to ERM-II. Graph II.3 shows the planned improvement in the structural balance for two groups of countries: (i) Member States which have achieved their MTO; (ii) Member States with deficits below 3 percent of GDP but which have not yet achieved their MTO.

Plausible macroeconomic assumptions

Another positive development is that Member States have lived up to the commitment taken in March 2005 to base their budgetary projections on realistic and cautious macroeconomic forecasts. Budgetary projections included in the 2005 updates of the Stability and Convergence Programmes seem to be based mainly on cautious or plausible growth assumptions. This is illustrated by Graph II.4 which shows that the average planned increase in nominal GDP and revenue is very similar to that observed over the period 1995-2005. Only in two cases the Council considered the macroeconomic projections as favourable. This constitutes a clear improvement compared to the experience of the last few years.

Fewer one-off and temporary measures

Finally, according to the 2005 updates of the Stability and Convergence Programmes, the recourse to one-off and temporary measures will be marginal in the coming years. In the revised SGP, one-off and temporary measures are excluded from the assessment of the budgetary adjustment. This avoids circumvention of the rules by measures that do not contribute to sound public finances and budgetary sustainability. On average in the EU-25 and in the euro area, one-off and temporary measures will amount to 0.1 percent of GDP in 2006, following 0.2 percent of GDP in 2005. One-off and temporary measures are projected to be negligible in 2007 and 2008.

As illustrated by Graph II.5, some countries however still foresee some one-off measures in the period covered by Stability and Convergence Programmes to improve the budget. Large one-offs are expected over the coming years in Malta, Cyprus and, to a lesser extent in Belgium, Denmark, and Greece (in 2006 only).

Deviations from the agreed principles were however identified

Lack of fiscal adjustment in 2006

Graph II.3 shows that the adjustment planned by Member States which have not yet reached their medium-term budgetary objective (but not in EDP) falls short of the 0.5

Graph II.3: **The adjustment path towards the medium-term objectives projected by Member States in the 2005 updated Stability and Convergence Programmes**
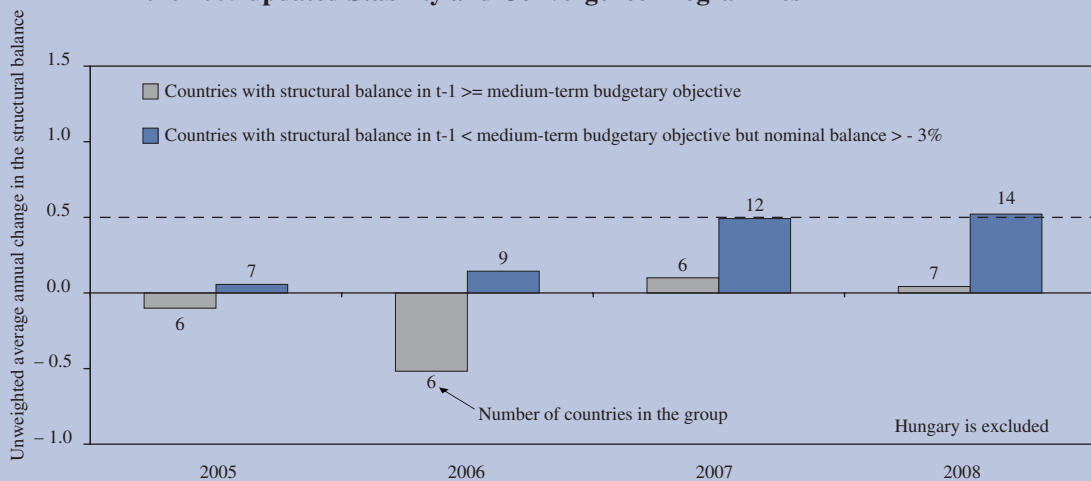
Graph II.4: **More cautious macroeconomic assumptions**
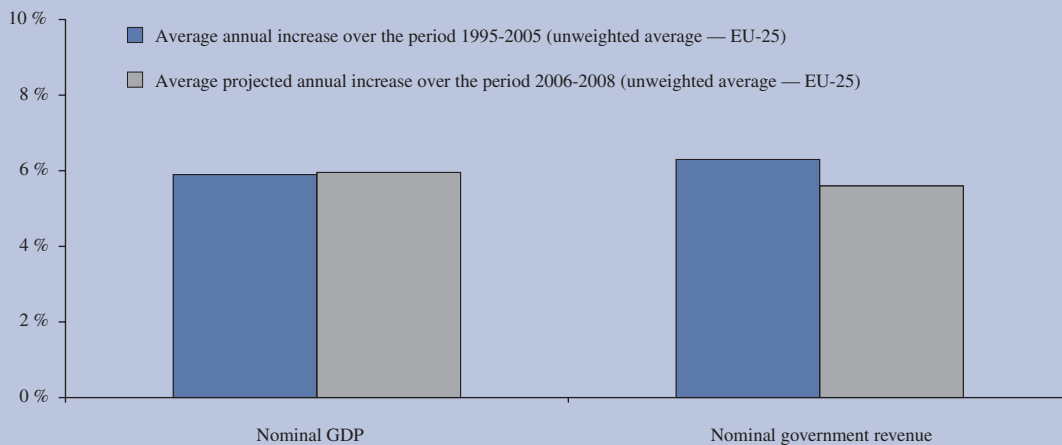
percent adjustment in the year 2006. According to the Commission spring forecast (see Graph II.6), the structural balance would even deteriorate in most of these countries in 2006.

In the same vein, while the budgetary plans of countries already at MTO respect the principle to keep a neutral fiscal stance and let automatic stabilisers play for the years 2007 and 2008, there is a deviation from this principle in 2006 (see Graph II.3. The worsening

of the structural balance in 2006 reflects the large deterioration projected by Ireland, Denmark and the Netherlands (respectively by 1.0 percent, 0.9 percent and 0.7 percent of GDP). In the Netherlands and Denmark, the large deterioration however partly reflects a reversal of the large improvement in the year 2005 explained by exceptional revenues which the governments prudently considered not to be repeated in 2006, and is therefore not the result of discretionary measures.

Graph II.5: **One-off and temporary measures implemented in 2005 and projected by Member States for the period 2006-2008**
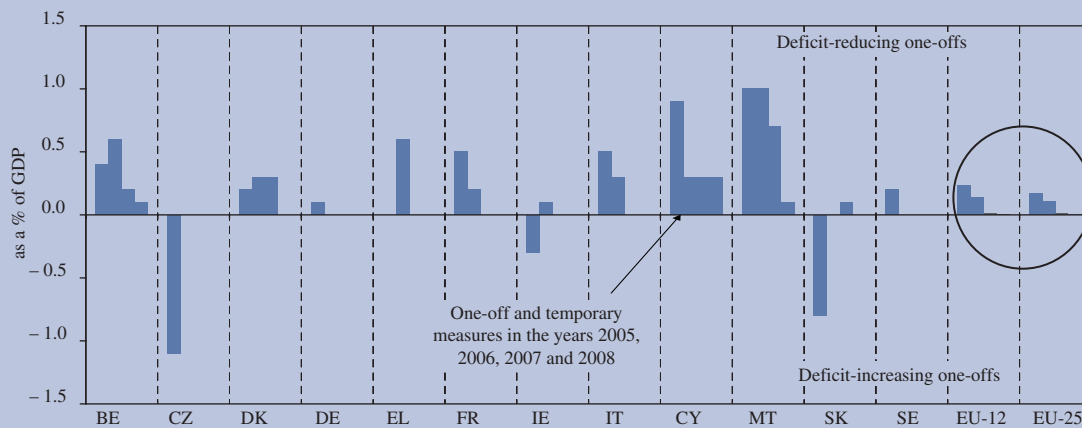
Back-loaded adjustments, insufficiently underpinned by concrete measures

There is in some Member States, an unfortunate combination of a back-loaded fiscal adjustment with a lack of specification of the measures underlying the (back-loaded) projected consolidation. While the compliance with the 0.5 percent effort should be assessed in a multi-annual perspective, the concentration of the adjustment in the outer years of the programme in some Member States is a source of concern, especially if it is not underpinned by concrete measures. This calls for a close monitoring of budgetary developments in the coming months and years and explains why the Commission spring 2006 forecast (made under the no-policy change assumption) projects the structural balance expected to remain unchanged in 2006 and to improve by only ¼ percent of GDP in 2007.

Graph II.6: **Forecast annual change in the structural balance – Spring 2006 Commission forecasts**
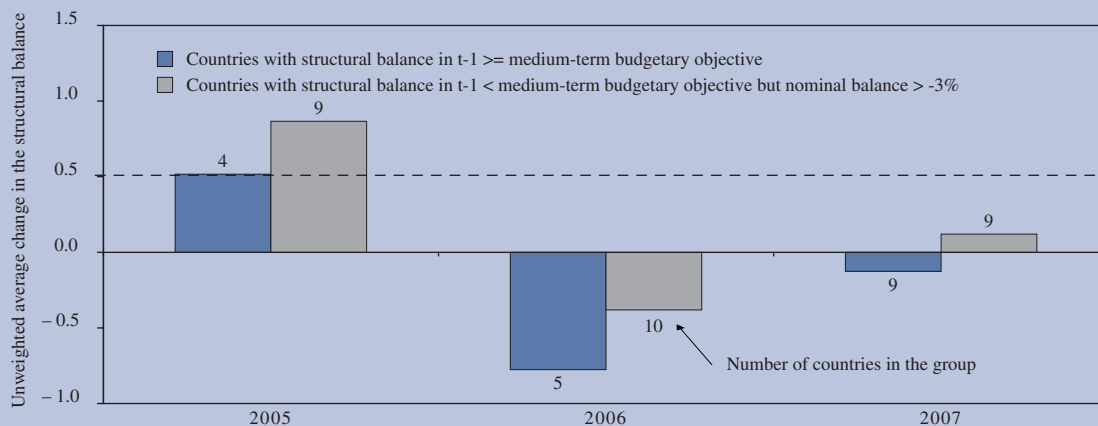
Larger efforts could be expected in good times

The lack of fiscal adjustment in 2006 suggests that the benign economic environment with growth close or above potential is not being exploited to progress towards the MTO. As mentioned above, the revised SGP requires Member States to pursue a larger adjustment effort in good times. Member States of the euro area and participating to ERM II are expected to pursue improvements in their structural balance by more than 0.5 percent of GDP as a benchmark. In practice, according to the information in the programmes, the 0.5 percent benchmark is, on average, not achieved in countries with a positive output gap (the same is true for countries with a positive change in the output gap).

It should however be noted in this respect that the discussions on the 2005 updated Stability and Convergence Programmes showed the difficulties of a forward-looking assessment of 'good' or 'bad' times, and confirmed that the estimated level or change of the output gap may not always be a good measure of good times. This confirms that the appraisal of good and bad times should be made in line with the provisions of the revised Code of Conduct according to which '*the identification of periods of economic "good times" should be made after an overall economic assessment*'.

No structural reforms were taken into account in this round of programmes

A last point to be noted is that a combination of the lack of information provided in the programmes on the content of the reforms and their budgetary implications and the conditions set by the SGP for allowing deviations from the adjustment path on ground of structural reform meant that virtually no cases of structural reform were discussed. An improved operation of the clause related to structural reforms could possibly benefit from the specification of the quantitative information necessary for assessing the impact of structural reforms. In addition, in the context of the re-launch of the Lisbon agenda, further progress on the integration between the National Reform Programmes and the Stability and Convergence Programmes would be desirable.

3. Making the revised Stability and Growth Pact operational – the corrective arm

3.1. Introduction

The 2005 reform of the Stability and Growth Pact introduced more economic rationale and more room for judgment in the application of the excessive deficit procedure. The revised SGP foresees that the influence of economic developments on the budgetary outcomes should be considered more systematically when preparing reports under Article 104(3) launching the excessive deficit procedure and when setting deadlines for the correction of excessive deficits, but also possibly when deciding on the existence of excessive deficits. It also increases emphasis on fiscal consolidation efforts rather than only on nominal results, which allows a better identification of inappropriate policies and contributed to a permanent and sustainable correction of excessive deficits.

This section assesses the implementation of the excessive deficit procedure since the 2005 SGP reform, taking into account that, at the time of the reform, concerns were raised that the flexibility introduced in the excessive deficit procedure would be abused, weakening the fiscal framework. This section does not aim at providing a comprehensive overview of the ongoing EDP procedures concerning the various countries (this is done in Part I of the report), but rather at assessing how the rules were applied in line with the letter and spirit of the revised SGP. In a second part, this section elaborates on a feature of the revised SGP which deserves particular attention and careful implementation: the assessment of *effective action* in the excessive deficit procedure. Provisions related to effective action play a central role in the revised SGP, which allows repeating steps in the EDP in case a Member State has acted in compliance with the previous recommendations of the Council. A number of simple and transparent principles for the implementa-

tion of the concept of effective action are presented, with a view to stimulating discussion on this issue.

3.2. The application of the excessive deficit procedure

This section discusses how the increased room for economic judgment of the revised SGP was used in the application of the excessive deficit procedure.

3.2.1. Preparation of Commission reports in accordance with Article 104(3)

The revised SGP foresees that the Commission should always prepare a report under Article 104(3) of the Treaty when a reported or planned deficit exceeds 3 percent of GDP. It also provides specifications on the content of the reports.

As was already foreseen in the original SGP, the Commission reports in accordance with Article 104(3) should notably examine if one or more of the exceptions foreseen in Article 104(2)(a) of the Treaty apply. The original SGP also foresaw that that the Commission reports should take into account whether the government deficit exceeds government investment expenditure and take into account *all other relevant factors*. The revised SGP specifies the nature (and role) of these 'other relevant factors': it states that the Commission report should appropriately reflect developments in the *medium-term economic position* and in the *medium-term budgetary position*. Furthermore, consideration should be given to *any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value*. To this end, Member States may put for-

ward to the Council and to the Commission the specific factors that they consider relevant ([1]).

Since March 2005, the Commission has adopted reports in accordance with Treaty Article 104(3) for three Member States: Italy, Portugal and the UK. In all cases, the Commission report contained a comprehensive assessment of 'other relevant factors':

• Under the heading 'medium-term economic position', the reports took into account considerations related to (i) the current and expected cyclical position of the economy; (ii) potential growth developments and (iii) the recent implementation of structural reforms and their expected impact on the economy.

• Considerations related to the 'medium-term budgetary position' included (i) an assessment of the structural position of government finances (net of cyclical influences and one-off and temporary measures); (ii) a review of the fiscal stance in previous episodes of economic good times; (iii) an overall assessment of the sustainability of government finances in the Member State concerned; and (iv) an analysis of recent developments in public investment and in the quality of government finances.

• Specific relevant factors put forward by the Member State concerned were also considered and assessed in a balanced way in the Commission reports. For instance, the UK provided information on a number of factors that influenced budgetary developments in the recent past (e.g. related to the timing of net payments to the EU and commitments to international aid and debt relief). Italy put forward factors on the nature of the statistical revisions in the recent years, the budgetary impact of the net contribution to the EU budget and the contribution to fostering international solidarity (due to the late submission, these factors could not be explicitly mentioned in the 104(3) Commission report; they were however duly taken into account by the Commission and the Council in the following steps of the excessive deficit procedure).

• Finally, the 104(3) reports took into account other factors that were considered relevant by the Commission for an overall appreciation of the situation. These factors were related, inter alia, to the quality of the statistical system, the institutional settings of the country concerned (existence of independent institutions in charge of providing inputs or analysis in the area of fiscal policy, quality of the budgetary process, strength of expenditure-control mechanisms, etc.).

In all cases, the Commission reports in accordance with Article 104(3) were accompanied with detailed technical annexes produced by the Commission services. The consideration of a wide range of relevant factors in the initiating step of the excessive deficit procedure ensures that decisions and recommendations are based on a comprehensive assessment of the budgetary developments in the context of the economic conditions prevailing in the country concerned. This contributes to an economically rationale implementation of the EU fiscal rules.

3.2.2. All deficits in excess of 3 percent of GDP have been considered excessive

The revised SGP foresees that 'other relevant factors' can be taken into account when deciding on the existence of an excessive deficit only if the excess of the deficit over 3 percent of GDP is temporary and the deficit remains close to the reference value. At the moment of the reform, some critics — ignoring these provisions — argued that Member States could be allowed under the

Table II.3

Data taken into account by the Council when deciding on the existence of an excessive deficit

	2004	2005	2006	Conclusions
IT	3.1 % of GDP (observed)	3.6 % of GDP (COM spring-05 forecast)	4.6 % of GDP (COM spring-05 forecast)	Close, not temporary
PT	2.9 % of GDP (observed)	6.2 % of GDP (Plans of the Portuguese authorities)	4.8 % of GD (Plans of the Portuguese authorities)	Not close, not temporary
UK	3.2 % of GDP (observed)	Just below 3½ % of GDP (COM autumn-05 forecast)	Around 3.1 % of GDP (COM autumn-05 forecast)	Close, not temporary

Source: Commission services.

([1]) The Code of Conduct specifies that the Member State concerned may put forward to the Council and to the Commission the specific factors that it considers relevant, in due time for the preparation of the report under Article 104(3) and as a rule within one month of the reporting dates established in Article 4 (2) and (3) of Regulation (EC) No 3605/93. The Member State shall provide the information necessary for the Commission and the Council to make a comprehensive assessment of the budgetary impact of these factors.

revised SGP to sustain deficits in excess of 3 percent of GDP for long periods without being considered in excessive deficit.

Since the reform all deficits in excess of 3 percent of GDP have been considered excessive. In all cases, deficits could not be considered close to the reference value or the excess could not be considered temporary (see Table II.3). For instance, the Commission and the Council considered the slight excess of 0.1 percent of GDP over the reference of 3 percent of GDP in Italy in 2003 and 2004 close to the reference value, but not temporary. Similarly, the excess of 0.2 percent of GDP over the reference value in the UK in fiscal year 2004/05 was considered close to the reference value, but not temporary as the deficit was not projected to decline below the reference value without corrective policy action. The large planned deficit in Portugal could not be considered close or temporary.

As the excess over the reference value was not close and could not be considered temporary under unchanged policies in any of these three cases, corrective action was necessary to correct the excessive deficit. Enhanced surveillance under the excessive deficit procedure was therefore appropriate and in line with the spirit of the revised SGP rules. The application of the provisions related to 'other relevant factors' in the steps leading to a decision on the existence of an excessive deficit has confirmed that the SGP remains essentially a rules-based framework. The increased room for judgment did not affect predictability of the actions taken and equal treatment across Member States. This reflects the fact that the room for judgment and the basis on which judgment has to be exerted have been well defined and codified in the revised Regulations and in the revised Code of Conduct.

3.2.3. Initial deadlines for the correction of excessive deficits were set taking into account economic circumstances

The revised SGP foresees that deadlines for the correction of excessive deficits should be set taking into account an overall and balanced assessment of 'other relevant factors'. Since the agreement on the revised SGP, recommendations in accordance with Article 104(7) of the Treaty were issued for three EU Member States. The room for judgment in the excessive deficit procedure has been applied to set realistic deadlines for Member States to correct their excessive deficits.

Italy and Portugal, two Member States with high initial deficits and relatively weak economic growth situations and prospects, were given longer deadlines for the correction of the excessive deficit (two to three years). The Commission and the Council considered, after an overall economic assessment of the situation, that shorter deadlines could have implied an overly large fiscal effort in a single year. This does not mean that the revised SGP systematically allows for longer deadlines and lower consolidation efforts. On the contrary, a comparison of the recommendations in accordance with Article 104(7) addressed under the original and revised SGP shows that the fiscal efforts recommended to Italy and Portugal are larger than those recommended on average in the past (see Table II.4). The recommended efforts are also significantly larger than the agreed benchmark of an annual fiscal effort of at least 0.5 percent of GDP in structural terms. The case of the UK illustrates that longer deadlines are not the standard. This country had a deficit slightly above 3 percent in the fiscal year 2004-05 and growth expected to be close to potential in the coming years. It was therefore given a short deadline for the correction of the excessive deficit and recommended to achieve fiscal efforts in line with the 0.5 percent of GDP benchmark.

3.2.4. An obligation of structural efforts, to ensure that excessive deficits are corrected in a permanent way

The Council recommendations and notices issued since the reform always specified the required structural fiscal effort, which excludes one-off and temporary effects on the budget balances. The emphasis on structural fiscal efforts ensures that excessive deficits will be corrected permanently. Recent updates of the Stability and Convergence Programmes confirmed that Member States in EDP plan significant consolidation efforts in the years 2006 to 2008. The improvement in the structural balance planned by these countries is on average significantly above the 0.5 percent benchmark introduced by the revised SGP.

The adjustment planned by Member States in EDP varies considerably. As shown in chart II.8, most of former EU-15 Member project significant improvements of their structural balance in the coming years. The projected fiscal adjustment in some new Member States in EDP falls short of the 0.5 percent of GDP adjustment benchmark, also taking a multi-annual average. In part, this reflects the fact that 104(7) recommendations for these Member States were issued under the original

Table II.4

104(7) recommendations formulated in the past for EU-15 Member States

		Indentification (= year t)	Deadline for the correction	Effort in t	Effort in t+1	Effort in t+2	Effort in t+3	Yearly average
104(7) rec. under the original SGP to EU-15 Member States	**DE**	2003	**2004 (t+1)**	1.0 % of GDP of structural measures	—	—	—	0.5 % of GDP
	FR	2003	**2004 (t+1)**	> 0 % of GDP	at least 0.5 % of GDP	—	—	0.3 % of GDP
	NL	2004	**2005 (t+1)**	0.6 % of GDP	at least 0.5 % of GDP	—	—	0.5 % of GDP
	GR	2004	**2005 (t+1)**	Structural measures of at least 1 % of GDP over the 2 years		—		0.5 % of GDP
104(7) rec. under the revised SGP	**IT**	2005	**2007 (t+2)**	> 0 % of GDP	Change in the structural balance of at least 1.6 % of GDP cumulated		—	0.6 % of GDP
	PT-II	2005	**2008 (t+3)**	Package of 0.6 % of GDP	1.5 % structural	0.75 % structural	0.75 % structural	0.9 % of GDP
	UK	2006 (fiscal year)	**2006 (t)**	0.5 % structural	—	—	—	0.5 % of GDP

Source: Commission services.

Graph II.7: **Medium-term budgetary plans of Member States in EDP (simple averages)**
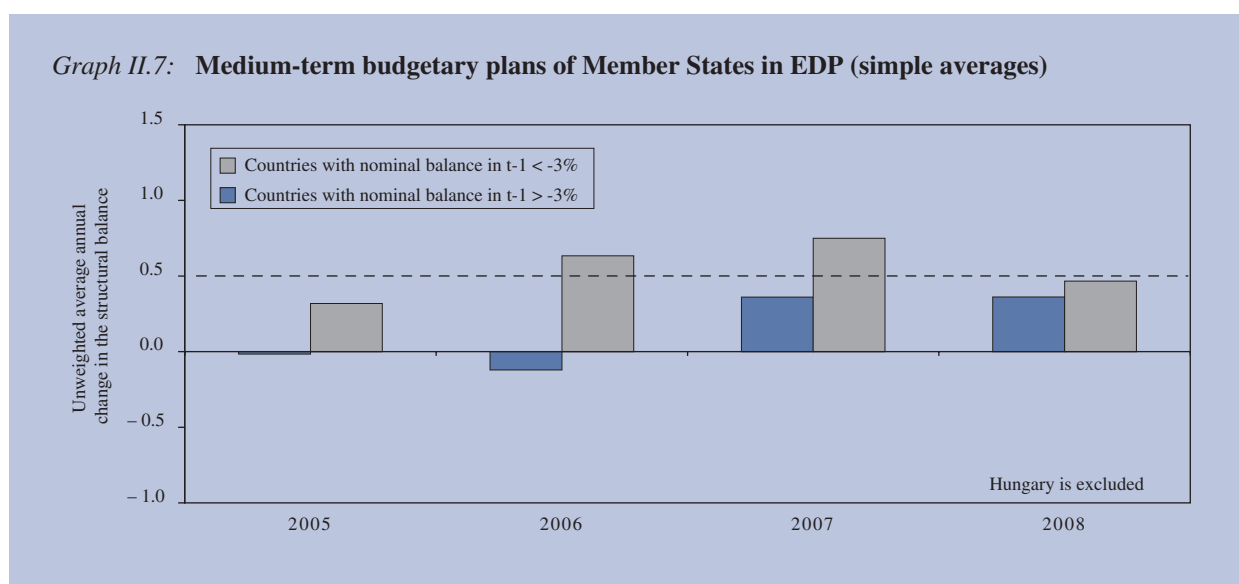
SGP, and did not explicitly require a quantified improvement in the cyclically-adjusted or structural balance. Since the deadlines were set, the growth situation has improved in a number of Member States, and the planned structural fiscal adjustment in these countries was revised downward but remains sufficient to correct the excessive deficit by the deadline set by the Council in the recommendation under article 104(7) set under the original SGP (the reduction in the deficit relies more on favourable growth conditions and less on structural

efforts). Recommendations under the revised SGP will ensure that Member States in EDP are always required to achieve improvements in their structural balance by at least 0.5 percent of GDP.

3.2.5. Improved economic dialogue between the Commission, the Council and the Member States

In March 2005, the Council stressed that improved cooperation between the Commission, the Council and Member

Graph II.8: The adjustment path towards the medium-term objectives

Annual change in structural
balance in the years 2006, 2007, 2008

Budget balance in 2005 (rhs)

Changes in structural balance (% of GDP)

Budget balance (as % of GDP)

DE   EL   FR   IT   PT   UK   CZ   CY   HU   MT   PL   SK
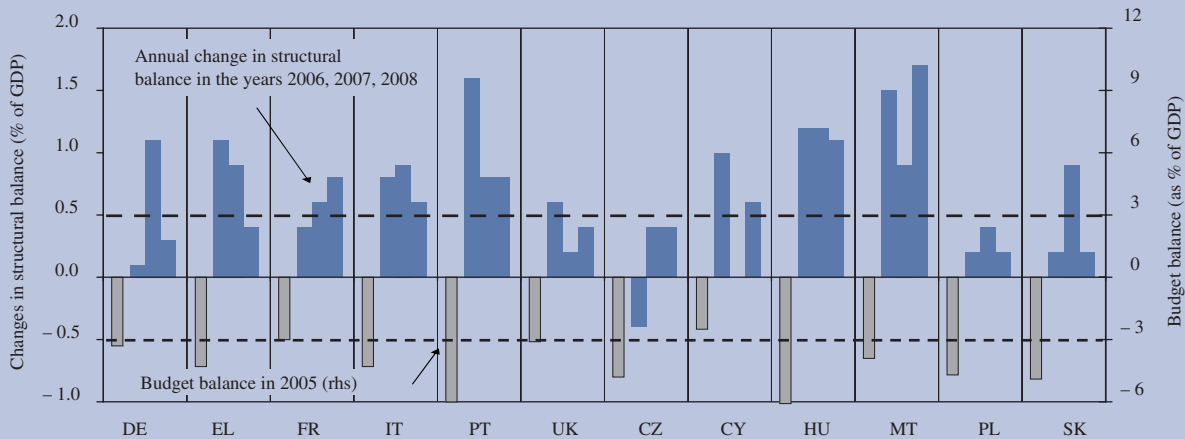
States was important to strengthen national ownership and enforcement of the SGP rules. The experience with the revised SGP has shown that, by introducing more room for economic judgment in the fiscal surveillance process, the reform stimulated a constructive and transparent economic policy dialogue at EU level on the individual country cases. This allowed better explaining decisions and recommendations in the context of the excessive deficit procedure and strengthened peer support and pressure.

The improved economic dialogue contributed to a smooth and efficient operation of the Pact. The large convergence of views between the Commission and the Council in the assessment of the 2005 Stability and Convergence Programme Updates and in the recommendations and decisions under the excessive deficit procedure since the SGP reform should be seen in this context. The progress made with the SGP reform highlights the importance of good communication and coordination of policies in the EU and the euro area.

3.3. The concept of 'effective action' in the excessive deficit procedure

The revised SGP formalises the important distinction between policy errors and events unrelated to policy. In the revised SGP, it is possible to repeat steps in the excessive deficit procedure if failure to correct the excessive deficit cannot be attributed to a policy error but to unexpected adverse economic event with a considerable negative impact on the budget. The revised SGP

makes clear that a repetition of these steps can only be invoked under the provision that *effective action* has been taken by the country concerned in compliance with the initial recommendation or notice. How the assessment of 'effective action' will be done in practice is therefore a key element for the success and credibility of the revised EU fiscal rules.

3.3.1. New definition and role of 'effective action' in the excessive deficit procedure

The 2005 SGP reform clarified the definition of effective action and how to assess it. The amended Regulation 1467/97 and the revised Code of Conduct make clear that the notion of 'effective action' covers both *the announcement of appropriate measures* within the six months period following the adoption of a 104(7) recommendation or the four months period following a 104(9) notice and *whether these measures are duly implemented and ensure the achievement of the fiscal effort initially recommended by the Council*. In line with Article 10(2) of Regulation 1467/97, which specifies that 'if action by a participating Member State is not being implemented or, in the Council's view, is proving to be inadequate, the Council shall immediately take a decision under Article 104 (9) or Article 104 (11) respectively', the surveillance of budgetary developments is made in real time.

The revised Code of Conduct provides elements on how the assessment of effective action should be made. It notably specifies that:

i. A Member State should be considered to have taken effective action if it has acted in compliance with the recommendation or notice, regarding both the implementation of the measures required therein and budgetary execution.

ii. The assessment should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall would be made.

The following section elaborates on these provisions.

3.3.2. A broad assessment of compliance with EDP recommendations

The revised SGP makes clear that the reference for the assessment of effective action in the EDP is whether the Member State concerned has achieved the annual improvement of its CAB, net of one-off and other temporary measures, initially recommended by the Council. However, taking into account that the ultimate objective is to determine whether national authorities have taken actions in compliance with the Council recommendations under Article 104(7) or notices under Article 104(9) of the Treaty, the revised Code of Conduct asks for a detailed analysis in case the improvement of the CAB, net of one-off and other temporary measures proves lower than recommended. In this analysis, a number of factors influencing developments in the CAB net of one-off measures should be taken into account, which can be classified in the following two broad categories:

i. *The factors which can be considered outside the control of the government* (budgetary effect of fluctuations in interest rates on the debt burden, revisions in potential growth, developments in the composition of growth, fluctuations in tax elasticities).

ii. *The factors which can be considered as under the control of the government.* This includes notably an assessment of whether all the announced corrective measures were actually introduced. As specified in the Code of Conduct, the analysis should also take into account whether budgetary plans were adequately implemented.

Factors outside the control of the government

The following factors can be considered to be largely outside the control of the government.

The effect of fluctuations in interest rates on the debt burden. This effect can be neutralised by focusing attention on the change in the cyclically-adjusted primary balance. When relevant, the impact on the general government balance of changes in the structure of the debt, which results from decisions of the government, could be taken into account (in most of cases, this effect should however be negligible).

Developments in potential growth. The change in the CAB net of one-off and temporary measures should be corrected for the effect of the change in the estimated potential growth compared to the level (implicitly or explicitly) assumed in the recommendation or notice. The idea underlying this correction is that of assessing the adjustment conditional upon a potential growth estimate established *ex ante*. The methodological elements are detailed in the 2004 edition of the Public Finance Report [1]. The 'surprise' in potential growth is the difference between the potential growth assumed in the recommendation or notice and the potential growth used to compute the change in the CAB at the moment of the assessment of compliance with the recommendation.

Composition of economic growth. A difference between the recommended change in the CAB, net of one-off and other temporary measures, and the one estimated at the time of the assessment can be due to shifts in the composition of economic growth towards more or less tax rich components compared to the projections underlying the recommendation or notice. Such unexpected changes need to be taken into account when measuring the fiscal effort.

Other factors such as changes in tax elasticities and the budgetary effects of revenues which may not be synchro-

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[1] This report showed that the effect of potential growth surprises on the change in the CAB can be computed as follows: $-\dfrac{G^S_{t-1}}{Y^P_{t-1}}(E_{t-1}\omega_t - \omega_t)$,

where $\dfrac{G^S_{t-1}}{Y^P_{t-1}}$ is the expenditure to GDP ratio net of cyclical factors in year

$t-1$ and $E_{t-1}\omega_t - \omega_t$ is the forecast error of the growth rate of potential GDP growth in year t.

nised with the economic cycle. These factors potentially include the effect of unexpected developments in the elasticity of individual taxes relative to their base and the behaviour of revenues the base of which is not necessarily synchronised with the economic cycle ([1]). In view of the diversity of these factors, their assessment cannot follow a uniform approach and should be done on a case-by-case basis.

Factors under the control of the government

Introduction of measures and policy changes. In line with the provisions of the revised Code of Conduct, the assessment of effective action takes into account whether all the measures or reforms announced by the government within the six or four months period following the adoption of the recommendation or notice were actually introduced. The assessment also takes into account other measures introduced since the adoption by the Commission of its Communication following the expiry of the 6-month or 4-month deadline.

Budgetary execution. As specified in the Code of Conduct, the assessment takes into account other elements related to the implementation of budgetary plans (it should encompass budgetary execution as a whole). What ultimately matters for the assessment of effective action is not only the impact of the specific corrective measures, including those activated following the Council recommendation or notice, but also the overall developments in the execution of the budget. The Code of Conduct assumes that all items of primary general government expenditure net of cyclical factors as well as

discretionary measures on the revenue side are under the control of the government.

Possible discrepancy between the expected and observed budgetary impact of measures and reforms. An element that deserves particular attention concerns the possible discrepancy between the expected and observed budgetary impact of measures and reforms. Considering that the decisions to implement specific measures and reforms are taken by the Member States and that their effectiveness largely depends on whether adequate control mechanisms were put in place, the responsibility for possible shortfalls in the effect of measures and reforms should, as a rule, fall on the Member State concerned. A lower-than-expected improvement in the CAB net of one-off and temporary measures resulting from a lower-than-expected impact of a given measure should therefore as a rule be considered as a lack of effective action by the Member State concerned. This is consistent with the focus put in the SGP framework on 'effective actions' rather than on 'actions'.

A point that may justify an exception to this principle concerns the particular case of certain major structural reforms. The economic effects of such reforms (labour market reforms and certain pension and health reforms for instance) depend on complex microeconomic interactions and on the behavioural response of private agents to new incentives. The *ex ante* estimation of the budgetary impact of such reforms therefore involves objective uncertainties. In some cases, the budgetary slippage – or part of it – stemming from a lack of effect of such structural reforms could be considered as an event outside the control of the government. This should however be conditional on the fact that the lack of effect of reforms was not predictable. The Commission forecasts could play a role in this respect.

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[1] Based on past experience, temporary movements of some tax revenues do not necessarily follow the economic cycle as measured by the output gap. In such a case there is the risk of misjudging the level of structural revenues.

4. Measurement and statistical issues

4.1. Introduction

The revised SGP increases the number of factors to be taken into account in budgetary surveillance. Stronger focus is also put on the quality of EU fiscal surveillance. As a consequence, the need to dispose of appropriate fiscal indicators has increased. Three issues treated in this section are related to the specific question of the measurement of budgetary positions and policies.

The *first* issue concerns the identification of temporary influences, other than those stemming from the cycle, on budgetary statistics. The Council Report of 20 March 2005, amending Regulations 1055/05 and 1056/05 and the revised Code of Conduct all refer to fiscal adjustments in cyclically-adjusted terms, net of *one-off and temporary measures*. The introduction of this concept in all documents of the SGP implies a common understanding between the Commission, Member States and the public of what are one-off and temporary measures, and agreeing on how to identify and take them into account in a transparent manner.

The *second* issue is that of the *cyclical adjustment of budget deficits*. The revised SGP clarifies that the compliance with the MTO and progress towards it need to be measured in cyclically-adjusted terms. Moreover, the MTO should be set in such a way to allow for a safety margin against the breach of the 3 percent deficit ceiling as a result of weak cyclical conditions. This means that MTOs need to be set below the so-called minimal benchmarks, i.e., the level of the CAB consistent with the full operation and the respect of the 3 percent ceiling for deficits under normal cyclical conditions. In the following, it will be described the recent work done within the EPC Working Group on Output Gaps on the estimation of budget elasticities and sensitivities for New Member States and on the updating of the same parameters for EU-15 Member States. It will also be illustrated the recent work done by the Commission services for the estimation of a new set of values for minimal benchmarks for the 25 Member States.

Statistical issues have been given more prominence by the SGP reform. Concrete initiatives in this field have been taken by the Commission and the Council in recent times. The *third* sub-section provides a summary of the *recent developments in relation to the governance of budgetary statistics* in the EU. In particular, it provides an illustration of the recent legislative changes in the regulation governing the reporting of deficit and debt statistics for the implementation of the SGP.

4.2. Definition and identification of one-off and temporary measures

The revised SGP requires that Member States in excessive deficit as well as those that have not yet reached their MTO have to achieve a minimum structural effort every year, defined as a change in the cyclically-adjusted balance net of one-off and temporary measures. This will ensure that respect of the nominal deficit limits of the EU fiscal framework is achieved through the implementation of sustained consolidation packages rather than by the use of non permanent measures.

This section first examines the rationale for the existence of one-off and temporary measures. Then, it specifies the concept of one-off and temporary measures and principles for taking into account such measures in the context of budgetary surveillance. It also provides an indicative list of types of operations that could be considered as one-off and temporary measures.

4.2.1. One-off and temporary measures in the context of numerical fiscal rules

The rationale for isolating temporary influences on the budget is to identify the more permanent or the underlying budgetary trends and efforts. Although one-off and temporary measures are not always associated with an intention to make the figures look better, it is clear that

the temptation exists for policy-makers to lower the budget deficit or public debt through 'easy' measures, which leave the government's net worth unchanged and imply no political cost. Some authors have also shown that the recourse to one-off and temporary measures is more frequent in Member States with high deficits and weak institutional settings or non-transparent budget processes and when there are numerical fiscal rules. The main explanation for this is related to the so-called Goodhart's Law, which says that when an economic indicator is made a target for the purpose of economic policy, which is generally the case following the introduction of a numerical fiscal rule, policy-makers change their behaviour and tend to take decisions which facilitate the respect of the target.

In the context of the revised SGP, relevant one-off and temporary measures are those with an impact on the general government balance. This section focuses exclusively on such measures.

4.2.2. Recent experience with one-off measures in the EU

The introduction of provisions on one-off and temporary measures in the revised SGP is a clear improvement in the economic rationale of the fiscal framework. This change was notably motivated by the frequent recourse to one-off and temporary measures in recent years. Graph II.9 below shows the impact of one-off and temporary measures on the general government balance in

the euro area since 1993 ([1]). While in theory one-off and temporary measures can be deficit-reducing and deficit-increasing, the chart shows that, on average, they have been deficit-reducing. This tends to confirm the view that one-off and temporary measures were used as a mean to improve budgetary figures. The size of one-offs also seems to be linked to cyclical developments. When growth was high (periods 1994-1995 and 19989-2000 on the chart), the budgetary effect of one-offs was on average small.

Graph II.10 below shows the link, for euro area countries, between the level of the deficit and the frequency and importance of one-off and temporary measures since 1993. Negative and small one-offs (below 0.3 percent of GDP) are not represented on the chart. The graph shows that there are more one-off measures when the deficit approaches 3 percent of GDP or is slightly above this ceiling. It also suggests that one-off measures are potentially larger when the deficit approaches 3 percent of GDP.

The recourse to one-off and temporary measures implied difficulties in the application of the SGP rules. The graph below illustrates the case of Portugal. This country brought its nominal deficit below 3 percent of GDP

([1]) This series was constructed using the database built by Van den Noord and Koen (2005) and Commission services' information on the recent past.

Graph II.9: **One-off and temporary measures in the euro area, as a % of GDP**

UMTS proceeds (1.1 % of GDP)
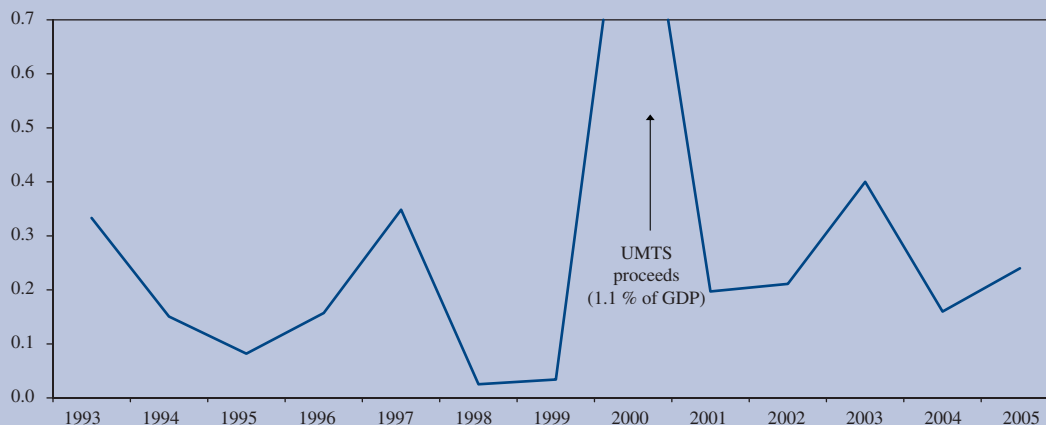
Graph II.10: **More and bigger one-offs when the deficit is close to 3 % (1993-2005, euro area countries)**
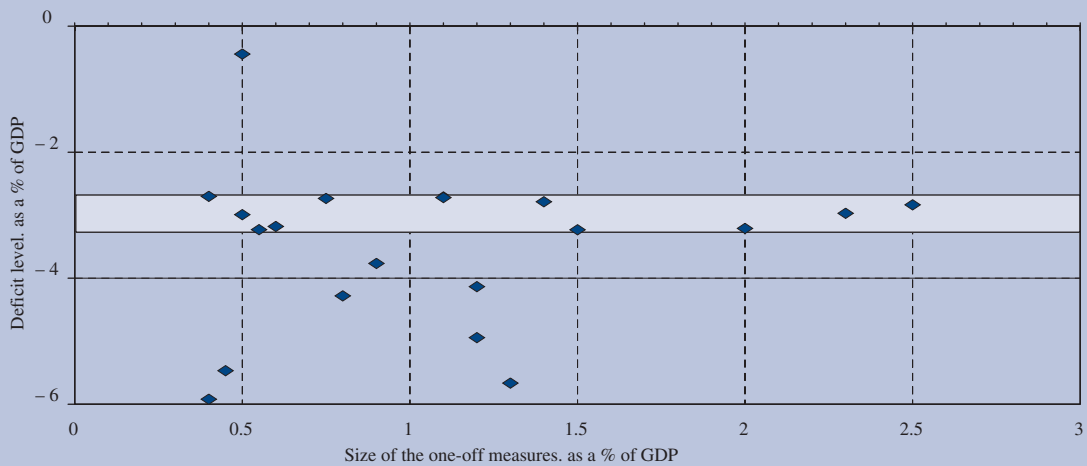
between 2002 and 2004, during 3 consecutive years, through the implementation of very large one-off measures. There was no structural effort during this period (the cyclically adjusted balance net of one-off and temporary measures was virtually unchanged) while the nominal deficit and the CAB improved to below 3 percent of GDP in the years 2002 to 2004. When the effect of the one-off measures vanished, the actual deficit converged towards its structural level, and reached 6 percent of GDP in 2005.

4.2.3. Guidance for the identification of one-off and temporary measures

Specification of the definition of one-off and temporary measures

Given the diversity of the measures potentially concerned, providing a simple and concise definition of one-off and temporary measures is difficult. The revised Code of Conduct specifies that '*one-off and temporary measures are measures having a transitory budgetary*

Graph II.11: **Why Portugal did not get out of trouble**
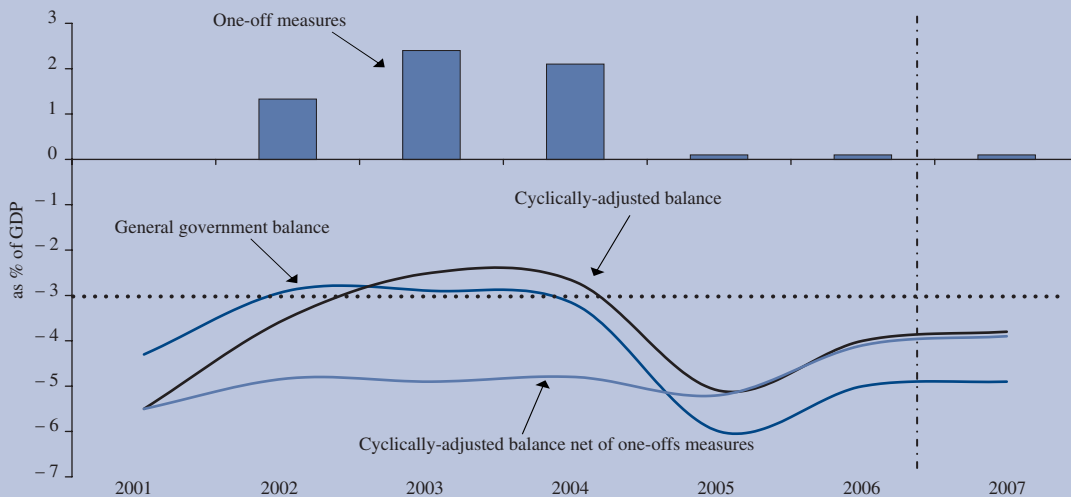
effect that does not lead to a sustained change in the intertemporal budgetary position'. However, the need for clarity of the concept calls for further specifications of this general definition. The following common features of one-off and temporary measures can be identified:

i. By nature, one-off and temporary measures have only a *temporary* influence on the headline and the cyclically-adjusted fiscal position. Their impact on the general government balance is concentrated in one or a very limited number of years.

ii. Such measures are *non-recurrent*. When deciding whether a particular measure is non-recurrent, the measure should be assessed in the context of the chain of measures of the same type. For instance, although each investment project is unique, a specific investment decision should be seen in the context of a continuity of investment decisions over time. As a rule, such measures should therefore not be considered as one-off and temporary measures, unless their size is exceptional ([1]).

The Council Report of 20 March 2005 and other SGP-related documents refer to one-off and temporary *measures*. However, to identify the underlying developments in the budgetary position, *transactions* resulting from events outside the control of the government (Court decision, call of a contingent liability agreed in previous years), and therefore not strictly corresponding to 'measures', having an important one-off or temporary impact on the general government balance, should also be taken into account in the context of budgetary surveillance.

One-off and temporary measures and the calculation of structural fiscal efforts

The assessment of whether specific measures should be considered as one-off measures and be taken into account in the context of fiscal surveillance and in the calculation of the structural balance and effort will inevitably depend on the issue at hand. However, a number of principles should be followed.

•   *First, only measures having a significant impact on the general government balance should be considered.* Widening the definition to a large number of measures would considerably increase the complexity of the monitoring of government finances developments.

•   *Second, as a rule no deficit-increasing measures should be excluded from the calculation of the fiscal effort* ([2]). In implementing the provisions related to one-off and temporary measures, the aims of the Council should be kept in mind. The Council intended to (i) ensure objective and transparent analysis of government finances developments; (ii) reduce incentives to pursue fiscal consolidation on the basis of one-off measures and; in turn, (iii) stimulate the implementation of sound consolidation measures with a sustained effect on government finances. The provisions on one-off and temporary measures were therefore primarily introduced in order to avoid that deficit-reducing one-off and temporary measures are treated as structural measures. They should not create incentives for Member States to present some deficit-increasing operations which could have a permanent character as one-off measures ([3]).

4.2.4. An indicative and open list of one-off and temporary measures

The difficulty to establish a clear definition of one-off and temporary measures is a strong argument in favour of relying on concrete examples to identify them. An indicative and open list facilitates the identification of one-off measures, although it is clear that this list cannot be exhaustive and definitive. In the report 'Public finances in EMU – 2004', the Commission services made an analysis of one-off and temporary measures and, without the ambition of being fully inclusive, gave a tentative list of one-off and temporary measures which could be taken into account in the context of budgetary surveillance.

In light of this previous work, recent economic literature on the issue, and recent developments in the EU Member

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([1]) When considering whether the costs associated with a natural catastrophe (flooding, livestock diseases) should be considered as a one-off and temporary measure, account should be taken of the fact that relatively minor or medium-size catastrophes occur every year and therefore do not require exceptional spending. Unless expenditure directly related to the catastrophe are significantly larger (as a percent of GDP) than those of the same type observed in 'normal' times, they should not be considered as a one-off measure.

([2]) Exceptions could be made in cases where there is a high degree of certainty on the transitory nature of the measure and on the fact that it will not be extended in time or repeated.

([3]) The exclusion of permanent deficit-increasing measures from the calculation of the fiscal effort would lead to an 'artificial' improvement of the fiscal effort, which would not reflect an improvement of the underlying fiscal position.

States, the following categories of operations could be considered as one-off or temporary measures and transactions, provided that they satisfy the criteria and principles mentioned above. The classification makes a distinction between deficit-reducing and deficit-increasing measures, which, as stated before, should be treated with particular caution.

Deficit-reducing measures

i. *Tax amnesties implying a one-off tax payment.* The typical case is that of a government offering an amnesty in order to repatriate capital from abroad. The amnesty may be subject to a one-off tax payment, which can potentially be large.

ii. *Sales of non-financial assets* (real estate, publicly owned licenses and concessions). (^{1}) (^{2}) The most famous example is the sale of UMTS licences in 2000 (and in some countries in subsequent years).

iii. *Temporary legislative changes in the timing of outlays or revenues with a positive impact on the general government balance.* This includes changes in tax rates that are clearly announced as temporary and temporary changes in the timing of expenditure and collection of revenues.

iv. *Exceptional revenues linked to the transfer of pension obligations* (^{3}). These revenues correspond to the payment by a given company to the government, in exchange for the transfer of the responsibility for the future payment of pensions of its employees. The magnitude of the one-off payment depends on the value of the pension commitments assumed by government and is potentially important.

v. *Changes in revenues or expenditure consecutive to Court or other authorities rulings.* Such measures include for instance reimbursements of subsidies to general government decided by the Commission.

vi. *Securitisation operations with a positive impact on the general government balance.*

vii. *Exceptional revenues from State owned companies.*

Deficit-increasing measures

i. *Short-term emergency costs associated with major natural catastrophes or other exceptional events* (e.g. military actions, others). Experience shows that the exceptionality of these costs depends considerably on the size of the country.

ii. *Changes in revenues or expenditure consecutive to Court rulings* or consecutive to Commission decisions.

4.2.5. Information requirements on one-off and temporary measures

The role played by one-off and temporary measures in the revised SGP strengthens the need for timely and reliable information on such measures.

The revised Code of Conduct specifies that 'measures having significant one-off' effects should be explicitly identified' in the programmes. Annex 1 of the Code of Conduct on the structure of Stability and Convergence Programmes foresees that Member States will provide in their programme information on one-off and temporary measures and developments in the structural balance. These provisions imply that implemented and planned one-off and temporary measures should be described and quantified in the Stability and Convergence Programmes. These refer both to planned measures and measures that took place in the recent past.

As regards the nature of the information to be provided by the Member States, the following elements seem particularly relevant:

i. A description of the transaction and of the events at the origin of the measure. This includes information on the entities involved and the flows foreseen by the operation.

ii. The observed or expected impact of the transaction on general government expenditure and revenues over time. Information on how the measure was quantified, including the main assumptions for the calculations and on the assumed treatment of the transaction in the national accounts should be provided.

(^{1}) One refers here to non-financial assets (buildings, land, licences and concessions) as, according to accounting rules, the disposal of financial assets does not reduce the deficit.
(^{2}) In the national accounts, such receipts are recorded as negative investment expenditure at the moment the sale takes place.
(^{3}) Regular payments and receipts in connection with the transfer of pension obligations of specific individuals are not relevant.

Although the provision of information in the context of Stability and Convergence Programmes constitutes a clear progress compared to the previous situation, exchanges of information on an annual basis may not seem sufficient for a timely monitoring of one-off and temporary measures, especially in the case of Member States in Excessive Deficit which are subject to an enhanced surveillance. Additional information could be provided in the context of the national budgetary procedures.

The Commission contributes to an improved transparency concerning these measures. The Commission services provide information on the effect of one-off and temporary measures included in its bi-annual forecasts. When assessing Stability and Convergence Programmes and compliance with the recommendations addressed by the Council, the Commission provides clear information on the measures that it considered as one-off and temporary measures, and that were excluded when estimating the fiscal effort.

4.3. The estimation of new and updated budgetary sensitivities and the determination of minimal benchmarks

Since the inception of the SGP, a great deal of attention was put on the need to distinguish the structural from the cyclical component of budget balances in EU budgetary surveillance. Progress was made in the past years on the front of defining an agreed methodology for the computation of output gaps, a necessary ingredient for adjusting budget balances for the cycle. In a first step, a methodology for computing output gap figures based on production function-based estimates of potential output was developed for the EU-15 Member States within the Working Group on Output Gaps (OGWG) of the Economic Policy Committee, and agreed by the Ecofin Council in July 2002 ([1]). In 2003, the OGWG undertook new work on to refine the production function methodology, and extend it to all EU countries, including the new Member States ([2]). Since 2004, production function-based output gap figures are available for all Member States.

In spite of this progress on the front of the estimation of output gaps, up to 2005 cyclically-adjusted budget balance (CAB) figures for new Member States were not available, due to missing values for budgetary sensitivities, the other necessary ingredient for the cyclical adjustment of budget balances. In 2005, progresses have been made on this front: values for the budgetary elasticities for the new Member States were computed according to a methodology agreed at EU level and values for EU-15 Member States were updated to account for possible changes in the structure of government revenues and expenditures. This work was carried out by the OECD and the Commission services within the framework of the OGWG. On the basis on the new set of budgetary elasticities, the Commission services constructed budgetary sensitivities, providing this way the link between output gaps and budget balances when computing CABs.

As a result of the 2005 SGP reform, medium-term budgetary objectives can differ across countries and will be set with the aim, *inter alia*, to ensure an adequate safety margin against the breach of the 3 percent reference value for deficits (see section II.3 of this report). In order to gauge the respect of such adequate safety margin, the Commission introduced in 2000 the concept of minimal benchmark and used it regularly in previous years in budgetary surveillance, mostly in the assessment of stability and convergence programmes. During 2005, on the basis of the recently computed full set of budgetary sensitivities, a new set of values for minimal benchmarks have been calculated by the Commission services, discussed and approved by the Member States.

4.3.1. Updating the estimation of budgetary sensitivities and computing sensitivities for the new Member States

Background information

In the European Commission approach, the CAB is computed by deducting from overall budgets the cyclical component, which is the product of the output gap and the sensitivity of the budget balance to the cycle (see Box II.3). The budgetary sensitivities used in budgetary surveillance by the European Commission are based on OECD estimates of budgetary elasticities, and the methodology for linking output gaps to budget balances is discussed and agreed by the EPC. Although figures for New Member States' output gaps computed according to the agreed production function methodology were available already since 2004, the computation of CABs was

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([1]) See Denis, McMorrow and Roeger (2002) for a description of the EU production function approach to the computation of output gaps.
([2]) An illustration of the main methodological improvements in the computation of output gaps is contained in Denis et al. (2006).

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Box II.3: **Budgetary sensitivities: definition and construction**

Budgetary sensitivities are a basic ingredient for the computation of cyclically-adjusted budget balance (CAB) according to the Commission method. Specifically, the CAB is derived by subtracting the temporary component of the budget balance from the overall nominal figure:

$$CAB_t = b_t - \varepsilon \cdot OG_t \quad (1)$$

where is the nominal budget balance-to-GDP ratio in year t, ε the budgetary sensitivity parameter and OG_t the output gap in year t (i.e., the difference between real GDP and potential GDP expressed in percent of potential GDP).

The sensitivity parameter ε represents the change in the budget balance-to-GDP ratio associated with an additional percentage point of output gap. It is obtained by aggregating the elasticities of individual budgetary items (the percentage change in budgetary items associated with a percentage change in output). The individual revenue elasticities, $\eta_{R,i}$, are first aggregated to an overall revenue elasticity η_R using the share of each on the total current tax burden (R_i/R) as weight:

$$\eta_R = \sum_{i=1}^{4} \eta_{R,i} \frac{R_i}{R} \quad (2)$$

Elasticities $\eta_{R,i}$ are computed according to the OECD methodology agreed within the OGWG. The weights R_i/R are computed by the Commission services as an average over the period 1995-2004. As for the expenditure elasticity, η_G, it can expressed as

$$\eta_G = \eta_{G,U} \frac{G_U}{G} \quad (3)$$

where $\eta_{G,U}$ is the elasticity of unemployment-related expenditures and G_U/G is the share of unemployment related expenditure on total current primary expenditure. Parameter $\eta_{G,U}$ is computed on the basis of the methodology developed by the OECD. The weight G_U/G is computed by the Commission services using OECD data or data from national source for non-OECD countries. The reference year is 2003.

The revenue and expenditure elasticities η_R and η_G are transformed into sensitivity parameters as follows:

$$\varepsilon_R = \eta_R \frac{R}{Y}, \varepsilon_G = \eta_G \frac{G}{Y} \quad (4)$$

where R/Y is the share of the current tax burden on GDP and G/Y is the share of primary current expenditure on GDP. Both weights are computed by the Commission services using 2003 as the reference year. The difference $\varepsilon_R - \varepsilon_G$ eventually yields the sensitivity parameter of the overall budget balance ε used in equation (1).

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made impossible by the lack of budgetary elasticities for New Member States until June 2005.

The EPC OGWG, following the latest EU enlargement, received a mandate by the Ecofin Council with a view '…to focus, together with the Economic and Financial Committee, on the linking of the output gaps and the cyclically-adjusted balance …'. On the basis of this mandate, the EPC OGWG, with the participation of the OECD, has been working in 2004 and 2005 towards producing budgetary elasticities for the EU-10 and to update the existing set of elasticities and sensitivities for the EU-15 Member States (published back in 2000, see Van den Noord (2000)), in order to take into account changes

that occurred since then in the policy environment and in structural fiscal parameters. The OECD also proposed some revisions in the methodology for estimating budgetary elasticities, that were discussed and agreed in the OGWG. The OECD computed new values for the elasticities for all OECD countries, including the four countries of recent EU accession (Czech Republic, Hungary, Poland, Slovakia). As for the six non-OECD EU Members, the elasticities were estimated by the Commission services using the OECD methodology.

Based on the work carried out by the EPC Output Gap Working Group (OGWG), on 27 June 2005 the EPC has approved the updated elasticity estimates by the OECD

for EU-15 Member States and the new values for the EU-10 Member States. A new set of budgetary sensitivities was then computed by the European Commission that was used in the Autumn 2005 forecast and in the assessment of the 2005 vintage of stability and convergence programmes.

The new and updated values for budgetary sensitivities for all new Member States

The first step for computing budgetary sensitivities is the estimation of *budget elasticities*. Table II.5. New and updated budgetary elasticities below reports the results from the latest estimates by the OECD (for all EU OECD countries) and the Commission services (non-OECD countries). Four different types of tax elasticities are estimated separately: personal income tax, corporate income tax, indirect taxes and social contributions. On the expenditure side, it is estimated the elasticity of only one cyclically-sensitive item: unemployment-related transfers.

The elasticity of personal taxes is just above unity for most countries, this being mainly the result of progressive tax schedules. The elasticity of corporate taxes is also higher than one in general, but in this case the result is mostly driven by the fact that corporate profits, the tax base for corporate taxes, react more than proportionally with output. Regarding the elasticity of social contributions, this is generally below unity instead, mainly due to a less than proportional reaction of the tax base (i.e., the wage bill) to output. As for indirect taxes, the elasticity is assumed to be equal to unity for all countries. On the expenditure side, elasticities are relatively small (equal to -0.12 for EU-25 average), given the relatively low share of unemployment related transfers on total primary current expenditure. EU-15 countries exhibit on average slightly higher revenue elasticities than EU-10 countries (by about 1 decimal point). A stronger difference is observed for expenditure elasticities (-0.15 for EU-15 versus -0.06 in the case of EU-10 countries).

Revenue elasticities for each tax component are aggregated into a single revenue elasticity using the weight of each tax category on the current tax burden (see columns (5) and (6) in Table II.5 and Box II.3). The figures obtained indicate that aggregate revenue elasticities are equal to 1.04 for EU-15 and to 0.96 for EU-10 countries. In comparison with the elasticities used in EU budgetary surveillance up to September 2005, for the EU-15 average there is a slight increase in the overall revenue elasticity, coupled with a more marked and generalised

reduction in expenditure elasticities due to changed estimations methodology [1].

The *budgetary sensitivity* parameters used for calculating cyclically-adjusted budget balances in EU budgetary surveillance aggregate revenue and expenditure elasticities into a single parameter representing the change in the budget balance/GDP ratio associated with a unit change in the output gap. The budgetary sensitivity is obtained as the difference between the a revenue and an expenditure sensitivity. The weight used to transform the revenue elasticity into the revenue sensitivity is the share of current tax burden on GDP, while that for translating the expenditure elasticity into the expenditure sensitivity is the share of primary current expenditure on GDP (see Box II.3).

Results are reported in Table II.6. New and updated budgetary sensitivities. Overall, budgetary sensitivities are on average lower for EU-10 Member States (0.36 as opposed to 0.49 for the EU-15 average).

The result is explained both by average lower revenue elasticities and expenditure elasticities and by both a lower share of current tax burden on GDP and of primary current expenditure on GDP. A comparison of the updated budgetary sensitivities for EU-15 Member States with those used so far in EU budgetary surveillance reveals that on average the overall sensitivity dropped slightly (from 0.51 to 0.49). However, this drop is entirely due to reduced values for expenditure sensitivities (in absolute value), since revenue sensitivities have slightly increased. The major increases in the overall budgetary sensitivity are observed for France, Ireland, Italy and Austria. Notable declines are observed instead in Belgium, Denmark, the Netherlands, Finland and Sweden.

4.3.2. The computation of new values for minimal benchmarks for budget balances

Background information

One of the key elements of the 2005 SGP reform is the differentiation of the medium-term budgetary objectives (MTOs) in accordance with country-specific characteris-

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[1] In the previous methodology unemployment-related expenditures included unemployment subsidies, subsidised employment and compensations for early retirement, while in the current methodology only unemployment subsidies, for which data availability is more homogenous across countries, are included. Moreover, the elasticity of unemployment with respect to the output gap is estimated directly, without the split between two separate elasticities (labour force wit respect to employment gap and employment with respect to the output gap). See Van den Noord (2000) and Girouard and André (2005).

Table II.5

New and updated budgetary elasticities

	Personal tax (1)	Corporate tax (2)	Social contributions (3)	Indirect taxes (4)	Elasticity of revenues (5)	Elasticity of expenditure (6)
BE	1.09	1.57	0.80	1.00	1.00	− 0.16
CZ	1.19	1.39	0.80	1.00	0.99	− 0.02
DK	0.96	1.65	0.72	1.00	1.00	− 0.30
DE	1.61	1.53	0.57	1.00	0.97	− 0.27
EE	0.80	1.40	0.70	1.00	0.88	− 0.05
EL	1.80	1.08	0.85	1.00	1.07	− 0.04
ES	1.92	1.15	0.68	1.00	1.09	− 0.16
FR	1.18	1.59	0.79	1.00	0.98	− 0.12
IE	1.44	1.30	0.88	1.00	1.14	− 0.16
IT	1.75	1.12	0.86	1.00	1.17	− 0.04
CY	2.10	1.50	0.70	1.00	1.14	− 0.02
LV	0.90	1.30	0.70	1.00	0.89	− 0.05
LT	0.90	1.40	0.70	1.00	0.90	− 0.03
LU	1.50	1.75	0.76	1.00	1.14	− 0.04
HU	1.70	1.44	0.63	1.00	1.02	− 0.03
MT	2.20	1.40	0.40	1.00	1.04	− 0.02
NL	1.69	1.52	0.56	1.00	1.01	− 0.42
AT	1.31	1.69	0.58	1.00	0.96	− 0.08
PL	1.00	1.39	0.69	1.00	0.91	− 0.17
PT	1.53	1.17	0.92	1.00	1.08	− 0.09
SI	1.40	1.50	0.70	1.00	0.96	− 0.13
SK	0.70	1.32	0.70	1.00	0.88	− 0.04
FI	0.91	1.64	0.62	1.00	0.92	− 0.21
SW	0.92	1.78	0.72	1.00	0.94	− 0.19
UK	1.18	1.66	0.91	1.00	1.10	− 0.05
Euroarea	1.48	1.43	0.74	1.00	1.04	− 0.15
EU-5	1.39	1.48	0.75	1.00	1.04	− 0.16
EU-10	1.29	1.40	0.67	1.00	0.96	− 0.06
EU 25	1.35	1.45	0.72	1.00	1.01	− 0.12

Source of elasticity parameters: Girouard and André (2005) for OECD Member States, Commission services for non-OECD Member States.

tics. The reform foresees that each Member State needs to have a budgetary objective, defined in structural terms, with the view to ensure, inter-alia, a safety margin with respect to the 3 percent of GDP government deficit ratio. This implies that the country-specific MTOs needs to be set above a threshold value which ensures the respect of the 3 percent reference value under normal cyclical fluctuations. In EU budgetary surveillance this threshold value for budget balances is referred to as 'minimal benchmark'.

The estimation of minimal benchmarks require two ingredients. First, a measure of the impact that cyclical fluctuations have on budgets. This is the budgetary sen-

sitivity (see previous section). Second, an estimate of a 'representative output gap' capturing by how much very negative, but still likely cyclical conditions would bring output below potential. Minimal benchmarks were estimated by the Commission services in past years. However, no estimates were available for the new Member States. Moreover, the updating of budgetary elasticities and sensitivities for all Member States in 2005 (see previous section) required re-estimating minimal benchmarks for EU-15 Member States as well.

On the basis of the new and updated values for budgetary sensitivities, the Commission services computed a new set of values for minimal benchmarks. On 26 October

2005 Member States agreed on the new set of values computed by the Commission services but invited the EPC to carry out further methodological work to explore the ways indicated by the Commission on possible methodological improvements compared with the current method.

The concept of minimal benchmark

Budget balances are affected by cyclical fluctuations through the effect of automatic stabilisers. Since in the EU fiscal framework the 3 percent reference value for deficits needs to be respected even in the event of adverse cyclical developments (with the possible exception of 'severe downturns' enabling the use of the 'exceptional circumstances' clause in the excessive def-

icit procedure), automatic stabilisers can be allowed to play freely over the cycle without breaching the 3 percent reference value only when the structural fiscal position incorporates a sufficient cyclical safety margin.

With a view to provide Member States with an indication on the minimal structural budgetary position consistent with a sufficient safety margin, the Commission introduced in 2000 the concept of 'minimal benchmark' (see European Commission (2002, 2000).

Graph II.12 an illustration provides a graphical illustration of the role and functioning of minimal benchmarks. The thin curve is the output gap, while the bold continuous curve is the general government balance. If a struc-

Table II.6

New and updated budgetary sensitivities

	Sensitivity of revenues	Sensitivity of expenditure	Budget sensitivity	Budget sensitivity used up to September 2005
BE	0.47	− 0.07	0.54	0.62
DE	0.40	− 0.11	0.51	0.48
EL	0.42	− 0.01	0.43	0.42
ES	0.38	− 0.05	0.43	0.40
FR	0.44	− 0.06	0.49	0.41
IE	0.36	− 0.05	0.40	0.32
IT	0.49	− 0.02	0.50	0.44
LU	0.48	− 0.01	0.49	0.60
NL	0.39	− 0.17	0.55	0.64
AT	0.43	− 0.04	0.47	0.29
PT	0.41	− 0.04	0.45	0.35
FI	0.41	− 0.09	0.50	0.66
Euro area	0.42	− 0.06	0.48	0.47
DK	0.50	− 0.15	0.65	0.77
SE	0.48	− 0.10	0.58	0.68
UK	0.40	− 0.02	0.42	0.49
EU-15	0.43	− 0.06	0.49	0.51
CZ	0.36	− 0.01	0.37	n.a.
EE	0.29	− 0.01	0.30	n.a.
CY	0.38	− 0.01	0.39	n.a.
LV	0.26	− 0.02	0.28	n.a.
LT	0.26	− 0.01	0.27	n.a.
HU	0.45	− 0.01	0.46	n.a.
MT	0.36	− 0.01	0.37	n.a.
PL	0.33	− 0.06	0.40	n.a.
SI	0.39	− 0.05	0.44	n.a.
SK	0.27	− 0.02	0.29	n.a.
EU-10	0.33	− 0.02	0.36	n.a.
EU-25	0.39	− 0.05	0.44	n.a.

Source: Commission services.

tural position in line with the minimal benchmark (dotted bold horizontal line) is maintained the budget balance oscillates in line with the output gap around the minimal benchmark. Even when the cyclical conditions are particularly negative, as assumed in the Graph, the budget balance would be above the -3 percent referent value without the need to carry out a discretionary adjustment.

Although, before the 2005 SGP reform, countries were expected to achieve over the medium term a budgetary position close-to-balance-or-in-surplus, without reference to country-specific considerations relating to minimal benchmarks, compliance with minimal benchmarks was systematically assessed by the Commission in the context of the analysis of the SCPs.

After the 2005 reform of the SGP medium-term budgetary objectives will be differentiated across countries, *inter alia* for what concerns the respect of a safety margin against the breach of the 3 percent reference value for deficits. Minimal benchmarks in the new system provide therefore key information for the determination of MTOs.

Updating the values for minimal benchmarks

In Autumn 2005, estimates for minimal benchmarks have been updated by the Commission for the EU-15 Member States and computed for the first time for New Member States. These new figures have been used

already in EU budgetary surveillance, notably in the preparation and assessment of the 2005 vintage of Stability Programmes.

The minimal benchmark is calculated in two steps. First, a cyclical safety margin against the 3 percent ceiling is calculated by multiplying the budgetary sensitivity by a 'representative output gap', which captures the value of the output gap that would realize under particularly weak, yet still typical, cyclical conditions. In the second step, the minimal benchmark itself is obtained by deducting the safety margin from the 3 percent deficit ceiling. Hence, the computation of the minimal benchmarks requires, for each Member State: (i) an estimate of the budgetary sensitivity to output fluctuations; (ii) the identification of a 'representative output gap' for particularly weak cyclical conditions.

The EPC OGWG has recently updated its estimates of the budgetary elasticities for EU-15 Member States and computed for the first time those for new Member States (see previous section). The identification of a 'representative output gap' for particularly weak cyclical conditions is based on the analysis of past cyclical developments in the EU. The data used for the computation of the representative output gap are obtained by applying the reference 'production function' method for the estimation of potential output and output gaps adopted by the Council on 12 July 2002.

Graph II.12: **Minimal benchmarks: an illustration**
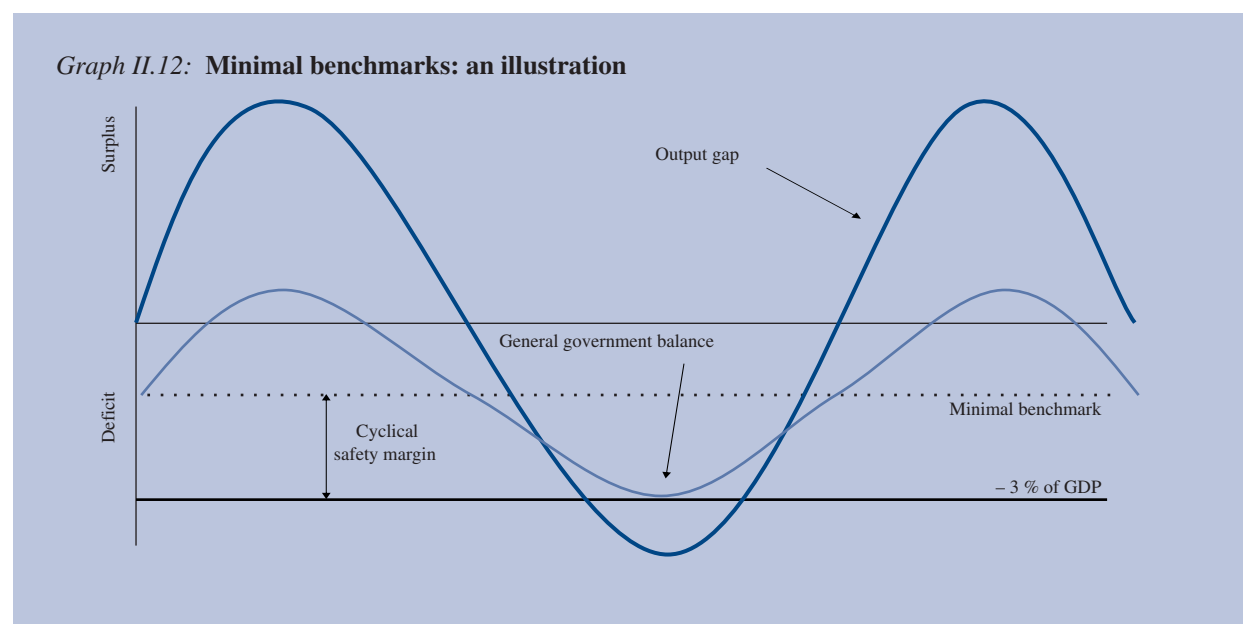
Table II.7

The output gap series for the EU-25 Member States: synthetic indicators (starting year see table, end year 2004)

	Starting year	Min	Max	Average	Standard deviation
BE	1980	− 3.7	2.0	− 0.7	1.6
CZ	1997	− 4.6	− 0.3	− 2.3	1.4
DK	1980	− 4.3	3.0	− 0.6	1.8
DE	1991	− 1.3	3.9	0.2	1.6
EE	1995	− 7.6	1.0	− 2.1	3.0
EL	1980	− 4.2	3.0	− 1.1	2.0
ES	1980	− 5.0	2.3	− 1.8	2.2
FR	1980	− 2.9	2.0	− 0.5	1.5
IE	1980	− 4.9	5.2	− 0.2	2.6
IT	1980	− 2.4	3.1	0.1	1.5
CY	1995	− 1.9	1.9	0.0	1.2
LV	1995	− 3.2	1.3	− 0.9	1.5
LT	1995	− 5.3	2.0	− 2.1	2.6
LU	1982	− 5.9	5.8	− 0.2	3.3
HU	1995	− 1.0	2.2	− 0.3	0.9
MT	1995	− 2.3	4.7	0.1	2.1
NL	1980	− 3.7	3.3	− 0.5	1.8
AT	1980	− 3.0	2.5	− 0.3	1.5
PL	1995	− 4.2	0.1	− 1.5	1.4
PT	1980	− 7.5	4.3	− 0.8	3.2
SI	1997	− 1.7	1.2	− 0.1	0.9
SK	1996	− 2.2	0.3	− 1.0	0.9
FI	1980	− 7.9	6.9	− 0.3	3.3
SE	1980	− 6.6	2.8	− 1.5	2.3
UK	1980	− 3.9	4.1	− 0.4	2.0
Simple averages					
EU-25	..	− 4.1	2.7	− 0.7	1.9
EU-15	..	− 4.5	3.6	− 0.6	2.2
EU-10	..	− 3.4	1.4	− 1.0	1.6
Euro area		− 4.4	3.7	− 0.5	2.2

Source: Commission services.

The sample used for refers to the period 1980 to 2004 for EU 15 countries, while the available output gap data for the New Member States starts in 1995 at the earliest. The 'representative output gap' for each Member State is calculated as the simple average of the highest and lowest of the following three alternatives:

i.   The largest negative output gap observed for each country in the period considered.

ii. The unweighted average of the largest negative output gaps in each country observed in the period.

iii. Two times the country-specific standard deviation of the output gap taken with minus sign ([1]).

Note that criterion ii. above considers information pertaining not only to the country concerned but to the whole sample of output gap data. The reason is that, in past years, some economies may have experienced structural changes that have modified their standard cyclical pattern. A way to overcome this problem is to complement country-specific information with information embedded in series of other countries, on the ground that output gap series of EU Member States have similar properties and that there are elements of the cycle that are common across countries.

Table II.7. reports synthetic statistical indicators for the output gap data for each EU Member States (mean, minimum, maximum values, standard deviations). The variation across countries of minimum values for output gaps highlights the need of eliminating possible 'outliers' from the sample, i.e., output gap observations exhibiting exceptionally high or low values that are likely to correspond to par-

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([1])   When output gaps are normally distributed, about 95 percent of the observations fall within the range of two times the standard deviation around the mean. Thus, since the average value of output gaps is theoretically close to zero, only about 2.5 percent of the observations fall below a value of the output gap equal to -2 times the standard deviation.

ticular events that are not representative of standard cyclical fluctuations and which will hardly be repeated in the future.

The sample of output gaps used to calculate the representative output gap was therefore re-defined in such a way to exclude all observations below and above, respectively, the 2.5 percent and the 97.5 percent percentiles of the distribution of output gaps for the sample including all EU Member States. Table II.7 also shows that, on average over the sample, new Member States have less negative minima for their output gaps than EU-15 countries as well as smaller standard deviations. These differences are due to a large extent to the shorter time series available for the new Member States and are likely to bias upward the estimation of 'representative output gaps' for these countries.

Table II.8 reports the updated minimal benchmarks. The minimal benchmarks for all countries result to be negative (meaning that a moderate structural deficit would be compatible with absence of risks of breaching the 3 percent deficit ceiling under normal cyclical fluctuations), while positive values were found in few cases in the previous computations. The simple average of minimal benchmarks across the EU-15 is -1.2, as opposed to an average of -1 in the previous computations. This revision is due to both to revised representative output gaps and to changes in the budgetary sensitivities. It is also to notice that the minimal benchmarks for the new Member States are in general considerably less ambitious than those of EU-15 Member States. This is to some extent the result of less negative representative output gaps, but also the consequence of smaller budgetary sensitivities (see Table II.5 in the previous section).

4.4. Recent developments in the governance of budgetary statistics

This section summarises recent developments in relation to the governance of budgetary statistics in the EU. It is an update of information provided on this topic on the 2003 and 2005 editions of this report [1].

This chapter places the discussions on the governance of budgetary statistics as a component of the reform of the Stability and Growth Pact (section 4.4.1) and summa-

rises recent changes in the legal text governing the provision of deficit and debt statistics for the implementation of the SGP (4.4.2).

Moreover, it summarises progress concerning the availability of fiscal statistics, with a specific emphasis on quarterly statistics (4.4.3), and describes some developments on the governance of statistics in general, a topic that goes much beyond, but have a direct impact on, fiscal statistics (4.4.4). The final section (4.4.5) concludes.

4.4.1. Statistical governance reform is part of the SGP reform

The long and in-depth discussions on the governance of budgetary statistics in EU reflect the increasing perception that high-quality budgetary statistics constitute the basic infrastructure of a rule-based fiscal framework. Low-quality fiscal statistics, or more generally poor macroeconomic statistics, may lead economists to draw wrong conclusions about the behaviour of economic agents and result in misguided choices by policymakers.

The effectiveness of fiscal rules depends on the quality of statistics

To be enforceable, fiscal rules require fiscal statistics which are timely, accurate, relevant and reliable; moreover, the credibility and transparency of fiscal surveillance depends much on the credibility and transparency of the underlying statistics. Therefore, the debates on the governance of budgetary statistics over the last two years – in particular since the call for action by the Ecofin Council of 2 June 2004 – should be seen as an integral part of the reform of the Stability and Growth Pact.

In its Communication of 3 September 2004 [2], which initiated the reform of the SGP, the Commission recognised that 'the implementation of the fiscal framework and its credibility (…) relies on the quality, timeliness and reliability of fiscal statistics' and that 'an improved monitoring (…) of the reported data' was necessary.

Moreover, the Ecofin Council Report 'Improving the implementation of the Stability and Growth Pact' of 21 March 2005, which was endorsed by the European Council of 22 and 23 March 2005, devoted a full section

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[1] See Chapter II-4 –The governance of budgetary statistics in EMU in the 2003 edition and box II-2 – Strengthening the governance of budgetary statistics in the 2005 edition.

[2] 'Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact', COM(2004) 581.

Table II.8

Updated values of the minimal benchmarks for the 25 EU Member States

	Budget Sensitivity to the cycle	Max negative output gap	- 2*std. dev. of the output gap	Average of the largest negative output gap across EU-25	Representative output gap: 0.5min[(2),(3),(4)]+0.5max[(2),(3),(4)]	Minimal benchmark	Minimal benchmark, old value
	(1)	(2)	(3)	(4)	(5)	(6)=-(1)*(5)-3	
BE	0.54	− 3.7	− 3.2	− 3.5	− 3.4	− 1.1	− 0.7
DE	0.51	− 1.3	− 2.4	− 3.5	− 2.4	− 1.8	− 1.6
EL	0.43	− 4.2	− 3.9	− 3.5	− 3.9	− 1.3	− 1.7
ES	0.43	− 5.0	− 4.4	− 3.5	− 4.2	− 1.2	− 1.5
FR	0.49	− 2.9	− 3.0	− 3.5	− 3.2	− 1.4	− 1.7
IE	0.40	− 4.9	− 4.6	− 3.5	− 4.2	− 1.3	− 1.3
IT	0.50	− 2.4	− 3.0	− 3.5	− 3.0	− 1.5	− 1.5
LU	0.49	− 4.3	− 4.5	− 3.5	− 4.0	− 0.8	0.1
NL	0.55	− 3.7	− 3.6	− 3.5	− 3.6	− 1.0	− 0.7
AT	0.47	− 3.0	− 3.1	− 3.5	− 3.2	− 1.5	− 2.1
PT	0.45	− 4.5	− 4.6	− 3.5	− 4.0	− 1.1	− 1.2
FI	0.50	− 3.8	− 3.4	− 3.5	− 3.6	− 1.1	0.8
Euro area	0.50	− 3.6	− 3.7	− 3.5	− 3.6	− 1.3	− 1.1
DK	0.65	− 4.3	− 3.6	− 3.5	− 3.9	− 0.5	− 0.8
SE	0.58	− 4.9	− 4.3	− 3.5	− 4.2	− 0.6	− 0.8
UK	0.42	− 3.9	− 3.6	− 3.5	− 3.7	− 1.4	− 1.4
EU-15	0.50	− 3.8	− 3.7	− 3.5	− 3.6	− 1.2	− 1.0
CZ	0.37	− 4.6	− 2.8	− 3.5	− 3.7	− 1.6	n.a.
EE	0.30	− 4.0	− 2.8	− 3.5	− 3.4	− 2.0	n.a.
CY	0.39	− 1.9	− 2.5	− 3.5	− 2.7	− 1.9	n.a.
LV	0.28	− 3.2	− 3.1	− 3.5	− 3.3	− 2.1	n.a.
LT	0.27	− 4.9	− 5.1	− 3.5	− 4.3	− 1.8	n.a.
HU	0.46	− 1.0	− 1.8	− 3.5	− 2.2	− 2.0	n.a.
MT	0.37	− 2.3	− 3.1	− 3.5	− 2.9	− 1.8	n.a.
PL	0.40	− 4.2	− 2.9	− 3.5	− 3.5	− 1.6	n.a.
SI	0.44	− 1.7	− 1.8	− 3.5	− 2.6	− 1.9	n.a.
SK	0.29	− 2.2	− 1.8	− 3.5	− 2.7	− 2.2	n.a.
EU-10	0.40	− 3.0	− 2.8	− 3.5	− 3.1	− 1.9	n.a.
EU-25	0.40	− 3.5	− 3.3	− 3.5	− 3.4	− 1.5	n.a.

Source: Commission services.

to statistical governance, stressing in particular the need to ensure that national statistical institutes and Eurostat have sufficient resources and capabilities and to put in place adequate safeguards so as guarantee their independence, integrity and accountability for the production of high-quality statistics.

4.4.2. Legislative changes related to reporting of deficit and debt levels

On 12 December 2005, the Council adopted a regulation amending Regulation (EC) No 3605/93 on the notification of deficit and debt data [1].

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[1] Council Regulation (EC) No 2103/2005 (OJ No L 337, 22.12.2005, p. 1).

Box II.4: Alternative methods for computing minimal benchmarks

Minimal benchmarks have been computed using alternative methods both by international organisations and academic economists. In spite of notable differences among the various approaches followed, results are remarkably similar.

Among the first estimates of minimal benchmarks were contained in OECD (1997) and IMF (1998). These approaches were analogous to that of the European Commission, but simpler and more direct. In OECD (1997) different hypothesis are made regarding the representative output gap in weak cyclical conditions. The alternatives considered are – 1, – 2 and – 3 percent of potential output. These output gap figures are in turn multiplied by the budgetary sensitivity to the cycle to obtain the cyclical safety margin and then the minimal benchmark for budget balances. In case of a representative output gap of – 3 percent the estimated minimal benchmarks appear broadly in line with those obtained using the Commission method. In IMF (1998), the method followed is that of choosing as representative output gap of each country the minimum output gap observed over the previous three decades. Results lead to minimal benchmarks ranging between – 0.5 percent of GDP and – 1.5 percent for most countries, dispersed around a simple average of – 1 percent.

Some analyses, rather than using ex-post information to infer which minimal benchmark should be kept by countries to avoid a breach of the 3 percent reference value for deficits, adopt an *ex ante* approach, based on model simulations. A further distinction can be made between the papers that base simulations on estimated structural VARs and the work carried out via macro models. In both cases the approach followed is that of providing random shocks to the model and deriving which level of the starting budget balance guarantees the respect of the 3 percent ceiling with a pre-determined level of statistical confidence. Dalsgaard and de Serres (2000) construct a structural VAR for 11 euro-area countries and show that for most countries minimal benchmarks between -1 percent and -1.5 percent would avoid breaching the 3 percent limit for deficits over a three year period with a 90 percent degree of statistical confidence. Artis and Onorante (2005) perform a similar exercise on a structural VAR estimated on quarterly data and identified along the same lines as Dalsgaard and de Serres, but define the benchmarks probability values on the basis of the 'exceptional circumstances' rules of the Stability and Growth Pact. They estimate minimal benchmarks for the 'pre-2005-refom Stability and Growth Pact ranging around budget balance positions, while minimal benchmarks for the 'reformed' Stability and Growth Pact consist of deficits slightly above 1 percent for most countries.

An indirect assessment of minimal benchmarks on the basis of stochastic simulations with the applied NiGEM macro model of the National Institute for Economic and Social Research is found in Dury and Pina (2003). The objective of analysis is to assess the probability of breaching the 3 percent reference value for deficits and incurring into sanctions under the SGP under the assumption that the budgetary commitments of EU countries incorporated in their first vintage of Stability programmes are respected. The analysis considers 10 euro area countries (all bar Greece and Luxemburg). This means assuming structural budget balances averaging – 1.9 percent in the first programme year (1999) and declining towards – 0.8 percent in the following years of the programme. The simulations show that cases of a 3 percent breach would have been very rare should countries have stuck to their commitments. This evidence also indirectly proves that deficits in the range assumed in the simulation could have served as effective minimal benchmarks.

This followed a proposal by the Commission in March 2005, which had already been shortly described and commented in last year's Public Finances in EMU report. While the final legal text adopted by the Council kept the main thrust of the Commission proposal, a number of differences should be noted.

Postponement of reporting deadlines…

Following a proposal by the Council, the reporting date for deficit and debt figures was postponed by one month, that is, from 1 March and 1 September to 1 April and 1 October, respectively. This move in the reporting deadlines intends to better align the reporting of govern-

ment deficit and debt levels with the availability of other related statistics, such as the detailed government revenue and expenditure accounts, the government financial transactions and financial balance sheets, as well as with the transmission of quarterly government accounts (on the availability of quarterly government accounts, see below 4.4.3). Therefore, the new reporting dates should contribute to improve the consistency and completeness of government statistics.

…will contribute to improve the reliability of data

Moreover, the extension by one month of the time lag for the compilation of the first outcome of government

deficit and debt figures is expected to improve other critical dimensions of government quality, notably reliability (¹). Given the fundamental objective of the excessive deficit procedure, namely of promptly identifying situations of excessive deficit and of putting an end to them, the first budgetary outcomes are those that really matter for the procedure. Revisions often arrive too late to be of relevance in the implementation of the fiscal surveillance. As a result, revisions in deficit and debt data – more than the revision of other macroeconomic statistics – may be detrimental for the credibility of the EU fiscal framework and raise issues of equal treatment among Member States, though experience indicates that, for most countries, data revisions are relatively small. The extension of the reporting deadlines by one month is all the more revealing of the importance of reliable and consistent government accounts as it goes against the trend for improving the timeliness of other macroeconomic statistics in the EU, such as GDP growth or HICP. As proposed by the Commission, the revised regulation also established the Member States' obligation of informing the Commission of any major revision in deficit and debt data occurring between the statutory deadlines, in particular when these revisions imply deficit and debt figures in excess of the Treaty reference values.

Assessment of data quality

As in the Commission proposal, the regulation adopted by the Council maintains a key role for Eurostat in assessing the quality of data reported by Member States – the topic which was the leitmotiv of the amended regulation. Eurostat's powers to check compliance of reported data with accounting rules were in this way strengthened (²).

According to the Commission proposal of March 2005, the assessment of the quality of government accounts would take place in dialogue visits and in in-depth monitoring visits, both of which should be carried out regularly in all Member States. While the former are designed to review reported data and examine methodological issues, the latter would monitor the processes and

accounts underlying the reported data, thus allowing detailed conclusions on the compliance with accounting rules, completeness, reliability and consistency of statistics. In the final text adopted by the Council, the dialogue visits remained as in the Commission proposal, but the in-depth monitoring visits (renamed methodological visits) became exceptional — 'in cases where substantial risks of potential problems with the quality of data are identified' — rather than a regular feature of the quality assessment.

The Council adopted the Commission proposals that strengthen the Eurostat's role in the provisions of data for fiscal surveillance. In particular, the amended regulation establishes that data for the implementation of the excessive deficit procedure are provided by Eurostat, and that the latter has the right of unilaterally amending the data compiled by a Member State and of publicly raising reservations to the quality of statistics.

Transparency and integrity

The Council adopted the Commission proposals aimed at strengthening the transparency of government accounts with no substantial changes. This covers the public availability of inventories describing the methods, procedures and sources used by Member States for the compilation of government finance statistics, the publication by Member States of the tables reported to the Commission, and the publication by Eurostat of regular reports on the quality of data reported by Member States, notably after each dialogue and methodological visit.

The regulation also requires Member States to put in place mechanisms that ensure that data reported are compiled with a number of statistical principles and that national officials responsible for the production of statistics abide by these principles, notably impartiality.

Clarification of accounting rules ex post and ex ante

Concerning the interpretation of rules for the accounting recording of government expenditure and revenue, and their application to complex cases, the Council established a distinction between the accounting of past transactions and guidance on the appropriate accounting treatment of planned government measures. As to the former, the amended regulation strengthens and clarifies a long-standing procedure involving Eurostat and the Committee on monetary, financial and balance of payment statistics (CMFB). Whenever there are doubts on how to apply the accounting rules to complex transac-

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(¹) Reliability denotes how statistical series are revised after their first publication; the more reliable series are those for which the first outcome is closer to final data. In the case of government accounts, final figures are only published after four years, or even later.

(²) However, not all the elements included in the original proposal by the Commission aimed at enhancing the data quality checking function of Eurostat were taken on board in the amending regulation 2103/2005.

tions, the Eurostat decision should be preceded by a consultation of the CMFB. The committee opinion itself is prepared by technical discussions in dedicated task-forces and working groups which involve the statistical authorities of all Member States. This procedure ensures that the final decision is widely shared among the EU statistical community, that is is based on technical considerations only and that all viewspoints have been duly taken into account. Simple cases can be solved bilaterally between Eurostat and the concerned Member State. However, to ensure accountability and multilateralism, Eurostat should inform the other Member States of issues solved without consulting the CMFB.

The clarification of the appropriate treatment of planned government measures is not dealt with by the amended regulation. However, the Ecofin Council of 8 November 2005 acknowledged that a timely clarification of accounting rules was essential to facilitate effective fiscal planning and forecasting. The Council invited the Commission to reflect on establishing procedural guidelines for the supply of accounting guidance on planned measures, with the aim of maximising the certainty of the guidance provided by Eurostat to Member States before the latter implement their fiscal policy measures.

The Eurostat's procedural guidelines on *ex ante* accounting guidance have already been discussed by the CMFB and the Economic and Financial Committee in spring 2006 and are expected to be endorsed by the Ecofin Council later in the year.

4.4.3. Progress in the availability of budgetary statistics

Quarterly government expenditure and revenue

In April 2006, Eurostat started the dissemination of data on the quarterly government deficit (¹), revenue and expenditure, as well as quarterly financial accounts (²) for most Member States. This publication is a milestone in a long process initiated in 1998 when the first discussions on the compilation of government accounts with a quarterly frequency started. Quarterly data on taxes, some social benefits and government debt have already been available for some time for most countries.

Although the implementation of the SGP and EDP will and should remain on an annual basis — most notably because the government budgets are adopted by the political institutions of each country with a yearly frequency — quarterly statistics will be an important tool for fiscal and economic analysis. They will provide early indications of budgetary developments allowing Member States' policy-makers to better react whenever any deviation vis-à-vis the plans occur within the year, and the EU institutions to better assess fiscal efforts put in place in each country. Infra-annual budgetary statistics should also help to better understand the interaction between fiscal developments and the economic activity. However, quarterly statistics require a specifically careful interpretation, as they are less reliable – i.e. they are subject to larger revisions – than annual data, and are more volatile from one period to the next (³).

Statistics on the functional classification of government expenditure

Concerning the availability and use of budgetary statistics, one should also mention the increased attention given by both data compilers and policy analysts to the functional classification of government expenditure. The functional classification of government expenditure — which consists at a breakdown of expenditure according to ten categories (⁴) — is more and more considered an appropriate framework to assess and compare developments in the quality of public expenditure (⁵). This is reflected in the inclusion of statistics on government expenditure by function in the stability and convergence programmes. Moreover, the national statistical institutes and Eurostat are currently working to improve the quality of these figures, in particular concerning their further harmonisation and availability of detailed breakdowns.

4.4.4. Institutional reform

Independence, integrity and accountability of the national statistical authorities

In a parallel development which concerns all official statistics, though it also has an impact on budgetary statistics, there have been discussions on the independence,

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(¹) However, a few Member States — notably France and Germany — do not yet allow publishing quarterly deficits for the ongoing year.

(²) Financial accounts cover below-the-line transactions, that is, the accumulation and decumulation of financial assets and liabilities.

(³) Notably, quarterly government accounts for most countries are not yet seasonally adjusted.

(⁴) These ten categories are general public services; defence; public order and safety; economic affairs; environmental protection; housing and community amenities; health; recreation, culture and religion; education; and social protection.

(⁵) For most countries, these data are available 12 months after the end of the reference year.

integrity and accountability of the national statistical institutes and of Eurostat.

On 24 February 2005, the director generals of the national statistical institutes and of Eurostat, gathered at the Statistical Programme Committee (SPC), unanimously adopted a European Statistics Code of Practice ([1]). This code of practice includes fifteen principles, notably professional independence of data compilers, statistical confidentiality, impartiality and objectivity, accuracy, reliability and timeliness of data and adequacy of resources of statistical institutes.

The code also contains a set of indicators associated to each of these principles which will facilitate reviewing the implementation of the Code. The Commission formally recommended that Member States recognise the European Statistics Code of Practice as a common set of standards for statistical authorities in the EU ([2]).

The Commission is setting up a reporting system to monitor adherence to the Code of Practice among the national statistical authorities, but also by Eurostat. In this context, the Ecofin Council of 8 November 2005 reiterated that the independence and credibility of Eurostat stems from its competence and operational capacity. The Council proposed the creation of a high-level advisory body to enhance the independence, integrity and accountability of Eurostat and of the national statistical authorities. This new body, which should draw up an annual report on the respect of the European Statistics Code of Practice should be composed by a small group

of independent and competent persons and chaired by an influential and well-regarded person. A formal Commission proposal on this issue is expected very soon.

4.4.5. Conclusion

This section described developments in the governance of statistics which have direct implications for the Stability and Growth Pact. Although the interest in the governance of budgetary statistics – that is on the accounting principles, rules, procedures and behaviour of institutions on the compilation and publication of fiscal indicators – was sparked by episodes of large revisions in the deficit and debt figures concerning a very limited number of countries, such debate is welcome and is, in fact, indispensable.

The implementation of the SGP has shown that the effectiveness of fiscal rules depends much on the quality of the underlying government finance statistics, and that these depend to a great extent on their governance. By moving the emphasis from a single indicator to a more reasoned analysis of the budgetary position of Member States, the reform of the Stability and Growth Pact has even reinforced the need for high-quality statistics, that is statistics which are accurate, reliable, timely, consistent across time and among countries, transparent and which are compiled by credible institutions.

As discussed previously, over the last months, several developments have contributed to improving the quality of budgetary statistics: notably the reinforcement of the Eurostat powers and responsibility in checking the quality of fiscal data reported by Member States, the publication of budgetary statistics with an infra annual frequency, as well the establishment of minimum standards for of the institutional set up of national and European statistical authorities.

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[1] The European Statistics Code of Practice can be downloaded from: http://epp.eurostat.cec.eu.int/pls/portal/docs/PAGE/PGP_DS_QUALITY/TAB47141301/VERSIONE_INGLESE_WEB.PDF.

[2] Communication from the Commission to the European Parliament and to the Council and Recommendation on the independence, integrity and accountability of the national and Community statistical authorities (COM(2005) 217 of 25 May 2005).

5. New long-term budgetary projections and improvements of the analysis of the long-term sustainability of public finances

5.1. Introduction

In the analysis of long-term sustainability of public finances in view of the budgetary challenge posed by ageing populations, long-term projections of government budgetary items are crucial. The recently completed long-term budgetary projections have been conducted with commonly agreed assumptions and methods for a wide range of budgetary items (pensions, healthcare, long-term care, education and unemployment benefits). In the context of EU multilateral budgetary surveillance, such projections need to be comparable across countries in order to ensure a consistent treatment and analysis of long-term budgetary trends and challenges in the different Member States. The new long-term projections therefore represent an important improvement of the analysis of public finance sustainability at EU level.

With regard to the analysis of public finance sustainability in the context of the assessment of the annual updates of stability and convergence programmes, some improvements were introduced in the latest assessment round. First, a decomposition of the sustainability indicators has been introduced, which enables the analysis of whether risks to public finance sustainability mainly come from the short-term or long-term budgetary developments. Second, a new sensitivity test has been introduced. It shows the supplementary budgetary cost that arises if an adjustment that ensures sustainable public finances is made in the future rather than today. In other words, it illustrates the 'cost of delay'.

5.2. The 2005/06 long-term projections of age-related expenditure for the EU-25

A new set of age-related expenditure projections for all EU-25 Member States has just been completed. The pro-

jections, based on a new population projection provided by Eurostat, cover pensions, healthcare, long-term care, education and unemployment transfers for the period 2005 to 2050. As part of the exercise, projections have also been made for the labour force and GDP growth potential up to 2050.

The projections have been prepared together by the Commission (DG ECFIN) and the Member States within the Ageing Working Group of the EPC, a group established in 1999.

Successive European Councils have recognised the need to address the implications of ageing populations at European level. In particular, by agreeing that 'the Council should regularly review the long-term sustainability of public finance, including the expected strains caused by the demographic changes ahead'. Following the indications of the European Council, the Commission and the Council now examine the long-term sustainability of public finance as part of the annual surveillance exercise, reflecting a broadening of the scope of public finance issues covered in the stability and convergence programmes, and the increased emphasis on medium to long-term sustainability issues.

The new projections provide a much more comparable, transparent and robust basis for assessing the budgetary implications of demographic change and the sustainability of public finances across Member States, which are a major element in the reformed Stability and Growth Pact in view of establishing appropriate budgetary plans. The new age-related expenditure projections are a key input to the reinforced analysis of the sustainability of public finances in the EU. Specifically, the Ecofin Council stressed in its report of 20 March 2005 that in the surveil-

lance of budgetary positions, sufficient attention should be given to debt and sustainability so as to safeguard the sustainability of public finances in the long run, and that the link between longer-term sustainability concerns and medium-term budgetary planning needs to be strengthened.

Europe's population will be older in 2050, with a much smaller population of working age. This is due to fertility rates remaining below the natural replacement rate and continuous increases in life expectancy which are only partially offset by inward migration. From an economic perspective, the most important development concerns the working-age population (15 to 64), which is projected to drop by 48 million (16 percent), between 2004

and 2050. In contrast, the elderly population aged 65+ will rise sharply by 58 million (77 percent). Europe will go from having four to only two persons of working-age for every elderly citizen (see Graph II.13.)

Despite higher employment rates, the number of employed persons will eventually fall and act as a drag on growth. The labour force projection shows that the overall employment rate would rise from 63 percent in 2003 to the 70 percent Lisbon employment rate target in 2020. The increase is mainly due to higher female employment rates as older women retire and are replaced by more economically active younger women. Notwithstanding this, the decline in the size of the working age population will eventually dominate. After increasing by

Graph II.13: **Age pyramids for EU-25 population**
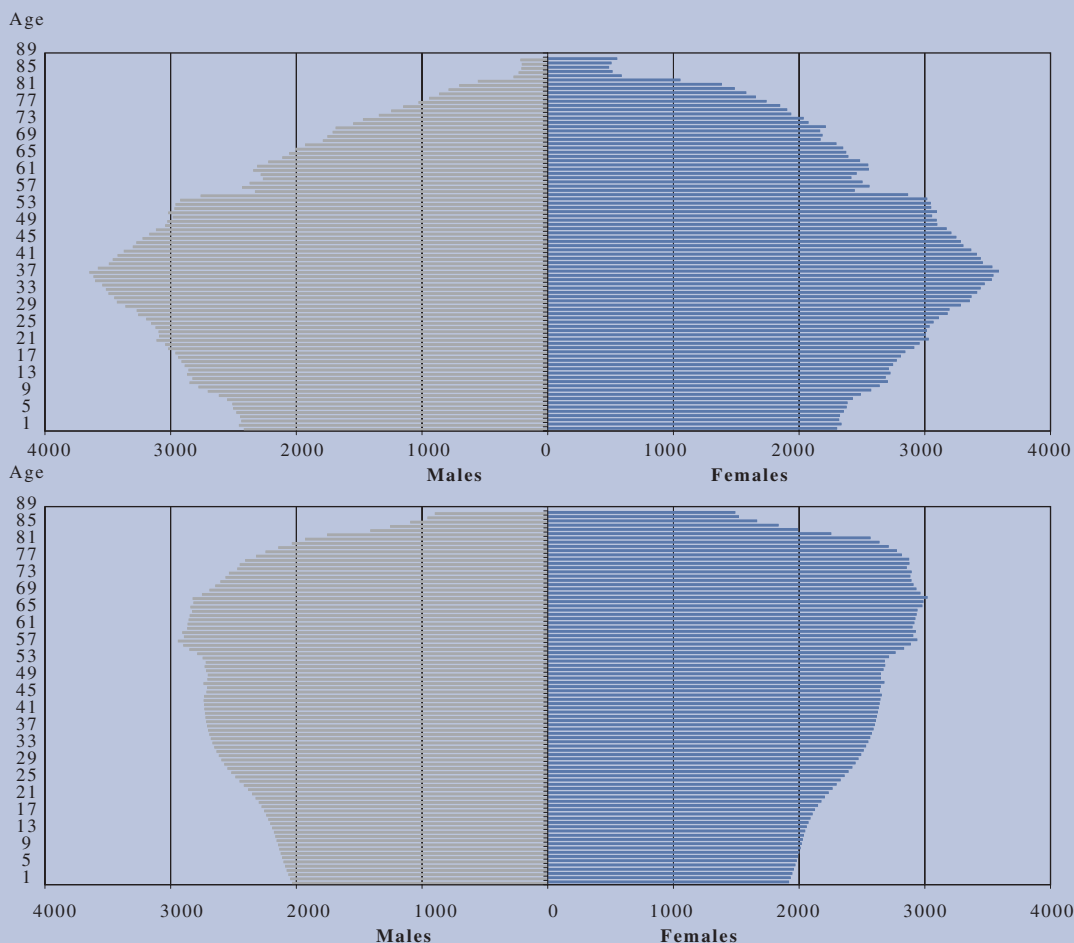
some 20 million between 2004 and 2017, total employ-ment in the EU-25 is thereafter projected to contract by almost 30 million by 2050, a fall of nearly 10 million over the entire projection period.

Potential GDP growth is therefore projected to decline. For the EU-15, the annual average potential GDP growth rate would fall from 2.2 percent in the period 2004-10 to 1.8 percent in the period 2011-30, and to 1.3 percent between 2031 and 2050. An even steeper decline is fore-seen in the EU-10 Member States, from 4.3 percent in the period 2004-10 to 3 percent in the period 2011-30 and to 0.9 percent between 2031 and 2050. Moreover, the sources of economic growth would alter dramati-cally. Employment will make a small positive contribu-tion to growth up to 2010, become neutral in the period 2011-2030, and turn significantly negative thereafter. Over time, labour productivity will become the domi-nant, and in some countries the only, source of growth (see Graph II.14). These GDP growth projections rest on several assumptions, including projected demographic developments, labour force developments and on assumptions regarding the structural unemployment rate and labour productivity growth.

Overall, the projections show that Europe faces a signifi-cant budgetary challenge posed by ageing populations. Most of the projected increase in public spending will be on pensions, healthcare and long-term care, becoming apparent as of 2010 and with the largest increases in spending projected to take place between 2020 and 2030.

Public spending on pensions will significantly rise, but there is a very large diversity across countries. In five Member States, it is projected to decrease, while in nine countries the increase is projected to be over 5 percent-age points of GDP. The potential offsetting savings in terms of public spending on education and unemploy-ment benefits are likely to be limited (see Table II.9).

The projections confirm the validity of the Lisbon strat-egy and the need to vigorously pursue measures that raise labour supply/utilisation and enhance productivity. Successfully implementing such measures, in line with achieving the Lisbon strategy, would imply raising potential GDP growth rates, with positive consequences for future living standards as well as for the long-term sustainability of public finances. Indeed, in many coun-tries, substantial benefits could be reaped by reducing structural unemployment further. Even if the EU reaches the Lisbon employment target as projected, significant pools of unused labour will remain. For example, while the EU as a whole is projected to meet the 70 percent employment target by 2020, the euro area would only do so by 2035. Moreover, even with the significant pro-jected increase in the employment rates of older workers by 2025, the average exit age from the labour market would be 62 despite life expectancy increasing to well over 80 for most persons.

The projections confirm the large potential benefits of pension reform, especially measures which extend work-

Graph II.14: **Potential growth rates and their determinants (employment/productivity)**
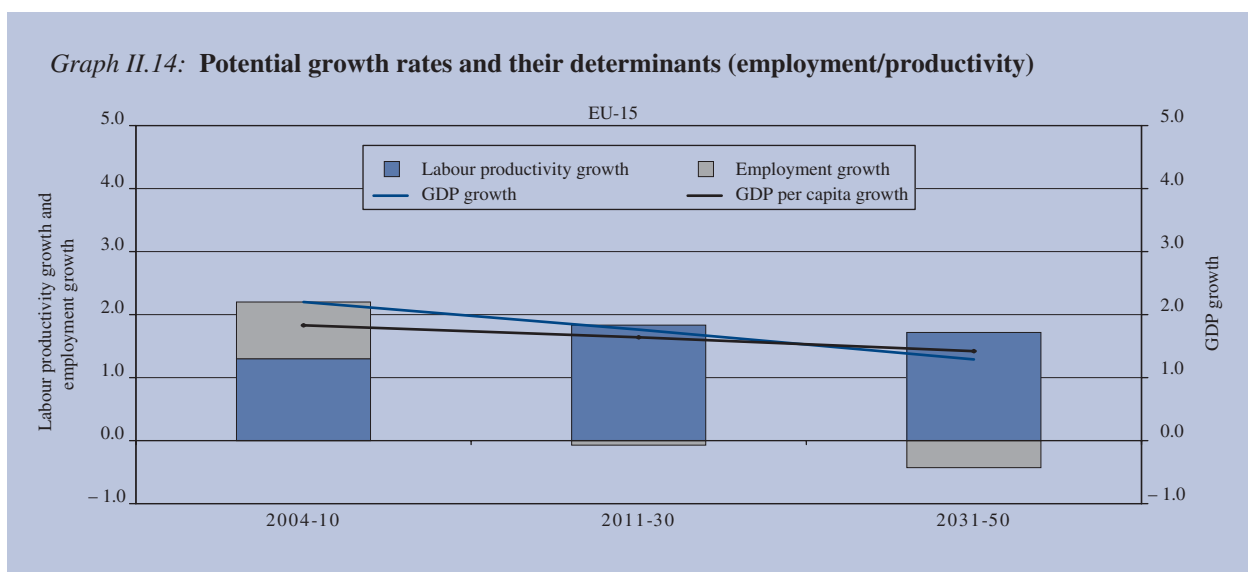
ing lives. Higher levels of employment does not per se lead to lower public spending on pensions since it leads to the accumulation of additional pension entitlements. However, raising employment is unequivocally welfare enhancing. It strengthens the financial sustainability of pension systems, delays the start of expenditure rises, increases contributions to pension schemes, and can generate additional budgetary savings if higher employment results from lower unemployment and less early-retirement. In addition, the projections indicate that pension reforms linking retirement age and pension benefits to life expectancy can reduce pension spending significantly.

The projections show that the recent pension reforms are helping to address the challenge of ageing. They provide concrete evidence that recent pension reforms in half of all EU-15 Member States are helping to raise the effective retirement age and are curtailing the impact of ageing on pension systems. In recent pension reforms, some Member States have introduced a link between life expectancy at retirement and pension benefits and these measures appear to achieve a better sharing of demographic risk.

The three-pronged strategy to deal with the economic and budgetary challenge of ageing needs to be pursued. Firstly, Member States need to achieve and sustain sound underlying budget positions and to run down public debt at a faster pace: reducing public debt can contribute to the financial sustainability of social security schemes in the long run. Moreover, sound public finances are a prerequisite for low interest rates and high and stable growth. Secondly, there is a need to raise employment rates, especially amongst women and older workers, and appropriate steps should be envisaged to raise labour supply, including the better management of economic migrants. Thirdly, appropriate reforms are required of pension, healthcare and long-term care, to ensure that they are financially viable in the face of ageing while at the same time securing core policy goals of adequacy and access. The three-pronged strategy therefore supports and complements the Lisbon strategy insofar as raising employment rates and running sound macro- and micro-economic policies are conducive to growth.

In the coming months, a fuller assessment of the sustainability of Member States' public finances should be carried out using these budgetary projections in line with the new code of conduct on the Stability and Conver-

gence Programmes. Further analysis is needed to achieve a comprehensive understanding of the new projection results, and in particular to get clearer insights of the key driving factors for each Member States and the impact on public finances sustainability.

The February 2006 Ecofin Council adopted conclusions among others inviting the Commission to undertake a comprehensive assessment of the sustainability of Member States public finances by the end of 2006. The new common long-term budgetary projections will be used as the basis in this report.

5.3. Improvements of the analysis of the long-term sustainability of public finances

The approach used at EU level to assess the long-term sustainability of public finances is based on a comprehensive assessment including elements of both quantitative and qualitative nature. This approach enables the formulation of an overall assessment of the degree of budgetary challenge that ageing populations represent in the different Member States and to identify the main driving factors of this challenge.

In the 2005/06 assessment round of stability and convergence programmes, Member States were classified in three categories in the Council Opinions: *low risk / medium risk / high risk*. This is a change compared with last year, when the Member States were divided in four categories in the Council Opinions: *favourable position, relatively favourable position, at some risks, at (serious) risks.*

This new risk categorisation involves:

- recognising that ageing population represents a budgetary challenge for all countries, albeit to varying degrees;
- providing a clear distinction between the different degrees of risks to public finance sustainability countries are facing.

The assessment of the long-term sustainability of public finances including the overall classification of risks to public finance sustainability is given in Part I of this report. In the following two sections, two improvements that were introduced in the 2005/06 assessment round of the stability and convergence programmes are described.

Table II.9

Projected changes in age-related public expenditure between 2004 and 2030/50 (% of GDP)

	Pensions Level 2004	Pensions Change 2030	Pensions Change 2050	Health care Level 2004	Health care Change 2030	Health care Change 2050	Long-term care Level 2004	Long-term care Change 2030	Long-term care Change 2050	Unemployment benefits Level 2004	Unemployment benefits Change 2030	Unemployment benefits Change 2050	Education Level 2004	Education Change 2030	Education Change 2050	Total* (without long term care) Level 2004	Total* (without long term care) Change 2030	Total* (without long term care) Change 2050	Total* (without education) Level 2004	Total* (without education) Change 2030	Total* (without education) Change 2050	Total* of all available items* Level 2004	Total* of all available items* Change 2030	Total* of all available items* Change 2050
BE	10.4	4.3	5.1	6.2	0.9	1.4	0.9	0.4	1.0	2.3	−0.5	−0.5	5.6	−0.6	−0.7	24.5	4.1	5.3	−2.3	5.1	7.0	25.4	4.5	6.3
DK	9.5	3.3	3.3	6.9	0.8	1.0	1.1	0.6	1.1	1.5	−0.3	−0.3	7.8	−0.4	−0.3	25.6	3.4	3.7	−1.5	4.4	5.1	26.8	4.0	4.8
DE	11.4	0.9	1.7	6.0	0.9	1.2	1.0	0.4	1.0	1.3	−0.4	−0.4	4.0	−0.8	−0.9	22.7	0.6	1.7	−1.3	1.8	3.6	23.7	1.0	2.7
EL	:	:	:	5.1	0.8	1.7	:	:	:	0.3	−0.1	−0.1	3.5	−0.5	−0.4	8.9	:	:	−1.1	:	:	8.9	:	:
ES	8.6	3.3	7.1	6.1	1.2	2.2	0.5	0.0	0.2	1.1	−0.4	−0.4	3.7	−0.7	−0.6	19.6	3.3	8.3	−1.1	4.0	9.1	20.1	3.3	8.5
FR	12.8	1.5	2.0	7.7	1.2	1.8			0.6	1.2	−0.3	−0.3	5.0	−0.5	−0.5	26.7	1.9	2.9	−1.2	2.4	3.4	26.7	1.9	2.9
IE	4.7	3.1	6.4	5.3	1.2	2.0	0.6	0.1	0.6	0.7	−0.2	−0.2	4.1	−0.9	−1.0	14.9	3.2	7.2	−0.7	4.3	8.8	15.5	3.3	7.8
IT	14.2	0.8	0.4	5.8	0.9	1.3	1.5	0.2	0.7	0.4	−0.1	−0.1	4.3	−0.8	−0.6	24.7	0.9	1.1	−0.4	1.8	2.4	26.2	1.0	1.7
LU	10.0	5.0	7.4	5.1	0.8	1.2	0.9	0.2	0.6	0.3	−0.0	−0.1	3.3	−0.5	−0.9	18.7	5.2	7.6	−0.3	6.0	9.1	19.5	5.4	8.2
NL	7.7	2.9	3.5	6.1	1.0	1.3	0.5	0.3	0.6	1.8	−0.2	−0.2	4.8	−0.2	−0.2	20.4	3.5	4.4	−1.8	4.0	5.2	20.9	3.8	5.0
AT	13.4	0.6	−1.2	5.3	1.0	1.6	0.6	0.3	0.9	0.8	−0.1	−0.1	5.1	−0.9	−1.0	24.5	0.5	−0.7	−0.8	1.8	1.2	25.2	0.9	0.2
PT	11.1	4.9	9.7	6.7	−0.1	0.5				1.0	−0.1	−0.1	5.1	−0.6	−0.4	23.8	4.1	9.7	−1.0	4.7	10.1	23.8	4.1	9.7
FI	10.7	3.3	3.1	5.6	1.1	1.4	1.7	1.2	1.8	1.5	−0.4	−0.4	6.0	−0.6	−0.7	23.7	3.5	3.4	−1.5	5.3	5.9	25.4	4.7	5.2
SE	10.6	0.4	0.6	6.7	0.7	1.0	3.8	1.1	1.7	1.1	−0.2	−0.2	7.3	−0.7	−0.9	25.7	0.3	0.5	−1.1	2.0	3.1	29.6	1.3	2.2
UK	6.6	1.3	2.0	7.0	1.1	1.9	1.0	0.3	0.8	0.4	−0.0	0.0	4.6	−0.5	−0.6	18.6	1.9	3.2	−0.4	2.7	4.6	19.6	2.2	4.0
CY	6.9	5.3	12.9	2.9	0.7	1.1			0.4	0.4	−0.0	0.0	6.3	−1.9	−2.2	16.4	4.1	11.8	−0.4	6.0	14.1	16.4	4.1	11.8
CZ	8.5	1.1	5.6	6.4	1.4	2.0	0.3	0.2	0.4	0.2	−0.0	0.0	3.8	−0.9	−0.7	19.0	1.6	6.8	−0.2	2.6	7.9	19.3	1.8	7.2
EE	6.7	−1.9	−2.5	5.4	0.8	1.1				0.1	−0.0	0.0	5.0	−1.1	−1.3	17.1	−2.3	−2.7	−0.1	−1.2	−1.4	17.1	−2.3	−2.7
HU	10.4	3.1	6.7	5.5	0.8	1.0				0.2	−0.0	0.0	4.5	−1.0	−0.7	20.7	2.8	7.0	−0.2	3.8	7.7	20.7	2.8	7.0
LT	6.7	1.2	1.8	3.7	0.7	0.9	0.5	0.2	0.4	0.1	−0.1	−0.1	5.0	−1.6	−1.6	15.5	0.2	1.0	−0.1	2.0	3.1	16.0	0.3	1.4
LV	6.8	−1.2	−1.2	5.1	0.8	1.1	0.4	0.1	0.3	0.3	−0.1	−0.1	4.9	−1.2	−1.4	17.1	−1.7	−1.6	−0.3	−0.4	0.1	17.5	−1.5	−1.3
MT	7.4	1.7	−0.4	4.2	1.3	1.8	0.9	0.2	0.2	1.2	−0.2	−0.4	4.4	−1.2	−1.2	17.3	1.6	0.1	−1.2	2.9	1.5	18.2	1.8	0.3
PL	13.9	−4.7	−5.9	4.1	1.0	1.4	0.1	0.0	0.1	0.5	−0.4	−0.2	5.0	−2.0	−1.9	23.6	−6.1	−6.8	−0.5	−4.1	−4.8	23.7	−6.1	−6.7
SK	7.2	0.5	1.8	4.4	1.3	1.9	0.7	0.2	0.6	0.3	−0.2	−0.1	3.7	−1.5	−1.3	15.5	0.1	2.3	−0.3	1.8	4.1	16.2	0.3	2.9
SI	11.0	3.4	7.3	6.4	1.2	1.6	0.9	0.5	1.2	0.5	−0.1	−0.1	5.3	−0.7	−0.4	23.2	3.9	8.4	−0.5	5.1	10.1	24.2	4.4	9.7
EU-25	10.6	1.3	2.2	6.4	1.0	1.6	0.9	0.2	0.6	0.9	−0.3	−0.3	4.6	−0.7	−0.6	22.5	1.3	2.8	−0.9	2.2	4.0	23.4	1.6	3.4
EU-15	10.6	1.5	2.3	6.4	1.0	1.6	0.9	0.2	0.7	0.9	−0.2	−0.2	4.6	−0.6	−0.6	22.6	1.6	3.0	−0.9	2.5	4.3	23.5	1.9	3.7
EU-12	11.5	1.6	2.6	6.3	1.0	1.5	0.7	0.1	0.5	1.0	−0.3	−0.3	4.4	−0.7	−0.6	23.3	1.7	3.2	−1.0	2.5	4.4	24.0	1.9	3.7
EU-10	10.9	−1.0	0.3	4.9	0.9	1.3	0.2	0.1	0.2	0.4	−0.2	−0.2	4.7	−1.5	−1.3	20.9	−1.8	0.0	−0.4	−0.3	1.6	21.1	−1.8	0.2
EU-9 (EU-10-PL)	8.8	1.6	4.8	5.5	0.9	1.3	0.3	0.2	0.3	0.3	−0.1	−0.1	4.4	−1.1	−0.9	19.0	1.4	5.1	−0.3	2.6	6.4	19.3	1.5	5.4

(1) Total expenditure for EL does not include pension expenditure. The Greek authorities have agreed to provide the pension projections in 2006. In the context of the most recent assessment of the sustainability of public finances based on the Greek stability programme, public spending on pensions was projected to increase by 10.3 % of GDP between 2004 and 2050.

(2) Total expenditure for: EL, FR, PT, CY, EE, HU does not include long-term care.

(3) The projection results for public spending on long-term care for Germany does not reflect current legislation where benefit levels are fixed. A scenario which comes closer to the current setting of legislation projects that public spending would remain constant as a share of GDP over the projection period.

Note: these figures refer to the baseline projections for social security spending on pensions, education and unemployment transfers. For health care and long-term care, the projections refer to 'AWG reference scenarios'.

Source: 'The impact of ageing on public expenditure: projections for the EU-25 Member States, pensions, health-care, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006.

A decomposition of the sustainability gap indicators

Based on the long-term budgetary projections and a set of assumptions, sustainability gap indicators are calculated. They provide an indication of budgetary adjustment required for a Member State to reach a sustainable public finance position over the long term as measured by the different definitions used. The two main indicators are called the S1 and S2 indicators.

The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60 percent of GDP and the current revenue ratio ([1]). It is possible to decompose S1, which is shown in equation 1.

The S2 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio. In this case, the budgetary adjustment is such that no other reform would be needed to ensure long-term sustainability. As for the S1 indicator it is possible to decompose S2, shown in equation 2.

A decomposition of the indicators has been introduced in the 2005/06 assessment round. It now separates the pure impact of ageing (i.e. the impact of the rise in age-related expenditure on the indicators) and the impact of the initial budgetary position (mainly the distance between the actual structural primary balance from the long-term debt-stabilising primary balance) ([2]).

This distinction reveals whether risks to public finance sustainability mainly come from the current budgetary situation or from the projected future budgetary trends in the Member States. Age-related expenditures are projected to rise in nearly all Member States over the long-term, which implies that difficult policy choices will have to be made. In general, countries may rely on either primarily a budgetary consolidation strategy to offset the future increase in spending or on a reform strategy aiming at curbing the long-term trend in spending, or on a combination of the two. This is an important policy decision and the sustainability gap indicators and their decomposition provide interesting information on the scale of adjustment that is required to ensure sustainable public finances over the long-term.

The formal decomposition of the S1 and S2 indicators is shown in equations 1 and 2, respectively.

$$S_1 = \underbrace{rD_{t_0} - PB_{t_0}}_{A} + \underbrace{\frac{r(D_{t_0} - 60)}{(1+r)^{2050-t_0}-1}}_{B} - \underbrace{\frac{\sum_{t=t_0+1}^{2050}\frac{\Delta PB_t}{(1+r)^{t-t_0}}}{\sum_{t=t_0+1}^{2050}\frac{1}{(1+r)^{t-t_0}}}}_{C}$$

(1)

where:

D_t = gross government debt (including pension funds assets) at date t relative to GDP;

PB_t = structural primary balance, i.e. cyclically-adjusted primary balance net of one-off and temporary measures at date t relative to GDP;

ΔPB_t = change in structural primary balance; $PB_t = PB_0 + \Delta PB_t$, relative to GDP

r = difference between nominal interest rate and nominal GDP growth rate ([3]).

The first term (A) is a condition concerning the initial budgetary position. The debt/GDP ratio increases by the difference between the nominal interest rate and the nominal growth rate. Should the initial structural primary balance exactly compensate for this increase, the debt/GDP ratio would remain stable and no adjustment would be necessary. However, if the initial structural primary balance is not sufficient, the debt/GDP ratio would be on an explosive path and the sustainability gap would be positive.

([1]) The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age-related primary spending could be preferable and has the same impact.

([2]) In the case of S1, the decomposition also separates the impact of the debt position (60 percent of GDP in 2050). In particular, if the current debt/GDP ratio is below 60 percent of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and vice versa.

([3]) The GDP growth assumptions set up in the AWG varies over time in line with development of labour supply while the real interest rate is set at 3 percent for the entire projection period, implying a non-constant discount rate. For presentational purposes, the formulae here (S1 and S2) are given under the assumption that the differential between nominal interest rate and nominal GDP growth rate is constant. A complete description of the case with non-constant discount rate is given in Annex 12 of 'The impact of ageing on public expenditure: projections for the EU-25 Member States on pensions, healthcare, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006.

The S1 indicator is set so that (adjusted) government debt will converge towards 60 percent of GDP at the end of the projections period: this is ensured by the second term (B).

Finally, the third term (C) calculates the discounted average of the future (up to 2050) changes in the structural primary balance compared with the base year. This is the impact of the, in nearly all countries, projected increase in age-related expenditure as a share of GDP over the long-term.

$$S_2 = \underbrace{rD_{t_0} - PB_{t_0}}_{D} - \underbrace{r \sum_{t = t_0 + 1}^{\infty} \frac{\Delta PB_t}{(1 + r)^{t - t_0}}}_{E} \quad (2)$$

Concerning the S2 indicator, the first term (D) in equation (2) is the same as (A) for S1 in equation (1): it ensures that the debt/GDP ratio remains constant, whatever its initial level: there is therefore no constraint on the level of debt. The second term (E) is very similar to the term (C) for S1 except that it takes into account changes in the structural primary balance compared with the base year over an infinite horizon rather than up to 2050.

The cost of delay in closing the sustainability gap

The timing of implementing a policy that results in sustainable public finances over the long-term has medium-term budgetary consequences. In order to illustrate this, a sensitivity test was introduced in the latest assessment round of the stability and convergence programmes. The 'cost of delay' is the difference between the size of the sustainability gap if it is closed at time t via a fiscal adjustment and its size if it is closed instead at time t+5, i.e. with a delay. It was calculated on the basis of the both the S1 and S2 sustainability gaps [1].

The application of the sensitivity test may be illustrated by an example. Assume that a country is facing a sustainability gap of 3 percent of GDP at time t. The fiscal adjustment that results in sustainable public finances is thus 3 percent of GDP. Assume further that the fiscal adjustment instead is made 5 years later. The sustainability gap in t+5 is instead 3.3 percent of GDP, reflecting the fact that additional interest payments will have had to be made over these five years. This is illustrated in Graph II.15 which shows that budgetary savings can be made if a consolidation of public finances is made sooner rather than later.

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[1] A complete description of the sensitivity test is given in Annex 13 of 'The impact of ageing on public expenditure: projections for the EU-25 Member States on pensions, healthcare, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006.

Graph II.15: **The cost of delay in implementing a fiscal adjustment**
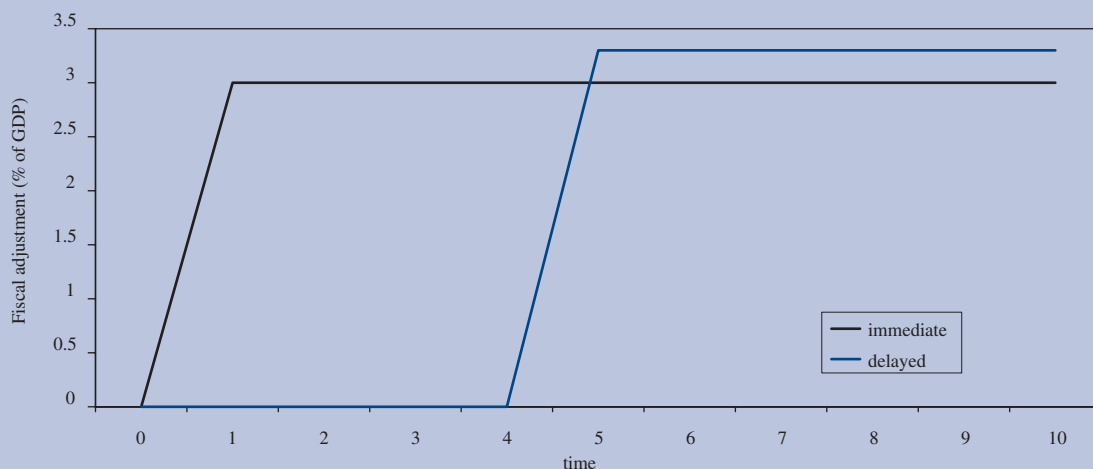
Part III

National numerical fiscal rules
and institutions for sound public finances

Summary

The economic literature has provided abundant analysis on how taxes, government expenditures and budget balances should be set over the business cycle for fiscal policy to be considered optimal and sustainable. However, experience has shown that such policies were in practice not always pursued by policymakers. Some of the most evident signs have been the tendency to conduct pro-cyclical fiscal policies and the large increase of debt ratios in a number of developed economies. The debate on the ways to favour sound fiscal policies has focused on the need to rebalance the incentives of policy-makers or impose constraints on the conduct of fiscal policy via the introduction of adequate fiscal rules and institutions.

At EU level, the Maastricht Treaty and the Stability and Growth Pact (SGP) impose budgetary obligations on Member States. In order to ensure the respect of objectives, both of them also stress the importance of national rules and institutions for budgetary discipline. In particular, the report on the SGP reform endorsed by the European Council on 22 March 2005 states that *national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact* and that *national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level.* The importance attached to national fiscal rules and institutions in the reformed SGP reflects the consensus among Member States that appropriate national fiscal rules and institutions could provide the basis for sound and sustainable budgetary developments and contribute to the respect of the objectives of the EU fiscal framework.

This chapter focuses on national numerical fiscal rules and independent institutions which may influence fiscal policy-making (e.g. 'fiscal councils'). It exploits the results of surveys which review the rules and institutions in force in the 25 EU Member States and assesses whether these arrangements have an effect on budgetary outcomes. The definition of 'fiscal rules' follows that proposed by Kopits and Symanski (1998), i.e. a *permanent* constraint on fiscal policy, expressed in terms of a *summary indicator* of fiscal performance. Numerical fiscal rules therefore specify numerical targets or limits for key budgetary aggregates such as annual budget balance, expenditure, revenue, or debt. The 'independent institutions' covered by the analysis are the *national bodies*, primarily financed by public funds, other than government and Parliament, which can be considered as functionally independent, and which regularly provide independent inputs, analysis, assessments or recommendations in the area of fiscal policy. The questions related to the desirable characteristics of the budgetary process, which have already been extensively addressed in the literature, are outside the scope of this chapter.

The analysis of the survey on numerical fiscal rules leads to the following conclusions:

- The number of rules in force in EU Member States has increased continuously over the past twenty years. This tendency has been accompanied by an interesting evolution in terms of the government sub-sectors covered by rules. While in the early 90s fiscal rules were mostly applied to territorial (local and regional) governments, a relatively recent feature has been the development of fiscal rules for the whole of the general government sector and the social security sub-sector. This may be a response to the increasing spending pressures in the social security sector and to the introduction of the EU fiscal rules, which impose requirements for the general government deficit and debt.

- The characteristics of the numerical fiscal rules in place vary depending on the sub-sector to which they apply. Most of the numerical rules applied to regional and local governments are enshrined in a legal text or constitution, while rules applying to the central government or the whole of the general

government sector are more frequently based on coalition agreements or political commitments. Similarly, while rules for regional and local governments seem to have relatively strong enforcement mechanism, rules applying to general and central governments generally do not envisage *ex ante* defined actions in case of non-compliance. Another interesting finding appears when taking into account the type of budgetary governance, namely the distinction between the so-called *contract* and *delegation* countries ([1]). Both sets of countries have a similar number of numerical fiscal rules. However, contract countries have more numerical fiscal rules applied to central government and social security sectors while delegation countries have a higher number of fiscal rules implemented at regional and local level.

- Statistical and econometric exercises suggest the existence of a link between numerical rules and budgetary outcomes. A preliminary descriptive analysis of data shows two interesting results. Firstly, the primary CAB on average improved in the years following the introduction of fiscal rules while it remained broadly stable over the period under consideration (1990-2005). Secondly, primary government expenditure adjusted for the cycle tend to grow more slowly in the years following the introduction of numerical expenditure rules.

- When enriching the analysis by taking into account the coverage and characteristics of fiscal rules and by controlling for various factors that may affect government budget balance and developments in primary expenditure (debt ratio, cyclical conditions), the presumption of a link between numerical fiscal rules and budgetary outcomes is strengthened. The analysis suggests that an increase in the share of government finances covered by numerical fiscal rules leads, *ceteris paribus*, to lower deficits or higher surpluses. In the case of expenditure rules, it appears that an increase in the coverage of government finances by expenditure rules leads to a reduc-

tion in the primary expenditure-to-GDP ratio. The analysis also suggests that the characteristics of fiscal rules matter for their influence on budgetary outcomes. Strong rules, enshrined in law or constitution and foreseeing automatic enforcement mechanisms, seem to have a larger influence on budgetary outcomes.

The main conclusions of the analysis of the survey on national independent institutions can be summarised as follows:

- Institutions having the characteristics of an independent fiscal institution (or 'fiscal council') exist in fifteen EU countries, thirteen of them being former EU-15 Member States. Interestingly, and contrasting with the results of the survey on fiscal rules, most of the institutions in place were created a long time ago, and there is no visible tendency towards the development of such institutions in the EU. There is a great deal of variety in the type of institutions in place. Two major categories of institutions can be distinguished: (i) institutions in charge of providing *forecasts* or/and conducting *positive* analyses on fiscal policy issues; and (ii) institutions issuing *normative* statements and *recommendations* on the conduct of fiscal policy.

- As regards the activity of forecasting, in ten EU countries there is at least one independent institution that produces macroeconomic or budgetary forecasts on a regular basis, against which the official projections can be assessed. In most cases, however, the government remains free to use its own macroeconomic forecasts for the preparation of the budget. There are, in the whole EU, only three exceptions to this rule. The basis for the forecast to be used for the budget preparation differs: in two cases, there is no formal obligation for the government, while there is a legal requirement in the third case. There are in the EU sixteen institutions conducting independent analysis on fiscal policy developments. Most of them also regularly issue recommendations in the area of fiscal policy. In almost all cases, there is no formal obligation for the government to follow the recommendations of the independent institution. According to the replies to the survey, independent institutions issuing fiscal policy recommendations mainly influence decisions through their effect on the public debate and reputation costs.

([1]) *Delegation* countries tend to centralise their budget process by delegating powers to a strong Minister of Finance. They generally have single-party governments or government coalitions of ideologically aligned parties. In contrast, *contract* or *commitment* countries usually present governments with a larger political dispersion. Different parties and ministries take part in the negotiation process leading to an agreement (a 'contract') on a set of key fiscal objectives. In theory, contract countries are expected to show a greater number of fiscal rules than delegation countries (see Box III.1 for more details).

- Assessing the influence of the institutions covered by the study on the conduct of fiscal policy is by nature a complex exercise. However, combining descriptive analysis, the result of existing empirical studies and the answers to the questionnaires, a number of conclusions on the possible contribution of such institutions to fiscal discipline can be drawn. First of all, delegation of the forecasting activity seems to be an efficient way to address possible optimistic biases in macroeconomic projections. Secondly, the institutions in place seem to have had a considerable impact on the public debate. In most of the cases, forecasts or recommendations issued by independent institutions benefit from large media coverage and the analysis undertaken by the institu-

tions are generally considered above or well above standards. The survey also provides evidence that recommendations formulated by the institutions covered by the study have an influence on fiscal policy developments. There is notably a perception that such institutions have contributed to fiscal discipline.

Overall, the empirical analysis in this part of the report confirms the influence of national fiscal rules and institutions in determining budgetary outcomes. It underlines the relevance of well-designed national fiscal rules and appropriate institutional fiscal frameworks to ensure sound fiscal policies and the respect of the objectives of the EU fiscal surveillance.

1. Introduction

The Maastricht Treaty and the Stability and Growth Pact (SGP) impose budgetary obligations on the Member States. In order to facilitate the respect of these obligations, both of them also stress the importance of national rules and institutions for budgetary discipline. The Protocol on the excessive deficit procedure annexed to the EU Treaty states that *Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area deriving from this Treaty*. The report on the SGP reform endorsed by the European Council on 22 March 2005 states that *national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact* and that *national institutions could play a more prominent role in budgetary surveillance to strengthen national ownership, enhance enforcement through national public opinion and complement the economic and policy analysis at EU level.*

The importance attached to national fiscal rules and institutions in the reformed SGP is not fortuitous. Recent economic history provides evidence that policymakers do not always pursue time consistent and sustainable fiscal policies: the tendency to conduct pro-cyclical fiscal policies and the recent increase of debt ratios in a number of developed economies point to the existence of a deficit bias. The explanations for this bias generally point to the consideration that policymakers may not have the right incentives to pursue sound public finances in the long run. In this context, a number of proposals have been put forward with the intention of modifying national fiscal frameworks that form the environment, the incentives and the constraints under which policymakers operate, in a way that would foster the conduct of sound fiscal policies.

The proposals concerned notably (i) the procedural rules laid down in law or constitution governing the elaboration and implementation of the annual budget law; (ii) the numerical fiscal rules which are guiding or imposing constraints on the discretion of policy-makers;

and (iii) national independent institutions, other than government and Parliament, possibly influencing fiscal policy.

This chapter reviews the numerical fiscal rules and the independent bodies or institutions in force in the 25 EU Member States and assesses their influence on budgetary developments. The questions related to the desirable characteristics of the budgetary process have already been extensively addressed in the literature and are outside the scope of this chapter. The aim of the analysis is not to make an overall judgment on the quality of national budgetary rules and institutions in the EU countries. The study should therefore not be read as a plea per se in favour of particular arrangements, since there is no single best institutional framework that would be suitable for all countries.

The first section provides empirical evidence on the existence of a deficit bias in the EU countries and other developed economies. It discusses the main reasons for the existence of such a bias and some possible ways to address it. The second section is devoted to the analysis of numerical fiscal rules in the EU Member States and their impact on budgetary developments. The analysis is based on a new dataset providing a comprehensive overview of existing numerical fiscal rules in the EU. The third section focuses on the existing independent bodies and institutions playing a role in the conduct of fiscal policy, either by providing inputs for the conduct of fiscal policy (e.g. forecasts on which budgets are based), conducting analysis on budgetary developments, or issuing normative statements or recommendations in the area of fiscal policy. Compared to fiscal rules, it is more difficult to analyse and reach firm conclusions on the effectiveness of fiscal institutions by means of statistical tools, in part because the institutional arrangements differ considerably from one country to another. The analysis is therefore supported by illustrative case studies on the reality of selected countries.

2. Rationale for the introduction of numerical fiscal rules and independent institutions at national level

2.1. Introduction

The economic literature has provided abundant analysis on how taxes, government expenditures and budget balance should be set over the business cycle for fiscal policy to be considered optimal and sustainable. However, experience has provided ample evidence that such policies were in practice not always pursued by policy-makers. Some of the most evident signs have been the tendency to conduct pro-cyclical fiscal policies and the propensity to finance public expenditure with debt in a number of industrialised economies. The debate on the ways to address the deficit bias has focused on the need to rebalance incentives of policy-makers and impose constraints on the conduct of fiscal policy, via the introduction of adequate fiscal rules and institutions. This section first provides empirical evidence for the existence of a deficit bias in most of developed economies (considerations related to the conduct of pro-cyclical policies are addressed in Part 4 of this report). Next, the main explanations for the existence of such a bias mentioned in the literature are reviewed. Finally, proposals for limiting or eliminating the deficit bias are examined.

2.2. The deficit bias in perspective

When looking at fiscal developments in a long-term perspective, it appears that episodes of protracted departure from budgetary balance have been rather uncommon in the history. Up to the first oil price shock, budgetary deficits were almost exclusively related to war episodes and were typically corrected promptly (see European Commission, 2004). The picture changed from the 70s onwards, when sustained deficits not related to exceptional public finance needs as during war periods were recorded in the most advanced economies.

The propensity to finance public spending with debt has become an increasing source of concern in Europe. As illustrated in Graph III.1 below, in the last thirty years the general government gross debt-to-GDP ratio has been increasing rapidly in the EU. In countries like Germany and France, for example, debt ratios – not debt levels – more than tripled over the last three decades. Even if most EU governments started to shift gear during the 1990s with the agreement on the Maastricht Treaty and the run-up to EMU, deficit and debt levels remain high in a number of EU countries [1].

In the absence of policy measures, government deficits and debt will further increase in the medium and long term. In most of EU countries, governments made in the past long-term welfare expenditure commitments which, against the background of demographic changes, i.e. low birth rates and longer life expectancy resulting in population ageing, may lead to unsustainable government finances. The recent long-run projections of the Commission (see Graph I.22) show that, under unchanged policies, the debt ratio could follow an explosive path in most EU countries due to the large amounts of implicit liabilities that Member States have accumulated and continue to build up. In light of this challenge, addressing the causes for the deficit bias is a major and urgent challenge in a number of EU countries.

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[1] For instance, in 2005, the debt-to-GDP ratio reached 107.5 percent of GDP in Greece, 106.4 percent in Italy, 93.3 percent in Belgium, 67.7 percent in Germany and 66.8 percent in France.

Graph III.1: **Developments in the debt ratio in the main industrialised regions since 1970**

N.B.: Data for EU are the weighted average by all the old 15 Member States, data for BE are available since 1971, for DK since 1971, for NL since 1975 and for PT since 1973
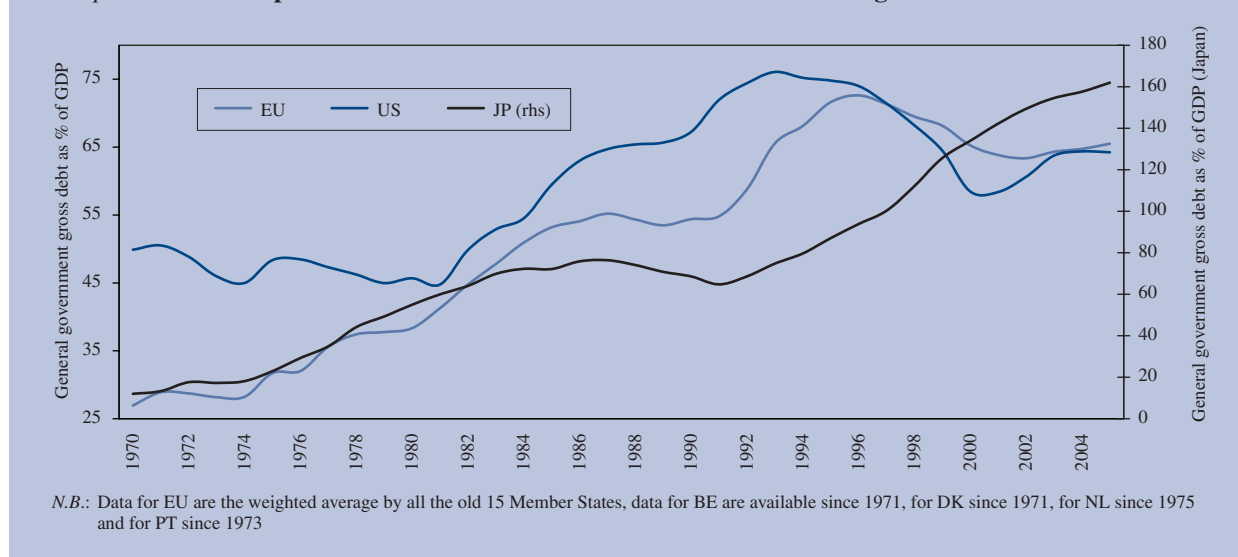
2.3. Reasons for the deficit bias point to the short-term horizon of policy-makers

2.3.1. Explanations for the deficit bias

The reasons for the conduct of undesirable fiscal policies leading to persistent deficits have been addressed extensively in the economic literature. Most explanations are based on political economy considerations related to the short-term horizon of policy-makers, which in turn leads to time-inconsistent fiscal policies.

The electoral cycle and voters' fiscal illusion

A first possible explanation for the existence of a deficit bias is related to the fact that individuals (voters) tend to see the short-term benefits they can get from lower taxes and increased government spending but are not always fully aware of the possible long-term costs of such policies [1]. This 'fiscal illusion' would notably explain why governments conducting policies leading to high and unsustainable deficits are not always punished by voters. Instead, voters' behaviour would provide incentives for opportunistic politicians to improve their chances to be re-elected through the implementation of unfinanced tax reductions or expenditure increases [2]. This can also

result in asymmetric fiscal policy over the cycle, since governments generally get more support for implementing expansionary fiscal policies during downturns than for consolidating government finances in upturns [3].

An alternative argument why voters would not punish excessive lending has to do with intertemporal redistribution. The generation that is alive today may prefer leaving the burden of debt to future generations while taking advantage of today's lower taxes and higher public spending. Since the current generation is the only one that votes, such preferences may provide incentives for undesirable policies from a society point of view.

Short-term strategic behaviour of political parties

Another explanation for the deficit bias is based on the influence of strategic actions of political parties. Several authors (see notably Persson and Svenson, 1989) argued that the behaviour of political parties that are likely to alternate in office can feed the deficit bias. For instance, governments with little chances of being re-elected may be tempted to run deficits and accumulate debt in the course

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[1] See Alesina and Perotti (1994) and papers of the 'public choice' school (Buchanan (1959), Buchanan and Wagner (1977), Buchanan and Tullock (1962)).

[2] Persson and Tabellini (1998) showed that taxes are generally cut before elections and that painful fiscal adjustments are postponed after elections. Buti and van den Noord (2004) put in evidence the role of electoral cycles in explaining budgetary developments.

[3] While electoral cycles and 'fiscal illusion' have so far been widely accepted as explanatory elements for the deficit bias, this view has been challenged by recent research. See notably Brender and Drazen (2006).

of their mandate so as to prevent future governments from engaging in ambitious programmes or in activities inconsistent with the priorities of the administration currently in power (Tabellini and Alesina, 1990). As a result, the larger the probability of an electoral defeat for the administration in power and the larger the difference in preferences between parties, the larger the deficit bias may be (Calmfors, 2005). This explanation might be particularly relevant for those countries experiencing a high political unrest.

Fragmented governments and the common pool problem

Another part of literature has studied the influence of voting rules and political systems on budgetary outcomes. Roubini and Sachs (1988) argued that the extent of dispersion of political power among different parties in the government could explain part of the rising spending pressures that appeared in the 70s and 80s. At that time, the growing strains on public budgets were not associated to demographic factors but to pressures exercised by different groups of interest through political parties. The theoretical underpinning of this explanation draws on the 'common pool' problem, which arises when several players representing different interest groups bargain on the allocation of public resources with the view to satisfy their own base. Each actor tends to maximise appropriation, without internalising the overall budget constraint (Hallerberg and Von Hagen, 1999). In the absence of a clear delegation of powers to a strong Finance Minister (delegation approach) or of preliminary agreements or pacts within the cabinet (contract approach) to decide on budgetary allocations in a centralised manner, this situation can lead to a deficit bias.

2.3.2. Recent economic and political developments might have strengthened those elements behind the deficit bias

Most of the possible explanations for the deficit bias described above were already valid a long time ago. However, as previously seen, the deficit bias has gained considerable strength from the 1970s onwards. This suggests that a number of recent political and economic developments have had an influence on the deficit bias [1].

Lower potential growth, the size of the public sector and globalisation

The increase in the deficit bias has coincided with decelerating growth rates in most advanced economies and an increase in the size of the public sector reflecting the involvement of governments in a growing number of economic activities (e.g. the production of goods and services) and the extension of the welfare state (see Graph III.2) [2]. The higher expenditure associated with the increasing demand for public services were not always matched by similar increases in revenues. This can be explained by the potential economic and electoral costs of raising an already high tax burden in an integrating world economy in which certain tax bases have become more mobile. Obviously, this does not entail a causality relationship between the size of the government and the deficit bias; some countries show simultaneously sizeable public sector and sound fiscal positions. This only suggests that large public sectors might favour those elements behind the deficit bias.

The role of monetary unions

The incentives for the conduct of unsound fiscal policies may also be stronger in a monetary union (Weale, 2004). In flexible exchange rate regimes, the negative effects of unsustainable or pro-cyclical fiscal policies have a direct negative impact on the country concerned (e.g. through higher real interest rate and lower growth prospects) [3]. In a monetary union, the effects of an expansionary fiscal policy on economic growth may be larger than would be the case in absence of monetary union because there is little crowding out of private investment and consumption due to the partial interest rate response. In addition, the adoption of a common currency eliminates the exchange rate risk and the associated interest rate risk premia among the participant countries, thus weakening the discipline and signalling function normally exerted by financial markets [4]. In the long term, if excessive

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[1] Political changes occurred during the twentieth century could also partially explain why those elements behind the deficit bias have gained strength. It is broadly recognised that policy-making in democratic systems is associated to an inherent deficit bias largely due to the elements described in section 2.3.1. As democratic regimes extended through most of industrialised countries those factors linked to the electoral cycle and 'selfish generation' may have had an increasing influence on the deficit bias.

[2] Explanations for the growing size of public sectors over the last decades point to a wide range of possible causes: from the Wagner's Law and Baumol disease theories to interpretations arguing that the expansion of the public sector mostly stemmed from economic policy decisions reflecting changing perceptions about the role of the government. In line with this reasoning, Rodrik (1998) argues that trade openness and market integration experienced in recent decades may help explain the rising burden on public budgets caused by public social expenditure, subsidies and transfers. The degree of exposure to international competition would increase the demand for insurance against external shocks and more open economies would have larger public sectors. This might have bolstered the tendencies towards time inconsistent fiscal policies and led to a higher deficit bias (Annet, 2005).

[3] Obviously, such policies would also have negative effects in fixed exchange rate regimes.

Graph III.2: **Developments in the debt ratio in the main industrialised countries and in the EU over the last 30 years**

N.B.: Data for EU are the weighted average by all the old 15 Member States, data for BE are available since 1971, for DK since 1971 for NL since 1975 and for PT since 1973
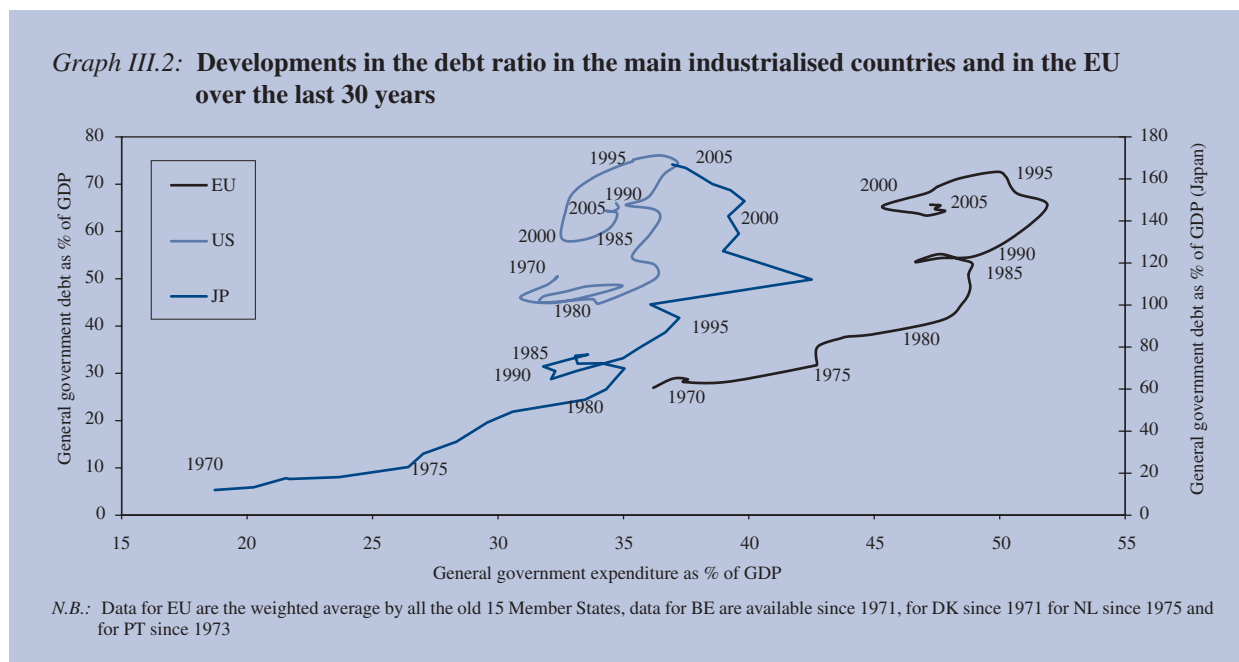
borrowing in one country or group of countries leads to inflationary pressures or even, in the extreme, to a risk of default, the implications in terms of monetary policy and financial stability may be shared by all the members of the union.

2.4. How can the deficit bias be addressed?

The debate on the ways to address the deficit bias has focused on the need to rebalance the *incentives* of policy-makers and/or to impose *constraints* on the conduct of fiscal policy. A commonly accepted view is that budgetary governance structures should provide sufficient information and the right incentives for governments and institutions concerned to interact in a way that favours or ensures sound fiscal policies.

Institutional settings at national level can play an important role in containing spending and deficit biases. These settings include in particular (i) the *procedural rules of the budgetary processes*, i.e. the process laid down in law or constitution governing the elaboration of the annual budget law; (ii) the *numerical fiscal rules* which are guiding or imposing constraints on the discretion of policy-makers; and (iii) the *independent bodies or insti-*

tutions in charge of providing inputs (forecasts, analysis) and formulating recommendations in the area of fiscal policy.

As mentioned in the introduction, the questions related to the desirable characteristics of the budgetary process are outside the scope of this chapter. The main findings of the literature on this issue are summarised in Box III.1. Procedural rules of the budget process and budgetary outcomes. The following sub-sections focus on the role of numerical fiscal rules and independent institutions, other than government and Parliament, which may have an influence on the conduct of fiscal policy.

2.4.1. Numerical fiscal rules

A simple way to promote or ensure the implementation of time-consistent policies is the introduction of numerical fiscal rules. Such rules can be defined in many different ways. They can for instance introduce limits on the deficit or debt of entities of the general government sector (budget balance and debt rules), on a yearly basis or on average over a given period. Alternatively, they can impose constraints on some categories of government expenditure or tax revenues (expenditure and revenue rules). A detailed typology and review of the properties of different types of fiscal rules is included in section 3.2 of this chapter.

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(4) This can be seen in developments of euro area government bond yields, which point to a narrowing of spreads across countries.

While not fully ruling out discretionary policy, fiscal rules, if enshrined in constitution or law and having strict monitoring and enforcement mechanisms, can impose binding constraints on the conduct of fiscal policy, and thereby *directly* contribute to fiscal discipline. The influence of numerical fiscal rules based on political commitments or informal agreements between different tiers of general government is more *indirect*. Such rules provide guiding principles for the conduct of fiscal policy and benchmarks against which it can be assessed. Apart from their influence on the deficit bias, numerical fiscal rules can also positively contribute to policy coordination between different levels of government, help mitigate uncertainty as to future government actions and, if properly designed, contribute to improving the quality of public finances.

Numerical fiscal rules are also subject to a number of drawbacks. Notably, they may be ineffective if they are not backed by strong political commitment or if they are not complemented by domestic budgetary institutions ensuring an appropriate monitoring and enforcement (von Hagen and al., 2005). Other well-known criticisms are that numerical fiscal rules do not easily allow dealing with unexpected circumstances, changes in the economic situation and preferences. For instance, some categories of fiscal rules may hamper the stabilisation function of fiscal policy (e.g. some types of balanced budget rules). Several authors (see notably Wyplosz, 2002a) also argued that rules tend to be rigid and artificial (setting arbitrary debt or deficit limits) and that they can be easily circumvented, e.g. through creative accounting. As argued by Kopits and Symanski (1998), there is therefore a need to carefully consider the design of fiscal rules (see also European Commission, 2005) ([1]).

2.4.2. Independent institutions, other than government and Parliament, influencing the conduct of fiscal policy

Another way to address the deficit bias is to complement the existing national institutional framework by independent public bodies designed to limit or ensure an appropriate use of discretion in the conduct of fiscal pol-

icies. In principle, such bodies can contribute to improve the conduct of fiscal policy in two different ways.

The *first* possibility would be to delegate part of fiscal policy to an 'independent fiscal agency'. There is currently no example of such 'independent fiscal agency' and their creation is not seriously envisaged anywhere. However, a number of theoretical proposals, inspired by the success of delegation of monetary policy to independent central banks, were put forward by the academia ([2]).

According to these proposals, a number of fiscal policy choices would be entrusted to a non-political body. Wyplosz (2005) argues for instance that an independent fiscal agency could be mandated to decide, every year, on the general government balance to be targeted in the Budget. The agency would set the target with the view to achieve in the long run a debt ratio objective specified by the Parliament. Whether there is a case for delegation of part of fiscal policy to such independent institutions is discussed more in depth in Box III.2.

The *second* possibility consists of institutions whose work may contribute to improving the conduct of fiscal policy in a more indirect way. These institutions, denominated as 'Fiscal Councils' in some pieces of literature, are not mandated to carry out any particular fiscal policy task (no delegation). Among other activities, they can ensure that fiscal policy is based on unbiased inputs (e.g. through the provision of independent macroeconomic forecasts), provide analysis on fiscal policy issues (e.g. independent estimates of the cost of policy measures; analysis of the sustainability of government finances), and release regular assessments and recommendations related to fiscal policy, with the view notably to increasing 'reputation costs' for the conduct of unsound policies.

These institutions differentiate from existing 'think tanks', such as some private banks' research departments, by the fact that they are primarily financed by public funds. Specific arrangements (legal provisions, appointment procedures…) are foreseen with a view to ensuring a high degree of independence vis-à-vis political authorities. As will be seen in section 4 of this chapter, several institutions of that kind are already in force in EU and other advanced economies and seem to have contributed to the conduct of sound fiscal policies.

([1]) According to Kopits and Symanski (1998), eight criteria should be taken into account when assessing the design of fiscal rules. Fiscal rules should be *well-defined* (no ambiguous definitions and competence divisions and clear escape clauses); there should be a *transparent* data reporting and accounting conventions; rules should be *simple* and *flexible* (rules should allow to deal with exceptional events). Rules should be *adequate* in relation to their final objectives, *credible* and *enforceable*. Finally, they should be *consistent* internally and with other policy objectives and *supportive of structural reforms*.

([2]) See notably Calmfors (2003) and Wyplosz (2005).

Box III.1: **Procedural rules of the budget process and budgetary outcomes**

Economic literature has underlined the importance of the characteristics of the budgetary process to achieve a level of aggregate expenditure consistent with overall macroeconomic constraints (see von Hagen 1992; von Hagen and Harden 1994; Poterba and von Hagen 1999; Strauch and von Hagen 2000; Hallerberg 2004). The budget process is governed by a number of procedural rules laid down in law or constitution. These rules establish the role of a limited number of participants which have to carry out their distinct tasks according to a specified timetable. A key element of the process is related to the distribution of powers between the government and the legislative branch and within the executive. Other important aspects concern which ministry has the agenda-setting power, how possible disputes between Ministries can be solved and the amendment power of the Parliament.

Among the desirable characteristics of the budget system, comprehensiveness, transparency and reliability are particularly important. *Comprehensiveness* is ensured if the budget covers almost all of government transactions. In practice, all public resources should be directed to a common pool from which expenditures are decided according to policy priorities. In this context, the use of extra budgetary funds should be exceptional. *Transparency* is notably achieved through a specification of the roles and responsibilities of all participants to the budget process and publication of reports at different stages of the process (pre-budget report, infra-annual monitoring reports, end-year report on compliance with plans, audit reports examined by Parliament). Finally, the budget plans are considered *reliable* if they are based on reasonable macroeconomic projections and if new policies are assessed carefully and their future costs and implications taken into account on a multiyear planning horizon.

Empirical research has looked at whether the key characteristics of the budget processes have an influence on budgetary outcomes. For example, the pioneering study by von Hagen (1992) builds an index that captures the degree of centralisation of the budget process. It covers the stages of: (i) budget formulation (including restrictions on the budget and the relative position of the minister of finance vis-à-vis the spending ministers) (ii) budget approval (focusing on the degree to which amendments in Parliament may increase the size of the budget) and (iii) budget implementation. Alesina et al. (1999) considered three different dimensions: (i) fiscal constraints that may be conducive to fiscal discipline; (ii) hierarchical procedures and (iii) transparency of the procedures. Both studies found evidence of a statistically significant link between the characteristics of the budgetary procedures and budgetary outcomes.

Centralisation of the decision-making in the budgetary process helps addressing the common pool problem. Several authors underlined that a high degree of centralisation is necessary to ensure a comprehensive view of the budgetary implications of all spending requests, and that it forces participants to recognise the real costs and benefits of each spending decision. Two main approaches to centralisation are generally identified (Hallerberg and Von Hagen 1999). Under the *delegation approach* a single policymaker, usually the finance minister, can significantly influence the budget process. Typically he is vested with agenda-setting power relative to other ministries in the preparation stage. He is responsible for monitoring the implementation of the budget and can correct deviations from plans. In countries adopting the delegation approach, the Parliament has generally a limited role in amending the cabinet's proposals. In the *contract approach* all ministries take part in a negotiation process leading to an agreement on a set of key fiscal figures and objectives, generally in a medium-term perspective. The Finance Minister has strong monitoring and enforcement powers in the execution stage. The Parliament has, in general, strong powers to amend the budget proposal.

The choice of the approach to centralisation depends on country-specific characteristics. Literature (Hallerberg and Hagen 1999) has underlined that the ideal way for a country to address common pool problems (see section 2.3.1) depends on its electoral system and the resultant degree of political dispersion of governments. Countries with an ideologically unified government (i.e. a one-party government or in which parties in government are close ideologically) generally rely on the delegation approach. Countries in which the government is less unified ideologically generally rely on fiscal contracts (e.g. coalition agreements). Several studies have shown that the approach followed by countries is also linked to their size (see European Commission (2005) and Von Hagen et al. (2002)). Large EU Member States are mostly delegation countries. In practice, the classification of countries according to the approach chosen to centralise the budgetary process is not always evident. Indeed, some countries combine features of both approaches (e.g. Denmark and Sweden), which complicates the categorisation, and reforms of fiscal institutions may change the classification of some countries over time.

Box III.2: **Is there a case for delegating part of fiscal policy to independent institutions?**

Proposals for delegating part of fiscal policy to independent institutions are generally inspired by the experience of independent central banks. Like monetary policy, fiscal policy faces trade-offs between short- and long-term objectives and is subject to time-inconsistency risks. Considering that delegation of monetary policy to independent central banks has been an efficient way to address the adverse effects of electoral incentives, several authors support the creation of 'independent fiscal agencies' that would be given responsibilities in the fiscal policy-making. Another relevant argument in favour of delegation of fiscal policy to 'independent fiscal agencies' is that, compared to other possible ways to directly address the deficit bias (e.g. implementation of strong numerical fiscal rules), reliance on independent institutions would safeguard a high degree of judgment and discretion in the conduct of fiscal policy. Budgetary objectives could for instance still be adjusted depending on cyclical circumstances and the desired degree of stabilisation of the economy.

Although so far no such independent institution with delegated fiscal tasks has been implemented, available literature provides a number of concrete proposals (see notably Calmfors, 2003; and Wyplosz, 2005). According to these proposals, the mandate of the institution would include an overall objective (e.g. debt sustainability, stabilisation), set by the government or the Parliament. This objective would have to be attained through intermediate short-term targets set by the independent fiscal agency (e.g. a budget balance consistent with an 'appropriate' debt level or/and with stabilisation purposes). Some proposals consider that the independent institution could also be given responsibilities for some fiscal policy instruments (e.g. control of some tax rates). Most of existing proposals foresee however that decisions on overall revenues and expenditures plans and their composition should remain under the authority of elected politicians. Literature also stresses that concrete features of independent fiscal institutions would vary depending on the country-specific characteristics (e.g. nature of the fiscal problem, institutional and political setting etc.).

Literature proposes a number of criteria to gauge whether some degree of economic policy delegation from governmental or political bodies to independent institutions would be desirable (see for instance Alesina and Tabellini (2003)). First, there may be harmful distortions in policymaking caused by political considerations (e.g. electoral cycles). Second, there must be a broad and stable consensus on what sound policy consists of. Without such a consensus, it would be difficult to establish a mandate for which the independent body can be held accountable. Third, the delegated mandate must not have any distributive consequences, since distributional decisions can be legitimately exercised only by elected representatives (there is no stable consensus on the optimal degree of redistribution). Fourth, delegation should not lead to a problem of policy coordination. If delegated policies are in conflict with other areas of policy that have not been delegated, coordination difficulties might outweigh the benefits from delegation.

While these four criteria are broadly met by monetary policy, it is not the case for fiscal policy. It can be argued that fiscal policy complies with the first criterion. Concerning the second criterion, the case is less simple than for monetary policy. While for central banks price stability is the ultimate goal, fiscal policy has to deal with a trade-off between sustainability and stabilisation (see Calmfors (2003) and Wyplosz (2002b)). As regards the third criterion, while monetary policy (under low inflation regimes) is not primarily redistributive, almost all fiscal policy decisions have redistributive consequences. Only if delegated fiscal policy tasks solely deal with budget balance and debt level targets while total expenditure and revenues levels and their composition remain under the control of elected bodies, the redistributive effect would be limited. Finally, the consequences of fiscal policy decisions on other policies (labour market, product market policies) are more likely to lead to policy coordination problems than in the case of monetary policy. Overall, considering that most of the required criteria making advisable delegation of fiscal policy are not met satisfactorily, there seems to be no strong case for fiscal policy delegation.

2.4.3. Concluding remarks

Numerical fiscal rules and independent institutions: complements or substitutes?

At first sight, independent institutions can be viewed as an alternative to numerical fiscal rules since they also aim at eliminating possible distortions in the conduct of fiscal policy. However, in general, numerical fiscal rules and institutions should not be seen as mutually exclusives but rather as complements.

The existence of numerical fiscal rules reflecting the main fiscal policy objectives of a country can help specifying the mandate and facilitate the work of independent institutions. Fiscal institutions, on their side, can effectively contribute to an independent

monitoring of the respect of the existing numerical fiscal rules, thereby increasing the chances that rules are respected. At the stage of budgetary planning and implementation, independent institutions can provide an assessment of whether budgetary plans and developments are in line with the rules. *Ex post*, independent institutions can increase the public accountability of the government, e.g. by providing a critical assessment of the reasons for possible non-compliance with the rule.

Another reason why rules and institutions could complement each other is that they potentially focus on different aspects of government finances. Numerical fiscal rules often apply to one sub-sector of the general government and generally have a short to medium-term orientation. On the contrary, independent fiscal institutions potentially conduct analysis covering the whole of government finances and may also consider the situation of government finances in a long-term perspective.

Consistency with the EU fiscal framework

The objectives of national fiscal rules and institutions largely fit with those of the EU fiscal framework. Adequate rules foster the attainment of sustainable budgetary positions and respect of the Treaty and SGP rules. Subject to their design and targets, national fiscal rules may also help preventing pro-cyclical loosening of the fiscal stance in economic 'good' times, which is also in line with one of the objectives of the 2005 reform of the SGP. However, compliance with national fiscal rules does not necessarily secure the respect of the EU fiscal rules. For instance, respect of expenditure rules does not guarantee convergence of the deficit towards levels consistent with the SGP, since this also depends on developments on the revenue side.

National independent institutions can also contribute to an effective functioning of the EU fiscal framework not only by tackling the main sources of fiscal profligacy at its roots but also by improving the knowledge and public awareness about economic and budgetary developments and raising reputation costs of non-compliance with the EU fiscal framework.

3. Numerical fiscal rules in the 25 EU Member States

3.1. Introduction

This section provides an overview of the numerical fiscal rules in force in the EU Member States and assesses whether these rules effectively influence budgetary outcomes. The definition of 'fiscal rules' followed in this chapter is that proposed by Kopits and Symanski (1998), i.e. *a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt or a major component thereof.* What distinguishes a numerical rule from the usual budget appropriations in the yearly budget cycle is therefore that there should be a *constraint* on one of the aggregates mentioned and that this constraint should be *permanent*. Numerical fiscal rules specify numerical targets for key budgetary *aggregates* such as annual budget balance, expenditure, revenue, or debt.

This section first reviews the different types of numerical fiscal rules and their properties with respect to various objectives assigned to fiscal policy. Then, it provides a descriptive analysis of the numerical fiscal rules in force in the EU Member States. Finally, the analysis investigates the existence of a link between numerical fiscal rules and budgetary outcomes.

3.2. Various types of numerical fiscal rules and their respective properties

The following broad categories of rules can be distinguished:

— *Budget balance, borrowing and debt rules.* Provided that targets are properly set, respect of such rules over time ensures the sustainability of government finances. These rules have been criticised for possibly introducing a pro-cyclical bias in the conduct of fiscal policy. Common ways to address this problem

are to extend the time-horizon of the rule or exclude the cyclically-sensitive items of the budget from the rule coverage. Another well-known potential drawback is the risk that respect of these rules might be achieved through cuts in the most productive expenditure items (investment, R & D expenditure), which may be less politically-sensitive. To avoid this problem some items may be excluded from the coverage of the rule (e.g. golden rules). However, this can in turn lead to monitoring difficulties and may facilitate circumvention of the rule.

— *Expenditure rules.* The main objective of these rules is to ensure fiscal discipline through improved expenditure control. Such rules directly target the part of the budget that the government controls most directly, making the authority responsible fully accountable for the respect of these rules. Expenditure rules can also be part of a strategy for redirecting public expenditure according to the priorities of the government by allowing increases above or below baseline for specific components. They can be instrumental in limiting the size of the government and hardly prevent automatic stabilisers from operating.

— *Revenue rules* can pursue different objectives. They can notably be designed to limit the increase in the tax burden or the size of the government, or on the contrary to ensure a sufficient amount of revenues for the government to finance its priorities. They can also aim at avoiding the conduct of pro-cyclical policies by pre-defining the allocation of possible higher-than-expected revenues.

Table III.1 below provides a review of the respective properties of various 'families' of fiscal rules with respect to different possible economic objectives.

3.3. Existing numerical fiscal rules in EU Member States

With a view to having a comprehensive picture of *numerical fiscal rules* in place in the EU Member States and to investigate the existence of a possible link between the design of these rules and budgetary outcomes, a questionnaire was prepared (see box III.3) and submitted to the national authorities of the 25 EU countries. Both numerical fiscal rules enshrined in the constitution or law and those based on political commitment or agreement between different general government tiers were included in the survey. As already mentioned, the procedural rules governing the annual budget process are not covered.

The survey covers the period 1990-2005. Sixty numerical fiscal rules were considered in the analysis [1]. Replies by Member States pointed to a larger number of rules, but some of them not considered in the study because they did not meet the pre-defined conditions to be considered genuine numerical fiscal rules. The reasons justifying these exclusions were notably that:

(i) some questionnaires concerned policy measures (e.g. freeze in the number of civil servants over a number of years) rather than genuine numerical fiscal rules;

(ii) some replies were related to procedural rules governing the budget process (relative powers of Parliament and government) and, therefore, could not be regarded as numerical fiscal rules;

(iii) some questionnaires concerned fiscal policy targets rather than numerical fiscal rules: the annual budgetary targets included in documents such as the Budget Law and the Stability and Convergence Programmes cannot be considered as numerical fiscal rules;

(iv) some rules were excluded to ensure a sufficient homogeneity of the sample [2].

The analysis of the questionnaires shows that there is a great deal of variety in the design of numerical fiscal rules as regards their coverage, the type of rule and the definition of the target. Likewise, the statuses of the rules as well as the monitoring and enforcement mechanisms vary considerably. The interesting messages emerging from the descriptive analysis of the questionnaires are summarised below.

Distribution of rules by sub-sectors of general government

A first result is that the number of fiscal rules in force in the EU Member States has grown continuously over the past twenty years (see Graph III.3) [3]. At present, almost all EU Member States have numerical fiscal rules. The number of rules varies widely across countries: Germany and Finland have five numerical fiscal rules; Hungary and Austria have one (see Annex 1 for more details).

There has been an interesting evolution in terms of the government sub-sectors covered by numerical fiscal rules. In the early 1990s, most numerical fiscal rules were applied at local or regional levels of government (see Graph III.3 above). This reflected the willingness of higher levels of government to impose constraints on local entities and the need to ensure sufficient coordination among general government tiers. Such rules continued to develop in the 90s and exist today in almost all EU Member States. A large and increasing number of numerical fiscal rules are found at the central government level. A relatively recent feature is the introduction of numerical fiscal rules in the social security sector and rules covering the whole of the general government sector. This may be a response to the increasing spending pressures in the social security sector and to the introduction of the EU fiscal rules, which impose requirements for the general government deficit and debt.

Distribution of the various types of numerical fiscal rules by fiscal aggregate

More than one third of the numerical rules in force in the EU Member States are budget balance rules (including golden rules) whereas expenditure and debt rules each represent about 25 percent of the total rules. Revenue

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[1] If those rules applied to more than one general government tier are counted according to number of sub-sector concerned (e.g. a balanced budget rule for regional and local governments would represent two rules), the sum of fiscal rules considered in the study would amount to 69 (66 in force in 2005). This figure is however attained by keeping rules for the whole of the general government as single rules.

[2] An example of such rules consists of arrangements foreseeing minimal expenditure increases for some strategic items or rules governing transfers among general government tiers.

[3] Obviously, the growing number of national fiscal rules in the EU is partly explained by the enlargements occurred since the 90s.

Table III.1

Properties of various 'families' of numerical fiscal rules with respect to different economic objectives

	Effect on the deficit bias [1]	Effect on macroeconomic stabilisation	Effect on the quality of government finances	Other properties
Budget balance rules	**Direct and positive** Efficiency in addressing the deficit bias depends on the degree of ambition of the numerical targets and on the design (time-horizon, definition of the objective, coverage) and characteristics of the rule (in particular monitoring and enforcement procedures).	**Possibly negative – depends on the design of the rule** Budget balance rules defined in nominal terms (in levels and as a % of GDP) introduce a pro-cyclical bias in fiscal policy. The bias is reduced in case the rule has a multiannual perspective. Budget balance rules targeting a cyclically-adjusted balance or to be respected over the cycle do not have such a bias (subject to uncertainties on the quality of the cyclical adjustment).	**Positive or negative, depending on the design of the rule** A negative effect is possible in case no item is excluded from the coverage of the rule, due to the political temptation to cut expenditure categories that are less politically-sensitive, including 'productive' expenditure (expenditure on R & D, infrastructure and education). Positive effect in case selected 'productive' items are subject to less strict constraints or excluded from the scope of the rule. This may however imply risks of inefficient allocation of public resources. Additionally, exclusion of selected items can raise monitoring difficulties and facilitate circumvention of the rule.	Such rules are frequently applied at regional and local levels of government. They are subject to a trade-off between, on the one hand, simplicity and straightforward monitoring of the rule and, on the other hand, stabilisation/quality aspects.
Expenditure rules	**Indirect and positive** Efficiency in addressing the deficit bias depends on the degree of ambition of the numerical targets, on the design and characteristics of the rule, but also on tax developments.	**Likely positive, but depends on the design of the rule** Expenditure rules contribute to macroeconomic stabilisation if the aggregate targeted by the rule is defined in level or growth rate of expenditure. Counter-cyclical contribution is maximal when the rule is defined in nominal terms (larger-than-expected demand-pull inflation) and when the coverage excludes cyclically-sensitive items. Expenditure rules can however entail a pro-cyclical bias if they are defined in terms of an expenditure-to-GDP ratio (this is rarely observed in practice).	**Positive or negative, depending on the design of the rule** Same as for budget balance rules.	Such rules are relatively rare at local government level and frequent at central government level. They may contribute to contain the size of the public sector. High accountability of the government for the respect of the rule since such rules directly target the part of the budget that the government controls most directly. Accountability is maximal if specific items not fully under the control of the government are excluded from the coverage of the rule (e.g. interest payments, unemployment benefits).
Revenue rules	**Positive or negative** Rules imposing limits on revenues (e.g. aiming at stabilising or reducing the tax burden) may have a negative impact on the deficit bias if they are not coupled with other rules, e.g. budget balance or expenditure rules. Indeed, stringent tax limits may have a negative impact on borrowing costs (markets might consider that the risk of default becomes higher if constraints are imposed on the capacity of the authority to increase taxes). On the contrary, rules pre-defining the allocation of higher-than-expected revenues generally help lessen the deficit bias by avoiding a relaxation of the fiscal stance in good times (depends on the allocation rule).	**Positive or negative** Such rules can be slightly pro-cyclical in case the rule targets a given revenue-to-GDP ratio (due to the progressivity of the tax systems). They can be strongly pro-cyclical if the rule targets a given amount of revenues in nominal terms (such rules are rare). Revenue rules pre-defining the allocation of higher-than-expected revenues may limit the conduct of pro-cyclical policies in good times (if all additional cyclical revenues are allocated to deficit reduction).	**Uncertain** No evident influence on the quality of government finances. However, in case only some categories of taxes are covered by the rule there can be an impact on the structure of the tax system.	Revenue rules pursue a wide variety of objectives. Rules imposing limits on revenues may contribute to contain the size of the public sector.
Debt rules	**Direct and positive** Efficiency in addressing the deficit bias depends on the degree of ambition of the numerical targets and on the design and characteristics of the rule (in particular monitoring and enforcement procedures).	**Possibly negative – depends on the design the rule** Depends on the design and time-horizon considered by the rule (see budget balance rules). In case the rule has to be respected over the business cycle, the stabilization objective is not hampered.	**Positive or negative — depends on the design the rule** Same as for budget balance rules.	Borrowing constraints are generally applied at sub-central levels of government. However, in some countries debt limits for the general government sector are enshrined in the law or constitution.

(1) Positive (negative) effect on the deficit bias means a decreasing (increasing) effect.

Graph III.3: **Number of numerical fiscal rules in force in the EU Member States**
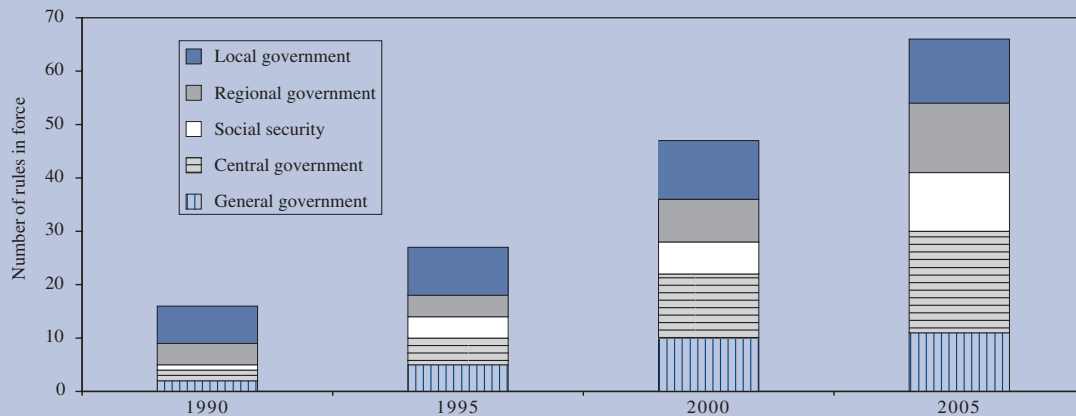
N.B.: Data for EU are the weighted average by all the old 15 Member States, data for BE are available since 1971, for DK since 1971, for NL since 1975 and for PT since 1973

rules account for less than 10 percent. Most of budget balance and debt rules are applied to regional and local governments and, to a lesser extent, to the central government. In contrast, expenditure rules are more frequent in the central government and social security sub-sectors (see Graph III.4 below) ([1]).

There is also a large diversity as regards the aggregates targeted by the various types of rules (see Table III.2). One third of budget balance rules in force target a balanced budget while one quarter are golden rules. Interestingly, only few budget balance rules, all of them applying to the general and central governments, are defined in structural (or cyclically-adjusted) terms. About half of debt rules, generally applied to local governments, establish debt limits depending on the repayment capacity (e.g. limit to total indebtedness in relation

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([1]) In the following graphs, the total number of fiscal rules does not always coincide since some replies did not answer all the questions included in the survey.

Graph III.4: **Number of numerical fiscal rules by sub-sector of general government**
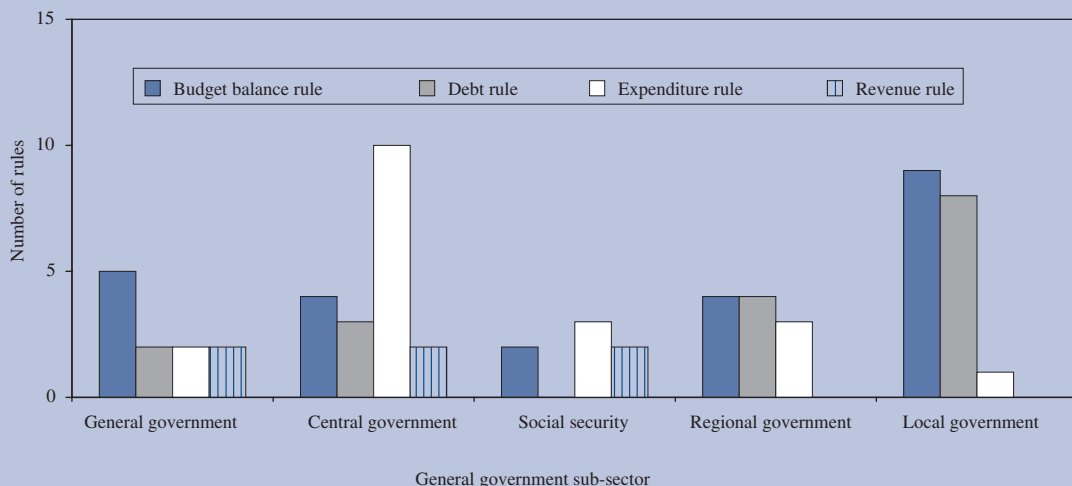
to current revenues). Expenditure rules are evenly distributed between those defining ceilings and those targeting expenditure growth rates. While ceilings are generally expressed in nominal terms, targeted growth rates are equally divided between nominal and real increases. Finally, more than half of revenue rules establish predefined principles for the allocation of higher-than-expected revenues.

The characteristics of the rules depending on the level of government to which they apply

Numerical fiscal rules in EU Member States are evenly divided between those that are incorporated into a multi-annual budgetary framework and those applied on an annual basis. Rules applied to regional and local governments rely preponderantly on annual schemes while most of those concerning the general government and central government sectors have a time horizon that goes beyond the yearly budgetary cycle and are integrated into a multi-annual fiscal framework (see Graph III.5). This provides an indication that fiscal rules applied at higher levels of government pursue medium-term policy objectives while those concerning local governments focus on short-term budgetary considerations.

Interestingly, the large majority of numerical fiscal rules applied to local and regional levels of governments are enshrined in law or in constitution, while rules concerning central and the whole of the general government sector tend to be more based on political agreements (internal stability pacts or other forms of political agreement or commitment).

Likewise, enforcement mechanisms are generally stronger for those rules applied at local and regional government levels than for rules applying to the central government (see Graph III.7). A majority of rules applying to local and regional governments sectors foresee either automatic correction mechanisms or the obligation for the authority responsible to adopt measures in case of non-compliance with the rule. In contrast, most of rules concerning the central government sub-sector do not include ex ante defined actions in case of non-respect of the rule.

The apparent weaker status and enforcement mechanisms of rules in force at the central government and general government levels may be linked with the fact that such rules draw much more public opinion and media interest than other rules (see Graph III.8). A high media visibility of the rule can, *ceteris paribus*, be expected to contribute to the enforcement of the rule, through higher reputation costs in case of non-compliance.

Table III.2

Target definitions by type of rule ([1])

Budget balance rules	Golden rules	Balanced budget rules	Nominal ceiling	Ceiling as a % GDP	Rules in structural terms	Total	
	5	8	5	1	3	22	38.6
Debt rules	Debt ceiling in nominal terms	Debt ceiling as a % of GDP	Debt ceiling related to repayment capacity	Other		Total	
	5	2	7	1		15	26.3
Expenditure rules	Nominal expenditure ceiling	Real expenditure ceiling	Expenditure growth rate (nominal)	Expenditure growth rate (real)	Other	Total	
	5	2	3	3	2	15	26.3
Revenue rules	Tax burden as a % GDP	Rule related to tax rates	Allocation of extra revenues	Other		Total	
	0	1	3	1		5	8.8
						Total	**100.0**

([1]) Without disaggregating fiscal rules according to number of sub-sectors concerned. Only rules in force in 2005 were considered in this table (57 rules).

Graph III.5: **Time horizon of fiscal rules by sub-sector of general government**
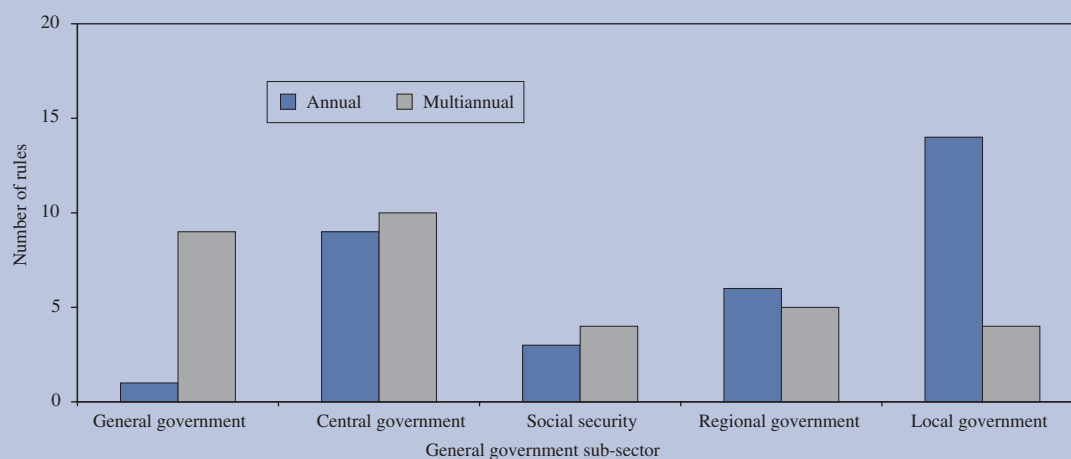
Graph III.6: **Statutory base of fiscal rules by sub-sector of general government**
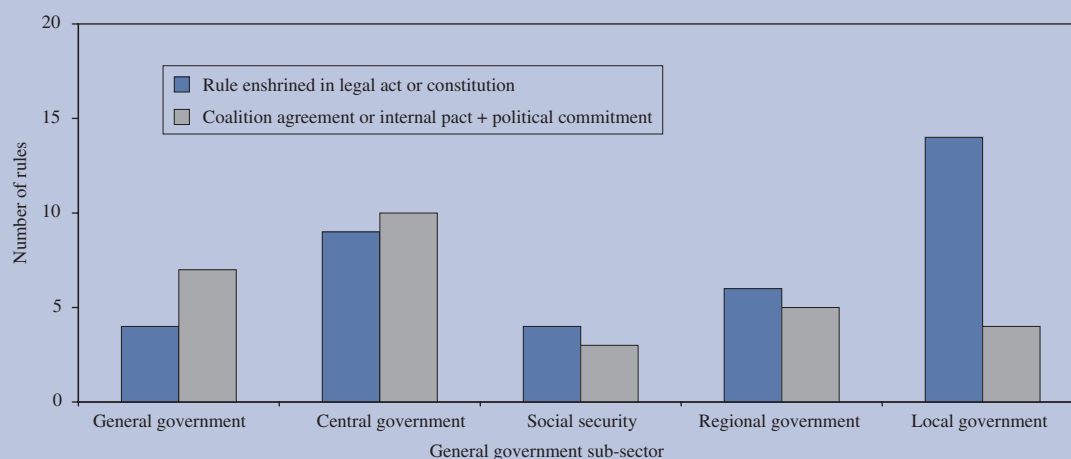
Different arrangements in contract *and* delegation *countries*

An interesting exercise consists of analysing whether there is a pattern in the distribution of different types of fiscal rules in EU Member States depending on the approach chosen by the country concerned for centralising its budget process. In other words, we examine whether the fact that a particular country adopts a *delegation* or *contract* (or commitment) approach yields specific results in terms of the numerical fiscal rules in force.

Broadly speaking, delegation countries (examples are the UK, France and most countries generally relying on single-party governments or on coalitions of ideologically aligned parties) tend to centralise their budget process by relying on the discretionary powers of a strong finance minister. In the contract or commitment countries (for instance Belgium and the Netherlands) all ministries take part in the negotiation process leading to a binding agreement on a set of key fiscal figures, often in a medium-term perspective. In practice, there are in some specific cases difficulties in distinguishing

Graph III.7: **Enforcement mechanisms of numerical fiscal rules by sub-sector of general government**
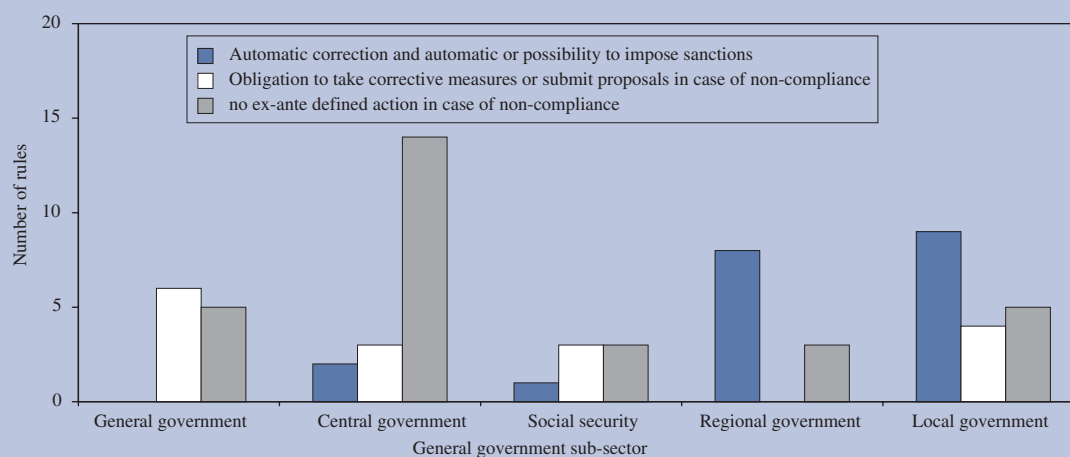
Graph III.8: **Media activity and numerical fiscal rules in different sub-sector of general government**
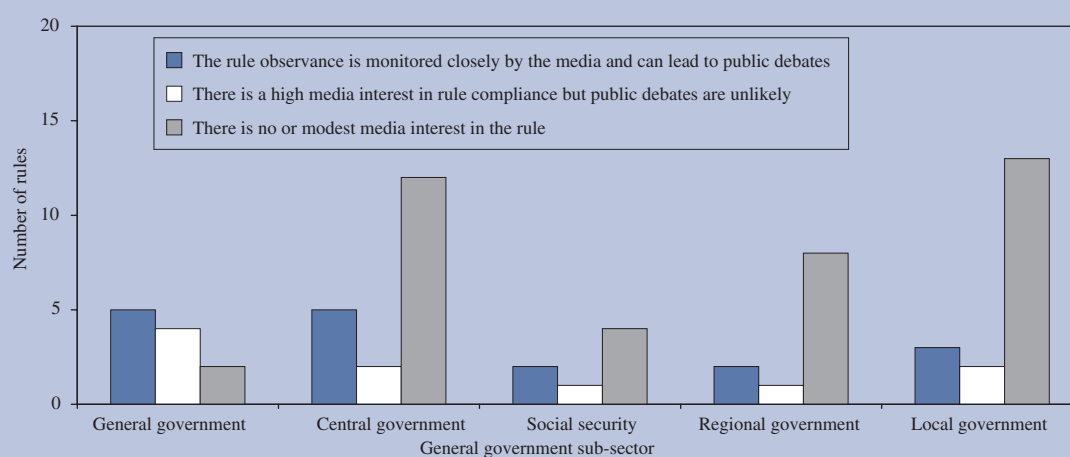
between commitment and delegation countries: some countries combine features of both approaches (e.g. Denmark and Sweden) and reforms of fiscal institutions may change the classification of some countries over time ([1]).

One would expect a priori countries following the contract approach to have a greater number of fiscal rules than those Member States that base their budgetary procedures on the delegation scheme. Table III.3 shows the existing fiscal rules in EU countries classified by type of rule and general government sub-sector, and distributed according to the approach chosen by the country concerned for centralising its budget process.

This table shows that delegation and contract countries present a similar number of fiscal rules (29 and 31 respectively), which departs from what could have been expected. In fact, rather than the number of rules by

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([1]) The classification used in our analysis is based on relatively recent papers (Von Hagen et al. (2001, 2002, 2005) and Yläoutinen (2004)).

Table III.3

Classification of numerical fiscal rules depending on the approach followed to centralise the budget process (only rules in force in 2005, disaggregated as explained in footnote No 12)

Sector	General government				Central/Federal government				Social security				Regional government				Local government				Totals
Rule	Contract	Deleg.	Mixed	Total	Contract	Deleg.	Mixed	Total	Contract	Deleg.	Mixed	Total	Contract	Deleg.	Mixed	Total	Contract	Deleg.	Mixed	Total	
ER	NL		DK	2	FI CZ IE IE LU SK	FR IT DE	SE	10	BE BE	FR	SE	4		IT IT DE		3		IT		1	20
RR	NL	ES UK	DK	2	LV	FR		2	FI LV			2				0				0	6
BBR	EE		SE DK	5	FI	PT AT DE		4	LU			1	BE	AT DE IT		4	FI LT BE IE	FR PT AT DE IT		9	23
DR	PL	UK		2	FI LT LU			3				0	CZ SK	ES ES		4	CZ EE LV SK	HU SI ES DE		8	17
Totals	**4**	**3**	**4**	**11**	**11**	**7**	**1**	**19**	**5**	**1**	**1**	**7**	**3**	**8**	**0**	**11**	**8**	**10**	**0**	**18**	**66**

ER: expenditure rules; RR: revenue rules; BBR: budget balance rules; DR: debt rules

Notes: (i) Those countries not included in the table do not have numerical rules; (ii) Due to changes in the budgetary process over time, some countries are difficult to be assigned to the delegation or contract approach (e.g. Italy); (iii) Germany has also numerical rules applied to the social security sub-sector but the relevant information about them could not be collected on time before the publication of this report.

type of country, the real difference is found in the distribution of fiscal rules among general government sub-sectors. Countries following the contract approach hinge more on numerical fiscal rules applied to central government and social security sectors, which contrasts with the few rules applied to these sub-sectors in delegation States. Conversely, delegation countries have a higher number of fiscal rules implemented at regional and local level than Member States relying on the delegation approach.

This distribution seems consistent with the fact that the larger political dispersion of governments in contracts countries is likely to promote fiscal rules ('contracts') at central level, while territorial sub sectors are likely to enjoy fewer restrictions imposed by central authorities. Likewise, delegation countries having a strong minister of finance and more homogeneous political majority in the Parliament are expected to enact relatively few fiscal rules for central levels of government and more rules (constraints) on regional and local governments in order to implement a more effective control on the whole of general government finances.

3.4. Do numerical fiscal rules improve budgetary performance?

In this section, the detailed information from the questionnaires on fiscal rules in the EU Member States is used to analyse whether there is link between numerical fiscal rules and budgetary outcomes. The analysis is conducted in three stages:

- In a first step, the analysis focuses on the link between the *existence* of numerical fiscal rules and budgetary outcomes. It notably looks at whether budgetary developments in the years immediately following the introduction of rules differ from those typically observed on average during the sample period 1990-2005 considered in the survey.

- In a second step, the analysis takes into account the *coverage* of fiscal rules and tests the existence of a link between the share of government finances covered by numerical fiscal rules and budgetary developments. In order to carry out such a test, a time-varying 'fiscal rule coverage index' is constructed, for each Member State, which summarises the information on the share of government finances covered by numerical fiscal rules.

- In a third step, the analysis takes into account the *characteristics* of fiscal rules along with their *coverage*. To this aim, an index on the *strength* of individual fiscal rules is constructed based on the desirable characteristics of fiscal rules defined in the literature (i.e. statutory base, body in charge of monitoring, body in charge of enforcement, enforcement mechanisms and media visibility of the rule) [1].

3.4.1. Relation between the introduction of numerical fiscal rules and budgetary outcomes

A first and simple way to assess the influence of fiscal rules on budgetary outcomes is to see whether budgetary developments in the years immediately following the introduction of fiscal rules differ from those observed on average during the sample period 1990-2005.

Table III.4 reports the average changes for different time horizons in the cyclically-adjusted primary balance (primary CABs) and in the ratio of cyclically-adjusted primary expenditure to GDP (over 1990-2005), and compares them with the changes recorded for the same variables in the years immediately following the adoption of new numerical fiscal rules [2]. All fiscal rules were considered when comparing the changes in the primary CABs and only expenditure rules when changes in the cyclically-adjusted primary expenditure were analysed [3]. Major changes in the design of rules were treated in the same way as the introduction of new fiscal rules.

The results indicate that the primary CAB on average improved in the years following the introduction of numerical fiscal rules. This conclusion holds for the different time-horizons considered, i.e. one, three and five years after the introduction of the rule. It contrasts with the fact that the primary CAB has on average been unchanged over the same time-horizons in the period

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[1] Although there is a close relationship, these characteristics do not have to be confused with the eight criteria listed in footnote 10 on the design of fiscal rules.

[2] For instance, the change in the cyclically-adjusted primary deficit in the year immediately after the introduction of a rule is compared to the average yearly change registered during the whole of the sample period. Similarly, the average change in the cyclically-adjusted primary deficit in the three years following the implementation of a rule is compared to the average three-year change over the sample period. An identical comparison is carried out for a five-year time horizon.

[3] A third possibility would have consisted of looking at developments in cyclically-adjusted revenue after the implementation of revenue rules. However, the relatively low number of revenue rules and their heterogeneity would have prevented from drawing any meaningful interpretation.

Box III.3: **The questionnaire on numerical fiscal rules**

In order to collect the most comprehensive and accurate information on the existing numerical fiscal rules in the EU, a questionnaire was sent to all EU Member States in the context of the Working Group on the Quality of Public Finances (WGQPF) attached to the Economic Policy Committee (EPC). The questionnaire covers all types of numerical fiscal rules such as budget balance rules including golden rules, debt rules, expenditure rules and rules concerning the revenue side of the budget. Member States were invited to fill out one questionnaire per fiscal rule. The questionnaire considers rules applied to all levels of government. The time frame covered by the questionnaire is the period from 1990 to 2005. Member States were invited to signal changes in their definition and/or contents during the period under review. Likewise, Member States were also requested to fill out the questionnaire for those fiscal rules that had prevailed for a certain period between 1990 and 2005. The survey is made up of 24 questions, which are grouped in 6 sections:

1. **General description of the rule.** This section required Member States to provide information on the general characteristics of the rule (targeted variable, coverage), the motivations for its introduction, and the relevant dates of introduction and entering into force of the rule, and concerning the main changes in the period under review.

2. **Design, time frame coverage, exclusions and target definition of the rule.** This section includes questions concerning the time span covered by the rule (annual/multiannual), specification on the aggregate targeted (definition of the variable and accounting system in which it is expressed, exclusions from the coverage of the rule, ratios vs. level and growth rates, aggregates defined in nominal vs. real term). This section also contains questions related to the properties of the rule.

3. **Statutory base of the rule.** This section allows to make a distinction between rules based on political commitments (coalition agreements, agreement reached by different levels of government), and those based on legal acts (law, constitution).

4. **Monitoring of compliance with the rule.** This section requests information on the body responsible for the monitoring of the rule. Answers provided by Member States give important indications on whether the rule is monitored by a partisan or a non-partisan institution and whether monitoring of compliance with the rule is ensured in real time or only ex post.

5. **Enforcement procedures.** This section contains questions related to the body in charge of ensuring enforcement of the rule (partisan vs. non-partisan) and the description of actions in case of non-compliance (obligation to propose corrective measures for the relevant authority, automatic correction mechanisms, possibility of imposing sanctions, existence of well-defined escape clauses). This section also contains questions related to the media visibility of the rule.

6. **Experience with the rule.** The last section of the questionnaire asks questions related to the track record in terms of compliance, and to the reasons for possible non-compliance with the rule. It also contains subjective questions related to the perception on whether the rule has contributed to fiscal discipline (definitively / significantly / modestly).

1990-2005. There seems to be also a link between developments in general government expenditure and expenditure rules. The decline in the ratio of primary government expenditure adjusted for the cycle is significantly larger in the years following the introduction of numerical expenditure rules than the average change in the period 1990-2005. Nevertheless, the results for expenditure rules have to be taken with caution given the relatively small number of expenditure rules in the sample.

This preliminary analysis suggests that there may be a link between the introduction of numerical fiscal rules and budgetary outcomes. However, this result should be considered cautiously since the analysis does not take into account the coverage and characteristics of fiscal

rules and does not control for other factors that may have affected government budgets and developments in primary expenditure in the last fifteen years (e.g. position in the economic cycle, level of the government debt…).

3.4.2. Relation between the share of government finances covered by numerical fiscal rules and budgetary outcomes

One major difficulty in assessing the influence of numerical fiscal rules on budgetary outcomes is that a large number of these rules apply to lower levels of governments while detailed budgetary data (notably estimates of budgetary aggregates corrected for the effect of the cycle) are only available for the general government. In order to overcome this difficulty, there is a need to take

Table III.4

Average change in budgetary variables following the introduction (or major changes) of fiscal rules in the EU-25 Member States (1990-2005)

	A fiscal rule is introduced (or strengthened)	Average over the sample
Change in the Primary CAB		
— In the following year	0.2 (– 0.2; 0.7)	0.0 (– 0.2; 0.2)
— In the following three years	0.4 (– 0.7; 1.5)	0.0 (– 0.4; 0.3)
— In the following five years	0.3 (– 0.9; 1.4)	– 0.1 (– 0.5; 0.3)
	An expenditure rule is introduced (or strengthened)	**Average over the sample**
Change in Primary Exp/GDP		
— In the following year	– 1.5 (– 2.8; – 0.2)	– 0.2 (– 0.5; 0.0)
— In the following three years	– 1.9 (– 3.3; – 0.6)	– 0.9 (– 1.3; – 0.4)
— In the following five years	– 3.1 (– 4.4; – 1.3)	– 2.1 (– 1.4; – 2.7)

NB: Extreme values from the sample were eliminated. For all time-horizons, the 2.5 % highest and lowest changes in the primary CAB and cyclically-adjusted primary expenditure-to-GDP ratio were removed from the sample. Confidence interval values (5 %) are in brackets.

Source: Commission services.

into account what part of government finances is covered by fiscal rules. To this aim, a 'fiscal rule coverage index' was constructed, for each Member State, which summarises the information on what fraction of general government finances is covered by numerical fiscal rules. This index was calculated for all the years covered by the study, i.e. the period 1990-2005. Details on the construction of the 'fiscal rule coverage index' are provided in box III.4 below.

As seen in section 3.2, the number of numerical fiscal rules in the EU Member States has continuously increased over the last two decades. The share of government finances covered by fiscal rules has naturally followed the same evolution. On average, less than 25 percent of government finances of EU Member States were covered by numerical fiscal rules in the beginning of the

1990s. This proportion today approaches 75 percent, with considerable differences across Member States ([1]).

Relation between the time-varying 'Fiscal rule coverage index' and budgetary outcomes

Graph III.10 reports the average value of the primary cyclically-adjusted balance observed in EU Member States over the period 1995-2005 for different groups of countries classified according to the value of the 'Fiscal rule coverage index'. This graph suggests that there may

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([1]) In 2005, about 30 percent of Hungarian Government finances were covered by numerical fiscal rules. This percentage reaches about 70 percent to 80 percent of general government finances in some countries (e.g. Belgium, France). In some other EU Member States (Sweden, the Netherlands, United Kingdom) 100 percent of general government are covered by one or more numerical fiscal rules.

Box III.4: Construction of a time-varying 'Fiscal rule coverage index' and a time-varying 'Expenditure rule coverage index'

In order to analyse the existence of a possible link between the share of government finances covered by fiscal rules and budgetary outcomes, a time-varying 'Fiscal rule coverage index' was constructed. This index summarises, for each Member State, the information on what part of general government finances is covered by numerical rules (measured as the share of government expenditure of the general government sub-sector to which the rule applies in total general government expenditure). When constructing this indicator, two main issues had to be addressed.

(Continued on the next page)

Box III.4 (continued)

- **The *first* one concerns how to deal with the fact that some Member States rely on different types of rules** (e.g. a country can have an expenditure rule for the central government and a budget balance rule for regional governments). Taking into account that the purpose of the analysis is to assess whether numerical fiscal rules can contribute to fiscal discipline, it was considered that all numerical fiscal rules – i.e. all expenditure, budget balance, borrowing, debt and revenue rules – could be aggregated in terms of coverage. In other words, if a part of government finances is covered by an expenditure rule, and another part is covered by a budget balance rule, the part of government finances covered by numerical fiscal rules can be considered to be the sum of both. A specific 'Expenditure rule coverage index', taking into account only expenditure rules, was calculated to assess the influence of expenditure rules on developments in primary expenditure.

- **The *second* issue is how to treat cases in which several rules apply to the same sub-entity of the general government sector**, e.g. the case of a Member State in which an expenditure rule at general government level (100 % coverage) coexists with a budget balance rule for local governments (for instance 10 % coverage, i.e. in a case where local governments' spending represent 10 % of total general government expenditure). In this situation, a possible approach would have been to consider that the coverage is 100 % since the whole of general government finances are covered by fiscal rules. However, this would not have allowed to take into account that the existence of several fiscal rules applying to the same sub-sector could potentially bring more benefits in terms of fiscal discipline than one single rule (in our example, local government finances are subject to an expenditure and a budget balance rule), even if the marginal benefit of the second rule can be assumed to be lower than for the first one. In order to take these considerations into account, the 'Fiscal rule coverage index' and the 'expenditure rule coverage index' were constructed following this simple approach: when more than one rule apply to the same sub-sector of general government, the index gives a weight of 1 to the coverage of the first rule considered (in practice, the rule with the wider coverage). In our example, the expenditure rule has 100 % coverage since it applies to the whole of the general government sector; the contribution of this rule to the 'Fiscal rule coverage index' is therefore equal to 1. The coverage of the second fiscal rule is given a lower weight of 0.5. In our example, the second fiscal rule is a budget balance rule for local governments covering 10 % of government finances. The contribution of this rule to the 'fiscal rule coverage index' equals to 10 % multiplied by 0.5 that gives 0.05. Therefore, the 'fiscal rule coverage index' for the country considered reaches 1.05 in the year considered.

A time-varying 'Expenditure rule coverage index' measuring the share of government finances covered by *expenditure* rules was constructed following exactly the same methodology, but restricting the sample to numerical expenditure rules.

Graph III. 9 below plots the 'fiscal rule coverage index' and the 'Expenditure rule coverage index' for the EU-25 (unweighted averages) since 1990.

Graph III.9: **'Fiscal rule coverage index' and 'Expenditure rule coverage index' – EU-25 (unweighted average)**
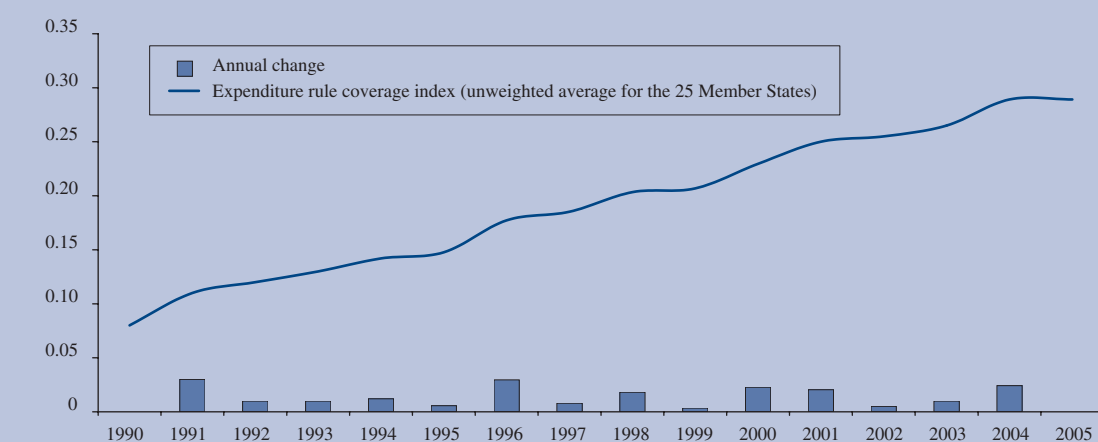
Source: Commission services.

be a link between the share of government finances covered by fiscal rules and the underlying position of government finances. However, such a static analysis does not allow to conclude on a possible relation between the two variables, and there is a need to control for other factors that may have an impact on government budgets.

A way to perform such control, and to infer more robust conclusions on the relation between fiscal rules and budgetary outcomes, is to estimate relations describing the reaction of fiscal authorities (in terms of chosen levels of budget balances or developments in government expenditure) to key macroeconomic and budgetary developments, such as those related to the cycle and the level of debt. The strategy followed consists of augmenting traditional forms of fiscal reaction functions with our indicator measuring the share of government finances covered by numerical fiscal rules in the 25 EU Member States. In such a relation, the influence of the coverage of numerical fiscal rules on budgetary policy can be gauged by looking at the sign of the regression coefficient of the 'Fiscal rule coverage index' and its statistical significance.

Table III.5. below reports the results for panel data estimation of a fiscal reaction function for the 25 EU Member States. The dependent variable is the primary cyclically-adjusted balance (CAPB). The explanatory variables are the lagged CAPB, the lagged debt, the output gap, two dummy variables, taking value 1, respectively, after 1992 and after 1999, and our fiscal rule coverage index. The CAPB and the debt level capture the fiscal stabilisation motive of fiscal authorities. The two

dummy variables are aimed at capturing possible behavioural changes occurred in correspondence with, respectively, the signing of the Maastricht Treaty (1992) and the completion of the EMU project (1999). The constant term captures the portion of the fiscal stance not explained by the chosen explanatory variables. The output gap is instrumented with its own lag and a lagged indicator of foreign output gap in order to avoid endogenity problems. All fiscal variables are expressed as shares of potential output. The period chosen for the estimation reflects the time frame considered in the questionnaire on fiscal rules, which includes all rules into force starting from 1990. The sample includes episodes of very large and rarely observed changes in budgetary data, observed mostly in New Member States. In order to avoid results being driven by these 'outliers', the sample was trimmed in such a way to exclude the observations exhibiting changes in the CAPB and in the primary cyclically-adjusted expenditure outside the 2.5 percent and the 97.5 percent percentiles of the overall distribution.

In accordance with existing estimates of fiscal reaction functions for EU countries, results indicate a non-significant response of fiscal authorities to output gap and a significant positive response to debt [1]. As for our 'Fis-

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[1] This would mean that EU countries attached more importance to the objective of fiscal consolidation that to stabilisation purposes during the period 1990-2005. This finding is consistent with the results obtained by others studies (see for instance Ballabriga and Martinez-Mongay, 2002).

Graph III.10: **Fiscal rule coverage index and average primary CABs in the EU-25 countries**
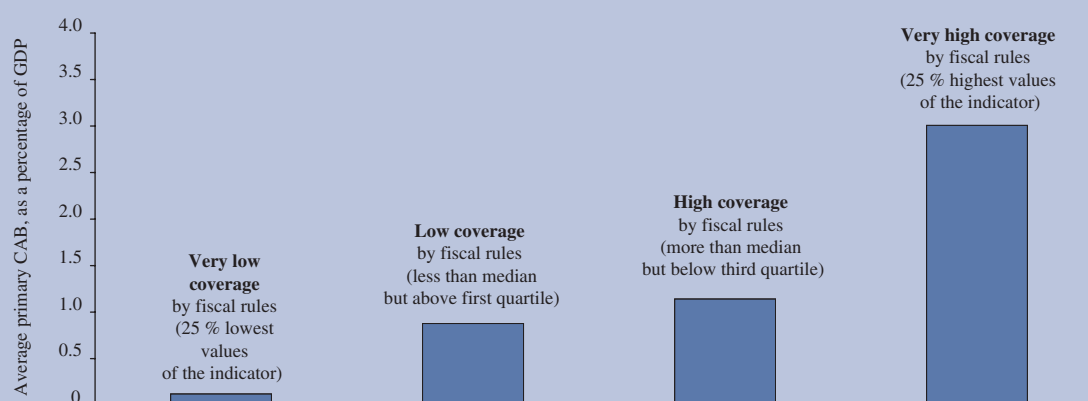
Table III.5

**Coverage of fiscal rules and developments
in the primary CAB (EU-25, 1990-2005)**

Explanatory variables	Dependent variable: primary CAB (CAPB)
OG	0.09 (1.5)
Constant	– 0.93 (– 2.1)**
Lagged CAPB	0.63 (15.8)***
Lagged debt/GDP ratio	0.02 (3.0)***
Fiscal rule coverage index	0.19 (1.6)*
Dummy 1992	0.68 (2.2)**
Dummy 1999	– 0.51 (– 2.7)***
N. obs.	260
R sq. within	0.59
R sq. between	0.93
R sq. overall	0.80

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and a lagged indicator of foreign output gap. The foreign output gap indicator is the export-weighted output gap of the 3 major export markets of each market. All fiscal variables are expressed as shares on potential output. 't' values are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients for country fixed effects are not reported.

Source: Authors' calculation and DG ECFIN AMECO database.

Table III.6

**Coverage of expenditure rules and developments
in primary expenditure (EU-25, 1990-2005)**

Explanatory variables	Dependent variable: primary CAE (PCAE)
OG	0.10 (1.5)
Constant	6.28 (4.0)***
Lagged PCAE	0.90 (25.4)***
Lagged debt/GDP ratio	– 0.02 (– 2.7)***
Expenditure rule coverage index	– 0.24 (– 1.7)*
Dummy 1992	– 0.51 (– 1.5)
Dummy 1999	0.01 (0.2)
N. obs.	260
R sq. within	0.77
R sq. between	0.99
R sq. overall	0.96

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and a lagged indicator of foreign output gap. The foreign output gap indicator is the export-weighted output gap of the 3 major export markets of each market. All fiscal variables are expressed as shares on potential output. 't' values are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients for country fixed effects are not reported.

Source: Authors' calculation and DG ECFIN AMECO database.

cal rule coverage index', the coefficient is positive, which indicates that an increase in the share of government finances covered by numerical fiscal rules leads to an improvement in the primary CAB. The coefficient is significant at the 10 percent level.

The same analysis was carried out focusing on the relation between expenditure rules and developments in general government expenditure. The dependent variable is now the ratio of cyclically-adjusted primary expenditure to GDP. The 'Fiscal rule coverage index' is replaced by the 'Expenditure rule coverage index'. The coefficient of this variable in the regression is negative and significant at the 10 percent level. This provides an indication that an increase in the coverage of government finances by expenditure rules leads, ceteris paribus, to a reduction in the primary expenditure-to-GDP ratio. Again, the results concerning expenditure rules must be interpreted with care, due to the relatively low number of expenditure rules considered.

3.4.3. Relation between the characteristics and coverage of numerical fiscal rules and budgetary outcomes

The previous sections examined the link between the *existence* and *coverage* of numerical fiscal rules and budgetary outcomes. However, economic literature

stresses that the effectiveness of fiscal rules also depends on their properties (see notably Inman, 1996), i.e. their statutory base and whether there are independent and efficient monitoring and enforcement mechanisms to ensure the respect of the rule.

An index on the strength of numerical fiscal rules

A fiscal rule is generally considered to be 'stronger', in the sense of having a higher likelihood to be respected and to influence developments in the targeted fiscal variables, if it has a strong *statutory base*, i.e if the provisions related to the existence of the rule are enshrined in the constitution or in law. While not ruling out discretionary policy, such rules impose binding constraints on the conduct of fiscal policy, thereby addressing the deficit bias in a direct way. The statutory base also provides an indication of the difficulty to amend or derogate the rule and of the importance given to the rule in the Member State concerned, at least at the moment of its introduction [1].

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[1] A distinction should be made between situations where the rule itself is enshrined in law or constitution (i.e. higher-than-expected revenues should be allocated to the reduction of the deficit) and cases where only the principle of the rule is considered in the relevant legal text (i.e. the government has to specify *ex ante* the use of possible higher-than-expected revenues). In the first case, the rule can be considered 'stronger' than in the second one.

The nature of the *body in charge of monitoring* the respect of the rule is another important element. When respect of the rule is monitored by an independent body, which has the possibility to send alert signals in case a risk of non-compliance is identified, the probability that fiscal variables are adjusted to ensure compliance with the rule can be expected to be higher. The nature of the *enforcement mechanisms* also matters. The existence of automatic correction mechanisms or the possibility to impose sanctions in case of non-respect of the rule can be expected to foster compliance. Enforcement of the corrective measures and sanctions should preferably be ensured by an *independent authority*. Finally, it is worth noting that those rules that are neither enshrined in law or constitution nor regularly monitored and for which no enforcement mechanisms have been defined ex-ante may also contribute to the conduct of sound fiscal policies. As a matter of fact, such rules can be useful in providing benchmarks against which fiscal policy can be monitored and assessed by the public. Therefore, the effectiveness of fiscal rules in ensuring fiscal discipline can be expected to be stronger when the rule benefits from a large *media visibility* and when not compliance is likely to trigger a public debate.

In order to assess whether the design of fiscal rules has an impact on their effectiveness, the country-specific 'Fiscal rule coverage index' constructed in section 3.4.2 was augmented to take into account the characteristics of the individual fiscal rules. To this aim, an index of the 'strength' of numerical fiscal rules was calculated, for each of the rules considered in the sample. The index takes into account the five criteria mentioned above: the statutory base of the rule; whether there is an independent monitoring of the rule; the nature of the institution responsible for the enforcement of the rule; the existence of pre-defined enforcement mechanisms; and the media visibility of the rule. For each criterion, scores were attributed, the higher value corresponding to the characteristic that is presumed desirable for a strong/effective rule. Details on how the scores were attributed depending on the characteristics of the rules and on the calculation of the synthetic index measuring the strength of each fiscal rule are provided in Box III.5.

Box III.5: Calculation of an index of strength of fiscal rules

The index of strength of numerical fiscal rules was calculated taking into account five criteria: the statutory base of the rule; whether there is an independent monitoring of the rule; the nature of the institution responsible for the enforcement of the rule; the existence of pre-defined enforcement mechanisms; and the media visibility of the rule. The methodology followed was inspired by the previous work by Deroose, Moulin and Wierts (2005). This box provides details on how the scores were attributed for each of these criteria and on the calculation of the synthetic index measuring the strength of individual fiscal rules.

Criterion 1: statutory base of the rule

The score of this criterion index is constructed as a simple average of the two elements below:

Statutory or legal base of the rule

4 is assigned for a constitutional base

3 if the rule is based on a legal act (e.g. Public finance Act, Fiscal Responsibility Law)

2 if the rule is based on a coalition agreement or an agreement reached by different general government tiers (and not enshrined in a legal act)

1 for political commitment by a given authority (central or local government, Minister of Finance)

Room for setting or revising objectives

3 if there is no margin for adjusting objectives (they are encapsulated in the document underpinning the rule)

2 there is some but constrained margin in setting or adjusting objectives

1 there is complete freedom in setting objectives (the statutory base of the rule merely contains broad principles or the obligation for the government or the relevant authority to set targets)

Criterion 2: Nature of the body in charge of monitoring respect of the rule

The score of this criterion index is calculated as follows:

3 if there is a monitoring by an independent authority (Fiscal Council, Court of Auditors or any other Court) or the national Parliament

2 monitoring by the Ministry of Finance or any other government body

1 no regular public monitoring of the rule (there is no report systematically assessing compliance)

(Continued on the next page)

Box III.5 (continued)

The score of this variable is augmented by one point in case there is a real time monitoring of compliance with the rule (e.g. existence of alert mechanisms in case there is a risk of non-respect of the rule).

Criterion 3: Nature of the body in charge of enforcement of the rule
The score of this criterion index is calculated as follows:
3   enforcement by an independent authority (Fiscal Council or any Court) or the National Parliament
2   enforcement by the Ministry of Finance or any other government body
1   no specific body in charge of enforcement

Criterion 4: Enforcement mechanisms of the rule
The score of this criterion index is calculated as follows:
4   there are automatic correction and sanction mechanisms in case of non-compliance
3   there is an automatic correction mechanism in case of non-compliance and the possibility of imposing sanctions
2   the authority responsible is obliged to take corrective measures in case of non-compliance or is obliged to present corrective proposals to Parliament or the relevant authority
1   there is no ex-ante defined actions in case of non-compliance
The score of this variable is augmented by 1 point in case escape clauses are foreseen and clearly specified.

Criterion 5: Media visibility of the rule
The score of this criterion index is calculated as follows:
3   is assigned if the rule observance is closely monitored by the media, and if non-compliance is likely to trigger a public debate
2   for high media interest in rule-compliance, but non-compliance is unlikely to invoke a public debate
1   for no or modest interest of the media

In absence of strong theoretical base or preference regarding the weight to be given to each criterion, it was decided to calculate the synthetic index in a large number of different ways, reflecting different possible weightings for the five criteria. The scores of the five criteria were first standardised to run between 0 and 1. Then, a random weights technique was used following the method used by Sutherland and al. (2005). This technique uses 10 000 sets of randomly-generated weights to calculate the synthetic indicator in 10 000 different ways. The random weights are drawn from a uniform distribution between zero and one and then normalised to sum to one. The resulting distribution for the synthetic indicator reflects the possible range of values given no a priori information on the weight to be given to each component of the index. Given that the weights are drawn from a uniform distribution, the mean value of the synthetic indicator is asymptotically equivalent to the indicator calculated using equal weights for the constituent components (unweighted arithmetic average). The chart below shows, for all the fiscal rules considered in the study, the range containing 98 % of the values of the index of strength of the rule calculated with 10 000 different sets of random weights (we eliminated the 1 % lowest and highest values of the synthetic index).

Graph III.11: **Index of strength of the fiscal rules in force in EU Member States in 2005 (classified according to the average value)**
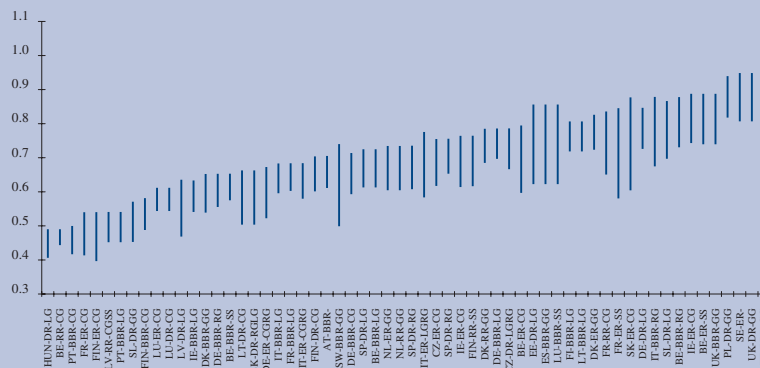
NB:
1.   The chart shows, for all the numerical fiscal rules considered in the study, the range containing 98 % of the values of the index of strength of the fiscal rule concerned. Rules were classified in an ascending order. The scores of the individual criteria taken into account in the calculation of the overall index were normalised to one. The size of the vertical line provides an indication of the heterogeneity of the scores related to the five criteria considered in the calculation of the synthetic index.
2.   When the characteristics of a rule have evolved over time, the chart only present the index consistent with the most recent features. Three rules presented in the chart are not anymore in force in 2005. For Belgium, the expenditure rule and the revenue rule were implemented for the convergence process leading to EMU qualification. For Slovenia, the debt rule was in force over 2000-2004.

A country-specific 'Fiscal rule index', taking into account the coverage *and the* characteristics *of numerical fiscal rules*

By combining the information contained in the 'Fiscal rule coverage index' and the information of the strength of each fiscal rule, a time-varying 'Fiscal rule index' was constructed, for each Member State, which takes into account all the available information on the national numerical fiscal rules. The indicator is calculated in two steps. *First*, we calculate the potential contribution of each rule to the 'Fiscal rule index' by multiplying the share of government finances covered by the rule by the indicator of the strength of the rule. *Second*, we sum these indicators by country, taking into account their changes over time [1]. In case two rules apply to the same general government sub-sector, we follow the same methodology as for the calculation of the 'Fiscal rule coverage index'. We give a weight of 1 to the rule which can be considered as the strongest one, based on the index of strength of fiscal rules, and a weight of 0.5 to the weaker rules. Following the same approach but taking into account only expenditure rules, a time-varying 'Expenditure rule index' was constructed for each Member State [2].

The influence of fiscal rules on budgetary outcomes depends on their characteristics

Like in section 3.4.2, we augment standard fiscal reaction functions with our 'Fiscal rule index', which incorporates information on the coverage and characteristics of the numerical fiscal rules in the EU-25 Member States [3]. Table III.7 reports the results of the econometric analysis.

A remarkable result is that the inclusion of information on the strength of the individual fiscal rules improves the quality and robustness of the relation between fiscal rules and budgetary outcomes. When comparing this regression to the one including the 'Fiscal rule coverage index', it appears that the coefficient measuring the influence of fiscal rules on budgetary outcomes is clearly more significant [4]. The level of this coefficient is also higher, suggesting that a change in the coefficient has a larger impact on budgetary outcomes (all 'Fiscal rule indexes' and 'Fiscal rule coverage indexes' were standardized, so that the size of the coefficients in the various regressions can be compared). Overall, these results provide a strong indication that the characteristics of fiscal rules matter for their influence on budgetary outcomes.

In order to test the robustness of the results, we estimated other regressions including alternative calculations of the 'Fiscal rule index' using different weighing for the calculation of the index of strength of fiscal rules (in practice we used the low and high values of the brackets in Graph III.11). It appeared (regressions results are not reported here) that weighing differently the various components of the index of strength of fiscal rules does not change the results significantly, suggesting that the relation is not strongly sensitive to the choice of the weights for the aggregation of the criteria taken into account in the calculation of the index on the strength of fiscal rules.

The same analysis was made for assessing the influence of expenditure rules on developments in cyclically-adjusted primary government expenditure (results are reported in Table III.8). The conclusions are very much the same as for the analysis considering all fiscal rules. Taking into account the characteristics of expenditure rules in the calculation of the index leads to a stronger relation between expenditure rules and budgetary outcomes. The coefficient of the 'Expenditure rule index' is higher and more significant than in the regression considering only the coverage of expenditure rules. Like for the regression on the 'Fiscal rule index', robustness tests confirm that results are not significantly affected by a change in the coefficients to calculate the index measuring the strength of expenditure rules.

3.4.4. Main conclusions from the study

The survey on numerical fiscal rules shows that the number of fiscal rules in force in the EU Member States has increased continuously over the past twenty years. At

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[1] For example, take the case of a country having three fiscal rules in year n: an expenditure rule to contain developments in healthcare spending (index of strength x) covering about a percent of general government expenditure; a budget balance rule for local governments (index of strength y) covering about b percent of general government finance and an expenditure rule at central government level (index of strength z) covering about c percent of total general government expenditure. The indicator for that country in year n equals to a*x + b*y + c*z.

[2] In order to test the sensitivity of the results to different choices for the weighting of the five criteria used in the calculation of the index of strength of fiscal rules, we calculated the 'Fiscal rule index' in two alternative ways, taking into account the low and high values of the possible index as illustrated in Graph III.11.

[3] In the analysis, the 'Fiscal rule index' is calculated using an index of strength of fiscal rules that gives an equal weight to the five criteria entering in the calculation of the indicator.

[4] The coefficient becomes significant at the 5 percent level as against 10 percent in the regression including an index taking into account only the share of government finances covered by fiscal rules.

Table III.7

**Influence of fiscal rules on the primary CAB
(EU-25, 1990-2005)**

Explanatory variables	Dependent variable: primary CAB (CAPB)
OG	0.09 (1.4)
Constant	− 0.90 (− 2.0)**
Lagged CAPB	0.63 (15.8)***
Lagged debt/GDP ratio	0.02 (3.1)***
Fiscal rule index	0.25 (2.1)**
Dummy 1992	0.63 (2.0)**
Dummy 1999	− 0.53 (− 2.9)***
N. obs.	260
R sq. within	0.59
R sq. between	0.94
R sq. overall	0.81

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and a lagged indicator of foreign output gap. The foreign output gap indicator is the export-weighted output gap of the 3 major export markets of each market. All fiscal variables are expressed as shares on potential output. 't' values are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients for country fixed effects are not reported.

Source: Authors' calculation and DG ECFIN AMECO database.

Table III.8

**Influence of expenditure rules on developments
in primary expenditure (EU-25, 1990-2005)**

Explanatory variables	Dependent variable: primary CAE (PCAE)
OG	0.10 (1.6)
Constant	6.43 (4.1)***
Lagged PCAE	0.89 (25.2)***
Lagged debt/GDP ratio	− 0.02 (− 2.8)***
Expenditure rule index	− 0.28 (− 2.0)**
Dummy 1992	− 0.44 (− 1.3)
Dummy 1999	0.01 (0.1)
N. obs.	260
R sq. within	0.77
R sq. between	0.98
R sq. overall	0.95

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and a lagged indicator of foreign output gap. The foreign output gap indicator is the export-weighted output gap of the 3 major export markets of each market. All fiscal variables are expressed as shares on potential output. 't' values are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients for country fixed effects are not reported.

Source: Authors' calculation and DG ECFIN AMECO database.

present, almost all EU Member States rely on such rules. This growing number of rules during the latest years has also undergone an interesting evolution in terms of the government sub-sectors covered by rules. In the early 90s, fiscal rules in EU countries were mostly to applied to territorial (local and regional) governments. A relatively recent feature has been the introduction of fiscal rules for the whole of the general government sector and for the social security sub-sector. This may be a response to the increasing spending pressures in the social security sector and to the introduction of the EU fiscal rules, which impose requirements for the general government deficit and debt.

The characteristics of fiscal rules vary depending on the sub-sector to which they apply. Fiscal rules applying to higher levels of government are usually incorporated into a multi-annual budgetary framework whereas most rules applied to regional and local governments rely preponderantly on annual schemes. Most of the numerical rules applied to regional or local levels of governments are enshrined in law or constitution, while rules applying to the whole of the general government sector are more frequently based on coalition agreements or political commitments. Similarly, while rules for regional and local governments seem to have relatively strong enforcement mechanisms,

rules applying to general and central governments generally do not envisage *ex ante* defined actions in case of non-compliance.

An interesting finding appears when taking into account the type of budgetary governance, namely the distinction between the so-called *contract* and *delegation* countries. Both sets of countries have a similar number of fiscal rules. However, contract countries tend to a have more numerical fiscal rules applied to central government and social security sectors while delegation countries have a higher number of fiscal rules implemented at regional and local level. This seems consistent with the fact that the (a priori) larger political dispersion of governments in contracts countries is likely to promote fiscal rules at central level, while territorial sub sectors are likely to enjoy fewer restrictions imposed by central authorities. Likewise, delegation countries are expected to enact relatively few fiscal rules for central levels of government and more rules on regional and local governments in order to implement a more effective control on the whole of general government finances.

Statistical and econometric exercises suggest the existence of a link between numerical rules and budgetary outcomes. A simple analysis of data shows two interest-

ing results. Firstly, the primary CAB improved in the years following the introduction of fiscal rules while on average it remained broadly stable over the period under consideration (1990-2005). Secondly, the decline in the ratio of primary government expenditure adjusted for the cycle has been significantly larger in the years following the introduction of numerical expenditure rules than the average change observed over the sample period. When enriching the analysis to take into account the coverage and characteristics of fiscal rules and control for various factors that may affect government budget balance and developments in primary expenditure, the presumption of a link between numerical fiscal rules and budgetary outcomes is strengthened. The analysis suggests that an increase in the share of government finances covered by numerical fiscal rules leads, ceteris paribus, to an improvement in the structural position of government finances. In the case of expenditure rules, it appears that an increase in the coverage of government finances by expenditure rules leads to a reduction in the primary expenditure-to-GDP ratio. The analysis also suggests that the characteristics of fiscal rules matter for their influence on budgetary outcomes. Strong rules, enshrined in law or constitution and foreseeing automatic enforcement mechanisms, seem to have a larger influence on budgetary outcomes.

4. National independent institutions

4.1. Introduction

As mentioned in the first section of this chapter, there is no independent fiscal agency in the EU to which part of fiscal policy has been delegated and the establishment of such institutions seems unlikely in the foreseeable future. This section therefore focuses on other national bodies, coming on top of or besides the usual budgetary process, which are providing independent analysis and/or recommendations in the area of fiscal policy, on a regular basis (including the so-called 'Fiscal councils') [1]. The institutions covered by the study should be primarily financed by public funds. They should be functionally independent; specifically, the institution should be given a large discretion in relation to the tasks considered in its mandate and there must be guarantees against any *ex ante* political guidance [2].

The influence of such bodies on fiscal policy-making can take place through different channels: they can provide *inputs* for ensuring a proper preparation of the budget (e.g. unbiased macroeconomic and/or budgetary forecasts), conduct *analysis* on fiscal policy issues (e.g. long-term sustainability analysis; alternative estimates of the budgetary impact of policy measures; assess the respect of existing fiscal rules); and issue *normative* reports and *recommendations* on appropriate policies in the prevailing circumstances. The institutions considered in the study are expected to have an impact on the public debate and possibly raise the reputation costs for the conduct of unsound policies.

The field covered in this part of the study is by nature more difficult to outline than in the case of numerical fis-

cal rules, due to the large diversity of the institutions considered. A possible consequence is that the survey may be less exhaustive than in the case of numerical fiscal rules. The analysis and findings should be considered with this caveat in mind. In addition, the matter is less prone to be analysed through traditional econometric and statistical instruments.

This section first reviews the different activities of the national bodies, other than government and Parliament, which may have an influence on the conduct of fiscal policy. Then, it provides an overview of the existing institutions in the 25 EU Member States. Finally, a number of considerations on the effectiveness and desirable characteristics of the institutions are made.

4.2. Independent institutions can participate in different activities

Given the potential wide diversity of the institutions covered in the study, classifying them is not an easy task. Overall, two main categories of institutions can be distinguished: those institutions operating in the field of *positive economics*, which provide independent forecasts and analyses of macroeconomic and budgetary developments and plans; and those operating in the field of *normative economics*, which issue normative assessments on budgetary developments and/or policy recommendations.

4.2.1. Institutions operating in the field of 'positive economics'

Preparation of macroeconomic forecasts

The Council report of 20 March 2005 on the SGP reform recognised that *it is important to base budgetary projections on realistic and cautious macroeconomic forecasts*. Macroeconomic forecasts are one of the main inputs for the preparation of budgetary plans. They largely determine revenue projections which will be the basis for expenditure plans.

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[1] Bodies like special Parliamentary Commissions or ad hoc Expert Groups that could fulfil such tasks on a one-off or occasional basis are not covered by the study.

[2] Thus, private 'Think Tanks' and research departments of private companies are not covered (private institutions can be vehicles of their own bias). Central Banks and Directorates of the Ministry of Finance are not covered either.

By nature, economic forecasts are subject to some degree of uncertainty. If official growth forecasts are unbiased (i.e. on average over time the projection does not differ from the observed value), the effect of over- or under-estimating economic growth on the budget balance target has to be accepted as the price of uncertainty and cancels out over time. However, a different conclusion is warranted if official growth forecasts suffer from some sort of structural optimism, systematically overrating the underlying rate of the economy. Recent analysis on the role of growth forecasts over the period 1987-2003 shows a forecast bias in three out of four large EU Member States (Larch and Salto, 2003). Graph III.12 which shows the difference between plans formulated by the EU Member States in their Stability and Convergence Programmes and the final outcomes illustrates the optimistic bias in the macroeconomic forecasts in the EU Member States and its consequences for budgetary developments (most of points are on the left hand side of the chart). Milesi-Feretti and Moriyama (2004) provided a possible explanation for the optimistic bias in macroeconomic forecasts. They argued that opportunistic governments may try to avoid the political cost associated with the implementation of difficult consolidation measures by using overly favourable growth assumptions. Corrective measures can then be avoided *ex ante*, while *ex post* the deficit will turn out to be higher-than-expected as growth is lower-than-projected. The resulting higher deficit is then blamed on bad luck, even if it results from a forecast bias in growth projections.

The recent experience of several countries has shown that a way to remedy such a bias is the establishment of institutions in charge of providing independent macroeconomic forecasts. This may have a direct beneficial impact if the government is obliged to use the forecasts of the independent institution in the preparation of the budgetary plans. A positive effect can also be expected when there is no formal obligation for the government to take into account these forecasts. In such cases, the independent forecasts provide benchmarks against which the plausibility of the macroeconomic forecasts of the government can be assessed, which may limit the temptation to overestimate growth [1] [2].

Provision of budgetary forecasts

Like in the case of macroeconomic forecasts, opportunistic governments may be tempted to avoid or postpone the implementation of unpopular consolidation measures by providing optimistic budgetary forecasts. One of the main functions of independent budgetary forecasts is then to provide benchmarks against which the government fiscal projections can be assessed. Like for mac-

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[1] Such institutions can be particularly useful for the provision of medium-term and long-term projections. The supply of short-term forecasts (t and t+1) is large, which facilitates the identification of a possible optimistic bias in the assumptions chosen by the government, while independent projections for medium- to long-term horizons are more rare.

[2] A noteworthy consideration is that forecasts produced by the government may be biased but need not be. A number of examples can be found in the EU.

Graph III.12: **Shortfall in real GDP growth and in the general government balance**
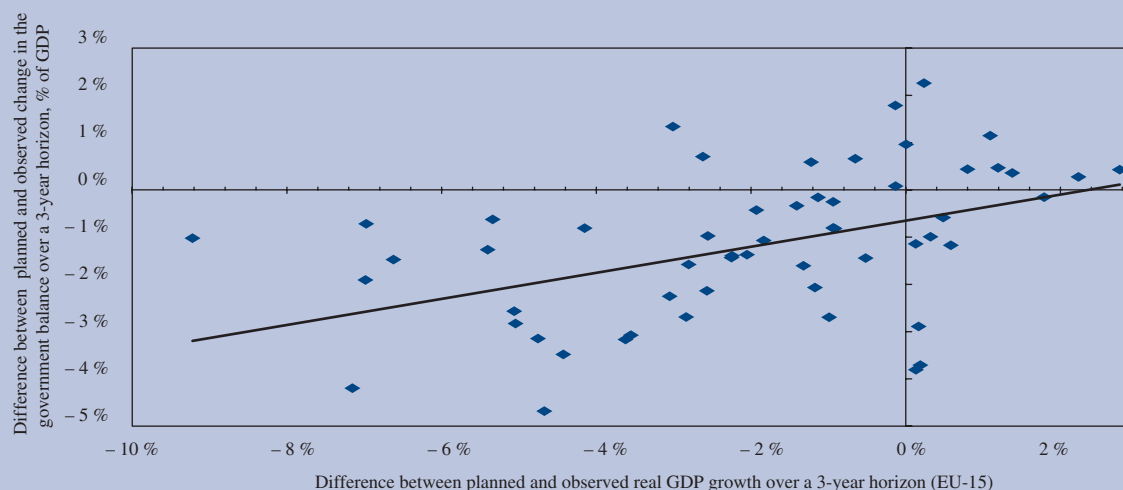
roeconomic projections, budgetary forecasts from independent institutions could also be directly used in the budget process and, therefore, directly address any possible optimistic bias in budgetary projections. Independent budgetary forecasts can also contribute to a non-partisan assessment of whether fiscal policy plans are in line with the fiscal policy objectives and rules in force. If they are regularly updated, they can participate to an efficient monitoring of the implementation of budget plans and respect of the fiscal rules.

Improving the quality of the information for the conduct of fiscal policy

Independent institutions can also provide regular analysis on issues relevant for the conduct of fiscal policy. They can provide, *inter alia*, independent quantifications of the economic and budgetary impact of specific measures and reforms for different time horizons, and detailed assessments of the sustainability of government finances. These institutions contribute to fiscal discipline by raising the awareness of politicians and the public opinion on the short- and long-run consequences of budgetary decisions.

4.2.2. Institutions operating in the field of 'normative economics' issue statements and recommendations on fiscal policy

Independent institutions can also make regular normative assessments in the area of fiscal policy. They can notably monitor whether fiscal developments are in line with the main fiscal policy objectives of the government or with the traditional objectives assigned to fiscal policy (sustainability of government finances, stabilisation). They can also issue statements and recommendations on the appropriateness of specific policy measures and ensure a regular and independent monitoring of the respect of budgetary targets and rules in force, for different levels of governments (e.g. internal stability pacts). An important function of such institutions is to influence the public debate and possibly raise the reputation costs for the conduct of unsound policies. Advisory councils, Wise Men committees and some Court of auditors fall in this category.

4.3. Institutions in place in the EU

With the view to having a comprehensive picture of the institutions currently in place in the EU, a questionnaire was prepared and submitted to the 25 EU Member States (see Box III.6). The survey concerns the independent bodies, other than government and Parliament, providing independent inputs, analysis, assessment or recommendations in the area of fiscal policy. The questionnaire made clear that (i) institutions providing independent forecasts for the preparation of the budget, or against which the official projections are systematically assessed, or/ and releasing regular and positive analyses on fiscal policy issues are covered by the survey; (ii) institutions formulating recommendations or normative statements on government finances developments and fiscal policy orientations (budgetary plans and their implementation) are also covered by the survey.

Answers by Member States show that twenty-three institutions corresponding to these characteristics exist in fifteen EU Member States, thirteen of them being former EU-15 Member States. Interestingly, and contrasting with the results of the survey on fiscal rules, most of these institutions were created a long time ago, and there is no visible tendency towards the development of such institutions in the EU Member States. Answers to the questionnaire confirm that there is a wide variety in the institutions currently in place. They can be classified into the two groups mentioned in the previous paragraph

4.3.1. Institutions in charge of providing forecasts and/or conducting positive analysis on fiscal policy issues

According to the results of the survey, there are in the EU twenty-one institutions in charge of preparing independent projections for macroeconomic or/and budgetary variables or/and conducting positive analysis on fiscal policy issues. Nine institutions are providing both macroeconomic and budgetary forecasts. Two are providing only macroeconomic forecasts and two only budgetary forecasts.

Sixteen institutions are making positive analysis on fiscal policy issues. Most of them also regularly issue fiscal policy recommendations.

Institutions in charge of providing macroeconomic forecasts

In ten EU countries, there is at least one institution that regularly produces independent macroeconomic forecasts against which the official projections can be assessed. However, in the large majority of cases, the government is free to base its budgetary plans on its own forecasts, without having to provide any justification in case there are deviations compared to the forecasts of the

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Box III.6: **The questionnaire on fiscal institutions or councils**

In order to collect the most comprehensive and accurate information on the existing independent fiscal institutions in the EU, a questionnaire was sent to all EU Member States in the context of the Working Group on the Quality of Public Finances (WGQPF) attached to the Economic Policy Committee (EPC). The questionnaire concerns the existing national institutions, others than the government, thecentral banks and the Parliament, which may have a direct or indirect influence on the conduct of fiscal policy. The bodies covered by the survey are the institutions providing independent analysis/assessment, forecasts/projections and/or recommendations in the area of fiscal developments and policy. Courts of Auditors were included when their activities go beyond the accounting control and include any of the abovementioned tasks. Only institutions primarily financed by public funds were considered; private think tanks and private research bodies were therefore excluded. Finally, Central Banks and Directorates of the Ministry of Finance are not considered by the definition. Member States were invited to fill out one questionnaire per institution. The time frame covered by the questionnaire is the period 1990-2005. For those institutions currently in place, Members States were invited to signal changes in their mandate/status or role during the period under review.

The questionnaire is made up of 35 questions which are grouped in 6 sections covering different aspects:

1. **General description of the institution.** This section required the Member States to provide an overall description of the institution, the main motivations for its introduction and the relevant dates (creation and any major changes) over the period considered.

2. **Mandate**. This section contains questions concerning the mandate of the institution considered; the specific task(s) fulfilled, and whether it has a specific role in the budgetary process.

3. **Role/Functions**. This section requests more details on the mandate of the institution, its publications, the variables projected or/and the type of recommendations issued, as well as on the existence of an obligation for the government to use the inputs, analysis or recommendations released by the independent institution.

4. **Composition**. This section is related to the composition of the governing board of the institution (background of the members, appointment procedures, compatibility of members' responsibilities with other political posts, size of the board, years in post, voting procedures) and the size of the institution.

5. **Status**. This section required information on the status of the institution. It notably asks whether the institution is formally attached to the Parliament or the government. It also contains questions related to whether the body has to assess political parties' economic programme ahead of the election and about the sources of financing of the institution.

6. **Visibility and influence.** The last section of the questionnaire allows evaluating the influence in the public debate of the analysis of the institution. It also compares the quality/reputation of the Fiscal Council's work with that of other (public or private) institutions operating in the same field. This section also contains questions related to the perception of the influence of the institution on budgetary discipline and the quality of public finances.

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independent institution. There are three exceptions to this rule:

— In Belgium, the *National Account Institute* (NAI, see Box III.7) provides the macroeconomic forecasts to be used by the federal government in the budgetary process. There is a legal obligation for the government to use the macroeconomic assumptions approved by this independent institution. Interestingly, among the twelve institutions providing macroeconomic forecasts, the NAI is one of the rare

institutions which is 'specialised' in the production of macroeconomic forecasts, in the sense that it does not at the same time provide projections for government finances. Likewise, it is the only institution whose macroeconomic forecasts have to be used for the budget on a compulsory basis.

— The second exception concerns Austria and the *Institute of Economic Research* (WIFO). This research institute analyses national and international economic trends and supplies short- to medium-

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Box III.7: **The Belgian National Account Institute (NAI)**

The NAI coordinates the production of the economic statistics and of the macroeconomic forecasts underlying the federal budget. It also fulfils a role of adviser to the public administration on the interpretation of the ESA 1995 Regulation. This institution was created by law in 1994.

There is a legal obligation for the government to base budgetary plans on the macroeconomic projections approved by the NAI. This obligation has not been respected only occasionally. When it was the case, the government based its budgetary projections on more prudent assumptions than those prepared by the NAI. The NAI functions like a committee (it has no own staff and resource) in which officials from the Ministry of Economic Affairs, the Federal Plan Bureau, the Central Bank and the National Statistical Institute agree on macroeconomic accounts and projections. These institutions have access to the inside information of the other institutions collected for the special purposes of the NAI. The NAI, which is attached to the Ministry of Economic Affairs with an autonomous legal statute, works in full independence and decisions are adopted at the majority.

To ensure a high level of independence and quality, the projections published by the NAI have to be submitted for advice to a committee of experts including economists from the Central Bank, the Federal Planning Bureau and various Ministries. In a subsequent step, they have to be approved by the NAI Board, which includes the highest civil servant of the Ministry of Economic Affairs, the Governor of the Central Bank, the Planning Bureau Commissioner, the Director General and a civil servant of the National Statistics Institute, and two members proposed respectively by the Central Bank and the Federal Planning Bureau. In practice, the projections discussed by the NAI are prepared by the Federal Plan Bureau (FPB). The forecasts are largely diffused and commented in the media by professional economists and by politicians. Several surveys recognised their quality and unbiased character.

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term economic forecasts. It is generally consulted (no obligation) by the government in the course of the budgetary process. Even if the government is formally free to prepare the budget and/or the Stability or Convergence Programme using its own macroeconomic assumptions, the WIFO macroeconomic forecasts usually constitute the basis for the preparation of fiscal plans. Deviations from this principle have in practice been rare.

— The third exception is the *Netherlands Bureau for Economic Policy Analysis* (CPB, see Box III.8). Like for Austria, there is no formal obligation for the government to use the projections of the CPB. However, the CPB macroeconomic forecasts are in practice (almost) always used for the preparation of the Budget.

A number of interesting remarks can be made concerning these three institutions. First, the basis for the forecast to be used for the budget preparation differs considerably. While in the case of Austria and the Netherlands the use of the projections of the independent institute is not based on any formal obligation, there is a legal requirement in the case of Belgium. Second, none of these institutions issues normative statements or policy recommendations in the area of fiscal policy. Their activity is circumscribed to 'positive' economic analysis. Third, these agencies are

all largely independent, in the sense that they are mostly or exclusively financed by public funds and that the government cannot interfere in the activities of the institution or influence its conclusions.

Institutions in charge of producing budgetary forecasts

According to the results of the survey, there are in the EU twelve independent institutions in charge of producing budgetary forecasts. In all cases, the government remains free to base the budget on its own assumptions for revenues and expenditure. In two cases, however, the projections of the independent institution play a central role in the preparation of the budget.

• The first case concerns the German *Working Party on Tax Revenue Forecasting*. This body prepares independent tax forecasts for different sub-sectors of general government. The broad composition of the institution contributes to its independence [1]. Interestingly, the Working Party on Tax Revenue Forecasting

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[1] The institution includes the Federal Ministry of Finance, the Federal Ministry of Economics, the six leading independent economic research institutes, the Federal Statistical Office, the German Federal Bank (Bundesbank), the German Council of Economic Experts, the Finance Ministries of the Länder and the Federal Union of Central Associations of Local Authorities.

was established in 1955 following a conflict concerning tax revenue estimates between the Ministry of Finance and a leading research institute. Since 1968 the federal government has adopted the results of the Working Party for the preparation of its medium-term budgetary plans. It should however be stressed that the revenues projections prepared by the Working Party on Tax Revenue Forecasting are usually based on the macroeconomic assumptions prepared by the German federal government, which limits the potential benefits of the work of the institution (any possible optimistic bias in the macroeconomic projections of the government may translate into an optimistic bias of the tax revenues projections of the institution).

• The second exception is the *Netherlands Bureau for Economic Policy Analysis (CPB)*. This institution prepares forecasts for the main macroeconomic and budgetary aggregates (including developments of total expenditure and sub-categories and on total revenue, divided by the different tax items and social security contributions). Although there is no obligation for the government to base the budget on these projections, there are usually no major differences between the budgetary projections of the government and those of the CPB.

Institutions conducting independent analysis on fiscal policy issues

There are in the EU seventeen institutions conducting independent analysis on fiscal policy developments. Almost all of them provide regular analyses of budget plans and monitor their implementation. Some of them also provide alternative quantifications of short-term and long-term effects of measures and reforms, and conduct analysis on the sustainability of government finances (see Table III.9 for more details). Finally, some institutions examine whether budgetary plans and outcomes are consistent with existing budgetary rules. Most of these bodies are also involved in normative activities and regularly issue recommendations in the area of fiscal policy. The only three institutions not involved in normative activities are the Greek KEPE (Center of Planning and Economic Research), the Dutch CPB (see Box III.8 for a detailed description) and the ISAE in Italy.

• In Greece, the KEPE is a Public Institute attached to the Minister of Economy and Finance. The governing members are appointed by the government. This institution does not have a particular mandate for conducting independent analysis of fiscal policy issues, but in practice fulfils such tasks in the context of its research. It regularly issues projections and technical advice on economic policy issues to the Minister of Economy and Finance. The work of this institution goes beyond fiscal policy issues.

In Italy, the ISAE (Institute for Studies and Economic Analyses) is a research body which carries out analyses and research on economic and social policy issues. The ISAE also provides technical and scientific support and advice upon request of the Ministry of Economics. Similarly, ISAE may be called upon request of the Prime Minister to collaborate to the analyses of the economic policy and public finance problems and contribute to draw up the economic policy decisions. The Parliament regularly includes ISAE in its calendar of parliamentary hearings on the most important documents of economic policy (the Economic and Financial Planning Document and the Financial Law project). Among other activities, the ISAE provides macroeconomic and budgetary forecasts and conducts national and international short-, medium- and long-term analyses, and studies on public finances.

4.3.2. Institutions in charge of issuing normative statements on the conduct of fiscal policies and recommendations

According to the survey, there are in the EU fifteen institutions in charge of issuing normative statements or recommendations in the area of fiscal policy. There are considerable differences as regards the mandate, status, and staff composition of these institutions.

The following three broad categories can be distinguished (i) *advisory bodies* which are mandated to make recommendations to the government; (ii) *independent research institutes*; and (iii) some *Court of Auditors* that, apart from their traditional task of *expost* monitoring and analyses on fiscal developments, provide normative statements and recommendations on fiscal policy issues.

Advisory bodies

According to the survey, institutions falling in this category can be found in four EU countries ([1]).

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[1] France has recently (in 2006) created a 'Conseil d'orientation des finances publiques'. This institution was not in place at the moment the study was launched (see Box III.9 for further details).

Box III.8: **The Netherlands Bureau for Economic Policy Analysis (CPB)**

The Netherlands Bureau for Economic Policy Analysis (CPB) started its work in September 1945. Its creation was inspired by the financial crisis in the 1930s and it was meant to contribute to the policy preparation for the recovery of the Dutch economy after World War II.

The main function of the CPB is to provide independent macroeconomic and budgetary forecasts. The CPB publishes a forecast in spring (called the Central Economic Plan), providing the first forecast for the upcoming year. In September the CPB publishes the macroeconomic outlook (called the MEV), on the same day that the budget is presented to Parliament. The macroeconomic outlook includes the proposed policy measures within the budget, the budgetary and economic impacts of which are discussed in the document. The CPB also produces medium-term forecasts (usually in preparation of a new coalition agreement) and long-term forecasts.

Besides its work on forecasting, the CPB also makes analyses on a broad range of issues that are relevant for policy-making in the Netherlands. CPB analyses topics like the welfare State, ageing, labour market, knowledge economics, competition, regulation and international economics. In particular, the CPB makes independent analyses on government finances and regularly assesses whether government policy is consistent with the policy goals and rules in force. In each short-term forecast, the CPB analyses the recent budgetary developments. The CPB does analyse the economic consequences of proposed government policy, in the short, medium and long term. It does not issue normative statements on the objectives and policies and does not formulate policy recommendations.

The activities of the CPB and its involvement in the budgetary process are not governed by formal rules. Although there is a Law (1947) that obliges CPB to prepare the Central Economic Plan (see above), there is no formal obligation for the CPB to provide inputs for the preparation of the budget, to assess budgetary developments, election platforms and coalition programmes. There is also no legal obligation for policy-makers to use the CPB projections in the preparation of the budgetary plans. However, in practice, all government parties use the CPB forecasts as a common basis for their budget proposals. Political parties generally submit their economic programme to the CPB ahead of the elections, for assessment. Besides, employees' and employers' organisations use the CPB forecasts in their wage negotiations.

The CPB is a research institute that is independent with respect to content, but at the same time is formally part of the central government. The CPB's independence is respected even at times when the government disagrees with its conclusions. Also contributing to CPB's independence is its funding from public resources. This provides CPB with considerable freedom in determining its research agenda. Another element possibly contributing to the independence of the CPB is that the institution places itself in an 'expert' position, and never interferes in political choices. The director is appointed by the government. There is no formal rule concerning the mandate of the members of the Board of the CPB, but the position of the director has to be formally extended every two years. There are about 170 employees (150 full-time equivalent employees).

The analyses of the CPB generally benefit from a high media coverage, possibly resulting in public debate on the subject. New macroeconomic forecasts always get attention of the media. The reputation of the institution reflects the quality of the analysis undertaken, the transparency of the institution, the broad scope of the fields covered (going clearly beyond fiscal policy issues), the active contacts with the academic world and regular evaluations, which are made public.

• In Belgium, the *High Council of Finance* (section 'Public sector borrowing requirements') is a coordination body that determines since 1992 the contribution of federated entities to the stabilisation function of fiscal policy and to the respect of the EU fiscal rules. Every year, around March, the HCF assesses the realisation of the objectives of the Belgian internal Stability Programme. In early summer, it analyses the budgetary situation and perspectives and makes recommendations about the fiscal targets for the short, medium and (since 2002) long term for the whole of the public sector, the federal and regional levels. The analyses of the HCF are limited to recommendations on the budget balances, and do not concern issues related to the redistributive function of fiscal policy. Since 2001 a Study Committee on Ageing within the High Council of Finance is in charge of approving and releasing projections of age-related budgetary expenditures, which are previously prepared by the Federal Plan Bureau (FPB).

Part III

N a t i o n a l   n u m e r i c a l   f i s c a l   r u l e s   a n d   i n s t i t u t i o n s   f o r   s o u n d   p u b l i c   f i n a n c e s

The section 'Public sector borrowing requirements' of the High Council of Finance takes these projections into account for its fiscal policy recommendations.

- In Denmark, the *Economic Council* is an advisory body that meets twice a year to discuss a report prepared by the Chairmanship. The report contains a set of forecast for the Danish economy and economic analyses and recommendations related notably to fiscal policy issues, covering the functioning of the public sector, the tax system, fiscal sustainability, and the appropriate fiscal stance in the prevailing cyclical conditions. The Council also monitors the fiscal rules in force (e.g. the 2010-plan of the Danish government) and issues recommendations with the view to ensure compliance.

- In Germany, the *Advisory Board to the Federal Ministry of Finance* (Board) is an independent body which advises the Federal Minister of Finance on fiscal policy issues. The advices are made public in reports and contribute to feed the public policy debate. Another institution, the *Joint Economic Forecast* made up of the six leading research institutes (JEF) formulates recommendations in the area of fiscal policy ([1]). Twice a year, this institution publishes a report which contains policy recommendations, notably on fiscal policy issues. Another important institution in Germany is the *Council of Experts for the Assessment of Overall Economic Trends.* In line with the mission assigned to it by law, this institution produces and publishes annually a report on the state of the economy as a whole and the foreseeable macroeconomic developments in Germany. The federal government has to respond to the Annual Report in Parliament in short delays. The government is free to prepare the budget using its own macroeconomic assumptions, but it has to publicly justify the deviations from the macroeconomic projections produced by the Council.

- In Austria, the *Government Debt Committee* makes written recommendations in the area of fiscal policy, taking economic conditions into consideration. It also provides budgetary forecasts and analysis of fiscal policy issues. This institution makes public in a report its recommendations to the Federal Minister

of Finance (the report includes the main results of the researches and analyses).

The composition of these institutions varies considerably from one case to another. It is generally relatively broad, which contributes to protect the instititution against possible political pressures from the government. In Belgium, the *High Council of Finance* (section 'Public sector borrowing requirements') is made up of twelve Members from the academia, the Government and the Central Bank. In Denmark, the *Economic Council* is made up of 29 members from the academia, the Government, the Central Bank, trade unions and employers. In Germany, the *Advisory Board to the Federal Ministry of Finance* consists of about 25 members, mainly university professors of economics or law with a special knowledge of fiscal policy issues. The *Council of Experts for the Assessment of Overall Economic Trends* is a body of academic policy advisers which consists of five independent members with special academic knowledge of economics and experience on national economic policy issues. Finally, in Austria the governing board of the *Government Debt Committee* is made up of twelve experts in the area of public finances who are appointed by the government.

There are also differences in the status and administrative position of these institutions. In Belgium, the *High Council of Finance* is attached to the Ministry of Economics and its independence benefits from the fact that its members are appointed upon proposals of various institutions (Ministry of Finance, Regional Governments and Central Bank) and cannot hold political mandates. The Danish *Economic Council* resides under the Ministry of Economic and Business Affairs, but in practice works in full independence since the Minister has no mandate to decide which analysis the chairmanship should carry out or what the conclusions should be. In Germany, the independence of the *Council of Experts for the Assessment of Overall Economic Trends* is ensured by Law (from the year 1963). The *Advisory Board to the Federal Ministry of Finance* is a completely independent body which advises the Federal Minister of Finance on all questions of fiscal policy. In Austria, the *Government Debt Committee* is attached to the Austrian National Bank.

There are also considerable differences as regards the formal role of such institutions in the fiscal policy debate. In Belgium, the government has to follow the recommendations on the fiscal targets of the federated

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([1])   This institution also provides macroeconomic and budgetary forecasts.

entities formulated by the *High Council of Finance.* Moreover, the annual report of the HCF is annexed to the budget and the chairman of the section is regularly auditioned by the Parliament. In Denmark, the *Economic Council* has no authority to ensure that its recommendations are followed by the government, and is not involved in the budgetary process. Its recommendations, which find a large visibility in the media, influence decisions through the public debate. In Germany, the *Council of Experts for the Assessment of Overall Economic Trends* plays no part in the drafting and passage of the budget but the federal government is required by law to respond to its Annual Report in Parliament within eight weeks following its publication. Its recommendations find a large visibility in the media and influence decisions through the public debate. As regards the Austrian *Government Debt Committee*, the report on the recommendations made to the Federal Minister of Finance has to be presented by the Federal Minister of Finance to the National Council and Federal Government.

Research institutes

Some research institutes, which are not specifically mandated to issue normative statements or recommendations in the area of fiscal policy, in practice contribute to the fiscal policy debate. According to the survey, the only one research institute regularly issuing normative statements and recommendations on fiscal policy issues is the Swedish *National Institute of Economic Research (NIER),* which is an agency under the Ministry of Finance, which also produces macroeconomic and budgetary forecasts. The NIER uses its forecasts as a basis for its assessment of the economic, fiscal and wage developments and for its advices on fiscal and other economic policy issues. The Institute provides regular analysis and formulates recommendations on fiscal policy orientation. It has no formal role in the budget process, no formal mandate in the area of fiscal policy, and the government is free to accept or ignore its recommendations. However, this institution plays in practice an important role in the internal fiscal policy debate. Its forecasts of public finances developments, assessments of compliance with fiscal rules and regular advices on the appropriate fiscal stance find a large visibility in the media.

Court of Auditors

The last category concerns the Court of Auditors. As already mentioned, these institutions were considered in the study only if their activities go beyond the control of public accounts. These institutions have specific charac-

teristics and deserve a particular treatment compared to the advisory bodies and research institutes described above, for several reasons. First, the main task of these institutions is the control public accounts and such institutions exist in all EU Member States. Second, they are fully independent from the executive and their status is generally enshrined in constitution. Finally, the Court of Auditors generally have competences in the retrospective assessment of the implementation of the budget plans (as will be seen below, there are some exceptions).

Seven countries provided replies concerning their Court of Auditors and therefore considered that the task of this institution goes beyond the *ex post* monitoring and analysis on fiscal developments: Estonia, France, Hungary, Luxembourg, Portugal, Spain and the United Kingdom. In all these countries, the Court of Auditors issues normative statements or recommendations in the area of fiscal policy. In four countries, the recommendations are issued with a clear forward-looking orientation (normative judgments on the plausibility of budgetary plans, respect of the fiscal policy rules and alternative estimates on the budgetary impact of policy measures included in the budget). It is worth noting that apart from the Luxembourg case, these institutions do not provide independent forecasts, which contrasts with the significant number of advisory bodies releasing both forecasts and analyses [1]. Among the Court of Auditors considered in the survey the following cases are particularly interesting.

- In the UK, the main role of the *National Audit Office* (NAO) is to scrutinise public spending on behalf of Parliament. However, since 1997, this institution has also the mandate to audit the key assumptions underlying the fiscal projections, e.g. trend growth, price developments, unemployment projections, with access to all relevant government documents. The NAO reports on whether the key assumptions for the preparation of the budget can be considered reasonable and cautious. Its statements are confined to the assumptions underpinning the fiscal projections, and do not concern the overall stance of fiscal policy or performance against the Government's fiscal rules. The Treasury is not obliged to follow the NAO's recommendations concerning the key assumptions underpinning the fiscal projections, but in practice generally does.

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[1] The 'Cour des Comptes' of Luxembourg provides revenue forecasts for the current year. In its analysis of the draft budget for year n+1, the plausibility of the n+1 revenue forecast in the draft budget is assessed on the basis of a 'Cour des Comptes' revenue forecast for the year n.

Table III.9

List of institutions considered in the study

| General information | | Tasks fulfilled by the institution | | | | | | | | | | | | | | | |
| | | Forecasts and projections of macroeconomic or / and budgetary assumptions | | | | | Independent analysis on fiscal policy developments | | | | | Normative reports and/or recommendations on fiscal policy | | | | | | Others |
Country	Institution	Macroecon. forecasts	Forecasts for gov. expenditure	Forecasts for gov. revenues	Forecasts for gov. balance and debt level	Long-term projections for gov. finances	Analysis of the budget	Monitoring of budgetary implementation	Estimates of short- and long-term effects of policy measures	Analysis of whether budgetary plans and outcomes are in line with fiscal rules	Not explicitly in charge of any of these tasks, but fulfils some of them	Normative statements on the budgetary plans and respect of the fiscal policy rules	Assessment of the budget / alternative quantifications of the measures therein	Proposals for changes in the budgetary plans	Normative statements on implementation of fiscal plans / respect of fiscal rules	'Alert function' to signal a possible deviation from plans	Recom. in case a slippage compared to initial fiscal plans is identified	Others
AT	Institute for Advanced Studies (IHS)	X			X													
AT	Institute of Economic Research (WIFO)	X			X													
AT	Government Debt Committee	X					X							X				
BE	National Account Institute	X																
BE	High Council of Finance - Section 'Public Sector borrowing requirements'							X		X	X			X (federated entities)	X	X	X	
DK	Danish Economic Council	X	X	X	X	X				X	X			X	X	X	X	
EE	State Audit Office														X	X	X	
FR	Commission Economique de la Nation and Conference Economique annuelle	X	X		X		X		X									
FR	Cour des Comptes							X							X			
DE	Working party on tax revenue forecasting			X														
DE	Joint Economic Forecast by 6 leading research institutes (JEF)	X	X	X	X						X						X	X
DE	Council of Experts on Overall Economic Trends	X				X					X						X	
DE	Advisory Board to the Federal Ministry of Finance										X							X
EL	Center of Planning and Economic Research (KEPE)	X	X	X							X							
HUN	State Audit Office (ASZ)						X	X		X			X		X			
IT	ISAE	X	X	X	X						X							
LU	Court of Auditors			X							X		X					
NL	The Netherlands Bureau for Economic Policy Analysis (CPB)	X	X	X	X		X	X	X	X						X	X	
PT	Court of Auditors							X			X				X			
ES	Court of Auditors						X	X		X		X			X		Only ex post	
ES	National Committee of local administration												Only local finances					
SE	National Institute of Economic Research	X	X	X	X	X	X				X	X			X			
UK	National Audit Office						X (assumptions)					X						X

Box III.9: **Other institutions**

This box provides a short description of the institutions that were not considered in the analysis. A number of different reasons motivated the decision not to consider some institutions in the analysis: some of them could not be considered as independent, since they consist of meetings between elected representatives of different levels of government; some of them are not primarily financed by public funds; some of them issue statements that are confidential; finally, some institutions not yet in force in 2005 (when the study was started) or dealing only marginally, occasionally or with very specific aspects of fiscal policy were not included. This does not mean that the institutions listed below do not contribute to sound fiscal policies. The exclusion was indeed primarily motivated to ensure a sufficient homogeneity of the sample.

(i) Institutions that were not considered as independent institutions

Spanish Council for Fiscal and Financial Policy (CPFF). This institution conducts the coordination between the Central and the Regional Governments. It brings together the State Ministers of Economy and Finance and the State Public Administration's Minister with 19 Regional Ministers of Finances. It assesses the overall fiscal objective for the Autonomous Communities, sets out the individual fiscal objectives for each Regional Government and makes normative statements concerning the compliance with these objectives. By Law, regional governments and the central government have to follow the objectives set out by the CPFF for each Autonomous Community.

German Financial Planning Council. In Germany, the coordination of the budgets and financial plans of the different levels of government is undertaken in the Financial Planning Council, which operates since 1968. The members of the Financial Planning Council are the Federal Ministers of Finance and of Economics, the Finance Ministers of the Länder as well as representatives of municipalities and associations of municipalities. The Deutsche Bundesbank has the right to participate to the sessions of the Financial Planning Council.

German Interdepartmental Working Party. Within the German Government, the Federal Ministry for Economic Affairs is in charge of producing forecasts of aggregate economic development in close cooperation and coordination with the Federal Ministry of Finance. The Interdepartmental Working Party (IWP) notably prepares the projections used in budgetary and fiscal planning. The IWP is under the supervision of a steering group consisting of the Finance Ministry, the Economics Ministry, the Federal Chancellery and the Federal Ministry of Health and Social Security.

(ii) Institution whose work is confidential

Economic Council of Finland. The Economic Council of Finland was established in 1966. It is an advisory body chaired by the Prime Minister. Its main objective is to facilitate cooperation between the Government, the Bank of Finland and major interest groups. The Council meets at least once a month to discuss economic and social issues that are of central importance (related to growth, stabilisation and incomes policy and questions of a structural nature). The discussions in the Council are confidential. The Economic Council is generally consulted (but there is no obligation) in the course of the budgetary process.

(iii) Institutions not primary financed by public funds

'Chambres Professionnelles' in Luxembourg. Six different 'Chambres' (agriculture, trade, private sector employees, public sector employees, craft and engineering, labour and employment) were created by law in 1924. These professional associations provide an opinion on the draft laws which are likely to have consequences in any of their specific sector. They give also their opinion on the draft budget. The Government has to consult the 'Chambres Professionnelles' in the course of the budgetary process but the government is not obliged to publicly respond or to follow the recommendations.

(iv) Institutions not yet in force when the study was started

Spanish State Agency for Evaluation of Public Policies and the Quality of Services. This body assesses public policies and the quality of public services. Its mission is to improve effectiveness and efficiency on the allocation of public resources. It provides evaluations and recommendations. The government has the possibility to consult the Agency in the course of the budgetary process. The Agency is attached to the government. Its creation is now under discussion in the Parliament and was expected to be approved in May 2006.

> *Box III.9 (continued)*
>
> *French Orientation Council of Public Finances.* This Council has been created in March 2006 and is directly attached to the Prime Minister. Its mission is to analyse the situation of public finances and to assess the challenges related the sustainability of government finances. Each year, after the budget is adopted and before the National Conference of public finances is held, a report is prepared for the Prime Minister and is then published. The Council can formulate proposals and recommendations to ensure the respect of the fiscal rules in force and of the budgetary objectives of the government.
>
> ***(v) Institution dealing only occasionally with fiscal policy issues***
>
> *Economic and Social Council in Spain.* It is a consultative council in socioeconomic and labour issues which was established in 1991. The 1978 Spanish Constitution foresees the creation of such a council bringing together business organisations, trade unions and other professional organizations. Its main objective is to offer to civil society the opportunity to cooperate with the government by giving their opinion on relevant economic issues. The Council belongs to the Ministry of Labour and Social Affaires but has full operational and functional autonomy from the government to perform its tasks.

- In Hungary, the State Audit Office issues normative statements when it considers the official projections of some revenues or expenditure as not plausible. The office may notably warn the government for possible risks of overspending or if it considers that projections for some revenues are overoptimistic. This analysis is made on the basis of the macroeconomic assumptions of the budget law.

4.4. Link with budgetary outcomes and conclusions from the analysis of the questionnaires

Assessing the influence of the institutions covered by the study on the conduct of fiscal policy is by nature difficult. However, combining descriptive analysis, the result of existing studies on the subject and the answers form the questionnaires, it is possible to draw tentative conclusions on the possible contribution of such institutions to fiscal discipline. The questionnaires and economic literature also raise a number of considerations on the elements that favour a larger influence of independent institutions on fiscal policy.

4.4.1. Link with budgetary outcomes

Existing studies and answers form the questionnaires suggest that independent institutions can make a significant contribution to fiscal discipline.

Delegation of forecasting activity

As shown by Jonung and Larch (2004), in countries where the task of the preparation of the macroeconomic forecasts underlying the budget is delegated to an independent authority, the macroeconomic forecasts have no statistically significant bias, while, such a bias exists in

some of the other countries where the government is in charge of the preparation of the forecasts. These conclusions are consistent with those reached earlier by Hallerberg et al. (2001), who showed that, where an independent agency is in charge of the macroeconomic forecasts, growth projections are more cautious than in countries where the government makes the predictions. These two studies provide convincing evidence that independent forecasting institutions can contribute to remove the possible biases in the macroeconomic projections used for fiscal planning, thereby contributing to addressing one of the causes for the deficit bias.

Impact on the public debate and credibility

Responses to the questionnaires show that, in about 70 percent of cases, the analysis, forecasts or recommendations issued by the independent institution considered benefit from a large coverage in the media and possibly trigger a public debate. Only in one third of cases, there seems to be a modest interest by the media and public opinion to the analysis of the institution. This suggests that independent institutions have a significant influence on the public debate.

Follow up to recommendations issued by the institutions

In more than half of the cases, there is a perception that recommendations issued by independent institutions are followed by the government. A number of questionnaires indicate that the analysis carried out by the institutions considered in the study triggered in the past significant policy debates and inflections. These elements are probably related to the fact that the institutions in place are highly credible. According to the replies to the questionnaires, the analysis undertaken by the institutions are never considered to be below standard, and, in

Graph III.13: **Perception of respondents on the visibility of the analysis made by independent institutions**

Perception on the influence of the work of the institution
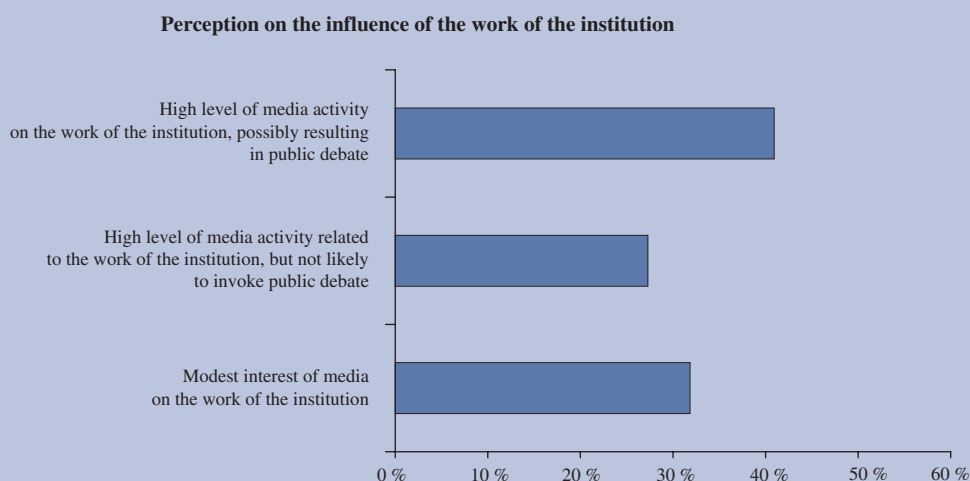
Graph III.14: **Perception of respondents on the quality of the analysis made by independent institutions and their impact on fiscal discipline**

Perception on the quality of the analysis conducted by the institution
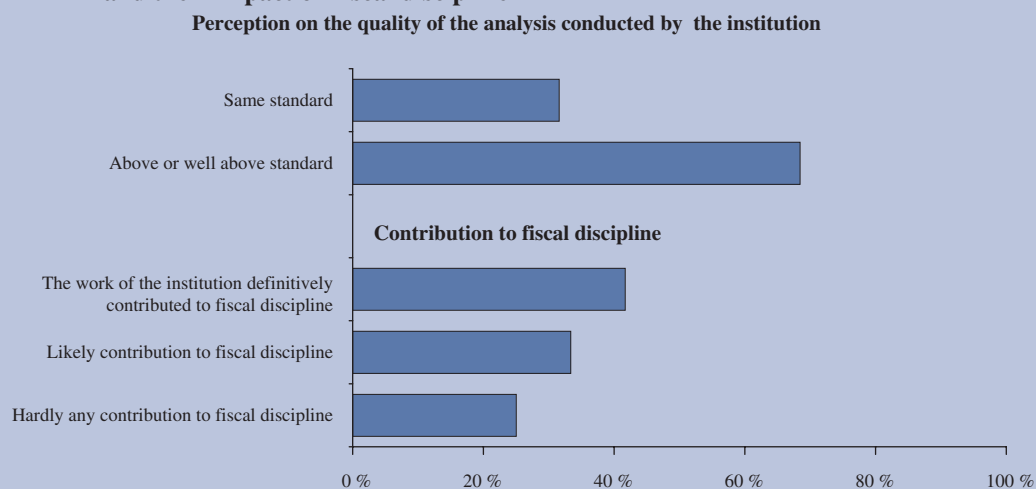
more than two-thirds of cases, are considered above or well above standards.

Contribution to fiscal discipline

As illustrated in Graph III.14 in more than 90 percent of cases, the institution is considered to have contributed to fiscal discipline. This can be considered a remarkable result. This is consistent with the fact that countries in

which such institutions exist exhibit better budgetary results. As shown by Graph III.15 countries having independent institutions have had, over the last ten years, better budgetary results than others. On average, countries having at least one independent institution had a larger primary surplus and the general government debt ratio has on average gone down in the last ten years, which is not the case in the group of countries with no independent institutions. Moreover, Member States where institu-

tions exist have on average stabilised their expenditure-to-GDP ratio over the last ten years while in other countries this ratio has increased.

These results must be interpreted with caution and hasty conclusions should be avoided. A key consideration is indeed whether the causality runs from institutions to outcomes or the other way round. On the one hand, the argument that the causality may run from budgetary outcomes to institutions is based on the observation that fiscal rules and institutional reform have generally been introduced in response to dissatisfaction with budgetary outcomes or/and because governments had a strong preference for budgetary discipline. On the other hand, the argument that budgetary institutions can be considered as an explanatory factor for budgetary outcomes is that the large majority of the institutions considered in the study existed well before the beginning of the period covered and that such institutions change very slowly over time so that it is reasonable to assume that they are exogenous (¹).

(¹)   It may also be the case that both budgetary institutions and budgetary outcomes may be a function of a third variable of voter preferences (Poterba (1996)). If this view is right, then countries with a strong preference for particular types of budgetary outcomes use the institutions as tools for reaching particular budgetary results.

4.4.2.   General considerations inspired by the answers to the questionnaires

Answers to the questionnaires and literature (see notably IMF, 2005) prompt a number of considerations on the elements that favour a larger influence of independent fiscal institutions. The following points seem particularly relevant.

The credibility and reputation of the instititution are key parameters

A key element seems to be related to the *reputation of the institution*. Since there is in general no formal obligation for the government to take into account the forecasts, analysis and recommendations formulated by the independent institutions, their influence generally depends on their capacity to impact on the public debate. The quality of the analysis undertaken has therefore to be considered above standards (which is generally the case), and there should be a high degree of transparency on the work of the institution. The results of the analysis and the underlying assumptions as well as the models and data used should be easily accessible. The appointment of the staff should preferably be based on professional capabilities in the fields of economics rather than on any other consideration.

In this respect, the nature of the tasks fulfilled by the institution has some relevance. As seen above, institutions can cover *'positive'* and *'normative'* activities. An

Graph III.15: **Budgetary developments in countries with and without independent institutions (1995-2005)**
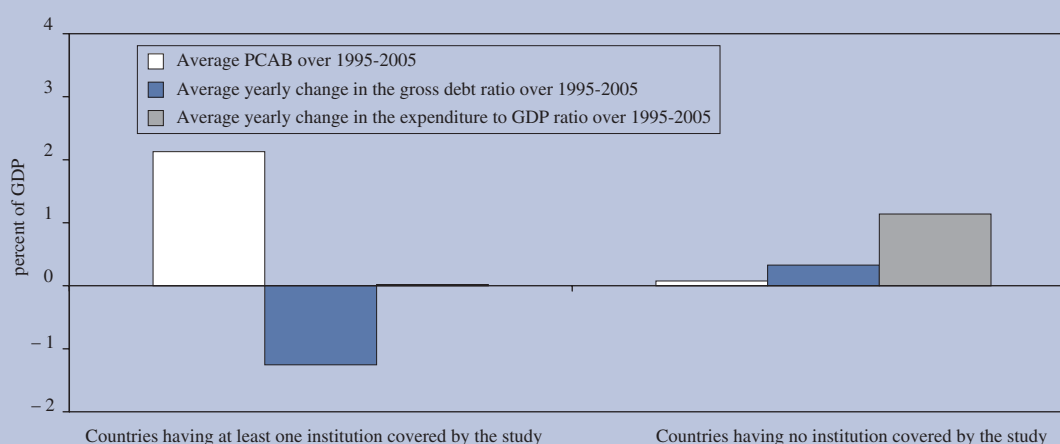
open issue is whether it is desirable that the same institution participates to both types of activities. On the one hand, it can be argued that the quality of normative statements and policy recommendations would benefit from the production of independent forecasts and analysis. On the other hand, there are good arguments for considering that the activities should be clearly separated. The reputation and independence of institutions operating in the area of 'positive' economics could be affected if these institutions started issuing normative statements on the conduct of fiscal policy. The government could be tempted, in the event of negative statements by the independent instititution, to criticise in return the institution. This could weight on the reputation of the institution and thus undermine the credibility of its work related to 'positive' activities. Interestingly, it seems that the most influent institutions in charge of 'positive analysis' in the EU stay in a modest 'expert' position and try not to interfere in political choices.

A direct involvement of the institution in the budget process is preferable

A *direct involvement of the institution in the budget process* can also be considered a positive factor. Although this is neither necessary nor a guarantee for ensuring a sufficient influence of the Council (there are counter-examples in the EU), it can be considered that a direct involvement may allow the independent institution to convey its messages in a more direct and efficient way. The strongest involvement would imply that the draft budget has to be approved by the independent institution. So far this option has not been implemented in the EU. However, other less strict arrangements are currently in place in some EU countries. The most widespread options consist of regular hearings of the institution by the Parliament, consultations by the government in the course of the budgetary process, or the obligation of the government to justify departures from the forecasts or recommendations of the independent instititution.

Autonomy, independence and ownership

Autonomy and independence are other important elements. Firstly, there should be some guarantees related to the financing of the institution, which should be primarily based on public funds. Legal provisions may be useful to protect the instititution in possible unfavourable political environments. Independence is however not necessarily ensured by a particular status, and the benefits of independence should be weighted against the

limitations to access to internal information, especially for the institutions in charge of forecasts. In this particular case, independence *within* government can be a good solution, since it can potentially ensure full access to internal information and a satisfactory ownership of institutions' output by the government.

Finally, a *high degree of ownership* seems to be a key condition for success. The country-specific dimension is crucial, and there is no ideal arrangement that could be transposed in all Member States [1]. In order to ensure a high degree of ownership, the institution should preferably have a *clear and unambiguous mandate*, broadly accepted by the public opinion. This is particularly important for cases in which there is a legal obligation for the government to take into account the analysis made by the independent institution.

4.4.3. Main conclusions and findings from the study

The survey on national independent institutions shows that national bodies other than government and Parliament which are providing inputs, analysis or recommendation in the area of fiscal policy exist in fifteen EU Member States, thirteen of them being former EU-15 countries. Contrasting with the conclusion reached for numerical fiscal rules, there is no visible tendency towards the development of such institutions in the EU Member States. The analysis shows that there is a great deal of variety in the type of institutions in place. Two major categories of institutions can be distinguished: (i) institutions in charge of providing forecasts or/and conducting positive analyses on fiscal policy issues; and (ii) institutions issuing normative statements and recommendations on the conduct of fiscal policy. Some institutions pertain to both groups.

As regards the activity of macroeconomic forecasting, results of the survey suggest that, in most of cases, governments rely on 'home-made' forecasts for the preparation of the budget and the Stability and Convergence Programmes. There are, in the whole EU, three exceptions to this rule. Interestingly, the basis for the forecast to be used for the budget preparation differs considerably: in two cases, there is no formal obligation for the government, while there is a legal requirement in the third case. According to the results of the survey, there are in the EU twelve independent institutions in charge

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[1] An illustration of this is that the influence of international organisations (IMF, COM), which fulfil a number of the typical tasks potentially covered by national independent institutions (forecasting, analysis of fiscal developments, of compliance with fiscal rules), varies significantly depending on the country.

of producing budgetary forecasts. However, in all cases, the government remains free to base the budget on its own assumptions for revenues and expenditure.

Fifteen institutions in charge of issuing normative statements or recommendations in the area of fiscal policy are currently in place in the EU countries. These institutions have different mandate, status, and composition. In most of cases, however, the independent institution has no authority to ensure that its recommendations are followed by the government, and the recommendations may influence policy decisions through public debate.

Assessing the influence of the institutions covered by the study on the conduct of fiscal policy is by nature difficult. However, combining descriptive analysis, the result of existing studies on the subject and the answers from the questionnaires, it is possible to draw tentative conclusions on the possible contribution of such institutions to fiscal discipline and the elements that favour a large influence of independent institutions on fiscal policy:

• Since there is in general no formal obligation for the government to take into account the analysis and recommendations formulated by the independent institutions in place, their influence generally depends on their capacity to impact on the public debate and to increase reputation costs for the conduct of unsound policies. A high degree of credibility of the institution and a strong ownership of its work by governments seem to be key conditions for success.

• The institutions in place seem to have a considerable impact on the public debate. In most of cases, forecasts or recommendations issued by independent institutions benefit from large media coverage. Delegation of the forecasting activity seems to be an efficient way to address possible optimistic biases in macroeconomic projections. This is confirmed by the answers to the questionnaire and empirical studies. Recommendations from independent institutions are generally followed by governments. According to replies to the questionnaires, the quality of the analysis undertaken by the institutions is, in more than two-thirds of cases, considered above or well above standards and there is a general perception that such institutions contributed to fiscal discipline.

Annex 1. Numerical fiscal rules considered in the study

Country	Type of rule	Definition of the rule (agregate targeted & relevant accounting system)	Sector(s) covered	Time frame	Statutory base	Body in charge of monitoring	Enforcement (body & actions in case of non-compliance)
Austria	Budget balance rule	Budget balance as a % of GDP ESA95 accounting	Central, regional and local governments	Multiannual (4 years)	Legal act (based on Constitution)	Governmental structure (Committee with central, regional and local government representatives)	Governmental structure Possibility of sanctions
Belgium	Expenditure rule (in the convergence process leading to EMU qualification)	Real expenditure growth rate Budgetary accounting	Central government	Multiannual (4 years)	Coalition agreement	Independent (Court of Auditors and the High Council of Finance) and National Parliament.	Governmental structure No pre-defined action
	Revenue rule (in the convergence process leading to EMU qualification)	Nominal growth of fiscal revenues in relation to nominal GDP growth Budgetary accounting	Central government	Multiannual (4 years)	Coalition agreement	No body	Government (Ministry of Finance) No pre-defined action
	Expenditure rule	Real expenditure growth rate Budgetary accounting (consistent with ESA95)	Social security	Multiannual (4 years)	Legal act	Independent (Court of Auditors and Wise Men Committee) and National Parliament	Government (Ministry of Health), possibly social partners Automatic mechanism if sanction
	Budget balance rule	Budget balance in nominal terms Budgetary accounting	Social security	Multiannual (4 years)	Coalition agreement	Governmental structure (Ministries of Budget and Social Affairs)	Governmental structure (Ministries of Budget and Social Affairs) No pre-defined action
	Budget balance rule	Real expenditure growth rate ESA95 accounting	Regional government	Multiannual (5 years)	Political agreement between central and regional governments (¹)	Independent (High Council of Finance)	Governmental structure Possibility of sanctions
	Budget balance rule	Budget balance in nominal terms Budgetary accounting	Local government	Annual	Legal act	Independent (High Council of Finance) and regional Government	Governmental structure (regional government) corrects possible slippages by taking appropriate actions
Czech Republic	Expenditure rule	Nominal expenditure ceiling Budgetary accounting	Central government	Multiannual (3 years)	Political agreement (medium-term expenditure framework enshrined in legal act	Government (Ministry of Finance)	None No pre-defined action; government provides explanations in case of non-compliance
	Debt rule	Limit on debt service Budgetary accounting	Regional and local governments	Annual	Political agreement	Government (Ministry of Finance)	Government Corrective measures are proposed — possibility of sanctions
Denmark	Expenditure rule	Real expenditure growth rate ESA95 accounting	General government	Multiannual	Political agreement	Government (Ministry of Finance)	Government (Ministry of Finance) No pre-defined action
	Revenue rule	Limits on direct or indirect tax rates (tax freeze)	General government	n.a.	Political agreement	Government (Ministry of Finance)	Government (Ministry of Finance) No pre-defined action

Country	Type of rule	Definition of the rule (agregate targeted & relevant accounting system)	Sector(s) covered	Time frame	Statutory base	Body in charge of monitoring	Enforcement (body & actions in case of non-compliance)
	Budget balance rule	Target as a % of GDP in structural terms ESA95 accounting	General government	Multiannual (up to 2010)	Political agreement	Government (Ministry of Finance)	Government (Ministry of Finance) No pre-defined action
Estonia	Budget balance rule	Budget balance in nominal terms Budgetary accounting	General government	Multiannual	Coalition agreement	Government (Ministry of Finance)	Government and national Parliament No pre-defined action; possibility of cuts in expenditure if revenue shortfall
	Debt rule	Debt limits as a % of budgeted revenues Budgetary accounting	Local government	Annual	Legal act	Government (Ministry of Finance)	Government and national Parliament Proposition of corrective measures (possible reduction in transfers)
Finland	Expenditure rule	Real expenditure ceiling Budgetary accounting	Central government	Multiannual (5 years)	Political agreement	Government (Ministry of Finance)	Governmental structure proposes corrective measures
	Budget balance rule	Budget balance as % GDP ESA95 accounting	Central government	Multiannual (5 years)	Political agreement	Government (Ministry of Finance)	Governmental structure No pre-defined action (political pressure to ensure compliance)
	Debt rule	Debt to GDP ratio has to be reduced Budgetary accounting	Central government	Multiannual (5 years)	Political agreement	Government (Ministry of Finance)	Governmental structure No pre-defined action (political pressure to ensure compliance)
	Revenue rule	Allocation of revenue surpluses ESA95 accounting	Social security	Multiannual (business cycle)	Legal act	Governmental structure (Ministry of Social Affairs and Health).	Independent enforcer No pre-defined action
	Budget balance rule	Budget balance rule in nominal terms Budgetary accounting	Local government	Multiannual (4 years)	Legal act	Independent (auditing committees) and governmental structure (Ministry of Interior)	Same as monitoring Preparation of plans to cover eventual deficits, possible personal admonitions
France	Expenditure rule	Real expenditure growth rate Budgetary accounting	Central government	Annual	Political agreement	Independent (Court of Auditors) and National Parliament	No pre-defined action in case of non-compliance
	Revenue rule	The government has to pre-define the allocation of possible higher-than-expected tax revenue Budgetary accounting	Central government	Annual	Legal act	Independent (Court of Auditors) and National Parliament	No pre-defined action in case of non-compliance
	Expenditure rule	Ceiling in volume for health expenditure growth rate ESA95 accounting	Social security	Annual	Legal act	Independent Alert Committee and Court of Auditors	Independent Alert Committee proposes corrective measures
	Budget balance rule	Golden rule Budgetary accounting	Local government	Annual	Legal act	Independent (regional Court of Auditors)	Obligation to propose corrective measures
Germany	Budget balance rule	Budget balance in nominal terms Budgetary accounting	Central government	Annual	Constitution and legal act	Government (Ministry of Finance) and National Parliament	Possibility of a challenge at Constitutional Court No pre-defined action
	Expenditure rule	Nominal expenditure growth rate Budgetary accounting	Central and regional governments	Multiannual (5 years)	Political agreement between central and regional governments	Governmental structure (Financial Planning Council with central, regional and local members)	None (Financial Planning Council can criticise rule violations and deviations) No pre-defined action

Country	Type of rule	Definition of the rule (agregate targeted & relevant accounting system)	Sector(s) covered	Time frame	Statutory base	Body in charge of monitoring	Enforcement (body & actions in case of non-compliance)
	Budget balance rule	Budget balance in nominal terms (golden rule) Budgetary accounting	Regional government	Annual	Constitution	Government (Ministries of Finance of Länders)	None, but possibility of a legal challenge at the Constitutional Court No pre-defined action
	Debt rule	Specific amount of debt in nominal terms Budgetary accounting	Local government	Annual (1 or 2 years)	Legal act	Governmental structure (Communal Supervisory Agencies of the Länder)	Governmental structure Permission for credits refused
	Budget balance rule	Budget balance in nominal terms Budgetary accounting	Local government	Annual	Legal act	Governmental structure (Communal Supervisory Agencies of the Länder)	Governmental structure Clear actions are foreseen in case of non-compliance
Hungary	Debt rule	Ceiling in proportion with capacity to repay debt Budgetary accounting	Local government	Annual	Legal act	No official body (supervision of private banks)	None No pre-defined action
Ireland	Expenditure rule	Automatic allocation of expenditure to the National Pension Reserve Fund Budgetary accounting	Central government	Annual	Legal act	Government (Ministry of Finance)	Government No pre-defined action
	Expenditure rule	Nominal expenditure ceiling Budgetary accounting	Central government	Multiannual (5 years)	Legal act	Governmental structure	Ministry of Finance No pre-defined action
	Budget balance rule	Budget balance nominal terms ESA95 accounting	Local government	Annual	Political agreement	Ministry of finance and governmental structure	Government Limits imposed on borrowing of local authorities
Italy	Expenditure rule	Nominal expenditure ceiling ESA95 accounting	Central and regional government	Annual	Legal act and internal pact between central and regional government	Government (Ministry of Finance) and governmental structure (Italian Pharmaceutical Agency-Ministry of Health)	Governmental structure Corrective actions
	Expenditure rule	Nominal expenditure growth rate Targets set in ESA95 (monitoring based on budgetary accounting)	Regional and local government	Multiannual (3 years)	Legal act	Government (Ministry of Finance)	Independent Automatic sanction mechanism
	Budget balance rule	Budget balance in nominal terms Targets in ESA95 accounting	Regional government	Multiannual (3 years)	Legal act	Board of Performance Assessors (with central and regional government representatives)	Government Automatic correction mechanism and possibility of financial sanctions
	Budget balance rule	Budget balance in nominal terms (excl. capital revenue and expenditure) Budgetary accounting	Local government	Multiannual	Constitution and legal act	Independent (Court of Auditors), Government (Ministry of Finance).	Government (Ministry of Finance) No pre-defined action
Latvia	Revenue rule	Actual revenues must cover completely the special government budget Budgetary accounting	Central government, social security	Annual	Legal act	Government (Ministry of Finance) and governmental structure (The State Treasury)	Governmental structure (The State Treasury) No pre-defined action

Country	Type of rule	Definition of the rule (agregate targeted & relevant accounting system)	Sector(s) covered	Time frame	Statutory base	Body in charge of monitoring	Enforcement (body & actions in case of non-compliance)
	Debt rule	Debt ceiling in nominal terms Budgetary accounting	Local government	Annual	Political agreement	Independent	Government (Ministry of Finance) No pre-defined action
Lithuania	Debt rule	Maximum possible net borrowing by the central government Budgetary accounting	Central government	Annual	Legal act	Independent	Government (Ministry of Finance) No pre-defined action
	Budget balance rule	Budget balance in nominal terms Budgetary accounting	Local government	Annual	Legal act	Governmental structure (Council of Municipality)	Government and National Parliament Possibility of sanctions and of clam to the Court (²)
Luxembourg	Expenditure rule	Over the medium-term, nominal expenditure increase in line with nominal GDP Budgetary accounting	Central government	Multiannual	Coalition agreement	None	None No pre-defined action
	Debt rule	The debt-to-GDP ratio should remain moderate (new debt only to finance rail infrastructure projects) Budgetary accounting	Central government	Multiannual	Coalition agreement	None	None No pre-defined action
	Budget balance rule	Reserve funds for healthcare, long-term healthcare and pension private sector schemes Budgetary accounting	Social security	Annual and Multiannual	Legal act	Government (Ministry of Social Security)	Governmental structure Corrective measures
Netherlands	Expenditure rule	Real expenditure ceiling ESA95 accounting	General government	Multiannual (4 years)	Coalition agreement	Government (Ministry of Finance)	Government (Ministry of Finance) proposes corrective measures
	Revenue rule	Allocation of higher-than-expected revenues ESA95 accounting	General government	Multiannual (4 years)	Coalition agreement	Government (Ministry of Finance)	Government (Ministry of Finance) proposes corrective measures
Poland	Debt rule	Ceiling in terms of debt/GDP ratio Budgetary accounting	General government	Annual	Constitution and legal act	Independent (Supreme Audit Office) and National Parliament	Government, Independent body (Supreme Audit Office) and national Parliament Government proposes corrective measures.
Portugal	Budget balance rule	Budget balance in nominal terms Budgetary accounting	Central government	Annual	Legal act	Government (Ministry of Finance)	Government (Ministry of Finance) No pre-defined action
	Budget balance rule	Budget balance in nominal terms ESA accounting	Local government	Annual	Legal act	Government (Ministry of Finance) and governmental structure (Directorate General for Local Government)	Government (Ministry of Finance) No pre-defined action and possibility of imposing actions
Slovakia	Expenditure rule	Nominal expenditure ceiling Budgetary accounting	Central government	Annual	Political agreement	Independent (Supreme Audit Office), Government and National Parliament	Independent (Supreme Audit Office, National Parliament) Obligation to take effective measures

Country	Type of rule	Definition of the rule (agregate targeted & relevant accounting system)	Sector(s) covered	Time frame	Statutory base	Body in charge of monitoring	Enforcement (body & actions in case of non-compliance)
	Debt rule	Limits on total debt and annual repayments as a % of real current incomes of t-1 budget year. Budgetary accounting	Regional and local government	Annual	Legal act	Independent (Supreme Audit Office) and Government (Ministry of Finance)	Government Possibility of sanctions
Slovenia	Debt rule	Ceiling of debt/GDP ratio Budgetary accounting	General government	Multiannual (4 years) (³)	Coalition agreement	Governmental structure	Governmental structure proposes corrective measures
	Debt rule	Limit on local government's total stock of debt Budgetary accounting	Local government	Annual	Legal act	Independent (Court of Auditors) and Government (Ministry of Finance)	Government (Ministry of Finance) No pre-defined action
Spain	Budget balance rule	Budget balance as % of GDP ESA95 accounting	General government	Multiannual (3 years)	Legal act	Government (Ministry of Finance) and governmental structure	Government (Ministry of Finance) presents corrective plan with appropriate actions
	Debt rule	Debt level in nominal terms ESA95 accounting	Regional government	Annual	Agreement between central and regional government	Government (Ministry of Finance)	Government (Ministry of Finance) Possibility of sanctions
	Debt rule	Limit in the debt level Budgetary accounting	Regional government	Annual	Legal act	Government (Ministry of Finance)	Government (Ministry of Finance) No pre-defined action
	Debt rule	Ceiling for local government debt as a % of current revenue. Budgetary accounting	Local government	Annual	Legal act	Government (Ministry of Finance) and Regional government	Government or Regional government Local government designs financial plan to be met in 3 years.
Sweden	Budget balance rule	Budget balance target in structural terms. ESA95 accounting	General government	Multiannual (business cycle)	Government commitment, endorsed by Parliament	Independent (Court of Auditors) Government and National Parliament	Government No pre-defined action
	Expenditure rule	Nominal expenditure ceiling for central government and extra old-age pension system expenditures Budgetary accounting	Central government and social security	Multiannual (3 years)	Legal act	Independent (Court of Auditors), Government and National Parliament	Government Obligation to correct by appropriate actions
United Kingdom	Budget balance rule	% of GDP (average across the cycle) ESA95 accounting	General government	Multiannual (economic cycle)	Legal act	Independent (National Audit Office), Ministry of Finance, Treasury and National Parliament	Government Appropriate actions have to be taken (⁴)
	Debt rule	Ceiling for the government debt at level as a % of GDP ESA95 accounting	General government	Multiannual (economic cycle)	Legal act	Independent. (National Audit Office), Ministry of Finance, Treasury and National Parliament	Government (ministry of Finance) Appropriate actions have to be taken

(¹) Domestic Stability Pact not enshrined in legal act.
(²) Administrative responsibility: The supervisor authorised by the Government has the right to submit a claim to the court in the case of infringement of legal acts.
(³) From 2000 to 2004.
(⁴) The Code for Fiscal Stability states that, 'The Government may depart from its fiscal objectives and operating rules temporarily, provided that it specifies: (a) the reasons for departing from the previous fiscal policy objectives and operating rules; (b) the approach and period of time that the Government intends to take to return to the previous fiscal policy objectives and operating rules; and (c) The fiscal policy objectives and ooperating rules that shall apply over this period.'

Annex 2: Independent fiscal institutions considered in the study

Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insititution	Status / composition of the governing board / indications on the size of the institution
Austria	Institute for Advanced Studies (IHS)	1963	Analyses economic trends and supplies short- to medium-term economic forecasts	Publications: regular reports including forecasts and analysis Variables projected: main macroeconomic variables, general government balance and debt (including for sub-sectors of general government)	HIS is generally consulted (no obligation) by the government in the course of the budgetary process No obligation for the government to use the forecasts of the IHS	Status: Independent research institute Composition: Board of trustees (politicians, civil servant, central bankers, Industry) and Advisory Council (international academics) Staff: 60 scientific and 26 administrative
	Institute of Economic Research (WIFO)	n.a	Analyses national and international economic trends Provides short- to medium-term economic forecasts	Publications: Regular reports (monthly, quarterly) and Working Papers Variables projected: main macroeconomic variables, general government balance and debt level (including for sub-sectors of general government)	WIFO is generally consulted by the government in the course of the budgetary process. There is no obligation for the government to use the WIFO's forecasts but deviations from WIFO's macroeconomic projections have to be publicly justified	Status: Independent economic research institute Composition: Scientific Board (international economists) and Executive Committee (civil servants and Social partners) Staff: 100 qualified researchers
	Government Debt Committee (STA)	1970	Analyses the sustainability and quality of government finances. The STA also issues written policy recommendations.	Publications: annual reports on public finances Recommendations: the institution issues recommendations on fiscal policy and financing	The Federal Minister of Finance presents a report (including recommendations) prepared by the STA to the national Council and Federal Government. There is no obligation for the government to follow the STA's recommendations.	Status: attached to the Austrian National Bank Composition: 12 experts in the areas of finance and budgetary activities Staff: provided by the Austrian National Bank
Belgium	High Council of Finance (HCF)- Section 'Public sector borrowing requirements"	HCF was created in 1936. The section 'Public sector borrowing requirements' was created in 1989 (mandate extended in 1992 and 2002)	Analyses budget developments Verifies whether budgetary developments are in accordance with existing financial objectives for the federated entities Issues recommendations about the fiscal targets for the whole public sector, the federal and regional levels	Publications: a first report monitors the achievement of the fiscal targets; a second report (the annual Report) analyses the budgetary situation of the public sector as a whole and of the federated entities and makes recommendations about fiscal targets for the short, medium and long term.	Advice from HCF is an important input for the preparation of the budget. The chairman of the section 'Public sector borrowing requirements' is regularly auditioned by the Parliament For Federal level: the government is not obliged (recommendations are generally taken into account) For federated entities: the government obliged to take into account analysis and also, in some circumstances, HCF's recommendations	Status: attached to the government Composition: 12 Members (academics, civil servants, members of the Monetary Policy Committee) appointed by the government (half of the members are proposed by the governments of the Communities and the Regions) Staff: 6 people

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Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insitution	Status / composition of the governing board / indications on the size of the institution
	National Account Institute (ICN)	1994	Coordinates the production of main national macroeconomic statistics and provides independent forecasts and projections. The ICN collaborates with three associated institutions: the National Statistical Institute, the Federal Planning Bureau and the National Bank of Belgium.	Variables projected (and published): main macroeconomic variables	As a rule, according to law, the macroeconomic forecasts of the ICN have to be used by the federal government for the preparation of the budget	Status: attached to the government, but works in full independence Composition: highest civil servant of the Ministry of Economic Affairs, governor of the Central Bank, the heads of the National Statistical Institute and of the Federal Planning Bureau, plus one person proposed by each associated institutions (in total 3 persons) Staff: provided by the participating institutions
Denmark	Danish Economic Council (DEC)	1962 (mandate extended in 1994)	Analyses, inter alia, the overall functioning of the public sector, the sustainability of government finances, and the fiscal stance Issues recommendations and normative statements on fiscal policy The DEC meets twice a year to discuss a report prepared by the Chairmanship, which notably contains a forecast for the Danish economy	Publications: biannual report on the overall development of public finances by the chairmanship Variables projected: detailed macroeconomic and budgetary forecasts, including for sub-sectors of general government are included in the report	The government is not obliged to respond to the analysis of the DEC but can comment on the report Recommendations by the DEC affect the decisions process via their impact on the public debate The government is free to prepare the budget using its own projections (without having to provide justification)	Status: independent body attached to the Ministry of Economic and Business Affairs Composition: 3 chairmen (independent academics appointed by the minister of Economic and Business Affairs); the Council has 29 members (from Unions, employers, the Central Bank, Government and Independent economic experts) Staff: 15 (10 economists)
Estonia	State Audit Office (SAO)	The pre-war SAO was established in 1918 and it acted until year 1940 Re-established in 1990 (enshrined in constitution in 1995; new act adopted in 2002)	Issues normative statements with a view to ensure an effective use of public funds Provides opinions on the implementation of the budget, formulates recommendations in case of deviation from initial plans	Fiscal policy recommendations are included in the audit reports and annual reports	Recommendations are used as an input for the preparation of the budget. The annual budget implementation review has to be audited by the SAO before being submitted to the Parliament The government has no obligation to follow SAO's recommendations (justifications are expected if recommendations are not followed).	Status: independent institution (enshrined in law and Constitution) Composition: the SAO is chaired by an Auditor General Staff: around 100
France	Commission Economique de la Nation (CEN) Annual Economic Conference (CEA)	1999 (replaced the Commission des comptes et des budgets économiques de la nation created in 1952) 1999	Analyses the provisional budget accounts and discusses economic issues selected by the Finance Minister Provides independent forecasts (compilations of existing forecasts) Holds meetings four times a year Informs and consults social partners on the evolution of the French economy as well as on economic, fiscal and taxation policies	No publication Variables projected: macroeconomic and government balance and debt forecasts (on the basis of a collection of forecasts from other institutions) Yearly meeting	The government consults the CEN in the course of the budgetary process, but is free to prepare the budget using its own projections (no justification required) The government consults the social partners in the course of the budgetary process	Status: Independent consultative body Composition: 28 members (academics, policy experts, members of the Central Bank, representatives of trade unions, private banks and companies) Staff: provided by the Ministry of Finance Status: Independent consultative body Staff: provided by the Ministry of Finance

Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insititution	Status / composition of the governing board / indications on the size of the institution
	Cour des Comptes	1807 (new budget organic law extends the mandate: the Court produces a report taken into account in the Budget Orientation Debate in June)	Analyses the fiscal situation of the country Audits and monitors the implementation of budget plans Issues recommendations and normative statements on fiscal policy (including on the composition of expenditure, debt management…)	Publications: Several regular reports published in the course of the year, including a Preliminary Report on the overall situation of government finances issued in June (first time in 2005); an Annual Public Report (published in October). Special Reports are also published. Recommendations: the Court issues recommendations on the conduct to fiscal policy	The Court provides evaluations of recent and current pubic finances trends that are taken into account in the budgetary process	Status: independent body Composition: the Court is chaired by the 'First president' nominated by decree in the Council of Minister; it is organised in 7 Chambers with particular competencies (about 30 magistrates and rapporteurs in each)
Germany	Council of Experts for the Assessment of Overall Economic Trends (SVR)	1963	Analyses fiscal policy developments, and points undesirable trends and ways to avoid and correct them, but does not make recommendations for specific policy measures Fosters cooperation between State and regional governments	Publications: annual Report on the state of the economy as a whole and the foreseeable economic developments in Germany Issues macroeconomic forecasts and, occasionally, analysis of government finances. In its annual report the Council also examines issues related to the sustainability of government finances	No specific role in the budgetary process The federal government has to publicly respond to the analysis prepared by the SVR. The government is free to prepare the budget using its own projections, but deviations have to be publicly justified	Status: Independent institution Composition: 5 independent economics experts appointed by the Federal President at the suggestion of the federal government Staff: about 20 (about half doing research)
	Joint Economic Forecast by 6 leading research institutes (JEF)	1950	Provides projections for international and national economic trends Issues policy recommendations, inter alia concerning fiscal policy	Publications: Spring and Autumn reports Variables projected: short term macroeconomic forecasts; general government expenditure (consumption, public sector building investment), revenue (taxes social contributions), balance and debt level Recommendations on economic policy in general, including fiscal policy especially if the JEF identifies a slippage compared to initial fiscal plans	The government is free to prepare the budget using its own forecasts and macroeconomic assumptions No specific role in the budgetary process (the government is not obliged to publicly respond to the analysis prepared by the JEF)	Status: independent research institution Composition: 6 members in the Board (one per research institute involved) Staff: during the two weeks which it takes to draw up the JEF, about 60 economists are involved in its production
	Advisory Board to the Federal Ministry of Finance	1950	Analyzes fiscal policy developments Issues recommendations and normative statements on the area of fiscal policy to the Federal Finance Minister	Publications: reports are presented to the Federal Minister of Finance and published afterwards Recommendations: the Advisory Board decides what issues it is going to consider, but it takes into account the priorities of the Federal Minister of Finance	No specific role in the budgetary process (government not obliged to publicly respond to its analysis). Reports contribute to the public policy debate.	Status: independent academic body that deliberates in complete independence on an honorary basis Composition: 25 honorary members (mostly university professors of economics or law) Staff: No own staff (staff provided by the Federal Ministry of Finance)

Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insititution	Status / composition of the governing board / indications on the size of the institution
	Working Party on Tax Revenue Forecasting	1955	Provides independent forecasts for government revenues	Variables projected: forecasts of government revenues for the whole of the general government sector, central, regional and local governments	The Working Party is generally consulted (no obligation) by the government in the course of the budgetary process. The Federal government adopts since 1955 the tax revenue forecast of the Working Group in the budget and since 1968 also in medium-term financial planning.	Status: independent advisory council at the Federal Ministry of Finance Composition: Federal Ministers, the 6 leading research institutes, the Federal Statistical Office, the Bundesbank, the German Council of Economic Experts, the Finance Ministries of the Länders and the Federal Union of Central Associations of local authorities. Staff::n.a
Greece	Centre of Planning and Economic Research (KEPE)	1959 (under Private law since 1964)	Analyses the problems of the Greek economy at national, regional level and by sector in applied research projects Provides technical advice on economic policy issues to the Minister of the Economy and Finance, and independent projections	Publications: studies, reports on applied economics, statistical series and discussion papers series Variables projected: macroeconomic and budgetary variables (expenditure and revenue) for the general government sector	No specific role in the budgetary process; the government is not obliged to publicly respond to the analysis prepared by the KEPE The government is free to prepare the budget using its own macroeconomic assumptions and projections (no justification required)	Status: Public institute attached to the Minister of Economy and Finance Composition: the Board of directors has 5 members (inducing the chairman of the institute) appointed by the government Staff: 45 researchers
Hungary	State Audit Office (ASZ)	1989	Analyses fiscal policy developments: The ASZ is in charge of assessing the draft budget and monitoring the implementation of budget plans. It also verifies whether budgetary plans are in accordance with existing budgetary rules and issues normative statement and recommendations in the area of fiscal policy	Publications: report on the budget law and report on the fulfilment of the annual budget law Normative statements generally take the form of warnings for 'improper' projections of revenues or expenditures	The government consults the ASZ in the course of the budgetary process. ASZ is auditioned by the Parliament in the course of the budgetary process. The government is not obliged to publicly respond to the analysis prepared by the ASZ and is free to prepare the budget using its own macroeconomic assumptions	Status: attached to the Parliament Composition: President and some vice presidents Staff: around 600 civil servants
Italy	Institute for Studies and Economic Analyses (ISAE)	1999	The ISAE is part of the Italian public research bodies and institutions. It carries out analyses useful for the economic and social policy decisions It notably analyzes fiscal policy developments for the whole of the general government sector and provides independent forecasts and projections	Publications: ISAE reports devoted to forecasts ('Forecasts on the Italian Economy') are issued twice a year Variables projected: main macroeconomic (quarterly an annual) and budgetary variables; forecasts are updated four times a year	The ISAE is generally consulted by the government and auditioned by the Parliament (no obligation for both) in the course of the budgetary process The government is not obliged to publicly respond to the analysis prepared by the ISAE and remains free to prepare the budget using its own macroeconomic assumptions (without having to provide justification)	Status: Independent body Composition: 9 Members in the governing board (academics, policy experts, civil servants, members of the Central Bank) Staff: around 150

Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insititution	Status / composition of the governing board / indications on the size of the institution
Luxembourg	Court of Auditors	1999	Analyses and performs an external control of public funds and audits the financial management of the State Provides independent forecasts for government revenues (year n) Issues recommendations (based on its analysis of the investment plan running over several years attached to the draft budget)	Publications: each year the Court of Auditors draws up a General Report on the Draft Bill of Settlement of the State General Account for the previous year. This report is sent to Parliament along with the point of view of the Government or the bodies concerned. Also, the Court can at any moment, either at the request of Parliament or on its own initiative, present its observations on specific aspects of financial management in the form of special reports.	The Court is generally auditioned by the Parliament in the course of the preparation of the budget (no obligation) The government is free to prepare the budget using its own macroeconomic assumption and projections	Status: Independent public institution Composition: 1 president, 1 vice president and 3 counsellors Staff: 34 civil servants
Netherlands	Netherlands Bureau for Economic Policy Analysis (CPB)	Created in 1945	Analyzes a broad range of economic and budgetary issues Monitors the implementation of budget plans; quantifies short term and long term effects of measures and reforms and checks compliance with budgetary rules Provides macroeconomic and budgetary economic forecasts and projections	Publications: the CPB yearly publishes a forecast in spring (the Central Economic Plan), providing the first forecast for the upcoming year. In September the CPB publishes the macroeconomic outlook (the MEV), on the same day that the budget is presented to Parliament. Besides these two forecast documents, the CPB provides some updates during the year. Variables projected: macroeconomic and budgetary variables forecasts (including for sub-sectors of general government) for the short and medium-term. Also long term projections (not annually).	The CPB is generally consulted (no obligation) by the government in the course of the budgetary process. The government is not obliged to publicly respond to the analysis prepared by the CPB. Forecasts are used for budget preparation, even if there is no legal obligation. If this would not be the case, an explanation would be expected.	Status: the CPB is formally attached to the Ministry of Economic Affairs, but works in full independence Composition: the Board of the CPB consists of three members (one director and two assistant directors). Normally, these members are selected among high civil servants (from ministries or the CPB itself) or the academic world. Staff: about 170 employees

Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insititution	Status / composition of the governing board / indications on the size of the institution
Portugal	Court of Auditors (Tribunal de Contas)	1976 in Constitution 1990 sovereign organ by law	Analyses fiscal policy developments. Monitors the implementation of budget plans of the State. Performs a control of public finances Issues normative statements and recommendations on the implementation of fiscal plans and respect of fiscal policy rules	Publications: annual reports on the Budget outturn for the State and other general government sub-sectors; occasional reports on issues relevant for public accounts Normative statements on the implementation of fiscal plans	The Court controls the budgetary execution at its own initiative. It provides an assessment of the budgetary developments for the central government and social security sectors before the budget is approved by the Parliament. The government has to follow the Court's recommendations related to accounting control. No obligation to follow the Court's recommendations on others fiscal policy issues	Status: sovereign organ Composition: the board is made of 1 president and 18 judges Staff: 596 (in 2004)
Spain	National Committee of local administration (CNAL)	1985	Issues recommendations in the area of fiscal policy concerning local government finances Fosters cooperation between State and local governments	Publications: report on the budgetary stability objectives for local governments fixed by Central Government. Recommendations: the CNAL is notably in charge of assessing the draft budget, but only in those aspects concerning local finances, it provides recommendations on the distribution of state grants to Local Governments.	The government has to consult the CNAL in the course of the budgetary process concerning the articles related to local governments finances	Status: attached to the Ministry for Public Administration Composition: members of the plenary board (28 members) are civil servants and politicians Staff: na
	Court of Auditors	1978	Analyses (ex post) the budget execution and monitors implementation. Verifies whether budgetary outcomes are in compliance with existing budgetary rules. Assesses the quality of government finances. Issues recommendations and normative statements in the area of fiscal policy.	Publications: annual report 'Final Declaration of the General Statement of State Accounts'; annual Memorandum of Performance; annual Report of the Activity of the Regional and Local Public Sectors; special audit reports; motions or notes	The Court only intervenes ex post. It examines the execution and provides information to the national and regional Parliaments and local governments The government is not obliged to publicly respond to the analysis prepared by the Court, but generally takes into account the recommendations	Status: independent institution Composition: the full session is made of 12 Counsellors of Accounts and the Prosecutor (six Members are appointed by the Congress of Deputies and the other six by the Senate) Staff: around 800

Country	Institution	Date of creation of the institution	Tasks related to fiscal policy issues fulfilled by the institution (analysis / forecasts / recommendations)	Output from the Institution (Publications, Variables projected, nature of Recommendations)	Role of the institution in the budgetary process and constraint (if any) for the government to use the output of the insitution	Status / composition of the governing board / indications on the size of the institution
Sweden	National Institute of Economic Research (NIER)	1937	Analyses, inter alia, fiscal policy developments of the whole of the general government sector and its sub-sectors. The analyses go beyond fiscal policy issues. Provides macroeconomic and public finances forecasts Issues recommendations and normative statements	Publications: fiscal and budgetary issues are analysed and commented in the institute's quarterly report 'Konjunkturläget' ('The Swedish economy') Variables projected: detailed macroeconomic and budgetary forecasts and long term projections on government finances (including for sub-sectors of general government and pension system) Normative statements on the budgetary plans and respect of the fiscal rules	No specific role in the budgetary process The government is not obliged to publicly respond to the analyses prepared by the NIER. The government is free to prepare the budget using its own projection and macroeconomic assumptions, without having to provide any justification The government has no obligation to follow the recommendations	Status: economic research institute under the Ministry of Finance Composition: the General Director is appointed by the government. all other staff is appointed by the institute Staff: 65
United Kingdom	National Audit Office (NAO)	Has existed since 1983 in its current form. Replaced the former Exchequer & Audit Department that had existed since 1866. Mandate extended in 1998 and in 2000	Issues recommendations and normative statements in the area of fiscal policy	Recommendations: the NAO audits changes in key assumptions and conventions underlying fiscal projections for the whole of the public sector; the NAO's conclusions and recommendations are confined to the assumptions underpinning the fiscal projections, not the overall stance of fiscal policy or performance against the Government's fiscal rules	The government has to consult the NAO in the course of the budgetary process. The Treasury is not obliged to follow the NAO's recommendations concerning the key assumptions underpinning the fiscal projections (in practice generally does)	Status: independent institution under the Parliament Composition: by statute, the Comptroller & Auditor General, the head of the NAO, is completely independent of government. Staff: the number of NAO officials involved in auditing the assumptions underpinning the fiscal projections varies depending on how many assumptions are due for audit alongside a specific Budget. In general, the number ranges from 5 to 10.

Part IV

Fiscal policy in good times

Summary

In spite of the unanimous view among economists and policy-makers that pro-cyclical fiscal policies should be avoided, counter-cyclical fiscal policies are far from being the norm in most countries. What is most surprising is that the available evidence seems to indicate that in most advanced countries pro-cyclicality is an issue that mostly arises in good times, when the economic activity is above potential or when growth is above trend. This is somehow puzzling, since while in bad times a trade-off could emerge between the objective of output stabilisation and that of budgetary discipline, the two objectives go hand in hand in good times.

The direct consequence of a pro-cyclical behaviour of fiscal policy is an unnecessary amplification of GDP fluctuations. Furthermore, the prevalence of pro-cyclical behaviour in good times is responsible for a considerable share of the current stock of debt in EU countries. When budgetary frameworks aimed at containing deficits are in operation, pro-cyclical fiscal policy in good times is often the cause of fiscal retrenchments occurring during periods where cyclical conditions are weak. This issue was particularly evident in the EU over the past decade. The failure of many countries to run a prudent budgetary policy at the crossroad of the decade when output was above potential and growth above trend translated in some cases in budgetary adjustment carried out in the periods of negative output gap following the downturn occurred in 2001.

Different reasons are at the ground of pro-cyclical fiscal policies in good times. First, the inevitable difficulty of forecasting and measuring the cycle in real time, coupled with the well-known implementation lags of fiscal policy. Second, there are so-called 'political economy' explanations, i.e, a suboptimal structure of incentives and mechanisms in policy-making. Pressure groups, spending ministries, local governments are likely to step up their spending requests exactly when resources are more abundant. Voters will normally expect to share in budgetary surpluses accumulated during good times via tax cuts. If governments lack effective commitment instruments not to spend budgetary windfalls arising from strong cyclical conditions, the result would be frequent budgetary loosening in good times.

The analysis carried out in this part of the Report confirms the findings of previous studies that episodes of pro-cyclical fiscal policy were frequent in euro-area countries in the past decades. During years where output was above potential, the fiscal stance was pro-cyclical in about 50 percent of the cases. Evidence of pro-cyclical behaviour is found using both a definition of good times based on the level and on the year-on-year change in the output gap. The picture, however, is quite different depending on the period considered. While during the run-up to EMU pro-cyclicality took place mostly during bad times, after the completion of EMU budgetary corrections in bad times became less common, but there was a greater incidence of pro-cyclical policies in good times.

Quantitative analysis provided in this part of the Report shows that there is evidence of a pro-cyclical bias of fiscal policy in good times also controlling for the major factors that affect the fiscal stance and that such bias emerges especially when output is above potential but also during upswings in economic activity, namely, when growth is above trend. The separate analysis of government revenues and expenditures reveals that the pro-cyclical bias is mainly related with the behaviour of expenditures, which appear to grow faster in periods of positive output gap. An explanation could be identification and implementation lags. Expenditure plans are based on growth forecasts. Such forecasts are likely to be optimistic especially after protracted periods of growth above trend, i.e., when the output gap is positive. Strong pressures to spend budgetary windfalls accruing in good times would be an aggravating factor.

A comparison between the values of the output gaps estimated in real time and those computed *ex post* reveals that measurement errors are potentially a serious issue.

In about 1/3 of the cases there was a real-time wrong assessment of the sign of the output gap of euro-area countries over the period 1995-2003. This evidence militates against a mechanistic use of real-time output gap figures in the identification of good and bad times. Further analysis shows, however, that errors in measuring the cycle in real time are not the main explanation for the observed pro-cyclical behaviour. The analysis shows that measurement errors may explain to some extent pro-cyclicality in bad times, but the same does not hold for pro-cyclical behaviour in good times. Furthermore, the stance was more strongly pro-cyclical when the output gap was large and positive: another piece of evidence pointing against the view that pro-cyclical episodes in good times were unintentional.

A possible response to the pro-cyclical bias of fiscal policy is setting up national-level rules and institutions that permit governments to credibly commit not to surrender to the pressures to raise spending or cut taxes in good times. Expenditure frameworks aimed at capping the growth of expenditure over a medium-term framework can address the tendency for expenditure to grow faster in good times. Revenue rules that determine *ex ante* which share of revenue windfalls will be saved or the establishment of rainy-day funds can strengthen the commitment of governments not to spend or give away via tax cuts better than expected budgetary outcomes materialising in good times. 'Fiscal councils' providing technical inputs in fiscal policy-making, including via high-quality independent macroeconomic forecasts and a thorough estimation of the budgetary impact of policy measures could permit a better working of the rules aimed at addressing the pro-cyclical bias.

The analysis in the report supports the view that expenditure rules could be an effective instrument to curb the pro-cyclical bias. It is shown that the countries endowed with effective expenditure frameworks were characterised, other things being equal, by a more moderate growth of expenditure especially in good times. This translated into a lower frequency of episodes in which the behaviour of expenditure was pro-cyclical. While this frequency was about 80 percent in countries without expenditure frameworks or with only weak frameworks, in countries with strong expenditure rules a pro-cyclical behaviour of expenditure in good times is observed in less that 60 percent of the cases.

Overall, the analysis in the report reveals that pro-cyclical policies in good times are far from being an exception. A durable correction of the pro-cyclical bias could be achieved by setting up adequate rules and institutions at the national level. A strengthened institutional framework for budgetary policy at national level would in this sense be consistent with the reformed Stability and Growth Pact, which puts enhanced emphasis on the need for countries to step up adjustment efforts in good times to achieve their medium-term budgetary objectives. Efforts to make progress on this front should not be delayed. There is mounting evidence that good times are going to be there again. Growth in the euro area is recovering and output may return above potential in a majority of countries in the near future. Member States need to avoid the mistakes of the past and be ready to make the best use of such an opportunity to combine an appropriate use of fiscal policy as a stabilisation tool with progresses towards achieving their medium-term budgetary objectives.

1. Introduction

This part of the report discusses the issue of pro-cyclicality of fiscal policy. Much has been debated about a possible pro-cyclical bias in bad times induced by budget balance rules. The focus here will be rather on pro-cyclical behaviour in good times. There are several reasons for this choice. First, the evidence shows that pro-cyclical behaviour in good times was quite common in EU countries, especially after the final stage of EMU. Second, while pro-cyclical behaviour in bad times can be the unavoidable price to pay when countries need to ensure a prompt correction of budgetary imbalances, pro-cyclical policies in good times not only destabilise output but also worsen countries fiscal positions and may be the cause of subsequent fiscal retrenchments in bad times. Third, there appears to be a bias towards fiscal loosening in good times related with the strong pressures to raise spending or cut taxes which governments are faced in the presence of budgetary windfalls. Such pro-cyclical bias has a structural nature and needs to be addressed with a structural response.

The bottom line of the following analysis is as follows. Both government revenues and expenditures contributed to the emergence of pro-cyclical policies in good times, with a particularly significant contribution of expenditures that appears to grow considerably faster during periods in which output is above potential. In general, pro-cyclical policies in euro-area countries do not seem to be the outcome of unintentional mistakes related with an incorrect reading of current cyclical conditions. Fiscal expansions in good times appears rather to be the fruit of deliberate decisions, with the episodes of strongest loosening in periods of positive and large output gaps.

A response to the pro-cyclical bias can come from strengthened national-level rules and institutions. Multi-year expenditure frameworks can curb the tendency for expenditures to grow faster during good times. *Revenue rules* and the establishment of *rainy-day funds* can strengthen the commitment by governments to save windfall budgetary gains arising in good times. 'Fiscal councils' providing technical inputs in fiscal policy-making can be helpful to ensure an effective use of the rules aimed at addressing the pro-cyclical bias. The analysis that follows shows that *expenditure rules* can indeed be an effective instrument: countries with stronger expenditure rules were characterised by slower growth of expenditures especially during good times and by a lower frequency of episodes in which expenditure policy was used in a pro-cyclical fashion.

Part IV of the report is structured as follows. Chapter 2 reviews the main theoretical arguments against a pro-cyclical conduct of fiscal policy and surveys the existing studies analysing how the fiscal stance behaved over the cycle in practice. Explanations for the observed recurrence of pro-cyclical fiscal policy in good times are discussed. Chapter 3 takes a close look at the behaviour of the fiscal stance in the EU. The analysis focuses on euro-area countries over the 1980-2005 period. The analysis considers separately different sub-periods and different definitions of good and bad times. Econometric analysis is performed to analyse the determinants of the fiscal stance in good and bad times separately for budget balances, government revenues and expenditures. The analysis of the cyclical behaviour of the fiscal stance is examined by referring also to good and bad times defined on the basis of real-time rather than *ex post* data. Chapter 4 discusses alternative ways to address the pro-cyclical bias via the establishment of national-level budgetary rules and institutions. Original analysis using questionnaires submitted to the Working Group on the Quality of Public Finances attached to the Economic Policy Committee is performed with a view to investigate the link between national level fiscal rules and the cyclical behaviour of the fiscal stance.

2. The cyclical behaviour of the fiscal stance

2.1. Introduction

This section discusses the broad issue of how fiscal policy should behave in theory over the cycle and what actually happens in reality. In spite of recommendations from all economic schools against pro-cyclical fiscal policy, existing analyses indicate that a pro-cyclical use of discretionary fiscal policy is quite common. While pro-cyclical fiscal policy in bad times may easily find a rationale in the inevitable trade-off between cyclical stabilisation and the need to contain budgetary imbalances, the explanations for pro-cyclical policy in good times are less obvious. A loose fiscal stance in good times may not only be due to difficulties in tracking correctly the cycle and to the well known issue of identification and implementation lags of fiscal policy, but also to weak control mechanisms over the budget, which may result into fiscal authorities surrendering to the pressure for tax cuts or expenditure increases when resources are more abundant.

2.2. Prescriptions from theory

The budget balance varies over the cycle for two main reasons. First, the working of automatic stabilisers. Government revenues and, to a lesser extent, government expenditures vary with the level of economic activity as a result of existing fiscal legislation. These variations are 'automatic', do not need any additional policy to take place, and are such that the budget balance follows the economic cycle: tax revenues are higher in booms, while unemployment compensations and other social expenditure are lower. The working of automatic stabilisers is thus counter-cyclical: fiscal policy behaves in such a way to counter cyclical developments. Second, discretionary action by governments. As opposed to automatics stabilisers, discretionary policies may induce a variation in the budget balance that may be either pro or counter-cyclical.

The use of discretionary fiscal policy as a tool to stabilise output has often given rise to controversy. Economists in the Keynesian tradition are generally in favour of active discretionary policies aimed at containing fluctuations of economic activity. In Keynesian theories, fiscal policy activism finds its rationale in widespread real and nominal rigidities that hamper a prompt adjustment of prices and delay the adjustment of output towards potential.

New classical macroeconomics rather favours a cyclically neutral fiscal stance. Such recommendation finds its foundation in the tax-smoothing principle, which advocates avoiding large changes in the tax burden over time in order to limit the dead-weight losses of taxation [1]. Moreover, the effectiveness of counter-cyclical discretionary activism is put in question on the basis of the so-called Ricardian equivalence [2]. Overall, according to the prescriptions from new classical macroeconomics fiscal policy should act counter-cyclically but mainly via the operation of automatic stabilisers.

Fiscal activism moved in and out of fashion over the past decades. After a broadly positive attitude by economists and policy-makers towards discretionary fiscal policy for stabilisation purposes in the 1950s, 1960s and early 1970s, a more pessimistic view became common. This change in attitude was partly associated with the stricter constraints on the use of fiscal policy as a demand management tool ensuing from large and rising budgetary imbalances, and partly was the result of accumulated experience showing the practical limits and pitfalls of discretionary fiscal policy. In recent years, a more bal-

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[1] See for instance Barro (1979).
[2] The basic argument underlying Ricardian equivalence is that the economic agents would anticipate future increases in taxes resulting from any present-day increases in borrowing. This would render expansionary fiscal policies ineffective as the economic agents save any additional income (stemming from reduced taxes or increased transfers) rather than spend it (an analogous argument can be made for contractionary policies). On the topic see, e.g., Barro (1974). Overall, the forward looking behaviour of economic agents tend to reduce the effectiveness of discretionary fiscal policy on output. Cases in which fiscal policy had an impact on economic activity contrary to what standard Keynesian macroeconomics would have predicted have also beeen found, as highlighted by episodes of 'expansionary fiscal consolidations' (see, e.g., Giavazzi, Jappelli, Pagano, and Benedetti (2005), European Commission (2003), Giudice, Turrini, and In't Veld (2004)).

anced consensus view is emerging (¹). There is increasing recognition that fiscal policy could be de-facto the only macroeconomic stabilisation left in many situations where exchange rates are kept fixed, given the stricter constraints faced by monetary policy resulting from increased capital mobility. A fortiori, this argument applies to monetary unions. Moreover, although the practical problems with discretionary fiscal stabilisation related with identification and implementation lags are now fully recognised in the academic and policy-making community, there is also awareness that in some cases automatic stabilisers may not be sufficient by themselves to counter large and persisting cyclical imbalances (²).

Overall, there was always consensus that pro-cyclical fiscal policy should be avoided. However, this judgment is subject to a fundamental asymmetry. While the objective of output stabilisation and that of debt stabilisation go hand in hand by running counter-cyclical policies in good times, a trade-off may emerge in bad times. Since fiscal activism to sustain economic activity in bad times comes at the cost of widening deficits and possibly destabilising debt, a sound structural fiscal position is a pre-requisite for running counter-cyclical policies in bad times. Conversely, a counter-cyclical fiscal stance in good times, by improving the budgetary position, sows the seeds for a supportive fiscal stance in bad times. In this respect, there is consensus that the lack of fiscal adjustment in good times is responsible of a considerable share of debt accumulation in many advanced economies and that the budgetary consolidation episodes that were carried out in periods of negative output gaps in several EU countries in recent years could have been avoided had the fiscal stance not been pro-cyclical in the good time periods at the cross-road of the decade (³).

2.3. Broad evidence

Although normative arguments plead against the pro-cyclical use of discretionary fiscal policy, the evidence indicates that episodes of pro-cyclical fiscal policy are far from being an exception. The issue became particularly evident in the euro area in recent years. Graph IV.1 reports figures for the year-on-year changes in the cyclically-adjusted primary balance (CAPB) taken as a meas-

ure of the fiscal stance and output gaps over the period 1996-2005 for the euro-area aggregate. The graph shows that in periods of negative output gaps changes in the CAPB were normally positive, denoting a pro-cyclical fiscal tightening in bad times. Conversely, in years when output was above potential, fiscal policy was loosened, thereby taking a pro-cyclical stance in good times.

The common prima-facie approach to obtain information on the behaviour of the fiscal stance over the cycle is to put in relation a measure of fiscal stance (generally the change in the CAPB) with cyclical indicators (normally the output gap) as in Graph IV.1. Although helpful, such an approach does not permit to gauge to what extent the observed stance of the fiscal policy was motivated by the stabilisation purpose or rather by other reasons. A more careful analysis of the behaviour of fiscal authorities would also attempt at isolating the main factors that affect the behaviour of fiscal authorities, in primis the need to keep debt under control. In recent years, it has become common practice to analyse the determinants of discretionary fiscal policy through the estimation of 'fiscal rules' summarising the behaviour of fiscal authorities (⁴). The purpose of such analytical exercises is that of identifying a limited set of macroeconomic determinants that explain developments in measures of discretionary fiscal policy. In most of these analyses the primary CAB is used to capture the discretionary component of the budget, which is assumed to depend upon cyclical conditions (the output gap) and the starting fiscal conditions (the level of debt and of the CAPB) (⁵).

The idea is that fiscal authorities are motivated by an objective of output stabilisation and by debt stabilisation motive.

Results from existing work analysing the cyclical behaviour of fiscal policy via the estimation of fiscal

(¹) See, e.g., Auerbach (2005).
(²) See also European Commission (2002) on the use of discretionary fiscal policy in currency unions.
(³) Balassone and Francese (2004) estimate that pro-cyclical discretionary measures in good times explain almost one fourth of the total increase in the debt/GDP ratio in industrial countries over the 1977-2000 period.

(⁴) Among the first studies analysing the cyclicality of public finances via the estimation of fiscal reaction functions see, e.g., Bohn (1988), Von Hagen, Hugues-Hallet and Strauch (2001), Ballabriga and Mongay (2002), Melitz (2002), Gali and Perotti (2003). For studies on the cyclical behaviour of public finances using alternative regression-based approaches see, e.g., Gavin and Perotti (1997), Hallerberg and Strauch (2001), Lane (2003), and Alesina and Tabellini.
(⁵) One difficulty in the estimation of fiscal reaction functions is that of the endogeneity of the output gap. The idea underlying fiscal reaction functions is that the budget balance depends on the cycle. However, the reverse is also true, i.e., the stance of fiscal policy affects economic activity. To get rid of this circularity, estimation methods that permit to isolate the variation in the output gap which is independent of the current fiscal policy of the country concerned are necessary. The easiest solution is to use the output gap taken with one lag as an explanatory variable. The most common solution is to use an instrumental variable estimator and to use as explanatory variable the variation of the output gap related with the chosen instruments, generally the lagged output gap and measures of the international cycle. A different route is that of using GMM methods, like the Arellano-Bond estimator.

Graph IV.1: **Fiscal stance (change in CAPB, GDP) measured against the output gap; euro area**
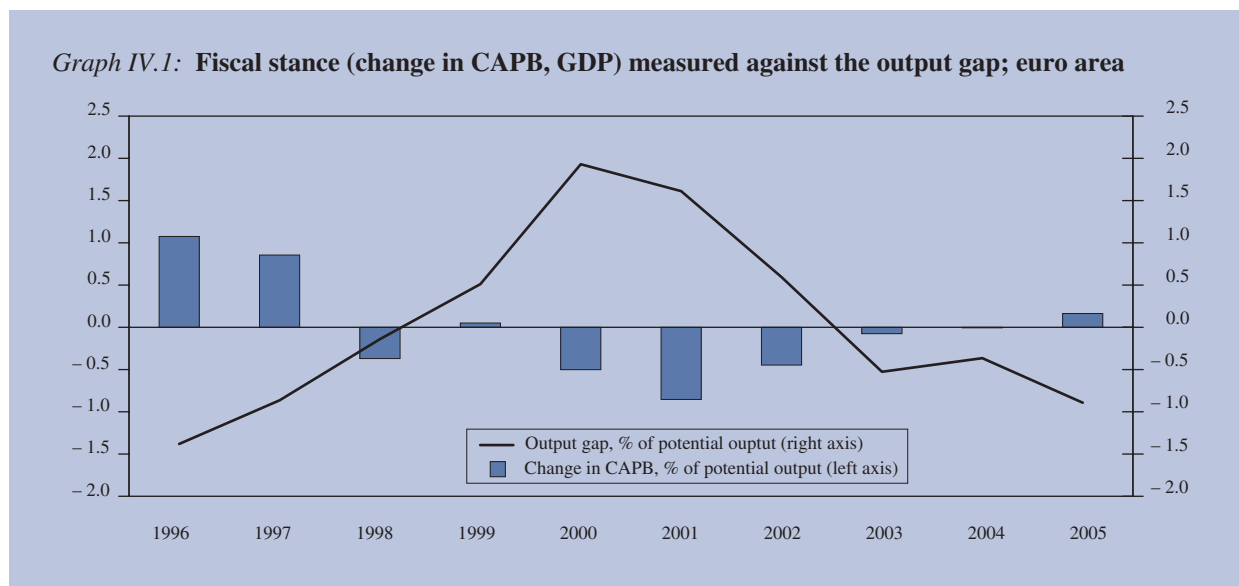
reaction functions differ to a certain degree depending on the sample considered and on the specific methodology applied. However, a series of common findings on the response of the fiscal stance to the cycle emerge. First, in many studies the reaction of the CAPB to the output gap appears to be weak, often not statistically significant from zero. This suggests that on average, over large samples, discretionary policy does not seem to be strongly related to cyclical indicators. Second, fiscal policy appears generally pro-cyclical in middle income and developing countries while for advanced economies the cyclical behaviour of the fiscal stance depends on specific periods and country aggregates [1]. Third, there appears to be a generalised tendency in advanced economies to engage less frequently in pro-cyclical fiscal policies over time [2]. Third, for euro-area countries, the evidence does not support the view that in the past decades fiscal authorities acted in general in such a way to counter cyclical imbalances via discretionary measures. Moreover, most existing studies do not support the view that after the introduction of the EU fiscal framework (the signing of the Maastricht Treaty), fiscal policy became more pro-cyclical [3]. However, there are indications that pro-cyclical behav-

iour in good times has become more common after the completion of EMU [4].

A number of studies also attempt to analyse whether the response of fiscal authorities to cyclical developments was symmetric over the cycle or rather different depending on whether good or bad times were prevailing. The evidence from this series of studies is not clear-cut. As evidenced in Table IV.1, some analyses report that the response of fiscal authorities to the output gap was not qualitatively different in good and bad times while in other studies significant differences are found. Moreover, results differ also for what concerns the sign of the response of budget balances to the cycle. This difference in results is due to several factors, relating to the country and time coverage of the sample, the source of data (e.g., different methodologies for computing output gaps and adjusting budget balances for the cycle) and the approach chosen in the estimation [5].

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[1] Evidence on both advanced economies and developing countries is reported for instance in Gavin and Perotti (1997) and Alesina and Tabellini (2005). Talvi and Vegh (2005) focus on developing countries only.

[2] Gali and Perotti (2003) show that in most OECD countries the response of the fiscal stance to output gaps become more counter-cyclical starting from the early 1990s.

[3] See, e.g, Gali and Perotti (2003), European Commission (2004a, 2004b), IMF (2004). A greater stabilisation role for fiscal policy at national level in monetary unions is one of the explanations put forward to explain a reduced rather increased pro-cyclicality after the introduction of the EU fiscal framework (Gali and Perotti (2003)).

[4] IMF (2004).

[5] Most studies use as the dependent variable capturing discretionary fiscal policy the CAPB in level or in change (Forni and Momigliano (2004)). In some studies, however, the overall budget balance is used instead (Balassone and Francese (2004), Manasse (2006)). The specification of the explanatory variables in the fiscal reaction function also varies somehow across studies. For instance, normally fiscal reaction functions include lagged budget balance measures as an explanatory variable, but there are exceptions (e.g., OECD (2003)).

In spite of such differences, *a counter-cyclical response of discretionary fiscal policy to the cycle in good times is seldom found*, while some studies report evidence consistent with counter-cyclical behaviour in bad times ([1]).

In summary, the available evidence suggests that, in spite of the prescriptions from economic theory and the broad agreement in the policy community against pro-cyclical fiscal policy, counter-cyclical behaviour was far from being the norm in advanced countries and notably EU countries in past decades. Overall, there is also no strong evidence in favour of the view that that the use of discretionary policy was effective in stabilising output ([2]). Even more puzzling seems the evidence that pro-cyclical behaviour was quite common especially in good times. Although in good times there are no fiscal discipline-related constraints to budgetary policy in keeping a counter-cyclical fiscal stance, the data suggest that fiscal authorities may find other type of constraints that may explain frequent pro-cyclical behaviour.

2.4. The recurrence of pro-cyclical fiscal policy: in search of explanations

What could explain the fact that the fiscal stance is quite often pro-cyclical? In the case of pro-cyclical fiscal policies in *bad times*, explanations are not hard to find, in light of the already mentioned trade-off faced by fiscal authorities between exerting an impulse on aggregated demand consistent with cyclical conditions and keeping a robust commitment towards fiscal discipline. This trade-off is in some cases somehow solved ex-ante, via the introduction of numerical rules aimed at ensuring the respect of budgetary discipline, thus limiting the discretion of fiscal authorities with the use of discretionary policy with stabilising purposes when deficits are too high. In a nutshell, the main explanation for pro-cyclical fiscal policy in bad times is an unsound starting fiscal position, which requires a correction irrespective of the prevailing cyclical conditions ([3]). The

reasons justifying the recurrence of pro-cyclicality in *good times* are more subtle. Two broad set of explanations are generally identified. A first set relates to problems in correctly measuring cyclical conditions. A second set of explanations focuses on the effective functioning of fiscal policy-making, which may lead to results different from those advocated by normative economic theory.

Measurement issues

Identification and implementation lags could explain excessive growth of expenditure in good times. The execution of government expenditure plans follow budgetary decisions with some delay, so that expenditures at time t are generally based on growth forecasts made at time t-1 or t-2. ([4]) Growth forecasts are generally influenced by current or recent growth developments. It follows that it is exactly when output gap is positive, i.e., after protracted periods of growth above trend, that expenditures are likely to grow faster. Moreover, due to the difficulty of predicting turning points in the cycle, the risk exists that expenditures grow fast also in correspondence with growth slowdowns ([5]).

Related to the issue of identification lags, there is the issue of satisfactorily *measuring the cycle in real-time*. Governments may be willing to engage into counter-cyclical fiscal policies, but they simply lack the tools to do that adequately because they have an imperfect reading of the current cyclical conditions. The estimation of output gaps in real time is subject to substantial uncertainty, mainly related to revisions in the estimates of

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[1] A significant counter-cyclical reaction, both in good and bad years, is reported only in Golinelli and Momigliano (2006). This study, which refers to the years starting from 1988, uses real time estimates for cyclical conditions and initial deficits and controls for the impact of the european fiscal rules on the behavior of countries in excessive deficits and for elections. Elections appear to induce a more expansionary stance, but only in good times.

[2] Quite at the opposite, Fatas and Mihov (2003) analysing a sample of 91 countries find that the discretionay fiscal policies have in general increased, rather than reduced, output volatility.

[3] An additional reason for pro-cyclicality in bad times are financing constraints: countries that rely heavily on foreign borrowing to finance their deficits may find it more difficult to obtain such finance in periods where the economy in undergoing recessions, due to lost confidence by international investors. However, although this explanation seems relevant for middle income and developing countries (Alesina and Tabellini (2005)) it is much less for advanced economies.

[4] Although the dynamics of government expenditure depend on the specific expenditure item considered, several assumptions have been formulated in the literature for what concerns the medium-term dynamic behaviour of aggregate primary cyclically-adjusted expenditures (see, e.g., Hugues Hallet et al. (2003)). It is often assumed that governments target a constant ratio of expenditure over potential GDP. In this case, expenditures are planned on the basis of expected potential growth. Alternatively, fiscal authorities could target the budget balance. In this case, expenditures would grow on the basis of the expected growth of revenues. In both cases, the growth of expenditures would be broadly in line with expected GDP growth.

[5] One needs to notice however that in case of long implementation lags and the economy undergoing a severe downturn, the strong expenditure increase planned during a period with positive output gap could end up being executed in years characterised by a negative output gap, so that the expenditure policy could turn up being counter-cyclical in bad times rather than pro-cyclical in good times.

Table IV.1

Discretionary fiscal policy in good and bad times: evidence from econometric estimation of fiscal reaction functions

Study, sample, data source	Dependent and explanatory variables	Estimation method and instruments	Response of the fiscal stance to the output gap in good times	Response of the fiscal stance to the output gap in bad times
Good and bad times defined in terms of the level of the output gap				
IMF (2004) Euro area 1971-2003 OECD analytical database	CAPB Lagged CAPB, output gap, lagged debt, 'monetary gaps'	IV, own lagged output gap, lagged output gap of US and FR for DE, and of US and DE for the other countries	Pro-cyclical	Not statistically significant
Balassone and Francese, (2004) 14 EU countries 1970-2000 European Commission data	Overall balance Lagged debt, lagged nominal balance, output gap	OLS, Arellano-Bond	Pro-cyclical (the overall balance does not react to the output gap indicating that the fiscal stance counter the automatic stabilisers)	Not statistically significant (a variation in the overall balance of the same order as that of automatic stabilisers)
Cimadomo (2005) Euro area 1981-2005 OECD Economic Out-look database	CAPB Lagged CAPB, lagged debt, lagged output gap	OLS, lagged output gap	Not statistically significant Pro-cyclical in very good times (output gap>3) after 1999	Not statistically significant
Manasse (2006) Both Industrialised and Developing countries 1970-2004 IMF World Economic Outlook database	Primary balance Lagged output gap, lagged debt, lagged primary balance	Pooled and fixed effect OLS on piece-wise linear specification (specification obtained via algorithms in the MARS software) IV using lagged output gap as instrument as alternative method	Pro-cyclical	Procyclical Not statistically significant in very bad times (output gaps <2)
Good and bad times defined in terms of the change of the output gap				
OECD (2003) 21 OECD countries 1980-2002 OECD Economic Outlook database	Change in the CAPB Change in the CAPB (output gap), lagged debt	Arellano-Bond estimator	Pro-cyclical	Counter-cyclical
Output gap measured in real time				
Forni and Momigliano, (2004) 10 Euro area countries 1993-2003 OECD Economic Outlook database	Change in the CAPB Output gap, 'Maastricht variable', lagged debt, lagged CAPB	OLS, lagged output gap, IV: own output gap, (average weighted) output gap of the other countries in the sample Arellano-Bond (alternative estimations method)	Not statistically significant with real-time data Not statistically significant with *expost* data Counter-cyclical with real-time data	Counter-cyclical with real-time data Not statistically significant with *ex post* data Counter-cyclical with real-time data
Golinelli and Momigliano (2006) 11 Euro area countries, 1988-2006 OECD Economic Outlook database	Change in the CAPB Lagged output gap, lagged, lagged primary balance, election dummies; 'Maastricht variable' in cases where it is binding	OLS (no fixed effects), lagged output gap		

Source: Commission services.

potential output ([1]). In case of a mistaken reading of the cycle, pro-cyclical policies may result *expost* while *ex ante* the intention was to keep a counter-cyclical stance.

'Genuine uncertainty' on real-time output gap figures can explain why fiscal policy is generally not counter-cyclical. However, such an explanation fails to explain why there are often stronger signs of pro-cyclicality in good rather than in bad times. If errors are simply due to lack of information, then one should expect measurement errors to be symmetrically distributed over sufficiently large samples: the probability of assessing that times are 'bad' when they are not should be roughly equal to the probability of assessing good times when *ex post* data indicate instead weak cyclical conditions. A possible explanation of such bias could be found in a *tendency by governments to inflate the growth projections* underlying their budgetary programmes, which has been documented for some EU countries over the past decade ([2]). Upward-biased growth forecasts result into an inflated real-time estimate of potential output and then into a downward-biased output gap level: fiscal expansions meant to be counter-cyclical in bad times may end up being pro-cyclical in good times ([3]).

Political economy

A different set of reasons for the observed pro-cyclical behaviour of fiscal policy is often referred to as 'political economy' explanations. The political economy arguments underlying the deficit bias are well-known and are reviewed in Part III in this report. Short-sighted governments may underestimate the longer term negative consequences of deficits; pressure groups, when competing for government resources neglect the repercussions of their decisions on overall public finances (common pool problem). The result is a tendency for deficits to build up. As long as a deficit bias is present irrespective of cyclical conditions, pro-cyclical policies could emerge.

More interestingly, recent theoretical work has shown that the deficit bias associated with *the common pool problem can get worse during good times*, thus leading to a growth of deficits above normal. A reason could be the so-called 'voracity effect': since competing pressure groups will devote a greater effort to obtain a share of government expenditure the higher is the total amount of resources available, spending is likely to grow more than proportionally with the increase in revenues. ([4]) Alternative arguments refer to the revenue side rather than the expenditure side of the budget. In order to curb pressures to increase spending in good times, forward-looking governments may decide not to allow the accumulation of any budgetary surpluses in the first place, preferring to cut taxes instead ([5]). Analogously, governments may cut taxes in good times as a consequence of the pressures by the electorate to benefit from budgetary windfalls ([6]).

Some implications for policy

The arguments that can explain pro-cyclical fiscal policies in good times listed above also indicate possible solutions to address the pro-cyclical bias. These solutions mainly consist of improved institutional settings underpinning national fiscal policy-making. Independent forecasting agencies and fiscal councils with an advisory role may be helpful in limiting a possible tendency by governments to inflate the growth forecasts underlying budgetary plans.

The procedures for the approval of the budget could be reformed in such a way to contain the influence of pressure groups on budgetary outcomes. Numerical ceilings on expenditure could prevent excessive spending increases during good times. The accumulation of rainy-day funds and the introduction of rules that define *ex ante* the use of the extra revenues accruing to the government during good times could contribute to contain both spending increases and tax cuts in good times. These possible solutions for the issue of pro-cyclicality are further discussed in section 4 of this part of the report.

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[1] Several reasons underlie the uncertainties in real-time output gap figures. First, when potential output is obtained by means of moving averages, measuring potential output for time *t* at time *t* requires disposing of GDP forecasts for subsequent periods: *t*+1, *t*+2, etc. Due to forecasting errors, the estimate of potential output in real time may need to be revised afterwards. Second, real-time estimates of GDP are inevitably subject to revisions because the construction of GDP for the current year is based on limited information. Third, GDP series may be modified backward due to statistical revisions. Among the first analyses of the magnitude of real-time errors in the estimation of the output gap (for the US) see Orphanides and van Norden (2002). Analyses referred to the EU include Camba-Mendez and Rodriguez-Palenzuela (2001) and Ruenstler (2002).

[2] Such findings are reported for instance in Strauch, Hallerberg and Von Hagen (2004), Larch and Salto (2005), Moulin and Wierts (2006).

[3] Of course, it is not always easy in short time series (such as those of the record of stability and convergence programmes) to distinguish to what extent optimistic growth forecasts are due to a bias by fiscal authorities or to an objective difficulty in predicting growth slowdowns.

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[4] This argument is formalised in Tornell and Lane (1999).

[5] Argument provided in Talvi and Vegh (2005).

[6] An argument along this lines is developed theoretically in Alesina and Tabellini (2005).

3. The stance of fiscal policy in EU countries during good and bad times

3.1. Introduction

This section takes a closer look at the behaviour of fiscal policy over the cycle in EU countries in recent decades. The analysis will focus on the reaction of the discretionary component of fiscal policy. Consistently, what will be put in relation to measures of the cycle are budgetary variables net of their cyclical component.

Although the vast majority of existing analyses considers good and bad times as periods in which actual output is, respectively, above or below ex-post measures of potential output, in practice there is less than full agreement among policy-makers regarding when fiscal policy should pay greater attention to avoiding a pro-cyclical stance. In light of this consideration, in the following analysis there will an effort to discuss the stance of the fiscal policy in the EU with respect to alternative definitions of good and bad times.

There will also be an attempt to take a step further to disentangle which side of the structural budget, revenues or expenditures, react to cyclical developments, in which way, and for which reasons. As will appear clear in the following analysis (Chapter 4 of this part of the report) this distinction is relevant to better understand the implications of national-level rules for fiscal discipline on the output-stabilisation function of fiscal policy.

The analysis covers the period 1980-2005 and in most cases the focus will be on data for euro-area countries. This permits to concentrate the analysis on a relatively homogenous set of countries and to better compare results from those from other existing studies, that are focused on the euro area in most cases.

3.2. Defining good and bad times

3.2.1. In search of an operational definition

In spite of wide consensus in principle against a pro-cyclical stance of fiscal policy, disagreement may occur in practice among experts and policy-makers as to when exactly fiscal policy should better be tightened or loosened for stabilisation purposes.

A first key conceptual distinction is whether good and bad times are defined according to the economic cycle or rather as periods where budget balances are, respectively, better and worse than expected. In the first case, the notion of good and bad times is relevant both for the purpose of keeping a fiscal stance consistent with the stabilisation of economic activity and for ensuring the adherence of budgetary results to plans. In the second case, the notion of good and bad times is instead not necessarily strictly linked to the economic cycle. Better (worse) than expected budgetary results could be the outcome of economic activity performing above (below) expectations, but there could be other reasons. There could be unforeseen developments in interest rates that unexpectedly improve budgetary results (see Box IV.1). Alternatively, unexpected changes in the elasticity of revenues with respect to output could take place. This could happen for several reasons. First, a non-negligible share of temporary revenue fluctuations is related to property taxes likely to be affected by swings in real and financial asset prices which may not necessarily follow the same pattern as economic cycles ([1]). Second, lags in

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[1] At the end of the 1990s, the boom in equity and real estate prices increased revenues substantially in a number of developed countries (notably the US, but also several EU countries), while depressed equity markets at the end of 2001 explained, in a symmetrical fashion, part of the abrupt fall in revenues. This may lead to the occurrence of 'unexpected' budgetary changes, as discussed for instance in Jaeger and Schuknecht (2003) and Eschenbach and Schuknecht (2004).

the collection of revenues may uncouple the revenues collected and then budget balances from current output. A further reason is related to changing average tax schedules: as output grows, the link between revenues and budget balances changes since the income of households and corporations move into higher tax brackets. In the remainder of the analysis the focus will be on a definition of good and bad times related to the economic cycle. This is the definition which bears more interest from the viewpoint of the implications of fiscal policy for stabilisation purposes and is the one normally used in existing analyses. However, alternative definitions of good times based on higher than expected revenues or budget balances will also be discussed since this is the notion which is often used in the definition and implementation of national-level fiscal rules aimed at defining *ex ante* how fiscal policy should behave in good times.

The major difficulties with the identification of good and bad times are related to the inevitable uncertainty surrounding the cycle ([1]). This uncertainty has two major consequences. First, there is no trivial operational definition of good and bad times. Any operational definition needs to define an indicator (or set of indicators) and a range of values for such indicator corresponding alternatively to good and bad times. However, these are no obvious choices, in light of the fundamental uncertainty underlying the origin of the shocks to economic activity and their magnitude. The output gap is a commonly used indicator to track the cycle ([2]). However, inflation data (for instance, the difference between core inflation and trend core inflation) also enter the assessment of cyclical conditions, and additional leading indicators (e.g., industrial production, energy consumption, real estate and financial asset price indicators, confidence indicators,…) could be useful especially in the assessment of the presence of a turning point in the cycle. Second, as already pointed out in section 2 of this part of the report, there is an inherent difficulty in forecasting and tracking the cycle in real time ([3]).

The level of the output gap provides information on whether the fiscal stance is likely to reduce or exacerbate any possible deviation of output from its potential level. ([4]) The year-on-year change in the output gap is strictly correlated with the difference between actual and potential growth. It is also helpful to analyse whether economic activity is falling below trend (a downturn, characterised by a negative change in the output gap) or growing at rates above trend (an upturn: the output gap is rising). In most analyses, bad times are identified by positive values of the output gap, good times by negative output gap values. However, especially in the context of defining criteria for the conduct of fiscal policy over the cycle, characterised by well-known implementation lags, consideration could be given also to the change in the output gap.

This would help understanding whether fiscal policy would support or offset developments in economic activity already taking place due to the working of the cycle and would also facilitate early action.

Graph IV.2 helps to visualise the issue of the identification of good and bad times. The graph depicts the typical behaviour of actual and potential output over time. Potential output grows following a relatively stable trend, while actual GDP follows a more erratic growth path, broadly centred around that of potential output. Four zones can be identified, depending on whether output is above or below potential and whether it is growing above of below trend. In a first zone (zone A), the output gap is negative and falling; in zone B actual growth is higher than potential (the output gap is improving), but the level of the output gap is still negative; in zone C, output is above potential and the economy is experiencing an upturn; finally, in zone D, actual growth is below potential, with an output gap that is still positive.

In most analyses, good (bad) times correspond to periods of positive (negative) output gap, thus being identified

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([1]) There is consensus among economists that economic fluctuations have not a deterministic nature but are rather the result of disturbances of various types and size occurring randomly and causing smooth movements in economic activity. New classical economists put emphasis on 'real business cycles' where economic disturbances generate on the supply side of the economy and do not need price rigidities for their propagation, while economists in the Keynesian tradition emphasize demand shocks and the role of nominal and real rigidities (see, e.g., Romer (2001)).

([2]) Strictly speaking, the cycle measured by deviations of actual from potential output is defined as 'growth cycle' or 'deviation cycle', which differs from the 'classical cycle' where measurement is made directly on GDP series (see, e.g., Artis, Marcellino, and Proietti (2004)).

([3]) In EU budgetary surveillance, there is not a strict operational interpretation of good and bad times. However, there are some guidelines outlined in the 'Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes' (see Resource Section in this report). The document specifies that '…good times should be identified as periods where output exceeds its potential level, taking into account tax elastictities.' Moreover, '…the change in the output gap could also be considered, especially when the output gap is estimated to be close to zero…The identification of periods of…good times should be made after an overall economic assessment'.

([4]) In the chapter the terms potential output or trend output are used interchangeably, irrespective of the specific computation method used.

Graph IV.2: **Distinguishing phases of the economic cycle on the basis of output gap changes and levels**
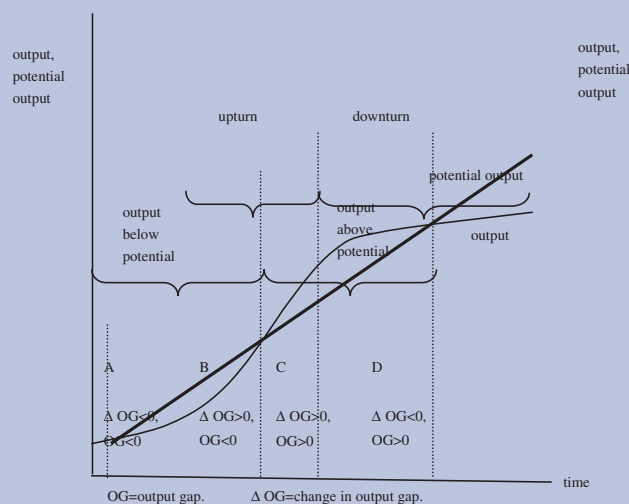
by zones C and D (A and B) in Graph IV.2 ([1]). An alternative could be to identify good times as periods in which the output gap is both positive and rising (area C) and, symmetrically, bad times as periods with negative and falling output gaps (area A). A definition of this type would be more restrictive but would permit to isolate episodes less subject to be followed by a change in the output gap sign: a relevant feature in light of the implementation lags characterising fiscal policy. Finally, in order to reduce the possibility of wrong real-time assessment of the sign of the output gap a definition of good and bad times could use a different benchmark, by considering for instance good times all periods characterised by positive and sufficiently big output gaps.

3.2.2. Measurement errors

Available studies conclude that revisions between real-time and ex-post output gaps can be substantial and impact therefore policy choices aimed at containing the amplitude of cyclical fluctuations (see section 2).

Table IV.2. Errors in assessing output gaps exante. Absolute value of differences between ex-ante and ex-post output gaps. EU-11, 1995-2003 reports information on the real-time errors in measuring output gaps in EU countries in the past decade obtained from Forni and Momigliano (2004) ([2]). The table shows that the mean absolute real-time measurement error was bigger for out-

put gap *levels* than for output gap *changes*. This is a regular feature observed also in other contexts ([3]). The real-time measurement error in case of output gap levels can be quite sizable: 1.4 percentage points of GDP on average, with 10 percent of cases in the sample with errors above 2.6. The magnitude of these errors is better understood when compared with statistics on the output gap series. The average ex-post output gap in the sample was equal to 0.07, with 80 percent of the values comprised between -2 and 2.3. Figures for one-year-ahead forecast errors are very close to those for real-time errors ([4]).

Information on real-time errors suggests that output gap measurement issues could be relevant but does not permit to assess whether real-time estimates or forecasts had any particular bias or whether measurement errors translated into a wrong assessment of the sign of the output gap.

To provide an answer to these questions Table IV.3. displays the frequency with which the sign of the output gap (in level and change) was wrongly assessed, distinguishing between cases where the output gap was estimated in real time (or forecast) to be positive or negative. While a wrong sign assessment for the output gap level was quite rare in case of positive real-time or forecast output gap, is was frequent in the case of negative real-time output gaps (in 1/3 of the cases the assessment of the sign results to be mistaken in the light of *ex post* revisions). In

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([1]) However, in the literature both levels and changes are found to assess budgetary behaviour over the cycle. A pioneer use of levels when assessing budgetary behaviours is found in Buti and Sapir (1998). A relevant example of using output gap changes is Fatas et al. (2003).

([2]) The Forni and Momigliano (2004) dataset on real-time output gaps is one of the most comprehensive for the EU. It covers the 1995-2003 period and the original source is OECD. Lorenzo Forni and Sandro Momigliano have kindly supplied their data for the analysis in this report and have given useful comments and suggestions. Their contribution is gratefully acknowledged.

([3]) To a very close approximation, the change in the output gap is equal to the difference between actual and potential growth. It is well known that, irrespective of the method used for computing potential output, there is less uncertainty on potential output growth rates than on levels.

([4]) Forni and Momigliano contains information also on on-year-ahead forecast output gaps. Forecast output gaps appear to be highly correlated to real-time output gaps (correlation coefficient 0.8). The size and distribution of forecast errors is thus similar to that of real-time errors.

called end point problem) and then to underestimate the output gap. It is important however to bear in mind that the real time short series is relatively short, and that the results are strongly influenced by the particular cyclical situation in Europe observed during the sample period. The number of cases in which output gaps were estimated to be positive is much smaller than those in which the output gap was negative. Part of the GDP forecasts included in the sample appears as optimistic due to the difficulty in predicting the turning point in 2001.

Table IV.2

Errors in assessing output gaps ex-ante. Absolute value of differences between ex-ante and ex-post output gaps. EU-11, 1995-2003

	Absolute value of errors from real time estimation	
	Output gap level	**Output gap year on year change**
Average	1.4	0.8
10 % percentile	0.3	0.1
Median	1.3	0.6
90 % percentile	2.6	1.9
Standard deviation	0.9	0.9

Source: AMECO database and Forni and Momigliano (2005).

This downward bias is not evident instead for what concerns the real-time measurement of output gap changes. Moreover, the overall frequency of cases in which the assessment of the sign of the change in the output gap resulted mistaken is lower compared with output gap in levels.

As pointed out previously, an operational definition of good and bad times could adopt a more stringent benchmark to reduce the possibility of wrong real-time assessment of the sign of the output gap. Good times could be identified by a sufficiently positive output gap; bad times by a sufficiently negative output gap. On the basis of past values of *ex post* and real-time output gap estimations, Table IV.4. permits to assess to what extent this could actually reduce the probability of wrong measurement of the output gap sign. Overall, there is an indication that a wrong assessment of the sign of the output gap due to real-time errors is less frequent the further away from zero is the estimate of the output gap. Of course, the choice of a more stringent benchmark value for the output gap for the identification of good and bad times implies a risk of restricting the attention especially to periods close to a turning point in the cycle. For instance, a very negative value for the output gap is likely to be observed when the cycle is close to its trough, and to be followed by growth above trend. In light of the long fiscal policy implementation lags, a loosening of the fiscal stance when the cycle is close to its peak may translate into a pro-cyclical expansion when the output gap turns positive again. To avoid this issue, data on output gap changes need to be evaluated in conjunction with output gap levels.

Table IV.3

Frequency of wrong ex-ante assessment of output gap sign. EU-11, 1995-2003

	Output gap level	**Output gap year on year change**
Number of cases	99	99
Number of errors when the real time estimation was positive	3	12
Number of errors when the real time estimation was negative	30	13
N errors	33	25
Frequency of errors	0.33	0.25

Source: AMECO database and Forni and Momigliano (2005).

3.3. The fiscal policy stance in good and bad times: a close look at the EU

The aim in this section is to analyse how the fiscal stance in EU countries related to the cycle in the past decades. Compared with existing work, the analysis aims at tak-

other terms, sample data suggests that in the past decade a wrong assessment of good times was less frequent than a wrong assessment of bad times. These findings are to some extent the consequence of upward biased GDP forecasts in several EU countries in the past decade ([1]). Optimistic growth forecasts indeed tend to inflate the real-time estimation of potential output (due to the so-

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[1] See, e.g., Strauch, M. Hallerberg and J. von Hagen (2004), Larch and Salto (2005), Moulin and Wierts (2006). On the track record of Commission GDP forecast in the 1990s see Keereman (1999).

Table IV.4

Probability of a wrong real-time assessment of the output gap sign

Positive real-time output gap

Real-time output gap value	Probability of error (%)
>0.5	2.0
>1	1.0
>1.5	0.0
>2	0.0

Negative real-time output gap

Real-time output gap value	Probability of error (%)
<-0.5	21.2
<-1	14.1
<-1.5	9.0
<-2	4.0

Source: AMECO database and Forni and Momigliano (2005)

ing a step forward in several respects. First, alternative definitions of good and bad times will be considered. Following the discussion in the previous section, the baseline definition of good and bad times based on output being above or below potential will be complemented with an alternative definition based on the change in the output gap (downturns vs. upturns). Moreover, the analysis will focus on the behaviour of year-on-year changes in the cyclically-adjusted primary balance (CAPB) as a measure of the fiscal stance, but there will also be a separate analysis on cyclically adjusted revenues and cyclically-adjusted primary expenditures. Finally, it will be analysed whether the difference between the *ex ante* and *ex post* estimation of output gaps associated with real-time measurement errors matters for the behaviour of the fiscal stance over the cycle.

The analysis will mainly focus on euro-area countries (except Luxemburg) over the 1980-2005 period [1]. This set of countries will be referred to, interchangeably as EU-11 or euro area in the remainder of the analysis. This data set permits to observe relatively homogenous countries over a representative time period. The source of

public finance and output gap data is the AMECO dataset of the European Commission DG ECFIN. Only public finance data complied according the ESA95 accounting standard are considered [2]. The output gap data are based on the European Commission production function methodology (see Denis et al. (2002)).

3.3.1. Basic evidence

A pro-cyclical (counter-cyclical) fiscal stance in good times would be characterised by a reduction (increase) in the CAPB, interpreted as a measure of the discretionary fiscal loosening (tightenining). Each point in Graph IV.4 represents the situation of a particular country in a particular year in the CAPB change/output gap space. Observations falling in the top-right and in the bottom-left quadrant are interpreted as cases of counter-cyclical policy; in the top-left quadrant are found pro-cyclical episodes in bad times while cases of pro-cyclical policy in good times are in the bottom-right quadrant. The graph shows that the frequency of pro-cyclical episodes does not seem to be very different from that of counter-cyclical ones. There is neither a very evident difference between the frequency of pro-cyclical episodes in good and bad times. The regression line fitting the cloud of points in Graph IV.4, does not exhibit a high explanatory power, as evidenced by the value of the R square statistics. The linear coefficient linking the change in the CAPB with the output gap represents the response of the fiscal stance to the cycle [3]. The estimated response appears to be on average negative but weakly so. This somehow contrasts with the more clear-cut evidence of pro-cyclicality emerging from *aggregate* euro-area data, reported in Graph IV.1, the explanation being that big euro-area countries run in general a more pro-cyclical fiscal stance during the past decade. Overall, this prima-facie evidence confirms the findings presented in most existing analyses: although there is an overall indication of pro-cyclicality, the relation between measures of the fiscal stance and the output gap is not a strong one.

Synthetic information on the relation between the fiscal stance and cyclical conditions can be obtained by comparing the average change in the CAPB across the sample when the output gap is negative and when it is positive Graph IV.5 performs this comparison for a sample

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[1] The exclusion of Luxemburg is due to shorter available output gap time series. For this country there is also lack of data on trade weights necessary to construct the measure for the representative foreign output gap used to instrument the output gap variable in the econometric estimation of fiscal reaction functions.

[2] This reduces to some extent the length of the time series for some countries (Greece, Spain, Ireland) for which data for the early 1980s are available only in ESA79 accounting standards.

[3] Strictly-speaking, the variation in the y-o-y change in the CAPB associated with a unit change in the output gap.

Box IV.1: **Interest rate developments and the fiscal stance. Are 'interest rate good times' coming to an end?**

This box discusses the relation between the fiscal stance in EU countries since the early 1990s and an alternative definition of good times, i.e., one defined in terms of the occurrence of budgetary windfalls associated with interest rate reductions. Overall, the reduction in interest expenditure that took place in the past decade as a result of a prolonged and continuous decline in nominal interest rates facilitated fiscal adjustment in most Member States. However, the relation between reduction in interest expenditure and the stance of fiscal policy in EU countries was considerably different before and after the completion of EMU.

(i) 1992-1998: Using 'good times' to speed up deficit reduction

During the period between the signing of the Maastricht Treaty and the completion of EMU, most EU countries embarked into a process of consolidation of their public finances. In Italy and Portugal, almost 5 percentage points of the improvement in nominal balances (and cyclically adjusted balances) was due to the reduction in interest rate expenditure to GDP ratio. Ireland and Belgium also benefited considerably from lower interest rate expenditure in that period. In all countries (except Portugal and Austria), the decline in interest rate expenditure was compounded with an improvement in the cyclically adjusted primary balances, leading to a rapid improvement in the nominal budget balances. The lack of a strong correlation between savings on interest expenditure and changes in the CAPB in the run-up to EMU (Graph IV.3) (a) can be interpreted as an indication that the fiscal challenge to meet the Maastricht criteria provided incentives to fully use the windfall expenditure savings related to the reduction in interest expenditures to speed up deficit reduction. There was no systematic redirection of savings in interest expenditure to other expenditure categories or tax reductions.

Graph IV.3: **Correlation interest expenditure ratio and CAPBs**

$$y = 0.8577x - 0.4884$$
$$R^2 = 0.243$$

Change in interest expenditure to GDP

(a) 1992-1998 (b) 1999-2005
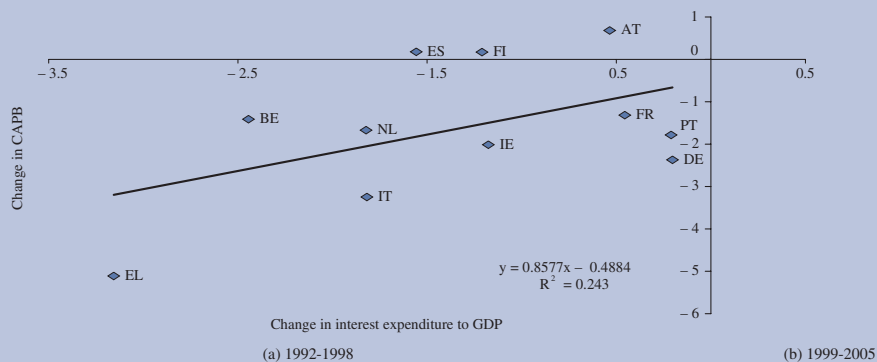
NB: Excluding Luxemburg and Spain (data deficiency)
Source: Commission services.

(ii) 1999-2005: Dissipating interest rate windfalls

During the period 1999-2005 the consolidation process stopped and budgetary developments took an opposite direction: deteriorations in the CAPB were widespread. Graph IV.3 (b) shows that the deterioration in CAPBs were larger in countries which saved more on interest expenditures. This suggests that in this period interest windfalls were not used to speed up the adjustment towards safe medium-term budgetary positions but were rather spent or translated into tax cuts.

Some policy lessons

The improvement of deficit positions in most EU countries in the past decade does not always closely reflect the effort of fiscal authorities. While during the run-up to EMU 'interest rate good times' were used to speed up the consolidation process, after 1998 the budgetary windfall arising from falling interest expenditures was spent or used to finance tax cuts. In perspective, increased focus on the development of the CAPB in addition to the CAB and nominal budget balances could improve the assessment of fiscal consolidation efforts and its effect on debt dynamics.

After an almost uninterrupted 15-year period, the good times in terms of declining interest rates on government debt seem to be over. This implies that a given improvement in structural budgetary positions will on average require a stronger effort in the future compared with the past decade. Some reversal of past interest rate developments would be a challenge for fiscal consolidation and would put upward pressure on debt/GDP ratios if it were not matched by improving primary balances.

Graph IV.4: **Fiscal stance and output gap. A basic scatterplot (EU-11, 1980-2005)**
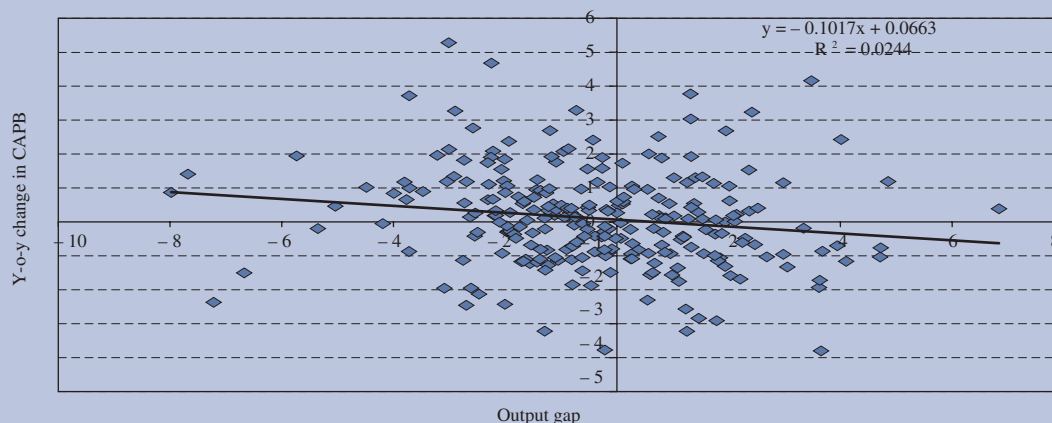
with all EU-25 countries, euro-area countries only, and EU-10 countries only. The graph indicates on average a slight relaxation of the fiscal stance in good times and a tightening in bad times for the EU-25 sample, an indication of pro-cyclical behaviour both in periods when output is above and below potential. An analogous and more clear-cut picture emerges for euro-area countries, while for the EU-10 (i.e., the Member States of recent accession), the stance appears to be on average expansionary, especially in bad times ([1]).

This evidence seems to suggest that the pattern observed for euro-area countries is not exactly the same as that in New Member States. However, such conclusion needs to be qualified in several respects. First, the comparison is not fully homogenous, being the available sample of data on output gaps and cyclically-adjusted budgetary figures for EU-10 countries much shorter (the most recent information on these variables is for 1995). Second, the analysis does not permit to distinguish whether the the average change in the CAPB is due to isolated episodes of very big expansions or contractions or whether instead it is the result of recurrent behaviour. In order to disentangle these two aspects, Graph IV.6 reports the frequency of cases of pro and counter-cyclical fiscal policy in good and bad times for the same country sample as in Graph IV.5. The graph shows that in general the frequency of pro and counter-cyclical episodes is roughly

equal for EU-25 and EU-10, but confirms the result that in the euro area there was a prevalence of pro-cyclical policies in recent decades (see survey of previous findings in section 2). Indications of pro-cyclical behaviour both in good and bad times on average for euro-area countries are also found by defining good and bad times in terms of upturns and downturns, i.e., periods where the output gap improves or worsens (see Graph IV.10 below).

A different question is whether the behaviour of fiscal authorities in euro-area countries was broadly the same over the years or whether there were evident changes. With a view to address this question Graph IV.7 and Graph IV.8 repeat the same type of analysis as in Graph IV.5 and Graph IV.6 but distinguishing this time the euro-area sample in different sub-periods.

The sub-periods have been chosen in such a way to reflect the main developments in the EU fiscal framework. The first sub-period (1980-1991) includes the years preceding the Maastricht Treaty. The second sub-period (1992-1998) corresponds with the run-up to EMU.

Finally, the third sub-period includes the years following the introduction of the euro and the SGP (1999-2005).

The data reveal that over time there has been a substantial change in the stance taken by fiscal authorities. The 1980s were years in which most countries inverted the tendency for budget deficits to grow started in the 1970s and where several countries undertook ambitious

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[1] This evidence contrasts somehow that provided in Coricelli and Ercolani (2002), which covers a subset of CEEC countries over the 1991-2000 period and used a different methodology for correcting budget balances for the cycle.

Graph IV.5: **Fiscal stance in good and bad times (EU-25, EU-11, EU-10, 1980-2005)**
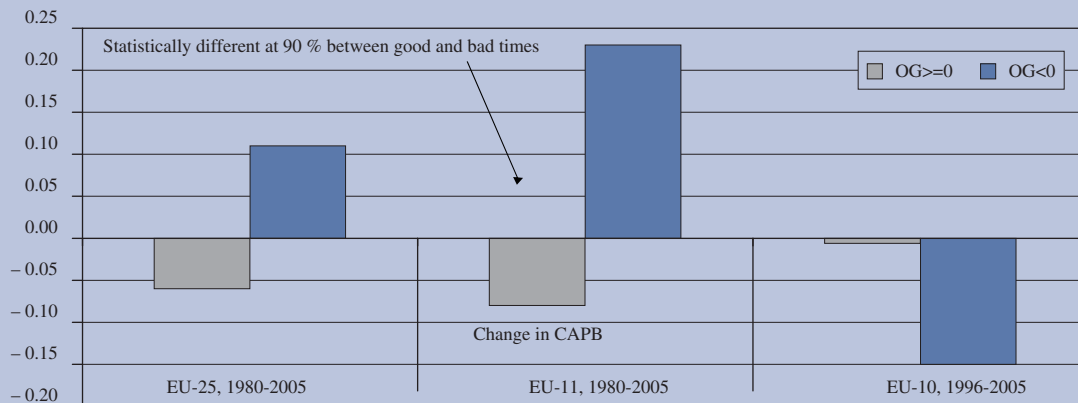
Graph IV.6: **Frequency of episodes of pro- and counter-cyclical in good and bad times (EU-25, EU-11, EU-10)**
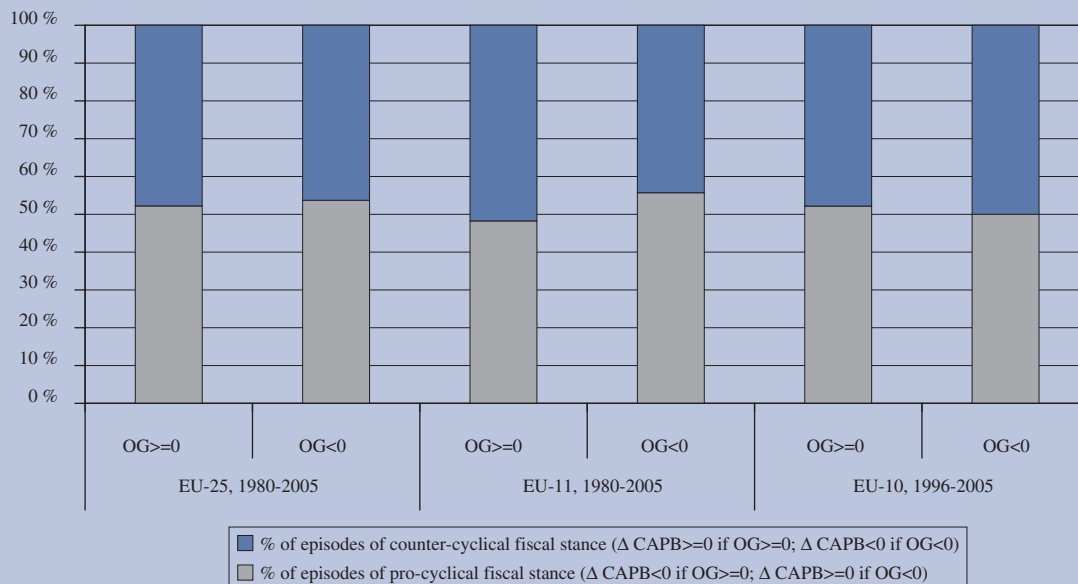
consolidation programmes to stabilise debt. This translated into a seemingly a-cyclical stance in good times and into apparently frequent cases of pro-cyclical fiscal policy in bad times. The run-up to EMU coincided with a tight fiscal stance irrespective of the cyclical position, so that pro-cyclicality concerned mostly bad times. A different picture emerges after the introduction of the euro. These years are characterised by a generalised loosening of the fiscal stance with the result that pro-cyclical behaviour seems to pertain mostly to good times, as evidenced in previous analyses ([1]).

([1]) E.g., IMF (2004).

Graph IV.7: **Fiscal stance in good and bad times (EU-11, 1980-2005, different sub-periods)**
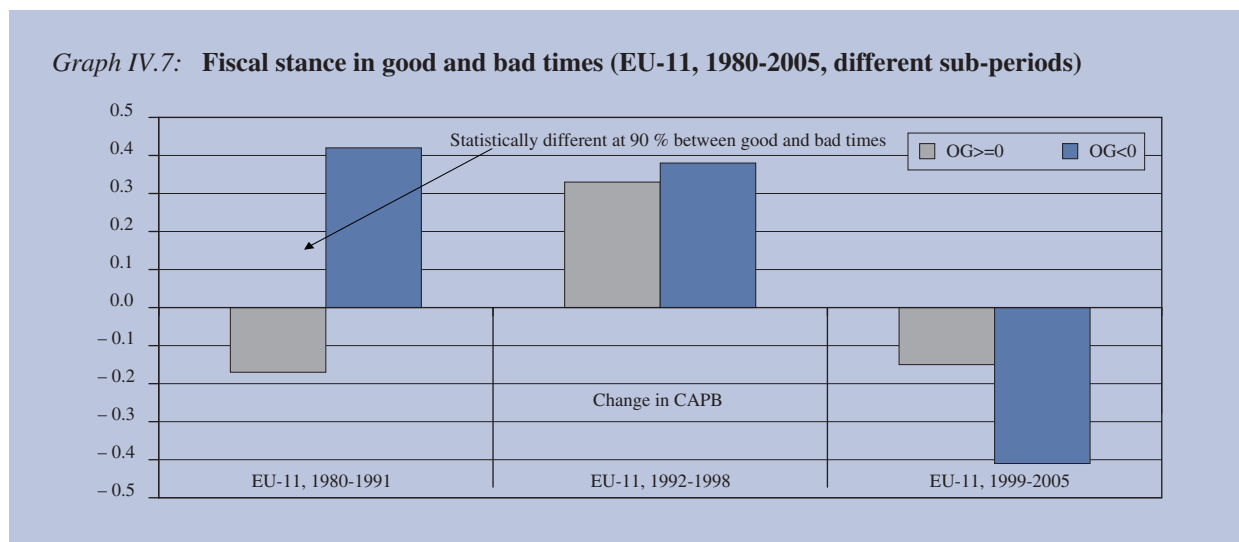
3.3.2. The cyclical behaviour of revenues and expenditures

To what extent were the episodes of pro-cyclical fiscal policy related to the behaviour of revenues and to what extent were they instead caused by expenditures? Graph IV.9 displays separately the average change in cyclically adjusted revenues and in primary cyclically-adjusted expenditures when output was alternatively positive or negative [1]. The Graph shows that while expenditures were strongly raised in good times and reduced in bad times (thus behaving pro-cyclically both in good and bad times), the behaviour of revenues was not significantly different in periods of positive or negative output gaps.

Interesting information can be obtained by comparing the dynamics of revenues and expenditures using the change in the output gap as an alternative criterion to identify good (upturn) and bad times (downturn). From Graph IV.10 it appears that the CAPB deteriorates on average during upturns and improve in downturns: indications of pro-cyclical behaviour are confirmed also using this alternative notion of good and bad times.

Conversely, results appear radically different using this notion of good and bad times for revenues and expenditures. In this case, the behaviour of expenditures seems almost unaffected by whether the economy is in an

upturn or in a downturn, while revenues generally fall slightly in upturns and rise strongly in downturns.

A better understanding of the previous results requires controlling for the main factors that could have affected the fiscal stance. Without controlling for other factors, the change in the CAPB provides a description of the fiscal stance, but is not sufficient to infer conclusions on which reasons underlie the observed behaviour of fiscal policy.

In such an attempt, the econometric estimation of fiscal reaction functions is helpful in isolating the impact of factors that have normally an influence on the stance of fiscal policy. Estimating separately fiscal reaction in periods of good and bad times permits to evaluate how these factors played differently over the cycle.

Table IV.5 (a) presents the results from the estimation of fiscal reaction functions distinguishing good and bad times defined, alternatively, as periods of output above or below potential or periods exhibiting a rising or falling output gap (growth above or below trend). The sample is EU-11 over the 1980-2005 period. The dependent variable is the year-on-year change in the CAPB [2].

The explanatory variables are the lagged CAPB, the lagged debt, the output gap, and two dummy variables, taking value 1, respectively, after 1992 and after 1999. The CAPB and the debt level capture the fiscal stabilisa-

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[1] Although a higher number of observations are available for revenues than for CAPBs and expenditures (due to missing observations on interest expenditures), the sample underlying the analysis presented in Graphs IV.8 and IV.9 keeps the same sample in case of CAPBs revenues and expenditures to improve comparability.

[2] In analogy, for instance, with Forni and Momigliano (2004).

Graph IV.8: **Frequency of episodes of pro- and counter-cyclical in good and bad times (EU-11, 1980-2005)**
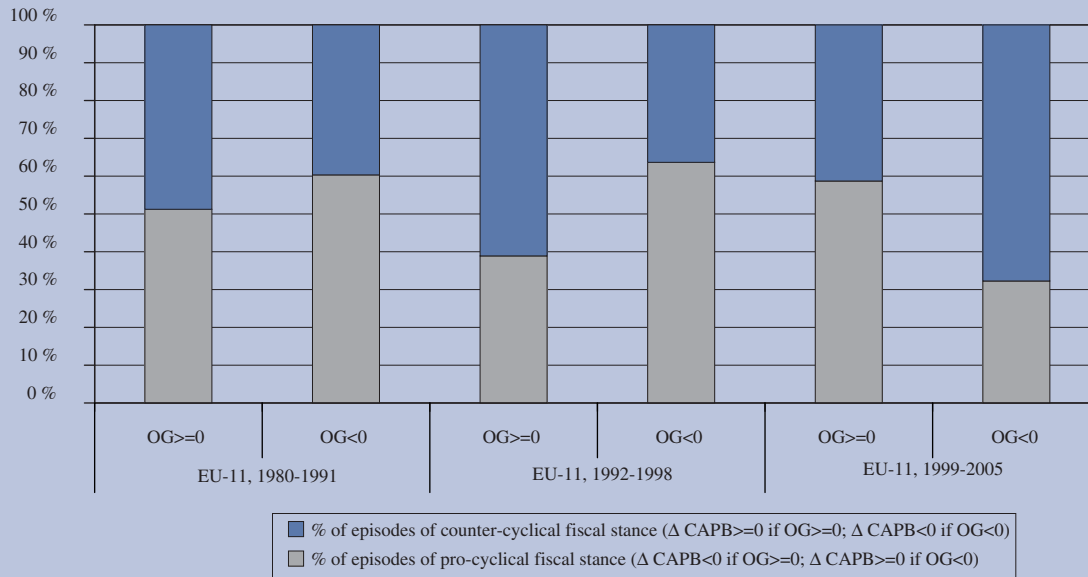
Graph IV.9: **Change in the primary cyclically-adjusted budget balances and its components in good and bad times (EU-11, 1980-2005)**
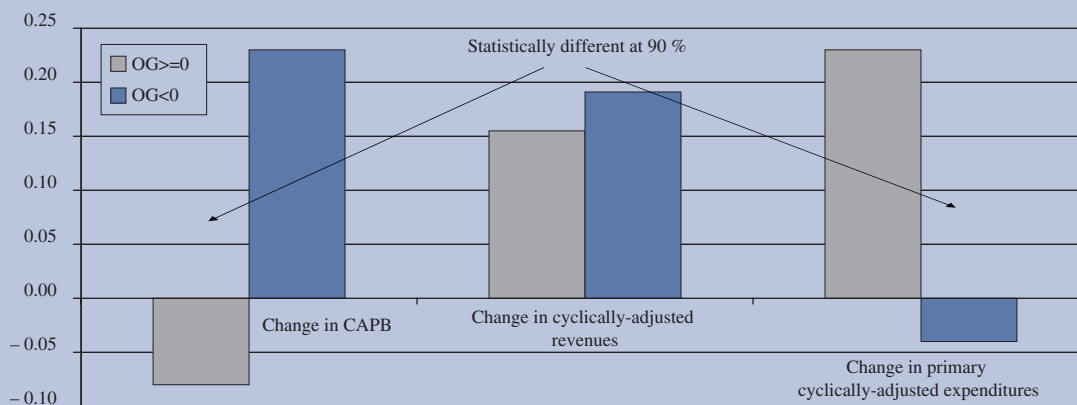
tion motive of fiscal authorities. The improvement in the CAPB is expected to be stronger the lower the starting level of the CAPB and the higher the debt (negative and positive expected sign expected, respectively, for these two variables). The output gap captures the output stabilisation motive. If fiscal authorities aim at stabilising economic activity, a rising output gap is expected to trigger a tightening in the fiscal stance (positive expected

sign) [1]. Finally, the two dummy variables are aimed at capturing possible behavioural changes occurred in correspondence with, respectively, the signing of the Maas-

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[1] To address the endogeneity problem, the output gap variable has been instrumented with its own lag and the lag of a measure of foreign output gap constructed, for each country, on the basis of export shares towards the biggest three export markets.

Graph IV.10: **Change in the primary cyclically-adjusted budget balances and its components in upturns and downturns (EU-11, 1980-2005)**
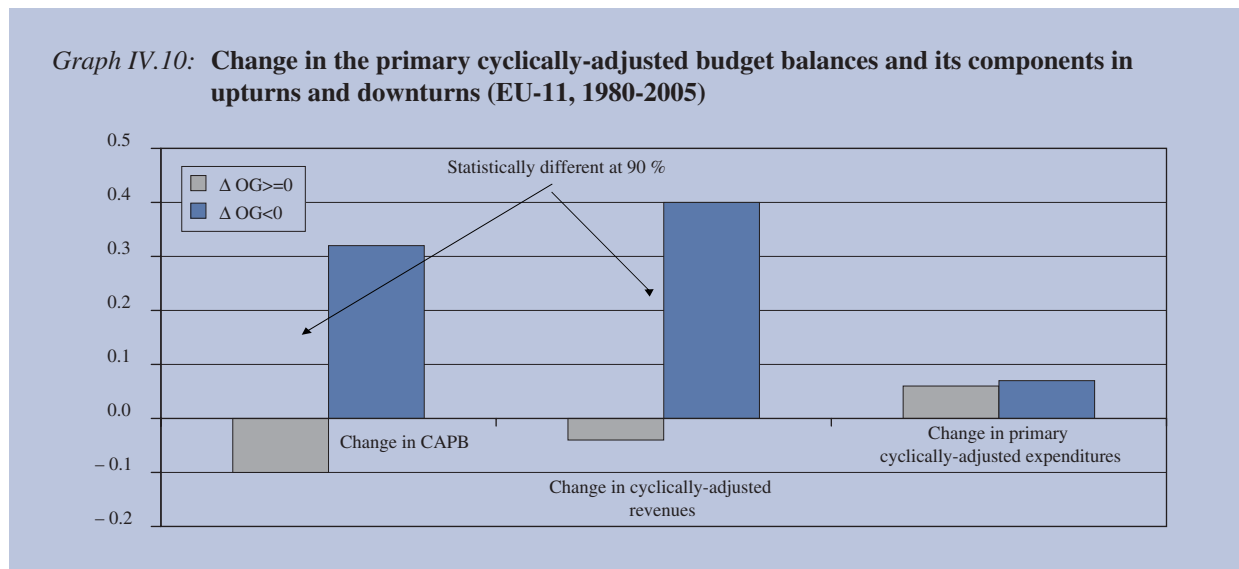
tricht Treaty (1992) and the completion of the EMU project (1999). The constant term captures the portion of the fiscal stance not explained by the chosen explanatory variables. By performing separate regressions for bad and good times, looking at the constant coefficient permits to test for a pro-cyclical bias in good times. *A procyclical bias would be reflected into a smaller constant term in good times* in the regressions for the change in the CAPB and the change in non-cyclical revenues, while a pro-cyclical bias acting on the expenditure side would translate into a higher coefficient in good times.

Results show that the coefficients of CAPB and debt levels have the expected sign, are significant, and have about the same value in good and bad times, however measured (Table IV.5 (a)). The coefficient for the output gap is not significantly different from zero, and has roughly the same value irrespective of cyclical conditions (good or bad times). Looking at the constant term, *there is evidence of a pro-cyclical bias in good times.* The estimated constant term in the equation indicates, ceteris paribus, a looser fiscal stance in good times. This difference is large and statistically significant when the good times are measured in terms of the level of the output gap, but the same qualitative results are obtained by measuring good times in terms of an upturn in economic activity. Overall, the prima-facie evidence emerging from Graph IV.9 and Graph IV.10 is confirmed.

Table IV.5 (b) repeats the same exercise using cyclically-adjusted revenues as dependent variable. The explanatory

variables are the same as those used for the CAPB, with the exception that the starting level of the CAPB is replaced by that of revenues. This variable captures the objective of restructuring the revenue side of the budget: revenues are more likely to be cut (increased) the higher (lower) the starting revenue/GDP ratio. Results indicate that this coefficient was more strongly negative in good times, meaning that during periods of output above potential or upturns revenue restructuring was stronger. Looking at the constant term of the regressions, there are no strong signs of pro-cyclical bias. (^{1})

The analysis on expenditures is reported in Table IV.5 (c). There is evidence that structural measures on the expenditure side were mainly taken during good times, as evidenced by a larger negative coefficient for the expenditure and the debt variables. It was during good times that expenditure cuts with the aim of containing the growth of the public sector and stabilising the debt took place more intensely. The constant terms gives a clear indication of pro-cyclical bias. So, *also controlling for the main determinants of expenditure policy there is evidence that expenditure growth is stronger in good times.* Among the possible explanations, as discussed previously, there could be the strong pressures to spend the budgetary windfall gains accruing in good times.

(^{1}) This contrasts somehow with the descriptive prima-facie evidence in Graph IV.10. The results from the estimation of the fiscal reaction function suggest that the fact that revenues grow slower in upturns is probably not related to a pro-cyclical bias but rather to the fact that during upturns took place more intensively tax cuts aimed at reducing the tax burden.

Table IV.5

The fiscal stance over the cycle: evidence from the estimation of fiscal reaction functions:
(a) Cyclically-adjusted primary balance, (b) Cyclically-adjusted revenues, (c) Cyclically-adjusted primary
expenditures, (EU-11, 1980-2005)

Explanatory variables	Output below potential (OG<0) (1)	Output above potential (OG>=0) (2)	Downturn (ΔOG<0) (3)	Upturn (ΔOG>=0) (4)
(a) Dependent variable: Δ primary CAB				
Constant	**− 0.356**	**− 2.869*****	− 0.811	− 1.427**
	(0.59)	(0.81)	(0.52)	(0.60)
Lagged CAPB	− 0.300***	− 0.376***	− 0.277***	− 0.234***
	(0.05)	(0.07)	(0.06)	(0.05)
Lagged debt/GDP ratio	0.023**	0.037***	0.027**	0.024***
	(0.009)	(0.01)	(0.009)	(0.009)
Output gap	0.115	0.241	− 0.065	− 0.010
	(0.13)	(0.21)	(0.07)	(0.06)
Dummy 1992	**− 0.148**	**0.992****	− 0.137	0.263
	(0.30)	(0.44)	(0.37)	(0.30)
Dummy 1999	− 0.698**	− 0.454	− 0.523	− 0.287
	(0.32)	(0.41)	(0.34)	(0.33)
N. obs.	149	102	122	129
R sq. within	0.24	0.21	0.25	0.16
R sq. between	0.48	0.01	0.68	0.06
R sq. overall	0.19	0.06	0.21	0.05
(b) Dependent variable: Δ cyclically-adjusted revenues				
Constant	6.03***	4.876**	4.232**	6.395***
	(1.47)	(2.06)	(1.36)	(1.68)
Lagged cyclically-adjusted revenues	− 0.116***	− 0.144**	− 0.079**	− 0.174***
	(0.03)	(0.05)	(0.03)	(0.04)
Lagged debt/GDP ratio	0.001	0.008	0.003	0.019**
	(0.008)	(0.01)	(0.007)	(0.009)
Output gap	0.260**	0.515**	0.136**	0.033
	(0.11)	(0.20)	(0.05)	(0.05)
Dummy 1992	**− 0.121**	0.652	− 0.107	0.059
	(0.25)	(0.40)	(0.26)	(0.25)
Dummy 1999	− 0.516	− 0.463	**− 0.900*****	**0.106**
	(0.28)	(0.378)	(0.25)	(0.28)
N. obs.	149	102	122	129
R sq. within	0.07	0.003	0.25	0.12
R sq. between	0.00	0.12	0.23	0.005
R sq. overall	0.05	0.07	0.21	0.02
(c) Dependent variable: Δ cyclically-adjusted primary expenditure				
Constant	**2.805****	**6.517*****	**2.446***	**5.064*****
	(1.28)	(1.72)	(1.42)	(1.47)
Lagged cyclically-adjusted primary expenditures	− 0.033	− 0.128***	**− 0.027**	**− 0.102*****
	(0.03)	(0.04)	(0.03)	(0.03)
Lagged debt/GDP ratio	− 0.019**	− 0.016**	− 0.016**	− 0.008
	(0.008)	(0.007)	(0.007)	(0.008)
Output gap	0.136	0.197	**0.198*****	**0.052**
	(0.11)	(0.168)	(0.05)	(0.05)
Dummy 1992	0.135	− 0.197	0.231	− 0.149
	(0.25)	(0.33)	(0.29)	(0.25)
Dummy 1999	0.267	0.116	− 0.283	0.383
	(0.269)	(0.31)	(0.27)	(0.27)
N. obs.	149	102	122	129
R sq. within	0.12	0.27	0.14	0.15
R sq. between	0.009	0.04	0.03	0.08
R sq. overall	0.07	0.12	0.07	0.13

NB: Estimations method: fixed effects, instrumental variables regression. The output gap is instrumented with its own lag and a lagged indicator of foreign output gap. The foreign output gap indicator is the export-weighted output gap of the 3 major export markets of each country. All fiscal variables are expressed as shares on potential output. Coefficient standard errors are reported in parentheses. *, **, and *** denote, respectively, significance at the 10, 5 and 1 percent level. Coefficients in bold are statistically different between good and bad times at the 10 percent level. Coefficients for country fixed effects are not reported.

Source: Elaborations on data contained in DG ECFIN AMECO database.

A further reason could be identification and implementation lags in expenditure. Expenditures are planned on the basis of the expected growth of GDP. Since GDP forecasts are to some extent affected by past GDP growth developments, the share of expenditure on GDP is likely to be higher when the output gap is positive (i.e., after periods of growth above trend) ([1]). Finally, there could be errors in estimating output gaps in real time, an issue that is investigated in the following section.

3.3.3. Ex-ante vs. ex-post assessment of the cycle

As discussed in section 2, an explanation for the observed pro-cyclical behaviour of fiscal authorities could be errors in measuring the cycle. According to this explanation pro-cyclical policies could occur for the simple fact that fiscal authorities are giving a mistaken reading the current cyclical conditions. An attempt to analyse to what extent pro-cyclical policies could be attributed to real-time measurement errors is made in Graph IV.11 and Graph IV.12. The first graph presents the average change in CAPBs, cyclically adjusted revenues and primary cyclically-adjusted expenditures when output was above or below potential using both *ex post* and real time data ([2]). The graph shows that, according to a real-time assessment of the cycle, the average fiscal

stance was more pro-cyclical in good times compared with that assessed using *ex post* data, while the opposite was true in bad times. The result is mostly explained by the behaviour of revenues: revenues fall much more in real-time good times than in *ex post* good times, while they grow less in real-time bad times.

Graph IV.12 reports the frequency of cases of pro-cyclical and counter-cyclical policies with output gaps estimated both ex-post and in real time. Consistently with the evidence presented in Graph IV.11, using real-time data pro-cyclical policies were slightly more frequent in good times and clearly less frequent in bad times ([3]).

In summary, the evidence seems to suggest that measurement errors could be an explanation to some unintentional pro-cyclical episodes that took place in bad times, while this does not seem to be the case for pro-cyclical behaviour in good times.

Although these results need to be interpreted with care, given the relatively short sample of real-time output gaps, several interesting questions emerge.

First, the results seem to indicate that a correct understanding of the current cyclical conditions do not necessarily make pro-cyclical revenue policies less likely.

([1]) The evidence reported in Strauch et al. (2004) on the recent EU experience seems consistent. GDP and budgetary forecasts reported in stability and convergence programmes tended to be more optimistic the higher the output gap at the time of forecast.

([2]) The sample on real-time output gap estimates is the one in Forni and Momigliano (2004). The sample underlying the analysis in Graph IV.11and IV.12 includes EU-11 countries over the period 1995-2003 both in case of ex-post and real time output gap estimates to permit comparability.

([3]) Overall, this result confirms the findings in Forni and Momigliano (2004) who estimate the reaction of the fiscal stance to the output gap controlling for other factors through the econometric estimation of fiscal reaction functions.

Graph IV.11: **Fiscal stance and the cycle measured ex-post and in real time (EU-11, 1995-2003)**
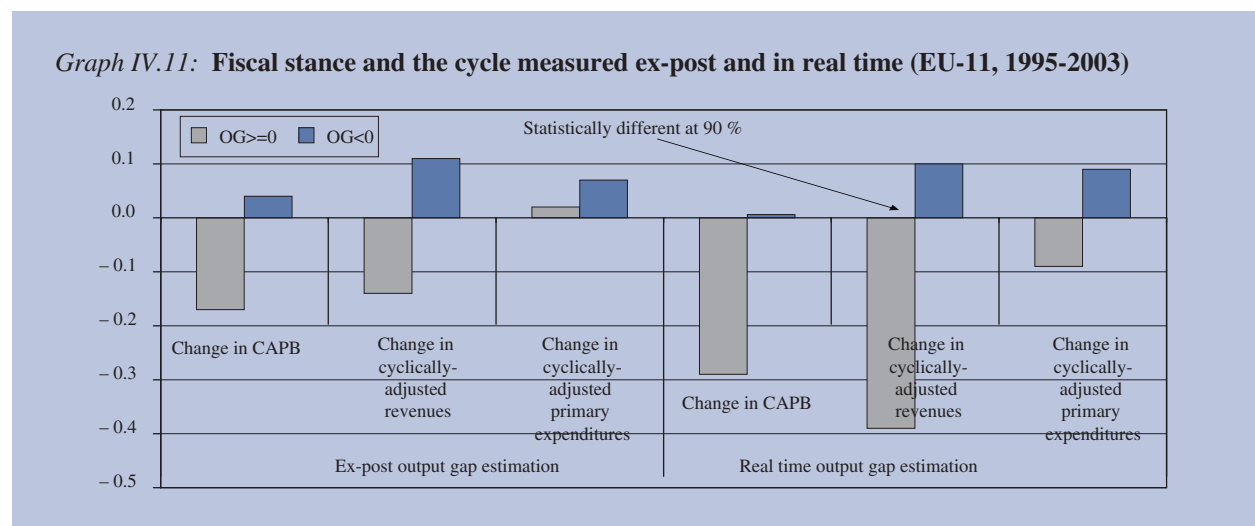
Graph IV.12: **Frequency of episodes of pro- and counter-cyclical behaviour of fiscal policy.**
Real-time and ex-post output gap estimation (22 EU countries, 1990-2005)
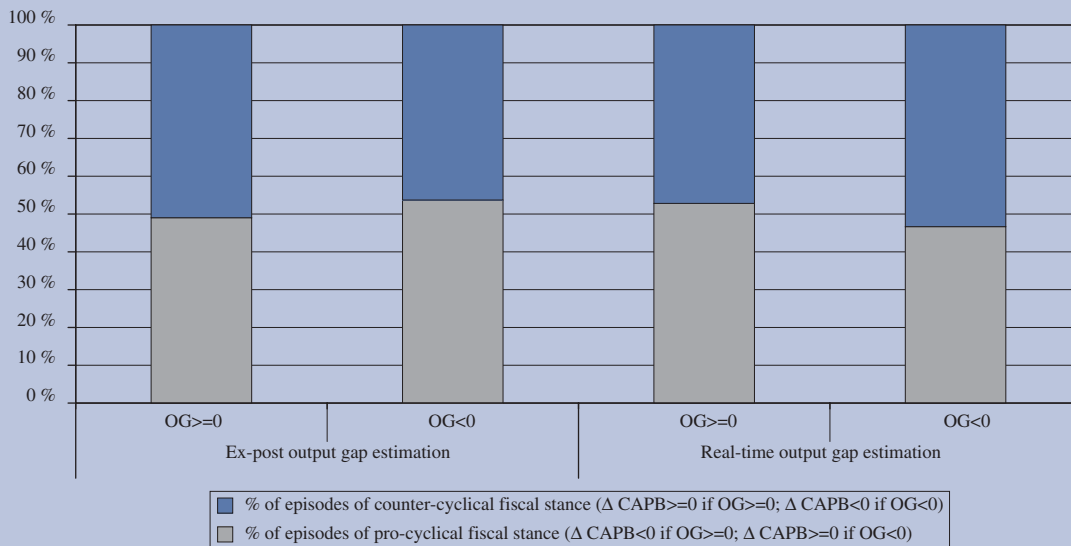
Second, in light of the tendency for real-time output gap estimates to be underestimated (see section 3.2), results run against the intuition. One would expect indeed that when real-time output gap estimates are below *ex post* figures, the probability of unintentionally carrying out pro-cyclical fiscal policies in good times increases, since some of the *ex post* good times may have been read instead as bad times in real time.

A possible explanation can be as follows. The episodes that are classified as good times in real time are most probably those associated with a largely positive ex-post output gap (assessing wrongly the cycle is more likely when output is close to potential). If the fiscal stance is more strongly pro-cyclical when the output gap is large, there could be stronger indications of pro-cyclical policies in good times when using real-time series. The histogram in Graph IV.13 provides information that corroborates this hypothesis. It reports the average change in the CAPB observed in correspondence with different ranges for the output gap. It is confirmed that that in cases of large positive output gaps the stance of the fiscal policy tended to be characterised by strong loosening ([1]).

3.4. Summary of findings

Overall, the preceding analysis confirms the broad outcome of preceding studies aimed at gauging whether in

past decades fiscal policy in the EU took a stance consistent with the prevailing cyclical conditions. Although the relation between the fiscal stance and the output gap is in general rather weak, there are indications of frequent pro-cyclical behaviour for euro-area countries. While the need to maintain public finances under control and measurement errors could explain pro-cyclical policies in bad times, the reasons for fiscal loosening in good times need to be found elsewhere: identification and implementation lags and lack of control of the budget in periods when pressures for increased spending or tax cuts become stronger.

The analysis in the previous sections allows making some progress in the understanding of the features of pro-cyclical fiscal policy episodes in the euro area, which can be summarised as follows.

* Achieving a consistent conduct of fiscal policy over the cycle is subject to difficulties related with the identification of good and bad times. The output gap

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([1]) Graph IV.11 also shows that, symmetrically, strong consolidations seem on average to characterize periods with largely negative output gaps. A tentative interpretation of these findings can be as follows. It is when the output gaps are very large that the pressures to increase expenditure or cut taxes become stronger, while it is after protracted periods of depressed economic activity that the deterioration in the budget balance can become so large to require a strong correction.

Graph IV.13: **Fiscal stance in correspondence with different levels of the output gap (EU-11, 1980-2005)**
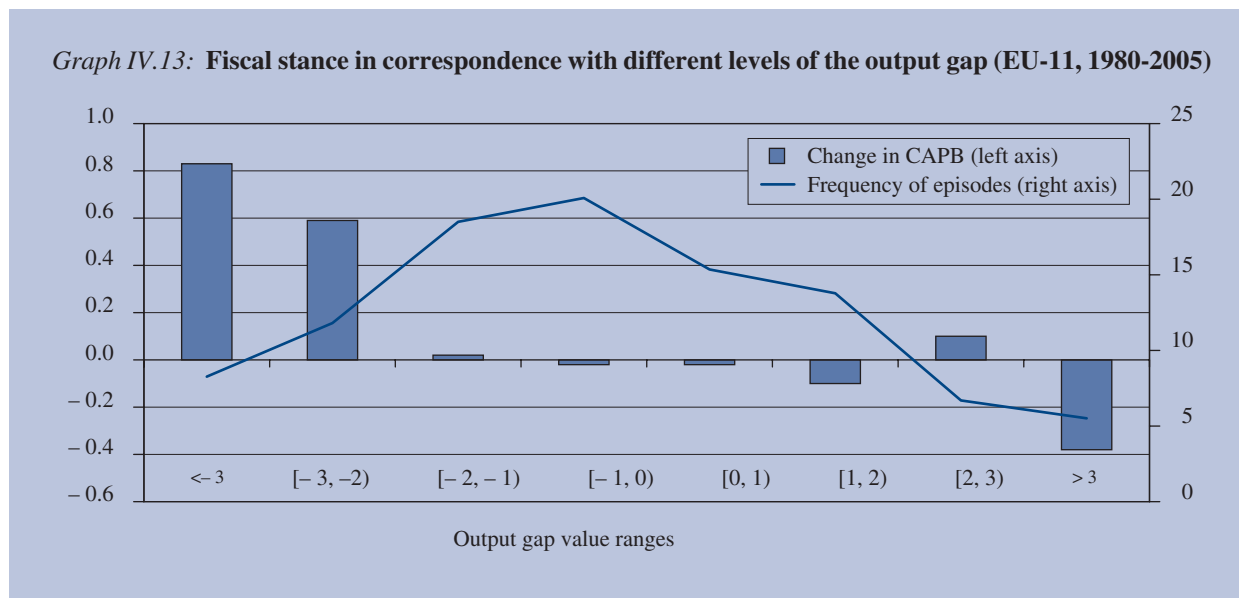
is a useful tool to for measuring the cycle, but a mechanic definition of good and bad times based on the sign of the output gap does not seem advisable. The difference between actual and potential growth (equivalently, the year-on-year change in the output gap) should be considered together with the output gap level to permit an early assessment of cyclical developments.

- Output gap measurement errors can be considerable. The data show that in the past decade real-time output gap estimates were generally biased downward, possibly as a result of overestimation of potential output stemming from optimistic growth forecasts. Measurement errors have led to a mistaken assessment of the output gap sign in about 1/3 of the cases. The probability of such mistakes could be considerably reduced by adopting a notion of good and bad times which would consider not only the output gap in level but also its change and based on the out gap being sufficiently positive (good times) or negative (bad times).

- The fiscal stance in the euro area since the 1980s seems on average moderately pro-cyclical both in good and bad times, irrespectively whether measured on the basis of the output gap levels or changes. The stance of fiscal policy, however, was quite different depending on the specific time periods con-

sidered. While during the 1980s and the run-up to EMU pro-cyclical policies were mainly enacted in periods where output was below potential, pro-cyclical policies in good times characterised the years following the completion of EMU.

- Evidence of a pro-cyclical bias in good times is there also after controlling for the main factors that influence the fiscal stance. The evidence is particularly strong for good times defined as periods with output above potential but analogous qualitative results are obtained also defining good times as upturns, i.e., periods with a positive change in the output gap. The pro-cyclical bias is mostly due to faster expenditure growth in good times. Possible explanations are identifications and implementation lags in setting government expenditures or pressures to spend windfall budgetary gains accruing in good times.

- While real-time measurement errors can explain to some extent pro-cyclical behaviour of fiscal policy in bad times, this does not seem the case for good times. Fiscal loosening during periods with output above potential appears to be more frequent when measuring output gaps with real-time data. These findings relate to another relevant piece of evidence: the fiscal stance was more markedly pro-cyclical in good times when output gaps were very large.

4. National rules and institutions to prevent pro-cyclical policies in good times

4.1. Introduction

The main message from the previous sections is that pro-cyclical policies are far from being an exception in the EU. While the origins of pro-cyclical policies in bad times can be generally related to the need to keep public finances under control, the explanations for pro-cyclicality in good times is less obvious. The main explanations are identification and implementation lags and 'political economy' arguments linked to the pressures for increasing spending and cutting taxes when government resources become abundant. This explanation has implications for an adequate response to avoid pro-cyclical behaviour in good times: governments could strengthen the instruments (rules, procedures, institutions) that permit to improve the formation, execution and control of their budgets.

This section first discusses how numerical fiscal rules at state level relate (deficit and debt rules, revenues rules, expenditure rules) to the cyclical behaviour of fiscal policy and which characteristics of such rules can prevent or facilitate pro-cyclical behaviour. National experiences aimed at dealing explicitly with pro-cyclicality in good times are reviewed. The role of fiscal councils in improving the ability of governments to effectively put in place counter-cyclical policies is discussed. In a second step, building on a new dataset on numerical fiscal rules at country level, there will be an attempt to measure how different types of fiscal rules relate to the stance of fiscal policy over the cycle in EU countries.

4.2. Fiscal rules

As illustrated in Part III of this report, the principal objective of national-level numerical fiscal rules is to limit the deficit bias by re-addressing the balance between discretionary and rules-based behaviour in fis-

cal policy-making. As pointed out in this part of the report, there is evidence supporting the view that numerical fiscal rules at national level, however defined, can be effective on outcomes: other things being equal, deficits tend to be lower in countries and periods characterised by stronger fiscal rules. The link between numerical fiscal rules and the cyclicality of public finances is necessarily more complex. Being containing deficits the main objective of fiscal rules, one may expect that such rules may clash with counter-cyclical behaviour in bad times.

A more thorough analysis shows that this expectation is not strongly supported by the facts. As will be clear from the following discussion, the impact of fiscal rules on cyclicality depends upon whether the rules apply to deficits or debt or rather to one side only of the budget (expenditure or revenues) and on the specific design of the rule. Moreover, the contemporaneous presence of several type of rules would also matter for the impact on the cyclical behaviour of fiscal policy. Appropriately designed fiscal rules on deficits or debt complemented by expenditure rules may help to reduce pro-cyclicality in good times without necessarily inducing a pro-cyclical behaviour in bad times.

4.2.1. Budget balance and debt rules

It is often held the view that rules that fix ceilings on deficits or on the amount of borrowing may introduce a constraint to the counter-cyclical use of fiscal policy in bad times. While the argument is quite straightforward in theory (the respect of numerical deficit results may require a correction when budgetary slippages are related with a worsening cyclical components in the budget), the evidence on their effect on the cyclicality of fiscal policy is not clear cut.

Most of the empirical work aimed at assessing the impact of deficit and debt rules on the response of the fiscal stance

to the cycle focus on the EU fiscal framework. As highlighted in section 2, the available studies based on the estimation of fiscal reaction functions conclude that, accounting for the most relevant factors that affect the fiscal stance, the introduction of the EU fiscal framework did not lead to a more pro-cyclical response of fiscal policy to cyclical conditions. Conversely, there is evidence that the response of the fiscal stance to the output gap turned from slightly pro-cyclical to broadly a-cyclical after the EU fiscal framework [1]. Even more to the point, the evidence provided in section 3 of this report (Graph IV.8) shows that the frequency of pro-cyclical episodes in bad times in euro-area countries dropped after the introduction of the SGP compared with previous periods. Evidence over a large sample of EU and non-EU countries go in the same direction. Manasse (2006) finds that countries where fiscal rules were in force exhibit on average a less pro-cyclical behaviour of fiscal policy [2].

A more differentiated picture emerges from the analyses that focus on borrowing constraints acting at lower levels of government. Most of the research concerns the impact of state-level borrowing constraints in the US on the cyclical behaviour of State-level budgets. While some studies do not find a significant impact, other analyses show that stricter borrowing constraints are associated with a less counter-cyclical response of local budgets to cyclical conditions [3]. In general, there are indications that budget balances at lower level of government exhibit a less counter-cyclical behaviour compared with the general government budget balance [4].

Overall, although the available studies do not support the view that budget balance or debt rules had a strong pro-cyclical impact, it would be simplistic to fully reject the issue of a possible pro-cyclical bias in good times introduced by budget balance rules on the basis of this evidence. These results need to be interpreted with care, given the major difficulty of controlling for all the factors that could drive the fiscal stance and of the issue of measuring the different degree of enforcement of the rules (countries with badly enforced rules may exhibit big budgetary loosening in bad times).

It needs also to be remarked that the design of budget balance rules can be such that to limit or minimise the possible pro-cyclical bias induced by the rule. First, budgetary targets could be specified in cyclically adjusted terms in order to permit the operation of automatic stabilisers. In spite of the known difficulties and uncertainties with the computation of cyclically-adjusted budget balances, deducting even indicative estimates of the cyclical component of budgets from budgetary targets could introduce some leeway in the implementation of deficit rules and contribute to ease the risk of pro-cyclical bias. Second, budget balance rules could apply over medium-term time horizons rather than on an annual basis, in such a way to allow some degree of variation in budgets according to cyclical patterns. The evidence of a potentially more pro-cyclical impact of budget balance and debt rules applied at lower levels of government could be related to the fact that in this case the rules are applied preponderantly on annual schemes while those applied at general government or other sub-sectors more often extend the time horizon beyond the yearly budgetary cycle and are integrated into a multi-annual fiscal framework (see Graph III.3 in Part III of this report) [5]. Last but not least, the risk of pro-cyclical corrections in bad times to respect budget balance rules could be reduced if effective mechanisms to foster budgetary prudence in good times are in place. A symmetric functioning is key to any effective and sustainable budgetary framework.

4.2.2. Expenditure rules

As opposed to budget balance rules, no concern for a pro-cyclical bias is there for expenditure rules. At the opposite, such arrangements can be effective in curbing the growth of expenditure in good times, thus preventing the fiscal stance from becoming pro-cyclical in good times. As

[1] The same qualitative result on a sample of euro-area countries is obtained in Gali and Perotti (2003) using 1992 as the start of the EU fiscal framework (i.e., the signing of the Maastricht Treaty) and by European Commission (2004) using 1994 (the beginning of phase II of EMU) as the start of the EU fiscal framework.

[2] The sample in Manasse (2006) includes both developed and developing countries. The dataset on fiscal rules used is the same as in Kopits and Symanski (1998) and the type of fiscal rules taken into account are mostly budget balance rules.

[3] Alesina and Bayoumi (1996) show that the cross-section relation between the cyclicality of State-level budgets and an index of stringency of borrowing constraints is a weak one. Conversely, Sorensen et al. (2001) show that US States characterised by strict borrowing constraints exhibit on average more counter-cyclical variability in budgets.

[4] See, e.g., Sorensen et al. (2001) on the US, Bayoumi and Eichengreen (1995) compare the case of the US, Japan, Germany, France, Canada and the Netherlands and find a pro-cyclical behaviour of *overall* local and state level budget balances in non-federal countries. For evidence on the state and local government cyclical variability of public finances in European and other advanced and middle income countries see, e.g., Rodden and Wibbels (2006). On Germany see Seitz (2000).

[5] In addition, two other factors needs to be considered. First, the enforcement of budget balance rules tend to be stronger at lower levels of government (see Graph III.5 in Part III of this report). Second, the intensity of a possible pro-cyclical bias at lower levels of government depends on which expenditure items are under the control of regional and local authorities (i.e. whether cyclically sensitive or neutral items) and what the main sources of revenue are (i.e. whether revenue consists mainly of transfers from central authorities or own tax collection exposed to business cycle fluctuations).

shown in section 3, cyclically-adjusted primary expenditures as a ratio of GDP increase especially in periods of positive output gap. Moreover, fiscal expansions in periods of positive output gap are mostly explained by the behaviour of expenditures. While potentially effective in limiting the risks of pro-cyclical behaviour in good times, expenditure rules are compatible with the working of automatic stabilisers on the revenue side in bad times. In spite of wide agreement that expenditure rules could be helpful in containing the pro-cyclical bias of fiscal policy (e.g., Daban et al. (2003), Brunila (2002), European Commission (2003, 2005)), systematic empirical analysis on their effectiness to that purpose is scarce.

The effectiveness of expenditure rules in reducing the risk of pro-cyclicality depends on their specific design. A number of elements need to be considered in this respect. First, how expenditure ceilings are defined. Ceilings define as maximum expenditure ratios on GDP may be less effective than ceilings defined in terms of maximum expenditure growth rates. In the former case, during good times expenditure could grow in nominal terms without violating the ceiling, while this eventuality is less likely in the latter case. As for the choice of nominal or real growth rates, counter-cyclical stabilisation is enhanced when it is nominal growth to be capped. In such a case indeed, if periods of GDP above potential are characterised by demand-pull inflation, expenditure adjustment in good times is stronger [1].

Second, which expenditure aggregate should be subject to ceilings. Obviously, expenditure ceilings have a higher chance of affecting the overall fiscal stance the broader is the expenditure aggregate subject to the ceiling. However, the exclusion of some categories could be advisable. Interest expenditures, being outside the direct control of fiscal authorities is one of such categories. The exclusion of cyclical components like unemployment subsidies permits the expenditure ceiling to be compatible with the full operation of automatic stabilisers. Conversely the definition of separate ceilings for particular type of expenditures characterised by a growing trend and that are hardly compressible downward in the short term (age-related expenditures in particular) could be advisable to avoid that expenditure rules translate into excessive compression of other expenditure categories.

Third, a medium term orientation of the expenditure rules is likely to increase the correction of the pro-cyclical bias. Expenditure caps need to be determined and implemented over the medium-term to avoid a systematic revision of the ceilings which follow ongoing cyclical developments. However, it needs to be recalled once more that realistic macroeconomic assumptions underlying expenditure ceilings are key for the effectiveness of such instruments.

Needless to say, expenditure rules per se, not applying to the revenue side, are not a guarantee that pro-cyclical policies will not be implemented. However, appropriately designed expenditure rules are potentially a very effective ingredient of broader rules-based frameworks for addressing the tendency for fiscal policy to behave pro-cyclically in good times.

4.2.3. Revenue rules and rainy-day funds

Revenue rules fall under two broad categories. There are rules defining caps on the tax burden or, conversely, minimum ceilings on revenues [2]. The purpose of such rules is, respectively, to prevent the tax burden to become too high and to ensure an adequate government financing. This first category of revenue rules may introduce a pro-cyclical bias. If the rule sets a cap on revenues, pro-cyclicality may show up in good times (depending on how the cap is defined, tax rates may need to be lowered when revenues become more abundant), while the opposite holds for rules that define minimum ceilings.

The second category of revenue rules deals with the use of windfall revenues ensuing from better than expected cyclical conditions or from 'elasticity surprises' related for instance to asset price cycles or tax-rich growth. This second category of revenue rules is potentially very effective in dealing with the issue of pro-cyclicality in good times. Rules of this type address in the most direct way the issue to which fiscal authorities are faced when better than expected budgetary outcomes materialise.

Pressures to cut taxes or increase expenditures become strong once there is awareness of unexpected extra-budgetary room. Defining *ex ante* which share of the windfall revenue will be saved could be an effective commitment device for fiscal authorities and could re-address the bias for fiscal policy to become pro-cyclical

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[1] Expenditure ceilings in terms of growth rates could be made conditional on prevailing and expected GDP growth rates and specified in terms of yearly ceilings on real or nominal expenditure levels. This is what is observed in the practice of some countries.

[2] An example of revenue rules setting a cap on the tax burden is found in Denmark. A rule fixing a minimum growth rate of nominal taxes equal to GDP growth was in place in Belgium.

Box IV.2: **Revenue rules to prevent pro-cyclical fiscal policy in good times in EU countries**

The replies to the questionnaires submitted to the EPC Working Group on the Quality of Public Finances indicate that while about half EU Member States have put in place expenditure rules (which, as discussed in section 4.2.2. could be a useful instrument to avoid pro-cyclical developments in expenditure in good times) there are only few countries that operate revenue rules explicitly aimed at preventing a pro-cyclical fiscal stance in good times.

Finland is characterised by a system of national fiscal rules aimed at the same time at containing deficits and at favouring an appropriate fiscal stance over the cycle. A budget balance rule applied to central government fixes a maximum ceiling of 2.75 % of GDP and requires a balance position in periods or normal growth conditions, admitting however short-term deviations related to cyclical conditions. The budget balance rule is complemented by an expenditure rule implemented over a multi-annual framework. The exclusions of cyclically-sensitive items from the expenditure ceilings favours the free operation of automatic stabilisers. A revenue rule stipulates that unemployment security contributions as well as earnings-related pension contributions are stabilised over the cycle with the help of so-called EMU-buffer funds, which work in a way akin to that of rainy day funds (see Box IV.2). This revenue rule contains the risk of increased spending or tax cuts in good times.

In the Netherlands, ceilings on real expenditure levels defined for different sub-sector of the central government and set for the length of a legislature limit the use by the national government of budgetary windfalls for additional expenditure in good times. The expenditure rule in the Netherlands is complemented by a medium-term framework aimed at stabilising revenues through the indication of yearly revenue targets. On top of this medium-term revenue framework, the Netherlands adopted a rule defining *ex ante* which share of higher than expected revenues could be spent or redistributed to citizens via tax cuts and which share should be used for the purpose of reducing the deficit.

A revenue rule to prevent dissipating budgetary windfalls arising in good times has been introduced in France in 2005, taking effect in 2006. The introduction was motivated by the episode of the large revenue windfall of 2000 ('la cagnotte'), which was allocated to tax cuts. The recently introduced French revenue rule requires that in the budget law the government defines how possible differences between actual and predicted revenues will be allocated. Which share of revenue windfalls will be used to reduce the deficit is thus set *ex ante* but on a year-by-year basis.

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in good times. It is relevant to highlight that the concept of good times that makes operational this type of rules only partly overlaps with that defined in terms of the prevailing cyclical conditions. The realisation of windfall revenues is normally related with strong cyclical conditions but does not need always to be so, given that elasticity surprises may have a considerable quantitative impact without being strictly related to GDP fluctuations. The experience of countries that have been adopting revenue rules of this type is summarised in Box IV.2. Since revenue rules are not very frequent, systematic empirical analysis aimed at assessing their effectiveness is not available.

Related to revenue arrangements to deal with windfall gains, there is the setting up of so-called rainy-day funds (see Box IV.3). The basic idea is that the accumulation of resources in a fund during good times permits to draw resources during bad times without the need to run into pro-cyclical budgetary adjustment. The mechanism could be a very effective complement to fiscal rules defined over cash variables. For instance, when sub-national levels of government are subject to bor-

rowing constraints putting ceilings on debt, rainy-day funds would help to avoid pro-cyclicality in good times and this way, to permit a counter-cyclical fiscal stance in bad times. When instead the rules affect budget balance defined in accrual terms, the effectiveness of rainy-day funds is reduced: the accumulation and decumulation of resources in the fund are recorded as financial operations and do not affect the size of budget balances.

It follows that drawing from the fund will not help to improve budgetary figures in bad times. However, this does not mean at all that the fund will be ineffective.

Moving resources in and out of the fund will still impact debt in a stabilising way. Additionally, rainy-day funds will in general fulfil a function akin to that of revenue rules for stabilising purposes. They can work as a commitment device for fiscal authorities to permit that when better than expected budgetary outcomes materialise a fraction of these resources is saved rather than spent or dissipated via tax cuts.

Box IV.3: **Rainy-day funds and their operation**

So-called rainy-day funds (alternatively referred to as extra-budgetary stabilisation funds) are an instrument specifically designed to prevent pro-cyclical behaviour of fiscal policy. [1] Such funds are replenished in good times in order to become available for spending in bad times. Until now, real-world experiences with rainy-day funds are abundant especially in US individual States. In the EU, the only country having set up a fiscal rule with effects similar to those of rainy-day funds is Finland.

The principle underlying the working of rainy-day funds is relatively simple. In good times government revenues are more abundant, and part of these extra revenues are used to accumulate financial assets in the fund. Conversely, when times are bad, assets are decumulated. The setting up of rainy day funds has a clear stabilising impact on the gross debt. During good times, there is less debt reduction because some resources are used to buy financial assets; during bad times, debt grows less, because financial resources are obtained from the sales of the assets accumulated in the fund. While fully effective in principle as a debt stabilisation tool, the impact on deficits is not equally effective. Budget balances are compiled net of financial transactions, so that any accumulation or decumulation of financial assets in rainy day funds would not have any direct stabilising impact on budget balances. [2] Surpluses in good times will not be smaller, deficits in bad times will appear equally large with or without rainy-day funds. This is a basic reason why rainy-day funds are so common in contexts where gross borrowing constraints are present (like in the US) while a similar widespread use is not observed in the case of fiscal constraints operating on deficits defined in relation to net borrowing. Although the operation of rainy-day funds does not have a direct impact on the stabilisation of deficits, their indirect effect could be relevant. In particular, they could be helpful in preventing that in good times budgetary resources are depleted. The commitment to transfer of resources in the fund in good times into a separate fund may contribute to discipline policymakers who might otherwise be inclined to give away any budgetary windfalls in the form of higher expenditure or lower taxes. The decumulation of rainy day fund assets in bad times would in any case permit to contain the growth of (gross) debt at given deficit.

For rainy-day funds to function properly in practice, several conditions will have to be met. First, the circumstances and modalities under which reserves could be accumulated and withdrawn need to be clarified *ex ante*, monitorable, and enforceable.[2] This requires a non-ambiguous definition of good times, such that the accumulation of resources into the fund cannot be denied on the basis of diverging views on what should be meant by good times. Clear provisions on the modalities for the accumulation of assets in the fund are also needed, in order to ensure that the payments to the fund are not delayed and that resources are invested in appropriate financial instruments. As for the rules governing the use of the assets in the fund, a non-ambiguous definition of bad times is needed. An effective monitoring and enforcement process is key to avoid that the funds are used for purposes different from debt stabilisation.

Second, the notion of good times used for the working of the fund should ideally be both easily made operational and useful for the purpose of output stabilisation. Having a definition closely linked to the amount or revenues perceived by the government (expressed for instance in terms of a sufficiently positive difference with respect to projected revenues) is likely to be more suited to ensure a smooth operation of the rainy day fund. The working would be similar to that of a revenue rule aimed at avoiding pro-cyclical budgetary loosening, with the additional requirement of the accumulation of resources in the fund. With such type of definition, however, it would not be guaranteed an effective impact on cyclical stabilisation since extraordinary government revenues may not necessarily be related to the cyclical conditions of the economy but to other reasons relating mainly to lags in revenue collection or changes in the elasticity of revenues with respect to output. An alternative would be to define good times on the basis of indicators relating directly to cyclical conditions. This is the practice followed in most US states. The problem with this definition is that revenues may not always be particularly abundant in periods of strong cyclical conditions or could be only with lags.

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[1]   Rainy-day funds have been discussed with a focus on the US, among others, by Kopits and Symanski (1998), Knight and Levinsohn (1999), Zahradnik and Johnson (2002), Hemming and Kell (2000). Among the papers addressing the issue in the EU context see Wagner and Elder (2002), Buti et al. (2003), Sapir et al. (2003), CESIFO (2003).
       Of course, this does not exclude the possibility of defining a different notion of government budget balance net of accumulation/decumulation of assets in the fund for analytical purposes. Moreover, it would not be inconceivable to carry out budgetary surveillance on such alternative notions of deficit. In the EU practice, however, this may entail a revision of the EDP Protocol of the Treaty where the concept of government deficit used in EU budgetary surveillance is defined.
[2]   On deposit and withdrawal provisions for rainy day finds, see for instance Sobel and Holcombe(1996) and Wagner and Gropp. (2002).

Box IV.3 (continued)

A further issue with the operation of rainy day funds is that there may be the risk that the accumulation of assets in good times in the fund occurs via additional borrowing. In this case, governments could be able both to put assets in the fund and spend budgetary windfalls at the same time. The reputational cost of such circumventing measures may not always be a sufficient deterrent for governments, so that explicit provisions addressing this specific issue might be desirable.

Finally, the amount of resources moved in and out rainy-day funds need to be sufficiently large in order to have an impact on the fiscal stance. An approach could be to determine accumulation thresholds that guarantee a significant impact on the fiscal stance. However, the limitation of this approach is that the extra resources available related to strong cyclical conditions may not large enough to reach the threshold. The alternative would be to define the minimum requirements for asset accumulation as percentages of the cyclical component of the budget or of the difference between expected and realised revenues.

4.3. National independent institutions

An alternative avenue to address the pro-cyclical bias of fiscal policy consists of the establishment of institutions independent of the government with a role in fiscal policy-making. In recent years, a certain number of proposals have been put forward by the academia advocating the creation of 'independent fiscal authorities' to address the deficit bias and the pro-cyclical bias in fiscal policy-making. As discussed in Part III of the report, these independent authorities would be delegated some tasks of fiscal policy-making, with a view to define and monitor budgetary targets not biased by the 'common pool problem' and the short-sightedness that often characterise political bodies. In theory, such solution would permit to maintain the advantages of discretionality, namely, the possibility to adapt budgetary policy to the unforeseen contingencies, getting rid of the problems that normally come with it: deficit bias and unsatisfactory fiscal stabilisation ensuing from pro-cyclical bias in good times.

Additionally, independent fiscal authorities are likely to be less prone to a time-inconsistency issue stemming from the difficulties that governments may have in keeping their commitments. Even in case numerical rules are in place, if enforcement is not strong enough governments may have an incentive to violate rules-based commitments *ex post* if the political gain of doing so is high enough, while such an incentive will not be there for non-political bodies. These arguments apply also to numerical rules to address the pro-cyclical bias, like the definition of *ex ante* arrangements on the use of windfall revenues or the establishment of rainy-day funds ([1]).

Although the establishment of independent fiscal authorities is vividly debated, such proposals for the time being have no real-world counterpart and are unlikely to be implemented for a series or major reasons, mainly relating to lack of guarantee of sufficient democratic accountability.

A different type of independent national institutions with a potential role in fiscal policy-making are so-called 'fiscal councils'. As illustrated in Part III of the report, these type institutions currently in operation in the EU and other industrial countries mainly have the function of supplying analytical inputs to fiscal policy-making, but may also have a role in providing normative indications and expressing a voice in the fiscal policy debate. Those councils that provide technical inputs generally prepare macroeconomic forecasts to be used in budgetary planning or that provide a counter-check to the official forecasts used by the government. A further relevant analytical task performed in relation with fiscal policy-making is the assessment of the budgetary impact of policy measures.

The role of this type of councils in preventing a pro-cyclical bias of fiscal policy in good times is only indirect, but potentially relevant for a number of reasons. First, independent high-quality macroeconomic forecast could help to address the pro-cyclicality of expenditure related with identification and implementation lags. As stressed previously, the issue of pro-cyclicality in good times is strongly related with the behaviour of expenditures. Disposing of high-quality and realistic growth forecast would contribute to limit expenditure growth in periods of positive output gap, where growth forecast run the highest risk of being excessively affected by recent periods of growth above trend. Second, independent forecasts would

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([1]) The establishment of independent fiscal authorities with a specific mandate for fiscal stabilisation has been advocated, inter-alia, by Eichengreen et al. (1999) for the US and Wren-Lewis (2002) and Calmfors (2003) for the EU.

increase the effectiveness of expenditure rules. Multi-year expenditure frameworks limiting putting a cap on the growth of government outlays are among the instruments that most directly deal with the issue of excessive expenditure growth in good times. However, as already pointed out, the effectiveness of such arrangements crucially depends on the quality of the surrounding macroeconomic forecast. Related to that, a high-quality assessment of the budgetary impact of policies can contribute to address a possible optimistic bias in expenditure planning. Finally, independent fiscal councils may feed the internal debate on how to improve the existing arrangements to prevent the pro-cyclical bias and may increase awareness among the policy community, academia, and the public opinion on existing problems with the design or the implementation of fiscal rules currently in place (e.g., the use of revenue rules of rainy-day funds).

4.4. National fiscal rules and the stance of fiscal policy over the cycle

The aim of this section is to provide analysis on the link between fiscal rules at national level and the issue of pro-cyclicality. The analysis will proceed in three steps. First, there will be an analysis of what are the perceptions by EU policy-makers on the impact of the fiscal rules in place at national level on the pro-cyclicality of fiscal policy. The information for this analysis is the one provided by the replies to questionnaires submitted by the European Commission to the Members of the Quality of Public Finances Working Group (QWG) of the Economic Policy Committee (EPC). In a second step, there will be an attempt to establish a link between fiscal rule indexes, measuring the strength of fiscal rules at national level (see Part III of this report for their construction) with the observed patterns of public finances cyclicality. A distinction will be made between the complex of rules that affect the budget balance and expenditure rules. Third, a synthetic index will be built at country level measuring the likely impact of the complex of the existing national-level fiscal rules on the stabilisation properties of fiscal policy. The index is constructed on the a priori expectations on the effects of the different type of rules on the basis of the arguments listed in the previous section. This index will be put in relation with country-level measures of the cyclicality of public finances to check whether the *ex ante* expectations on the impact of rules are confirmed by the data.

The questionnaire submitted to the QWG members included explicit questions on the perception of Members (experts from Finance Ministries) on whether or not each of the rules in place in their country would entail a pro-cyclical bias in the conduct of fiscal policy. The replies to this question are synthetically reported in Graph IV.14. The hystograms summarise the replies over the sample according to the type of rules concerned: budget balance, debt, expenditure or revenue rules. It turns out that the respect of the rule may imply the conduct of a pro-cyclical fiscal policy in the majority of cases relating to budget balance and debt rules. This findings are consistent with the arguments spelled out previously when discussing the potential implications of different types of fiscal rules for the cyclical behaviour of the fiscal stance. However, an interesting distinction needs to be made between budget balance and debt rules. While the vast majority of debt rules is perceived to be pro-cyclical, the judgment is much more balanced in the case of debt rules. This difference is mostly explained by the fact that borrowing constraints apply at lower levels of government and are specified on an annual basis, while a substantial share of budget balance rules are defined either 'over the cycle', or on a multi-annual basis, or excluding cyclically-sensitive items.

The perception on expenditure rules fully confirm expectations: none of them is perceived as leading to pro-cyclical outcomes. Regarding revenue rules, the majority is judged not to entail a pro-cyclical bias.

In order to perform an analysis on the link between national fiscal rules and the stance of fiscal policy over the cycle a necessary ingredient is a measure of the strength of fiscal rules at the national level. To this purpose, the 'fiscal rules index', and the 'expenditure rule index' are put in relation with measures of the fiscal stance (see Part III of this report).

The first index provides a synthetic measure of the strength of all the fiscal rules in force in a given country (deficit rules, debt rules, expenditure rules, revenue rules) in a given period, taking into account their coverage in terms of government sectors concerned (e.g., only sub-national levels of government or general government), their statutory basis, the body in charge of monitoring and enforcing the rules, the type of enforcement mechanism foreseen, and the media visibility of the rules.

The 'overall expenditure rule index' provides analogous information but regarding expenditure rules only. Although these indexes vary both across countries and

Graph IV.14: **Fiscal rules and stabilisation: questionnaire replies**
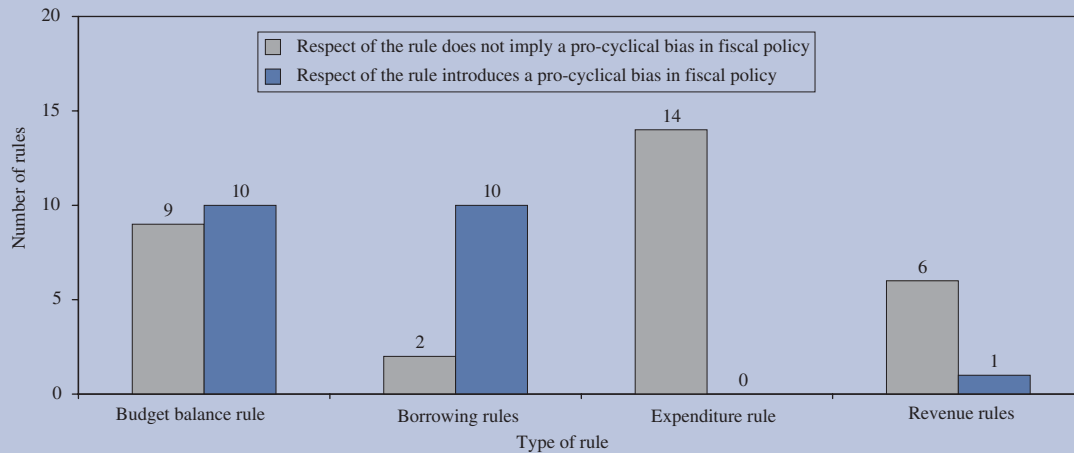
Graph IV.15: **Frequency of episodes of pro- and counter-cyclical fiscal policy. Weak and strong fiscal rule countries (22 EU countries, 1990-2005)**
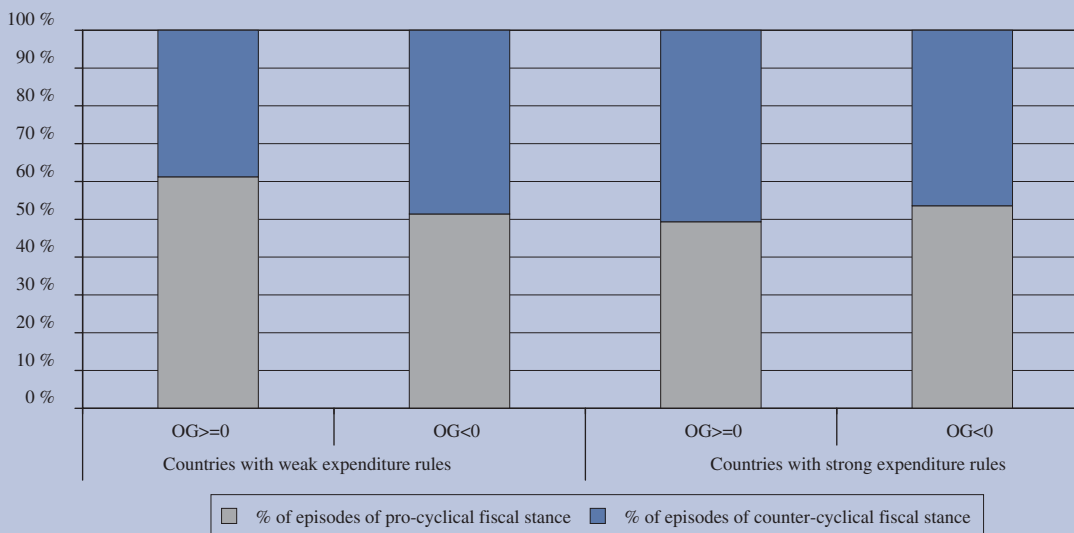
over time, only the cross-country variation can be exploited in the following analyses. This limitation comes from the need to estimate the fiscal stance prevailing in good and bad times over a sufficiently long time period. The fiscal rule indexes are put in relation with indicators of the fiscal stance. The overall fiscal rule index is linked with the year-on-year change in the CABP, while the overall expenditure rule index is put in

relation with the change in the primary cyclically-adjusted expenditures.

Graph IV.15 shows the frequency of counter and pro-cyclical fiscal policy episodes in good and bad times (as measured by output being, respectively, above or below potential) separately for countries with high and low overall fiscal rules indexes. The breakdown of countries

is on the basis of the average value of the index over the period. Countries with an index value above the median are classified as countries with strong overall fiscal rules; countries with an index below the median as countries with weak rules. The graph indicates that the percentage of pro-cyclical fiscal policy episodes was slightly higher in countries with strong overall fiscal rules both in good and bad times.

More frequent episodes of fiscal tightening in periods with output below potential in strong rule countries is consistent with expectations, especially if these countries rely strongly on deficit and debt rules to keep under control the budgetary position of lower levels of government.

In order to disentangle the contribution to the stance of fiscal policy associated with the strength of expenditure rules, the frequency of episodes of pro- and counter-cyclical behaviour of government expenditure was computed separately for weak and strong expenditure rule countries, defined, respectively, as countries with the average overall expenditure rule index below or above the median.

Graph IV.16 displays histograms on the change in cyclically-adjusted expenditure as a percentage of GDP (ΔCAPE) shows that *countries with strong expenditure rules were less likely to run pro-cyclical expenditure poli-*

cies. In line with expectations, the difference is considerable especially in good times: countries with strong rules are considerably less prone to raise expenditure when output is above potential. As pointed out in section 3, the ratio of primary cyclically-adjusted expenditure on GDP tends to raise especially in periods of positive output gap, possibly due to identification and implementation lags: expenditures are planned on the basis of growth expectations, largely determined by current and recent growth developments. Expenditure frameworks putting a limit on the yearly growth expenditures are likely to be effective especially when expenditures grow faster, namely, when the output gap is positive. Regarding the lower frequency of episodes of pro-cyclical behaviour of expenditure in good times, a possible explanation could be related to the fact that a lower growth of expenditure in good times reduces the likelihood of expenditure retrenchments in bad times to respect budgetary targets.

The sample used in the analyses covers all the countries for which information on fiscal rules were obtained from the questionnaires submitted to Member States within the framework of the Quality of Public Finances Working Group attached to the Economic Policy Committee. These countries are all EU countries with the exception of Greece, Cyprus and Malta. The period considered is 1990-2005. The period chosen reflects the time frame

Graph IV.16: **Frequency of episodes of pro- and counter-cyclical behaviour of government expenditure. Weak and strong expenditure rule countries (22 EU countries, 1990-2005)**
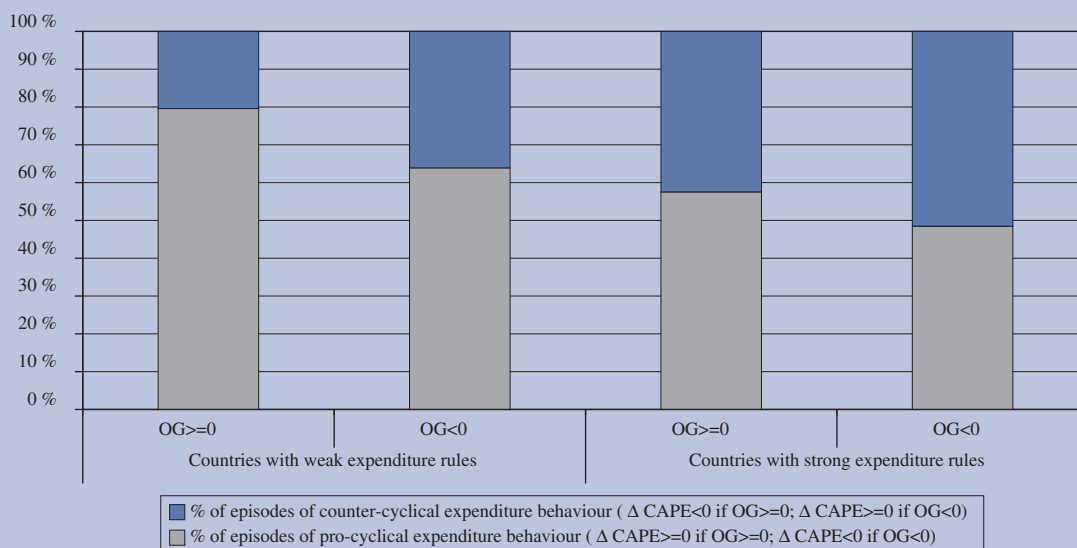
considered in the questionnaire on fiscal rules, which includes all rules into force starting from 1990. The sample includes episodes of very large and rarely observed changes in budgetary data, observed mostly in New Member States. In order to avoid results being driven by these 'outliers', the sample was trimmed in such a way to exclude the observations exhibiting changes in the CAPB and in the primary cyclically-adjusted expenditure outside the 2.5 percent and the 97.5 percent percentiles of the overall distribution.

4.5.   Summary of results

National-level rules and institutions matter for the cyclical behaviour of fiscal policy. In particular, a number of points can be highlighted as follows.

- Whether budget balance rules introduce a pro-cyclical bias in bad times depends crucially on the way the rule is designed. Rules that exclude cyclical items, or that are applied 'over the cycle' may contribute to reduce the risk of a pro-cyclical bias. The extent to which budget balance rules and borrowing constraints applied at lower levels of government induce a pro-cyclical behaviour depend also on the cyclical behaviour of the type of expenditures delegated to local governments and on the source of their finances.

- Expenditure rules can be an effective tool to curb the tendency for expenditures to grow faster during good times. The effectiveness of such rules depends on their design. Multi-year expenditure frameworks capping the growth of relatively broad expenditure aggregates on the basis of realistic macroeconomic assumptions would be the most effective instrument.

- Revenue rules defining *exante* which share of revenue windfall materialising in good times are to be saved, or the establishment of 'rainy-day funds' could help governments to credibly commit not to spend or give away via tax cuts better than expected budgetary outcomes emerging during good times.

- 'Fiscal councils' providing analytical inputs, notably high-quality independent macro- economic forecasts and an assessment of the budgetary impact of measures would improve the effectiveness of national-level rules aimed at addressing the pro-cyclical bias in good times.

- Analysis on the basis of questionnaires submitted to the EPC Quality Working Group reveals that countries with overall stronger fiscal rules behaved slightly more pro-cyclically in bad times. This confirms that a certain trade-off could emerge between fiscal rules for fiscal discipline and stabilisation in good times. However, the evidence also shows that those countries with the strongest expenditure rules were characterised by a considerably less frequent pro-cyclical behaviour of expenditure in periods with positive output gaps.

Part V

Member State developments

1. Belgium

Recent developments and medium-term prospects

In 2005, the general government accounts posted a small surplus of 0.1 percent of GDP, close to the original target of a balanced budget in the 2004 update of the stability programme. Tax revenue remained relatively strong in spite of a slowdown in economic growth. Nevertheless, in order to reach the target the Belgian authorities had to step up the recourse to one-off measures towards the end of the year, from 0.4 percent of GDP as planned to over 0.5 percent of GDP, notably payments by the national railways (SNCB) and the Antwerp port authorities in connection with the transfer of pension obligations to social security. Moreover, a 2.5 percent-of-GDP debt assumption from the national railways (SNCB) has been treated without impact on the deficit, although Eurostat has made a reservation to the recording of this transaction ([1]). The debt-to-GDP ratio in 2005 — which now also includes the debt assumed from the SNCB — further decreased by 1.4 points to 93.3 percent, which is lower than foreseen in the 2004 update of the stability programme (95.5 percent). However, this is largely the result of the upward revision of GDP series by about 1.5 percent.

The 2006 budget was presented in October 2005 and finally approved by Parliament on 15 December. The budget aims at limiting real growth of federal primary expenditure to 0.3 percent, strict expenditure control in the social security sector and a broadening of the tax base. Moreover, the government announced a significant package of new one-off measures (0.6 percent of GDP), such as real-estate sales and a fiscal regularisation procedure, but also the securitisation of VAT arrears. The initial target of a balanced budget was confirmed in the lat-est update of the stability programme ([2]), submitted on 5 December 2005. The Commission services' 2006 spring forecast foresees a small deficit of 0.3 percent of GDP mainly as a result of lower estimates for the proceeds of some new taxes (such as taxes on financial investment funds and on unused production capacity in the electricity sector) and less optimistic assumptions regarding government expenditure. In the first months of 2006, tax revenue continued to increase strongly, but this was offset by an unanticipated increase in interest expenditure following recent interest rate rises. On the whole, the structural balance as well as the structural primary balance are expected to deteriorate by 0.6 percent of GDP, which can be considered as expansionary.

As for 2007, a deficit of 0.9 percent of GDP is projected in the Commission services' 2006 spring forecast, on the basis of a no-policy-change scenario. The further deterioration of the general government balance is mainly due to the phasing out of the abovementioned one-off measures. New measures to reduce the tax burden on labour (0.2 percent of GDP) will also reduce government revenue, but this will be partly offset by anticipated reductions in spending by local authorities (0.2 percent of GDP) after the 2006 local elections, following a similar pattern observed in the past.

In the latest update of the stability programme, Belgium aims at a surplus of 0.3 percent of GDP in 2007. However, the government has not yet announced how it plans to reach this target. The government projects to step up the surplus to 0.5 percent of GDP in 2008 and to 0.7 percent in 2009.

According the to the 2006 spring forecast, the public debt-to-GDP ratio maintains its downward trend, though at a slightly lower pace than foreseen in the 2005 update of the stability programme. By the end of 2006 it should be reduced to below 90 percent of GDP, and to 87 per-

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([1]) Eurostat considers that this transaction should result in a capital transfer from government to SNCB, with a one-off impact on the government deficit by the same amount. Belgium has informed Eurostat of its intention to introduce legislation to retroactively annul this operation. The accounting consequences of this are expected to be clarified before October 2006 (See Eurostat News Release No 46/2006 of 24.4.2006).

([2]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.1

Budgetary developments 2004-2009, Belgium (% of GDP)

Outturn and forecast [1]	**2004**	**2005**	**2006**	**2007**		
General government balance	0.0	0.1	− 0.3	− 0.9		
- Total revenues	49.4	50.1	49.3	48.5		
Of which: - *current taxes*	29.8	30.3	30.1	29.9		
- *social contributions*	16.3	16.2	16.0	15.7		
- Total expenditure	49.4	50.0	49.6	49.4		
Of which: - *collective consumption*	8.7	8.7	8.7	8.7		
- *social transfers in kind*	14.3	14.4	14.3	14.4		
- *social transfers other than in kind*	16.0	16.0	15.9	15.8		
- *interest expenditure*	4.8	4.4	4.2	3.9		
- *gross fixed capital formation*	1.6	1.8	1.7	1.7		
Primary balance	4.8	4.5	3.8	3.1		
Tax burden	45.3	45.7	45.2	44.6		
One-off and temporary measures	0.8	0.5	0.6	0.0		
Structural balance [2]	− 0.8	0.1	− 0.5	− 0.3		
Structural primary balance	4.0	4.4	3.8	4.0		
Government gross debt	94.7	93.3	89.8	87.0		
Pm *Real GDP growth (%)*	2.6	1.2	2.3	2.1		
Stability programme [3]	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance	0.0	0.0	0.0	0.3	0.5	0.7
Primary balance	4.8	4.3	4.1	4.2	4.1	4.1
Structural balance [4]	n.a.	0.0	− 0.3	0.4	0.7	0.9
Government gross debt	94.7	94.3	90.7	87.0	83.0	79.1
Pm *Real GDP growth (%)*	2.6	1.4	2.2	2.1	2.3	2.2

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

[2] Cyclically-adjusted balance excluding one-off and temporary measures.

[3] Submitted in December 2005.

[4] Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.4 % in 2005, 0.6 % in 2006, 0.2 % in 2007, 0.1 % in 2008 and 0.0 % in 2009; all deficit-reducing; the figures for the one-off measures from 2007 onwards were provided by the Belgian authorities after the submission of the programme with the caveat that they 'should be considered as assumptions and do not prejudge any decision by the Belgian authorities').

Source: Commission services and stability programme of Belgium.

cent in 2007. Due to a slightly better starting position in 2005, this still corresponds to the objective foreseen in the latest update of the stability programme. According to the stability programme, the debt should fall below 80 percent of GDP in 2009.

Budgetary coordination and the Belgian High Finance Council [1]

In the 1990s, Belgium was successful in reducing its high deficits of around 8 percent of GDP to a balanced budget, which has been largely maintained since 2000 [2]. At the same time it has brought the debt ratio down from its historical highpoint of 137 percent of GDP in 1993 to about 93 percent in 2005. This fiscal consolidation was backed by a strong political commitment to reduce the deficits and debt in order to meet the criteria for euro-area membership, and subsequently the close-to-balance target of the Stability and Growth Pact.

Fiscal decentralisation in Belgium had started as early as 1970. Since then the country has evolved from a strictly unitary State into a rather complex federal structure of regions (Flanders, Brussels and Wallonia) and commu-

[1] See also: Gerrit Bethuyne, *Federalisation and fiscal consolidation: the Belgian experience*, Country Focus, Volume II. Issue 16, September 2005, European Commission – DG Ecfin, Brussels, 6 pp.

[2] For 2005, the caveat regarding the assumption of debt from the SNCB mentioned above applies.

Table V.2

Main measures in the budget for 2006, Belgium

Revenue measures ([1])	Expenditure measures ([2])
• Final stage of the implementation of the 2001 tax reform (-0.4 % of GDP)	• Real growth limited to 0.3 % in federal primary expenditure and 1.2 % in social security expenditure
• Additional measures to reduce the tax burden on labour (-0.2 % of GDP)	• Reduced expenditure by regions and communities
• Real estate sales (0.2 % of GDP)	• (-0.1 % of GDP)
• Securitisation of VAT arrears (0.2 % of GDP)	
• New measures to fight fiscal fraud (0.2 % of GDP)	
• New taxes on insurance products and financial investment funds (0.1 % of GDP)	
• Introduction of a new fiscal regularisation procedure (0.1 % of GDP)	

([1]) Estimated impact on general government revenues.
([2]) Estimated impact on general government expenditure.

Source: Commission services.

nities (the Flemish, French and German-speaking Communities). Currently, the communities exercise powers in fields directly relating to people, such as education, culture, welfare and certain aspects of health policy.

Regional powers include town and country planning, housing, the environment, public works and certain aspects of agriculture, energy, transport, employment and the economy. The regions also exercise the supervision over local authorities. Each region and community has its own parliament and government. In Flanders, the regional and community institutions have been merged given the large overlap in population and territory concerned. The French-speaking Community and the Walloon Region on the other hand, which also show a large territorial overlap (but much less in terms of population), still have separate institutions.

Although the institutional reform started as early as 1970, it was not until 1989 that the current system became fully operational with the adoption of the 'Special Financing Law' and the creation of the 'Public Sector Borrowing Requirements' section within the High Finance Council, a supervisory agency composed of relatively independent high-level experts. This provided the framework for the current system of budgetary conventions, which are political agreements between the federal and regional governments that set medium-term targets and act like internal stability programmes.

Although before 1989 regional entities already had some limited budgetary autonomy (about 3 percent of GDP by 1988), their funding solely consisted of transfers from the federal government. From 1989 onwards, regions and communities received a separate budget based on the new Special Financing Law ([1]) and became responsi-

ble for their own treasury management. While in 1988 federal expenditure (excluding social security) was still almost 30 percent of GDP, it is now down to 12 percent (of which about one third can be attributed to the interest payments on federal government debt). On the other hand, regional expenditure is now over 11 percent of GDP (about ¼ of total government expenditure – see Graph V.1.).

The sources of funding attributed by the Special Financing Law are different between regions and communities. Currently, regions and communities are mainly financed with a share of personal income tax revenue and (for communities only) of VAT revenue (see Graph V.2). Regions also derive funding from a dozen types of taxes exclusively assigned to them, including registration taxes (on real estate sales, mortgages and gifts), inheritance taxes and road taxes. They can create new taxes, provided that the same tax base is not already in use for a federal tax, but (except for the Brussels Region, where they represent over 7 percent of total revenue) these new taxes play only a marginal role. The remaining sources of revenue for the regions and communities are quite diverse, such as transfers from the federal budget to the communities in relation to foreign students and, for the Brussels region, a specific transfer to compensate for its function as the country's capital. Finally, regions and communities can issue debt, subject to notification to, and approval by, the federal government.

Despite the large transfer of revenue and expenditure to regions and communities, since 1989 only a small part (less than 4 percent of GDP) of the total government debt (about 130 percent of GDP at that time) was transferred to the regional level. The rest remained at the federal level for the most part (some 117 percent of GDP), and at the local authority level (about 9 percent of GDP). However, from the start, regions and communities also inherited a small part of the (substantial) fed-

([1]) A separate arrangement was created earlier in 1983 for the (much smaller) German-speaking Community.

Graph V.1: Government expenditure as % of GDP

Legend: Social security · Federal · Regional · Local

Graph V.2: Revenue sources for regions and communities in 2005

Categories: Flanders · French Community · Walloon Region · Brussels Region

Legend: Regional taxes · Income tax · VAT · Other revenue
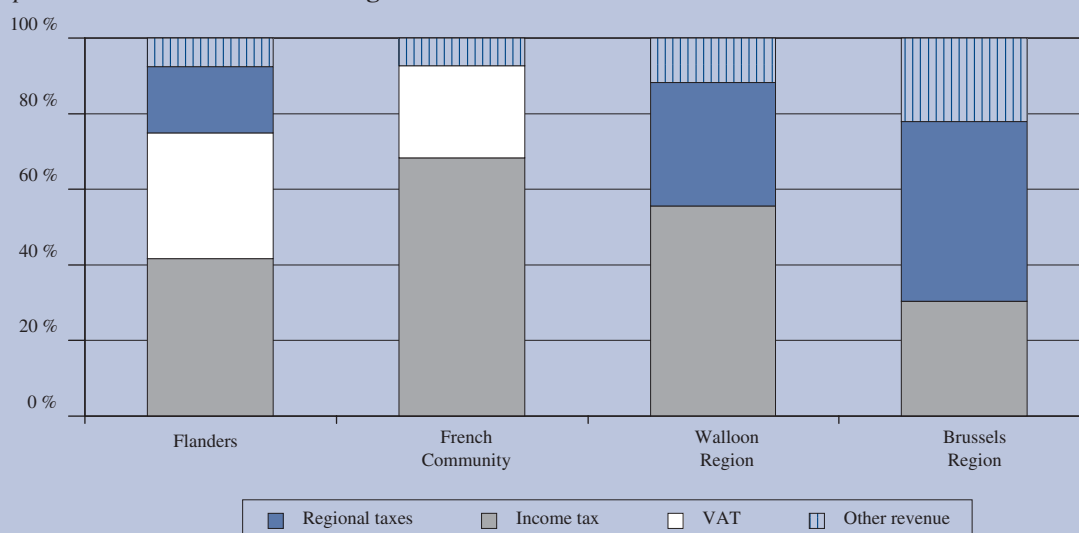
eral deficits, which they had to finance themselves. Their combined deficit peaked in 1992 at 1 percent of GDP, but since then it generally followed a downward trend. In 1997 the Flemish budget entered positive territory and its surplus soon became larger than the deficits of other regions and communities. As a result, the regional debt level, which had continued to increase until 1997 (at just over 7 percent of GDP), has since fallen to less than 5 percent of GDP. At the same time, the federal deficit has been brought down from over 7 percent of GDP in 1992 to less then 0.5 percent of GDP in recent years.

This result required clear budgetary targets for all levels of government and an efficient mechanism to enforce them. The Belgian coordination mechanism is largely based on a consensus between the different govern-

ments, laid down in 'budgetary conventions'. These political agreements set the medium-term budgetary targets and act as internal stability programmes. Until 1999 they were also integrated in the Belgian convergence programme and since then have been integrated in the Belgian stability programmes. Although the federal government (on recommendation by the High Finance Council) can limit the borrowing capacity of a non-compliant region or community, which puts the long-term sustainability of public finances at risk, it has not been considered necessary to use this sanctioning mechanism so far.

On the contrary, regions and communities have demonstrated a strong commitment to stick to the medium-term targets set in the conventions and often performed better than planned. The Belgian National Bank estimated that,

between 1994 and 2003, the regions' and communities' budget balance usually exceeded the target: on average, the difference between the actual outcome and the target expressed as a percentage of total revenue was 2.4 percent per annum for Flanders, 0.3 percent for the Walloon Region and 5.2 percent for the Brussels Capital Region. Only the French-speaking Community had an average performance slightly below the target (by 0.4 percent of its revenue).

From an institutional point of view, a key role in the monitoring of public finances has been played by the 'Public Sector Borrowing Requirements' section of the Belgian High Finance Council. It is composed of high-level experts from ministries, the National Bank, the Federal Planning Bureau and academia. Its members have a renewable five-year mandate which is incompatible with a political office to ensure its independence and the chairman is an academic. Every year the High Finance Council produces an analysis of the borrowing requirements of the regional entities and the budgetary policy to be adopted, including recommendations on the budget balances of the various levels of government. It also publishes an annual *ex post* evaluation of the implementation of the stability programme. Overall, the High Finance Council's recommendations and *ex post* evaluation of the implementation of the stability programme created a transparent system with clear objectives and the opportunity to 'name and shame' authorities that did not meet their targets. This imposed discipline and helped policy-makers to resist pressures to increase

expenditure ([1]). Following the recommendations of the High Finance Council, Belgium is planning to build up surpluses, starting in 2007 (0.3 percent of GDP) and increasing them by 0.2 percent points each year until 2012. Until now, the general government balanced budget position since 2000 was mainly the result of surpluses created by the regions and communities and in the social security sector, which offset the deficits created by the federal government and (to a much lesser extent) local authorities. For the next few years, the Belgian authorities project decreasing surpluses by regions and communities, compensated by some improvement in the budgetary position of the local authorities, whereas social security is expected to maintain a balanced position. Therefore the planned surpluses should result mainly from efforts by the federal government. So far the federal government's budgetary position benefited significantly from the reduction of the interest burden of the debt, because of the continuous debt reduction and favourable interest rate developments. Moreover, one-off measures also regularly supported the federal budget. However, in view of the recent upward trend in interest rates and a depletion of the pool of potential one-off measures, additional structural measures will be required to reach the proposed targets.

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[1] However, in 2005 the 'Public sector borrowing requirements' section did not publish its usual reports, because the Belgian authorities had not yet replaced some of its members after their mandate expired. The High Finance Council is expected to resume its normal activities in the course of 2006.

2. Czech Republic

Recent developments and medium-term prospects

In 2005, the general government deficit was 2.6 percent of GDP, compared with the deficit target of 4.7 percent of GDP set out in the November 2004 convergence programme. Both higher-than-planned revenues and lower-than-budgeted expenditures contributed to the better-than-expected deficit. Like in 2004, low expenditures reflected the possibility given to government departments to carry over unspent funds, rather than intentional and durable spending cuts. Additional expenditure carryovers created in 2005 amounted to about 0.9 percent of GDP, amounting cumulatively to some 1¾ percent of GDP. Public debt, which was recently revised downwards because of the reclassification of a state guarantee, reached about 30½ percent of GDP.

The State budget law for 2006 was approved by Parliament on 2 December 2005. The 2006 budget incorporates fiscal measures presented in the November 2005 convergence programme ([1]). On the revenue side, several new measures are introduced to lower taxation of personal income. On the expenditure side, there are no new specific measures. The increase in budgetary expenditures is budgeted to be lower than growth of nominal GDP, leading to a fall in the expenditure ratio. The 2006 budget exceeds the legally binding nominal medium-term expenditure ceilings set by the Czech authorities in 2004 (see below). Nevertheless, strong economic growth is expected to ensure the achievement of the deficit target of 3.8 percent of GDP in 2006. If the expenditure carryovers were spent on top of the budgeted expenditures, the deficit could be even higher. The Commission services are more optimistic about revenues in 2006 and forecast a deficit of some 3¼ percent of GDP. This forecast already takes into account a debt cancellation of

about ¼ percent of GDP and is based on the assumption that expenditure carryovers will remain constant in 2006, unlike in 2005. Mainly as a result of this assumption, fiscal policy is expected to be expansionary in 2006 as the ratio of the structural primary balance to GDP is projected to deteriorate significantly, by almost 2 percentage points.

The Commission services' forecast for 2007 is a deficit of 3½ percent of GDP, based on the no-policy change assumption and taking into account the recently approved social spending package. The structural balance is foreseen to further worsen in 2007. The deficit target for 2007 set in the November 2005 convergence programme is 3.3 percent of GDP and for 2008 it is 2.7 percent of GDP.

The public-debt ratio is projected by the Commission services to increase in 2006 to 31½ percent of GDP and to further grow in 2007.

New budgetary institutions and their impact on the budgetary process

The quality of the budgetary process in the Czech Republic was affected by two major institutional innovations introduced by the new law on budgetary rules of mid-2004: the possibility to carry over unspent expenditures and medium-term budgetary planning based on fiscal targeting. This section describes those two new institutional features of the Czech budgetary process and assesses their effect.

The possibility of expenditure carryovers

In 2004, the spending ministries were given the possibility to carry over unspent expenditures into the following year.

The main motivation of this measure was to avoid wasteful spending towards the end of the year. In 2004, expenditures of about 1 percent of GDP were rolled over into

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([1]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/year/year20052006_en.htm.

Table V.3

Budgetary developments 2004-2008, The Czech Republic (% of GDP)

Outturn and forecast (¹)	**2004**	**2005**	**2006**	**2007**	
General government balance	– 2.9	– 2.6	– 3.2	– 3.4	
- Total revenues	41.4	41.1	40.8	40.4	
Of which: - current taxes	21.4	21.4	21.5	21.3	
- social contributions	15.0	15.2	15.2	15.1	
- Total expenditure	44.3	43.7	44.1	43.9	
Of which: - collective consumption	11.1	11.2	10.7	10.3	
- social transfers in kind	11.3	11.3	11.0	10.6	
- social transfers other than in kind	11.8	11.6	11.7	12.8	
- interest expenditure	1.2	1.2	1.4	1.4	
- gross fixed capital formation	4.9	4.5	6.5	6.8	
Primary balance	– 1.7	– 1.4	– 1.8	– 2.0	
Tax burden	36.7	37.0	37.2	36.9	
One-off and temporary measures	– 0.7	– 1.1	– 0.2	0.0	
Structural balance (²)	– 1.3	– 1.4	– 3.4	– 4.0	
Structural primary balance	– 0.1	– 0.2	– 2.0	– 2.6	
Government gross debt	30.6	30.5	31.5	32.4	
Pm Real GDP growth (%)	4.7	6.0	5.3	4.7	
Convergence programme (³)	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 3.0	– 4.8	– 3.8	– 3.3	– 2.7
Primary balance	– 1.8	– 3.5	– 2.5	– 2.0	– 1.2
Structural balance (⁴)	– 1.9	– 3.4	– 3.8	– 3.4	– 3.0
Government gross debt (⁵)	36.8	37.4	37.1	37.9	37.8
Pm Real GDP growth (%)	4.4	4.8	4.4	4.2	4.3

(¹)   Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²)   Cyclically-adjusted balance excluding one-off and temporary measures.
(³)   Submitted in November 2005.
(⁴)   Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures are based on information from the November 2005 convergence programme (0.5 % of GDP in 2004, 1.1 % in 2005, 0.2 % in 2006, 0 % in 2007 and 0 % in 2008; all deficit-increasing).
(⁵)   Public debt in the November 2005 update of the convergence programme included a State guarantee of some 6 % of GDP which was reclassified in the spring 2006 fiscal notification.

Source: Commission services, convergence programme of the Czech Republic and the spring 2006 fiscal notification.

2005. In 2005, the expenditure carryovers further increased and their cumulated size is currently estimated at some 1¾ percent of GDP.

The fiscal targeting mechanism

Fiscal targeting was set up to give a medium-term perspective to the process of budgetary planning and to contribute to the reinforcement of aggregate fiscal discipline and to deficit reduction. The mechanism of fiscal targeting is based on the following five steps:

1.   The authorities decide about fiscal targets defined in terms of the general government balance as a percentage of GDP. Currently, national fiscal targets

are those defined in the Council recommendation under Article 104(7) of 5 July 2004 (3.8 percent of GDP in 2006 and 3.3 percent of GDP in 2007). For 2008, the November 2005 update of the convergence programme foresees a deficit target of 2.7 percent of GDP.

2.   The general government target is translated into the central government target (i.e. for the State budget and the State funds) also as a percentage of GDP. Privatisation funds, social security funds and local governments are not subject to fiscal targeting since they are not under the direct control of the central government. To translate the general government

target into the central government target, assumptions have to be made about the fiscal behaviour of these sectors.

3. Central government revenues (in nominal levels) are projected autonomously, usually using growth assumption of the July quarterly forecast of the Ministry of Finance which are at the same time used for the first draft of the next year budget.

4. The combination of the central government fiscal target (step 2) and central government revenues (step 3) results in the definition of the balance (in nominal levels) and of the corresponding expenditure ceiling (in nominal levels) for central government.

5. The central government expenditure ceiling (as defined in step 4) is divided into the expenditure ceilings for the State budget and for the State funds. Within these units, the expenditure ceilings are translated into expenditure ceilings for individual budgetary chapters and lines.

According to the fiscal targeting mechanism, the central government should thus follow medium-term expenditure ceilings defined in nominal levels. The main economic rationale behind this was to create conditions for an effective functioning of automatic fiscal stabilisers. If the government sticks to the expenditure ceilings in case of higher-than-expected GDP growth, the expenditure ratio will decrease faster (or increase slower) than expected and the budgetary outcome will automatically be better-than-planned. At the same time, expenditure ceilings defined in nominal levels should guarantee that higher-than-expected revenues are not spent, but used for a faster improvement in the budgetary balance. On the contrary, in case of lower-than-expected economic growth, automatic stabilisers would be effective only on the revenue side and contained on the expenditure side due to the ceilings. This would limit the potential worsening of the budgetary balance. In case growth is lower than expected and the government still wants to achieve the original fiscal target, it has the possibility to present a budget with expenditures below the adopted ceilings to compensate for the revenue loss.

These steps are repeated every year when the budget is prepared. The planning horizon is three years. In each year (*n*), the expenditure ceilings for years *n+2* and *n+3* are adopted together with the central government budget

for year *n+1*. According to the law on budgetary rules, the expenditure ceiling set in the previous year is binding for the government when preparing the next year's budget. However, no sanctions are foreseen if the government exceeds them.

The ceilings were applied by the government on a voluntary basis in 2004 and 2005 and became legally binding only for the 2006 budget. This means that, in 2005, when the government prepared the 2006 budget and the expenditure ceiling for 2007, the expenditure ceilings which were adopted in 2004 had to be followed ([1]). Nevertheless, the 2006 budget explicitly exceeded the binding expenditure ceilings as adopted in 2004, by a substantial margin of about 0.8 percent of GDP. It was not consistent with the record of significant expenditure under-execution in 2004 and 2005.

Assessment

The new budgetary rules (medium-term fiscal planning based on nominal expenditure ceilings and the possibility of expenditure carryovers) introduced in mid-2004 contributed to the much better-than-expected budgetary outcomes in 2004 and 2005. The November 2004 convergence programme projected a general government deficit of 5.2 percent of GDP in 2004. The final outcome was 2.9 percent of GDP, much lower than expected. For 2005, the November 2005 update of the convergence programme estimated a deficit of 4.8 percent of GDP and the final outcome was only 2.6 percent of GDP.

The systematic overestimations of the outcome for the general government deficit can be attributed to three factors:

1. Medium-term budgetary planning based on fiscal targeting is subject to a high degree of uncertainty on economic growth and tax revenues. This is particularly true for an economy at the end of the transition process, like the Czech Republic, which still faces several structural problems. It seems that the Ministry of Finance has applied cautious assumptions about economic growth and tax revenues within the fiscal targeting framework. Both in 2004 and 2005, budgetary revenues were higher than budgeted (by some ½ percent and 1 percent of GDP, respectively). These positive tax developments

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([1]) There are some exceptions which are mentioned in the law.

occurred despite the decrease of the statutory tax rate in both years.

2. There appears to be a systemic under-execution of budgetary expenditures resulting in a sizeable accumulation of deferred expenditures. Apart from the already mentioned cautious approach to GDP forecasting, there are two further reasons for the under-execution of budgetary expenditures. On the one hand, the spending ministries have difficulties to execute expenditures, mostly due to new comprehensive rules on public procurement and to low absorption of the EU structural funds. On the other hand, the significant carryovers point to potential over-budgeting of expenditures by spending ministries.

3. The budgetary process, including the expenditure ceilings, is on a cash basis (with some modifications) and there is still a high degree of uncertainty about the 'translation' of cash results into accrual accounting according to the ESA95 methodology. Given this uncertainty, it seems that the Ministry of Finance applies a 'safety margin' in its accrual-based forecasts.

The experience with the functioning of these two budgetary rules also reveals two important shortcomings. First, expenditure ceilings which aim at introducing a medium-term perspective to the process of fiscal planning appear not to be fully compatible with the possibility of expenditure carryovers. The sizeable expenditure carryovers distort fiscal targeting and thus undermine its credibility [1].

Second, uncertainty about the spending or further accumulation of expenditure carryovers erodes fiscal policy control by the Ministry of Finance as the decision about the extent and timing to use these carryovers is de facto with spending ministries. This uncertainty also creates more general risks for management of macroeconomic policy mix, in particular for the conduct of monetary policy based on inflation targeting. Enhanced budgetary planning and requiring a justification for spending the funds, carried over from the past, may limit their volume.

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[1] The credibility of the fiscal targeting mechanism was also weakened by the explicit breach of the expenditure ceiling in the 2006 budget.

Table V.4

Main measures in the budget for 2006, The Czech Republic

Revenue measures [1]	Expenditure measures
Personal tax relief (– ¾ % of GDP)	No new measures
• reduction of the tax rates for the two lowest brackets (from 15 % to 12 % and from 20 % to 19 %, respectively)	
• increase in the first income-tax bracket (by almost 11 %)	
• replacement of deductible entries with tax credits	

[1] Estimated impact on general government revenues.

Source: Commission services and the November 2005 convergence programme.

3. Denmark

Recent developments and medium-term prospects

In 2005, the general government recorded a surplus of 4.9 percent of GDP ([1]). This was substantially higher than the surplus of 2.2 percent of GDP foreseen in the 2004 update of the convergence programme. The strength of public finances is partly explained by stronger than expected economic growth: 3.1 percent, compared with 2.5 percent expected in the 2004 convergence programme. However, the main factors explaining the stronger outcome were higher than expected revenues from oil and gas exploitation in the North Sea and from the pension yield tax, where elevated prices and favourable financial market developments respectively boosted tax bases. Against the background of the strong surplus, the stock of government debt was reduced further and the level of the general government debt ratio fell to 35.9 percent of GDP.

The central government budget for 2006 was adopted on 14 December 2005. The new expenditure measures were limited and focused mainly on initiatives in light of the challenges from globalisation, i.e. research, innovation and entrepreneurship. A few initiatives also aimed at the elderly, families with children and vulnerable groups (see Table V.6). On the revenue side, there were no quantitatively significant measures and the so-called tax freeze, which was fully implemented in the context of the 2004 spring fiscal package, remains in force until further review. The tax-freeze implies that no tax rate may be increased and that some individual duties and taxes have been frozen in nominal terms. As in the most recent update of the convergence programme submitted to the Commission on 30 November 2005, a general government surplus of 3.1 percent of GDP was projected outturn of a surplus of 3.6 per-

cent of GDP for 2005, is markedly higher than the 2006 surplus of 1.8 percent of GDP expected in the previous 2004 update. The upward revision to the surplus projection is due partly to lower labour market-related expenditure and, as for 2005, partly to higher revenues from the pension fund yield tax and North Sea oil and gas related activities. Taking account of the higher recorded outturn in 2005, and based on continued strong GDP growth and high oil prices, the Commission services' spring forecast estimate a surplus of 3.9 percent of GDP in 2006. As measured by the change in the structural primary balance, the fiscal stance in the spring 2006 forecast appears to be easing. However, the change in the structural primary balance needs to be interpreted with caution as the sizable surplus in 2005, as mentioned above, was partly due to exceptional factors, not clearly linked to the economic cycle.

For 2007, the Commission services' spring 2006 forecast project a general government surplus of 4.0 percent of GDP. This estimate is based on a no-policy change assumption and, hence, only takes into account adopted fiscal policy measures. As in 2006, the Commission services' surplus forecast is somewhat higher than the projection provided by the government in the latest update of the convergence programme. In the period beyond 2007, the general government balance according to the updated convergence programme is projected to record surpluses between 2¾ percent and 3¼ percent of GDP. This is somewhat higher than the medium-term target interval for the general government balance that has been defined by the government.

On the basis of expected continued general government surpluses, the government debt ratio is expected to fall further. According to the Commission services' spring 2006 forecast, the debt ratio is foreseen to reach and then fall well below 30 percent of GDP in 2006 and 2007 respectively. This broadly corresponds to the reduction of the debt ratio foreseen in the 2005 updated convergence programme.

([1])   All budgetary data quoted here exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes: see footnote ([1]) to Table V.5. Budgetary developments 2004-2010, Denmark* (% of GDP).

Table V.5

Budgetary developments 2004-2010, Denmark ([¹]) **(% of GDP)**

Outturn and forecast ([²])	**2004**	**2005**	**2006**	**2007**		
General government balance	2.7	4.9	3.9	4.0		
- Total revenues	57.2	57.4	54.7	53.8		
Of which: *- current taxes*	47.4	48.5	46.5	46.0		
- social contributions	3.1	2.9	2.9	2.8		
- Total expenditure	54.4	52.6	50.8	49.8		
Of which: *- collective consumption*	8.0	7.7	7.6	7.5		
- social transfers in kind	18.5	18.1	17.7	17.6		
- social transfers other than in kind	16.9	16.2	16.0	15.8		
- interest expenditure	2.2	1.9	1.8	1.5		
- gross fixed capital formation	1.9	1.7	1.7	1.6		
Primary balance	4.9	6.8	5.7	5.5		
Tax burden	50.0	51.0	49.0	48.3		
One-off and temporary measures	0.2	0.2	0.3	0.3		
Structural balance ([³])	3.3	3.9	2.6	2.5		
Structural primary balance	5.5	5.8	4.4	4.0		
Government gross debt	42.6	35.8	30.0	26.5		
Pm *Real GDP growth (%)*	1.9	3.1	3.2	2.3		
Convergence programme ([⁴])	**2004**	**2005**	**2006**	**2007**	**2008**	**2010**
General government balance	2.3	3.6	3.1	3.2	2.7	2.9
Primary balance	4.7	5.6	4.7	4.1	3.5	3.7
Structural balance ([⁵])	2.6	3.6	2.7	3.3	3.3	3.3
Government gross debt	42.3	35.6	31.7	28.9	26.5	21.5
Pm *Real GDP growth (%)*	2.0	2.4	2.4	1.1	1.6	2.1

([¹]) The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact the general government balance according to the updated convergence programme would be 1.7 % of GDP in 2004, 4.0 % in 2005, 2.9 % in 2006 and 3.8 % in 2007, while government gross debt would be 43.8 % of GDP in 2004, 37.0 % in 2005, 31.2 % in 2006 and 27.7 % in 2007.
([²]) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
([³]) Cyclically-adjusted balance excluding one-off and temporary measures.
([⁴]) Submitted in November 2005.
([⁵]) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.2 % of GDP in 2004 and 2005, and 0.3 % in 2006 and 2007; all deficit-reducing).

Source: Commission services and convergence programme of Denmark.

Table V.6

Main measures in the budget for 2006, Denmark

Revenue measures ([¹])	**Expenditure measures** ([²])
	• Globalisation — research, innovation education and improved conditions for the private sector (0.1 % of GDP)
	• Improved child and elderly care, and more generous early pensions (0.1 % of GDP)
	• Improved healthcare and measures aimed at vulnerable groups, including improved food safety (0.1 % of GDP)

([¹]) Estimated impact on general government revenues.
([²]) Estimated impact on general government expenditure.

Source: Commission services and Danish Ministry of Finance.

4. Germany

Recent developments and medium-term prospects

In 2005, the general government deficit amounted to 3.3 percent of GDP, exceeding the target ratio of 2.9 percent as set in the December 2004 update of the stability programme. On the one hand, revenues turned out higher than projected, despite the shortfall in growth. While the previous programme had projected real growth at 1.7 percent of GDP for 2005, it actually turned out at 0.9 percent. However, the growth composition was more tax-favourable than expected in autumn 2004 implying a higher-than-projected tax-to-GDP ratio. The share of 'other revenues' in GDP was also higher than projected, partly due to higher interest income received. On the other hand, the expenditure share also turned out higher than projected in the 2004 update of the stability programme, largely on account of overspending on social assistance. Notably with regard to the reforms of social benefits implemented on 1.1.2005 ('Hartz IV'), the previous year's programme projected employment to rise by 0.5 percent in 2005, while it actually decreased by 0.3 percent. Also, expenditure overruns by the public health insurers contributed to the increase slippage. General government debt amounted to 67.7 percent of GDP in 2005; the difference to the target as set in the 2004 update of the stability programme being due to the upward revision of the deficit.

The draft federal budget for 2006 was presented on 22 February 2006 and is scheduled to be finally adopted by 7 July 2006. On the revenue side, the main measures concern the increase of some and the cutback of other tax allowances on direct taxation while loopholes on tax-saving investment funds are being removed. The fiscal effects of these measures tend to cancel out. On the expenditure side, the allocation for active labour market policies (ALMPs) is increased at the federal level, but reduced by the Federal Employment Agency. Subsidies to new technologies and spending on road and railway infrastructure are stepped up. The abolition of the subsidy on owner-occupied housing will make a small contribution to budgetary consolidation in 2006, with the effect growing over time. The main budgetary effects, however, will derive from action taken well before this budget. As a consequence of the 2005 pension reform, pension expenditure will rise only slightly. Given the public sector wage agreements, negotiated increases in working hours and the trend decline in personnel, the public sector wage bill should contribute substantially to consolidation in 2006. Finally, companies have to carry forward their monthly social contributions from the middle of the following month to the end of the month when the payment is due. This will lead to thirteen instead of twelve cash payments in 2006, providing temporary cash relief until 2007 of almost 1 percent of GDP. However, since this does not affect the budget balance according to ESA95 accrual accounting rules, the social security system would record deficits in 2006 and 2007.

The February 2006 update of the stability programme [1] sets the target for the 2006 general government deficit at 3.3 percent of GDP. The Commission services' spring 2006 forecast projects the deficit at 3.1 percent of GDP, mainly because domestic economic activity is expected more dynamic than by the update. Fiscal policy is forecast to be broadly neutral in 2006, with a slight improvement in the structural balance, i.e. the budget balance net of one-off and other temporary measures.

For 2007, the Commission services spring 2006 forecast, considering those policy measures for which at least a draft law exists, projects the general government deficit at 2.5 percent of GDP. The increase in the central VAT rate from 16 percent to 19 percent should add almost 1 percent of GDP to revenues.

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[1] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

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Table V.7

Budgetary developments 2004-2009, Germany (% of GDP)

Outturn and forecast (^{1})		2004	2005	2006	2007		
General government balance		– 3.7	– 3.3	– 3.1	– 2.5		
- Total revenues		43.2	43.4	43.1	43.0		
Of which:	*- current taxes*	21.7	21.9	21.9	22.7		
	- social contributions	17.8	17.7	17.4	16.6		
- Total expenditure		46.8	46.7	46.1	45.5		
Of which:	*- collective consumption*	7.9	7.8	7.7	7.6		
	- social transfers in kind	10.8	10.8	10.7	10.6		
	- social transfers other than in kind	19.1	19.2	18.9	18.4		
	- interest expenditure	2.8	2.8	2.8	2.8		
	- gross fixed capital formation	1.4	1.3	1.3	1.3		
Primary balance		– 0.8	– 0.5	– 0.3	0.3		
Tax burden		39.0	39.0	38.7	38.8		
One-off and temporary measures		0.1	0.1	0.0	0.0		
Structural balance (^{2})		– 3.5	– 3.1	– 3.0	– 2.3		
Structural primary balance		– 0.7	– 0.3	– 0.2	0.5		
Government gross debt		65.5	67.7	68.9	69.2		
Pm	*Real GDP growth (%)*	1.6	0.9	1.7	1.0		
Stability programme (^{3})		**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance		– 3.7	– 3.3	– 3.3	– 2 ½	– 2	– 1 ½
Primary balance		– 0.8	– 0.5	– ½	½	1 ¼	1 ½
Structural balance (^{4})		– 3.4	– 3.0	– 2.9	– 1.8	– 1.5	– 1.1
Government gross debt		65.5	67 ½	69	68 ½	68	67
Pm	*Real GDP growth (%)*	1.6	0.9	1 ½	1	1 ¼	1 ¾

(^{1}) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(^{2}) Cyclically-adjusted balance excluding one-off and temporary measures.
(^{3}) Submitted in February 2006.
(^{4}) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.1 % of GDP in 2004 and 2005, both deficit-reducing).

Source: Commission services and stability programme of Germany.

On the other hand, the government has adopted legislation to lower the contribution rate to the unemployment insurance from 6.5 percent to 4.5 percent and intends to increase the pension contribution rate from 19.5 percent to 19.9 percent, which might not be sufficient to keep retirement finances in balance. Under current legislation, public health insurers are projected to increase contribution rates by ½ percentage point. Overall, the revenue share in GDP is expected to remain broadly constant compared with 2006, whereas the expenditure share is projected to decline by ½ percentage point or more, reflecting continuing wage restraint and reductions in labour-market-related spending. The projected reduction in the deficit ratio corresponds to the target set in the February 2006 update of the stability programme which, going forward, foresees further deficit

reductions by about ½ percentage point annually to reach 1½ percent of GDP by 2009.

With low nominal GDP growth, the Commission services spring 2006 forecast projects the public debt ratio to increase from 67.7 percent of GDP in 2005 to 69.2 percent in 2007, despite dampening effects expected from the above-entioned cash relief in the social systems and from privatisations. The February 2006 update of the stability programme expects the debt ratio to fall to about 67 percent of GDP by 2009. According to this projection, the reduction in the primary deficit would contribute to the reduction in the debt ratio from 2007 on. Yet, only in the final year of the programme period, the budgetary consolidation would over-compensate the 'snowball effect', i.e. the automatic increase in the debt-to-

GDP ratio caused by interest expenditure that is not balanced by nominal GDP growth. Throughout the programme period, the update assumes 'stock-flow adjustments' to contribute considerably to debt reduction. Such adjustments are primarily due to sales of assets, for example the KfW's sale of its asset holdings on behalf of the government, initial public offerings of publicly-owned companies and the sales of building companies owned by municipalities.

National budgetary coordination

The Protocol on the excessive deficit procedure annexed to the Treaty of Maastricht stipulates: 'Member States shall ensure that national procedures in the budgetary area enable them to meet their obligations in this area from this Treaty.'

The excessive deficit situation, in which Germany has been since 2003, has brought to the fore difficulties in implementing corrective measures. Some of these difficulties arose because of the way national budgetary procedures are institutionalised in Germany.

In addition to the reasons for policy failure discussed in part III of this report, any single budgetary authority has an incentive to free-ride on budgetary consolidation by another, given that the target is specified in terms of the general government deficit.

The German Constitution grants full autonomy to budgetary authorities in Germany. This primarily concerns the federal budget, which (netting out intra-government transfers) accounts for 19 percent of total consolidated expenditure but through which the social security schemes (44½ percent of expenditure) are controlled. Constitutional autonomy also applies to each of the

budgets of the 16 Länder, which sum up to 21½ percent of total expenditure. Each Land is supposed to supervise local budgets on its territory, which account for 15 percent of general government expenditure.

Despite budgetary autonomy, the federal and the Länder levels have to pass almost all tax legislation jointly by finding majorities in both *Bundestag* and *Bundesrat*. Moreover, all federal expenditure legislation that significantly impacts on the Länder budgets must be passed jointly. This has repeatedly led to inaction when the two levels could not find an agreement.

Recently, there have been initiatives to improve coordination in the federal system. First, in 2002, an expenditure coordination mechanism was installed. Second, the draft law to amend the Constitution, submitted to the *Bundestag* in March 2006 (in the context of the reform commission on the federal system, *Föderalismuskommission*), contains a provision to allocate possible sanctions arising from the Stability and Growth Pact across levels of government. Third, the government coalition envisages initiating a revision of the foundations of the tax revenue sharing system in the course of this legislative period [1]. Last, the forthcoming judgment by the Constitutional Court on the budgetary distress of the Land of Berlin might give rise to a reconsideration of insolvency procedures in the federal system.

Apart from the legislative bodies, the coordination of budgetary policy in Germany takes place in the Fiscal

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[1] A future reform of the fiscal relations between levels of government was announced in the 2005 German National Reform Programme in the context of the Lisbon Process.

Table V.8

Main measures in the budget for 2006, Germany

Revenue measures [1]	Expenditure measures [2]
• VAT deduction method (-0.05 % of GDP)	• Public consumption (0.1 % of GDP)
• Indirect taxes (see text) (-0.05 % of GDP)	• Monetary transfers (-0.05 % of GDP)
	• Subsidies (0.1 % of GDP)
	• Investment (0.05 % of GDP)

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.

Source: Commission services and various draft laws.

Planning Council (*Finanzplanungsrat*, FPLR ([1])). This is attached to the federal government and does not have its own office or staff. Chaired by the Federal Minister of Finance, its members are the Federal Minister for the Economy, the finance ministers of the Länder and representatives of local government. The FPLR meets behind closed doors. Consensual conclusions are usually published in a tight-lipped press release.

In July 2002, an amendment to the Law on Budgetary Principles (*Haushaltsgrundsätzegesetz*, HGrG) entered into force, with a view to implementing at national level the commitments made by Germany in the context of the Stability and Growth Pact. At the time, this meant the general government account in balance by 2004 (see 2002 update of the stability programme).

The new Article 51a of the HGrG stresses the common responsibility of the federal level and the Länder for complying with budgetary discipline within the framework of European economic and monetary union. Federal level and Länder are invited to reduce their net borrowing with the aim of achieving balanced accounts. The FPLR gives recommendations for budgetary discipline, notably on a common expenditure line for the central and Länder (including local authorities) governments. The FPLR also assesses whether trends in the budgets of central, Länder and local government are in line with the provisions of Article 104 of the EC Treaty and the Stability and Growth Pact. If necessary, the FPLR makes recommendations on measures to be taken to restore compliance with budgetary discipline.

In the FPLR, the levels of government agreed to implement the law as follows. In 2003 and 2004, the federal level was to reduce expenditure by ½ percent on average per year (in nominal terms), the Länder were to limit joint expenditure growth to 1 percent on average per year. The 2002 agreement was renewed on 16 June 2004, relaxing the expenditure target for the federal level: its expenditure growth should not exceed 1 percent annually on average in 2005 and 2006. The target for the Länder level remained unchanged.

The agreement is neither detailed as regards data requirements for monitoring, nor are progress reports published. Table V.9 shows compliance with the targets

under the following assumptions. The federal level and social security are combined, since the social security schemes are controlled by the federal budget through legislation and transfers. Data are in national accounts terms in order to ensure coherence with the SGP, and transfers within government are netted out because they are a zero-sum game from the EU perspective.

Table V.9. shows that the federal level did not meet its target set for 2003-04, although both the federal budget and the social security systems strongly reduced their expenditure in 2004. Yet, the FPLR did not publish a recommendation. The Länder exceeded their target in 2003-04. For the target set for 2005-06, the updated programme does not provide enough detail to assess whether the target is planned to be met by 2006. However, compliance with the target would imply that the federal level (including social security) would have to limit expenditure growth in 2006 to 0.4 percent. Under current budgetary plans, this is unlikely. Being constrained by their constitutional budgetary requirements, the Länder, however, are under pressure to strictly limit their expenditure growth in 2006. Still, for general government, expenditure growth at 1 percent in 2006 would be consistent with the expenditure projection provided in the stability programme update. However, the FPLR would have to tighten the expenditure ceilings, if it was to conclude a new agreement beyond 2006. Extrapolating the expenditure growth at 1 percent annually between 2007-09, would result in an expenditure share of 44 percent of GDP in 2009, which is ½ percentage point higher than that envisaged in the stability programme.

The analysis suggests that the agreement on expenditure growth has not performed well. Its targets are not well defined, the monitoring is intransparent, and the sanctioning device (recommendation by the Fiscal Planning Council) not applied. Its relation to other devices for budgetary policy at sub-sectors of government is not clear, either.

For example, 'golden rules' apply to the federal and each of the Länder budgets, anchored in the respective constitutions. These golden rules stipulate that net borrowing should not exceed gross investment (in cash terms including loans granted), unless special economic circumstances would warrant it. The local level is subject to stricter borrowing constraints and supervision by the Länder; the social security schemes are subject to rules that ensure balanced budgets (in cash terms and after transfers from the federal budget).

([1]) See also Public Finances in EMU 2003, Part V, Chapter 3.4.2.

In the literature, proposals have been made to improve the procedures of budgetary coordination. The Advisory Council to the Federal Ministry of Finance ([1]) has suggested transposing the indicator-based system of fiscal surveillance used at the EU-level into the German federal structure with the following elements. When presenting its draft budget, each budgetary authority would have to publish its deficit projection in ESA95 terms. In addition, each budgetary authority would publish a stability programme ([2]), to be assessed at the national level. Thus, a strong monitoring organisation at the national level exercising continuous and public control of the current budgetary situation at sub-sectors of government in ESA95 terms should be established, for example a Conference of Finance Ministers with the ability to take binding decisions, with permanent staff at its disposal (unlike the FPLR). An impasse in decision-taking should be prevented by creating a 'default rule' for allocating maximum deficits across budgetary authorities ex ante, which would be applied if no decision was taken. The monitoring organisation would have instruments similar to that of the EU (early warning, etc.). Ex post, a predefined correction mechanism, set as the default rule in case the Conference of Finance Ministers did not find an agreement, would specify the contributions of each budgetary authority to correct an excessive deficit. Finally, an allocation of sanction payments from the excessive deficit procedure (EDP) across national budgetary authorities is proposed.

([1]) Wissenschaftlicher Beirat beim Bundesministerium der Finanzen: Stellungnahme Verbesserungsvorschläge für die Umsetzung des Deutschen Stabilitätspaktes, 4 July 2003, available at: www.bmf.bund.de
([2]) The federal government would possibly remain solely responsible for the stability programme for general government to be submitted to the EU.

The draft law of March 2006 that emerged from the *Föderalismuskommission* sets up such a sanction allocation to be inserted into the German Constitution. It is foreseen that 65 percent of potential sanctions would be allocated to the federal level (which roughly corresponds to the consolidated share of the federal level and social security in total government expenditure in 2005) and the remainder to the Länder (supervising budgets at the local level).

Amongst them, the Länder would allocate their share in the order of 35 percent according to inhabitants and in the order of 65 percent according to the individual contribution to the total budget deficit of the Länder. The idea behind this is to establish a joint liability for sanctions in order to create a common interest in consolidation measures, which, as laid out above, often have to be decided jointly.

The draft law also lays out the statistical foundations for this allocation rule. Since ESA95 national accounts do not exist for individual Länder budgets (only for the total), the draft law proposes an approximation to be compatible with the Stability and Growth Pact.

Currently, budgets must be drafted in cash accounting in Germany, which is one of the reasons why the consequences of budget-drafting at the sub-sector level to requirements of the SGP are absent from the public debate in Germany. Thus, even without sanctions being imminent, this proposal could lead to greater awareness about the SGP at all levels of government.

However, this sanction allocation mechanism does not solve the free-rider problem. For stronger incentives at

Table V.9

Agreements on expenditure growth for sub-sectors of government

	2002	2003	2004	Target	Result	2005	2006 ([1])	Target
	% of total expend.	(1)	(2)	Aver. (1), (2)	Aver. (1), (2)	(3)	(4)	Aver. (3), (4)
Fed. + soc. sec.	63.0	2.2	− 1.3	− 0.5	0.5	1.6	(0.4)	1
L¼nder + local	37.0	0.5	− 0.1	1	0.2	− 0.1	(2.1)	1
General govt. ([2])	100	1.6	− 0.8	(0.06)	0.35	1.0	(1.0)	(1)

NB:
([1]) Required to comply with the target.
([2]) The agreement does not contain a target for general government. Numbers in brackets are implicit.

Source: Federal Statistical Office, Commission services' calculations.

the level of each budgetary authority, it was proposed to tighten the golden rule provisions and to insert the requirement of a structurally-balanced budget in the medium-term into the respective constitutions ([1]). Moreover, for the envisaged second phase of the reform of the federal system, which would aim at the reorganisation of the fiscal relations between levels of government, more revenue autonomy for budgetary authorities has been proposed. For example, the federal level would levy income taxes with a base rate, to which any Land could introduce a surcharge. Such a surcharge could become compulsory as a budgetary correction mechanism ([2]).

Compliance with such a pre-set correction mechanism might further be made a premise for a fiscal bail-out of any national budgetary authority in distress by other national budgetary authorities ([3]). At present, there is no bail-out procedure specified in German law; however, in its decisions the Constitutional Court has defined some principles for bail-outs. A future reform of the fiscal relations between levels of government that was announced in the 2005 German National Reform Programme in the context of the Lisbon Process could take into account these elements.

([1]) Deutsche Bundesbank: Deficit-limiting budgetary rules and a national stability pact in Germany, *Monthly Report* April 2005.

([2]) Deutsche Bundesbank, *op.cit.*

([3]) Wissenschaftlicher Beirat beim Bundesministerium der Finanzen: Gutachten Haushaltskrisen im Bundesstaat, April 2005, available at: www.bmf.bund.de.

5. Estonia

Recent developments and medium-term prospects

Public finances in Estonia in 2005 were substantially stronger than expected. The general government surplus was 1.6 percent of GDP, compared to the target of balanced general government accounts, as projected in the December 2004 update of the convergence programme. The main factors behind this outcome were higher-than-expected revenues due to stronger-than-anticipated economic activity and a considerable rise in employment, which was partly also owed to a whitening of parts of the 'informal' economy and declaration of formerly grey employment contracts, leading to a high surplus in the social security accounts. In addition, further improvements in tax collection and windfall gains from inflation boosted revenues, while on the expenditure side the nominal expenditure ceilings were respected. The level of the debt ratio continued to decline and stood at 4.8 percent of GDP in 2005, which is the lowest in the EU.

The budget for 2006 was adopted on 7 December 2005. The main measures on the income side are a cut of the flat income tax rate for both individuals and corporations by 1 percentage point to 23 percent, combined with an increase of the tax-free threshold, which both entered into force on 1 January 2006. On the expenditure side, EU co-financing requirements and increases to pensions and parental leave entitlements are the main budgetary measures. The target for the general government balance in 2006 according to the December 2005 update of the convergence programme was a surplus of 0.1 percent of GDP [1]. Against the background of expected continued robust GDP growth, this target was raised by the government on 17 March 2006 to 1.6 percent of GDP, in the

framework of the new official forecast by the Ministry of Finance. This upward revision of the target for the budget surplus responds to a relevant recommendation by the Council in its opinion of 14 February 2006 on the December 2005 convergence programme update, which stated that it would be appropriate for Estonia to aim for a higher budgetary surplus in 2006 and in the subsequent years. The new target is broadly in line with the Commission services' spring 2006 forecast which projects a surplus of 1.4 percent of GDP for 2006. As measured by the change in the structural budget balance, the fiscal stance in 2006 in the spring 2006 forecast is mildly expansionary. Discrepancies with the structural balance as calculated in the framework of the assessment of the convergence programme are explained by the markedly prudent growth and revenue assumptions in the programme.

In 2007, the Commission services' spring 2006 forecast, based on the customary no-policy-change assumption, projects a general government surplus of 0.8 percent of GDP. This is higher than the balanced budget projected in the December 2005 update of the convergence programme which is maintained also in the updated government forecast of March 2006. The rationale for a more optimistic assumption in the Commission services' forecast lies with Estonia's track record of prudent forecasting and repeated overachievement of fiscal targets over the past few years.

Beyond 2007, the projected evolution of the general government balance in the convergence programme update is one of balanced budgets. This reflects the official medium-term objective of the Estonian budget policy.

Estonia's public debt is forecast to decline further to 3.6 percent of GDP in 2006 and to 3 percent in 2007, according to the Commission services' spring 2006 forecast.

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[1] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.10

Budgetary developments 2004-2009, Estonia (% of GDP)

Outturn and forecast [1]		2004	2005	2006	2007		
General government balance		1.5	1.6	1.4	0.8		
- Total revenues		37.9	37.5	37.3	36.8		
Of which:	- current taxes	21.3	21.4	20.9	20.4		
	- social contributions	11.2	11.0	10.6	10.4		
- Total expenditure		36.4	35.9	35.8	35.9		
Of which:	- collective consumption	8.4	8.1	7.9	7.8		
	- social transfers in kind	10.6	10.1	9.8	9.7		
	- social transfers other than in kind	10.0	9.6	9.5	9.6		
	- interest expenditure	0.2	0.2	0.2	0.2		
	- gross fixed capital formation	3.0	4.0	4.0	4.1		
Primary balance		1.8	1.8	1.6	1.0		
Tax burden		32.5	32.6	31.8	31.2		
One-off and temporary measures		0.0	0.0	0.0	0.0		
Structural balance [2]		1.8	1.5	1.1	0.5		
Structural primary balance		2.0	1.7	1.3	0.7		
Government gross debt		5.4	4.8	3.6	3.0		
Pm	*Real GDP growth (%)*	7.8	9.8	8.9	7.9		
Convergence programme [3]		**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance		1.7	0.3	0.1	0.0	0.0	0.0
Primary balance		1.9	0.5	0.3	0.2	0.1	0.1
Structural balance [4]		1.7	0.4	0.3	0.2	0.1	0.0
Government gross debt		5.4	4.6	4.4	3.3	3.0	2.8
Pm	*Real GDP growth (%)*	7.8	6.5	6.6	6.3	6.3	6.3

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
[2] Cyclically-adjusted balance excluding one-off and temporary measures.
[3] Submitted in Dec 2005.
[4] Commission services' calculations on the basis of the information in the programme

Source: Commission services and convergence programme of Estonia.

Table V.11

Main measures in the budget for 2006, Estonia

Revenue measures [1]	Expenditure measures [2]
• Personal and corporate income tax: reduction of income tax rate from 24 % to 23 % (– 0.39 % of GDP)	• Extension of parental subsidies by three months (0.13 % of GDP)
• Personal income tax: increase of basic allowance from 20 400 EEK to 24 000 EEK, combined with lowering of tax deduction limit by half (– 0.3 % of GDP)	• Raise in pensions (0.91 % of GDP) • Increases in health insurance costs (0.45 % of GDP) • Modernisation of infrastructure (0.37 % of GDP)
• Unemployment insurance contribution: decrease of the contribution rates for both employers and employees, from 1 %/0.5 % to 0.6 %/0.3 % respectively (– 0.13 % of GDP)	• Increase of subsidies in agriculture and fisheries (0.25 % of GDP)
• Social tax: the monthly base rate for the minimum social tax liability was raised from 700 EEK to 1400 EEK (– 0.13 % of GDP)	
• Increases in excise duties on tobacco, alcohol and fuel (incl. additional VAT) (+ 0.4 % of GDP) as of 1 July 2007 [3]	

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.

Source: Commission services and Estonian Ministry of Finance.

6. Greece

Recent developments and medium-term prospects

The government deficit in 2005 was 4.5 percent of GDP ([1]). This compares with the figure of 3.7 percent of GDP projected in the update of the Stability Programme of Greece ([2]) submitted in March 2005. The difference is mainly explained by statistical revisions carried out since the EDP notification of September 2004. The deviation is also due to the reimbursement penalty of EU funds amounting to ¼ percent of GDP, following a Eurostat decision that specifies that the whole amount should be booked in 2005 expenditures. The debt-to-GDP ratio is moving downwards slowly, from an average of above 110½ percent of GDP over the period 2000-2004 to around 107½ percent of GDP in 2005.

The budget for 2006 was adopted by Parliament on 22 December 2005. On the revenue side, the budget envisages a reform in property taxation and a rise in excises on fuel, while the authorities restated their commitment to pursue their fight against tax evasion. The budget also includes temporary revenues amounting to 0.6 percent of GDP (dividends, sale and extension of concession rights and payments by the Hellenic Telecommunications and Post Commission, revenues from fines and licenses). On the expenditure side the main measures aim at restraining both the wage bill and operational expenditures. The government has also adopted a new framework law for public enterprises and entities with a view to increasing their efficiency. New legislation regarding public-private partnerships is expected to facilitate infrastructure investment without putting

immediate pressure on the government accounts. According to the December 2005 update of the Stability Programme of Greece, the target deficit for 2006 is 2.6 percent of GDP. The Commission services' spring 2006 forecast project a deficit of just below 3 percent of GDP. The difference with the Greek target is mainly due to lower Commission's GDP growth rate projections coupled with more prudent tax revenue and government consumption projections. Moreover, the Commission services have included only half of the one-off operations amounting to 0.6 percent of GDP, as their accounting treatment requires clarification. However, the recent announcement of a permanent increase in oil taxes amounting to 0.1 percent of GDP, and the temporary increase in corporate withholding taxes, amounting to ¼ percent of GDP, have been considered in the Commission's projection. The planned adjustment is mainly expenditure-driven. The expenditure ratio is projected to fall by ¾ percent points of GDP, of which less than half is accounted for by primary current spending. Measures to improve tax administration, coupled with the broadening of tax bases brought about by the fight against tax fraud and evasion, should raise revenues by less than ¼ percent of GDP. Overall, the structural deficit is projected to improve by about 1 percent of GDP in 2006.

Assuming unchanged policies, the deficit projection for 2007 would be around 3½ percent of GDP. This shows that structural measures will be necessary to keep the deficit below 3 percent in a durable manner. The projection for 2007 takes account of further permanent increase of oil taxes representing 0.1 percent of GDP and compares with the target set in the December 2005 update of the Stability Programme of Greece of 2.3 percent of GDP for 2007 (and 1.7 percent of GDP for 2008).

The Commission services' spring 2006 forecast projects a general government debt-to-GDP ratio at slightly below 105 percent in 2006 and about 102 percent in 2007, which is somewhat less favourable than the targets shown in the updated stability programme (for 2007, the difference

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([1])   Despite the recent improvement in the statistical processes and good cooperation between Eurostat and the Greek national authorities, issues remain related to the Greek government accounts of a structural and systemic nature. (See Eurostat News Release No 48/2006 of 24.4.2006.)

([2])   The programme, as well as its assessment by the Commission and the Council, can be found at:
http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.12

Budgetary developments 2004-2008, Greece (% of GDP)

Outturn and forecast (¹)	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	− 6.9	− 4.5	− 3.0	− 3.6	
- Total revenues	42.0	41.8	41.9	41.3	
Of which: *- current taxes*	21.6	21.7	22.4	22.4	
- social contributions	14.6	14.3	14.8	14.8	
- Total expenditure	48.9	46.3	44.9	44.9	
Of which: *- collective consumption*	9.8	9.9	10.3	10.2	
- social transfers in kind	6.7	6.4	5.6	5.7	
- social transfers other than in kind	17.1	16.7	18.0	18.0	
- interest expenditure	5.4	5.0	4.9	4.9	
- gross fixed capital formation	4.2	3.5	3.1	3.1	
Primary balance	− 1.5	0.5	1.9	1.4	
Tax burden	35.2	35.2	35.3	35.3	
One-off and temporary measures	0.0	− 0.2	0.6	0.0	
Structural balance (²)	− 7.7	− 5.5	− 4.3	− 4.4	
Structural primary balance	− 2.3	− 0.1	0.5	0.6	
Government gross debt	108.5	107.5	105.0	102.1	
Pm *Real GDP growth (%)*	4.7	3.7	3.5	3.4	
Stability programme (³)	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	− 6.6	− 4.3	− 2.6	− 2.3	− 1.7
Primary balance	− 0.9	0.9	2.3	2.4	2.8
Structural balance (⁴)	− 7.2	− 4.8	− 3.7	− 2.8	− 2.4
Government gross debt	109.3	107.9	104.8	101.1	96.8
Pm *Real GDP growth (%)*	4.7	3.6	3.8	3.8	4.0

(¹) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²) Cyclically-adjusted balance excluding one-off and temporary measures.
(³) Submitted in December 2005.
(⁴) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.0 % of GDP in 2004, -0.2 % in 2005, 0.5 % in 2006, 0.0 % in 2007 and 0 % in 2008; all deficit-reducing, except in 2005).

Source: Commission services and stability programme of Greece.

amounts to 1 percent of GDP). Increasing primary surpluses, diminishing stock-flow adjustments, privatisations, and sustained nominal GDP growth are all contributing to a diminishing debt ratio. In 2005, factors other than the deficit (i.e. the stock-flow adjustment) contributed to increasing the debt by 2.1 percent of GDP. Differences between cash and accrual accounting, including statistical discrepancies, were the main contributors to the stock-flow adjustment, partially offset by a small reduction in government holdings of shares and liquidities. For 2006, the Greek authorities expect to reduce the stock-flow adjustment to 1.6 percent of GDP.

Greece: Another twin deficit case?

The story of the Greek economy in the current decade is one of buoyant growth and remarkable success in

terms of real convergence. Joining the single currency represented a positive confidence shock for the Greek economy. Since 1999, interest rates have steadily declined to the current levels which, at close to 2 percent, are the lowest the country has seen in recent times. This has provided positive leverage for private investment and consumption.

However, during this cycle of buoyant growth, several economic imbalances have either emerged or worsened. Very high deficits in goods trade, above 15 percent of GDP, are only partially compensated by increasing surpluses in services (mainly tourism and transportation) of around 9 percent of GDP. In parallel, the cumulated surpluses of the incomes and current transfers accounts account negatively for around − 1 percent of GDP. As a result, the current account

deficit has jumped to above 9 percent of GDP in the most recent past, compared with a position close to the surplus in the mid-nineties. Once the capital transfers of around 1½ percent to 2 percent of GDP are considered, the overall external deficit of the country in the mid-2000 posts a deficit of around 7 percent of GDP, which compares with a balanced situation recorded ten years ago.

The persistence in the net borrowing position of Greece vis-à-vis the rest of the world is mirrored by a large and persistent deficit recorded by the government in combination with a steady worsening of private balances.

While in the second half of the 1990s private surpluses practically compensated government deficits of 5 to 10 percent of GDP, since the early 2000s, the increase in spending on housing by Greek households coupled with increasing borrowing by the corporate sector, have pushed the combined net balance of the private sector into deficit.

As a result, high government deficits are not financed anymore by domestic saving and their developments almost fully mirror the external borrowing of the country. Although part of the increase in government deficits over the last five years has financed public works and other major initiatives linked to the organisation of the Olympic Games, infrastructure investment is not

the main source of the persistent Greek Government deficit. As a matter of fact, public investment in Greece hovered around 3½ percent of GDP during the second half of the 1990s while it did not go significantly further than 4 percent in some of the years between 2000 and 2004, before returning to the current 3 percent of GDP. Therefore, the external borrowing is largely devoted to finance current public spending. This includes not only high interest expenditure, because of the persistently very large government debt, but also other current expenditures, such as public consumption and social payments. Although the Greek government appears firmly committed to fiscal consolidation, further focus on spending items which follow long-run trends linked to population ageing seems necessary. Specifically, ¾ of the total nominal adjustment projected for the period 2005-2008 is explained by higher revenues, lower interest expenditure and miscellaneous expenditures.

Unless decisive steps are taken to correct the source of imbalances, especially those expenditure items that put pressure on the public deficit in the long run, the external deficit, which reflects lack of competitiveness, may eventually weigh on growth prospects, thus harming Greece's attractiveness as a place for productive investment. This requires a combination of fiscal consolidation, a rise of domestic savings, and comprehensive structural reforms to support growth and job creation.

Table V.13

Main measures in the budget for 2006, Greece

Revenue measures [1]	Expenditure measures [2]
• Dividends (0.3 % of GDP, one-off) • Sale and extension of concession rights (0.24 % of GDP, one-off) • Payments by the Hellenic Telecommunications and Post Commission revenues from fines and licenses (0.06 % of GDP, one-off) • Fighting against tax evasion and a reform in property taxation (0.4 % of GDP) • A rise in excise taxes on fuel (0.08 % of GDP) • An increase in the rate of income tax pre-payment for enterprises and banks (0.23 % of GDP)	• Refunding to pensioners of past contributions on behalf of the Solidarity Account of Social Security Funds (0.08 % of GDP) • Elections for local government (0.03 % of GDP)

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.

Source: Commission services and stability programme of Greece.

Table V.14

Composition of the Greek foreign net lending/borrowing

% of GDP	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Trade balance	− 12.2	− 13.2	− 13.5	− 14.8	− 15.6	− 18.3	− 16.0	− 16.3	− 16.7	− 17.7	− 16.2
Services balance	4.9	5.3	6.1	6.4	7.1	7.4	6.3	6.6	7.1	8.9	9.0
Net primary income	3.2	2.8	2.8	2.7	1.3	0.8	− 0.7	− 0.7	− 1.1	− 0.8	− 1.8
Net transfers	3.3	2.8	2.4	2.1	1.5	1.3	1.2	0.7	0.6	0.1	− 0.1
Current account balance	− 0.9	− 2.4	− 2.1	− 3.5	− 5.7	− 8.8	− 9.2	− 9.7	− 10.0	− 9.5	− 9.2
Net capital transfers	0.8	1.4	1.8	2.1	1.8	2.6	1.2	1.1	1.5	1.8	1.5
Foreign net lending balance	− 0.1	− 1.0	− 0.4	− 1.4	− 4.0	− 6.2	− 8.0	− 8.6	− 8.6	− 7.7	− 7.7

Source: Ameco, for 2006 and 2007 Commission services spring 2006 forecasts.

Graph V.3: **Composition of the Greek foreign net lending/borrowing**
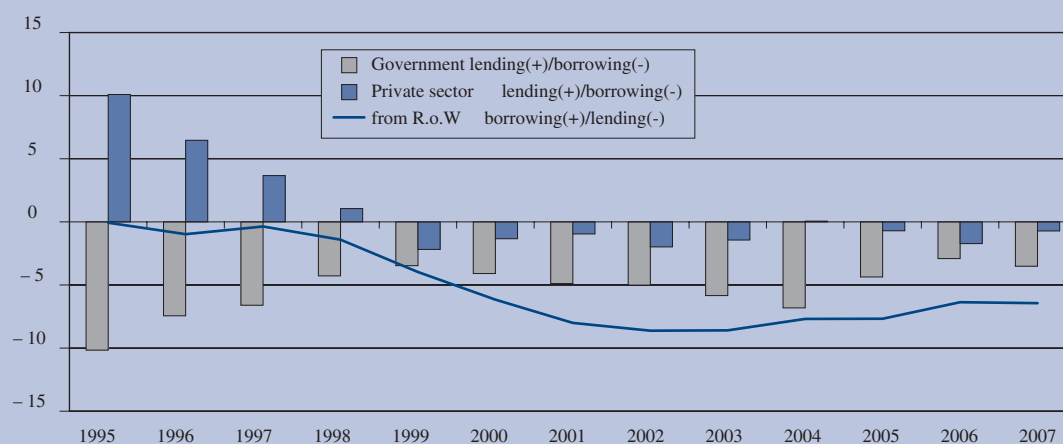
7. Spain

Recent developments and medium-term prospects

In 2005, the general government surplus was 1.1 percent of GDP. This compares with a surplus of 0.1 percent of GDP projected in the 2005 Budget Law, a surplus of 1 percent of GDP in the December 2005 updated stability programme and a surplus of 0.2 percent of GDP in the previous December 2004 updated stability programme. The better-than-expected outturn is largely explained by higher revenues, accounting for 0.9 percent of GDP. By levels of government, the central government posted a surplus of 0.4 percent of GDP, whereas regional and local authorities registered a deficit of 0.2 percent and 0.1 percent respectively. The social security sector achieved a surplus of 1.0 percent of GDP. Public debt attained 43.2 percent of GDP.

In 2006, the Budget Law adopted by the government on 29 December 2005 projected a surplus in the general government's accounts of 0.2 percent of GDP. However, the most recent update of the stability programme (¹) forecasts a surplus of 0.9 percent of GDP due to the carry-over effect of higher-than-expected revenues in 2005. The Commission services' spring 2006 forecast is broadly in line with the projections for 2006 of the latest update of the stability programme. More in detail, according to the 2006 Budget Law, central government revenues are expected to increase by around 9 percent in nominal terms. Direct taxes and social security contributions are expected to grow by 10 percent and 7½ percent respectively, due to strong job creation, while private consumption growth should increase indirect tax revenues by 5¼ percent. Central government expenditures are targeted to grow by around 8 percent. Particular efforts are devoted to productivity-enhancing budgetary measures on the expenditure side, which will concen-

trate on R & D, innovation, education and investment in infrastructure. Specifically, the budget encompasses a 30 percent of R & D expenditure with a view to catching up with the euro area average reaching a level of 1½ percent of GDP in 2007 and 2 percent in 2010. Expenditure on education will increase by 17 percent on the previous year. Most of this increase will translate into more and higher grants for students. It is worth mentioning that the central government only manages around 5 percent of total education expenditure with the rest being managed by regional governments. Finally, the budget gives priority to investment in infrastructure, with spending planned to increase by 12½ percent on the previous year. Special attention will be paid to improving terrestrial transport, notably motorways and the promotion of high-speed railway network. Furthermore, the Budget Law includes an additional transfer to the regions of around 0.05 percent of GDP to fund healthcare expenditure.

In 2007, the most recent update of the stability programme targets a surplus of 0.7 percent of GDP for the general government. This projection is slightly more optimistic than the Commission services' spring 2006 forecast, in which, under a no-policy change scenario, the general government balance is expected to achieve a surplus of 0.4 percent of GDP. In 2007 a reform of the personal income tax is expected to come into force. The reform was adopted by the government and is currently discussed in parliament. It encompasses a broad range of measures affecting personal income tax and, to a lesser extent, the corporate tax. Specifically, for the personal income tax, the top marginal rate is lowered by 2 percentage points, from 45 percent to 43 percent, the number of tax brackets is reduced from 5 to 4 and personal savings will be taxed at a single flat rate of 18 percent. The corporate tax should gradually ease from the current rate of 35 percent to 30 percent by 2011.

In the case of small and medium enterprises the rate would go down from 30 percent to 25 percent. The reform would imply a reduction of tax revenues of

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(¹) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.15

Budgetary developments 2004-2008, Spain (% of GDP)

Outturn and forecast (¹)		**2004**	**2005**	**2006**	**2007**	
General government balance		– 0.1	1.1	0.9	0.4	
- Total revenues		38.7	39.3	39.3	38.8	
Of which:	- *current taxes*	22.1	23.1	23.2	23.0	
	- *social contributions*	13.0	13.0	12.9	12.8	
- Total expenditure		38.8	38.2	38.3	38.5	
Of which:	- *collective consumption*	7.5	7.5	7.6	7.7	
	- *social transfers* (²)	10.3	10.3	10.3	10.3	
	- *interest expenditure*	2.0	1.8	1.6	1.5	
	- *gross fixed capital formation*	3.4	3.6	3.6	3.7	
Primary balance		1.9	2.9	2.6	1.9	
Pm	*Tax burden*	35.1	36.1	36.1	35.8	
Government debt		46.4	43.2	40.0	37.9	
Pm	*Cyclically-adjusted balance* (⁵)	0.0	1.3	1.3	1.0	
Pm	*Cyclically-adjusted primary balance*	2.0	3.1	3.0	2.5	
Pm	*Real GDP* (³)	3.1	3.4	3.1	2.8	
Stability programme (⁴)		**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		– 0.1	1.0	0.9	0.7	0.6
Primary balance		1.9	2.8	2.6	2.2	2.0
Government debt		46.6	43.1	40.3	38.0	36.0
Pm	*Real GDP* (³)	3.1	3.4	3.3	3.2	3.2

(¹)   Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²)   In kind and other than in kind.
(³)   Annual % change.
(⁴)   Submitted in December 2005.
(⁵)   Calculated using the HP filter.

Source: Commission services and Stability programme of Spain.

around 5 percent in nominal terms (around 0.4 percent of GDP) in comparison with current legislation.

The reform seems compatible with the maintenance of a balanced budget. In 2008, a surplus of 0.6 percent of GDP is forecast in the 2005 updated stability programme.

Concerning gross public debt, the 2005 updated stability programme foresees a gradual decline towards 38 percent of GDP in 2007. This is broadly in line with the projections in the Commission services' spring 2006 forecast.

Regional governments' finances

In the early 1980s, half of the general government expenditure was managed by the central government. Around one third represented the social security system, 10 percent was managed by the local authorities and only

7 percent was controlled by the regions. The far-reaching decentralisation process that has taken place in Spain during the last 25 years has led to a redistribution of spending from the central government to the regions.

In 2005, regional governments controlled 40 percent of the general government expenditure, whereas the central government only managed 20 percent. The share in total expenditures of social security and of the local authorities has remained broadly stable at around 30 percent and 10 percent respectively. In terms of GDP, regional expenditures represented 5 percent of GDP in 1985, whereas they accounted for 15 percent in 2005, with an average annual growth in real terms at around 10 percent, well above real GDP growth (see Graph V.4).

This increase has been the result of important transfers of public services such as healthcare or education to the regional governments. In parallel, revenues have been

transferred from the central to the regional governments in order to allow the latter coping with their new responsibilities.

Regional budgets

According to the General Law for Budgetary Stability (GLBS, 2002), each regional government must present a balance-or-in surplus budget. This requirement aims at ensuring that increased fiscal decentralisation does not come at the expenses of budgetary stability.

However, regional authorities have some margin of manoeuvre during the execution of budgets, and deficits may emerge. Specifically, in 2001, the deficit of regional governments reached 0.6 percent of GDP. Then, following a decreasing path, regions presented balanced accounts in 2004. However, in 2005, a small deficit is estimated to have come up again, attaining 0.2 percent of GDP (see Graph V.5).

Revenues of the regional governments can be divided into two different categories: own resources and transfers from the central government. Own resources represent so far around 60 percent of regional government revenue, coming mainly from a share of personal income tax and VAT, although for the latter, regional authorities have no legislative capacity. The rest 40 percent are current transfers from the central government.

From a historical perspective, three main periods can be considered when referring to the financing of regions. Between 1978 and 1992, transfers from the central government covered the effective costs of the services provided by regional governments. Between 1992 and 1996, a certain degree of fiscal co-responsibility was introduced by transferring 15 percent of the personal income tax.

Since 1997, the transfer of the personal income tax has been increased to 30 percent and, additionally, regions have some legislative capacity. Specifically, regional authorities may increase or decrease up to 10 percent the personal income tax within the 30 percent under their control and could also modify personal or family allowances. Referring to indirect taxes, which include not only the VAT, but also others such as taxes on hydrocarbons, the share transferred to the regions accounts so far for around 50 percent.

Regional expenditures encompass a wide variety of areas, namely, healthcare, education, agriculture and fisheries, tourism, and even a part of infrastructure investments in the region. Health care and education represent more than half the budget of the regions (33 percent and 23 percent respectively). Agriculture and fisheries account for around 8 percent, infrastructures 6 percent, security and social protection 5 percent and general administration 5 percent. Furthermore, the regions transfer part of their revenues (around 5 percent) to the local layer. The remaining 15 percent includes various items such as social promotion, housing or industry.

The rapid increase in the regions' spending is the consequence of the transfer from the general government of all those services over the last 25 years. However, regions competences are not the same across the country and some regional governments control more services than others. Furthermore, transfers of competences did not take place at the same time. For example, Catalonia started managing healthcare in 1981, whereas the Canary Islands did it in 1994 and Madrid region in 2002. In the case of tertiary education, Valencia has managed universities since 1985, whereas the region of Madrid received the competence from the central government ten years later, in 1995.

Table V.16

Main measures in the budget for 2006, Spain

Revenue measures	Expenditure measures
• The tax brackets of the personal income tax will be deflated	• Increase in R & D spending (0.15 % of GDP)
• Social security bonus aiming at encouraging non-fixed contracts in the labour market (reduction of 0.2 % of GDP)	• Increase in investment in transport infrastructure, namely roads and railways (0.15 % of GDP)
	• Increase in social benefits (housing accessibility, minimal pensions, dependency) (0.25 % of GDP)
	• Transfer to the regions for healthcare expenditure (0.05 % of GDP)

Source: Commission services and 2005 Budget Law

Graph V.4: Evolution of regional expenditure (% of GDP and % of total government expenditure)
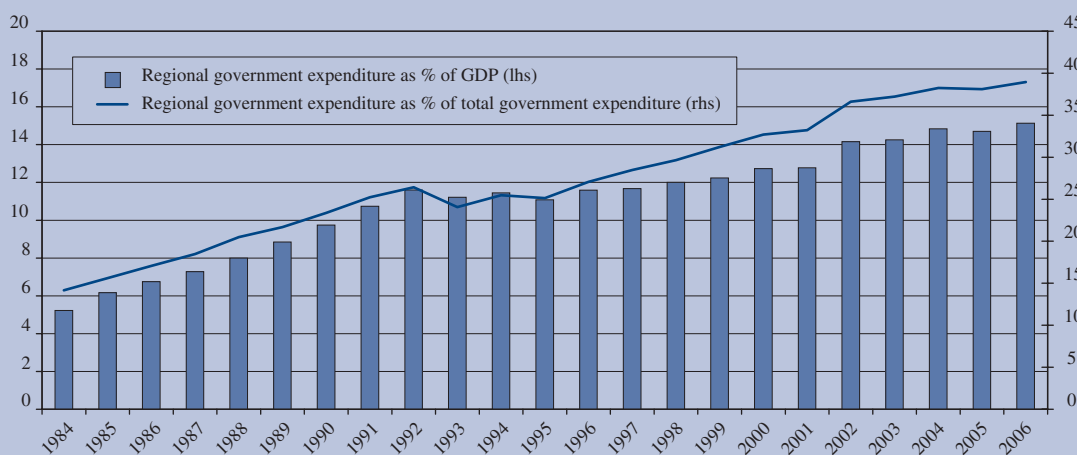
Graph V.5: Deficit and debt of regional governments (in % of GDP)
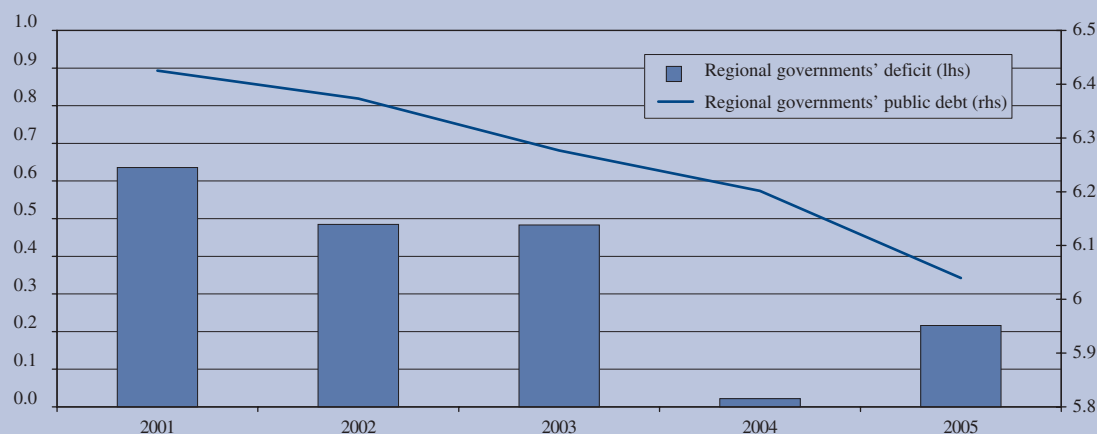
The debt of the regional governments is following a slightly decreasing path in terms of GDP. In 2001, it accounted for around 6½ percent of GDP, whereas in 2005, it is estimated to represent 6 percent.

Health and education

As mentioned above, these two items account for more than half the regional expenditures. In 2005, most regional governments took over the management of healthcare and education spending. Thus, the central government only controls so far around 8 percent of the total expenditure in healthcare and around 5 percent in education and, there-

fore, the bulk of the expenditure in these two items comes from the regional governments ([1]).

Between 2001 and 2005, healthcare expenditure is estimated to have grown at an average rate of around 10 per-

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([1]) Data on the functional classification of regional governments' expenditure are published with a delay of around two years. Therefore, it is difficult to assess the evolution of items such as healthcare and education in a timely way. Specifically, the last functional classification release refers to the year 2003. Estimates from 2004 onwards have been calculated by the Commission Services on the basis of the regional budgets and the implementation data release based on the economic classification if available.

Graph V.6: **Regional government expenditure in healthcare and education (in % of GDP)**
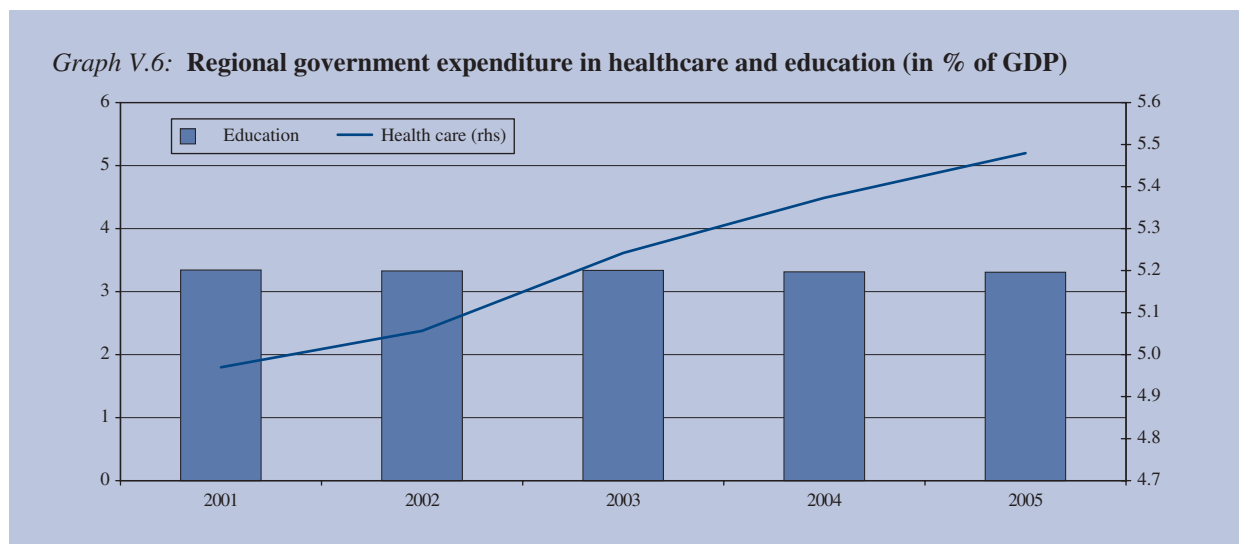
cent per year in nominal terms. As total regional government expenditure has also been growing at a similar pace, its share in total regional expenditure has remained rather stable at around 1/3. Specifically, in Andalusia, healthcare expenditure represents 30 percent of the regional government budget, whereas in Catalonia and Valencia it approaches 40 percent.

As general government expenditure has been growing at around 7½ percent in nominal terms during the same period, the share of healthcare in general government expenditure has increased from around 12¾ percent in 2001 to around 14¼ percent in 2005. In the same vein, with nominal GDP growing at around 7¾ percent per year in the same period, the share of health-related expenditure rose from 5 percent to 5½ percent of GDP (see Graph V.6).

Education expenditure has been slightly less dynamic than healthcare. Between 2001 and 2005, education expenditure has been growing at an average rate of around 8 percent in nominal terms. This would represent a slight decline in the share of total regional expenditure from 24 percent in 2000 to 22 percent in 2005, whereas its share in general government expenditure would have remained unchanged at around 8½ percent. In terms of GDP, education expenditure by regional governments represents a rather stable 3½ percent.

Whereas education expenditure has remained broadly stable in terms of GDP, the healthcare bill has increased its GDP share from 5 percent in 2001 to an estimated 5½ percent in 2005. This rapid increase in healthcare spending might explain in part the origin of regional deficits. Specifically, and in order to cope with growing expenditures on this item, the central government included in the 2006 Budget Law an additional transfer to the regional governments of around 0.1 percent of GDP.

Outlook

According to the Commission services spring 2006 forecast, general government expenditure should grow by around 8 percent in 2006 and 7 percent in 2007, slightly above nominal GDP growth. This projection for total public expenditure takes account for healthcare and education dynamics. Specifically, in 2006, healthcare regional expenditures are projected to grow by around 10 percent, whereas education should approach 8¼ percent, both well above nominal GDP.

In spite of such an increase, regional accounts are not foreseen to depart significantly from a close-to-balance position. This rapid increase in public expenditure by the regions has been so far compatible with general government surpluses in a context of a sustained GDP growth.

8. France

Recent developments and medium-term prospects

Following a decline from 4.2 percent to 3.7 percent of GDP in 2004 ([1]), the general government deficit was further reduced to 2.9 percent in 2005. The deficit reduction of 0.8 percentage point, nearly entirely relied on exceptional factors, notably substantial one-off revenues amounting to 0.6 percent of GDP ([2]). The 2005 deficit outcome is at the target presented in the December 2004 update of the stability programme ([3]) despite lower growth (1.4 percent against 2.5 percent anticipated). This was possible thanks to stronger-than-expected tax receipts notably linked to the strong performance of housing and asset prices. As a result, the ratio of total revenues to GDP increased by 1.4 percentage point to 51.0 percent of GDP, with the tax burden having risen by a full percentage point to 44.1 percent of GDP. Also, the deficit benefited from the implementation of the Eurostat decision on the recording of military expenditure at the time of their delivery, which led to a decrease in the 2005 deficit in France by 0.1 percentage point of GDP ([4]). On the expenditure side, targets were respected at the State level and for healthcare expenditures; nevertheless total public expenditure overshot the official target, mainly due to slippages in expenditures of local governments and social security other than the health insurance

scheme. All in all, the expenditure-to-GDP ratio increased by 0.7 percentage point of GDP to 53.9 percent. The debt-to-GDP ratio surged to 66.8 percent, increasing by more than 2 percentage points compared to 2004. At this level, the debt-to-GDP ratio is 1.8 percentage point higher than that foreseen in the December 2004 update of the stability programme despite the fact that the deficit target was achieved. This larger increase in the gross debt is mainly explained by (i) an accumulation of financial assets, notably by the pension reserve fund (*Fonds de réserve des retraites*) and (ii) an accumulation of liquidity at the end of the year in connection with the end-December 2005 change in the tax code that yielded higher corporate tax receipts.

The budget for 2006 adopted by the Parliament in December 2005 plans a deficit at 2.9 percent of GDP in 2006 thanks to a marked slowdown in public spending through (i) a stabilisation of State expenditures in real terms for the fourth year in a row; (ii) a deceleration in healthcare expenditure growth (from 3.8 percent in 2005 to 2.5 percent in 2006), and (iii) a slowdown in local authorities' expenditures, but also thanks to the reliance on one-off revenues of about ¼ percent of GDP ([5]).

The Commission services' 2006 spring forecast anticipates a general government deficit at 3.0 percent of GDP. This is slightly above the latest official target announced by the Ministry of Finance at the time of the 1 April 2006 fiscal notification (2.8 percent of GDP) ([6]). The difference is mainly due to (i) a more cautious macroeconomic scenario (1.9 percent real GDP growth foreseen by the Commission services as against 2.0-2.5 per-

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([1]) In 2004 the deficit was reduced by 0.1 percent of GDP thanks to a one-off payment by EDF and Cogema (both government-owned companies) to the general government for the decommissioning of an old nuclear power plant.

([2]) One-off revenues are linked to the inclusion of the specific electricity and gas companies' pension schemes in social security (amounting to 0.5 percent of GDP, of which one third was already paid and the remainder will be effectively paid to government over several years) and exceptional revenues from the December 2005 change in the corporate tax code which brought forward revenue initially planned to be collected in 2006 (0.1 percent of GDP).

([3]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

([4]) Eurostat required Member States to apply the decision in relation to 2005, but allowed them to choose whether or not to revise the data for 2004 and earlier years. There was no retropolation in France, thus leading to a break in the deficit series.

([5]) The forecast for 2006 incorporates one-off revenues of about ¼ percent of GDP in connection with the transfer to social security of pension commitments vis-à-vis the postal sector employees and the exceptional collection of social contributions on specific saving plans that were to be collected at a later stage.

([6]) The French authorities revised the planned deficit to 2.8 percent for 2006, due to the favourable effect of the Eurostat decision on the recording of military expenditures.

Table V.17

Budgetary developments 2004-2009, France (% of GDP)

Outturn and forecast [1]	2004	2005	2006	2007		
General government balance	− 3.7	− 2.9	− 3.0	− 3.1		
- Total revenues	49.6	51.0	51.0	50.7		
Of which: - current taxes	26.3	27.0	27.0	26.7		
- social contributions	18.0	18.3	18.4	18.5		
- Total expenditure	53.2	53.9	54.0	53.8		
Of which: - collective consumption	8.4	8.3	8.4	8.3		
- social transfers in kind	15.4	15.5	15.5	15.3		
- social transfers other than in kind	17.6	17.9	18.0	18.0		
- interest expenditure	2.7	2.6	2.6	2.6		
- gross fixed capital formation	3.1	3.3	3.3	3.4		
Primary balance	− 1.0	− 0.3	− 0.4	− 0.5		
Tax burden	43.1	44.1	44.2	43.9		
One-off and temporary measures	0.1	0.6	0.2	0.0		
Structural balance [2]	− 3.7	− 3.1	− 2.7	− 2.5		
Structural primary balance	− 1.0	− 0.5	− 0.1	0.1		
Government gross debt	64.4	66.8	66.9	67.0		
Pm Real GDP growth (%)	2.3	1.4	1.9	2.0		
Stability programme [3]	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance	− 3.7	− 3.0	− 2.9	− 2.6	− 1.9	− 1.0
Primary balance	− 0.8	− 0.3	− 0.3	0.0	0.6	1.6
Structural balance [4]	− 3.5	− 3.4	− 2.9	− 2.3	− 1.5	− 0.6
Government gross debt	65.1	65.8	66.0	65.6	64.6	62.8
Pm Real GDP growth (%)	2.3	1.5– 2.0	2.0– 2.5	2 ¼	2 ¼	2 ¼

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
[2] Cyclically-adjusted balance excluding one-off and temporary measures.
[3] Submitted in January 2006.
[4] Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the Commission services' 2006 spring forecast (0.6 % of GDP in 2005 and 0.2 % in 2006; all deficit-reducing).

Source: Commission services and January 2006 stability programme of France.

cent by the French authorities), and (ii) somewhat higher expenditures in the areas of healthcare and local government. Concerning healthcare expenditure, while the 2004 healthcare reform has noticeably curbed expenditure, the expected dynamics are forecast to be somewhat higher than assumed by the government based on a prudent assessment of some of the measures announced in the 2006 budget bill for social security. The Commission services' 2006 deficit forecast implies no change in the cyclically-adjusted balance and an improvement in the structural balance (i.e. cyclically-adjusted balance excluding one-off and temporary measures) by 0.4 percentage points of GDP (reflecting less recourse to one-offs in 2006 compared to 2005).

The Commission services' spring 2006 deficit forecast for 2007, 3.1 percent of GDP, follows the conventional

assumption of unchanged policies. It thus takes only account of already decided measures such as (i) the income tax reform, (ii) the increase in the employment premium and in the income tax allowance for children, and (iii) lower tax rates on new capital expenditures, which will, altogether, negatively impact the deficit by about ¼ percent of GDP. On the other hand, it does not include the new expenditure rules and ceilings for the sub-sectors of the general government as announced in the 2006 update of the stability programme, and notably the new rule of a decrease in the State expenditure by 1 percent in volume terms (worth about -0.15 percent of GDP), as details on their implementation are expected to be presented by the Prime Minister in June (see below).

The spring 2006 forecast compares to the official deficit target of 2.6 percent of GDP in 2007 from the January

2006 update of the stability programme (or 2.5 percent when implementing Eurostat decision on military expenditures).

The update also projects a continuous reduction in the deficit in the coming years, yielding a deficit at 1.0 percent of GDP in 2009.

According to the spring 2006 forecast, the debt-to-GDP ratio is still expected to slightly increase over the forecast horizon from 66.8 to 67.0 percent in 2007, but this increase would be limited thanks to the allocation of privatisation receipts to debt reduction. In 2006, receipts are linked to the privatisation of motorway companies; for 2007 the forecast includes EUR 7.5 bn of receipts; i.e., the middle of the announced range presented in the stability programme. As noticed above, the debt-to-GDP ratio overshot the stability programme target in 2005. However, according to planned data reported in April 2006, the French authorities keep their intention of reducing the debt-to-GDP ratio from this year onwards.

New expenditure rules

In 1998, France introduced a new budgetary strategy based on setting multi-annual objectives for increases in general government expenditure [1]. However, the strategy aiming at consolidating public finances through a structural decline in the expenditure-to-GDP ratio did not lead to the expected results. Initial targets were

missed by a large margin [2] despite the fact that the State expenditure target was respected (apart from one year). State expenditures only represent about 30 percent of the general government expenditure, with those of social security and local government now accounting for about 45 percent and 20 percent of total expenditure, respectively. The slippage in the general government expenditure in 2005 by 0.6 percent in real terms occurred despite the respect of the expenditure targets both at the State and healthcare expenditure level. Slippages emanated from local governments and social benefits other than healthcare, the two sectors where so far no specific rules have applied. Therefore, ensuring that the overall general government target is reached requires that all sub-sectors participate in the expenditure restraint effort.

In this context, the medium-term strategy of the most recent update of the French stability programme (January 2006) moves in the right direction as the planned reduction is based on new and enhanced definitions of expenditure-growth ceilings for the different sub-sectors of the general government. However, the establishment of these new ceilings should be backed by the definition of new rules and control mechanisms, as underlined by the 14 March 2006 Council opinion on the stability programme, which invited France to 'strengthen the monitoring and enforcement of expenditure rules defined for the sub-sectors of the general government so as to ensure

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[1] See 'Expenditure rules à la française: an assessment after five years', ECFIN country focus, 2004 vol. 5 (http://europa.eu.int/comm/economy_finance/publications/country_focus/2004/cf5en.pdf)

[2] The cumulated increase in real expenditure over the period 2000-2002 reached 6.8 percent, as against 3.5 percent targeted in 1998 in the initial stability programme; over the period 2001-2003 real expenditure increased by 7.4 percent, as against 4.0 percent targeted in 1999 in the first update; over the period 2002-2004 the increase reached 7 percent, as against 4.5 percent targeted in 2000 in the second update.

Table V.18

Main measures in the budget for 2006, France

Revenue measures [1]	Expenditure measures [2]
• Increases in local taxes (+ 0.1 % of GDP) • Lower tax rates on new capital expenditure (– 0.1 % of GDP) • Transfer of pension commitments vis-à-vis the postal sector employees to social security (+ 0.1 % of GDP) • Exceptional collection of social contributions on specific saving plans (+ 0.1 % of GDP)	• Diverse tax reductions, notably on inheritance tax and tax on research projects (– 0.02 % of GDP) • Increase in the employment premium (– 0.1 % of GDP)

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.

Source: Commission services and 2006 Budget Bill and 2006 Social security Budget Bill.

the respect of the ambitious multi-annual expenditure ceilings'. Steps in this direction are expected to be taken in June 2006 at the time of the budget preparation ('Débat d'orientation budgétaire') when the Prime Minister is expected to announce the results of the working groups on the definition of new ceilings and rules for all sub-sectors of the general government. These groups were set up after the first National Public Finances Conference held in January 2006 which gathered all public finance managers, with the aim to raise accountability of all levels for spending control. Such conference will be held every year and a new organism, the 'Conseil d'orientation des finances publiques', will ensure continuity between the conferences. The move towards this new strategy also followed the publication of the 'Pébereau report'[1] which advocated a return to balance of government accounts by 2010.

While the details of the control mechanisms are not known yet, as already mentioned, some ceilings have been defined in the January 2006 update of the stability programme.

At the *State* level, the rule is to be progressively enhanced from the current 'zero real spending growth' rule to a 'zero nominal spending growth' rule starting from 2007 onwards. State expenditure would be reduced by 1 percent in volume terms in 2007, 1.25 percent in 2008, and 1.5 percent in 2009, so that 0 percent nominal

growth applies from 2010. The programme explains that this tighter control of State expenditure should be attained thanks to a more effective public management related to the full impact of the Constitutional Bylaw on the Budget Act (Loi organique relative aux lois de finances or LOLF) and to potential savings identified by the audits conducted as part of the State modernisation process. However, as 'compulsory expenditures' (pension and interest expenditures) represent a growing part of the State budget, reducing State expenditure in value terms is challenging and will require not only large re-allocations of expenditures but also sizeable reductions in some spending items. A recent paper published by the Ministry of Finance [2], proposed some ways forward, notably concerning civil servant wage policy. This would be managed through a multi-annual framework compatible with the expenditure norm, in which ministries would be free to decide between wages and recruitments within a defined envelope. The paper recognised that some productivity gains could emerge from the results of the ongoing audits notably as regards real estate, technology and purchases policies. Following-up on the conclusions from the 'Pébereau report', it is acknowledged that some existing structures could be rationalised for a better adequacy between responsible entities and tasks (notably following the transfers of tasks between the State and the local governments).

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[1] Report from an independent committee chaired by Mr Pébereau.

[2] 'Assurer la soutenabilité de long terme des finances publiques', Notes bleues de Bercy, number 304.

Graph V.7: **Central government expenditure (% nominal change)**
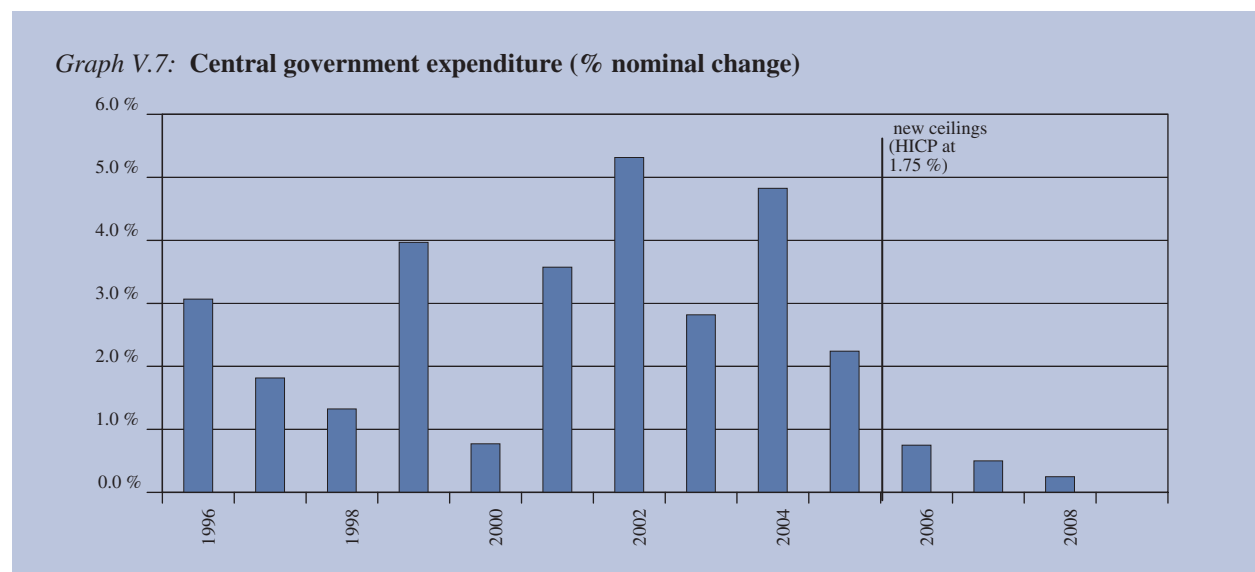
Concerning *social security*, the previous norm only defined a national health insurance spending target (ONDAM: Objectif national des dépenses d'assurance maladie). The new rule aims at limiting the average real increase in the overall social security sector expenditure to about 1 percent per year in real terms from 2007 to 2009. As regards healthcare expenditures, the increase would be limited to 2.2 percent per year in nominal terms on average over the period. This would represent a clear slowdown compared to recent trends, as healthcare nominal expenditure increased by 6 percent on average over the period 2000-2004. The slowdown is expected to result from the effects of the reform of the health insurance system implemented in the summer of 2004 and new measures taken in the context of the 2006 Budget Bill for social security. The expenditure restraint in this sector should also be facilitated by the expected improvement on the unemployment front. However, in the spring 2006 forecast exercise, the Commission services estimated — based on a prudent assessment of some of the measures announced in the 2006 budget bill for social security — that more measures were needed to achieve this target as the expected dynamics (a nominal annual increase in spending of 3.2 percent in 2006 and 2007) were forecast to be somewhat higher than assumed by the government. It should be noted that, for the social security as a whole, healthcare expenditure are continuously growing in connection with population ageing, new technologies, etc. In order to reach the ceiling of annual expenditure growth by 1 percent in volume, it appears necessary to implement some new measures. Another interesting development could be the extension of the tasks of the alert committee to the overall social security's expenditure together with a strengthening of its powers. In its current function, this committee is responsible for warning the Parliament, the government and the social security of a healthcare expenditure overrun, in case the slippage is estimated to be larger than 0.75 percent. Subsequently, the social security agencies should propose corrective measures which it will evaluate. Extending its role to the social security's expenditure would allow for better intra-annual budgetary management.

At the *local authorities'* level, for which no rule currently exists, the update of the stability programme announced that local governments, 'aware of the need to take part in the debt-reduction effort', will curb their expenditures and let them only increase by 0.5 percent per year in real terms, approaching the 'zero real spending growth rule' by 2009 (expenditure growth should reach 1 percent in volume in 2007, 0.5 percent in 2008 and 0 percent in 2009). However, no specific measures were spelled out. The programme anticipated that purchases of goods and services and the wage bill of local authorities will become relatively stable with the expected deceleration in the increase in staff. However, some of the transferred tasks, notably in the social area have lead to a quite strong dynamics in expenditure while transferred revenues are growing much slower, thus leading to some tension between the State and the local levels. The definition of ceilings and rules for local

Graph V.8: **Social security funds' expenditure (% nominal change)**
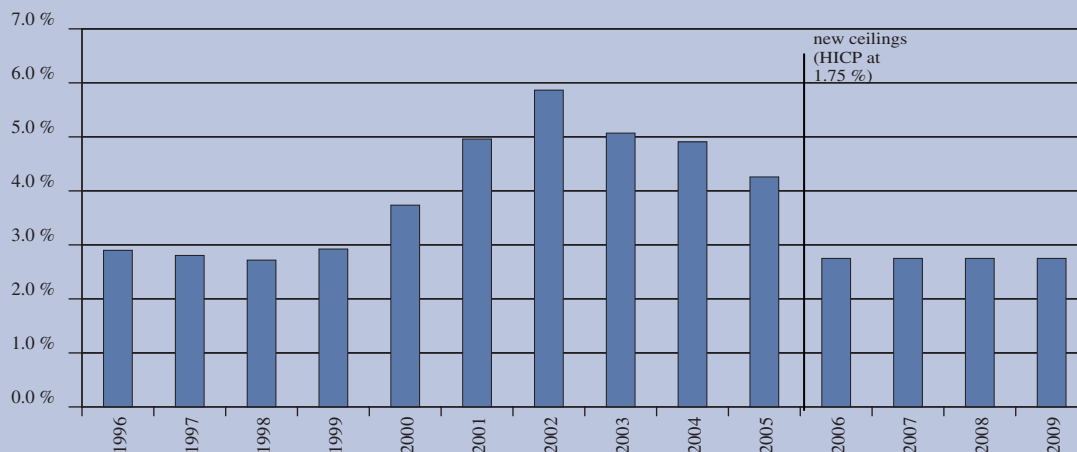
government expenditure, their endorsement and respect, are going to be crucial at this level of the general government as this is the level on which the Government has

less control. In this context, the implication of local government actors at the National Public Finances Conference was a positive signal.

Graph V.9: **Local government expenditure (% nominal change)**
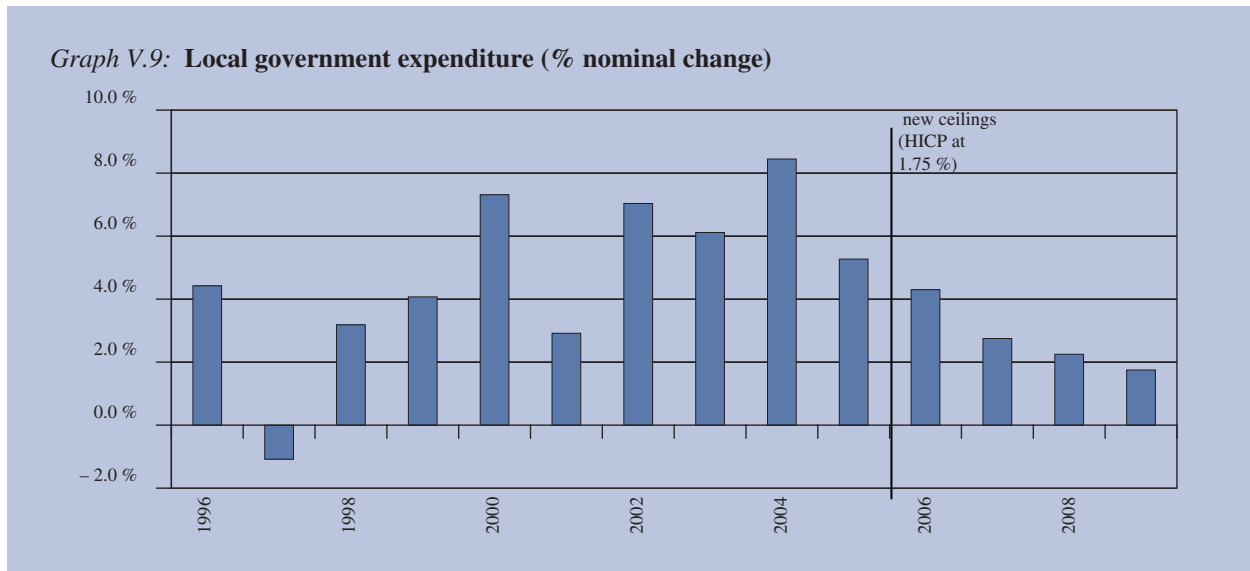
9. Ireland

Recent developments and medium-term prospects

The general government balance posted a surplus in 2005 of 1.0 percent of GDP. This compares with a targeted deficit of 0.8 percent of GDP set in the December 2004 update of the stability programme. The significantly better-than-expected outturn in 2005 owes mainly to a tax overshooting, notably driven by buoyant capital taxes and stamp duties. Some items of general government expenditure turned out lower than budgeted, in particular capital spending and interest payments, but this was partly offset by one-off costs (0.7 percent of GDP) following a February 2005 court ruling on nursing home repayments. Government debt represented 27.6 percent of GDP in 2005.

The budget for 2006 was unveiled on 7 December 2005 together with the updated stability programme for the period 2006-08 ([1]). On the revenue side, the main measures include an upward adjustment of the standard tax band for personal income and some further relief through an increase in the employees' tax credit. On the expenditure side, the social welfare package is somewhat more generous than in 2005. A significant rise in capital spending is also foreseen for 2006 and 2007, focusing in particular on improvements in transport infrastructure ([2]). The original budget-day target for the general government balance in 2006, a deficit of 0.6 percent of GDP, was revised to 0.3 percent of GDP, ([3]) mainly on account of an upward revision of the tax revenue projections. The Commission services' spring 2006 forecasts project a somewhat better outcome, with a surplus of 0.1 percent of GDP, in line with the forecast of buoyant domestic demand and solid revenue growth., The deterioration in the structural balance, i.e. the cyclically-adjusted budget balance net of one-off and other temporary measures, by around ¾ percent of GDP points to an expansionary fiscal stance in 2006. However, this result is subject to the caveat that calculations of cyclically-adjusted balances for Ireland are surrounded by a particularly high degree of uncertainty linked to the difficulty of obtaining reliable output gap estimates.

Given the non-indexed nature of the tax and social benefit systems, the Commission services spring forecast's no-policy-change assumption for 2007 is made operational, in the absence of previously announced measures, by freezing average tax rates and adjusting social transfer payments by the forecast CPI inflation rate (with a small top-up). On these assumptions, the spring forecast projects a deficit of 0.4 percent of GDP in 2007, again somewhat better than the target in the December 2005 stability programme update (a deficit of 0.8 percent of GDP). This target includes a contingency provision against unforeseen developments of 0.4 percent of GDP. Overall, the public finances are expected to remain strong in 2006 and 2007. Over the medium term, however, there are some macroeconomic risks to the outlook for the Irish economy, notably related to developments in the housing sector and the sensitivity to changes in the global economic environment. These, if realised, have the potential for the general government balance to record a larger deficit than projected in the spring 2006 forecast.

The government debt ratio is projected to remain broadly stable in 2006-2007 at around 27 percent of GDP. In the absence of the accumulation of non-general government assets in the National Pensions Reserve Fund (NPRF), established in 2001 to pre-fund future pension liabilities, the gross debt ratio would be falling over the period to end-2007 (see special topic below).

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[1] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[2] Further details on the main measures in the budget for 2006 are given in the accompanying table below.

[3] April 2006 reporting of government deficits and debt levels.

Table V.19

Budgetary developments 2004-2007, Ireland (% of GDP)

Outturn and forecast (¹)		2004	2005	2006	2007	
General government balance		1.5	1.0	0.1	− 0.4	
- Total revenues		35.2	35.5	35.1	34.7	
Of which:	- current taxes	25.3	25.6	25.4	25.4	
	- social contributions	6.1	6.2	6.3	6.3	
- Total expenditure		33.7	34.5	34.9	35.1	
Of which:	- collective consumption	5.4	5.5	5.6	5.6	
	- social transfers in kind	10.3	10.4	10.6	10.6	
	- social transfers other than in kind	9.0	9.9	9.8	9.7	
	- interest expenditure	1.2	1.2	1.2	1.2	
	- gross fixed capital formation		3.4	3.7	4.0	
Primary balance		2.7	2.2	1.3	0.8	
Tax burden		30.3	30.7	30.5	30.5	
One-off and temporary measures		0.7	− 0.3	0.1	0.0	
Structural balance (²)		0.7	1.8	1	0.8	
Structural primary balance		1.9	3.0	2.2	2.0	
Government gross debt		29.4	27.6	27.2	27.0	
Pm	Real GDP growth (%)	4.5	4.7	4.9	5.1	

Stability programme (³)	2004	2005	2006	2007	2008
General government balance	1.4	0.3	− 0.6	− 0.8	− 0.8
Primary balance	2.6	1.5	0.6	0.4	0.5
Structural balance (⁴)	0.7	1.1	0.1	0.1	0.1
Government gross debt	29.4	28.0	28.0	28.2	28.3

(¹) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²) Cyclically-adjusted balance excluding one-off and temporary measures.
(³) Submitted in December 2005.
(⁴) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures (provided by the Department of Finance, Ireland (0.7 % of GDP in 2004 and 0.1 % in 2006; both surplus increasing; and 0.3 % in 2005, surplus decreasing).

Source: Commission services and stability programme of Ireland.

Government gross debt and the impact of the National Pensions Reserve Fund

The establishment of the National Pensions Reserve Fund (NPRF) in Ireland, in operation since 2001, has been expected to *facilitate the easing of age-related expenditure in view of the ageing of the population.*

The statute of the National Pensions Reserve Fund provides for a build-up of assets that will contribute to the funding of the expected ageing-related general government costs from 2025 onwards (¹). The statutory contri-

bution to the NRPF has been set at 1 percent of GNP annually, but the Irish Government may also make additional contributions where circumstances allow. At inception, the government paid 5.6 percent of GDP to the NPRF, including receipts from the privatisation of Telecom Éireann. The market value of the NPRF's assets is estimated by the December 2005 stability programme at just above 9 percent of GDP at the end of 2005.

The NPFR is not a pension fund in the sense of a pension scheme that collects social contributions and pays pensions. The NPFR is a reserve fund, that is, an institution that accumulates and manages assets which are economically and legally owned by the government, not by future pensioners. Since the NPRF is part of the government sector, payments to it by the Exchequer consolidate and do not count as government expenditure and the

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(¹) For details *on* the National Pensions Reserve Fund Act (2000), see www.finance.gov.ie/viewdoc.asp?fn=/ documents/news/june/mcc655pr.htm — 37k

NPRF's funding thus does not directly affect the general government balance. However, the NPRF's accumulation of non-government assets does add to the general government gross debt ratio compared with the situation where the build-up of NPRF assets consisted of claims towards government paper. Therefore, the accumulation of assets by the NPRF explains a large part of the discrepancy between the deficit and debt figures (that is the stock-flow adjustment in Ireland).

In order to understand the underlying debt dynamics and the related impact of the NPRF, it is necessary to analyse the different contributions to the changes in government gross debt ratio. In recent years, the pace of debt reduction in Ireland has been slower than implied by the primary surplus and the interaction between interest expenditure and GDP growth (so-called 'snowball effect'), which both contributed to lowering the debt ratio.

Their contributions were largely offset by sizeable stock-flow adjustments (SFA), which mainly reflected the acquisition of non-government instruments by the NPRF.

While the NPRF does not issue debt and therefore does not directly contribute to increase government gross debt, the accumulation of outside financial assets prevents a quicker fall in the debt. The recent pattern is expected to continue also in the years ahead, in the absence of which the government debt-to-GDP ratio would be falling over the programme period (see Graph V.10).

According to the NPRF's statute, the drawdown from the NPRF will not begin before 2025, in line with the decrease of the proportion of persons of working age relative to those over 65 years of age, though detailed legislation governing the manner of the fund's withdrawal has not yet been enacted. Financing pension payments through drawdown of the NPFR does not avoid an increase in government expenditure and a corresponding deterioration in the general government balance. However, it reduces the debt issuance to finance such spending and the concomitant increase in the gross debt (during the drawdown phase net debt would then be expected to increase more quickly/fall more slowly than gross debt).

The establishment of the NPRF is an important initiative to address the budgetary impact of population ageing, by pre-funding the expected future payments. Nevertheless, as the long-term public finance projections included in the stability programme update [1] reveal, the role of the NPRF should not be overestimated.

Total age-related expenditures are projected in the 2005 stability programme to increase by around 9 percentage points of GDP between years 2005 and 2050. In 2050, the NPRF's fund assets are expected by the programme (after partial drawdown, assumed to start after year 2025) at around 22 % of GDP, i.e. covering just around 2½ years of the projected increase in age-related expenditures at this time horizon. Moreover, in terms of fiscal

[1] See December 2005 stability programme, Department of Finance, Ireland (Chapter 6, Table 14).

Table V.20

Main measures in the budget for 2006, Ireland

Revenue measures [1]	Expenditure measures [2]
• Personal income tax measures: a widening of the standard rate band and an increase in employee and personal tax credits (– 0.5 % of GDP) • Termination of certain tax reliefs: a series of tax reliefs (in particular for some property based tax incentive schemes) has been abolished (around 0.1 % of GDP)	• Social welfare package: notably increase in social welfare benefit rates (0.7 % of GDP) • Childcare package: a five-year programme to increase the provision of childcare (around 0.2 % of GDP) • Capital expenditure – addition to available envelope for Exchequer-funded capital spending (0.1 % of GDP) plus a carry-over from unspent allocations in 2005 (0.2 % of GDP)

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.

Source: Commission services and Department of Finance, Ireland (the budget for 2006 — http://www.finance.gov.ie).

Table V.21

Ireland – general government gross debt dynamics (average 2000-2004, in % of GDP)

Change in debt ratio (1=2+3+4)	– 3.7
— Primary balance (2)	– 2.7
— 'Snow-ball' effect (3)	– 2.2
— Stock-flow adjustment (4)	1.1
p.m. Gross debt ratio (in 2004)	*29.4*

Source: Commission services and Department of Finance, Ireland.

sustainability, the only significant difference between a strategy of accumulating assets in the NPRF and of reducing the government gross debt is related to the difference between the average interest rate of the government debt and the potentially higher rate of return (including capital gains) of the reserve fund. Indeed, in order to fully meet the budgetary challenges posed by population ageing, some further fiscal effort in Ireland will be needed over the long run.

Graph V.10: **Ireland — general government debt net of the NPRF's assets (in % of GDP)**
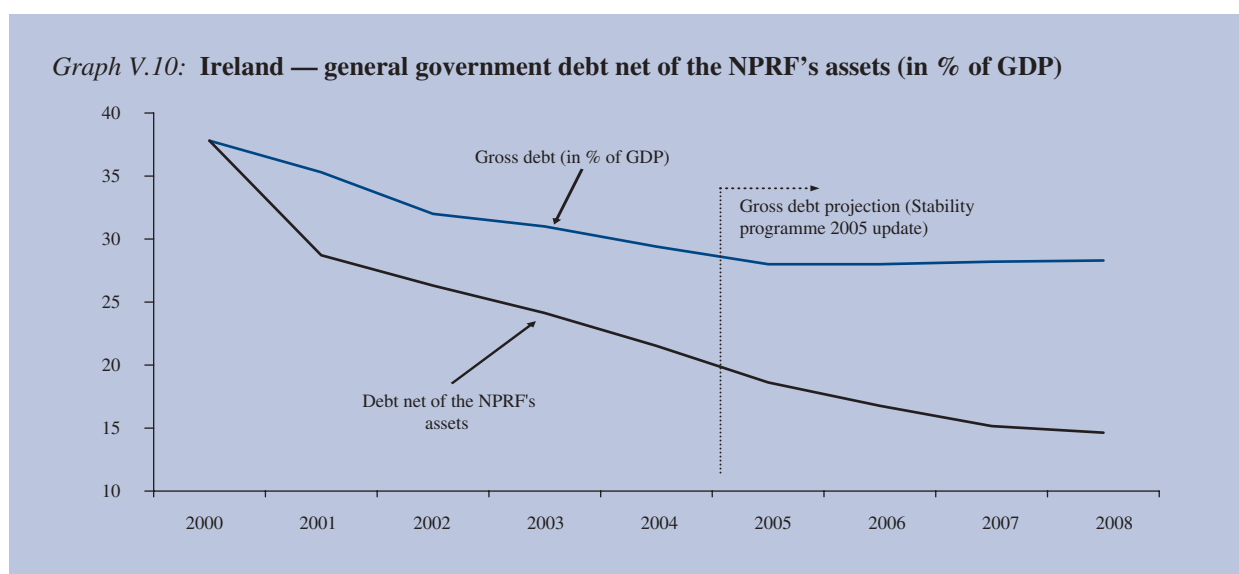
10. Italy

Recent developments and medium-term prospects

In 2005, the general government deficit was 4.1 percent of GDP, compared with a deficit target of 2.7 percent of GDP set in the 2004 update of the stability programme. Lower-than-expected economic growth explains one percentage point of the difference. Another ½ of a percentage point is accounted for by the negative carry-over effects from 2004 [1]. Additional slippages in primary expenditure were compensated by lower interest expenditure and higher than expected revenue. The positive budgetary impact of one-offs and temporary measures is estimated at ½ percent of GDP, on a downward trend since 2003. This is ¼ percent of GDP lower than expected, as sales of real estate fell short of the budgeted amount.

As a result of economic stagnation and the erosion of the primary balance, the debt ratio rose for the first time in ten years to 106.4 percent of GDP, from 103.8 percent in 2004. Debt-increasing financial transactions amounted to around 1¼ percent of GDP, of which ½ percent of investment in liquid assets.

The 2006 budget and related legislation were adopted by parliament on 22 December 2005. The legislation foresees a number of growth-supporting measures including a general reduction in social contributions. Corrective measures comprise sizeable savings on central government current and capital expenditure and on the healthcare sector, which is under the regions' responsibility. Additional substantial savings on regional and local government expenditure are to be achieved through a further extensive revision of the 'domestic stability pact' intro-

duced in 1999. Expenditure cuts are supplemented by an increase in revenues, mainly from higher taxes on companies. New one-off measures consist of taxes on the re-evaluation of corporate assets and a new tax amnesty linked to a tax agreement with the self-employed and small firms.

In the 2005 update of the stability programme submitted on 23 December 2005, the general government deficit in 2006 was targeted at 3.5 percent of GDP, built on an economic growth forecast of 1.5 percent and assuming the full implementation of the 2006 and previous Budget Laws. However, despite the better than expected 2005 deficit outturn (4.1 percent of GDP instead of 4.3 percent in the update of the stability programme), on 5 April 2006, the Ministry of Economy and Finance revised the official deficit forecast upward, to 3.8 percent of GDP. With real GDP projected to grow at 1.3 percent, the new deficit forecast mainly reflects higher expenditure. In the Commission services' spring 2006 forecast, the projected budgetary outturn for 2006 is a deficit of 4.1 percent of GDP, also based on an economic growth forecast of 1.3 percent. The difference with the new official forecast is largely due to the assessment of the size of savings foreseen in the 2006 Budget Law, notably those resulting from the planned substantial cuts on healthcare and other government expenditure, in particular of local government. On the revenue side, the Commission services' projections are overall in line with those in the Budget Law, except for the additional revenue to be realised by regions having a structural deficit in healthcare accounts, as the procedures necessary to trigger this increase have not yet been fully implemented. The impact of one-off measures (sales of real estate and revenues from taxes on the revaluations of corporations' assets and tax amnesties) is expected to diminish further to ¼ percent of GDP.

According to the Commission services' forecast, net of cyclical factors and excluding one-off measures, both the deficit and the primary balance are projected to improve by slightly less than ¼ of a percentage point of

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[1] Statistical revisions released on 1 March 2006 increased the government deficit by around 0.2 percent of GDP for all the years from 2002 to 2004. Incorporating the effect of the upward revision of the nominal GDP level, the deficit is now reported at 3.1 percent of GDP in 2001, 2.9 percent of GDP in 2002 and 3.4 percent of GDP both in 2003 and 2004.

Table V.22

Budgetary developments 2004-2009, Italy (% of GDP)

Outturn and forecast [1]	2004	2005	2006	2007		
General government balance	− 3.4	− 4.1	− 4.1	− 4.5		
- Total revenues	44.3	44.0	44.0	43.8		
Of which: *- current taxes*	27.4	27.6	27.9	27,8		
- social contributions	12.7	12.9	12.7	12,7		
- Total expenditure	47.7	48.1	48.1	48.4		
Of which: *- final consumption*	19.8	20.3	20.2	20,1		
- social transfers other than in kind	16.9	17.1	17.3	17,3		
- interest expenditure	4.7	4.6	4.5	4,8		
- gross fixed capital formation	2.4	2.4	2.5	2,5		
	1.3	0.4	0.5	0,2		
Primary balance	1.3	0.4	0.5	0.2		
Tax burden	40.7	40.6	40.7	40.5		
One-off and temporary measures	1.2	0.5	0.3	0.0		
Structural balance [2]	− 4.6	− 3.9	− 3.8	− 3.8		
Structural primary balance	0.1	0.7	0.7	1.0		
Government gross debt [3]	103.8	106.4	107.4	107.7		
Pm *Real GDP growth (%)*	1.1	0.0	1.3	1.2		
Stability programme [4]	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance	− 3.2	− 4.3	− 3.5	− 2.8	− 2.1	− 1.5
Primary balance	1.8	0.6	1.3	1.9	2.6	3.2
Structural balance [5]	− 4.3	− 4.0	− 3.2	− 2.3	− 1.7	− 1.2
Government gross debt	106.5	108.5	108.0	106.1	104.4	101.7
Pm *Real GDP growth (%)*	1.2	0.0	1.5	1.5	1.7	1.8

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

[2] Cyclically-adjusted balance excluding one-off and temporary measures.

[3] On 1 March 2006, the Italian statistical office carried out a comprehensive revision of national accounts. The upward revision of nominal GDP (2¾ %.in 204) has substantially reduced the debt ratio.

[4] Submitted in December.

[5] 2005 Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (1.4 % of GDP in 2004, 0.5 % in 2005, 0.4 % in 2006; all deficit-reducing).

Source: Commission services and stability programme of Italy.

GDP. This compares with the more than ¾ percent of GDP structural adjustment targeted in the 2005 updated stability programme.

The Commission services' forecast for a 2007 deficit of 4.5 percent of GDP is based on the customary no-policy-change scenario and mainly reflects higher interest expenditure and the expiry of one-off measures. Interest expenditure is expected to increase as a percentage of GDP, reversing the downward trend observed over the past decade, as a result of the rising interest rates and debt-to-GDP ratio. Beyond 2007, the 2005 updated stability programme targets the deficit to gradually decline to 2.1 percent in 2008 and 1.5 percent of GDP in 2009.

In the Commission services' forecast, the debt ratio in 2006 is projected to increase by 1 percentage point, to attain 107½ percent of GDP, which contrasts with the decrease of half a percentage point of GDP planned in the 2005 update of the stability programme. Apart from the difference stemming from the higher deficit, the Commission services' forecast takes account of the new official estimation of cash borrowing requirement in 2006 released on 5 April 2006. Privatisation receipts are assumed to amount to around ¾ of a percentage point of GDP, as planned in the 2005 updated stability programme. Based on the no-policy-change scenario, the debt-to-GDP ratio is expected to increase slightly in 2007.

Table V.23

Main measures in the budget for 2006, Italy

Revenue measures (^{1})	Expenditure measures (^{2})
• Cuts to social contributions (-0.1 % of GDP) • Additional regional revenue to finance structural deficit in the healthcare accounts (0.1 % of GDP) • Other additional revenue (0.6 % of GDP)	• Savings on intermediate consumption expenditure (0.4 % of GDP) • Savings on healthcare expenditure (0.1 % of GDP) • Cuts to transfers to the State-owned railway and road maintenance companies (0.2 % of GDP) • Other savings on primary expenditure (0.2 % of GDP)

(^{1}) Estimated impact on general government revenues.
(^{2}) Estimated impact on general government expenditure.

Source: Commission services and Italian Ministry of Economy and Finance.

Transparency of the budgetary process

In spite of several reforms (^{1}), the process that leads to the formulation of the Italian budget and the monitoring of its execution are still based on numerous documents that use different aggregation and accounting methods. This situation, as well as delays in the presentation of some planning and reporting documents, reduce the transparency of the budgetary process and hamper the monitoring of budgetary developments.

The budgetary process in Italy typically starts at the end of June, with the publication of the Economic and Financial Planning Document (*Documento di Programmazione Economica e Finanziaria or* DPEF), which covers the following four years. The DPEF describes macroeconomic and budgetary trends, the budgetary plans, and any other envisaged major economic policy measures that can be expected to have an impact on macroeconomic and public finance developments. Since 1999, the budgetary trends are projected on the basis of a scenario based on 'unchanged legislation', which assumes that future expenditure and revenues reflect only legislation already approved by the Parliament. Unlike an 'unchanged policy' scenario (as in the Commission forecasts), which assumes a continuity of present trends for all expenditure items which are not yet known in sufficient detail, the unchanged legislation scenario tends to underestimate expenditure. For instance, the compensation of public employees is determined by laws that establish the parameters to be followed to compute the total amount of public wages; however, these parameters are affected by future renewals of public wages contracts and thus will give rise to a different, normally greater,

budgetary impact compared to the one based on unchanged parameters. Another example is investment expenditure, where account is only taken of funding needs for projects foreseen in current legislation; however, it can be expected that new funds will be allocated to new projects by future legislation.

Concerning budgetary plans, the DPEF indicates the targets for the deficit and the debt but it does not quantify policy targets for the different expenditure components and the tax burden. Italy's stability programme follows the same approach. The parliament is called to endorse the DPEF, although this does not become a law, but remains a political act.

At the end of September, the government presents to parliament, for approval by 31 December, (i) a draft comprising a detailed annual and a less detailed multi-annual State budget under unchanged legislation *(Bilancio dello Stato a legislazione vigente)* and (ii) a draft Budget Law (*Disegno di legge finanziaria*) including the corrective measures judged necessary to reach the budgetary targets set in the DPEF. Possible accompanying bills to the Budget Law (*disegni di legge collegati alla finanziaria*) can be submitted by 15 November. A multi-annual State budget based on plans is also transmitted to parliament, but it is not voted. The information included in the budget does not provide a comprehensive and clear picture of the Italian public finances. First, the budget is structured in about one thousand budget forecasting units (*unità previsionali di base*), which reflects the fragmented administration behind the various activities rather than the policy targets. Second, the budget includes only expenditure and revenue pertaining to the State rather than the general government. The difference between these two aggregates, especially in the light of the process of decentralisation, is widening. Finally,

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(^{1}) In particular, Laws 468/1978, 362/1988, 94/1997, and 208/1999.

although presented both in cash and accrual terms, the budget is not in line with the European System of Accounts (ESA95). The only official document referring to the general government that presents the assessment of the budgetary implications of the Budget Law in line with ESA95 is the 'second section' of the planning and forecasting document (*Relazione previsionale e programmatica — RPP*), which in principle is presented to the parliament together with the budget. In 2005, this key document was made available only with a considerable delay.

Together with a reshuffling of the budget, each year the Budget Law envisages a correction meant to bridge the gap between the target for the following year's general government balance and the trend deficit at unchanged legislation as projected in the DPEF. This complex and legalistic way of measuring the size of the correction is very opaque, as it was highlighted by the stepwise presentation of the 2006 Budget Law. The original draft budget law and the accompanying legislation presented to parliament on 4 October 2005 projected a correction of around EUR 12 billion (0.8 percent of GDP), bridging the gap between the unchanged legislation deficit estimated at 4.7 percent of GDP and the deficit target of 3.8 percent of GDP set in DPEF. However, in late October, i.e. almost one month after the government's adoption of the draft Budget Law and three months after the DPEF publication, it became evident that an overestimation of the planned sales of real assets in 2006 resulted in an underestimation of the 2006 trend deficit. Although partially offset by higher estimates of dividends from State-owned companies, the downward revision of real estate sales worsened the trend deficit projection by around 0.3 percent of GDP and triggered the adoption of corresponding corrective measures. Subsequently, the government further increased the size of the correction in order to target a lower structural deficit which would be in line with the Council recommendation under Article 104(7) of the Treaty. In this last round of changes, the projected revenue-to-GDP ratio was also revised significantly upwards with respect to the DPEF, without any explicit explanation for the revision being given. [1]

Article 81 of the Italian Constitution establishes the principle that all new legislation entailing higher expenditure should indicate the means for its financing. A traditionally loose interpretation of this provision has allowed large deficits and the accumulation of a debt well above 100 percent of GDP. Even after the recent improvement in the legislation [2] implementing this constitutional principle, it should be noted that the financing of increases in expenditure or decreases in revenue outside the budget session is not presented in terms consistent with ESA95. Hence, new measures approved during the year may negatively affect the budget balance that constitutes a reference for the Treaty provisions on fiscal discipline.

Documents which would allow monitoring budgetary developments in cash terms, namely the Report on the estimated State cash borrowing requirement for the current year and the Report on the outcomes of the cash management of the State budget and of the Treasury account (referred to as *Relazione Trimestrale di Cassa*) are regularly presented well after the statutory deadlines. This is an obstacle to the prompt identification of budgetary slippages. This problem is aggravated by the fact that data related to the local and regional finances are available with considerable delay. The establishment of the Information System on the Operations of Government Bodies (SIOPE), which collects online information on budgetary transaction made by public administrations, aims at addressing this shortcoming. A further major improvement would be the adoption of ESA95 for compiling budgetary data at all government levels.

To sum up, the present budgetary process in Italy is not transparent enough, complex and does not allow for an immediate translation of transactions in ESA95 terms. It may be useful to consider ways to raise the efficiency of the budgetary process and the accountability of the fiscal authorities.

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[1]   This is not a criticism to the revised revenue projections.
[2]   Law 468/1978 as amended by Law 246/2002.

11. Cyprus

Recent developments and medium-term prospects

In 2005, the general government deficit in Cyprus was 2.4 percent of GDP. This is slightly better than the expected deficit of 2.9 percent of GDP targeted in the December 2005 update of the convergence programme, which was submitted in December 2004. (^{1}) In nominal terms, the deficit outturn represents an improvement of around 1¾ percent of GDP compared with 2004. The better-than-expected outcome was due to higher-than-expected revenues from structural measures on the back of high-tax content of growth, which was almost fully based on domestic private consumption thus leading to higher indirect tax revenues, and was accompanied by sustained employment growth. The one-off impact on revenues from tax amnesty amounted to almost one percentage point of GDP, a similar figure to that of 2004. Revenues were also supported by the regularisation of dividend income policy from semi-governmental organisation. The deficit outcome might have been even better, since part of such base-year effects and additional revenues were offset by expenditure overruns. Although the cap on wages of public sector employees was broadly respected and capital expenditures actually fell in nominal terms, social transfers increased at 13 percent of GDP.

The general government debt ratio attained around 70¼ percent of GDP in 2005 compared with 71¾ percent a year earlier, slightly better than the 70½ percent of GDP target projected in the convergence programme. This difference is mainly explained by the higher primary balance and growth.

The 2006 Budget Law, which was approved by the Parliament on 15 December 2005 and incorporated in the December 2005 update of the convergence programme (^{2}),

targets a nominal general government deficit of 1.9 percent of GDP. It projects total revenues to fall by around half a percentage point of GDP, mainly reflecting the expiry of temporary revenues worth almost 1 percent of GDP, which will be only partially compensated by new one-off proceeds from the issuance of title deeds for buildings with irregularities (0.3 percent of GDP). The budget also contemplates an increase of the contribution levels of the self-employed to social security funds worth 0.1 percent of GDP. On the expenditure side, the budget sets a ceiling on the nominal growth rate of current expenditures of 2 percent, the containment of current transfers and subsidies in line with inflation, and the increase in the retirement age of public employees. According to the Commission services' spring 2006 forecast, the general government deficit for 2006 is projected just above 2 percent of GDP, or about ¼ of a percentage point of GDP higher than the official target. The difference is mainly explained by a more optimistic growth scenario in the official projections. According to the 2005 update of the convergence programme, GDP is projected to grow at 4.2 percent this year, while the Commission services' spring 2006 forecast expects GDP to increase by 3.8 percent. The primary surplus is projected to remain at 1 percent of GDP. The projected improvement of the structural balance, i.e. the budget balance net of cyclical factors and one-offs and other temporary measures amounts to about ¾ of a percentage point of GDP.

In 2007, based on the customary no-policy-change assumption, the Commission services project a general government deficit of 2.0 percent of GDP. The 2005 update of the convergence programme targets a deficit of 1.8 percent of GDP, which then gradually declines to 0.6 percent of GDP in 2009.

(^{1}) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

(^{2}) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.24

Budgetary developments 2004-2009, Cyprus (% of GDP)

Outturn and forecast (¹)	2004	2005	2006	2007		
General government balance	− 4.1	− 2.4	− 2.1	− 2.0		
- Total revenues	39.7	42.3	41.8	41.8		
Of which: - *current taxes*	25.6	26.9	26.9	26.8		
- *social contributions*	7.8	8.4	8.1	8.1		
- Total expenditure	43.8	44.7	43.9	43.8		
Of which: - *collective consumption*	9.9	10.0	9.8	9.8		
- *social transfers in kind*	8.2	8.3	8.2	8.2		
- *social transfers other than in kind*	12.2	12.9	11.4	11.4		
- *interest expenditure*	3.2	3.4	3.1	3.0		
- *gross fixed capital formation*	4.1	3.2	3.4	3.4		
Primary balance	− 0.9	1.0	1.0	1.0		
Tax burden	34.1	36.3	35.2	35.2		
One-off and temporary measures	1.0	0.9	0.3	0.3		
Structural balance (²)	− 4.9	− 3.0	− 2.2	− 2.3		
Structural primary balance	− 1.7	0.4	0.9	0.7		
Government gross debt	71.7	70.3	69.1	67.8		
Pm *Real GDP growth (%)*	3.9	3.8	3.8	3.8		
Convergence programme (³)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance	− 4.1	− 2.5	− 1.9	− 1.8	− 1.2	− 0.6
Primary balance	− 0.9	0.7	1.2	1.2	1.4	1.7
Structural balance (⁴)	− 4.6	− 3.1	− 2.1	− 2.1	− 1.5	− 0.6
Government gross debt	71.3	70.5	67.0	64.0	56.9	53.5
Pm *Real GDP growth (%)*	3.8	4.1	4.2	4.2	4.2	4.3

(¹) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²) Cyclically-adjusted balance excluding one-off and temporary measures.
(³) Submitted in December 2005.
(⁴) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (1.0 % of GDP in 2004, 0.9 % in 2005, 0.3 % in 2006, 0.3 % in 2007, and 0.3 % in 2008; all deficit-reducing)

Source: Commission services and update of the convergence programme of Cyprus.

The Commission services' spring 2006 forecasts project the debt-to-GDP ratio to continue its downward path reaching 69 percent in 2006, down from 70.3 percent in the previous year, and 67¾ percent in 2007. According to the 2005 update of the convergence programme, the debt-to-GDP ratio is projected to decline from 70.5 percent in 2005 to 64 percent in 2007, before gradually improve further and reach 53.5 percent in 2009. The difference between the Commission services' forecast and the updated convergence programme over 2006-2007, is mainly explained by different projections of the primary balance and nominal GDP growth. The Commission services' forecasts do not include the debt-reducing effects of the decumulation of sinking funds, financial assets of the government in the form of deposits in the Central Bank, which have been used for the repayment of long-term loans.

Tax amnesty in Cyprus

In order to reduce the general government deficit ratio to below the 3 percent reference value, the Cypriot government adopted a series of measures in 2004 and 2005. The aim was twofold. Namely, to enhance revenues through 'the special settlement of tax liabilities law' — a tax amnesty — while at the same time discourage future tax evasion, by (i) broadening the monitoring authority of the Commissioner of Inland Revenue Department and (ii) increasing the penalties for non-compliance.

The tax amnesty, which took effect in 2004-2005, aimed at settling any existing tax liabilities of individuals and corporations relating to undeclared income earned before 31 December 2002. Specifically, the law provided for the

establishment of an independent Committee that would officially receive the special declaration forms submitted by the taxpayers and collect the taxes due. The declarations included undeclared income or profits that (i) had been deposited with banks in Cyprus or abroad, or (ii) had been converted to movable or immovable property in or outside the country, or (iii) had been spent domestically or abroad before 31 December 2002.

The law provided for a special tax charge of 5 percent for any amounts declared until 6 December 2004 and of 6.5 percent for amounts declared thereafter, until the end of December 2004. These deadlines however were extended to 31 December 2004 and 28 February 2005, respectively, in order to accommodate the delayed response of the public. The tax amnesty did not include value added tax.

The projected yield of the tax amnesty was around ½ percent of GDP. However, the final amount collected was more than 1½ percent of GDP, of which ¾ of a percentage point was recorded in 2004. The direct impact of the tax amnesty has been crucial in the fiscal consolidation effort as it has contributed significantly to the reduc-

tion of the general government budget deficit from 6.3 percent of GDP in 2003 to 4.1 percent in 2004 and 2.4 percent in 2005.

A significant determinant of the success of the tax amnesty in Cyprus was the firm commitment of the government and the fiscal authorities, alongside an extensive public campaign. The broadness of the measure, covering both physical and legal tax-payers, has also been key in this respect.

Beyond the direct impact the Government expects the tax amnesty to also have a more permanent positive effect on the public finances. This is due to come through the increase of the tax base and higher tax compliance of the tax-payers. Legislation passed in 2005 and designed to enforce better tax compliance, in conjunction with efforts to enforce the collection capacity and efficiency of the public service's revenue collecting departments, is expected to yield higher tax revenues. However, due to the time lag between the enactment of the measures and the response of tax revenues, it is still early to see the full magnitude of this 'more permanent effect' in 2006 and beyond.

Table V.25

Main measures in the budget for 2006, Cyprus

Revenue measures [1]	Expenditure measures [2]
• Regularisation of dividend income policy for semi-governmental organisations (0.3 % of GDP); • Issuance of title deeds for buildings with irregularities (0.3 % of GDP); • Increase of Land and Survey department services fees (0.2 % of GDP); • Improve the efficiency of the Revenue Collecting departments.	• Ceiling on the nominal growth rate of current expenditures of 2 % (– 0.8 % of GDP) • Ceiling on the nominal growth rate of capital expenditures of 6 % • Containment of current transfers and subsidies in line with inflation (– 0.1 % of GDP); • Increase in the retirement age of public sector employees (– 0.2 % of GDP); • Adjustment of the contribution levels of self-employed to the Social Security Funds (– 0.1 % of GDP).

[1]   Estimated impact on general government revenues.
[2]   Estimated impact on general government expenditure.

Source: Commission services and update of the convergence programme of Cyprus.

12. Latvia

Recent developments and medium-term prospects

In 2005 the general government recorded a surplus of 0.2 percent of GDP. This is significantly better than the targeted deficit of 1.6 percent of GDP set in the December 2004 update of the convergence programme. It was also a surprising outturn, given the estimated deficit of 1.5 percent in the December 2005 convergence programme. The better-than-expected outcome was mainly due to very strong tax revenues coming from real GDP growth significantly higher than foreseen (10.2 percent instead of 6.7 percent in the 2005 budget law). In particular, receipts of VAT and excise taxes were much stronger than expected. The 2005 budget was amended in August 2005 and provided for additional spending of about 1½ percent of GDP. This increase provided for a capital injection into a State-owned bank, an increase in the limit on local governments' borrowing and higher subsidies to farmers. In nominal terms, both revenues and expenditure exceeded the levels foreseen in the November 2005 convergence programme, albeit the difference in the case of revenues was much more significant. The debt-to-GDP ratio at end-2005 fell to 11.9 percent.

The 2006 budget law was presented to Parliament on 29 September 2005 and adopted on 20 October. The budget, in line with the November 2005 convergence programme, targets a deficit of 1.5 percent of GDP. ([1]) Compared to the 2005 budget, revenues are projected to increase by 18.8 percent and expenditure by 17.5 percent. About half of the budgeted expenditure increase is allocated to higher public sector wages, increased pensions and other benefits. The most significant budget priorities also include expenditure underpinning continued integration into the EU and NATO, including a contribution to the EU budget in 2006 about a third

higher than the year before. A counterpart to the latter, however, is that Latvia is expected to receive financing of about 4 percent of GDP from the EU as co-financing for projects implemented in the country. Overall on the revenue side, strong economic growth, improved tax-collection and VAT increases implied by EU accession are expected to provide the main financing. Furthermore, changes to the spending structure, including administrative reform, are expected to result in some efficiency savings; however, the impact is not expected to be significant in the near future. In the Commission services' spring 2006 forecast, the projected outcome is slightly better than the official deficit target, based on higher growth assumptions (an 8.5 percent annual growth rate rather than 7.5 percent) but with a more cautious estimate of revenues from EU funds. These projections imply an expansionary fiscal stance in 2006, an election year, as indicated by a 1.1 percent point of GDP increase in the structural budget deficit. However, this result is subject to the caveat that calculations of cyclically-adjusted balances for Latvia are surrounded by a particularly high degree of uncertainty linked to the difficulty of obtaining reliable output gap estimates.

In 2007, based on a no-policy change assumption, the Commission services' spring 2006 forecast projects the general government deficit to remain broadly unchanged at around 1 percent of GDP. This is slightly better than the targets outlined in the November 2005 convergence programme that aims at a slight reduction of the general government budget deficit from 1.5 percent of GDP in 2006 to 1.4 percent of GDP in 2007 and 1.3 percent of GDP in 2008.

The debt-to-GDP ratio is projected in the Commission services' forecast to drop just below 11 percent of GDP at the end of 2007, a profile that is somewhat more optimistic than in the November 2005 update of the convergence programme projecting the debt-to-GDP ratio at 13.7 percent of GDP at the end of 2008.

([1])   The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.26

Budgetary developments 2004-2009, Latvia (% of GDP)

Outturn and forecast [1]	2004	2005	2006	2007	
General government balance	− 0.9	0.2	− 1.0	− 1.0	
- Total revenues	34.9	36.4	36.1	36.1	
Of which: - current taxes	19.7	20.7	20.5	20.4	
- social contributions	8.9	8.7	8.6	8.5	
- Total expenditure	35.9	36.2	37.1	37.1	
Of which: - collective consumption	10.3	9.4	9.4	9.3	
- social transfers	9.3	8.4	8.5	8.4	
- social transfers other than in kind	9.2	8.8	8.7	8.6	
- interest expenditure	0.7	0.6	0.6	0.6	
- gross fixed capital formation	1.9	2.1	2.7	3.2	
Primary balance	− 0.2	0.8	− 0.5	− 0.4	
Tax burden	28.6	29.2	28.9	28.7	
One-off and temporary measures	0.0	0.0	0.0	0.0	
Structural balance [2]	− 0.8	− 0.1	− 1.2	− 0.8	
Structural primary balance	− 0.1	0.5	− 0.6	− 0.2	
Government gross debt	14.6	11.9	11.3	10.9	
Pm Real GDP growth (%)	8.5	10.2	8.5	7.6	
Convergence programme [3]	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	− 1.0	− 1.5	− 1.5	− 1.4	− 1.3
Primary balance	− 0.2	− 0.7	− 0.8	− 0.6	− 0.6
Structural balance [4]	− 1.1	− 1.7	− 1.6	− 1.3	− 1.0
Government gross debt	14.7	13.1	14.9	13.6	13.7
Pm Real GDP growth (%)	8.5	8.4	7.5	7.0	7.0

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
[2] Cyclically-adjusted balance excluding one-off and temporary measures.
[3] Submitted in November 2005.
[4] Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.04 % of GDP in 2004 and 0.02 % in 2005, all deficit-increasing)

Source: Commission services and convergence programme of Latvia.

Table V.27

Main measures in the budget for 2006, Latvia

Revenue measures [1]	Expenditure measures [2]
• Increase in the personal income tax-free threshold from LVL 26 (EUR 37) per month to LVL 32 (EUR 45) per month and the setting of income tax rebates for dependents at LVL 22 (EUR 31) per month (− 0.2 % of GDP); • Increase in excise duties on oil and tobacco products and beer (0.1 % of GDP).	• Financing for EU structural funds and other financial instruments (4.0 % of GDP); • Reform of the National Armed Forces and NATO integration-related requirements (0.4 % of GDP); • Modernisation and restructuring of the healthcare system (0.3 % of GDP); • Increased teachers' wages (0.3 % of GDP); • Other measures to improve social conditions including pension indexation, increase in minimum wage (0.9 % of GDP).

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.

Source: Commission services and the explanations to the 2006 budget law.

13. Lithuania

Recent developments and medium-term prospects

The general government deficit was 0.5 percent of GDP in 2005. This compares with a deficit target of 2.1 percent of GDP in the 2004 update of Lithuania's convergence programme ([1]). The more favourable result stems from a good budgetary performance at all levels of general government, which are estimated to have recorded higher-than-planned revenues while expenditure plans were broadly achieved. This was possible due to higher-than-foreseen economic activity and improvements in tax collection and enforcement. In contrast to previous practice, substantial additional expenditure through supplementary budgets in the second half of the year was avoided. Good times were thus used to step up the budgetary consolidation effort in 2005. The debt ratio decreased further to below 19 percent in 2005, thanks to an improvement in the primary balance and a positive snow-ball effect.

The budget for 2006 was approved on 8 December 2005. The general government deficit target confirmed in the most recent update of the convergence programme ([2]) is 1.4 percent of GDP in ESA 95 terms. The budget contains important new measures on the revenue side. They include the introduction of a new 'social tax', effective from January 2006, which is a *de facto* increase in the corporate tax rate by 4 percentage points, and a decrease of the personal income tax rate from 33 percent to 27 percent with effect as of July 2006. The costs of the pension reform which started in 2004 are estimated to account for 0.7 percent of GDP in 2006. The direct impact of the tax reform, which is included in the budget for 2006, is likely to be broadly neutral in 2006. On the expenditure side, the budget includes a significant increase in social transfers in kind and public investment. This compares with an estimated deficit of 0.6 percent of GDP in the Commission services' spring 2006 forecast. The main reason explaining the difference is the better-than-expected deficit outturn in 2005, which was not anticipated by the authorities at the moment presenting the programme. If the better outcome is carried over to 2006 and the budget is strictly implemented, the deficit is likely to be significantly lower than planned. It is also noted that the authorities' revenue forecast is conservative given the higher-than-expected revenue base achieved in 2005. Under a no-policy change assumption, the Commission services' spring 2006 forecast expects the fiscal stance to remain broadly neutral in 2006, when the primary structural deficit, i.e. the primary deficit net of cyclical and one-off and other temporary measures, is forecast to remain unchanged at 0.3 percent of GDP.

The Commission services' spring 2006 forecast projects a deterioration of the general government deficit in 2007 to 0.9 percent of GDP. This is derived under a no-policy change assumption and includes the impact of the tax reform, namely a planned decrease of 1 percentage point of the 'social tax' in the beginning of 2007 and the loss of personal income tax revenue resulting from the tax cut due to take effect in July 2006. The main reason for the deterioration is explained by the negative impact of the tax reform, together with the increasing costs of the pension reform. The most recent update of the convergence programme foresees the deficit to remain broadly stable at 1.3 percent of GDP in 2007.

This deficit target does not take into account of the better-than-expected budgetary outcome in 2005 and the expected outcome in 2006 if the budget is strictly implemented. Beyond 2007, the authorities project the deficit to decrease to 1 percent of GDP.

([1]) Following a decision by Eurostat in May 2005 on the classification of payments related to the compensation for lost rouble savings in the early years of transition and the restitution of real estate property confiscated in Soviet times, the deficit target set in the previous update (2.5 percent of GDP) has been adjusted to exclude payments related to these liabilities to allow for a meaningful comparison.

([2]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

The Commission services' spring 2006 forecast expects the general government debt ratio to remain low at about 19-20 percent in 2006-2007. The authorities foresee the debt ratio to remain around the same level in 2008.

Table V.28

Budgetary developments 2004-2008, Lithuania (% of GDP)

Outturn and forecast (¹)	2004	2005	2006	2007	
General government balance (²)	– 1.5	– 0.5	– 0.6	– 0.9	
- Total revenues	31.9	33.1	32.0	30.7	
Of which: *- current taxes*	19.8	20.3	20.2	19.7	
- social contributions	8.7	8.6	8.3	8.2	
- Total expenditure	33.4	33.7	32.6	31.7	
Of which: *- collective consumption*	7.5	7.1	6.9	6.8	
- social transfers in kind	10.5	9.7	9.4	9.2	
- social transfers other than in kind	9.1	9.0	8.8	8.8	
- interest expenditure	0.9	0.8	0.7	0.7	
- gross fixed capital formation	3.4	3.5	3.5	3.3	
Primary balance	– 0.5	0.3	0.1	– 0.2	
Tax burden	28.4	28.8	28.5	27.9	
One-off and temporary measures	0.0	0.0	0.0	0.0	
Structural balance (³)	– 2.0	– 1.1	– 1.0	– 1.0	
Structural primary balance	– 1.1	– 0.3	– 0.3	– 0.3	
Government gross debt	19.5	18.7	18.9	19.8	
Pm *Real GDP growth (%)*	7.0	7.5	6.5	6.2	
Convergence programme (⁴)	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 1.4	– 1.5	– 1.4	– 1.3	– 1.0
Primary balance	– 0.4	– 0.6	– 0.6	– 0.6	– 0.2
Structural balance (⁵)	– 2.1	– 2.3	– 2.0	– 1.4	– 1.2
Government gross debt	19.5	19.2	19.9	19.8	18.9
Pm *Real GDP growth (%)*	7.0	7.0	6.0	5.3	6.8

(¹) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²) The costs of the ongoing pension reform (introduction of a second pillar) are included in the deficit. The costs are estimated at 0.3 % of GDP in 2004, 0.5 % in 2005, 0.7 % in 2006, 0.8 % in 2007 and 0.8 % in 2008.
(³) Cyclically-adjusted balance excluding one-off and temporary measures.
(⁴) Submitted in December 2005.
(⁵) Commission services' calculations on the basis of the information in the programme. There are no one-off and other temporary measures taken from the programme.

Source: Commission services and convergence programme of Lithuania.

Table V.29

Main measures in the budget for 2006, Lithuania

Revenue measures (¹)	Expenditure measures (²)
• Social tax (0.6 % of GDP)	
• Personal income tax cut (– 0.7 % of GDP)	
• Pension reform (– 0.7 % of GDP)	

(¹) Estimated impact on general government revenues.
(²) Estimated impact on general government expenditure.

Source: Commission services and convergence programme.

14. Luxembourg

Recent developments and medium-term prospects

The 2004 update of Luxembourg's stability programme projected the general government deficit to decrease from an estimated 1.4 percent of GDP in 2004 to 1.0 percent in 2005. However, according to the latest available data, the deficit actually rose from a revised 1.1 percent of GDP in 2004 to 1.9 percent in 2005 ([1]). General government total spending increased by 1.1 percentage point of GDP instead of 0.8 as planned, while total revenues rose by 0.3 percentage points of GDP instead of 1.2, in particular because of large unexpected VAT refunds. The debt-to-GDP ratio was 6.2 percent in 2005 compared to 6.6 percent in 2004.

The 2006 budget was adopted by Parliament on 14 December, 2005. It targets a general government deficit of 1.8 percent of GDP in 2006, down from the 2.3 percent level estimated at that moment for 2005. The latest update of the stability programme, submitted on 28 November 2005 ([2]), contains the same projections. To date, the deficit target for 2006 has not been adapted despite the recent downward revision of the deficit for 2005 from 2.3 percent of GDP to 1.9 percent (according to the April 2006 reporting, the deficit is now planned to decline to 1.7 percent of GDP in 2006, compared to 1.8 percent in the stability programme, but this is only due to an upward revision in the projected 2006 GDP level). The planned consolidation is supposed to occur exclusively on the expenditure side since the budget projects revenues to rise by 6½ percent (a rather low figure by Luxembourg standards), implying a 0.2 percentage points decline in the revenue-to-GDP ratio. A 1 percentage point of GDP fall in indirect taxes is projected to

be partly compensated by a 0.4 percentage point of GDP rise in direct taxes (which are expected to be boosted by buoyant profits in the financial sector and by the introduction of a withholding tax on savings income) and by a 0.4 percentage point of GDP increase in other revenues. On the other hand, public expenditure is planned to decline by 0.7 percentage points of GDP in 2006, with more than half of this decrease coming from a decline in social transfers, thanks to the effects of reforms initiated in recent years in the fields of disability and health expenditure. The budget and the stability programme update state the government's intention to prevent the rise in current expenditure from exceeding the increase in nominal GDP. On the other hand, government investment is projected to remain at the high level reached in 2005 (5.5 percent of GDP).

The Commission services' spring 2006 forecast foresees the deficit to decline to 1.8 percent of GDP in 2006, which, given the revision in the 2005 figures, represents a more limited reduction than planned in the budget and the stability programme update. Government revenues are expected to decrease by 0.2 percentage points of GDP (the same figure as in the budget) and expenditure by 0.3 point (compared to 0.7 point in the budget and the stability programme update). The fiscal stance in 2006 as assessed in the Commission services' forecast may be described as neutral since the structural balance is forecast to remain constant at 1.1 percent of GDP. On the contrary, the structural balance calculated by the Commission services on the basis of the data in the stability programme should improve by 0.3 percentage point of GDP in 2006 because the programme projects a significantly bigger improvement in the headline deficit.

In 2007, the spring 2006 forecast of the Commission services projects the general government deficit to decline to about 1½ percent of GDP.

This forecast was made under a no-policy change assumption but it incorporates some additional meas-

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[1]   The 2005 update of the stability programme estimated it at 2.3 percent of GDP, a figure subsequently revised to 1.9 percent

[2]   The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.30

Budgetary developments 2004-2008, Luxembourg (% of GDP)

Outturn and forecast (¹)	2004	2005	2006	2007	
General government balance	− 1.1	− 1.9	− 1.8	− 1.5	
- Total revenues	42.1	42.4	42.2	42.3	
Of which: *- current taxes*	26.8	27.3	27.3	27.4	
- social contributions	11.7	11.8	11.7	11.8	
- Total expenditure	43.2	44.3	44.0	43.8	
Of which: *- collective consumption*	6.7	7.1	7.1	7.0	
- social transfers in kind	10.2	10.4	10.3	10.2	
- social transfers other than in kind	15.0	15.0	14.9	14.8	
- interest expenditure	0.2	0.1	0.1	0.1	
- gross fixed capital formation	4.4	4.7	4.7	4.8	
Primary balance	− 1.0	− 1.8	− 1.7	− 1.4	
Tax burden	37.9	38.5	38.5	38.7	
One-off and temporary measures	0.0	0.0	0.0	0.0	
Structural balance (²)	− 0.5	− 1.3	− 1.3	− 1.0	
Structural primary balance	− 0.3	− 1.2	− 1.2	− 0.9	
Government gross debt	6.6	6.2	7.9	8.2	
Pm *Real GDP growth (%)*	4.2	4.2	4.4	4.5	

Stability programme (³)	2004	2005	2006	2007	2008
General government balance	− 1.2	− 2.3	− 1.8	− 1.0	− 0.2
Primary balance	− 0.9	− 2.1	− 1.6	− 0.7	+ 0.1
Structural balance (⁴)	− 0.3	− 1.5	− 1.2	− 0.6	+ 0.1
Government gross debt	6.6	6.4	9.6	9.9	10.2
Pm *Real GDP growth (%)*	4.2	4.0	4.4	4.9	4.9

(¹)   Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(²)   Cyclically-adjusted balance excluding one-off and temporary measures.
(³)   Submitted in November 2005
(⁴)   Commission services' calculations on the basis of the information in the programme

Source: Commission services and convergence programme of Luxembourg

Table V.31

Main measures in the budget for 2006, Luxembourg

Revenue measures (¹)	Expenditure measures (²)
• introduction of a withholding tax on income from savings of residents and non residents (0.3 % of GDP)	• the (by definition non-recurrent) costs related to Luxembourg's presidency of the EU in the first half of 2005 are estimated at 0.2 % of GDP

(¹)   Estimated impact on general government revenues.
(²)   Estimated impact on general government expenditure.

Source: Commission services, 2005 stability programme of Luxembourg and STATEC, *La situation économique au Luxembourg. Evolution récente et perspectives.* Note de conjoncture No 3, 2005.

ures, announced by the Luxembourg authorities at the end of April, especially increases in the personal income tax, corporate tax and social contributions as well as the abolition of the special 12 percent VAT rate on certain services, which will be replaced by the normal 15 percent rate. Other measures, more specifically targeted at curbing government expenditure, were announced on May 2, too late to be incorporated in the spring forecast. The 2005 update of the stability programme projects the general government deficit to decline more significantly, from 1.8 percent of GDP in 2006 to 1.0 percent in 2007 and 0.2 percent in 2008.

According to the spring 2006 forecast, the debt-to-GDP ratio should rise from 6.2 percent in 2005 to 7.9 percent in 2006 and 8.2 percent in 2007 as the authorities intend to issue new bonds in order to finance projects in the fields of roads and railways infrastructure, while taking advantage of the currently low interest rates [1].

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[1] Although the central government has been recording deficits since 2002, these deficits have been financed with the reserves accumulated during the surplus years and no new debt has been issued since 1998.

15. Hungary

Recent developments and medium-term prospects

In 2005, the general government deficit increased by 0.7 percentage point of GDP, reaching 6.1 percent of GDP ([1]). This is substantially higher than the original deficit target of 3.8 percent of GDP in the 2004 update of the convergence programme, despite some corrective measures taken in the first half of the year. The sizeable deviation is due to a significant revenue shortfall, compared to overly optimistic budget assumptions, and an expenditure overrun due to the underestimation of open-ceiling expenditures. The Hungarian authorities had originally intended to reduce the deficit through the sale of motorways to Private-Public-Partnerships (PPPs), for an amount of 1.9 percent of GDP. However, Eurostat clarified that this could not be counted as a deficit-reducing measure. The debt-to-GDP ratio in 2005 increased to 58.4 percent of GDP from 57.1 percent of GDP in the previous year.

The 2006 budget, adopted by parliament on 19 December 2005, aims at a 1 percentage point reduction of public investment expenditure (through recourse to PPP projects in motorway construction). Moreover, the budget assumes a 0.4 percentage point decline in the interest burden mainly linked to a continued trend of interest rate decline. On the revenue side the main measures are cuts in the upper VAT rate and in personal income taxes. The initial target in the 2006 budget was a deficit of 4.7 percent of GDP. The government has since acknowledged that the correct reporting of the purchase of military aircraft under a financial lease contract will add 0.3 percent of GDP to the deficit in 2006 (and 0.2 percent of GDP in 2007). The Commission services' spring 2006 forecast projects a deficit of 6.7 percent of GDP. Expenditures are expected to be higher than offi-

cially estimated. In particular, substantial expenditure overruns are expected in the areas of pension payments, health expenditures, and operational and wage costs at all levels of government. Interest expenditure is also expected to be higher than budgeted in view of the slightly higher debt level and the projected rise in interest rates. Data for the first quarter appear to confirm all these assumptions. In the absence of a decision from Eurostat, the Commission services' spring 2006 forecast assumes that investment in new motorways built in PPPs (over 1 percent of GDP) is recorded as private investment rather than as government expenditure. Although the PPPs would improve the budget balance by reducing public investment expenditure, they would also generate implicit liabilities for the government. The structural primary balance is expected to deteriorate by 0.5 percent of GDP in 2006, indicating an expansionary stance of fiscal policy.

In 2007, the Commission services' spring 2006 forecast projects a further worsening in the government deficit to 7 percent of GDP, based on the no-policy-change assumption. This is considerably higher than the deficit target of 3.3 percent of GDP in the 2005 update of the convergence programme (submitted on 1 December 2005) ([2]), subsequently revised to 3.5 percent of GDP. The forecast includes the next steps of the 5-year tax cut strategy, which was approved by Parliament on 7 November 2005. This would lead to revenue losses of around 1 percent of GDP in 2007, only partly compensated by a slowdown in expenditure growth ([3]).

For 2008, the convergence programme update plans a sizeable reduction in the deficit to 1.9 percent of GDP.

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[1]   All the fiscal numbers exclude the costs of the pension reform as explained in the first comment of Table V.32. Budgetary developments 2004-2008, Hungary* (% of GDP).

[2]   The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/ about/activities/sgp/main_en.htm.

[3]   Under the adopted no-policy-change assumption, all expenditures except interest outlays and social transfers other than in kind are assumed to remain constant in real terms at 2006 levels.

Table V.32

Budgetary developments 2004-2008, Hungary ([1]) **(% of GDP)**

Outturn and forecast ([2])	2004	2005	2006	2007	
General government balance	− 5.4	− 6.1	− 6.7	− 7.0	
- Total revenues	44.1	44.5	43.1	42.2	
Of which: *- current taxes*	25.4	24.8	23.8	23.4	
- social contributions	13.6	14.1	13.8	13.1	
- Total expenditure	49.5	50.6	49.8	49.2	
Of which: *- collective consumption*	10.7	10.5	10.4	10.2	
- social transfers in kind	13.1	13.1	13.2	13.0	
- social transfers other than in kind	14.1	14.8	15.4	15.3	
- interest expenditure	4.2	3.8	3.7	3.7	
- gross fixed capital formation	3.6	3.4	2.7	2.6	
Primary balance	− 1.2	− 2.3	− 3.0	− 3.3	
Tax burden	39.0	38.9	37.7	36.6	
One-off and temporary measures ([3])	0.3	0.5	0.1	− 0.2	
Structural balance ([4])	− 5.5	− 6.3	− 6.7	− 6.9	
Structural primary balance	− 1.3	− 2.5	− 3.0	− 3.2	
Government gross debt	57.1	58.4	59.9	62.0	
Pm *Real GDP growth (%)*	4.6	4.1	4.6	4.2	
Convergence programme ([5])	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	− 5.4	− 6.1	− 4.7	− 3.3	− 1.9
Primary balance	− 1.1	− 2.5	− 1.5	− 0.3	0.8
Structural balance ([6])	− 4.8	− 5.7	− 4.5	− 3.2	− 2.1
Government gross debt	57.2	57.7	58.4	57.9	56.2
Pm *Real GDP growth (%)*	4.6	4.2	4.3	4.1	4.1

([1]) The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact the general government balance would be – 6.6 % of GDP in 2004, – 7.5 % in 2005, – 8.2 in 2006, and – 8.6 % in 2007, while government gross debt would be 60.2 % of GDP in 2004, 62.4 % in 2005, 65.3 % in 2006, and 69 % in 2007.
([2]) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
([3]) The planned PPP operations, included in the Commission services' spring 2006 forecasts as expenditure-reducing (pending a Eurostat decision on the matter), are not considered as one-off measures.
([4]) Cyclically-adjusted balance excluding one-off and temporary measures.
([5]) Submitted in December 2005
([6]) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.1 % GDP in 2007, deficit-reducing)

Source: Commission services and convergence programme of Hungary

According to the Commission services' spring 2006 forecast, the debt-to-GDP ratio will increase in 2006 to 59.9 percent and exceed the 60 percent threshold in 2007, as opposed to the slight decline targeted in the updated convergence programme. The difference is explained by the systematically higher deficit forecasts in the spring forecast. The Commission services' projections take into account to a large extent privatisation operations announced by the government.

This would lead to revenue losses of around 1 percent of GDP in 2007, only partly compensated by a slowdown in expenditure growth ([1]). For 2008, the convergence programme update plans a sizeable reduction in the deficit to 1.9 percent of GDP.

([1]) Under the adopted no-policy-change assumption, all expenditures except interest outlays and social transfers other than in kind are assumed to remain constant in real terms at 2006 levels.

Table V.33

Main measures in the budget for 2006, Hungary

Revenue measures (¹)	Expenditure measures (²)
• 5 % cut in the upper level of VAT rate (-1 % of GDP)	• 1 percentage point of GDP decrease in public investment expenditures
• 2 % cut in the higher rate of personal income tax, an increase of the lower tax bracket by HUF 50 000, cancellation of some exemptions (-0.1 % of GDP)	• 0.4 percentage point of GDP expected decline in interest expenditures
• 100 % of local business tax deducible from corporate tax base, and a decrease of the rate of corporate tax to 10 % for micro companies (up to HUF 5 million annual revenue) (-0.1 of GDP)	• setting an 'emergency' budget reserve against a possible departure from the 2006 target (0.3 % of GDP)
• Abolition of the lump sum health insurance contribution (effective from 01/11/2006) (-0.05 % of GDP)	• unused appropriations frozen at their end-2005 level
• Increase in registration and excise duties to partly compensate VAT revenues losses (+ 0.2 % of GDP)	
• Introduction of luxury tax (property tax on real estate worth more than HUF 100 million) (negligible)	

(¹)   Estimated impact on general government revenues.
(²)   Estimated impact on general government expenditure.

Source: Commission services and convergence programme of Hungary

16. Malta

Recent developments and medium-term prospects

The general government deficit for 2005 is estimated at 3.3 percent of GDP, which is below the target of 3.7 percent set out in the updated convergence programme submitted on 7 December 2004. This deviation is explained by lower-than-planned expenditure of about 1 percentage point which more than offset a shortfall of around ½ of a percentage point in revenues. While the lower expenditure was attributable to an improvement in the primary deficit, the shortfall in revenues was mainly due to a lower yield from social contributions. Relative to GDP, general government debt stood at slightly below 75 percent in 2005, which is higher than the target of 72 percent set out in the updated convergence programme. The difference is mainly explained by the downward revision of the higher-than-expected nominal GDP for 2005.

The 2006 budget was approved by the Maltese Parliament on 18 November 2005. The main revenue-raising measures include a reform of taxes on the transfer of immovable property, further tightening of rules to prevent tax fraud and the sale of government property. On the expenditure side, measures include support to the main sectors of the economy and others intended to mitigate the impact of higher oil prices on public finances. On the revenue side, the measures announced in the budget are projected to lower the deficit ratio for 2006 by around ½ a percentage point of GDP, while the remaining ¼ percentage point is envisaged to be achieved from lower expenditure. The Commission services' spring 2006 forecast projects the deficit to fall to slightly below 3 percent of GDP in 2006, compared to the official budget target of around 2¾ percent presented in the latest update of the convergence programme (¹). The projected improvement in the deficit-to-GDP ratio is a result of tax buoyancy mirroring the

domestically-led composition of growth and capital transfers. In structural terms i.e. net of cyclical factors and one-off and other temporary measures, the primary balance is expected to improve to around 1 percent of GDP, from a ½ percent of GDP in 2005.

On a no-policy change basis, which takes into account the reduction in public investment linked with the Mater Dei Hospital but excludes one-off revenue operations (sale of land estimated at ¾ percent of GDP), the Commission services' spring 2006 forecast projects a rebound in the general government deficit to almost 3¼ percent of GDP in 2007. The latest updated of the convergence programme foresees a general government deficit target of around 2¼ percent of GDP for 2007. For 2008, the programme projects a further improvement in the deficit-to-GDP ratio to 1¼ percent.

The Commission services' spring 2006 forecast projects an improvement in the general government debt level for 2006 to 74 percent of GDP, from slightly below 75 percent the previous year. In 2007, the debt ratio is projected to remain unchanged. These projections do not take into account possible privatisation proceeds planned by the government (estimated at around 7 percent of GDP). According to the latest updated of the convergence programme the debt-to-GDP ratio is envisaged to decline from around 76¾ percent of GDP in 2005 to slightly below 69 percent in 2007. The general government debt target for 2008 is set at around 67¼ percent of GDP.

From public to private: some considerations on privatisation in Malta

Similar to the experience observed in most countries, Malta has been pursuing economic reforms with varying degrees of intensity during the past years. Privatisation has occupied an important place in this reform process, especially since the late 1980s. Through privatisation, resources held-up by the public are released to the private sector, potentially enhancing economic efficiency. Moreover, by enabling

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(¹) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.34

Budgetary developments 2004-2008, Malta (% of GDP)

Outturn and forecast [1]	**2004**	**2005**	**2006**	**2007**	
General government balance	− 5.1	− 3.3	− 2.9	− 3.2	
- Total revenues	43.4	44.2	42.4	40.2	
Of which: *- current taxes*	27.4	27.5	27.4	27.3	
- social contributions	8.5	8.9	8.7	8.6	
- Total expenditure	48.5	47.5	45.3	43.4	
Of which: *- collective consumption*	10.5	10.2	10.0	9.8	
- social transfers in kind	12.2	11.8	11.5	11.3	
- social transfers other than in kind	13.4	13.3	13.3	13.4	
- interest expenditure	4.1	4.0	3.8	3.7	
- gross fixed capital formation	4.5	5.5	4.6	4.1	
Primary balance	− 1.1	0.7	0.9	0.5	
Tax burden	34.6	35.4	35.1	35.0	
One-off and temporary measures	0.7	1.0	1.0	0	
Structural balance [2]	− 4.6	− 3.4	− 3.2	− 2.6	
Structural primary balance	− 0.6	0.5	0.6	1.1	
Government gross debt	76.2	74.7	74.0	74.0	
Pm *Real GDP growth (%)*	− 1.5	2.5	1.7	1.9	
Convergence programme [3]	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	− 5.1	− 3.9	− 2.7	− 2.3	− 1.2
Primary balance	− 1.0	0.3	1.4	1.5	2.4
Structural balance [4]	− 5.1	− 3.8	− 2.3	− 1.4	0.3
Government gross debt	76.7	76.7	70.8	68.9	67.3
Pm *Real GDP growth (%)*	0.2	0.9	1.1	1.2	2.0

[1]   Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
[2]   Cyclically-adjusted balance excluding one-off and temporary measures.
[3]   Submitted in January 2006.
[4]   Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.7 % of GDP in 2004, 1.0 % in 2005, 1.0 % in 2006, 1.0 % in 2007, 0.1 % in 2008; all deficit-reducing).

Source: Commission services and convergence programme of Malta.

governments to reduce the budget deficit through lower subsidies and other transfers to public enterprises, privatisation can contribute to improve fiscal performance. Privatisation receipts may also be employed to reduce, or contain the rise in, public debt with favourable consequences on the budget through lower interest expenditure.

Public enterprises in Malta consist of public corporations and state-owned enterprises (¹) which operate in various

activities including energy, communications, banking, transport and shipyards. Originally, the underlying rationale behind State involvement was to bridge the gap left by the failure of private operators to invest in activities which were essential to Malta's development needs. Most State-owned enterprises were therefore given a statutory monopoly to operate which guaranteed a return on their initial investment.

Privatisation in Malta has moved at varying speeds and two distinct phases can be identified. In the first phase, spanning the late 1980s to mid-1990s, government's objective was to sell off or liquidate a number of (small mostly manufacturing) enterprises, while shares in other public enterprises operating in services activities (banking and communications) were partly sold to the general public.

(¹)   The difference between public corporations and State-owned enterprises is that the former are established and governed by ad hoc legislation. More-over, apart from being entirely government-owned, their financial estimates are scrutinised each year by parliament whilst government has the right to establish budgets or demand payments out of their profits. State-owned enterprises, refer to entities set-up under the general company laws and having at least 50 percent of the capital held by government. In their case, government policy usually flows through board appointees.

Table V.35

Main measures in the budget for 2006, Malta

Revenue measures ([1])	Expenditure measures ([2])
• Prevention against tax fraud (0.2 % of GDP) • Sale of land (1 % of GDP) • Reform of taxes on the transfer of immovable property	• Support to economic sectors (0.6 % of GDP) • Water & electricity surcharge • Reform in student maintenance grant

([1]) Estimated impact on general government revenues.
([2]) Estimated impact on general government expenditure.

Source: Commission services and update convergence programme of Malta.

In the second phase, starting from the late 1990s, privatisation underwent a major shift of focus. High-quality assets were now the main target, while the involvement of strategic partners was being sought, thereby ensuring that transactions transcend financial considerations. Government's stated objective of privatisation in the latter phase was directed to the enhancement of the economy's long-term performance.

Privatisation since 1999 included public companies operating in the banking sector (1999) and airport and postal services (2002). While the former sector was characterised by a number of operators, airport and postal services operated in a monopolistic environment. Moreover, the banking sector has for a long time operated within a strong regulatory and legislative framework, while in the case of the post office a regulator and new legislation were introduced in 2003. Given its important spill-over effects over the whole economy, an assessment of the banking sector's performance allows to apprehend the efficiency gains following privatisation. In 1999, Mid-Med Bank, a major local bank, was sold to an established international financial player, in the process transforming the market in important ways. In the aftermath of privatisation, the sector underwent substantial restructuring as competition in the market intensified and, spurred by the inward transfer of knowledge, a number of innovative products and delivery channels were introduced by banks. Indeed, privatisation paid off in terms of increased productivity and improved the resilience of the sector. Following exceptional results in 2000, the profitability of the banking sector suffered a substantial drop in the subsequent year but increased steadily thereafter regaining more than it had lost. In addition, after increasing in the year following privatisation, private sector employment in the banking sector declined.

The second privatisation phase came amid deteriorating public finances. While privatisation proceeds do not directly affect the government deficit, privatisation may have two opposing effects on the government primary balance. To the extent that privatisation leads to lower subsidies and other transfers to public enterprises, the primary balance should improve. On the other hand, privatisation may lead to a reduction in non-tax revenue as government will no longer receive the dividends that used to be paid by public enterprises out of their yearly profits. Historically, expenditure flows from the budget to public enterprises (in the form of subsidies and advances) have been substantially larger than the contribution of the entities to the budget. Since 1999, improvements in the government primary balance-to-GDP ratio were generally concentrated in the year when privatisation took place but deteriorated thereafter which seems to suggest that privatisation had a marginal impact on current budgetary operations. One explanation for this is that the privatised companies were profitable and as a result the net effect was a reduction in government revenues. This may however change in the subsequent years as the privatised companies restructure and grow thereby increasing their contribution to tax revenues. It should however be underlined that the aspect of improving budgetary outcomes in the case of Malta is being addressed through restructuring and by reducing transfers and subsidies to inefficient public entities.

In conclusion, it appears that, in the case of Malta, privatisation has been more conducive to achieving the stated objective of enhancing efficiency than in supporting fiscal performance. In terms of factors such as service expansion and operating efficiency, a marked improvement after privatisation has been registered, at least in the case of the banking sector. The extent to which privatisation resulted in better budgetary outcomes was limited, although the proceeds derived from the sale of assets contained the growth in debt.

Graph V.11: **Malta – Privatisation proceeds and debt (million MTL)**

Legend:
- Privatisation receipts (rhs)
- Government debt (lhs)
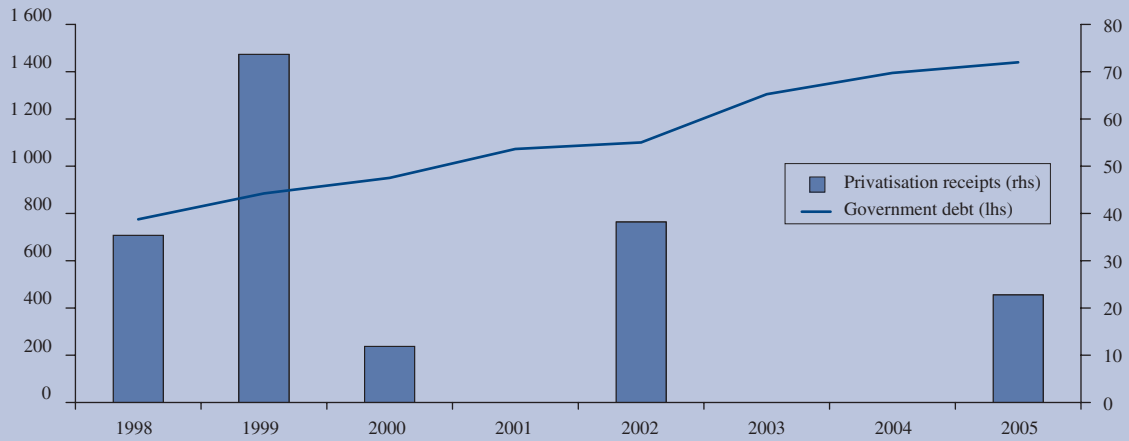
17. Netherlands

Recent developments and medium-term prospects

The general government deficit in 2005 was 0.3 percent of GDP. The official target for the deficit, as indicated in the December 2005 update of the stability programme [1], was 2.6 percent of GDP. The much better outturn is almost entirely located at the central government level, which recorded to a 0.1 percent surplus in 2005 instead of a targeted deficit of 2.2 percent. Remarkably, despite the fact that economic growth turned out somewhat lower than expected, the better outcome is largely the result of higher revenues, with total taxes (excluding gas related revenues) and social contributions turning out 1.4 percent of GDP higher than projected. Additional items are higher gas receipts, as well as lower deficits of local governments. An upward revision in the GDP series also contributed to reduce the deficit ratio. These additional factors explain 0.9 percent of GDP. The debt ratio increased in 2005 by 0.3 percent points to 52.9 percent of GDP. One factor explaining this increase was the purchase of the company in charge of gas transport, a financial transaction that amounted to 0.6 percent of GDP. In the previous update of the stability programme, the debt ratio was expected to turn out much higher, at 58.1 percent of GDP. The difference is due to the upward revision of GDP as well as the lower deficit.

The budget for 2006 was presented on 20 September 2005 and adopted on 6 October 2005. It targeted a general government deficit of 1.8 percent of GDP. The main thrust of the budget is the intention to use the budgetary leeway created by the recent years' policies to increase expenditures and reduce the tax burden, for a total amount of 0.3 percent of GDP. In the Commission serv-

ices' spring 2006 forecast, the budget deficit for 2006 is expected to turn out better, at 1.2 percent of GDP, as higher oil and gas prices lead to higher revenues and 2005 data have created a better starting position.

In the Spring note on budgetary implementation, adopted by government on 12 May, the target for 2006 has been revised to a deficit of 1.0 percent, due to higher outturns of tax revenues and social premiums in the first months. The Spring note specifies some supplementary measures that aim to support purchasing power and counteract the negative financial consequences the healthcare reform has had for specific social groups.

Based on the spring forecast, the fiscal stance in 2006 as measured by the change in the structural balance (i.e. the cyclically-adjusted balance net of one-offs) is expansionary. The structural balance is forecast to deteriorate from a surplus of 1 percent of GDP in 2005 to a deficit of some ¼ percent of GDP in 2006, as the better-than-expected tax receipts in 2005 will not be fully retained in 2006 and expenditure ceilings are forecast to again be fully utilised. Out of this 1¼ percentage points deterioration, half a percentage point is connected to the advancing of profit taxes by companies that took advantage of above-market interest rates in 2005 on taxes to be refunded. On the basis of the data in the stability programme, the Commission services' recalculations showed a much smaller deterioration of the structural balance in 2006, of 0.7 percentage point of GDP. The main reason why the deterioration in 2006 is now estimated to be significantly larger is the better budgetary outcome in 2005, which resulted in an upward revision of the structural balance in 2005 vis-à-vis the previous estimate.

In the Commission' services spring 2006 forecast, based on the assumption of no-policy change, the general government deficit is expected to improve in 2007 to 0.7 percent of GDP on the back of strong economic growth. This forecast is 0.5 percent of GDP better than the target set in the last update of the stability pro-

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[1]   The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.36

Budgetary developments 2004-2008, The Netherlands (% of GDP)

Outturn and forecast [1]	2004	2005	2006	2007
General government balance	− 1.9	− 0.3	− 1.2	− 0.7
- Total revenues	44.5	45.4	46.5	46.4
Of which: *- current taxes*	23.0	24.4	23.7	23.7
- social contributions	15.0	14.3	15.7	15.4
- Total expenditure	46.4	45.7	47.7	47.1
Of which: *- collective consumption*	10.6	10.4	10.2	10.1
- social transfers in kind	13.7	13.6	15.3	15.2
- social transfers other than in kind	11.5	11.2	11.7	11.4
- interest expenditure	2.6	2.5	2.3	2.3
- gross fixed capital formation	3.1	3.0	2.9	2.8
Primary balance	0.7	2.3	1.2	1.6
Tax burden	37.8	38.5	38.8	38.6
One-off and temporary measures	0.3	0.0	0.0	0.0
Structural balance [2]	− 1.4	1.0	− 0.3	− 0.2
Structural primary balance	1.2	3.5	2.3	2.4
Government gross debt	52.6	52.9	51.2	50.3
Pm *Real GDP growth (%)*	1.7	1.1	2.6	2.6

Stability programme [3]	2004	2005	2006	2007	2008
General government balance [4]	− 2.1 (− 1.9)	− 1.2 (− 0.3)	− 1.5 (− 1.0)	− 1.2	− 1.1
Primary balance	0.6	1.4	1.1	1.4	1.5
Structural balance [5]	− 1.3	0.0	− 0.7	− 0.6	− 0.6
Government gross debt	53.1	54.4	54.5	53.9	53.1
Pm *Real GDP growth (%)*	1.7	3/4	2 1/2	2 1/2	2 1/4

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

[2] Cyclically-adjusted balance excluding one-off and temporary measures.

[3] Submitted in December 2005.

[4] Figures for 2004 and 2005 have been revised in the most recent April notification. The 2006 target has been revised in the Spring note on budgetary implementation 2006.

[5] Commission services' calculations on the basis of the information in the programme. There are no one-off or other temporary measures in the programme.

Source: Commission services, stability programme of the Netherlands, April notification, Spring note on budgetary implementation 2006.

gramme (which was based on a previous estimate for 2005 and 2006), mainly because of the improved starting position. Further factors include lower interest expenditure, as well as gas revenues that are likely to turn out higher because of the increase in oil and gas prices. Furthermore, in line with a slightly higher economic growth, tax receipts are also expected to turn out above plans in the stability programme. For 2008, the stability programme foresees a small improvement in the general government deficit from the projected 1.2 percent of GDP in 2007 to 1.1 percent of GDP.

The public debt ratio is expected to fall in 2006 to 51.2 percent of GDP and to decrease further to 50.3 percent of GDP in 2007, mainly because of strong nominal GDP growth in both years.

Table V.37

Main measures in the budget for 2006, The Netherlands

Revenue measures [1]	Expenditure measures [2]
• Increasing the number of students & Abolishing tuition fees for 16 &17 year olds (0.1 % of GDP)	• Reductions in environmental levies [3] (0.1 % of GDP) • Security & infectious diseases preparation (0.1 % of GDP) • Investment in infrastructure (0.1 % of GDP)

[1] Estimated impact on general government revenues.
[2] Estimated impact on general government expenditure.
[3] This partly reflects measures that are not in the budget for 2006 but were specified in the Spring note.

Source: Commission services, Miljoenennota 2006, Spring note on budgetary implementation, 12 May 2006.

18. Austria

Recent developments and medium-term prospects

In 2005, the general government deficit amounted to 1.5 percent of GDP, which was 0.4 percentage point lower than the government's initial expectation, presented in the update of the stability programme submitted in November 2004. The budget was affected by the second step of the tax reform started one year earlier, which *ex ante* was expected to burden the budget in 2005 by 0.8 percent of GDP. Nevertheless, tax revenue turned out to be higher than anticipated, mainly owing to higher proceeds from VAT and corporate tax. At the same time, the planned expenditure was also exceeded (e.g. on education and family benefits), though by a smaller margin. The debt-to-GDP ratio went down by almost ¾ percentage point to 62.9 percent, somewhat bigger improvement than planned in the previous update.

The budget for 2006 was prepared together with the 2005 budget, but for formal reasons it was only adopted on 7 April 2005. As in the two previous years, the 2006 budget will bear the consequences of the 2004/2005 tax reform, which according to the Ministry of Finance is to result in a 1.4 percent of GDP revenue loss. The cost could turn out even higher as the loss not fully realised in 2005 might be deferred to 2006. One of the question marks on the revenue side is the impact of the recently introduced comprehensive taxation of holding companies (*Gruppenbesteuerung*), which is difficult to forecast and could diminish tax revenues by more than the planned EUR 100 million (0.04 percent of GDP). The budget will be additionally burdened with the cost of the regional employment and growth initiative of August 2005 and a package of measures aimed at combating youth unemployment and helping women re-enter the job market that the government adopted in September 2005 (about 0.16 percent of GDP in total). On the other hand, implementation of the second stage of the administrative reform, agreed on by the different levels of government in November 2005, should result in expenditure savings of around 0.1 percent of GDP. According to the most recent update of the stability programme, submitted in November 2005, the general government deficit will amount to 1.7 percent of GDP in 2006. This is 0.2 percentage point lower than the Commission services' spring 2006 forecast. The difference is mainly due to the government's more optimistic predictions as to revenue from direct taxes. In addition, the 2006 (as well as 2007) outturn could be negatively affected by an up to EUR 900 million (0.36 percent of GDP) state guarantee, valid till 1 July 2007, given to BAWAG (Austria's fourth-largest bank, currently in financial distress). However, at the moment it is rather unlikely that the guarantee will be called. The fiscal stance in 2006 is expected to be expansionary, as the structural primary surplus goes down by some ¾ percentage point of GDP according the spring forecast, while the stability programme projected an improvement. This is explained by (i) the base effect of a more favourable outturn in 2005, (ii) the slightly higher 2006 deficit predicted by Commission services and (iii) a substantial upward revision of GDP growth compared to the stability programme.

In 2007, on a no-policy-change assumption, the Commission services expect that the deficit will decline to 1.4 percent of GDP, which is considerably higher than the 0.8 percent of GDP target presented in the latest update of the stability programme. The latter foresees a balanced budget for 2008.

According to the Commission services' spring 2006 forecast, the debt-to-GDP ratio will fall from 62.4 percent in 2006 to 61.6 percent in 2007.

Reform of the budgetary law

Following international examples of best practice, the Austrian authorities started preparing a reform package which aims at creating a modern, objective-driven budgetary law. In practical terms, a draft constitutional amendment has been put together which would consti-

Table V.38

Budgetary developments 2004-2008, Austria (% of GDP)

Outturn and forecast [1]	2004	2005	2006	2007	
General government balance	– 1.1	– 1.5	– 1.9	– 1.4	
- Total revenues	48.8	48.0	46.6	46.8	
Of which: - current taxes	27.8	27.1	25.8	26.2	
- social contributions	16.1	16.1	16.0	15.9	
- Total expenditure	49.9	49.5	48.6	48.2	
Of which: - collective consumption	6.9	7.0	6.8	6.7	
- social transfers in kind	11.1	11.1	11.1	11.1	
- social transfers other than in kind	18.9	18.7	18.5	18.5	
- interest expenditure	2.8	2.8	2.7	2.6	
- gross fixed capital formation	1.1	1.1	1.1	1.1	
Primary balance	1.7	1.2	0.8	1.3	
Tax burden	42.7	41.9	40.6	40.9	
One-off and temporary measures	0.0	0.0	0.0	0.0	
Structural balance [2]	– 0.8	– 1.0	– 1.7	– 1.2	
Structural primary balance	2.0	1.8	1.0	1.4	
Government gross debt	63.6	62.9	62.4	61.6	
Pm Real GDP growth (%)	2.4	1.9	2.5	2.2	
Stability programme [3]	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	– 1.0	– 1.9	– 1.7	– 0.8	0.0
Primary balance	2.1	1.1	1.2	2.0	2.7
Structural balance [4]	– 0.9	– 1.6	– 1.2	– 0.4	0.2
Government gross debt	63.6	63.4	63.1	61.6	59.5
Pm Real GDP growth (%)	2.4	1.7	1.8	2.4	2.5

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
[2] Cyclically-adjusted balance excluding one-off and temporary measures.
[3] Submitted in November 2005.
[4] Commission services' calculations on the basis of the information in the programme.

Source: Commission services and stability programme of Austria.

tute a basis for the new budgetary framework on which additional legal steps would be elaborated. The planned reform would only concern the federal government and not the sub-national governments. Solely the expenditure side would be affected by the reform.

The first element of the envisaged budgetary legislation reform package is the introduction of a medium term budgetary framework. According to the new rules, the Parliament will be obliged to adopt a four-year plan concerning expenditure limits in the main budgetary categories (such as justice and security, education, research and culture, etc.) and then roll it forward by one year every spring. Expenditure ceilings will be divided into fixed and flexible ones. The latter will concern areas that are significantly affected by cyclical fluctuations such as

unemployment benefits, pensions, family transfers, etc. Such a law would give a national dimension to multi-annual budgetary planning, which at the moment is mainly driven by the requirements of the European Stability and Growth Pact. The initial plan was for the new law to come into force on 1 January 2007.

The other part of the package is the idea to change the budgetary law so that it would be driven by outputs and not inputs as is currently the case. According to the proposed amendments, economic stability and sustainability of public finances should be an over-arching goal of budgetary policy. Performance budgeting, transparency, efficiency and accurate presentation of the financial situation by the federal government shall be guiding principles in the budgetary process. The provisions concern-

ing the abovementioned are supposed to come into force on 1 January 2011.

According to the Austrian authorities' estimate, once implemented the reform could contribute to expenditure reduction in the range of 5 percent of the federal government budget expenditure.

However, while the principle of such reform is uncontroversial, the original schedule for its adoption has not been respected. Initially all the political parties repre-

sented in the Parliament had agreed to adopt the new law before summer 2005. Then, for political reasons, this decision was reversed. Later on the political parties were debating for a long time which parliamentary committee should handle the issue. Finally a compromise was found, but first discussion in the parliamentary committees planned for the beginning of May 2006 has been postponed. Therefore, it seems less and less likely that the first element of the reform package — the medium term budgetary framework — will come into force on 1 January 2007 as initially planned.

Table V.39

Main measures in the budget for 2006, Austria

Revenue measures [1]	**Expenditure measures** [2]
• The 2004/2005 tax reform (-1.4 % of GDP)	• Package of measures aimed at reducing unemployment and regional employment and growth initiative (0.2 % of GDP) • The second stage of the administrative reform (-0.1 % of GDP)

[1]   Estimated impact on general government revenues.
[2]   Estimated impact on general government expenditure.

Source: Commission services and Austrian Ministry of Finance.

19. Poland

Recent developments and medium-term prospects

In 2005, the general government deficit was 2.5 percent of GDP, compared to 3.9 percent targeted in the December 2004 convergence programme. This significant difference is mainly due to one-off factors: a new formula transforming cash data into accrual data, an upward revision of GDP by the statistical office and lower absorption of EU funds, which resulted in lower investment expenditure. In addition, the record-high corporate profits resulted in a large increase of corporate income tax revenues. Nevertheless, the debt ratio increased to 42.5 percent of GDP in 2005, as targeted in the convergence programme which points to higher-than-expected negative stock-flow adjustment.

The amended 2006 budget was adopted on 1 February 2006. The new government had decided to increase social expenditure by almost 0.1 percent of GDP. The Parliament adopted additional social expenditure and subsidies by over 0.1 percent of GDP. As a result, the Ministry of Finance revised its target for general government deficit from 2.6 percent of GDP (presented in January 2006 convergence programme) [1] to 2.8 percent (April 2006 fiscal notification). According to the Commission services' spring 2006 forecast, the general government deficit will reach 3 percent of GDP. This forecast reflects the high uncertainty concerning the execution of the 2006 budget. Furthermore, the projected acceleration of GDP growth, revenues from indirect taxes are likely to be lower than in the rather very optimistic outlook presented in the budget. Numerous

expenditure-increasing initiatives have already been presented in the coalition agreement which was signed in April 2006. The expected fiscal stance is expansionary as the structural primary balance will deteriorate by 0.5 percent of GDP, more than implied by the figures presented in the January 2006 convergence programme.

Based on the no-policy-change assumption, the Commission services' spring 2006 forecast expects the general government deficit to stabilise at 3 percent of GDP in 2007, against the background of slightly accelerating economic growth. This projection contrasts with the consolidation path set out in the January 2006 Convergence Programme which targeted a deficit of 2.2 percent of GDP in 2007 (and 1.9 percent of GDP in 2008). The Commission services' forecast includes the revenue-reducing reforms in social contributions, personal income tax and value added tax announced on 31 March 2006. In particular, the cuts in contributions to the disability and sickness funds (estimated at more than 0.6 percent of GDP), pro-family tax reliefs and the indexation of brackets of personal income tax (overall estimated at about 0.4 percent of GDP) will weigh on the 2007 budget. The revenue losses are expected to be partially offset by increased revenues from higher excise duties on fuel and cigarettes and the removal of private construction and renovation tax reliefs (about 0.6 percent of GDP together).

The Commission services project the debt-to-GDP ratio to increase by more than 4 percentage points between 2005 and 2007, reaching 46.7 percent of GDP in 2007. The large increase of the ratio in 2006 (3 percentage points) is largely due to stock-flow adjustment, distributed equally across net accumulation of financial assets, valuation effects and the difference between cash and accrual balance.

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[1] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.40

Budgetary developments 2004-2008, Poland (¹) (% of GDP)

Outturn and forecast (²)	2004	2005	2006	2007	
General government balance	− 3.9	− 2.5	− 3.0	− 3.0	
- Total revenues	38.6	40.8	41.6	40.7	
Of which: *- current taxes*	19.2	20.9	21.4	21.9	
- social contributions	13.4	13.8	14.2	13.6	
- Total expenditure	42.5	43.3	44.6	43.7	
Of which: *- collective consumption*	8.2	8.7	8.0	7.9	
- social transfers in kind	9.7	10.0	9.5	9.3	
- social transfers other than in kind	16.1	15.9	16.3	15.8	
- interest expenditure	2.6	2.4	2.5	2.6	
- gross fixed capital formation	3.4	3.1	4.0	4.1	
Primary balance	− 1.3	− 0.1	− 0.5	− 0.4	
Tax burden	32.7	34.8	35.6	35.5	
One-off and temporary measures	0.0	0.0	0.0	0.0	
Structural balance (³)	− 4.2	− 2.6	− 3.3	− 3.5	
Structural primary balance	− 1.6	− 0.2	− 0.8	− 0.9	
Government gross debt	41.9	42.5	45.5	46.7	
Pm *Real GDP growth (%)*	5.3	3.2	4.5	4.6	
Convergence programme (⁴)	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	− 3.8	− 2.9	− 2.6	− 2.2	− 1.9
Primary balance	− 1.2	− 0.3	− 0.2	0.3	0.6
Structural balance (⁵)	− 4.1	− 2.9	− 2.7	− 2.3	− 2.1
Government gross debt	41.9	42.5	45.0	45.3	45.4
Pm *Real GDP growth (%)*	5.3	3.3	4.3	4.6	5.0

(¹) The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact the general government balance according to the updated convergence programme would be 1.8 % of GDP in 2004, 4.7 % in 2005, 4.6 % in 2006, 4.1 % in 2007 and 3.7 % in 2008, while government gross debt would be 45.9 % of GDP in 2004, 47.9 % in 2005, 51.2 % in 2006, 52.1 % in 2007 and 52.6 % in 2008.
(²) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(³) Cyclically-adjusted balance excluding one-off and temporary measures.
(⁴) Submitted in January 2006.
(⁵) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme.

Source: Commission services and convergence programme of Poland.

Table V.41

Main measures in the budget for 2006, Poland

Revenue measures (¹)	Expenditure measures (²)
• Retroactive indexation of personal income tax brackets (³) (– 0.1 % of GDP)	• Increased social expenditure (child benefits, longer paid maternity leaves, children nutrition) and subsidies to fuel in agriculture (0.2 % of GDP)

(¹) Estimated impact on general government revenues.
(²) Estimated impact on general government expenditure.
(³) Proposed by the Ministry of Finance on 31 March 2001.

Source: Commission services, amended 2006 budget bill and the proposals of changes in taxes and social contributions announced by the Ministry of Finance on 31 March 2001.

20. Portugal

Recent developments and medium-term prospects

In 2005, the general government deficit amounted to 6 percent of GDP. This outturn compares with a target deficit of 2.8 percent of GDP set in the December 2004 update of the stability programme and with a target of 6.2 percent of GDP presented in the June 2005 update of the stability programme of Portugal ([1]). The latter revealed a substantial change in the budgetary strategy of the Portuguese authorities as decided in the aftermath of the general elections and a new government taking office in March 2005. The sharp rise in the government deficit in 2005 was largely due to the government decision of no longer implementing sizeable deficit-reducing one-off measures and a considerable upward revision of government expenditure growth ([2]). In 2005, government debt continued on an upward trend, reaching 63.9 percent of GDP.

The budget for 2006 was adopted on 30 November 2005, with a target of 4.6 percent of GDP for the 2006 general government deficit is, which has been confirmed in the December 2005 stability programme update ([3]). The planned deficit reduction vis-à-vis the 2005 outturn is based on measures raising the tax burden and curbing primary expenditure growth. According to the budget, some two-thirds of the fiscal adjustment relies on additional revenues and the rest on expenditure restraint as the result of various corrective measures that have been introduced since mid-2005. The most sizeable discretionary measures supporting the 2006 fiscal target are

the hike in the VAT standard rate from 19 to 21 percent, changes to health and pensions schemes, in particular for government employees, and changes in the public administration functioning. The Commission services' spring 2006 forecast projects a deficit of 5 percent of GDP, with the difference vis-à-vis the official deficit target being essentially due to a less benign assessment of current expenditure growth. In 2006, the fiscal stance, as measured by the change in the structural balance, i.e. the budget balance net of one-off and other temporary measures, is expected to be restrictive: the Commission services' spring 2006 forecast projects a reduction of the structural deficit by slightly over 1 percent of GDP. This is somewhat less than the expected improvement of 1½ percent of GDP in the December 2005 stability programme. In both cases, the improvement in the structural primary balance will be marginally better.

For 2007, under the customary no-policy change assumption, the Commission services' spring 2006 forecast projects the general government deficit to remain broadly unchanged at 4.9 percent of GDP. This represents the persistence of large fiscal imbalances amidst a continued expansion of expenditure against a backdrop of weak economic growth. At the same time, the budgetary impact of public-private partnerships established in previous years will be felt more clearly as from 2007. The 2007 government deficit target in the December 2005 update of the stability programme is 3.7 percent of GDP, with the improvement compared with 2006 owing to a slightly higher tax burden and a more substantial expenditure restraint.

The difference between the official target and the Commission services' spring 2006 forecast is largely due to the latter being based on a no-policy-change assumption, but also being more sceptical on the dynamism of social transfers being contained.

Beyond 2007, the December 2005 stability programme projects the general government balance to decline

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([1]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

([2]) Compared with the June 2005 programme, the nominal general government balances have 'mechanically' been revised down by some ¼ percentage point of GDP entirely due to significant upward revisions of the GDP series.

([3]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.42

Budgetary developments 2004-2009, Portugal (% of GDP)

Outturn and forecast ([1])	2004	2005	2006	2007		
General government balance	− 3.2	− 6.0	− 5.0	− 4.9		
- Total revenues	43.2	41.8	43.0	43.1		
Of which: - *current taxes*	23.0	23.9	24.9	25.2		
- *social contributions*	12.4	12.5	12.4	12.3		
- Total expenditure	46.4	47.8	48.0	48.0		
Of which: - *final government consumption*	20.6	21.1	20.9	20.8		
- *social transfers other than in kind*	14.2	14.8	15.3	15.5		
- *interest expenditure*	2.6	2.7	2.9	3.1		
- *gross fixed capital formation*	3.0	3.1	2.9	2.8		
Primary balance	− 0.5	− 3.3	− 2.1	− 1.8		
Tax burden	34.5	35.4	36.3	36.6		
One-off and temporary measures	2.1	0.1	0.1	0.1		
Structural balance ([2])	− 4.8	− 5.2	− 4.1	− 3.9		
Structural primary balance	− 2.2	− 2.5	− 1.2	− 0.8		
Government gross debt	58.7	63.9	68.4	70.6		
Pm *Real GDP growth (%)*	1.1	0.3	0.9	1.1		
Stability programme ([3])	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance	− 3.0	− 6.0	− 4.6	− 3.7	− 2.6	− 1.5
Primary balance	− 0.3	− 3.2	− 1.7	− 0.6	0.6	1.5
Structural balance ([4])	n.a.	− 5.0	− 3.4	− 2.6	− 1.8	− 1.2
Government gross debt	59.4	65.5	68.7	69.3	68.4	66.2
Pm *Real GDP growth (%)*	1.2	0.5	1.1	1.8	2.4	3.0

([1]) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
([2]) Cyclically-adjusted balance excluding one-off and temporary measures.
([3]) Submitted in December 2005.
([4]) Commission services' calculations on the basis of the information in the programme. There are no one-offs and other temporary measures in the programme.

Source: Commission services and stability programme of Portugal.

below 3 percent of GDP in 2008 and to approach some 1½ percent of GDP in 2009, mainly helped by expenditure restraint.

In all, the stability programme reveals an ambitious fiscal consolidation strategy which has to be underpinned by a thorough implementation of a broad range of effective corrective measures.

According to the Commission services' spring 2006 forecast, the government debt ratio is projected to be 68.4 percent of GDP in 2006 and 70.6 percent of GDP in 2007. In all, it represents the continuation of the upward trend which has been rooted in high primary deficits, low nominal GDP growth and sizeable debt-increasing stock-flow adjustments. The December update of the stability programme projects the debt ratio to peak at slightly over 69 percent of GDP in 2007 and to decline thereafter to just above 66 percent of GDP in 2009. According to the programme, the drivers of the declining debt ratio in those years will be the return to primary surpluses, the acceleration of nominal GDP growth and the end of stock-flow adjustments, helped also by privatisation proceeds.

Table V.43

Main measures in the budget for 2006, Portugal

Revenue measures [1]	Expenditure measures
• Increase in excise taxes on petrol and tobacco products (+ 0.15 % and + 0.1 % of GDP, respectively). • Creation of an additional personal income tax bracket for incomes over EUR 60 000/year with a marginal tax rate of 42 % (present top rate at 40 %); and lower allowances for income from pensions. • Increase in the VAT standard rate from 19 to 21 % (+ 0.5 % of GDP; NB: implemented in July 2005 will have its full effect in 2006 for the first time).	• Freeze of nominal transfers to regional and local governments from central government, and of local government compensation of employees at their 2005 nominal level. At the same time, the debt of regional and local governments cannot exceed its end-2005 level.

[1]   Estimated impact on general government revenues.

Source: Commission services, 2006 budget, and December 2005 stability programme update.

21. Slovenia

Recent developments and medium-term prospects

The general government deficit declined to 1.8 percent of GDP in 2005, by 0.3 of a percentage point more than targeted in the January 2005 update of the convergence programme. The outcome was in line with the supplementary budget, adopted in June 2005, following the upward revision of revenue projections as well as the upward realignment of expenditures according to the priorities of the new government. The revenues came in higher than expected as the tax collection based on the new personal and corporate income tax regimes, effective since 1 January 2005, had been underestimated. At the same time, higher indirect taxes compensated the loss on the excise duties, incurred after the unexpected oil price hikes had prompted the government to lower the rate of excise taxes on oil to the minimum level allowed so as to contain inflationary pressures. General government expenditure increased less than anticipated against a backdrop of restrictive employment and wage policies in the public sector and rationalisation of government goods and services purchases. Like in 2004, the deficit reduction was facilitated by favourable cyclical conditions as the negative output gap is slowly closing. At the end of 2005, the general government debt accounted for about 29 percent of GDP.

Due to the October 2004 parliamentary elections, the 2006 budget could not be adopted in 2004, compliant with the budgetary procedure of simultaneously presenting two consequent budgets on a rolling basis. The parliament passed the initial Budget Bill and the accompanying Budget Implementation Act for 2006 together with a 2007 budget only on 12 December 2005. In 2006, the deficit ratio is projected to remain unchanged compared with the previous year against the background of counteracting revenue and expenditure measures. On the revenue side, the modifications mainly concern further simplification of the direct tax regime following adjustments to the personal income tax and corporate income tax, as adopted at the end of November 2005 and in force from 1 January

2006. Furthermore, in the framework of a gradual elimination of the payroll tax by 2009 its rate is lowered by 20 percent. On the expenditure side, cost effectiveness and flexibility will continue to be pursued through measures related to restrictive employment and wage policies in the public sector. However, the decision to index pensions to wages will keep the share of mandatory spending well above 80 percent of total outlays. As the effects of the anticipated structural reforms and the relevant features of the EU financial perspectives 2007-2013 have not yet been included in the budget, the bill is expected to be amended. According to the second update of the convergence programme [1], submitted in December 2005, the target for the general government deficit was 1.7 percent of GDP but became 1.8 percent with the April 2006 EDP notification, which is broadly in line with the Commission services' spring 2006 forecast of 1.9 percent of GDP. Based on the limited policy efforts on the side of expenditure, the projections imply some fiscal loosening in 2006. The Commission services spring 2006 forecasts anticipate the primary structural balance to turn negative this year.

The broadly positive economic trends are expected to endure in 2007. However, the Commission services forecast that the general government deficit would improve only slightly, to 1.6 percent of GDP, against the commitment of the new government to gradually abolish the payroll tax.

Following the no-policy change assumption, this forecast does not include the effect of a possible increase in the VAT rates to offset the loss in revenue due to the phasing out of the payroll tax. The updated convergence programme of December 2005 envisaged a steady fiscal consolidation in the period 2005-2008, with the general government deficit projected to decrease from 1.7 percent to 1 percent of GDP.

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[1] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

To this end, the programme announced tax reform measures, leading to a drop in the share of revenue as a percentage of GDP by 1.8 percentage points, and measures on the expenditure side, resulting in a decline in the expenditure ratio by 2.5 percentage points of GDP.

The Commission services spring 2006 forecast projects the general government debt to stay below 30 percent in 2006-2007. However, the Commission services' projection of an explosive path of the debt ratio beyond 2020 puts Slovenia at a high risk as regards the long-term sustainability of public finances.

Table V.44

Budgetary developments 2004-2007, Slovenia (% of GDP)

Outturn and forecast [1]		**2004**	**2005**	**2006**	**2007**	
General government balance		– 2.3	– 1.8	– 1.9	– 1.6	
- Total revenues		45.3	45.5	45.5	45.3	
Of which:	*- current taxes*	24.7	24.8	25.0	25.0	
	- social contributions	15.0	15.2	15.0	14.8	
- Total expenditure		47.6	47.3	47.3	47.0	
Of which:	*- collective consumption*	7.7	7.8	7.6	7.5	
	- social transfers in kind	11.8	11.9	11.7	11.6	
	- social transfers other than in kind	16.9	16.9	16.8	16.9	
	- interest expenditure	1.9	1.6	1.5	1.4	
	- gross fixed capital formation	3.4	3.3	3.4	3.3	
Primary balance		– 0.5	– 0.1	– 0.4	– 0.2	
Tax burden		39.7	39.8	39.8	39.6	
One-off and temporary measures		0.0	0.0	0.1	0.0	
Structural balance [2]		– 1.8	– 1.5	– 1.8	– 1.7	
Structural primary balance		0.0	0.1	– 0.3	– 0.3	
Government gross debt		29.5	29.1	29.9	29.7	
Pm	*Real GDP growth (%)*	4.2	3.9	4.3	4.1	
Convergence programme [3]		**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		– 2.0	– 1.7	– 1.7	– 1.4	– 1.0
Primary balance		– 0.5	– 0.2	– 0.3	– 0.1	0.2
Structural balance [4]		– 1.4	– 1.2	– 1.4	– 1.3	– 1.0
Government gross debt		29.5	29.0	29.6	29.8	29.4
Pm	*Real GDP growth (%)*	4.2	3.9	4.0	4.0	3.8

[1]   Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
[2]   Cyclically-adjusted balance excluding one-off and temporary measures.
[3]   Submitted in December 2005.
[4]   Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme.

Source: Commission services and convergence programme of Slovenia.

Table V.45

Main measures in the budget for 2006, Slovenia

Revenue measures [1]	**Expenditure measures** [2]
• Lowering the rate of payroll tax by 20 % (– 0.3 % of GDP)	• Indexation of pensions to wages (0.1 % of GDP)
• Simplification of the personal income tax (0.1 % of GDP)	
• Simplification of the corporate income tax (0.2 % of GDP)	

[1]   Estimated impact on general government revenues.
[2]   Estimated impact on general government expenditure.

Source: Commission services and the 2006 Budget Bill.

22. Slovakia

Recent developments and medium-term prospects

The general government deficit for 2005 amounted to 2.9 percent of GDP which is 0.5 percentage point below the deficit target presented in the 2005 budget. Tax revenues were 1 percent of GDP and overall public revenues even 1.2 percent of GDP higher than foreseen in the budget, mostly due to higher-than-expected economic growth. However, two unplanned one-off/temporary effects (penalty to the national oil refinery company for abusing a monopoly position and accumulation of stocks of cigarettes and alcohol at the end of 2005 resulting in extra VAT and excise duties) account for 0.4 percentage points of the additional revenues. Moreover, interest expenditure was 0.5 percent of GDP lower than planned, while expenditures amounting to 0.8 percent of GDP were deferred into 2006. These positive developments were partly outweighed by deficit increasing debt cancellations of 0.9 percent of GDP and some other smaller expenditure increases amounting to 1.1 percent of GDP which were not foreseen in the 2005 budget. Gross public debt decreased sharply to around 34½ percent of GDP in 2005 as a part of the privatisation revenues from previous years has been used to pay-off some of the country's debt.

The 2006 budget was approved by parliament on 13 December 2005. The budget targets a nominal general government deficit of 2.9 percent of GDP. Planned increases in public expenditure largely offset favourable revenue growth as well as declining interest payments, preventing a more significant fiscal consolidation. Major spending increases are planned in the area of education, environmental protection, research and development (i.e. the priority areas identified in the National Reform Programme) while only modest increases are foreseen for public transport, justice and interior affairs. On the revenue side, the main measures consist in restrictions on child tax allowances and increases in taxes on cigarettes and alcohol as well as some administrative fees. However, the accumulation of stocks of cigarettes and alcohol at the end of 2005 which was not anticipated in

the budget could have a deficit increasing impact of some 0.3 percent of GDP due to lower than expected imports and sales of these goods in the first half of 2006. The Commission services' spring 2006 forecast expects the 2006 deficit at 2.7 percent of GDP as it anticipates higher GDP and employment growth and lower interest expenditure than the 2006 budget. Expenditure increases in the election year are projected to result in an expansionary fiscal stance with the structural primary balance deteriorating from 0.1 percent of GDP in 2005 to – 0.6 percent of GDP in 2006.

Under the customary no-policy-change assumption, the general government deficit net of the pension reform cost is expected to fall to around 2 percent of GDP in 2007 as a result of accelerating growth. The December 2005 convergence programme [1] foresees the general government deficit net of the pension reform cost at 1.6 percent and 1.3 percent of GDP in 2007 and 2008 respectively.

According to the Commission services' spring 2006 forecast the debt ratio is projected to slightly increase over the forecast period, but should remain below 40 percent of GDP. Moreover, anticipated significant privatisation revenues in 2006 create room for further debt reductions.

Evaluation of the introduction of the flat tax rate in Slovakia

In 2004 Slovakia introduced a comprehensive tax reform which consisted of 5 key measures: [2]

(1) The introduction of a flat tax rate of 19 percent on personal and corporate income. As there still is a level of

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[1] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[2] Supplementary measures included:
(1) An increase in consumption taxes slightly above the minimum levels required by the EU;
(2) An increase in the level of the tax-free personal income;
(3) The introduction of child tax bonuses.

Table V.46

Budgetary developments 2004-2008, Slovakia ([1]) **(% of GDP)**

Outturn and forecast ([2])		**2004**	**2005**	**2006**	**2007**	
General government balance		− 3.0	− 2.9	− 2.7	− 2.1	
- Total revenues		35.9	33.9	33.0	32.5	
Of which:	- current taxes	18.3	18.3	17.7	17.7	
	- social contributions	12.1	11.1	10.8	10.5	
- Total expenditure		38.9	36.8	35.7	34.6	
Of which:	- collective consumption	12.4	10.4	9.8	9.4	
	- social transfers in kind	7.5	8.3	8.2	8.1	
	- social transfers other than in kind	10.2	10.7	10.0	9.5	
	- interest expenditure	2.2	1.7	1.8	1.7	
	- gross fixed capital formation	2.4	2.1	1.9	1.5	
Primary balance		− 0.8	− 1.1	− 0.9	− 0.4	
Tax burden		30.4	29.6	28.9	28.5	
One-off and temporary measures		0.0	− 0.8	0.0	0.1	
Structural balance ([3])		− 2.3	− 1.6	− 2.4	− 2.2	
Structural primary balance		− 0.1	0.1	− 0.6	− 0.5	
Government gross debt		41.6	34.5	34.3	34.7	
Pm	*Real GDP growth (%)*	5.5	6.0	6.1	6.5	
Convergence programme ([4])		**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		− 3.2	− 4.1	− 2.9	− 1.6	− 1.3
Primary balance		− 1.0	− 2.3	− 1.0	0.4	0.7
Structural balance ([5])		− 2.6	− 2.8	− 2.6	− 1.7	− 1.5
Government gross debt		42.6	33.7	35.5	35.2	36.2
Pm	*Real GDP growth (%)*	5.5	5.1	5.4	6.1	5.6

([1]) The general government balance projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact the general government balance according to the updated convergence programme would be -3.2 % of GDP in 2004, -4.9 % in 2005, -4.2 % in 2006, -3.0 % in 2007 and -2.7 % in 2009.

([2]) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

([3]) Cyclically-adjusted balance excluding one-off and temporary measures.

([4]) Submitted in December 2005.

([5]) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.0 % of GDP in 2004, -0.8 % in 2005, 0.0 % in 2006, 0.1 % in 2007, 0.0 % in 2008).

Source: Commission services and convergence programme of Slovakia.

non-taxable personal income, the flat tax remains to some extent progressive. Before, the corporate tax rate was 25 percent and the personal income tax rates ranged from 10 percent to 38 percent;

(2) The harmonisation of the VAT rates at 19 percent, from 2 rates before, namely 20 percent and 14 percent;

(3) The cancellation of the tax on dividends;

(4) The abolition of inheritance and gift taxes as well as of taxes on transfers of property estates;

(5) The elimination of almost all tax exemptions, deductions and special tax regimes.

The reform decreased direct taxes while it increased indirect taxes. When preparing the 2004 budget the Min-

istry of Finance overestimated the loss in direct taxes and the gain in indirect taxes. As shown in Table V.46, the direct tax revenues in 2004 were lower than in the absence of any reform, but they turned out to be higher than foreseen. The opposite result applies to indirect taxes. All in all, and in line with expectations, the tax reform was not revenue neutral as it led to a revenue shortfall of 0.5 percent of GDP.

Overall tax revenues in 2004 were actually 0.5 percent of GDP higher than foreseen in the budget but as nominal GDP also ended up 2.5 percent higher than anticipated the tax revenues share of GDP turned out to be broadly in line with the budget. The Financial Policy Institute of the Slovak Ministry of Finance attributes the differences between actual and expected tax revenues to five factors.

First, the economic environment had a positive impact on the difference between actual and planned revenues. A higher-than-expected wage growth more than compensated for a slower employment growth and thus led to an increase in income tax revenues. Similarly, a higher household consumption growth had a positive impact on VAT revenues.

Second, taxes, not directly connected to the reform, contributed positively as local taxes, set independently by municipalities, increased, while property taxes were positively affected by the deferred payments from the previous years.

Thirdly, the largest negative effect was due to a fall-out in VAT revenues. The growth of VAT revenues dropped suddenly after the entry of Slovakia into the EU on May 1, 2004, although household consumption grew stronger in 2004 than in 2003. This fall in VAT revenues is attributed to the adjustment to a new tax collection system.

Fourth, the advanced payment of taxes on dividends anticipated in the 2004 budget did not take place.

Finally, there are some residual factors which are difficult to quantify. They include effects like a higher willingness to pay taxes induced by the reform and an increase in the tax base resulting from the elimination of the majority of tax exemptions, deductions and special tax regimes. The size of this category is estimated at some 1 percent of GDP.

It is still too early to analyse the macroeconomic impact of the reform. Although, the short term fiscal impact of the tax reform was negative (Table V.48. Impact of the tax reform on public finance, preliminary results for 2004) it is expected to have a positive effect over the longer run as the reformed system should stimulate both work and investment and thus growth.

Table V.47

Main measures in the budget for 2006, Slovakia

Revenue measures (¹)	Expenditure measures (²)
• Increases in consumption taxes on alcohol and cigarettes and in some administration fees (0.13 % of GDP)	• Increased expenditure on education (0.27 % of GDP)
• Increased child tax bonus (– 0.09 % of GDP)	• Increased expenditure on defence (0.16 % of GDP)
• Abolition of child social contribution bonus (0.09 % of GDP)	• Increased State aid to FDIs (0.12 % of GDP)
	• Increases in heath expenditure (0.12 % of GDP)
	• Increased agriculture subsidies (0.12 % of GDP)

(¹) Estimated impact on general government revenues.
(²) Estimated impact on general government expenditure.

Source: Commission services and the Ministry of Finance (The 2006 budget).

Table V.48

Impact of the tax reform on public finance, preliminary results for 2004

% of GDP (ESA 95)	Pro memori: Actual revenues in 2003	2004 budget	Actual revenues in 2004	Potential revenues in case of no reform	Difference between reality and 2004 budget	Difference between no reform and reform
	(1)	(2)	(3)	(4)	(3)-(2)	(3)-(4)
Individual income tax	3.3	2.1	2.6	3.5	0.6	– 0.8
Corporate income tax	2.8	1.8	2.5	3.1	0.7	– 0.6
Advanced tax payments	0.8	0.9	0.4	0.6	– 0.5	– 0.2
Value-added tax	6.7	8.8	7.9	7.1	– 0.9	0.8
Consumption taxes	3.1	3.3	3.4	3	0	0.3
Property taxes	0.2	0.1	0.2	0.2	0.1	0
Local taxes	0.6	0.6	0.6	0.6	0	0
Other	0.5	0.3	0.3	0.3	0	0
Together	18.1	17.9	18.0	18.4	0 (¹)	– 0.5 (¹)

(¹) Discrepancies caused by rounding

Source: The Ministry of Finance

23. Finland

Recent developments and medium-term prospects

The outcome for the general government balance in 2005 was a surplus of 2.6 % of GDP, which is markedly higher than the surplus target of 1.8 percent of GDP set in the update of the Stability Programme presented in November 2004 ([1]). The improvement in the balance was due to higher revenues and lower spending. A sharp increase in employment and buoyant consumer spending gave a boost to tax revenues. At the same time expenditure was lower-than-predicted, mainly due to lower spending on social transfers. The debt ratio declined to 41.1 percent of GDP from 44.3 percent of GDP in the previous year. Besides the 2005 surplus, the exceptionally large decline in the debt was due to the reduction of central government financial assets (deposits with banks and shares) that had been accumulated in previous years.

The State budget for 2006 was approved by the Parliament in December 2005. Notably, the budget includes income tax cuts amounting to 0.5 percent of GDP, which are part of a larger tax cut package over 3 years to supplement the centralised wage agreement for 2004-2007. Spending is contained within the central government expenditure ceilings. The Finnish Ministry of Finance expects in its latest semi-annual economic survey of April 2006 that the general government surplus will reach 2½ *percent* of GDP in 2006, a marked upward revision compared with the 1½ percent of GDP foreseen in the Stability Programme of November 2005. Based on the Finnish Government's medium-term spending guidelines of spring 2006 (covering the period 2007-2011), the upward revision originates from improvements in the central government finances. Local govern-

ment finances are seen to remain in deficit, and social security should maintain the same strong surplus as predicted before. The Commission services' spring 2006 forecast predicts the general government surplus to reach 2.8 percent of GDP in 2006, an almost 1 percentage point upward revision compared with the previous autumn 2005 forecast exercise. Lower-than-predicted spending on social transfers in 2005 will carry over into 2006, while revenues are growing strongly, benefiting also from exceptionally large dividends of EUR 0.4 billion (0.3 percent of GDP). The fiscal stance is broadly neutral. In spite of the small improvement in the general government balance, the structural balance falls slightly by 0.4 percentage points. This is due to a closure of the negative output gap, which follows the temporary slowdown in GDP growth in 2005 caused by a production stoppage in the paper industry due to a labour dispute.

For 2007, the Commission services' spring 2006 forecast predicts the general government surplus to reach 2.5 percent of GDP, under the customary no-policy change assumption. This is almost one percentage point higher than the target set in the Stability Programme of November 2005, but is in line with the latest projections by the Ministry of Finance included in the Spending Limits Guidelines for 2007-2011. Revenue collection is assumed to remain solid, while expenditure ceilings are expected to restrain central government spending. The income tax cuts will be worth 0.3 percent of GDP, somewhat less than in 2006. On the other hand, unlike in 2006, revenues will no longer benefit from exceptionally large dividends. For 2008-2009, the Stability Programme of November 2005 projects the general government surplus to stay at around 1½ percent of GDP.

The latest mid-term projections by the Finnish Ministry of Finance, included in the Spending Limits for 2007-2011, raises the general government surplus projections to 2 ½ % of GDP beyond 2007.

([1]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

According to the Commission services' spring 2006 forecast, the debt ratio will decline steadily from 41.1 percent of GDP in 2005 to 38.3 percent of GDP by 2007, which is broadly in line with the latest projection in the Finnish Ministry of Finance Economic Survey of April 2006.

Table V.49

Budgetary developments 2004-2009, Finland (% of GDP)

Outturn and forecast (^{1})		**2004**	**2005**	**2006**	**2007**		
General government balance		2.3	2.6	2.8	2.5		
- Total revenues		52.4	53.1	52.7	52.1		
Of which:	*- current taxes*	31.3	31.8	31.2	30.9		
	- social contributions	11.8	12.2	12.4	12.3		
- Total expenditure		50.1	50.5	49.9	49.6		
Of which:	*- collective consumption*	7.6	7.8	7.7	7.7		
	- social transfers in kind	14.3	14.7	14.8	14.8		
	- social transfers other than in kind	16.6	16.6	16.4	16.2		
	- interest expenditure	1.5	1.5	1.4	1.3		
	- gross fixed capital formation	2.9	2.8	2.7	2.7		
Primary balance		3.8	4.1	4.2	3.9		
Tax burden		43.8	44.6	44.2	43.9		
One-off and temporary measures		0.0	0.0	0.3	0.0		
Structural balance (^{2})		2.5	3.2	2.8	2.7		
Structural primary balance		4.0	4.7	4.2	4.0		
Government gross debt		44.3	41.1	39.7	38.3		
Pm	*Real GDP growth (%)*	3.6	2.1	3.6	2.9		
Stability programme (^{3})		**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
General government balance		2.1	1.8	1.6	1.6	1.5	1.5
Primary balance		3.7	3.4	3.1	2.9	2.8	2.8
Structural balance (^{4})		2.1	2.1	1.7	1.7	1.7	2.0
Government gross debt		44.9	42.7	41.7	41.1	40.6	40.1
Pm	*Real GDP growth (%)*	3.6	2.1	3.2	2.6	2.3	2.1

(^{1}) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
(^{2}) Cyclically-adjusted balance excluding one-off and temporary measures.
(^{3}) Submitted in Nov 2005.
(^{4}) Commission services' calculations on the basis of the information in the programme.

Source: Commission services and convergence programme of Finland.

Table V.50

Main measures in the budget for 2006, Finland

Revenue measures (^{1})	**Expenditure measures** (^{2})
• Income tax cuts worth EUR 850 million (-0.5 % of GDP) • A 2 % inflation adjustment across the central government income tax scale, reducing tax revenues by EUR 150 million (-0.1 % of GDP) • Tax deductibility of health contributions levied on wage and corporate income, worth EUR 100 million (-0.1 % of GDP)	• New transport infrastructure projects, of which EUR 233 million is spent between 2006 and 2007 (0.1 % of GDP for 2 years) • Increasing funding for research and product development by EUR 83 million 0.05 % of GDP)

(^{1}) Estimated impact on general government revenues.
(^{2}) Estimated impact on general government expenditure.

Source: Commission services and Finnish Ministry of Finance central government budget 2006.

24. Sweden

Recent developments and medium-term prospects

The general government recorded a budget surplus of 2.9 percent of GDP in 2005. The surplus was much better than the 0.6 percent of GDP target given in the 2004 convergence programme update. It was also unexpectedly high given the 1.4 percent surplus estimate given in the 2005 updated convergence programme (¹). The better than expected outcome was mainly due to significant additional inflows of tax revenues; in particular, there were temporary revenues of corporate taxes (amounting to a cumulative 1 percent of GDP over 2004-2005 and classified as one off for the calculation of structural budget balances (²)). Also other taxes, such as VAT grew stronger than previously forecasted. Expenditures developed in line with expectations and observance of the central government nominal expenditure ceilings was achieved with a margin. While the revenue ratio increased, partly due to the temporary items, the expenditure ratio fell. The general government gross debt ratio continued to fall, dropping to 50.3 percent of GDP.

The 2006 Budget Bill was adopted by the government on 16 September 2005. The updated convergence programme for the period 2005-2008, drawing fully on the budget, was submitted to the Commission on 24 November 2005. These plans have been complemented by the annual Spring Budget Bill presented on 18 April 2006. On the revenue side, the main measure for 2006 is the completion of the last step in the income tax reform initiated in 2000. On the expenditure side, the main elements relate to a substantial expansion of active labour market measures with additional places in programmes equal to 1.2 percent of the workforce. In the Spring Budget Bill, the govern-

ment forecast the 2006 surplus to be 2.1 percent of GDP. This is similar to the figure in the Commission services' spring 2006 forecast. It implies a substantial upward revision as compared to the 1.6 percent surplus forecast in the 2006 Budget Bill and the 2005 updated convergence programme. The main reason behind this improvement is an upward shift in forecast revenues given the much improved tax situation in 2005 over and beyond the temporary elements. The upward revision also implies that the surplus would be broadly in line with the national objective of a 2 percent surplus over the cycle as the average nominal balance over the 2000-2006 period would be 2 percent of GDP. The structural balance is around 2 percent of GDP, also supporting such an assessment. However, the fiscal stance in 2006, an election year, remains expansionary as indicated by the narrowing of the structural budget balance (thus taking into account the fall out of one off tax receipts in 2005) by 0.6 percentage points of GDP compared with 2005. In 2007, the Commission services forecast that, on the basis of current policies, the budget surplus will improve marginally to 2.3 percent of GDP, close to the forecast in the Spring Budget Bill. While GDP growth is expected to return towards potential rates, the situation in the labour market is expected to continue to improve, leading to lower expenditures. It is worth noting that according to the government figures there would remain a 0.4 percent of GDP contingency margin under the expenditure ceilings in 2007. Based on historical experience it can be expected that part of this margin will be used for further expenditures initiatives in the upcoming 2007 Budget Bill, thus tending to reduce the surplus. For 2008, the convergence programme targets a general government surplus of 1.7 percent of GDP.

The general government debt ratio is projected to continue to decline in 2006-07, to close to 45 percent of GDP. Differently from previous years, also the nominal level of debt is projected to decline, reflecting the improved situation in central government finances. The pace of reduction of the debt ratio is therefore relatively quick despite the pension system surplus of 2 percent of

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(¹)   The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

(²)   See Box 1 in the Commission assessment of the 2005 Swedish convergence programme for a detailed explanation (see foot-note 1).

Table V.51

Budgetary developments 2004-2008, Sweden (¹) **(% of GDP)**

Outturn and forecast (²)		**2004**	**2005**	**2006**	**2007**	
General government balance		1.8	2.9	2.2	2.3	
- Total revenues		58.3	59.1	58.2	57.7	
Of which:	*- current taxes*	36.3	36.9	36.3	36.1	
	- social contributions	14.6	14.7	14.5	14.4	
- Total expenditure		56.5	56.2	55.9	55.5	
Of which:	*- collective consumption*	8.0	8.0	8.0	7.9	
	- social transfers in kind	19.3	19.3	19.3	19.2	
	- social transfers other than in kind	17.8	17.4	17.2	16.9	
	- interest expenditure	1.6	1.6	1.8	1.8	
	- gross fixed capital formation	3.0	3.0	3.0	3.0	
Primary balance		3.4	4.5	4.0	4.1	
Tax burden		50.6	51.2	50.4	50.1	
One-off and temporary measures		0.6	0.4	0.0	0.0	
Structural balance (³)		1.3	2.6	2.0	2.3	
Structural primary balance		2.9	4.2	3.8	4.1	
Government gross debt		50.5	50.3	47.6	44.8	
Pm	*Real GDP growth (%)*	3.7	2.7	3.4	3.0	
Convergence programme (⁴)		**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		1.6	1.6	0.9	1.2	1.7
Primary balance		3.2	3.2	2.5	3.0	3.6
Structural balance (⁵)		1.1	1.6	0.9	1.1	1.7
Government gross debt		51.1	50.9	49.4	47.8	46.0
Pm	*Real GDP growth (%)*	3.6	2.4	3.1	2.8	2.3

(¹) The budgetary projections exclude the impact of the Eurostat decision of 2 March 2004 on the classification of funded pension schemes, which needs to be implemented by the time of the spring 2007 notification. Including this impact the general government balance according to the updated convergence programme would be 0.8 % of GDP in 2004,1.9 % in 2005, 1.2 % in 2006, 1.3 % in 2007, while government gross debt would be 51.0 % of GDP in 2004, 50.8 % in 2005, 48.1 % in 2006, 55.3 % in 2007.

(²) Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

(³) Cyclically-adjusted balance excluding one-off and temporary measures.

(⁴) Submitted in November 2005.

(⁵) Commission services' calculations on the basis of the information in the programme. One-off and other temporary measures taken from the programme (0.6 % of GDP in 2004, 0.4 % in 2005; all deficit-reducing)

Source: Commission services and convergence programme of Sweden.

GDP being mainly invested in non-government financial assets, thus not contributing to reduce gross debt.

Divergences between budget plans and outcomes: prudence or surprises?

In Sweden, a framework of national rules guides budgetary policy. The framework has three components. First, since 1997, there are multi-annual nominal expenditure ceilings for central government expenditures. Second, since 2000, there is a budget balance requirement at local government level. Third, also since 2000, there is a general government surplus objective of 2 percent of GDP on average over the cycle.

In comparison with the requirements of the SGP, this national framework is clearly more demanding, as has been recognised in successive Council Opinions on Swedish budget plans. Nevertheless, each year since the 2002 convergence programme plans, the Council has also noted that Sweden did not seem to be in line with its national 2 percent of GDP surplus objective and stressed the importance of its achievement for preparing to meet the budgetary costs of ageing. For example, in the most recent Opinion (January 2006), the Council recognised that while the budgetary position in 2005 seemed to be broadly in line with the objective, the expansionary stance for 2006 reintroduced a divergence from the objective, putting at risk its achievement in 2008, the end year of the programme.

However, while it is not fully straightforward to assess compliance with the national 2 percent surplus objective ([1]), the upward revision of 2005-2007 balances in the Spring Budget Bill as outlined above and confirmed in the Commission forecast now appear to imply budget positions broadly in line with the objective, not only for these years but also on average since 2000.

A question that thus arises in this context is how for some years *ex ante* budget plans have not been in line with the objective but now, *ex post*, appear to be so? Is this due to general prudence, incorrect assessments or genuine surprises? A starting point is to look more closely at the budgetary plans as outlined in successive convergence programmes.

Comparing plans with first outcomes

Table V.53 below compares the forecasts (differences in percent of GDP for real GDP growth, net lending, revenues, primary expenditures and interest expenditures) made in the convergence programme of year t for the coming budgetary year t+1 with the outcomes as measured in the programme of year t+1 (still a forecast at this point but made towards the end of the year) and year t+2. The choice of time frame is explained in the context of the following year's budget polices being set taking account of the perceived situation at the time of the budget formulation. It follows that 'divergences' between plans and first outcomes would generally not be explained by new policy measures as most such measures would be included in the initial budget. Of course, final data from the most recent national accounts may show larger differences to initially planned figures, but in these cases it is more difficult to control for changes

in accounting rules. However, the figures should still be interpreted with caution as they do not control for possible methodological changes to the accounting rules within the time-frame ([2]).

Looking at the net lending figures, three periods stand out: 2000-2001 with better than planned outcomes, 2002-2003 with worse than planned outcomes and 2004-2005 again with positive developments. It is interesting to see that in most cases the divergence between plans and outcomes increases when more final data is available towards the end of t+1.

Very broadly, different factors can help explain these 'divergences' each year: In *2000*, the reason was mainly economic growth, in that the upswing was substantially more powerful than forecast, leading both to higher revenues and lower expenditures. In *2001*, the growth upswing was abruptly halted as external demand faltered and household consumption grew more weakly than expected (developments that were further reinforced by the September 11 events). Nevertheless, tax payments grew more than expected due to high household sector capital gains and corporate profits in 2000, taxes which were paid and accounted for in 2001. In addition, employment grew more strongly than expected. In *2002 and 2003* the net lending surprises were on the negative side. Explanatory factors were a continuously weaker cycle than foreseen and the downturn of the ICT sector. Nevertheless, the budgetary impact and persistence of the very expansionary budget for 2002 (an election year) were underestimated.

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[1]   See Fischer, J. (2005).

[2]   However, changes in figures between accounting standards from ESA79 to ESA95 have been taken into account.

Table V.52

Main measures in the budget for 2006, Sweden

Revenue measures ([1])	Expenditure measures ([2])
• Second half of the fourth and last step of the income tax reform (0.3 % of GDP)	• Increased volume of active labour market measures (0.3 % of GDP)
• Further steps in 'green tax swap' (neutral budget impact, volume 0.1 % of GDP)	• Increase in child allowance (0.1 % of GDP)
	• Higher education (0.1 % of GDP)
	• Additional support to local government (0.1 % of GDP)

[1]   Estimated impact on general government revenues.
[2]   Estimated impact on general government expenditure.

Source: Commission services, 2006 Budget Bill, Spring Budget Bill 2006.

In *2004*, growth was substantially higher than forecast, driven by a surprisingly strong export performance. The budget balance outcome measured at the end of 2004 was better than expected in 2003 but by a small margin. This was explained by the low tax content of the export-driven growth and weak labour market developments. According to the current CP, the surplus will be even higher, now largely explained by the one-off corporate tax revenues from the liquidation of corporate tax allocation funds. For *2005*, corporate tax developments, largely dependent on the 2004 profit levels and also to some extent on the liquidation of the tax periodisation funds, are again explanatory factors. In addition, for the later years, the lower interest expenditure, as a consequence of persistently low inflation, has contributed to higher net lending than expected.

In order to disentangle the various factors behind better-than-expected outturns, it is useful to compare government expenditure and tax revenue developments in nominal terms. First, central government expenditures in nominal terms have remained under control in line with the set ceilings. It is true that planned contingency margins under the ceilings have tended to melt away at the time of budget execution but even so the ceilings have been respected (see Fischer, op. cit.).

At local level consumption growth has at times followed a pro-cyclical pattern (see the section on Sweden in Public Finances in EMU, 2005 and Fischer, op. cit.). Rather, there has been more volatility on the revenue side, as would be expected given the higher degree of automaticity and link to the cycle. However, it is in particular those taxes that show a relatively weak link to the cycle such

as capital taxes that have accounted for many of the surprises over the last few years. As mentioned above, in 2001, capital tax revenues increased rapidly despite weak growth developments.

In 2004-2005 capital taxes have again surprised on the upside. Capital taxes account for about 12 % of general government tax revenues [1]. Taxes on capital include both corporate income taxes and household taxes on capital gains. Corporate earnings do not always fluctuate linearly with the cycle and corporate tax behaviour includes a strategic element. Household capital gains depend not only on fluctuations in asset prices but also on how expectations influence the realisation of profits. As mentioned above, the temporary fluctuations in corporate income taxes in 2004-2005 amounted to a cumulative 1 percent of GDP. Thus, fluctuations can be very large for individual years even if the overall share in taxes is relatively small compared to the proportionately more important taxes such as taxes on those on labour.

Concluding remarks

The Swedish budgetary framework has continued to perform well. Differently from the assessments made over the last few years, it now appears that budgetary policies conform with the national objective of a 2 percent surplus on average over the cycle. It is noteworthy that as late as in the Swedish convergence programme presented in November 2005, the government defended a 'planned departure' from the objective via an expansion-

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[1] See 'Sweden Economy', Annex 1 to the Swedish Spring 2006 Budget Bill.

Table V.53

Convergence Programme (CP) plans versus outcomes (% of GDP)

% of GDP	Forecast year (t+1):	2000		2001		2002		2003		2004		2005	
	CP of year t+1 and t+2	CP 2000	CP 2001	CP 2001	CP 2002	CP 2002	CP 2003	CP 2003	CP 2004	CP 2004	CP 2005	CP 2005	n.a.
Difference late forecast for t+1 in CP t+1 and outturn in CP t+2 from forecast made in CPt for:	GDP	0.9	0.6	− 1.8	− 2.3	− 0.3	− 0.5	− 1.1	− 0.9	1.5	1.6	− 0.6	n.a.
	Net lending	1.3	2.0	1.1	1.3	− 0.4	− 1.0	− 1.3	− 1.0	0.3	1.0	0.8	n.a.
	Revenues	0.6	1.2	1.9	2.0	0.2	0.5	0.5	0.2	− 0.9	− 0.5	1.2	n.a.
	Primary exp.	− 0.4	− 0.6	0.9	0.8	0.8	1.6	2.0	1.7	− 0.7	− 0.9	0.7	n.a.
	Interest exp.	− 0.3	− 0.2	− 0.1	− 0.1	− 0.2	0.0	− 0.2	− 0.6	− 0.5	− 0.6	− 0.2	n.a.

NB: The table shows the difference between the planned figures for year t+1 in the CP of year t with the comparable figures in the CP of year t+1 and t+2. For example, the budget balance outcome for 2000 as reported in the CP submitted in the end of 2001 was 2.0 % of GDP better than the figure planned for 2000 in the CP of 1999.

Source: Swedish convergence programmes and Commission technical assessments 1998-2005

ary budget by referring to the weak situation in the labour market. However, only some months later, the budgetary situation and forecast already look decisively stronger. A key reason behind this relatively rapid change of assessment is the improved situation on the tax revenue side.

Indeed, the analysis above has illustrated that there is a large potential for 'surprises' when drawing up budgetary plans on the basis of forecasts [1]. Of course, a key uncertainty in the current outlook is to what extent the better general picture is of a permanent nature and not only a temporary improvement (i.e. beyond the purely one-off items). Such a 'negative surprise' could of course change the assessment of the strength of the cur-

rent position. Overall, it appears that forecast uncertainties are relatively larger in small open economies with large public sectors. In most cases in the EU, negative deviations from budget targets tend to be explained by difficulties in adhering to nominal expenditure plans [2]. However, in a country like Sweden, with a credible framework guiding the expenditure side of the budget, most budget surprises (in nominal terms) stem from the revenue side and apparently in particular from taxes on capital. In order not to be caught out in budgetary planning by the inherent uncertainty of forecasting, the Swedish case illustrates the value-added of supporting a budget balance objective with a clear medium-term expenditure framework.

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[1]   See Boije and Fischer (2006).

[2]   See Moulin and Wiertz (2006).

25. United Kingdom

Recent developments and medium-term prospects

The preliminary outturn for the general government balance in the 2005/06 financial year ([1]), as reported in the Commission services spring forecasts is a deficit of 3.1 percent of GDP, worse than the deficit of 2.8 percent of GDP projected in the 2004 update of the convergence programme (submitted by the UK on 17 December 2004) ([2]). Compared with the 2004/05 outturn of a deficit of 3.3 percent of GDP, this marks a moderate improvement, achieved despite a marked slowdown in economic growth from 2.8 percent in 2004/05 to an estimated 1.9 percent in 2005/06, albeit with a quickening in the latter part of the year. This consolidation appears to be mainly due to a strong recovery in corporation tax receipts, boosted by buoyant performance in the financial services sector (reflecting a rising stock market) and by rising oil prices, which in the short term have a positive fiscal impact by boosting profitability of companies operating in the UK continental shelf. High oil prices might also have amplified the positive impact of a one-off change to the payment profile of North Sea corporation tax (estimated in the March 2005 Budget to be about 0.1 percent of GDP for oil prices assumed to be about 25 percent lower than those actually recorded in 2005 ([3])). Despite the economic slowdown, income tax and social security receipts also grew relatively strongly.

The general government gross debt ratio is estimated to have risen to around 42 percent of GDP at the end of

March 2006, compared with 40.2 percent at the end of the previous financial year.

The 2006 Budget was presented on 23 March 2006, setting out a number of small discretionary changes that have a broadly neutral impact on the overall fiscal position. Among these are a further set of measures to improve tax compliance. More sizable measures to be implemented from the 2006/07 financial year had already been announced in the December 2005 Pre-Budget Report, most notably an increase in corporation tax on oil companies yielding around 0.2 percent of GDP. The 2006 Budget projects a general government deficit in 2006/07 of 3.0 percent of GDP, an upward revision over the projection of 2.8 percent of GDP in the 2005 convergence programme ([4]). The national authorities explain this revision as reflecting a temporary drop in oil production, which should partly offset the impact of rising oil prices on corporation tax receipts. The Commission services' spring 2006 forecast also projects the deficit at 3.0 percent of GDP in 2006//07. As in the Budget projections, the small improvement is driven by a further recovery on the revenue side, partly due to an expected improvement in economic conditions, partly by fiscal drag and partly by further underlying growth in corporation tax receipts, supported by the continued rise in oil prices (the Commission services' forecast assumes higher oil prices than the national authorities, taking into account more recent market developments) and, in the short term, by continuing profitability of the financial services sector.

The improvement in the fiscal balance is partly offset by an increase in the expenditure-to-GDP ratio. As the nominal balance improves slightly while the negative output gap is estimated to widen, the fiscal stance is estimated to become mildly tighter: the primary structural balance is estimated to improve from a deficit of 1.1 percent of GDP in 2005 to

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([1]) The financial year runs from April to March.
([2]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.
([3]) As noted in the 2005 Public Finance Report, this one-off measure (as originally estimated) was entirely offset by a one-off increase in entitlements for pensioners, and thus was originally estimated not to have an impact on the structural balance.

([4]) The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.54

Budgetary developments 2004/05-2010/11, United Kingdom (% of GDP)

Outturn and forecast [1]	**2004**	**2005**	**2006**	**2007**			
General government balance [2]	− 3.3 (− 3.3)	− 3.5 (− 3.1)	− 3.0 (− 3.0)	− 2.8 (− 2.7)			
- Total revenues	39.9 (40.3)	41.3 (41.9)	42.2 (42.3)	42.7 (42.6)			
Of which: - *current taxes*	28.2	29.0	29.8	30.2			
- *social contributions*	8.2	8.5	8.5	8.6			
- Total expenditure	43.2 (43.6)	44.8 (44.9)	45.2 (45.3)	45.5 (45.3)			
Of which: - *collective consumption*	8.1	8.3	8.5	8.5			
- *social transfers in kind*	12.8	13.1	13.5	13.6			
- *social transfers other than in kind*	13.1	13.2	13.0	12.8			
- *interest expenditure*	2.0	2.2	2.0	2.1			
- *gross fixed capital formation*	1.8	2.0	2.2	2.4			
Primary balance	− 1.3	− 1.3	− 1.0	− 0.7			
Tax burden	36.5	37.6	38.3	38.8			
One-off and temporary measures	0.0	0.0	0.0	0.0			
Structural balance [3]	− 3.5	− 3.3	− 2.7	− 2.5			
Structural primary balance	− 1.5	− 1.1	− 0.7	− 0.5			
Government gross debt	40.8 (40.2)	42.8 (42.0)	44.1 (43.3)	44.7 (43.8)			
Pm *Real GDP growth (%)*	3.1	1.8	2.4	2.8			
Convergence programme [4]	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**
General government balance	− 3.3	− 3.1	− 2.8	− 2.4	− 1.9	− 1.7	− 1.5
Primary balance [5]	− 1.3	− 1.0	− 0.7	− 0.3	0.1	0.4	0.5
Structural balance [6]	− 3.5	− 2.9	− 2.3	− 2.1	− 1.7	− 1.5	− 1.3
Government gross debt [7]	40.9	43.3	44.4	44.8	44.7	44.6	44.4
Pm *Real GDP growth (%)*	2¾	1¾	2¼	3	2¾	2¼	2¼

[1] Commission services' spring 2006 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure. Figures in brackets are on a financial year basis (so that the figure in the 2005 column refers to the 2005/06 financial year). The UK financial year begins in April; the excessive deficit procedure applies to the United Kingdom on a financial year basis. Outturns for deficit and debt in 2005/06 are based on preliminary data.

[1] The increase in the expenditure and revenue ratio between 2005/06 and 2006/07 is partly due to the reclassification of the British Broadcasting Corporation (BBC) into central government, which, while having a neutral effect on the aggregate balance, increases both total revenue and total expenditure by around 0.2 % of GDP.

[2] Actual general government balance data reported here apply the Eurostat decision of 14 July 2000 on the allocation of UMTS receipts. The UK has not generally applied this decision in domestic publication of its deficit data, which results in the deficit on a Eurostat basis being up to 0.1 % points of GDP per annum higher than reported in UK national accounts from 2001/02 onwards.

[3] Cyclically-adjusted balance excluding one-off and temporary measures.

[4] Submitted in December 2005.

[5]   The UK authorities provide primary balances on an ESA definition (i.e. excluding gross rather than net interest payments) only up to 2007/08. Figures shown afterwards are those recalculated by the Commission services, based on the reported budget balance and information from the UK authorities.

[6]   Commission services' calculations on the basis of the information in the programme.

[7]   Growth scenario used in the public finances projection.

Source: Commission services and convergence programme of the United Kingdom.

a deficit of 0.7 percent of GDP in 2006 [1]. However, the structural improvement might be partly due to favourable developments in factors such as oil and asset prices, which are not captured by the conventional cyclical adjustment methodology and by the definition of structural deficit, but might still be subject to marked fluctuations. Under a no-policy change assumption, the Commission services' spring 2006 forecast projects for 2007/08 a general government deficit of 2.7 percent of GDP, compared with the 2005 convergence programme projection of 2.4 percent of GDP (confirmed in the March 2006 Budget).

The difference is mainly explained by a more moderate increase in non-oil corporation tax receipts assumed by the Commission services.

Beyond 2007/08, the 2006 Budget projects a steady improvement of the general government balance, reach-

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[1] The output gap is calculated on a calendar year basis, and thus it is not possible to have an estimate of the structural balances on a financial year basis strictly based on the commonly agreed methodology. However, given the milder improvement of the nominal balances on a financial year basis, the structural improvement between financial years would be smaller. An approximation suggests that the cyclically-adjusted primary balance would improve from a deficit of 0.8 percent of GDP in 2005/06 to a deficit of 0.6 percent of GDP in 2006/07.

Table V.55

Main measures in the 2005 Pre-Budget Report and the 2006 Budget, United Kingdom

Revenue measures [1]	Expenditure measures [2]
• Increase in corporation tax paid by oil companies (0.2 % of GDP) • Specific countermeasures to prevent tax avoidance and evasion (aggregate: 0.1 % of GDP) • Deferral of previously planned inflation-based increase in main road fuel duties to 1 September 2006 (– 0.06 % of GDP)	• Increased winter fuel payments (transfers to pensions) (0.05 % of GDP)

[1]   Estimated impact on general government revenues.
[2]   Estimated impact on general government expenditure.

Source: Commission service, UK convergence programme and UK Budget.

ing a deficit of 1.7 percent of GDP by 2010/11. In line with the 2005 convergence programme, the fiscal consolidation is driven most notably by a significant reduction of the expenditure ratio (as planned year-on-year expenditure growth slows sharply) but also by an increase in the revenue ratio.

According to the Commission services' spring 2006 forecast, the debt to GDP ratio is expected to rise over the forecast period, from an estimated 42 percent of GDP in 2005/06 to 43¾ percent of GDP in 2007/08.

Reviewing the methodology for measuring government output and productivity

Measuring government output and productivity is conceptually challenging. There is no obvious way to quantify the volume of government output for (a) collective services such as defence or public administration, due to the difficulty of identifying the exact nature of the output; or (b) services supplied to individuals, such as health or education, where placing a value on services provided meets the difficulty of there being typically no market transaction.

In early experience in producing national accounts in the United Kingdom, some direct measures of the volume of government output were employed; however, the results were considered unsatisfactory. Therefore, in national accounts published from the early 1960s up to 1997, measurement of the output of the government sector adopted the convention that the volume of such output was represented by the volume of the inputs, with the latter constructed by deflating inputs by appropriate labour cost and price series. The convention that output equals input was, however, subject to the weakness of being unable to provide information on changes in government sector productivity, which by construction was zero.

Starting with the national accounts published in 1998 (including series backdated to the 1980s), the United Kingdom Office for National Statistics (ONS) has moved towards the replacement of the output=input approach by once more employing direct measurements of the volume of government output [1]. Direct output indicators have been developed for areas covering around two-thirds of general government final consumption. In education, for example, output has been based on pupil enrolments. In addition, some rudimentary allowances for quality improvements have also been incorporated in certain instances: in education, the output series based on pupil enrolment has been augmented by 0.25 percent p.a., reflecting the trend of secondary school examination results achieved in the mid-1990s.

Incorporating direct output measurement, by separating output from input measurement, has enabled estimates to be calculated of changes in government sector productivity. Based on the revised methodology, measured productivity increased from 1995 to 1998 but subsequently declined (Graph V.12) [2].

However, these 'first generation' direct measures of government output revealed the need for further improvements. A principal concern was that the measurement of output did not necessarily adequately reflect changes in its quality.

In December 2003 the government therefore commissioned an independent review of the measurement of government output in the national accounts. The review, led by

[1]   Some of these measurements are discussed in some detail in Eurostat (2001), *Handbook of Price and Volume Measures of National Accounts* and in OECD (2001), *Measuring Productivity: OECD Manual Measurement of Aggregate and Industry-level Productivity Growth*.
[2]   Data series are reconstructed with the methodology used since 1998. Currently, no updated data are available.

Graph V.12: **Indicative Index of Productivity 1995-2002, 1995=100**
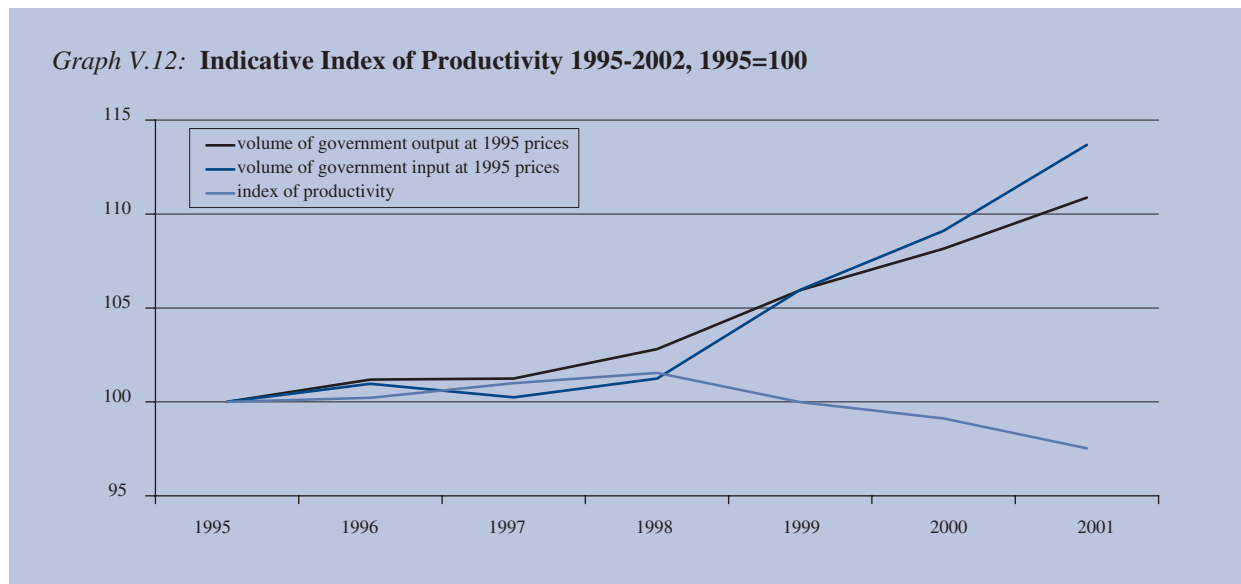
Sir Tony Atkinson ([1]), and of which the final report was published in January 2005 ([2]), develops 54 recommendations for improving the measurement of government output and productivity. A first major recommendation is that the range of output categories considered should be widened (e.g. in healthcare, the proposed number of treatment categories covered increases from 1 732 to 1 929) or replaced (e.g. pupil attendance is proposed as a better estimate of the number of pupils taught in schools than pupil enrolment). Secondly, the Atkinson Review emphasises the need to better take into account quality improvements. For example, in education, class size or a teacher/pupil ratio could be used for measuring quality, based on the assumption that the smaller the ratio the better should be the quality of learning; however, the recommendation is conditional on clear evidence of such relationships being established in each case. Thirdly, improved measures of inputs and deflators are also proposed, such as taking into account full capital services, and adopting a disaggregated approach to calculating fixed capital depreciation.

A more radical departure from the conventional approach is represented by the recommendation that government outputs such as health, education and justice become more valuable as the economy grows and assets increase (thus, for example, for increasingly rich prop-

erty-owners, the benefits of effective law enforcement increase). The review therefore proposes further adjustments to government output measures, in addition to quality, to represent this increased *relative* value: based on whole economy real earnings growth, an increase of around 1.5 percent p.a. The review recognises, however, that its suggestion is subject to wider discussion, with so far no other country employing such an approach.

Some of the more incremental changes advocated in the Atkinson Review were already incorporated in the UK national accounts published in 2005 (see Graph V.13) ([3]). In addition, in July 2005 the ONS launched its UK Centre for the Measurement of Government Activity (UKCeMGA) to carry forward the Atkinson Review recommendations. UKCeMGA has already released work on new or revised output series and productivity analyses in some key areas such as education (October 2005) and health (February 2006): these two sectors together representing around 29 percent of total government expenditure.

The 2005 national accounts imply that productivity in education fell between 1995 and 2004 ([4]). However, the experimental estimates of October 2005 — following the recommendations of the Atkinson Review to adjust

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([1])   Warden of Nuffield College Oxford.
([2])   Atkinson Review: Final report. *Measurement of Government Output and Productivity for the National Accounts*, January 2005.

([3])   ONS UK Centre for the Measurement of Government Activity (UKCeMGA), *Annual Report 2005-06*.
([4])   Economic Trends 626, January 2006.

the output estimate to take account of the trend rate at which real earnings have risen — show that productivity growth in education ranged from – 2 to ± 2 percent p.a. over the period considered.

In February 2006 UKCeMGA reported similar experimental estimates of productivity in the National Health Service (NHS) [1]. According to the 2005 national accounts, NHS productivity growth is estimated to have fallen by an annual average of between 0.6 percent and 1.3 percent p.a. between 1995 and 2004 (with the range generated by different assumptions for calculating *input* volumes: see note to graph). Estimates including output quality changes show instead that NHS productivity changed between minus 0.5 percent and plus 0.2 percent p.a. during the same period. Allowing in addition for an estimate of the increased value of healthcare, in line with the Atkinson Review's recommendations, produces a third range of plus 0.9 percent to plus 1.6 percent.

Measurements of government productivity also impact on the GDP growth rate, all the more as government expenditure as a share of UK GDP has increased in recent years. Over the period 1995-2003, the real GDP growth rate

would have been about 0.25 percent a year higher had the former input/output convention been retained [2].

However, the new data approaches advocated in the Atkinson report and published by the ONS have also attracted criticism [3]. It could be, for instance, that the existing national accounts measurement approach, which shows falling public sector productivity, may be capturing the reality. The major input in public services is labour and, in many instances, it may be difficult to raise productivity because of the nature of the service. Alternatively, there may be lag effects at work, such that the output gains from higher public spending take time to come through. To the extent that measurement methods need revision, however, it should be recognised that some of the adjustments recommended by the Atkinson Review have a strong judgmental component, and thus will need time to determine whether they can be absorbed in a methodological approach that is generally accepted and internationally comparable.

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[1] Economic Trends 628, March 2006.

[2] The Atkinson Review notes that this would have halved the measured gap between GDP growth in the UK and the USA, which continues to use an input-based measure.

[3] See for example, 'Health-service productivity: take your pick', The Economist, 2 March 2006.

Graph V.13: **NHS output, 1999=100**

- - - *Output as currently published
——— *Output including value of health and adjusted for quality
——— *Output adjusted for quality
- - - **Output as currently published
——— **Output including value of health and adjusted for quality
——— **Output adjusted for quality
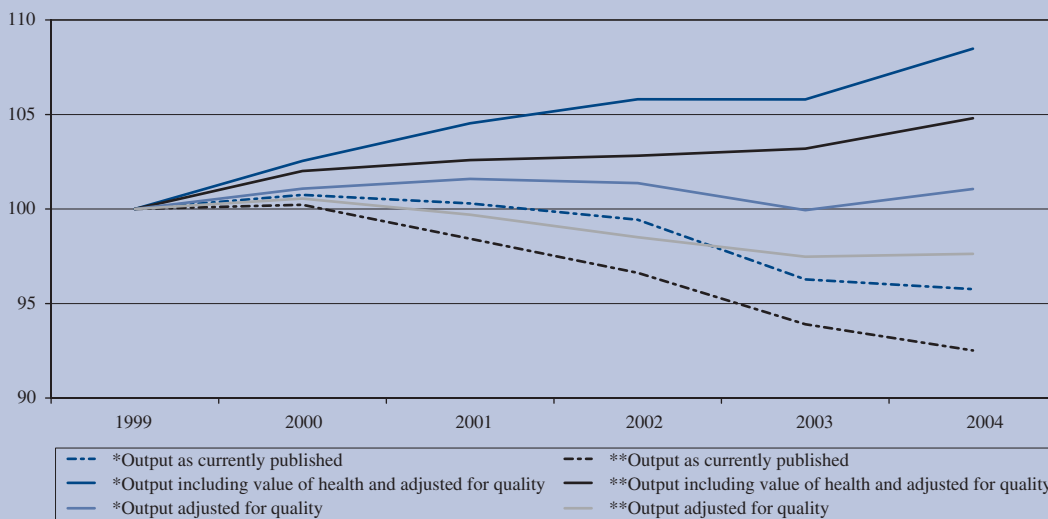
Part VI

Resources

1. Consolidated version of Council Regulation (EC) No 1466/97 of 7 July 1997

Consolidated version of

Council Regulation (EC) No 1466/97 of 7 July 1997

on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies

(OJ L 209, 2.8.1997 p. 1–5)

as amended by

Council Regulation (EC) No 1055/05 of 27 June 2005

(OJ L 174, 7.7.2005 p. 1– 4)

Amending provisions are in bold and italics
This document has no official character and is meant purely as a documentation tool

Recitals of Council Regulation (EC) No 1466/97 of 7 July 1997

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 103 (5) thereof,

Having regard to the proposal from the Commission (¹),

Acting in accordance with the procedure referred to in Article 189c of the Treaty (²),

(1) Whereas the Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation;

(2) Whereas the Stability and Growth Pact consists of this Regulation which aims to strengthen the surveillance of budgetary positions and the surveillance and coordination of economic policies, of Council Regulation (EC) No 1467/97 (³) which aims to speed up and to clarify the implementation of the excessive deficit procedure and of the Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact (⁴), in which, in accordance with Article D of the Treaty on European Union, firm political guidelines are issued in order to implement the Stability and Growth Pact in a strict and timely manner and in particular to adhere to the medium term objective of budgetary positions of close to balance or in surplus, to which all Member States are committed, and to take the corrective budgetary action they deem necessary to meet the objectives of their stability and convergence programmes, whenever they have information indicating actual or expected significant divergence from the medium-term budgetary objective;

(3) Whereas in stage three of Economic and Monetary Union (EMU) the Member States are, according to Article 104c of the Treaty, under a clear Treaty obligation to avoid excessive general government deficits; whereas under Article 5 of Protocol (No 11) on certain provisions relating to the United Kingdom of Great Britain and Northern Ireland to the Treaty, Article 104c(1) does not apply to the United Kingdom unless it moves to the third stage; whereas the obligation under Article 109e(4) to endeavour to avoid excessive deficits will continue to apply to the United Kingdom;

(4) Whereas adherence to the medium-term objective of budgetary positions close to balance or in surplus will allow Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3 percent of GDP reference value;

(5) Whereas it is appropriate to complement the multilateral surveillance procedure of Article 103(3) and (4) with an early warning system, under which the Council will alert a Member State at an early stage to the need to take the necessary budgetary corrective action in order to prevent a government deficit becoming excessive;

(6) Whereas the multilateral surveillance procedure of Article 103(3) and (4) should furthermore continue to monitor the full range of economic developments in each of the Member States and in the Community as well as the consistency of economic policies with the broad economic guidelines referred to in Article 103 (2); whereas for the monitoring of these developments, the presentation of information in the form of stability and convergence programmes is appropriate;

(7) Whereas there is a need to build upon the useful experience gained during the first two stages of economic and monetary union with convergence programmes;

(8) Whereas the Member States adopting the single currency, hereafter referred to as 'participating Member States', will, in accordance with Article 109j, have achieved a high degree of sustainable convergence and in particular a sustainable government financial position; whereas the maintenance of sound budgetary positions in these Member States will be necessary to support price stability and to strengthen the conditions for the sustained growth of output and employment; whereas it is necessary that participating Member States submit medium-term programmes, hereafter referred to as 'stability programmes'; whereas it is necessary to define the principal contents of such programmes;

(9) Whereas the Member States not adopting the single currency, hereafter referred to as 'non-participating Member States', will need to pursue policies aimed at a high degree of sustainable convergence; whereas it is necessary that these Member States submit medium-term programmes, hereafter referred to as 'convergence programmes'; whereas it is necessary

to define the principal contents of such convergence programmes;

(10) Whereas in its Resolution of 16 June 1997 on the establishment of an exchange-rate mechanism in the third stage of Economic and Monetary Union, the European Council issued firm political guidelines in accordance with which an exchange-rate mechanism is established in the third stage of EMU, hereafter referred to as 'ERM2'; whereas the currencies of non-participating Member States joining ERM2 will have a central rate vis-à-vis the euro, thereby providing a reference point for judging the adequacy of their policies; whereas the ERM2 will also help to protect them and the Member States adopting the euro from unwarranted pressures in the foreign-exchange markets; whereas, so as to enable appropriate surveillance in the Council, non-participating Member States not joining ERM2 will nevertheless present policies in their convergence programmes oriented to stability thus avoiding real exchange rate misalignments and excessive nominal exchange rate fluctuations;

(11) Whereas lasting convergence of economic fundamentals is a prerequisite for sustainable exchange rate stability;

(12) Whereas it is necessary to lay down a timetable for the submission of stability programmes and convergence programmes and their updates;

(13) Whereas in the interest of transparency and informed public debate it is necessary that Member States make public their stability programmes and their convergence programmes;

(14) Whereas the Council, when examining and monitoring the stability programmes and the convergence programmes and in particular their medium-term budgetary objective or the targeted adjustment path towards this objective, should take into account the relevant cyclical and structural characteristics of the economy of each Member State;

(15) Whereas in this context particular attention should be given to significant divergences of budgetary positions from the budgetary objectives of being close to balance or in surplus; whereas it is appropriate for the Council to give an early warning in order to prevent a government deficit in a Member State becoming excessive; whereas in the event of persistent budgetary slippage it will be appropriate for the Council to reinforce its recommendation and make it public; whereas for non-participating Member States the Council may make recommendations on action to be taken to give effect to their convergence programmes;

(16) Whereas both convergence and stability programmes lead to the fulfilment of the conditions of economic convergence referred to in Article 104c.

Recitals of Council Regulation (EC) No 1055/05 of 27 June 2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 99(5) thereof,

Having regard to the proposal from the Commission,

Having regard to the Opinion of the European Central Bank ([1])*,*

Acting in accordance with the procedure referred to in Article 252 of the Treaty ([2])*,*

Whereas:

(1) The Stability and Growth Pact initially consisted of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies ([3])*, Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure* ([4]) *and the Resolution of 17 June 1997 on the Stability and Growth Pact* ([5])*. The Stability and Growth Pact has proven its usefulness in anchoring fiscal discipline, thereby contributing to a high degree of macroeconomic stability with low inflation and low interest rates, which is necessary to induce sustainable growth and employment creation.*

(2) On 20 March 2005 the Council adopted a report entitled 'Improving the implementation of the Stability and Growth Pact' which aims to enhance the governance and the national ownership of the fiscal framework by strengthening the economic underpinnings and the effectiveness of the Pact, both in its preventive and corrective arms, to safeguard the sustainability of public finances in the long run, to promote growth and to avoid imposing excessive burdens on future generations. The report was endorsed by the European Council in its conclusions of 23 March 2005 ([6])*, which stated that the report updates and complements the Stability and Growth Pact, of which it is now an integral part.*

(3) According to the 20 March 2005 Ecofin report endorsed by the Spring 2005 European Council, the Member States, the Council and the Commission reaffirm their commitment to implement the Treaty and the Stability and Growth Pact in an effective and timely manner, through peer support and peer pressure, and to act in close and constructive cooperation in the process of economic and fiscal surveillance, in order to guarantee certainty and effectiveness in the rules of the Pact.

(4) Regulation (EC) No 1466/97 needs to be amended in order to allow the full application of the agreed improvement of the implementation of the Stability and Growth Pact.

(5) The Stability and Growth Pact lays down the obligation for Member States to adhere to the medium term objective for their budgetary positions of 'close to balance or in surplus' (CTBOIS). In the light of the economic and budgetary heterogeneity in the Union, the medium-term budgetary objective should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, also in the face of prospective demographic changes. The medium-term budgetary objective may diverge from CTBOIS for individual Member States. For euro area and ERM II Member States, there would thus be a defined range for the country-specific medium-term budgetary objectives, in cyclically adjusted terms, net of one-off and temporary measures.

(6) A more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in economic good times should be achieved, with the objective to avoid pro-cyclical policies and to gradually reach the medium-term budgetary objective. Adherence to the medium-term budgetary objective should allow Member States to deal with normal cyclical fluctuations while keeping the government deficit below the 3 % of GDP reference value and ensure rapid progress towards fiscal sustainability. Taking this into account, it should allow room for budgetary manoeuvre, in particular for public investment.

(7) Member States that have not yet reached their medium-term budgetary objective should take steps to achieve it over the cycle. In order to reach their medium-term budgetary objective, Member States of the euro zone or of ERM II should pursue a minimum annual adjustment in cyclically adjusted

([1]) OJ C 144, 14.6.2005, p.17.
([2]) Opinion of the European Parliament of 9 June 2005 (not yet published in the Official Journal), Council Common Position of 21 June 2005 (not yet published in the Official Journal) and Decision of the European Parliament of 23 June 2005 (not yet published in the Official Journal).
([3]) OJ L 209, 2.81997, p.1.
([4]) OJ L 209, 2.81997, p.6.
([5]) OJ L 236, 2.81997, p.1.
([6]) Annex 2 of conclusions of the European Council of 22 and 23 March 2005.

terms, net of one-offs and other temporary measures.

(8) *In order to enhance the growth oriented nature of the Pact, major structural reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable impact on the long-term sustainability of public finances, should be taken into account when defining the adjustment path to the medium-term budgetary objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that* *have already reached it. In order not to hamper structural reforms that unequivocally improve the long-term sustainability of public finances, special attention should be paid to pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar, because these reforms entail a short-term deterioration of public finances during the implementation period.*

(9) *Deadlines set for the examination of stability and convergence programmes by the Council should be extended in order to allow for a thorough assessment of stability and convergence programmes.*

Consolidated Articles of

Council Regulation (EC) No 1466/97 of 7 July 1997,

as amended by Council Regulation (EC) No 1055/05 of 27 June 2005

HAS ADOPTED THIS REGULATION:

SECTION 1

PURPOSE AND DEFINITIONS

Article 1

This Regulation sets out the rules covering the content, the submission, the examination and the monitoring of stability programmes and convergence programmes as part of multilateral surveillance by the Council so as to prevent, at an early stage, the occurrence of excessive general government deficits and to promote the surveillance and coordination of economic policies.

Article 2

For the purpose of this Regulation 'participating Member States' shall mean those Member States which adopt the single currency in accordance with the Treaty and 'non-participating Member States' shall mean those which have not adopted the single currency.

SECTION 1A

MEDIUM-TERM BUDGETARY OBJECTIVES

Article 2a

Each Member State shall have a differentiated medium-term objective for its budgetary position. These country-specific medium-term budgetary objectives may diverge from the requirement of a close to balance or in surplus position. They shall provide a safety margin with respect to the 3 % of GDP government deficit ratio; they shall ensure rapid progress towards sustainability and, taking this into account, they shall allow room for budgetary manoeuvre, considering in particular the needs for public investment.

Taking these factors into account, for Member States that have adopted the euro and for ERM-II Member States the country-specific medium-term budgetary objectives shall be specified within a defined range between –1 % of GDP and balance or surplus, in cyclically adjusted terms, net of one-off and temporary measures.

A Member State's medium-term budgetary objective can be revised when a major structural reform is implemented and in any case every four years.

SECTION 2

STABILITY PROGRAMMES

Article 3

1. Each participating Member State shall submit to the Council and Commission information necessary for the purpose of multilateral surveillance at regular intervals under Article **99** of the Treaty in the form of a stability programme, which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation.

2. A stability programme shall present the following information:

(a) *the medium-term budgetary objective and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio;*

(b) the main assumptions about expected economic developments and important economic variables which are relevant to the realisation of the stability programme such as government investment expenditure, real gross domestic product (GDP) growth, employment and inflation;

(c) *a detailed and quantitative assessment of the budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme, comprising a detailed cost-benefit analysis of major structural reforms which have direct long-term cost-saving effects, including by raising potential growth;*

(d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position;

(e) *if applicable, the reasons for a deviation from the required adjustment path towards the medium term budgetary objective.*

3. The information about paths for the general government surplus/deficit ratio and debt ratio and the main economic assumptions referred to in paragraph 2(a) and (b) shall be on an annual basis and shall cover, as well as the current and preceding year, at least the following three years.

Article 4

1. Stability programmes shall be submitted before 1 March 1999. Thereafter, updated programmes shall be submitted annually. A Member State adopting the single currency at a later stage shall submit a stability programme within six months of the Council Decision on its participation in the single currency.

2. Member States shall make public their stability programmes and updated programmes.

Article 5

1. Based on assessments by the Commission and the Committee set up by Article 114 of the Treaty, the Council shall, within the framework of multilateral surveillance under Article 99 of the Treaty, examine the medium-term budgetary objective presented by the Member State concerned, assess whether the economic assumptions on which the programme is based are plausible, whether the adjustment path towards the medium-term budgetary objective is appropriate and whether the measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the medium-term objective over the cycle.

The Council, when assessing the adjustment path toward the medium-term budgetary objective, shall examine if the Member State concerned pursues the annual improvement of its cyclically-adjusted balance, net of one-off and other temporary measures, required to meet its medium-term budgetary objective, with 0.5 % of GDP as a benchmark. The Council shall take into account whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times.

When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective and in allowing a temporary deviation from this objective for Member States that have already reached it, under the condition that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council shall take into account the implementation of major structural reforms which have direct long-term cost-saving effects, including by raising potential growth,

and therefore a verifiable impact on the long-term sustainability of public finances.

Special attention shall be paid to pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. Member States implementing such reforms shall be allowed to deviate from the adjustment path to their medium-term budgetary objective or from the objective itself, with the deviation reflecting the net cost of the reform to the publicly managed pillar, under the condition that the deviation remains temporary and that an appropriate safety margin with respect to the deficit reference value is preserved.

The Council shall furthermore examine whether the contents of the stability programme facilitate the closer coordination of economic policies and whether the economic policies of the Member State concerned are consistent with the broad economic policy guidelines.

2. The Council shall carry out the examination of the stability programme referred to in paragraph 1 within at most *three months* of the submission of the programme. The Council, on a recommendation from the Commission and after consulting the Committee set up by Article *114*, shall deliver an opinion on the programme. Where the Council, in accordance with Article *99*, considers that the objectives and contents of a programme should be strengthened, the Council shall, in its opinion, invite the Member State concerned to adjust its programme.

3. Updated stability programmes shall be examined by the Committee set up by Article *114* on the basis of assessments by the Commission; if necessary, updated programmes may also be examined by the Council in accordance with the procedure set out in paragraphs 1 and 2 of this Article.

Article 6

1. As part of multilateral surveillance in accordance with Article *99* (3), the Council shall monitor the implementation of stability programmes, on the basis of information provided by participating Member States and of assessments by the Commission and the Committee set up by Article *114*, in particular with a view to identifying actual or expected significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, as set in the programme for the government surplus/deficit.

2. In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, address, in accordance with Article *99* (4), a recommendation to the Member State concerned to take the necessary adjustment measures.

3. In the event that the Council in its subsequent monitoring judges that the divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, is persisting or worsening, the Council shall, in accordance with Article *99* (4), make a recommendation to the Member State concerned to take prompt corrective measures and may, as provides in that Article, make its recommendation public.

SECTION 3

CONVERGENCE PROGRAMMES

Article 7

1. Each non-participating Member State shall submit to the Council and the Commission information necessary for the purpose of multilateral surveillance of regular intervals under Article *99* in the form of a convergence programme, which provides an essential basis for price stability and for strong sustainable growth conducive to employment creation.

2. A convergence programme shall present the following information in particular on variables related to convergence:

(a) *the medium-term budgetary objective and the adjustment path towards this objective for the general government surplus/deficit and the expected path of the general government debt ratio; the medium-term monetary policy objectives; the relationship of those objectives to price and exchange rate stability;*

(b) the main assumptions about expected economic developments and important economic variables which are relevant to the realisation of the convergence programme, such as government investment expenditure, real GDP growth, employment and inflation;

(c) *a detailed and quantitative assessment of the budgetary and other economic policy measures being taken*

and/or proposed to achieve the objectives of the programme, comprising a detailed cost-benefit analysis of major structural reforms which have direct long-term cost-saving effects, including by raising potential growth;

(d) an analysis of how changes in the main economic assumptions would affect the budgetary and debt position;

(e) if applicable, the reasons for a deviation from the required adjustment path towards the medium term budgetary objective.

3. The information about paths for the general government surplus/deficit ratio, debt ratio and the main economic assumptions referred to in paragraph 2 (a) and (b) shall be on an annual basis and shall cover, as well as the current and preceding year, at least the following three years.

Article 8

1. Convergence programmes shall be submitted before 1 March 1999. Thereafter, updated programmes shall be submitted annually.

2. Member States shall make public their convergence programmes and updated programmes.

Article 9

1. *Based on assessments by the Commission and the Committee set up by Article 114 of the Treaty, the Council shall, within the framework of multilateral surveillance under Article 99 of the Treaty, examine the medium-term budgetary objective presented by the Member State concerned, assess whether the economic assumptions on which the programme is based are plausible, whether the adjustment path towards the medium-term budgetary objective is appropriate and whether the measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the medium-term objective over the cycle.*

The Council, when assessing the adjustment path toward the medium-term budgetary objective, shall take into account whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times. For ERM-II Member States, the Council shall examine if the Member State concerned pursues the annual improvement of its cyclically adjusted balance, net of one-off and

other temporary measures, required to meet its medium-term budgetary objective, with 0.5 % of GDP as a benchmark.

When defining the adjustment path to the medium-term budgetary objective for Member States that have not yet reached this objective and in allowing a temporary deviation from this objective for Member States that have already reached it, under the condition that an appropriate safety margin with respect to the deficit reference value is preserved and that the budgetary position is expected to return to the medium-term budgetary objective within the programme period, the Council shall take into account the implementation of major structural reforms which have direct long-term cost-saving effects, including by raising potential growth, and therefore a verifiable impact on the long-term sustainability of public finances.

Special attention shall be paid to pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. Member States implementing such reforms shall be allowed to deviate from the adjustment path to their medium-term budgetary objective or from the objective itself, with the deviation reflecting the net cost of the reform to the publicly managed pillar, under the condition that the deviation remains temporary and that an appropriate safety margin with respect to the deficit reference value is preserved.

The Council shall furthermore examine whether the contents of the convergence programme facilitate the closer coordination of economic policies and whether the economic policies of the Member State concerned are consistent with the broad economic policy guidelines.

2. The Council shall carry out the examination of the convergence programme referred to in paragraph 1 within at most *three months* of the submission of the programme. The Council, on a recommendation from the Commission and after consulting the Committee set up by Article *114*, shall deliver an opinion on the programme. Where the Council, in accordance with Article *99*, considers that the objectives and contents of a programme should be strengthened, the Council shall, in its opinion, invite the Member State concerned to adjust its programme.

3. Updated convergence programmes shall be examined by the Committee set up by Article *114* on the basis of assessments by the Commission; if necessary, updated programmes may also be examined by the Council in

accordance with the procedure set out in paragraphs 1 and 2 of this Article.

Article 10

1. As part of multilateral surveillance in accordance with Article *99* (3), the Council shall monitor the implementation of convergence programmes on the basis of information provided by non-participating Member States in accordance with Article 7 (2) (a) of this Regulation and of assessments by the Commission and the Committee set up by Article *114* of the Treaty, in particular with a view to identifying actual or expected significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, as set in the programme for the government surplus/deficit.

In addition, the Council shall monitor the economic policies of non-participating Member States in the light of convergence programme objectives with a view to ensure that their policies are geared to stability and thus to avoid real exchange rate misalignments and excessive nominal exchange rate fluctuations.

2. In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to given early warning in order to prevent the occurrence of an excessive deficit, address in accordance with Article *99* (4), a recommendation to the Member State concerned to take the necessary adjustment measures.

3. In the event that the Council in its subsequent monitoring judges that the divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, is persisting or worsening, the Council shall, in accordance with Article *99* (4), make a recommendation to the Member State concerned to take prompt corrective measures and may, as provided in that Article, make its recommendation public.

SECTION 4

COMMON PROVISIONS

Article 11

As part of the multilateral surveillance described in this Regulation, the Council shall carry out the overall assessment described in Article *99* (3).

Article 12

In accordance with the second subparagraph of Article **99** (4) the President of the Council and the Commission shall include in their report to the European Parliament the results of the multilateral surveillance carried out under this Regulation.

Article 13

This Regulation shall enter into force on 1 July 1998.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 7 July 1997.

For the Council
The President
J.-C. JUNCKER

Important note:

Amendments introduced by Regulation (EC) No 1055/05 of 27 June 2005 entered into force on 27 July 2005

2. Consolidated version of Council Regulation (EC) No 1467/97 of 7 July 1997

Consolidated version of

Council Regulation (EC) No 1467/97 of 7 July 1997
on speeding up and clarifying the implementation of the excessive deficit procedure
(OJ L 209, 2.8.1997 p. 6–11)

as amended by

Council Regulation (EC) No 1056/05 of 27 June 2005
(OJ L 174, 7.7.2005 p. 5–9)

Amending provisions are in bold and italics
This document has no official character and is meant purely as a documentation tool

Recitals of Council Regulation (EC) No 1467/97 of 7 July 1997

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the second subparagraph of Article 104 (14) thereof,

Having regard to the proposal from the Commission (¹),

Having regard to the opinion of the European Parliament (²),

Having regard to the opinion of the European Monetary Institute,

(1) Whereas it is necessary to speed up and to clarify the excessive deficit procedure set out in Article 104c of the Treaty in order to deter excessive general government deficits and, if they occur, to further their prompt correction; whereas the provisions of this Regulation, which are to the above effect and adopted under Article 104c (14) second subparagraph, constitute, together with those of Protocol (No 5) to the Treaty, a new integrated set of rules for the application of Article 104c;

(2) Whereas the Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation;

(3) Whereas the Stability and Growth Pact consists of this Regulation, of Council Regulation (EC) No 1466/97 (³) which aims to strengthen the surveillance of budgetary positions and the surveillance and coordination of economic policies and of the Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact (⁴), in which, in accordance with Article 4 of the Treaty on European Union, firm political guidelines are issued in order to implement the Stability and Growth Pact in a strict and timely manner and in particular to adhere to the medium term objective for budgetary positions of close to balance or in surplus, to which all

Member States are committed, and to take the corrective budgetary action they deem necessary to meet the objectives of their stability and convergence programmes, whenever they have information indicating actual or expected significant divergence from the medium-term budgetary objective;

(4) Whereas in stage three of Economic and Monetary Union (EMU) the Member States are, according to Article 104c of the Treaty, under a clear Treaty obligation to avoid excessive government deficits; whereas under Article 5 of Protocol (No 11) to the Treaty, paragraphs 1, 9 and 11 of Article 104c do not apply to the United Kingdom unless it moves to the third stage; whereas the obligation under Article 109e (4) to endeavour to avoid excessive deficits will continue to apply to the United Kingdom;

(5) Whereas Denmark, referring to paragraph 1 of Protocol (No 12) to the Treaty has notified, in the context of the Edinburgh decision of 12 December 1992, that it will not participate in the third stage; whereas, therefore, in accordance with paragraph 2 of the said Protocol, paragraphs 9 and 11 of Article 104c shall not apply to Denmark;

(6) Whereas in stage three of EMU Member States remain responsible for their national budgetary policies, subject to the provisions of the Treaty; whereas the Member States will take the necessary measures in order to meet their responsibilities in accordance with the provisions of the Treaty;

(7) Whereas adherence to the medium-term objective of budgetary positions close to balance or in surplus to which all Member States are committed, contributes to the creation of the appropriate conditions for price stability and for sustained growth conducive to employment creation in all Member States and will allow them to deal with normal cyclical fluctuations while keeping the government deficit within the 3 % of GDP reference value;

(8) Whereas for EMU to function properly, it is necessary that convergence of economic and budgetary performances of Member States which have adopted the single currency, hereafter referred to as 'participating Member States', proves stable and durable;

(¹) OJ No C 368, 6.12.1996, p.12.
(²) OJ No C 380, 16.12.1996, p. 29.
(³) See p. 1 of this Official Journal.
(⁴) OJ No C 236, 2.8.1997, p. 1.

whereas budgetary discipline is necessary in stage three of EMU to safeguard price stability;

(9) Whereas according to Article 109k (3) Articles 104c (9) and (11) only apply to participating Member States;

(10) Whereas it is necessary to define the concept of an exceptional and temporary excess over the reference value as referred to in Article 104c (2) (a); whereas the Council should in this context, inter alia, take account of the pluriannual budgetary forecasts provided by the Commission;

(11) Whereas a Commission report in accordance with Article 104c (3) is also to take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State;

(12) Whereas there is a need to establish deadlines for the implementation of the excessive deficit procedure in order to ensure its expeditious and effective implementation; whereas it is necessary in this context to take account of the fact that the budgetary year of the United Kingdom does not coincide with the calendar year;

(13) Whereas there is a need to specify how the sanctions provided for in Article 104c could be imposed in order to ensure the effective implementation of the excessive deficit procedure;

(14) Whereas reinforced surveillance under the Council Regulation (EC) No 1466/97 together with the Commission's monitoring of budgetary positions in accordance with paragraph 2 of Article 104c should facilitate the effective and rapid implementation of the excessive deficit procedure;

(15) Whereas in the light of the above, in the event that a participating Member State fails to take effective action to correct an excessive deficit, an overall maximum period of ten months from the reporting date of the figures indicating the existence of an excessive deficit until the decision to impose sanctions, if necessary, seems both feasible and appropriate in order to exert pressure on the participating Member State concerned to take such action; in this event, and if the procedure starts in March, this would lead to sanctions being imposed within the calendar year in which the procedure had been started;

(16) Whereas the Council recommendation for the correction of an excessive deficit or the later steps of the excessive deficit procedure, should have been anticipated by the Member State concerned, which would have had an early warning; whereas the seriousness of an excessive deficit in stage three should call for urgent action from all those involved;

(17) Whereas it is appropriate to hold the excessive deficit procedure in abeyance if the Member State concerned takes appropriate action in response to a recommendation under Article 104c (7) or a notice issued under Article 104c (9) in order to provide an incentive to Member States to act accordingly; whereas the time period during which the procedure would be held in abeyance should not be included in the maximum period of ten months between the reporting date indicating the existence of an excessive deficit and the imposition of sanctions; whereas it is appropriate to resume the procedure immediately if the envisaged action is not being implemented or if the implemented action is proving to be inadequate;

(18) Whereas, in order to ensure that the excessive deficit procedure has a sufficient deterrent effect, a non-interest-bearing deposit of an appropriate size should be required from the participating Member State concerned, whenever the Council decides to impose a sanction;

(19) Whereas the definition of sanctions on a prescribed scale is conducive to legal certainty; whereas it is appropriate to relate the amount of the deposit to the GDP of the participating Member State concerned;

(20) Whereas, whenever the imposition of a non-interest-bearing deposit does not induce the participating Member State concerned to correct its excessive deficit in due time, it is appropriate to intensify the sanctions; whereas it is then appropriate to transform the deposit into a fine;

(21) Whereas appropriate action by the participating Member State concerned in order to correct its excessive deficit is the first step towards abrogation of sanctions; whereas significant progress in correcting the excessive deficit should allow for the lifting of sanctions in accordance with paragraph 12 of Article 104c; whereas the abrogation of all outstanding sanctions should only occur once the excessive deficit has been totally corrected;

(22) Whereas Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community (5) (¹)

contains detailed rules for the reporting of budgetary data by Member States;

(23) Whereas, according to Article 109f (8), where the Treaty provides for a consultative role for the European Central Bank (ECB), references to the ECB shall be read as referring to the European Monetary Institute before the establishment of the ECB.

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(¹)   OJ No L 332, 31.12.1993, p. 7.

Recitals of Council Regulation (EC) No 1056/05 of 27 June 2005

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the second subparagraph of Article 104 (14) thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the European Central Bank (¹),

Having regard to the opinion of the European Parliament (²),

Whereas:

(1) The Stability and Growth Pact initially consisted of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies (³), Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (⁴) and the Resolution of 17 June 1997 on the Stability and Growth Pact (⁵). The Stability and Growth Pact has proven its usefulness in anchoring fiscal discipline, thereby contributing to a high degree of macroeconomic stability with low inflation and low interest rates, which is necessary to induce sustainable growth and employment creation.

(2) On 20 March 2005 the Council adopted a report entitled 'Improving the implementation of the Stability and Growth Pact' which aims to enhance the governance and the national ownership of the fiscal framework by strengthening the economic underpinnings and the effectiveness of the Pact, both in its preventive and corrective arms, to safeguard the sustainability of public finances in the long run, to promote growth and to avoid imposing excessive burdens on future generations. The report was endorsed by the European Council in its conclusions of 23 March 2005 (⁶), which stated that the report updates and complements the Stability and Growth Pact, of which it is now an integral part.

(3) According to the 20 March 2005 Ecofin report endorsed by the Spring 2005 European Council, the Member States, the Council and the Commis-

sion reaffirm their commitment to implement the Treaty and the Stability and Growth Pact in an effective and timely manner, through peer support and peer pressure, and to act in close and constructive cooperation in the process of economic and fiscal surveillance, in order to guarantee certainty and effectiveness in the rules of the Pact.

(4) Regulation (EC) No 1467/97 needs to be amended in order to allow the full application of the agreed improvement of the implementation of the Stability and Growth Pact.

(5) The guiding principle for the application of the excessive deficit procedure is the prompt correction of an excessive deficit. The procedure should remain simple, transparent and equitable.

(6) The concept of exceptional excess over the reference value resulting from a severe economic downturn should be revised. In doing so, due account should be taken of the economic heterogeneity in the European Union.

(7) The Commission should always prepare a report on the basis of Article 104(3) of the Treaty. In its report, it should examine whether the exceptions provided for in Article 104(2) apply. The Commission report under Article 104(3) should appropriately reflect developments in the medium-term economic position and in the medium-term budgetary position. Furthermore, due consideration should be given to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value.

(8) Careful consideration should be given in all budgetary assessments in the framework of the excessive deficit procedure to an excess close to the reference value which reflects the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar, because the implementation of those reforms leads to a short-term deterioration of the budgetary position, while the long-term sustainability of public finances clearly improves. In particular, when assessing under Article 104(12) whether the excessive deficit has been corrected, the Commission and the Council should assess developments in EDP deficit figures while also considering the net cost of the reform to the publicly managed pillar.

(9) The procedural deadlines for Council decisions in the excessive deficit procedure should be extended in order to allow the Member State concerned to

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(¹) OJ C 144, 14.6.2005, p. 16.
(²) Opinion of 9 June 2005 (not yet published in the Official Journal).
(³) OJ L 209, 2.8.97, p. 1.
(⁴) OJ L 209, 2.8.97, p. 6.
(⁵) OJ C 236, 2.8.1997, p. 1.
(⁶) Annex 2 of conclusions of the European Council of 22 and 23 March 2005.

better frame its action within the national budgetary procedure and to develop a more coherent package of measures. In particular, the deadline for the Council to decide on the existence of an excessive deficit in accordance with Article 104 (6) of the Treaty should be set, as a rule, to four months after the reporting dates established in Article 4(2) and (3) of Council Regulation (EC) No 3605/93 of 22 November 1993 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community (¹). This would address the cases in which the budgetary statistical data has not been validated by the Commission (Eurostat) shortly after the reporting dates established in Regulation (EC) No 3605/93.

(10) In order to ensure a prompt correction of excessive deficits, it is necessary for Member States that are in a situation of excessive deficit to take effective action and to achieve an annual minimum fiscal improvement in their cyclically adjusted balance, net of one-off and temporary measures. As a benchmark, countries in excessive deficit will be required to achieve an annual minimum fiscal effort in cyclically adjusted terms, net of one-off and temporary measures.

(11) Maximum time periods within which Member States are to take effective action and measures

should be extended to allow better framing of the action in the national budgetary procedures and the development of more articulated packages of measures.

(12) If the Member State concerned has taken effective action in response to a recommendation under Article 104 (7) or a notice issued under Article 104 (9) and unexpected adverse economic events with major negative consequences for government finances prevent the correction of the excessive deficit within the time limit set by the Council, it should be possible for the Council to issue a revised recommendation under Article 104 (7) or a revised notice under Article 104 (9).

(13) The current overall maximum period of 10 months from the reporting dates established in Article 4 (2) and (3) of Regulation (EC) No 3605/93 until the decision to impose sanctions would be inconsistent with the amended deadlines in each step of the procedure and the possibility to issue revised recommendations under Article 104 (7) or revised notices under Article 104 (9). The overall maximum period should therefore be adjusted in accordance with these amendments.

(14) The provisions applicable to the implementation of the excessive deficit procedure in the case of the United Kingdom, which are set out in the Annex to Regulation (EC) No 1467/97, also need to be modified to reflect those changes.

(¹) OJ L 332, 31.12.1993, p. 7. Regulation as last amended by Regulation (EC) No 351/2002 (OJ L 55, 26.2.2002, p.23).

Council Regulation (EC) No 1467/97 of 7 July 1997, as amended by Council Regulation (EC) No 1056/05 of 27 June 2005

HAS ADOPTED THIS REGULATION:

SECTION 1

DEFINITIONS AND ASSESSMENTS

Article 1

1. This Regulation sets out the provisions to speed up and clarify the excessive deficit procedure, having as its objective to deter excessive general government deficits and, if they occur, to further their prompt correction.

2. For the purpose of this Regulation 'participating Member States' shall mean those Member States which adopt the single currency in accordance with the Treaty and 'non-participating Member States' shall mean those which have not adopted the single currency.

Article 2

1. The excess of a government deficit over the reference value shall be considered exceptional and temporary, in accordance with Article 104(2) (a), second indent, when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn.

In addition, the excess over the reference value shall be considered temporary if budgetary forecasts as provided by the Commission indicate that the deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

2. The Commission and the Council, when assessing and deciding upon the existence of an excessive deficit in accordance with Article 104 (3) to (6) of the Treaty, may consider an excess over the reference value resulting from a severe economic downturn as exceptional in the sense of the second indent of Article 104 (2) (a) of the Treaty if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential.

3. The Commission, when preparing a report under Article 104 (3) of the Treaty shall take into account all relevant factors as indicated in that Article. The report shall appropriately reflect developments in the medium-term economic position (in particular potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster research and development

and innovation) and developments in the medium-term budgetary position (in particular, fiscal consolidation efforts in 'good times', debt sustainability, public investment and the overall quality of public finances). Furthermore, the Commission shall give due consideration to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value and which the Member State has put forward to the Commission and to the Council. In that context, special consideration shall be given to budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State. A balanced overall assessment shall encompass all these factors.

4. If the double condition of the overarching principle – that, before the relevant factors mentioned in paragraph 3 are taken into account, the general government deficit remains close to the reference value and its excess over the reference value is temporary – is fully met, these factors shall also be taken into account in the steps leading to the decision on the existence of an excessive deficit, foreseen in paragraphs 4, 5 and 6 of article 104 of the Treaty. The balanced overall assessment to be made by the Council shall encompass all these factors.

5. The Commission and the Council, in all budgetary assessments in the framework of the excessive deficit procedure, shall give due consideration to the implementation of pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar.

6. If the Council has decided, on the basis of Article 104 (6) of the Treaty, that an excessive deficit exists in a Member State, the Commission and the Council shall take into account the relevant factors mentioned in paragraph 3 also in the subsequent procedural steps of Article 104 of the Treaty, including as specified in Articles 3(5) and 5(2). However those relevant factors shall not be taken into account for the decision of the Council under Article 104 (12) of the Treaty on the abrogation of some or all of its decisions under paragraphs 6 to 9 and 11 of Article 104 of the Treaty.

7. In the case of Member States where the deficit exceeds the reference value, while remaining close to it, and where this excess reflects the implementation of a pension reform introducing a multi-pillar system that includes a mandatory, fully funded pillar, the Commis-

sion and the Council shall also consider the cost of the reform to the publicly managed pillar when assessing developments in EDP deficit figures. For that purpose, consideration shall be given to the net cost of the reform on a linear degressive basis for a transitory period of five years. This net cost shall be taken into account also for the decision of the Council under Article 104 (12) of the Treaty on the abrogation of some or all of its decisions under paragraphs 6 to 9 and 11 of Article 104 of the Treaty, if the deficit has declined substantially and continuously and has reached a level that comes close to the reference value.

SECTION 2

SPEEDING UP THE EXCESSIVE DEFICIT PROCEDURE

Article 3

1. Within two weeks of the adoption by the Commission of a report issued in accordance with Article *104* (3), the Economic and Financial Committee shall formulate an opinion in accordance with Article *104* (4).

2. Taking fully into account the opinion referred to in paragraph 1, the Commission, if it considers that an excessive deficit exists, shall address an opinion and a recommendation to the Council in accordance with Article *104* (5) and (6).

3. *The Council shall decide on the existence of an excessive deficit in accordance with Article 104 (6) of the Treaty, as a rule within four months of the reporting dates established in Article 4 (2) and (3) of Regulation (EC) No 3605/93. When it decides that an excessive deficit exists, the Council shall at the same time make recommendations to the Member State concerned in accordance with Article 104 (7) of the Treaty.*

4. *The Council recommendation made in accordance with Article 104 (7) of the Treaty shall establish a deadline of six months at most for effective action to be taken by the Member State concerned. The Council recommendation shall also establish a deadline for the correction of the excessive deficit, which should be completed in the year following its identification unless there are special circumstances. In the recommendation, the Council shall request that the Member State achieves a minimum annual improvement of at least*

0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation.

5. *If effective action has been taken in compliance with a recommendation under Article 104 (7) of the Treaty and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 104 (7) of the Treaty. The revised recommendation, taking into account the relevant factors mentioned in Article 2 (3) of this Regulation, may notably extend the deadline for the correction of the excessive deficit by one year. The Council shall assess the existence of unexpected adverse economic events with major unfavourable consequences for government finances against the economic forecasts in its recommendation.*

Article 4

1. Any Council decision to make public its recommendations, where it is established that no effective action has been taken in accordance with Article *104* (8), shall be taken immediately after the expiry of the deadline set in accordance with Article 3(4) of this Regulation.

2. The Council, when considering whether effective action has been taken in response to its recommendations made in accordance with Article *104* (7), shall base its decision on publicly announced decisions by the Government of the Member State concerned.

Article 5

1. *Any Council decision to give notice to the participating Member State concerned to take measures for the deficit reduction in accordance with Article 104 (9) of the Treaty shall be taken within two months of the Council decision establishing that no effective action has been taken in accordance with Article 104 (8) of the Treaty. In the notice, the Council shall request that the Member State achieves a minimum annual improvement of at least 0.5 % of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the notice.*

2. If effective action has been taken in compliance with a notice under Article 104 (9) of the Treaty and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that notice, the Council may decide, on a recommendation from the Commission, to adopt a revised notice under Article 104 (9) of the Treaty. The revised notice, taking into account the relevant factors mentioned in Article 2 (3) of this Regulation, may notably extend the deadline for the correction of the excessive deficit by one year. The Council shall assess the existence of unexpected adverse economic events with major unfavourable consequences for government finances against the economic forecasts in its notice.

Article 6

Where the conditions to apply Article *104* (11) are met, the Council shall impose sanctions in accordance with Article *104* (11). Any such decision shall be taken no later than *four months* after the Council decision giving notice to the participating Member State concerned to take measures in accordance with Article *104* (9).

Article 7

If a participating Member State fails to act in compliance with the successive decisions of the Council in accordance with Article 104 (7) and (9) of the Treaty, the decision of the Council to impose sanctions, in accordance with Article 104 (11) of the Treaty, shall be taken as a rule within sixteen months of the reporting dates established in Article 4 (2) and (3) of Regulation (EC) No 3605/93. In case Article 3 (5) or 5 (2) above is applied, the sixteen-month deadline is amended accordingly. An expedited procedure shall be used in the case of a deliberately planned deficit which the Council decides is excessive.

Article 8

Any Council decision to intensify sanctions, in accordance with Article *104* (11), other than the conversion of deposits into fines under Article 14 of this Regulation, shall be taken no later than two months after the reporting dates pursuant to Regulation (EC) No 3605/93. Any Council decision to abrogate some or all of its decisions in accordance with Article *104* (12) shall be taken as soon as possible and in any case no later than two months after the reporting dates pursuant to Regulation (EC) No 3605/93.

SECTION 3

ABEYANCE AND MONITORING

Article 9

1. The excessive deficit procedure shall be held in abeyance:

— if the Member State concerned acts in compliance with recommendations made in accordance with Article *104* (7),

— if the participating Member State concerned acts in compliance with notices given in accordance with Article *104* (9).

2. *The period during which the procedure is held in abeyance shall be included neither in the period referred to in Article 6 nor in the period referred to in Article 7 of this regulation.*

3. *Following the expiry of the period referred to in the first sentence of Article 3 (4) and following the expiry of the period referred to in the second sentence of Article 6 of this Regulation, the Commission shall inform the Council if it considers that the measures taken seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council, provided that they are fully implemented and that economic developments are in line with forecasts. The Commission statement shall be made public.*

Article 10

1. The Commission and the Council shall monitor the implementation of action taken:

— by the Member State concerned in response to recommendations made under Article *104* (7),

— by the participating Member State concerned in response to notices given under Article *104* (9).

2. If action by a participating Member State is not being implemented or, in the Council's view, is proving to be inadequate, the Council shall immediately take a decision under Article *104* (9) or Article *104* (11) respectively.

3. If actual data pursuant to Regulation (EC) No 3605/93 indicate that an excessive deficit has not been corrected

by a participating Member State within the time limits specified either in recommendations issued under Article *104* (7) or notices issued under Article *104* (9), the Council shall immediately take a decision under Article *104* (9) or Article *104* (11) respectively.

SECTION 4

SANCTIONS

Article 11

Whenever the Council decides to apply sanctions to a participating Member State in accordance with Article *104* (11), a non-interest-bearing deposit shall, as a rule, be required. The Council may decide to supplement this deposit by the measures provided for in the first and second indents of Article *104* (11).

Article 12

1. When the excessive deficit results from non-compliance with the criterion relating to the government deficit ration in Article *104* (2) (a), the amount of the first deposit shall comprise a fixed component equal to 0.2 % of GDP, and a variable component equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 % of GDP.

2. Each following year, until the decision on the existence of an excessive deficit is abrogated, the Council shall assess whether the participating Member State concerned has taken effective action in response to the Council notice in accordance with Article *104* (9). In this annual assessment the Council shall decide, in accordance with Article *104* (11), and without prejudice to Article 13 of this Regulation, to intensify the sanctions, unless the participating Member State concerned has complied with the Council notice. If an additional deposit is decided, it shall be equal to one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3 % of GDP.

3. Any single deposit referred to in paragraphs 1 and 2 shall not exceed the upper limit of 0.5 % of GDP.

Article 13

A deposit shall, as a rule, be converted by the Council, in accordance with Article *104* (11), into a fine if two years after the decision to require the participating Member State concerned to make a deposit, the excessive deficit has in the view of the Council not been corrected.

Article 14

1. In accordance with Article *104* (12), the Council shall abrogate the sanctions referred to in the first and second indents of Article *104* (11) depending on the significance of the progress made by the participating Member State concerned in correcting the excessive deficit.

Article 15

In accordance with Article *104* (12), the Council shall abrogate all outstanding sanctions if the decision on the existence of an excessive deficit is abrogated. Fines imposed in accordance with Article 13 of this Regulation will not be reimbursed to the participating Member State concerned.

Article 16

Deposits referred to in Articles 11 and 12 of this Regulation shall be lodged with the Commission. Interest on the deposits, and the fines referred to in Article 13 of this Regulation constitute other revenue referred to in Article 20l of the Treaty and shall be distributed among participating Member States without a deficit that is excessive as determined in accordance with Article *104* (6) in proportion to their share in the total GNP of the eligible Member States.

SECTION 5

TRANSITIONAL AND FINAL PROVISIONS

Article 17

For the purpose of this Regulation and for as long as the United Kingdom has a budgetary year which is not a calendar year, the provisions of sections 2, 3 and 4 of this Regulation shall be applied to the United Kingdom in accordance with the Annex.

Article 18

This Regulation shall enter into force on 1 January 1999.

This Regulation shall be binding in its entirety and directly applicable in all Member States.

Done at Brussels, 7 July 1997.

For the Council
The President
J.-C. JUNCKER

Important note:
Amendments introduced by Regulation No 1056/05 of 27 June 2005 entered into force on 27 July 2005

Annex

Time limits applicable to the United Kingdom

1. In order to ensure equal treatment of all Member States, the Council, when taking decisions in Sections 2, 3 and 4 of this Regulation, shall have regard to the different budgetary year of the United Kingdom, with a view to taking decisions with regard to the United Kingdom at a point in its budgetary year similar to that at which decisions have been or will be taken in the case of other Member States.

2. The provisions specified in Column I shall be substituted by the provisions specified in Column II.

Column I	Column II
'as a rule, within four months of the reporting dates established in Article 4 (2) and (3) of Council Regulation (EC) No 3605/93'	(Article 3(3))
'as a rule, within six months after the end of the budgetary year in which the deficit occurred'	'The year following its identification'
(Article 3 (4))	'the budgetary year following its identification'
'as a rule, within sixteen months of reporting dates established in Article 4(2) and (3) of Regulation (EC) No 3605/93'	(Article 7)
'as a rule, within eighteen months from the end of the budgetary year in which the deficit occurred'	'the preceding year'
(Article 12 (1))	'the preceding budgetary year'

3. Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes

Contents

Introduction

This Opinion updates and replaces the opinion of the Economic and Financial Committee on the content and format of the Stability and Convergence Programmes, endorsed by the Ecofin Council on 10 July 2001.

The Stability and Growth Pact fully entered into force on 1 January 1999 and consists of a rules-based framework with both preventive and corrective elements. It initially consisted of Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure and the Resolution of 17 June 1997 on the Stability and Growth Pact. On 20 March 2005 the Council adopted a report entitled 'Improving the implementation of the Stability and Growth Pact'. The report was endorsed by the European Council in its conclusions of 22 March 2005, which stated that the report updates and complements the Stability and Growth Pact, of which it is now an integral part. On 27 June 2005 the Pact was complemented by two additional Regulations amending the Regulations 1466/97 and 1467/97.

The Stability and Growth Pact is an essential part of the macroeconomic framework of the Economic and Monetary Union, which contributes to achieving macroeconomic stability in the EU and safeguarding the sustainability of public finances. A rules-based system is the best guarantee for commitments to be enforced and for all Member States to be treated equally. The two nominal anchors of the Stability and Growth Pact — the 3 % of GDP reference value for the deficit ratio and the 60 % of GDP reference value for the debt ratio — and the medium-term budgetary objectives are the centrepiece of multilateral surveillance.

Member States, the Commission and the Council are committed to deliver on their respective responsibilities, applying the Treaty and the Stability and Growth Pact in an effective and timely manner. In addition, since effectiveness of peer support and peer pressure is an integral part of the Stability and Growth Pact, the Council and the Commission are expected to motivate and make public their positions and decisions at all appropriate stages of the procedure of the Stability and Growth Pact. Member States are expected to regularly inform the national Parliaments of developments in the procedures.

In order to enhance ownership of the EU budgetary framework, national budgetary rules should be complementary to the Stability and Growth Pact. Without prejudice to the balance between national and Community competences, their implementation could be discussed at European level in the context of the Stability and Convergence Programmes. In the same vein, governance arrangements at national level should complement the EU framework. National institutions could play a more prominent role in budgetary surveillance to enhance enforcement through national public opinion and complement the economic and policy analysis at EU level. In particular, Member States could establish an economic council of wise people who would advise on the main macroeconomic projections.

These Guidelines for the implementation of the Stability and Growth Pact consist of 2 sections. The first section elaborates on the implementation of the Stability and Growth Pact. The second section consists of guidelines on the content and format of the stability and convergence programmes.

Section I

Specifications on the implementation of the Stability and Growth Pact

A. *The preventive arm of the stability and growth pact*

1. The medium term budgetary objective (MTO)

Definition of the MTO

The MTO is defined in cyclically adjusted terms, net of one-off and other temporary measures. The reference method for the estimation of potential output is the one adopted by the Council on 12 July 2002 ([1]). One-off and temporary measures are measures having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position ([2]).

The MTO pursues a triple aim:

(i) *providing a safety margin with respect to the 3 % of GDP deficit limit.* This safety margin is assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations.

(ii) *ensuring rapid progress towards sustainability.* This is assessed against the need to ensure the convergence of debt ratios towards prudent levels taking into account the economic and budgetary impact of ageing populations.

(iii) taking (i) and (ii) into account, allowing room for budgetary manoeuvre, in particular taking into account the needs for public investment.

The MTOs are differentiated for individual Member States to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances, also in face of prospective demographic changes. The country-specific MTOs may diverge from the requirement of a close to balance or in surplus position.

Until criteria and modalities for taking into account implicit liabilities are appropriately established and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth, while preserving sufficient margin

below the reference value of -3 % of GDP ([3]). In this transition period, the country-specific MTOs for euro area and ERM II Member States would be in a range between -1 % of GDP for low debt / high potential growth countries and balance or surplus for high debt / low potential growth countries.

Potential growth should be assessed in a long-term perspective on the basis of the projections produced by the Working Group on Ageing attached to the Economic Policy Committee.

Member States may present more ambitious MTOs than implied by these criteria if they feel their circumstances call for it.

For Member States outside of the euro area and not participating in ERM II, country-specific MTOs would be defined with a view to ensuring the respect of the triple aim mentioned above.

Procedure for defining and revising the MTOs

In order to ensure a consistent application of the principles mentioned above for defining the country-specific MTOs, regular methodological discussions take place in the Economic and Financial Committee.

Taking into account the results of these discussions, Member States present their MTO in their Stability or Convergence programme. The MTOs are examined by the Commission and the Council in the context of the assessment of the Stability and Convergence Programmes. In accordance with Article 99(3) of the Treaty and Article 5(2) of Regulation 1466/97, where the Council considers that the MTO presented in a Stability or Convergence programme should be strengthened, it shall, in its opinion, invite the Member State concerned to adjust its programme.

The MTOs could be revised when a major reform is implemented and in any case every four years, in order to reflect developments in government debt, potential growth and fiscal sustainability.

2. The adjustment path toward the medium-term budgetary objective and deviations from it

Fiscal behaviour over the cycle and adjustment path toward the MTO

Member States should achieve a more symmetrical approach to fiscal policy over the cycle through enhanced budgetary discipline in periods of economic

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([1]) Due to data problems, a different method may be used for the estimation of potential output in the case of recently acceded Member States (RAMS). The method used should be agreed by the Economic Policy Committee on the basis of a proposal of the Output Gap Working Group.

([2]) Examples of one-off and temporary measures are the sales of non-financial assets; receipts of auctions of publicly owned licenses; short-term emergency costs emerging from natural disasters; tax amnesties; revenues resulting from the transfers of pension obligations.

([3]) The Council Report on 'Improving the implementation of the Stability and Growth Pact' of 20 March 2005 and endorsed on 22 March 2005 by the Heads of State and Government stated that 'by the end of 2006, the Commission should report on progress achieved towards the methodology for completing the analysis by incorporating implicit liabilities'.

recovery, with the objective to avoid pro-cyclical policies and to gradually reach their medium term objective, thus creating the necessary room to accommodate economic downturns and reduce government debt at a satisfactory pace, thereby contributing to the long-term sustainability of public finances. The presumption is to use unexpected extra revenues for deficit and debt reduction.

Member States that have already reached their MTO could let automatic stabilisers play freely over the cycle. They should in particular avoid pro-cyclical fiscal policies in 'good times'.

Member States that have not yet reached their MTO should take steps to achieve it over the cycle. Their adjustment effort should be higher in good times; it could be more limited in bad times. In order to reach their MTO, Member States of the euro zone or of ERM-II should pursue an annual adjustment in cyclically adjusted terms, net of one-offs and other temporary measures, of 0.5 % of GDP as a benchmark.

Member States that do not follow the required adjustment path will explain the reasons for the deviation in the annual update of their Stability/Convergence Programme.

Based on the principles mentioned above and on the explanations provided by Member States, the Commission and the Council, in their assessments of the Stability or Convergence Programmes, examine whether the adjustment path towards the medium-term budgetary objective is appropriate. In particular, they examine whether a sufficient adjustment effort is made in economic good times, and take into account that the effort may be more limited in economic bad times.

In case the Council considers that the adjustment path towards the MTO should be strengthened, it shall, in accordance with Article 99(3) of the Treaty and Article 5(2) of Regulation 1466/97, invite the Member State concerned to adjust its programme.

Definition of economic 'good times'

Economic 'good times' should be identified as periods where output exceeds its potential level, taking into account tax elasticities.

Given the uncertainty surrounding output gap levels' estimates, the change in the output gap could also be considered, especially when the output gap is estimated to be close to zero. For instance, periods where the output gap is slightly negative but moving rapidly towards positive values could be considered as 'good times'. Symmetrically, periods where the output gap is slightly positive but moving rapidly towards negative values could not be considered as 'good times'.

The identification of periods of economic 'good times' should be made after an overall economic assessment.

The reference for the estimation of potential output is the methodology adopted by the Council on 12 July 2002 [1]. The reference to 'tax elasticities' should be understood as the overall elasticity of taxes to GDP, resulting from the influence of economic factors (fiscal leads and lags, supply and demand composition of growth), abstracting from the implementation of discretionary measures.

Structural reforms

In order to enhance the growth oriented nature of the Pact, structural reforms will be taken into account when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it.

Only major reforms that have a verifiable positive impact on the long-term sustainability of public finances will be taken into account. This includes reforms with direct long-term cost-saving effects and reforms raising potential growth. For instance, major health, pension and labour market reforms will be considered.

Special attention will be paid to pension reforms introducing a multi-pillar system that includes a fully funded pillar, which have a direct negative impact on the general government deficit (as defined in Article 1 of Regulation 3605/93). This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme [2]. In this specific case, the allowed deviation from the MTO should reflect the net

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[1] See footnote 1.

cost of the reform to the publicly managed pillar, provided the deviation remains temporary and an appropriate safety margin to the reference value is preserved. The net cost of the reform is measured as its direct impact on the general government deficit.

Only adopted reforms should be considered, provided that sufficient, detailed information is provided in the Stability and Convergence Programmes (see Section II). The budgetary effects of the reforms over time are assessed by the Commission and the Council in a prudent way, making due allowance for the margin of uncertainties associated to such an exercise.

Major structural reforms as identified above will be taken into account when defining the adjustment path to the medium-term objective for countries that have not yet reached this objective and in allowing a temporary deviation from this objective for countries that have already reached it, with the clear understanding that:

(i) *a safety margin to ensure the respect of the 3 % of GDP reference value for the deficit is guaranteed.* This safety margin will be assessed for each Member State taking into account past output volatility and the budgetary sensitivity to output fluctuations;

(ii) *the budgetary position is expected to return to the MTO within the period covered by the Stability or Convergence Programme.* For this purpose, the period under consideration will be limited to — at most — the four years following the year of the presentation of the programme.

In case a temporary deviation from the medium-term objective or the adjustment path toward it is allowed, this should be specified in the Council Opinion on the Stability/Convergence Programme.

3. Commission policy advice and early warning

The Commission will issue policy advice to encourage Member States to stick to their adjustment path. Such policy advice, given in accordance with Article 211, second indent, of the Treaty, will be replaced by warnings in accordance with Article III-179 (4) of the Constitution as soon as it becomes applicable. The Commission policy

advice and warnings are made public. The Commission continues to have the possibility to propose recommendations for the Council to issue an early warning, in accordance with Article 99 (4) of the Treaty and Article 6(2), 6(3), 10(2) and 10(3) of Regulation (EC) No 1466/97.

B. The excessive deficit procedure

1. Preparation of a Commission report under Article 104(3) in case of non-compliance with the deficit criterion

The Commission will always prepare a report under Article 104 (3) of the Treaty when a reported or planned deficit exceeds 3 % of GDP. The Commission may, in accordance with Article 104 (3), also prepare a report notwithstanding the fulfilment of the requirements under the criteria laid down in Article 104 (2)(a) of the Treaty if it is of the opinion that there is a risk of an excessive deficit in a Member State.

The Commission shall examine in its report if one or more of the exceptions foreseen in Article 104(2)(a) apply. In particular, the Commission shall consider whether the deficit ratio has declined substantially and continuously and reached a level that comes close to the reference value.

The Commission shall also consider whether the excess over the reference value is only exceptional and temporary and whether the ratio remains close to the reference value. In order to be considered as exceptional, the excess has to result from an unusual event outside the control of the Member State concerned and with a major impact on the financial position of the general government, or it has to result from a 'severe economic downturn'. The Commission and the Council may consider an excess over the reference value resulting from a 'severe economic downturn' as exceptional in the sense of the second indent of Article 104(2) (a) of the Treaty if the excess over the reference value results from a negative annual GDP volume growth rate or from an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential. The indicator for assessing accumulated loss of output is the output gap, as calculated according to the method agreed by the Council on 12 July 2002 ([1]). The excess over the reference value shall be considered as temporary if the forecasts provided by the Commission indicate that the

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(2) For more information on the classification of pension schemes, see Eurostat decision on the 'Classification of funded pension schemes in case of government responsibility or guarantee' of 2 March 2004.

(1) See footnote 1.

deficit will fall below the reference value following the end of the unusual event or the severe economic downturn.

The Commission report under Article 104 (3) shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors.

The Commission report should appropriately reflect developments in the medium-term economic position (in particular potential growth, prevailing cyclical conditions, the implementation of policies in the context of the Lisbon agenda and policies to foster R & D and innovation) and in the medium-term budgetary position (in particular, fiscal consolidation efforts in 'good times', debt sustainability, public investment and the overall quality of public finances). Furthermore, due consideration will be given to any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess in qualitative terms the excess over the reference value. To this end, the Member State concerned may put forward to the Council and to the Commission the specific factors that it considers relevant, in due time for the preparation of the report under Article 104 (3) and as a rule within one month of the reporting dates established in Article 4(2) and (3) of Regulation (EC) No 3605/93. The Member State shall provide the information necessary for the Commission and the Council to make a comprehensive assessment of the budgetary impact of these factors. In that context, special consideration will be given to budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe if it has a detrimental effect on the growth and fiscal burden of a Member State. A balanced overall assessment has to encompass all these factors.

The Commission report will give due consideration to the implementation of pension reforms introducing a multi-pillar system that includes a fully funded pillar, if these reforms have a direct negative impact on the general government deficit (as defined in Article 1 of Regulation 3605/93. This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure will be, after the reform, paid by the pension scheme. In particular, the Commission report will examine the net cost of the reform to the publicly managed pillar. The net cost of the reform is measured as its direct impact on the general government deficit.

2. Increasing the focus on debt and sustainability

In line with the provisions of the Treaty, the Commission has to examine compliance with budgetary discipline on the basis of both the deficit and the debt criteria. The Council has agreed that there should be increased focus on debt and sustainability, and reaffirmed the need to reduce government debt to below 60 % of GDP at a satisfactory pace, taking into account macroeconomic conditions. The higher the debt to GDP ratios of Member States, the greater must be their efforts to reduce them rapidly.

The debt surveillance framework and the excessive deficit procedure should be strengthened by applying the concept of 'sufficiently diminishing and approaching the reference value at a satisfactory pace' for the debt ratio in qualitative terms, by taking into account macroeconomic conditions and debt dynamics, including the pursuit of appropriate levels of primary surpluses as well as other measures to reduce gross debt and debt management strategies and the relationship between the evolution of the deficit and the evolution of the general government gross debt.

The Commission will always prepare a report on the basis of Article 104(3) of the Treaty, in which it shall examine if one or more of the exceptions foreseen respectively in Article 104(2)(a) and (b) apply.

For countries in which the debt ratio is above the reference value, the Council will formulate recommendations on the debt dynamics in its opinions on the Stability and Convergence Programmes.

3. The decision on the existence of an excessive deficit

If the double condition of the overarching principle — that, before the relevant factors mentioned in Article 2(3) of Regulation 1467/97 are taken into account, the general government deficit remains close to the reference value and its excess over the reference value is temporary — is fully met, the relevant factors assessed in the Commission report under Article 104(3) will also be taken into account in the steps leading to the decision on the existence of an excessive deficit, foreseen in paragraphs (4), (5) and (6) of Article 104 of the Treaty. The

balanced overall assessment to be made by the Council in accordance with Article 104(6) shall encompass all these factors.

In the case of Member States where the deficit exceeds the reference value, while remaining close to it, and where this excess reflects the direct impact on the general government deficit (as defined in Article 1 of Regulation 3605/93) stemming from the implementation of a pension reform introducing a multi-pillar system that includes a fully funded pillar, the Commission and the Council shall also consider the cost of the reform to the publicly managed pillar when assessing developments in EDP deficit figures. This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme. Consideration to the net cost of the reform will be given for the initial five years after a Member State has introduced a fully-funded system, or five years after 2004 for Member States that have already introduced such a system. Furthermore, it will also be regressive, i.e. during a period of five years, consideration will be given to 100, 80, 60, 40 and 20 percent of the net cost of the reform to the publicly managed pillar. The net cost of the reform is measured as its direct impact on the general government deficit.

The Council shall decide on the existence of an excessive deficit in accordance with Article 104 (6) of the Treaty, on the basis of a Commission recommendation, as a rule within four months of the reporting dates established in Article 4(2) and (3) of Regulation (EC) No 3605/93. The Council may decide later in the cases in which the budgetary statistical data have not been validated by the Commission (Eurostat) shortly after the reporting dates established in Regulation (EC) No 3605/93.

4. The correction of an excessive deficit

Minimum fiscal effort for countries in excessive deficit and initial deadline for its correction

The Council recommendations under Article 104 (7) and notices under Article 104 (9), based on recommendations of the Commission, will request that the Member State concerned achieves a minimum annual improvement in its cyclically adjusted balance net of one-off and temporary measures of at least 0.5 % of GDP as a bench-

mark, in order to correct the excessive deficit within the deadline set in the recommendation.

As a rule, the initial deadline for correcting an excessive deficit should be the year after its identification and thus, normally, the second year after its occurrence. This deadline should be set taking into account the minimum adjustment, in cyclically adjusted terms net of one-off and other temporary measures, requested by the Council. If this effort seems sufficient to correct the excessive deficit in the year following its identification, the initial deadline needs not to be set beyond that year.

In case of special circumstances, the initial deadline for correcting an excessive deficit would be set, as a rule, one year later, i.e. the second year after its identification and thus normally the third year after its occurrence. The determination of the existence of such circumstances will take into account a balanced overall assessment of the factors mentioned in the report under Article 104(3).

Longer deadlines could be set for new and future Member States, i.e. in the case of Members States being placed in excessive deficit immediately following their accession. Longer deadlines could also be set for Member States implementing pension reforms introducing a multi-pillar system that includes a fully funded pillar.

Clarifying the conditions for abeyance

Following the expiry of the six month period following the adoption of a recommendation under Article 104(7) or the four months period following the adoption of a notice under Article 104(9), the Commission shall assess whether the Member State concerned has acted in compliance with the recommendation or notice. This assessment should consider whether the Member State concerned has publicly announced or taken measures that seem sufficient to ensure adequate progress towards the correction of the excessive deficit within the time limits set by the Council.

In case it appears that the Member State concerned has not acted in compliance with the recommendation or notice, the following step of the procedure provided by Article 104 of the Treaty, as clarified by Regulation (EC) No 1467/97, shall be activated.

If the Commission considers that the Member State has acted in compliance with the recommendation or notice, it shall inform the Council accordingly, and the pro-

cedure shall be held in abeyance. If, thereafter, it appears that action by the Member State concerned is not being implemented or is proving to be inadequate and if the possibility of repeating the same step does not apply, the following step of the procedure provided by Article 104 of the Treaty, as clarified by Regulation (EC) No 1467/97, shall be immediately activated. When considering whether the following step of the procedure should be activated, the Commission and the Council should take into account whether the measures required in the recommendation or notice are fully implemented and whether other budgetary variables under the control of the government are developing in line with what was assumed in the recommendation or notice.

In the specific case of recommendations or notices which have set a deadline for the correction of the excessive deficit more than one year after its identification, the assessment made by the Commission after the expiry of the six month period following the adoption of a recommendation under Article 104(7) or the four month period following a notice under Article 104(9) should mainly focus on the measures taken in order to ensure an adequate fiscal adjustment in the year following the identification of the excessive deficit. The Commission should, during the period of abeyance, assess whether the measures already announced or taken are being adequately implemented and whether additional measures are announced and implemented in order to ensure adequate progress toward the correction of the excessive deficit within the time limits set by the Council.

Clarifying the concept of effective action and repetition of steps in the excessive deficit procedure

If effective action has been taken in compliance with a recommendation under Article 104(7) (or notice under Article 104(9)) of the Treaty and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation or notice, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of Regulation 1467/97, to adopt a revised recommendation under Article 104(7) (or notice under Article 104(9)) of the Treaty. The revised recom-mendation (or notice), then taking into account the relevant factors mentioned in Article 2 (3) of Regulation 1467/97, may notably extend the deadline for the correction of the excessive deficit by one year.

A Member State should be considered to have taken 'effective action' if it has acted in compliance with the recommendation or notice, regarding both the implementation of the measures required therein and budgetary execution. The assessment should in particular take into account whether the Member State concerned has achieved the annual improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall would be made.

The occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the Council recommendation or notice.

5. Abrogation of Council decisions in the context of the EDP for Member States having implemented multi-pillar pension reforms

Abrogation of Council decisions under paragraphs (6) to (9) and (11) of Article 104 of the Treaty is possible only if the general government deficit has declined substantially and continuously and has reached a level that comes close to the reference value.

The Commission and the Council, when considering under Article 104 (12) whether some or all of the Council decisions under Article 104 (6) to (9) and (11) should be abrogated, consider carefully an excess close to the deficit reference value which reflects the implementation of a pension reform introducing a multi-pillar system that includes a fully-funded pillar.

Consideration to the net cost of the reform will be given for the initial five years after a Member State has introduced a fully-funded system, or five years after 2004 for Member States that have already introduced such a system (¹). Furthermore, it will also be regressive, i.e. during a period of five years, consideration will be given to 100, 80, 60, 40 and 20 percent of the net cost of the reform to the publicly managed pillar. The net cost of the reform is measured as its direct impact on the general government deficit (as defined in Article 1 of Regulation

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(¹) Up to the March 2007 notification, these provisions do not apply to Member States that benefit from the special treatment granted by Eurostat for the implementation of the 2 March 2004 decision on the classification of second-pillar funded pension schemes. See Eurostat News Releases No 30/2004 of 2 March 2004 and No 117/2004 of 23 September 2004.

3605/93). This impact stems from the fact that revenue, which used to be recorded as government revenue, is diverted to a pension fund, which is fully-funded and classified in a sector other than general government, and that some pensions and other social benefits, which used to be government expenditure, will be, after the reform, paid by the pension scheme.

This implies in particular that for those Member States that already have implemented such reforms, it will be considered for 100 % in 2005, 80 % in 2006, 60 % in 2007, 40 % in 2008 and 20 % in 2009. For reforms implemented after 2005, the net impact of such reforms will be considered accordingly. For example, in the case of a Member State that would implement such a reform in 2007, the net budgetary impact of the reform will be considered for 100 % in 2007, 80 % in 2008, 60 % in 2009, 40 % in 2010 and 20 % in 2011. The Member State shall provide the information necessary for the Commission to assess the net budgetary impact of the reform.

SECTION II

Guidelines on the format and content of Stability and Convergence Programmes

The Stability and Growth Pact requires Member States to submit Stability or Convergence Programmes and updates thereof, which are at the basis of the Council's surveillance of budgetary positions and its surveillance and coordination of economic policies. The Council may, on a recommendation from the Commission, and after consulting the Economic and Financial Committee, deliver an opinion on each of the updated programmes and, if it considers that its objectives and contents should be strengthened, invite the Member State concerned to adjust its programme.

Member States are expected to take the corrective action they deem necessary to meet the objectives of their Stability or Convergence Programmes, whenever they have information indicating actual or expected significant divergence from those objectives.

In view of the fundamental role of the Stability and Convergence Programmes in the process of multilateral surveillance, it is important that their information content is suitable and allows for comparison across Member States. Whilst acknowledging that the programmes are the responsibility of national authorities and that the possibilities and practices differ across countries, Council Regulation (EC) No 1466/97 as amended by Council Regulation (EC) No 1055/05 sets out the essential elements of these programmes.

The experience gathered during the first years of implementation of the Pact with the Stability and Convergence Programmes shows that guidelines on the content and format of the programmes not only assist the Member States in drawing up their programmes, but also facilitate their examination by the Commission, the Economic and Financial Committee and the Council.

The guidelines set out below should be considered as a code of good practice and checklist to be used by Member States in preparing Stability or Convergence Programmes. Member States are expected to follow the guidelines as far as possible, and to justify any departure from them.

1. Status of the programme and of the measures

Each programme mentions its status in the context of national procedures, notably with respect to the national Parliament. The programme also indicates whether the Council opinion on the previous programme has been presented to the national Parliament.

The state of implementation of the measures (enacted versus planned) presented in the programme should be specified.

2. Content of Stability and Convergence Programmes

In order to facilitate comparison across countries, Member States are expected, as far as possible, to follow the model structure for the programmes in Annex 1. The standardisation of the format and content of the programmes along the lines set below will substantially improve the conditions for equality of treatment.

The quantitative information should be presented following a standardised set of tables (Annex 2). Member States should endeavour to supply all the information in these tables. The tables could be complemented by further information wherever deemed useful by Member States.

In addition to the guidelines set out below, the programmes should provide information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them, as well as on the measures to enhance the quality of public finances and to achieve long-term sustainability.

Objectives

Member States will present in their Stability and Convergence Programmes budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio. Convergence programmes shall also present the medium-term monetary policy objectives and their relationship to price and exchange rate stability.

Member States, when preparing the first update of their Stability or Convergence Programme after a new government has taken office, are invited to show continuity with respect to the budgetary targets endorsed by the Council on the basis of the previous update of the Stability/Convergence Programme and — with an outlook for the whole legislature — to provide information on the means and instruments envisaged to reach these targets by setting out its budgetary strategy.

To permit a fuller understanding of the path of the government balance and of the budgetary strategy in general, information should be provided on expenditure and revenue ratios and on their components separately identified, as well as on one-off and other temporary measures ([1]). To

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([1]) Countries that benefit, over a transition period up to the March 2007 notification, from the special treatment granted by Eurostat for the implementation of the 2 March 2004 decision on the classification of second-pillar funded pension schemes, should present in their programmes detailed information on the impact on the general government balance as well as on the revenue and expenditure side separately and, if possible, on the debt ratio.

permit a fuller understanding of the path of the debt ratio, information should be provided, to the extent possible, on components of the stock-flow adjustment, such as privatisation receipts and other financial operations.

The budget balances should be broken down by subsector of general government (central government, State government for Member States with federal or quasi-federal institutional arrangements, local government and, social security).

Assumptions and data

Stability and Convergence programmes should be based on realistic and cautious macroeconomic forecasts. The Commission forecasts can provide an important contribution for the coordination of economic and fiscal policies. Member States are free to base their Stability/Convergence Programmes on their own projections. However, significant divergences between the national and the Commission services' forecasts should be explained in some detail. This explanation will serve as a reference when forecast errors are assessed *ex post*.

The programmes should present the main assumptions about expected economic developments and important economic variables that are relevant to the realisation of their budgetary plans, such as government investment expenditure, real GDP growth, employment and inflation. The assumptions on real GDP growth should be underpinned by an indication of the expected demand contributions to growth. The possible upside and downside risks to the outlook should be brought out.

Furthermore, the programmes should provide sufficient information about GDP developments to allow an analysis of the cyclical position of the economy and the sources of potential growth. The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance should be analysed.

As regards external macroeconomic developments, euro area Member States and Member States participating in ERM II in particular should use the 'common external assumptions' on the main extra-EU variables if provided by the Commission in due time or, for comparability reasons, present sensitivity analysis based on the common assumptions for these variables when the differences are significant. The assumptions are to be provided in due time by the Commission services (after consultation with national experts), on the basis of the final table in Annex 2, for discussion by the EFC.

Assumptions about interest rates and exchange rates, if not presented in the programme, should be provided to the Commission services to allow for the technical assessment of the programmes.

In order to facilitate the assessment, the concepts used shall be in line with the standards established at European level, notably in the context of the European system of accounts (ESA). The programmes should ensure the formal and substantial consistency of the required information on budgetary aggregates and economic assumptions with ESA concepts. This information may be complemented by a presentation of specific accounting concepts that are of particular importance to the country concerned.

Measures, structural reforms and long-term sustainability

The programmes should describe the budgetary and other economic policy measures being taken or proposed to achieve the objectives of the programme, and, in the case of the main budgetary measures, an assessment of their quantitative effects on the general government balance. Measures having significant 'one-off' effects should be explicitly identified. The further forward the year of the programme, the less detailed the information could be. However, budgetary targets should be backed by an indication of the broad measures necessary to achieve them.

Structural reforms should be specifically analysed when they are envisaged to contribute to the achievement of the objectives of the programme. In particular, given the relevance of 'major structural reforms' in defining the adjustment path to the medium-term objective for Member States that have not yet reached it and allowing a temporary deviation from the MTO for Member States that have already reached it (see Section I), the programmes should include comprehensive information on the budgetary and economic effects of such reforms. Programmes should notably include a detailed quantitative cost-benefit analysis of the short-term costs — if any — and of the long-term benefits of the reforms from the budgetary point of view. They should also analyse the projected impact of the reforms on economic growth over time while explaining the used methodology.

The programmes should also describe measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).

The programmes could further include information on the implementation of existing national budgetary rules (expenditure rules, etc.) as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.

Finally, the programmes should outline the countries strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.

The Working Group on Ageing (AWG) attached to the Economic Policy Committee (EPC) is responsible for producing common budgetary projections on: public spending on pensions; healthcare; long-term care; education; unemployment transfers; and where possible and relevant, age-related revenues, such as pension contributions. These common projections will provide the basis for the assessment by the Commission and the Council of sustainability of the Member States' public finances within the context of the SGP. They should be included in the programmes.

The programmes should include all the necessary additional information, both of qualitative and quantitative nature, so as to enable the Commission and the Council to assess the sustainability of Member States of public finances based on current policies. To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections. For example, Member States might want to include information on the latest demographic trends and major policy changes in pension and healthcare systems. Programmes should clearly distinguish between measures that have been enacted and measures that are envisaged.

Given the uncertainty surrounding long-term projections, the assessment by the Commission and the Council should include stress tests that provide an indication of the risks to public finance sustainability in the event of adverse demographic, economic or budgetary developments.

In addition to the requirements mentioned above, Member States may present different projections, based on national calculations. In such a case, Member States should explain in detail the underlying assumptions of these projections, the used methodology, the policies implemented or planned to meet the assumptions, and the divergences between the national projections and the common projections produced by the Working Group on Ageing attached to the Economic Policy Committee.

These national projections and their assumptions, including their plausibility, will enter the basis for the assessment by the Commission and the Council of sustainability of the Member States' public finances within the context of the SGP.

Sensitivity analysis

Given the inevitability of forecast errors, Stability and Convergence Programmes include comprehensive sensitivity analyses and/or develop alternative scenarios, in order to enable the Commission and the Council to consider the complete range of possible fiscal outcomes.

In particular, the programmes shall provide an analysis of how changes in the main economic assumptions would affect the budgetary and debt position and indicate the underlying assumptions about how revenues and expenditures are projected to react to variations in economic variables. This should include the impact of different interest rate assumptions and, for non-participating Member States, of different exchange rate assumptions, on the budgetary and debt position. Countries that do not use the common external assumptions should endeavour to provide a sensitivity analysis also on main extra-EU variables when the differences are significant.

In the case of 'major structural reforms' (see section I), the programmes shall also provide an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.

Time horizon

The information about paths for the general government surplus/deficit ratio, the expenditure and revenue ratios and their components as well as for debt ratio and the main economic assumptions should be on an annual basis and should cover, as well as the current and preceding year, at least the three following years (Article 3(3) and Article 7(3)), leaving it open to Member States to cover a longer period if they so wish.

The horizon for the long-term projections on the budget-ary implications of ageing should cover the same period as the EPC projections.

Updating of programmes

In order to promote the efficiency of the budgetary and economic surveillance and achieve a better interaction between different procedures, submissions of SCP updates should take place shortly after national govern-ments have presented their budget proposals to parlia-ments, but not earlier than mid-October and not later than the 1 of December (¹) (²). (³). This should increase the comparability of the programmes, the consistency of

the assessments and the equality of treatment. The EFC and the ECOFIN should examine the SCP updates in a maximum of three sessions. The whole process should be completed before the end of March each year.

Annual updates of Stability and Convergence Pro-grammes should show how developments have com-pared with the budgetary targets in the previous pro-gramme or update. When applicable, they should explain in detail the reasons for the deviations from these targets. When substantial deviations occur, the update should mention whether measures are taken to rectify the situa-tion, and provide information on these measures.

(¹) In the case of the UK, which has a different fiscal year, submission should be as close as possible to the presentation of the autumn pre-Budget report.
(²) Austria and Portugal cannot comply at this stage with this schedule, but they will submit their Stability Programmes no later than 15 December.

(³) Ireland will be regarded as meeting this commitment by submitting its Sta-bility Programme update on its annual Budget day, which traditionally takes place on the first Wednesday of December.

Annex 1

Model structure for the Stability and Convergence Programmes

1. Overall policy framework and objectives

2. Economic outlook
(on the basis of Tables 1a-1d, 5 and 8)

- World economy/technical assumptions
- Cyclical developments and current prospects
- Medium-term scenario
- Sectoral balances
- Growth implications of 'major structural reforms'

3. General government balance and debt
(on the basis of Tables 2, 3, 4 and 5)

- Policy strategy
- Medium-term objectives
- Actual balances and implications of budget for next year
- Structural balance (cyclical component of the deficit, one-off and temporary measures), fiscal stance
- Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments
- Budgetary implications of 'major structural reforms'

4. Sensitivity analysis and comparison with previous update
(on the basis of Table 6)

- Alternative scenarios and risks
- Sensitivity of budgetary projections to different scenarios and assumptions
- Comparison with previous update

5. Quality of public finances

(on the basis of Tables 2 and 3)

- Policy strategy
- Developments on the expenditure side
- Developments on the revenue side

6. Sustainability of public finances

(on the basis of Table 7)

- Policy strategy
- Long-term budgetary prospects, including the implications of ageing populations

7. Institutional features of public finances

- Implementation of national budgetary rules
- Budgetary procedures, inclluding public finance statistical governance
- Other institutional developments in relation to public finances

Annex 2

Tables to be contained in the Stability and Convergence Programmes and their updates

Provision of data on variables in bold characters is a requirement.

Provision of data on other variables is optional but highly desirable.

Table 1a.

Macroeconomic prospects

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1*g						
2. Nominal GDP	B1*g						
Components of real GDP							
3. Private consumption expenditure	P.3						
4. Government consumption expenditure	P.3						
5. Gross fixed capital formation	P.51						
6. Changes in inventories and net acquisition of valuables (% of GDP)	P.52 + P.53						
7. Exports of goods and services	P.6						
8. Imports of goods and services	P.7						
Contributions to real GDP growth							
9. Final domestic demand		-					
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-					
11. External balance of goods and services	B.11	-					

Table 1b.

Price developments

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator							
2. Private consumption deflator							
3. HICP (¹)							
4. Public consumption deflator							
5. Investment deflator							
6. Export price deflator (goods and services)							
7. Import price deflator (goods and services)							

(¹)   Optional for Stability Programmes.

Table 1c.

Labour market developments

	ESA Code	Year X-1	Year X-1	Year X	Year X+1	Year X+2	Year X+3
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, persons (¹)							
2. Employment, hours worked (²)							
3. Unemployment rate (%) (³)							
4. Labour productivity, persons (⁴)							
5. Labour productivity, hours worked (⁵)							
6. Compensation of employees	D.1						

(¹)   Occupied population, domestic concept national accounts definition.
(²)   National accounts definition.
(³)   Harmonised definition, Eurostat; levels.
(⁴)   Real GDP per person employed.
(⁵)   Real GDP per hour worked.

Table 1d.

Sectoral balances

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
1. Net lending/borrowing vis-à-vis the rest of the world	B.9				optional	optional
of which:						
— Balance on goods and services						
— Balance of primary incomes and transfers						
— Capital account						
2. Net lending/borrowing of the private sector	B.9/EDP B.9					
3. Net lending/borrowing of general government	B.9					
4. Statistical discrepancy			optional	optional	optional	optional

Table 2.

General government budgetary prospects

	ESA code	Year X-1 Level	Year X-1 % of GDP	Year X % of GDP	Year X+1 % of GDP	Year X+2 % of GDP	Year X+3 % of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13						
2. Central government	S.1311						
3. State government	S.1312						
4. Local government	S.1313						
5. Social security funds	S.1314						
General government (S13)							
6. Total revenue	TR						
7. Total expenditure	TE (¹)						
8. Net lending/borrowing	EDP B.9						
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM						
pm: 9a. FISIM							
10. Primary balance	(²)						
Selected components of revenue							
11. Total taxes (11=11a+11b+11c)							
11a. Taxes on production and imports	D.2					optional	optional
11b. Current taxes on income, wealth, etc.	D.5					optional	optional
11c. Capital taxes	D.91					optional	optional
12. Social contributions	D.61					optional	optional
13. Property income	D.4					optional	optional
14. Other (14=15-(11+12+13))						optional	optional
15=6. Total revenue	TR						
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) (³)							
Selected components of expenditure							
16. Collective consumption	P.32						
17. Total social transfers	D.62 + D.63						
17a. Social transfers in kind	P.31 =D.63						
17b. Social transfers other than in kind	D.62						
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM						
19. Subsidies	D.3						
20. Gross fixed capital formation	P.51						
21. Other (21=22-(16+17+18+19+20))							
22=7. Total expenditure	TE (⁴)						
Pm: compensation of employees	D.1						

(¹)   Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
(²)   The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).
(³)   Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.
(⁴)   Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3.

General government expenditure by function

% of GDP	COFOG Code	Year X-2	Year X +3
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (= item 7=26 in Table 2)	TE (¹)		

(¹)   Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 4.

General government debt developments

% of GDP	Year X-1	Year X	Year X+1	Year X+2	Year X+3
1. Gross debt (¹)					
2. Change in gross debt ratio					
Contributions to changes in gross debt					
3. Primary balance (²)					
4. Interest expenditure (incl. FISIM) (³)					
5. Stock-flow adjustment					
of which: — Differences between cash and accruals (⁴)					
— Net accumulation of financial assets (⁵) *of which:* — *privatisation proceeds*					
- Valuation effects and other (⁶)					
p.m. implicit interest rate on debt (⁷)					
Other relevant variables					
6. Liquid financial assets (⁸)					
7. Net financial debt (7=1-6)					

(¹)   As defined in Regulation 3605/93 (not an ESA concept).
(²)   Cf. item 10 in Table 2.
(³)   Cf. item 9 in Table 2.
(⁴)   The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.
(⁵)   Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.
(⁶)   Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.
(⁷)   Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.
(⁸)   AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5.

Cyclical developments

% of GDP	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
1. Real GDP growth (%)						
2. Net lending of general government	EDP B.9					
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD.41+FISIM					
4. Potential GDP growth (%) (^{1})						
contributions:						
— labour						
— capital						
— total factor productivity						
5. Output gap						
6. Cyclical budgetary component						
7. Cyclically-adjusted balance (2-6)						
8. Cyclically-adjusted primary balance (7-3)						

(^{1}) Until an agreement on the Production Function Method is reached, Member States can use their own figures (*SP*)

Table 6.

Divergence from previous update

	ESA Code	Year X-1	Year X	Year X+1	Year X+2	Year X+3
Real GDP growth (%)						
Previous update						
Current update						
Difference						
General government net lending (% of GDP)	EDP B.9					
Previous update						
Current update						
Difference						
General government gross debt (% of GDP)						
Previous update						
Current update						
Difference						

Table 7.

Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2050
Total expenditure						
Of which: age-related expenditures						
Pension expenditure						
Social security pension						
Old-age and early pensions						
Other pensions (disability, survivors)						
Occupational pensions (if in general government)						
Health care						
Long-term care *(this was earlier included in the healthcare)*						
Education expenditure						
Other age-related expenditures						
Interest expenditure						
Total revenue						
Of which: property income						
of which: from pensions contributions (or social contributions if appropriate)						
Pension reserve fund assets						
Of which: consolidated public pension fund assets (assets other than government liabilities)						
Assumptions						
Labour productivity growth						
Real GDP growth						
Participation rate males (aged 20-64)						
Participation rates females (aged 20-64)						
Total participation rates (aged 20-64)						
Unemployment rate						
Population aged 65+ over total population						

Table 8.

Basic assumptions
This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	Year X-1	Year X	Year X+1	Year X+2	Year X+3
Short-term interest rate [1] **(annual average)**					
Long-term interest rate (annual average)					
USD/EUR exchange rate (annual average) (euro area and ERM II countries)					
Nominal effective exchange rate					
(for countries not in euro area or ERM II) exchange rate vis-à-vis the euro (annual average)					
World excluding EU, GDP growth					
EU GDP growth					
Growth of relevant foreign markets					
World import volumes, excluding EU					
Oil prices, (Brent, USD/barrel)					

[1]   If necessary, purely technical assumptions.

4. Glossary

Accession Countries Countries in the process for accession to the European Union. They include Bulgaria and Romania.

Automatic stabilisers Various features of the tax and spending regime which react automatically to the economic cycle and reduce its fluctuations. As a result, the budget balance tends to improve in years of high growth, and deteriorate during economic slowdowns.

Broad Economic Policy Guidelines (BEPGs) Annual guidelines for the economic and budgetary policies of the Member States. They are prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (Ecofin).

Budget balance The balance between total public expenditure and revenue in a specific year, with a positive balance indicating a surplus and a negative balance indicating a deficit. For the monitoring of Member State budgetary positions, the EU uses *general government* aggregates. See also *structural budget balance*, *primary budget balance*, and *primary structural balance*.

Budgetary rules Rules and procedures through which policy-makers decide on the size and the allocation of public expenditure as well as on its financing through taxation and borrowing.

Budgetary sensitivity The variation in the budget balance in percentage of GDP brought about by a change in the output gap. In the EU, it is estimated to be 0.5 on average.

Candidate countries Countries that wish to accede to the EU. Besides the *accession countries*, they include Croatia and Turkey.

Close-to-balance requirement A requirement contained in the *Stability and Growth Pact*, according to which Member States should, over the medium term, achieve an overall *budget balance* close to balance or in surplus.

Code of Conduct on the format and content of the stability and convergence programmes Policy document endorsed by the Ecofin Council in July 2001 setting down the information requirements and key definitions to be followed by Member States in preparing their stability or convergence programmes.

Convergence Programmes Medium term budgetary and monetary strategies presented by each of those Member States that have not yet adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. Prior to the third phase of EMU, convergence programmes were issued on a voluntary basis and used by the Commission in its assessment of the progress made in preparing for the euro. See also S*tability programmes*.

Crowding-out effects Offsetting effects on output due to changes in interest rates and exchange rates triggered by a loosening or tightening of fiscal policy.

Cyclical component of budget balance That part of the change in the *Budget balance* that follows automatically from the cyclical conditions of the economy, due to the reaction of public revenue and expenditure to changes in the *Output gap*. See *Automatic stabilisers*, *Tax smoothing* and *Structural budget balance*.

Cyclically-adjusted budget balance See *Structural budget balance*.

Demand and supply shocks Disturbances that affect the economy on the demand side (*e.g.* changes in private consumption or exports) or on the supply side (*e.g.* changes in commodity prices or technological innovations). They can impact on the economy either on a temporary or permanent basis.

Dependency ratio A measure of the ratio of people who receive government transfers, especially pensions, relative to those who are available to provide the revenue to pay for those transfers.

Direct taxes Taxes that are levied directly on personal or corporate incomes and property.

Discretionary fiscal policy Change in the *budget balance* and in its components under the control of government aiming at stabilising the economy. It is usually measured as the residual of the change in the balance after the exclusion of the budgetary impact of *automatic stabilisers*. See also *fiscal stance*.

Early-warning mechanism Part of the preventive elements of the SGP, and is activated when there is significant divergence from the budgetary targets set down in a stability or convergence programme.

Economic and Financial Committee (EFC) Formerly the Monetary Committee, renamed the Economic and Financial Committee as of January 1999. Its main task is to prepare and discuss (Ecofin) Council decisions with regard to economic and financial matters.

Economic Policy Committee (EPC) Group of senior officials whose main task is to prepare discussions of the (Ecofin) Council on structural policies. It plays a large role in the preparation of the BEPGs, and it is active on policies related to labour markets, methods to calculate cyclically-adjusted budget balances and ageing populations.

Effective tax rate The ratio of broad categories of tax revenue (labour income, capital income, consumption) to their respective tax bases.

ESA95 / ESA79 European accounting standards for the reporting of economic data by the Member States to the EU. As of 2000, ESA95 has replaced the earlier ESA79 standard with regard to the comparison and analysis of national public finance data.

Excessive Deficit Procedure (EDP) A procedure according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in order to assess the risk of an excessive deficit in each Member State. Its application has been further clarified in the *Stability and Growth Pact*. See

also s*tability programmes* and *Stability and Growth Pact*.

Expenditure rules A subset of *fiscal rules* that target (a subset of) public expenditure.

Fiscal consolidation A continuous improvement in the *budget balance*, either specified by the amount of the improvement or the period over which the improvement continues.

Fiscal decentralisation The transfer of authority and responsibility for public functions from the central government to intermediate and local governments or to the market.

Fiscal federalism A subfield of public finance that investigates the fiscal relations across levels of government.

Fiscal impulse The estimated effect of fiscal policy on GDP. It is not a model-free measure and it is usually calculated by simulating an econometric model. The estimates presented in the present report are obtained by using the Commission services' model *QUEST*.

Fiscal rule A permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing, debt, or a major component thereof. See also *budgetary rule, expenditure rules*.

Fiscal stance A measure of the discretionary fiscal policy component. In this report, it is defined as the change in the *primary structural budget balance* relative to the preceding period. When the change is positive (negative) the fiscal stance is said to be expansionary (restrictive).

General government As used by the EU in its process of budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure*, the general government sector covers national government, regional and local government, as well as social security funds. Public enterprises are excluded, as are transfers to and from the EU Budget.

Government budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, government borrowing, or changes in the monetary base. In the context of EMU,

the ability of governments to finance spending through money issuance is prohibited. See also *Stock-flow adjustment, sustainability*.

Government contingent liabilities Obligations for the government that are subject to the realisation of specific uncertain and discrete future events. For instance, the guarantees granted by governments to the debt of private corporations bonds issued by enterprise are contingent liabilities, since the government obligation to pay depend on the non-ability of the original debtor to honour its own obligations.

Government implicit liabilities Government obligations that are very likely to arise in the future in spite of the absence of backing contracts or law. The government may have a potential future obligation as a result of legitimate expectations generated by past practice or as a result of the pressure by interest groups. Most implicit liabilities are contingent, i.e., depend upon the occurrence of uncertain future events.

Hodrick-Prescott (HP) filter A statistical technique used to calculate trend GDP and *output gaps* by filtering actual GDP.

Indirect taxation Taxes that are levied during the production stage, and not on the income and property arising from economic production processes. Prominent examples of indirect taxation are value added tax (VAT), excise duties, import levies, energy and other environmental taxes.

Interest burden *General government* interest payments on public debt as a share of GDP.

Maastricht reference values for public debt and deficits Respectively, a 60 percent *general government* debt/ GDP ratio and a 3 percent *general government* deficit/ GDP ratio. These thresholds are defined in a protocol to the Maastricht Treaty on European Union. See also *Excessive Deficit Procedure*.

Maturity structure of public debt The profile of total debt in terms of when it is due to be paid back. Interest rate changes affect the budget balance directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *Public debt*.

Minimal benchmarks Values indicating a budgetary position that would provide a cyclical safety margin for the *automatic stabilisers* to operate freely during economic slowdowns without leading to excessive deficits. The minimal benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks and should not be confused with the '*close-to-balance or in surplus*' medium-term requirement of the Pact.

Monetary Conditions Index (MCI) An indicator combining the change in real short-term interest rate and in the real effective exchange rate to gauge the degree of easing or tightening of monetary policy.

Mundell-Fleming model Macroeconomic model of an open economy which embodies the main Keynesian hypotheses (price rigidity, liquidity preference). In spite of its shortcomings, it remains useful in short-term economic policy analysis.

NAIRU Non-Accelerating Inflation Rate of Unemployment.

Non-Keynesian effects Supply-side and expectations effects which reverse the sign of traditional Keynesian multipliers. Hence, if non-Keynesian effects dominate, fiscal consolidation would be expansionary.

Old age dependency ratio Population aged over 65 as a percentage of working age population (usually defined as persons aged between 15 and 64).

Output gap The difference between actual output and estimated potential output at any particular point in time. See also *Cyclical component of budget balance*.

Pay-as-you-go pension system (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees.

Pre-accession Economic Programmes (PEPs) Annual programmes submitted by candidate countries which set the framework for economic policies The PEPs consist of a review of recent economic developments, a detailed macroeconomic framework, a discussion of public finance issues and an outline of the structural reform agenda.

Pre-accession Fiscal Surveillance Framework (PFSF) provides the framework for budgetary surveillance of candidate countries in the run up to accession. It closely approximates the policy coordination and surveillance mechanisms at EU level.

Policy-mix The overall stance of fiscal and monetary policy. The policy-mix may consist of various combinations of expansionary and restrictive policies, with a given *fiscal stance* being either supported or offset by monetary policy.

Primary budget balance The *budget balance* net of interest payments on *general government* debt.

Primary structural budget balance The *structural (or cyclically-adjusted) budget balance* net of interest payments.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by increasing the *structural primary deficit* during an economic upturn, or by decreasing it in a downturn. It can be contrasted with (discretionary) counter-cyclical policy that has the opposite effects. A neutral fiscal policy keeps the *cyclically-adjusted budget balance* unchanged over the economic cycle but lets the *automatic stabilisers* work. See also *Tax-smoothing*.

Production function approach A means to estimate the potential level of output of an economy on taking inputs on labour and capital as well as trend factor productivity into account. This is used to estimate the *output gap* that is a key input in the estimation of cyclical budget component.

Public debt Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by public institutions in the Member State, except that part of the debt which is owed to other public institutions in the same Member State.

Public goods Those goods and services that are consumed jointly by several economic agents and for which there is no effective pricing mechanism that would allow private provision through the market.

Public investment The component of total public expenditure through which governments increase and improve the stock of capital employed in the production of the goods and services they provide.

Public-private partnerships (PPP) Agreements that transfer to the private sector investment projects that traditionally have been executed or financed by the public sector. To qualify as a PPP, the project should concern a public function, involve the general government as the principal purchaser, be financed from non-public sources and engage a corporation outside the general government as the principal operator that provides significant inputs in the design and conception of the project and bears a relevant amount of the risk.

Quality of public finances The part of the EU fiscal framework that relates to the identification of strategic priorities and the effective and efficient use of resources in reaching them.

Quasi-fiscal activities Activities promoting public policy goals carried out by non-government units.

QUEST The DG ECFIN's macroeconomic model of the EU Member States plus the US and Japan.

Recently acceded Member States Countries that became members of the EU in May 2004 and include Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

Ricardian equivalence Under fairly restrictive theoretical assumptions on the consumer's behaviour (*inter alia* infinite horizon for decision-making), the impact of fiscal policy does not depend on whether it is financed by tax increases or by a widening deficit. The basic reasoning behind this statement dates back to Ricardo and was revisited by Robert Barro in the 1970s.

Securitisation Borrowing (issuing of bonds) with the intention of paying interest and capital out of the proceeds derived from assets (use or sale of) or from future revenue flows.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection, given various changes in the underlying assumptions.

Significant divergence A sizeable excess of budget balance over the targets in the stability or convergence programmes, that triggers the *Early warning* procedure of the *SGP*.

'Snow-ball' effect The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest rate paid on public debt and the growth rate of the national economy. See also *Government budget constraint*.

Social Security Contributions (SSC) Mandatory contributions paid by employers and employees to a social insurance scheme to cover for pension, healthcare and other welfare provisions.

Stability and Growth Pact (SGP) Approved in 1997, the SGP clarifies the provisions of the Maastricht Treaty regarding the surveillance of Member State budgetary policies and the monitoring of budget deficits during the third phase of EMU. The SGP consists of two Council Regulations setting out legally binding provisions to be followed by the European Institutions and the Member States and two Resolutions of the European Council in Amsterdam (June 1997). See also *Excessive Deficit Procedure*.

Stability Programmes Medium term budgetary strategies presented by those Member States that have already adopted the euro. They are updated annually, according to the provisions of the *Stability and Growth Pact*. See also *Convergence Programmes*.

Stock-flow adjustment The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between the net borrowing (flow) and the variation in the stock of gross debt. It includes the accumulation of financial assets, changes in the value of debt denominated in foreign currency, and remaining statistical adjustments.

Structural budget balance The actual *budget balance* adjusted for its *cyclical component*. The structural balance gives a measure of the underlying trend in the budget balance, when taking into account the automatic effect on the budget of the economic cycle. It is referred to also as the *cyclically-adjusted budget balance*. See also *Primary structural budget balance*.

Sustainability A combination of budget deficits and debt that ensure that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Tax gaps Measure used in the assessment of the *sustainability* of public finances. They measure the difference between the current tax ratio and the constant tax ratio over a given projection period to achieve a predetermined level of debt at the end of that projection period.

Tax smoothing The idea that tax rates should be kept stable in order to minimise the distortionary effects of taxation, while leaving it for the *automatic stabilisers* to smooth the economic cycle. It is also referred to as neutral *discretionary fiscal policy*. See also *Cyclical component of fiscal policy*.

UMTS Third generation of technical support for mobile phone communications. Sale of UMTS licences gave rise to sizeable one-off receipts in 2001.

Wagner's law Theory according to which public spending – since it comprises 'luxury goods' with high elasticity to income – would tend to rise as a share of GDP as per-capita income increases.

Welfare State Range of policies designed to provide insurance against unemployment, sickness and risks associated with old age.

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6. Useful Internet links

European Union

European Commission	www.europa.eu.int/comm
Directorate General for Economic and Financial Affairs	www.europa.eu.int/comm/dgs/economy_finance/index_en.htm
European Council	www.ue.eu.int/
European Parliament	www.europarl.eu.int/

Economics and Finance Ministries

Belgium	www.treasury.fgov.be/interthes	Ministère des Finances — Ministerie van Financen
Denmark	www.fm.dk	Ministry of Finance
Germany	www.bundesfinanzministerium.de	Bundesministerium der Finanzen
Spain	www.mineco.es/	Ministerio de Economía y Hacienda
France	www.finances.gouv.fr	Ministère Économie, Finances et l'Industrie
Ireland	www.irlgov.ie/finance	Department of Finance
Italy	www.tesoro.it	Ministero dell'Economia e delle Finanze
Luxembourg	www.etat.lu/FI	Ministère des Finances
Netherlands	www.minfin.nl	Ministerie van Financien
Austria	www.bmf.gv.at	Bundesministerium für Finanzen
Portugal	www.min-financas.pt	Ministério das Finanças
Finland	www.vn.fi/vm	Ministry of Finance
Sweden	www.finans.regeringen.se	Finansdepartementet
United Kingdom	www.hm-treasury.gov.uk	Her Majesty's Treasury
Bulgaria	www.minfin.bg	Ministry of Finance
Cyprus	www.mof.gov.cy	Ministry of Finance
Czech Republic	www.mfcr.cz	Ministry of Finance
Estonia	www.fin.ee	Ministry of Finance
Hungary	www.p-m.hu	Ministry of Finance
Latvia	www.fm.gov.lv	Ministry of Finance
Lithuania	www.finmin.lt	Ministry of Finance
Malta	mfea.gov.mt	Ministry of Finance and Economic Affairs
Poland	www.mofnet.gov.pl	Ministry of Finance
Romania	www.mfinante.ro	Ministry of Finance
Slovak Republic		Ministry of Finance
Slovenia	www.sigov1.sigov.si/mf	Ministry of Finance
Turkey	www.maliye.gov.tr	Ministry of Finance
Japan	www.mof.go.jp	Ministry of Finance
United States of America	www.ustreas.gov	Department of the Treasury

Central Banks

European Union	www.ecb.int	European Central Bank
Belgium	www.nbb.be	Banque Nationale de Belgique / Nationale Bank van België
Denmark	www.nationalbanken.dk	Danmarks Nationalbank
Germany	www.bundesbank.de	Deutsche Bundesbank
Greece	www.bankofgreece.gr	Bank of Greece
Spain	www.bde.es	Banco de España
France	www.banque-france.fr	Banque de France
Ireland	www.centralbank.ie	Central Bank of Ireland
Italy	www.bancaditalia.it	Banca d'Italia
Luxembourg	www.bcl.lu	Banque centrale du Luxembourg
Netherlands	www.dnb.nl	De Nederlandsche Bank
Austria	www.oenb.co.at	Oestereichische Nationalbank
Portugal	www.bportugal.pt	Banco de Portugal
Finland	www.bof.fi	Suomen Pankki
Sweden	www.riksbank.com	Sveriges Riksbank
United Kingdom	www.bankofengland.co.uk	Bank of England
Bulgaria	www.bnb.bg	Bulgarian National Bank
Cyprus	www.centralbank.gov.cy	Central bank of Cyprus
Czech Republic	www. cnb.cz	Czech National Bank
Estonia	www.eestipank.info	Eesti Pank
Hungary	www.mnb.hu	National Bank of Hungary
Latvia	www.bank.lv	Bank of Latvia
Lithuania	www.lb.lt	Lietuvos Bankas
Malta	www.centralbankmalta.com	Central Bank of Malta
Poland	www.nbp.pl	Narodowy Bank Polski
Romania	www.buro.ru	National Bank of Romania
Slovak Republic	www.nbs.sk	National Bank of Slovakia
Slovenia	www.bsi.si	Bank of Slovenia
Turkey	www.tcmb.gov.tr	Central Bank of the Republic of Turkey
Japan	www.boj.or.jp	Bank of Japan
United States of America	www.federalreserve.gov	Board of Governors of the Federal Reserve System

Statistical annex

Statistical annex

List of tables

Table A.1.1

Resources and expenditure of general government (% of GDP)

(% of GDP)

Belgium		**ESA 95 definitions** [1]							
		1995	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	13.0	12.9	12.7	12.7	13.0	13.2	13.3	13.3
2.	Current taxes on income and wealth	16.8	17.1	17.1	16.7	16.8	17.1	16.9	16.6
3.	Social contributions	16.3	16.0	16.6	16.6	16.3	16.2	16.0	15.7
4.	*Of which* actual social contributions	14.1	13.9	14.4	14.4	14.1	14.0	13.9	13.6
5.	Other current resources	2.6	3.0	3.0	2.9	2.6	2.8	2.7	2.6
6.	Total current resources	48.6	49.0	49.4	48.9	48.6	49.3	48.8	48.1
7.	Government consumption expenditure	22.9	21.3	22.5	23.0	22.9	23.1	23.1	23.1
8.	*Of which* compensation of employees	12.0	11.5	12.2	12.3	12.0	12.2	12.1	12.0
9.	Collective consumption	8.7	8.3	8.8	8.8	8.7	8.7	8.7	8.7
10.	Social benefits in kind	14.3	13.0	13.7	14.2	14.3	14.4	14.3	14.4
11.	Social transfers other than in kind	16.0	15.2	15.8	16.1	16.0	16.0	15.9	15.8
12.	Interest payments	4.8	6.6	5.8	5.3	4.8	4.4	4.2	3.9
13.	Subsidies	1.2	1.3	1.2	1.4	1.2	1.6	1.8	1.9
14.	Other current expenditure	2.3	2.0	2.1	2.3	2.3	2.3	2.3	2.3
15.	Total current expenditure	47.2	46.3	47.4	48.1	47.2	47.4	47.2	47.0
16.	Gross savings	1.3	2.6	1.9	0.7	1.3	1.8	1.5	1.0
17.	Capital transfers received	0.9	0.5	0.5	2.4	0.9	0.9	0.5	0.5
18.	Total resources	49.4	49.1	49.8	51.2	49.4	50.1	49.3	48.5
19.	Gross fixed capital formation	1.6	2.0	1.7	1.6	1.6	1.8	1.7	1.7
20.	Other capital expenditure	0.7	1.1	0.9	1.5	0.7	0.9	0.8	0.8
21.	Total expenditure	49.5	49.1	49.8	51.1	49.5	50.1	49.7	49.5
22.	Tax burden	46.7	46.9	47.0	46.6	46.7	47.3	47.0	46.4
23.	Net lending (+) or net borrowing (-)	0.0	0.1	0.0	0.1	0.0	0.1	-0.3	-0.9

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.2

Resources and expenditure of general government (% of GDP)

(% of GDP)

Germany (¹)	ESA 95 definitions (²)							
	1995	2000	2002	2003	2004	2005	2006	2007
1. Taxes on production and imports	11.1	11.9	11.7	11.8	11.7	11.8	11.9	12.9
2. Current taxes on income and wealth	11.1	12.5	11.1	10.8	10.6	10.2	10.1	10.2
3. Social contributions	18.8	18.6	18.5	18.5	18.6	18.2	18.0	17.8
4. *Of which* actual social contributions	17.7	17.6	17.5	17.4	17.5	17.2	17.0	16.8
5. Other current resources	3.5	2.9	3.1	3.0	2.9	2.6	2.7	2.5
6. Total current resources	44.8	46.1	44.5	44.2	44.1	42.9	42.7	42.4
7. Government consumption expenditure	19.8	19.0	19.0	19.2	19.2	18.7	18.5	18.2
8. *Of which* compensation of employees	9.0	8.2	8.0	8.0	7.9	7.6	7.6	7.4
9. Collective consumption	8.4	7.9	7.9	8.0	7.9	7.7	7.5	7.3
10. Social benefits in kind	11.4	11.1	11.1	11.3	11.3	11.0	11.0	10.9
11. Social transfers other than in kind	18.1	18.7	18.8	19.4	19.7	19.4	19.3	18.8
12. Interest payments	3.7	3.4	3.3	3.1	3.1	3.0	3.0	3.0
13. Subsidies	2.1	1.7	1.6	1.5	1.4	1.3	1.2	1.2
14. Other current expenditure	1.2	1.7	1.6	1.7	1.8	1.7	1.6	1.6
15. Total current expenditure	44.9	44.5	44.3	45.0	45.2	44.2	43.5	42.8
16. Gross savings	-0.1	1.6	0.2	-0.8	-1.1	-1.2	-0.9	-0.4
17. Capital transfers received	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
18. Total resources	46.1	47.1	45.5	45.1	45.0	43.8	43.6	43.4
19. Gross fixed capital formation	2.3	1.8	1.8	1.7	1.5	1.4	1.4	1.4
20. Other capital expenditure	1.5	-1.1	1.7	1.6	1.6	1.5	1.5	1.4
21. Total expenditure	49.4	45.7	48.3	48.7	48.8	47.5	47.0	46.2
22. Tax burden	42.2	43.8	42.0	41.5	41.6	40.7	40.4	40.3
23. Net lending (+) or net borrowing (-)	-3.3	1.3	-2.8	-3.7	-3.8	-3.7	-3.3	-2.8

(¹) From 1991 including former East Germany.
(²) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
  Line 6 = line 1 + line 2 + line 3 + line 5
  Line 7 = line 9 + line 10
  Line 15 = total of lines 9 to 14
  Line 16 = line 6 - line 15
  Line 18 = line 6 + line 17
  Line 21 = line 15 + line 19 + line 20
  Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.3

Resources and expenditure of general government (% of GDP)

(% of GDP)

		ESA 95 definitions [1]							
Greece		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	13.5	13.3	13.1	13.1	13.3	13.4	13.5	13.8
2.	Current taxes on income and wealth	7.4	12.7	11.8	11.5	11.4	11.6	11.6	11.4
3.	Social contributions	12.6	15.9	15.7	15.8	15.6	15.6	15.6	15.3
4.	*Of which* actual social contributions	10.5	14.8	14.6	14.7	14.5	14.5	14.4	14.2
5.	Other current resources	4.5	3.4	3.6	3.4	3.4	3.4	3.4	3.4
6.	Total current resources	38.1	45.2	44.2	43.8	43.6	44.1	44.1	43.9
7.	Government consumption expenditure	15.3	19.6	20.2	20.5	20.3	20.4	20.4	20.3
8.	*Of which* compensation of employees	11.3	10.4	10.4	10.5	10.4	10.4	10.3	10.2
9.	Collective consumption	9.4	8.0	:	:	:	:	:	:
10.	Social benefits in kind	5.9	11.6	:	:	:	:	:	:
11.	Social transfers other than in kind	15.1	16.2	16.5	16.7	16.6	16.7	16.7	16.5
12.	Interest payments	12.7	3.9	3.5	3.3	3.1	3.0	2.9	3.0
13.	Subsidies	0.4	1.4	1.4	1.4	1.3	1.2	1.2	1.2
14.	Other current expenditure	1.3	1.8	1.9	2.0	2.0	2.0	2.0	2.1
15.	Total current expenditure	44.9	43.0	43.5	43.8	43.3	43.3	43.3	43.0
16.	Gross savings	-6.8	2.2	0.7	-0.1	0.3	0.7	0.7	0.9
17.	Capital transfers received	1.6	0.5	0.5	0.9	0.7	0.7	0.6	0.5
18.	Total resources	40.9	46.3	45.1	45.1	44.7	45.2	45.0	44.8
19.	Gross fixed capital formation	3.2	2.5	2.4	2.5	2.4	2.4	2.5	2.5
20.	Other capital expenditure	1.7	0.2	1.3	1.4	1.3	1.3	1.2	1.2
21.	Total expenditure	51.0	46.3	47.7	48.2	47.5	47.6	47.4	47.2
22.	Tax burden	34.4	42.5	41.0	40.8	40.5	41.0	40.9	40.8
23.	Net lending (+) or net borrowing (-)	-10.2	0.0	-2.5	-3.0	-2.8	-2.4	-2.4	-2.3

[1]   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.4

Resources and expenditure of general government (% of GDP)

(% of GDP)

Spain		ESA 95 definitions ([1])							
		1995	2000	2002	2003	2004	2005	2006	2007
1.	Taxes on production and imports	9.9	11.4	11.2	11.5	11.9	12.1	12.2	12.2
2.	Current taxes on income and wealth	9.9	10.2	10.4	10.1	10.2	11.0	11.0	10.9
3.	Social contributions	12.7	12.9	13.0	13.0	13.0	13.0	12.9	12.8
4.	*Of which* actual social contributions	11.8	12.0	12.1	12.2	12.2	12.1	12.1	12.0
5.	Other current resources	4.0	3.4	3.4	3.3	3.1	3.1	3.1	3.0
6.	Total current resources	36.6	37.8	38.0	38.0	38.3	39.2	39.2	38.9
7.	Government consumption expenditure	17.7	17.2	17.2	17.4	17.8	17.8	17.9	18.0
8.	*Of which* compensation of employees	11.0	10.3	10.0	10.1	10.1	9.9	9.8	9.7
9.	Collective consumption	7.8	7.4	7.3	7.4	7.5	7.5	7.6	7.7
10.	Social benefits in kind	9.9	9.8	9.9	10.0	10.3	10.3	10.3	10.3
11.	Social transfers other than in kind	13.6	12.0	11.8	11.7	11.7	11.6	11.7	11.8
12.	Interest payments	5.1	3.2	2.7	2.4	2.0	1.8	1.6	1.5
13.	Subsidies	1.0	1.1	1.1	1.0	1.0	1.0	0.9	0.9
14.	Other current expenditure	0.9	1.3	1.4	1.5	1.5	1.6	1.7	1.7
15.	Total current expenditure	38.4	34.8	34.1	34.0	34.1	33.8	33.9	34.0
16.	Gross savings	-1.8	3.0	3.9	3.9	4.2	5.3	5.3	4.9
17.	Capital transfers received	1.4	0.6	0.7	0.7	0.8	0.7	0.6	0.4
18.	Total resources	37.6	38.1	38.4	38.3	38.7	39.3	39.3	38.8
19.	Gross fixed capital formation	3.6	3.2	3.5	3.6	3.4	3.6	3.6	3.7
20.	Other capital expenditure	2.4	1.3	1.3	1.1	1.7	1.3	1.3	1.3
21.	Total expenditure	44.1	39.0	38.7	38.3	38.8	38.2	38.3	38.5
22.	Tax burden	33.3	35.0	35.0	35.0	35.4	36.4	36.5	36.3
23.	Net lending (+) or net borrowing (-)	-6.5	-0.9	-0.3	0.0	-0.1	1.1	0.9	0.4

([1]) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
   Line 6 = line 1 + line 2 + line 3 + line 5
   Line 7 = line 9 + line 10
   Line 15 = total of lines 9 to 14
   Line 16 = line 6 - line 15
   Line 18 = line 6 + line 17
   Line 21 = line 15 + line 19 + line 20
   Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.5

Resources and expenditure of general government (% of GDP)

(% of GDP)

France		ESA 95 definitions [1]							
		1995	2000	2002	2003	2004	2005	2006	2007
1.	Taxes on production and imports	15.2	15.2	14.9	15.0	15.3	15.6	15.6	15.6
2.	Current taxes on income and wealth	8.1	12.0	11.3	10.9	11.1	11.4	11.4	11.0
3.	Social contributions	20.3	17.9	18.0	18.1	18.0	18.3	18.4	18.5
4.	*Of which* actual social contributions	18.6	16.1	16.2	16.3	16.2	16.4	16.5	16.6
5.	Other current resources	4.4	3.7	4.0	3.7	3.8	3.8	3.9	4.0
6.	Total current resources	48.0	48.9	48.2	47.7	48.1	49.1	49.4	49.2
7.	Government consumption expenditure	23.6	22.9	23.4	23.7	23.7	23.8	23.8	23.6
8.	*Of which* compensation of employees	13.6	13.3	13.5	13.5	13.3	13.3	13.2	13.0
9.	Collective consumption	9.2	8.6	8.4	8.4	8.4	8.3	8.4	8.3
10.	Social benefits in kind	14.5	14.3	15.0	15.4	15.4	15.5	15.5	15.3
11.	Social transfers other than in kind	17.9	17.1	17.3	17.5	17.6	17.9	18.0	18.0
12.	Interest payments	3.5	2.9	2.9	2.8	2.7	2.6	2.6	2.6
13.	Subsidies	1.6	1.5	1.7	1.6	1.5	1.4	1.4	1.3
14.	Other current expenditure	2.2	2.3	2.6	2.8	2.8	3.0	3.0	3.0
15.	Total current expenditure	48.9	46.7	47.9	48.4	48.3	48.7	48.9	48.6
16.	Gross savings	-0.8	2.2	0.3	-0.8	-0.2	0.3	0.5	0.6
17.	Capital transfers received	0.2	0.3	0.4	0.6	0.6	1.0	0.8	0.8
18.	Total resources	49.0	50.2	49.5	49.2	49.6	51.0	51.0	50.7
19.	Gross fixed capital formation	3.2	3.1	2.9	3.1	3.1	3.3	3.3	3.4
20.	Other capital expenditure	1.7	0.9	0.9	1.0	0.9	1.0	1.0	1.1
21.	Total expenditure	54.5	51.6	52.6	53.4	53.2	53.9	54.1	53.8
22.	Tax burden	44.4	45.7	44.7	44.3	44.5	45.5	45.6	45.4
23.	Net lending (+) or net borrowing (-)	-5.5	-1.5	-3.2	-4.2	-3.7	-2.9	-3.0	-3.1

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
 Line 6 = line 1 + line 2 + line 3 + line 5
 Line 7 = line 9 + line 10
 Line 15 = total of lines 9 to 14
 Line 16 = line 6 - line 15
 Line 18 = line 6 + line 17
 Line 21 = line 15 + line 19 + line 20
 Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.6

Resources and expenditure of general government (% of GDP)

(% of GDP)

Ireland	ESA 95 definitions (¹)							
	1995	2000	2002	2003	2004	2005	2006	2007
1. Taxes on production and imports	13.4	13.1	12.0	12.3	13.0	13.4	13.4	13.4
2. Current taxes on income and wealth	13.5	13.3	11.5	11.8	12.3	12.2	12.0	12.0
3. Social contributions	6.7	5.6	5.7	5.8	6.1	6.2	6.3	6.3
4. *Of which* actual social contributions	4.9	4.4	4.4	4.4	4.6	4.7	4.7	4.7
5. Other current resources	2.8	2.1	2.1	1.9	2.0	2.0	1.9	1.9
6. Total current resources	36.4	34.1	31.2	31.8	33.3	33.9	33.6	33.6
7. Government consumption expenditure	16.3	13.8	15.0	15.3	15.6	15.9	16.2	16.3
8. *Of which* compensation of employees	10.1	8.0	8.6	9.0	9.3	9.9	10.1	10.1
9. Collective consumption	6.5	5.2	5.3	5.3	5.4	5.5	5.6	5.6
10. Social benefits in kind	9.9	8.6	9.7	10.0	10.3	10.4	10.6	10.6
11. Social transfers other than in kind	11.7	8.0	8.7	9.0	9.0	9.9	9.8	9.7
12. Interest payments	5.3	2.0	1.3	1.2	1.2	1.2	1.2	1.2
13. Subsidies	1.0	0.7	0.6	0.6	0.6	0.6	0.6	0.7
14. Other current expenditure	2.1	1.9	2.2	2.0	2.3	2.4	2.3	2.3
15. Total current expenditure	36.4	26.4	27.9	28.1	28.7	30.0	30.1	30.1
16. Gross savings	0.0	7.7	3.4	3.7	4.6	3.9	3.5	3.5
17. Capital transfers received	1.8	1.3	1.2	1.2	1.3	1.1	0.9	0.6
18. Total resources	39.0	35.9	33.0	33.6	35.2	35.5	35.1	34.7
19. Gross fixed capital formation	2.3	3.5	4.2	3.8	3.6	3.4	3.7	4.0
20. Other capital expenditure	1.6	1.1	0.7	0.9	0.7	0.6	0.5	0.5
21. Total expenditure	41.1	31.5	33.4	33.4	33.7	34.5	34.9	35.1
22. Tax burden	34.7	32.7	29.6	30.3	31.6	32.1	31.9	31.9
23. Net lending (+) or net borrowing (-)	-2.1	4.4	-0.4	0.2	1.5	1.0	0.1	-0.4

(¹) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.7

Resources and expenditure of general government (% of GDP)

					ESA 95 definitions [1]				
Italy		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	11.8	14.7	14.3	14.0	14.1	14.2	14.2	14.2
2.	Current taxes on income and wealth	14.5	14.4	13.9	13.4	13.3	13.3	13.6	13.5
3.	Social contributions	14.4	12.4	12.5	12.6	12.7	12.9	12.7	12.7
4.	*Of which* actual social contributions	12.7	12.1	12.2	12.4	12.5	12.6	12.5	12.5
5.	Other current resources	3.0	3.0	3.5	3.4	3.6	3.5	3.5	3.5
6.	Total current resources	43.7	44.6	44.1	43.4	43.7	44.0	44.1	44.0
7.	Government consumption expenditure	17.4	17.9	19.2	19.7	19.8	20.3	20.2	20.1
8.	*Of which* compensation of employees	10.9	10.4	10.6	10.8	10.8	11.0	11.0	10.9
9.	Collective consumption	7.1	6.9	:	:	:	:	:	:
10.	Social benefits in kind	10.3	11.0	:	:	:	:	:	:
11.	Social transfers other than in kind	16.3	16.4	16.5	16.8	16.9	17.1	17.3	17.3
12.	Interest payments	11.2	6.3	5.5	5.1	4.7	4.6	4.5	4.8
13.	Subsidies	1.4	1.2	1.1	1.1	1.0	0.9	0.9	0.9
14.	Other current expenditure	1.0	1.3	1.4	1.5	1.6	1.6	1.7	1.7
15.	Total current expenditure	47.4	43.2	43.8	44.2	44.1	44.5	44.6	44.7
16.	Gross savings	-3.7	1.4	0.2	-0.9	-0.4	-0.6	-0.5	-0.8
17.	Capital transfers received	0.8	0.4	0.4	1.7	0.8	0.4	0.4	0.3
18.	Total resources	44.6	45.3	44.4	44.8	44.3	44.0	44.0	43.8
19.	Gross fixed capital formation	2.1	2.3	1.7	2.5	2.4	2.4	2.5	2.5
20.	Other capital expenditure	2.4	0.2	1.9	1.8	1.5	1.7	1.4	1.6
21.	Total expenditure	52.0	46.0	47.4	48.3	47.8	48.2	48.1	48.4
22.	Tax burden	41.3	42.1	41.0	40.3	40.4	40.7	40.8	40.8
23.	Net lending (+) or net borrowing (-)	-7.4	-0.7	-2.9	-3.4	-3.4	-4.1	-4.1	-4.5

[1]   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.8

Resources and expenditure of general government (% of GDP)

(% of GDP)

Luxembourg		ESA 95 definitions (¹)							
		1995	2000	2002	2003	2004	2005	2006	2007
1.	Taxes on production and imports	11.0	13.5	12.5	12.3	13.6	13.6	13.3	13.0
2.	Current taxes on income and wealth	15.3	14.9	15.2	14.7	13.2	13.7	14.0	14.4
3.	Social contributions	10.9	10.9	11.7	11.7	11.7	11.8	11.7	11.8
4.	*Of which* actual social contributions	9.8	10.1	10.9	10.8	10.7	10.9	10.8	10.9
5.	Other current resources	4.8	4.3	3.9	3.5	3.5	3.1	3.0	2.9
6.	Total current resources	42.0	43.6	43.4	42.2	42.0	42.2	42.0	42.1
7.	Government consumption expenditure	15.9	15.1	16.3	16.5	16.9	17.5	17.4	17.3
8.	*Of which* compensation of employees	8.5	7.5	8.0	8.1	8.3	8.2	8.1	8.0
9.	Collective consumption	6.8	6.3	6.6	6.7	6.7	7.1	7.1	7.0
10.	Social benefits in kind	9.2	8.9	9.6	9.8	10.2	10.4	10.3	10.2
11.	Social transfers other than in kind	14.4	13.1	14.6	15.0	15.0	15.0	14.9	14.8
12.	Interest payments	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1
13.	Subsidies	1.6	1.5	1.5	1.5	1.6	1.7	1.6	1.6
14.	Other current expenditure	2.4	2.9	2.8	3.1	3.7	3.6	3.5	3.5
15.	Total current expenditure	34.7	33.0	35.5	36.3	37.3	37.9	37.6	37.4
16.	Gross savings	7.3	10.5	7.9	5.9	4.7	4.3	4.4	4.7
17.	Capital transfers received	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3
18.	Total resources	42.1	43.5	43.4	42.2	42.1	42.4	42.2	42.3
19.	Gross fixed capital formation	3.8	3.8	4.8	4.6	4.4	4.7	4.7	4.8
20.	Other capital expenditure	1.3	1.0	1.3	1.3	1.6	1.8	1.7	1.7
21.	Total expenditure	39.8	37.7	41.4	42.1	43.2	44.3	44.0	43.8
22.	Tax burden	38.1	39.8	39.7	38.9	38.7	39.3	39.2	39.4
23.	Net lending (+) or net borrowing (-)	2.3	5.9	2.0	0.2	-1.1	-1.9	-1.8	-1.5

(¹)   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
   Line 6 = line 1 + line 2 + line 3 + line 5
   Line 7 = line 9 + line 10
   Line 15 = total of lines 9 to 14
   Line 16 = line 6 - line 15
   Line 18 = line 6 + line 17
   Line 21 = line 15 + line 19 + line 20
   Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.9

Resources and expenditure of general government (% of GDP)

(% of GDP)

The Netherlands	ESA 95 definitions [1]							
	1995	2000	2002	2003	2004	2005	2006	2007
1. Taxes on production and imports	10.3	11.6	12.1	12.2	12.5	12.7	12.7	12.5
2. Current taxes on income and wealth	11.9	11.6	11.4	10.7	10.5	11.7	11.0	11.1
3. Social contributions	16.5	16.4	14.3	14.8	15.0	14.3	15.7	15.4
4. *Of which* actual social contributions	15.4	15.4	13.3	13.8	14.0	13.3	14.6	14.4
5. Other current resources	5.7	4.6	4.9	4.8	4.9	5.2	5.3	5.4
6. Total current resources	44.4	44.2	42.7	42.4	42.9	43.8	44.7	44.6
7. Government consumption expenditure	23.0	21.8	23.7	24.4	24.3	24.0	25.5	25.3
8. *Of which* compensation of employees	10.3	9.6	9.8	10.1	10.0	9.9	9.6	9.5
9. Collective consumption	11.1	10.2	10.6	10.8	10.6	10.4	10.2	10.1
10. Social benefits in kind	12.0	11.5	13.1	13.6	13.7	13.6	15.3	15.2
11. Social transfers other than in kind	14.7	11.3	11.2	11.5	11.5	11.2	11.7	11.4
12. Interest payments	5.6	3.7	2.9	2.7	2.6	2.5	2.3	2.3
13. Subsidies	1.0	1.4	1.5	1.4	1.4	1.3	1.2	1.2
14. Other current expenditure	1.1	1.6	1.8	1.7	1.9	2.0	1.8	1.7
15. Total current expenditure	45.5	39.8	40.9	41.6	41.6	40.9	42.5	41.9
16. Gross savings	-1.1	4.4	1.8	0.7	1.3	2.9	2.1	2.6
17. Capital transfers received	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
18. Total resources	45.3	45.6	44.2	43.9	44.5	45.4	46.5	46.4
19. Gross fixed capital formation	2.8	3.0	3.5	3.4	3.1	3.0	2.9	2.8
20. Other capital expenditure	0.4	-0.3	0.7	0.8	0.6	0.6	0.8	1.0
21. Total expenditure	49.3	43.4	46.2	47.1	46.6	45.7	47.7	47.1
22. Tax burden	39.8	40.5	38.4	38.1	38.5	39.1	39.4	39.2
23. Net lending (+) or net borrowing (-)	-4.0	2.1	-2.0	-3.1	-1.9	-0.3	-1.2	-0.7

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.10

Resources and expenditure of general government (% of GDP)

(% of GDP)

Austria	ESA 95 definitions (¹)							
	1995	2000	2002	2003	2004	2005	2006	2007
1. Taxes on production and imports	13.9	14.4	14.3	14.7	14.5	14.5	14.3	14.3
2. Current taxes on income and wealth	11.6	13.1	15.0	14.0	13.5	13.4	12.8	11.5
3. Social contributions	17.1	16.6	16.5	16.3	16.3	16.1	16.1	16.0
4. *Of which* actual social contributions	14.9	14.7	14.7	14.6	14.6	14.5	14.5	14.5
5. Other current resources	4.9	3.2	4.0	3.8	3.8	3.6	3.6	3.6
6. Total current resources	47.5	47.2	49.7	48.8	48.0	47.5	46.7	45.4
7. Government consumption expenditure	20.1	18.4	18.2	18.2	18.2	18.0	18.0	17.9
8. *Of which* compensation of employees	12.5	10.9	9.7	9.6	9.6	9.3	9.2	9.1
9. Collective consumption	8.1	7.3	7.3	7.1	7.2	6.9	7.0	6.8
10. Social benefits in kind	12.0	11.1	10.9	11.0	11.1	11.1	11.1	11.1
11. Social transfers other than in kind	19.5	18.5	18.6	19.0	19.2	18.9	18.7	18.5
12. Interest payments	3.8	3.5	3.4	3.1	2.9	2.8	2.8	2.7
13. Subsidies	2.8	2.8	3.0	2.9	3.2	3.0	2.9	2.7
14. Other current expenditure	2.2	2.2	2.9	2.8	2.7	2.5	2.5	2.3
15. Total current expenditure	48.4	45.4	46.2	46.0	46.3	45.2	44.8	44.0
16. Gross savings	-1.0	1.6	3.4	2.7	1.6	2.2	1.8	1.3
17. Capital transfers received	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
18. Total resources	50.3	49.8	50.7	50.0	49.2	48.8	48.0	46.6
19. Gross fixed capital formation	3.0	1.5	1.1	1.3	1.2	1.1	1.1	1.1
20. Other capital expenditure	2.0	2.0	2.5	2.3	2.3	2.5	2.5	2.4
21. Total expenditure	56.0	51.4	50.8	50.7	50.9	50.0	49.6	48.7
22. Tax burden	43.5	44.7	46.4	45.5	44.7	44.2	43.4	42.1
23. Net lending (+) or net borrowing (-)	-5.6	-1.5	0.0	-0.5	-1.5	-1.1	-1.5	-1.9

(¹) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.11

Resources and expenditure of general government (% of GDP)

(% of GDP)

		ESA 95 definitions [1]							
Portugal		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	12.9	13.5	14.2	14.8	14.3	15.3	16.0	16.1
2.	Current taxes on income and wealth	8.4	9.8	9.3	8.7	8.7	8.6	8.9	9.1
3.	Social contributions	10.4	11.2	11.7	12.3	12.4	12.5	12.4	12.3
4.	*Of which* actual social contributions	9.6	10.3	10.8	11.2	11.3	11.3	11.3	11.3
5.	Other current resources	3.9	3.3	3.6	3.5	3.7	3.5	3.7	3.7
6.	Total current resources	35.7	37.8	38.8	39.3	39.1	39.9	41.0	41.3
7.	Government consumption expenditure	17.7	19.3	20.0	20.4	20.6	21.1	20.9	20.8
8.	*Of which* compensation of employees	12.9	14.2	14.7	14.3	14.4	14.5	14.2	14.0
9.	Collective consumption	7.2	7.7	7.9	8.0	8.1	8.3	8.2	8.2
10.	Social benefits in kind	10.4	11.6	12.1	12.4	12.5	12.8	12.7	12.6
11.	Social transfers other than in kind	11.2	11.7	12.6	13.8	14.2	14.8	15.3	15.5
12.	Interest payments	5.9	3.0	2.9	2.7	2.6	2.7	2.9	3.1
13.	Subsidies	1.3	1.2	1.5	1.8	1.6	1.6	1.5	1.5
14.	Other current expenditure	1.6	1.9	2.0	1.9	2.3	2.5	2.5	2.4
15.	Total current expenditure	37.6	37.2	39.1	40.7	41.3	42.8	43.1	43.3
16.	Gross savings	-2.0	0.6	-0.3	-1.4	-2.2	-2.8	-2.1	-2.0
17.	Capital transfers received	1.8	1.4	1.7	2.7	3.6	1.4	1.4	1.3
18.	Total resources	37.6	40.2	41.4	42.9	43.2	41.8	43.0	43.1
19.	Gross fixed capital formation	3.5	3.8	3.5	3.1	3.0	3.1	2.9	2.8
20.	Other capital expenditure	1.5	1.2	0.7	1.1	1.5	1.5	1.4	1.2
21.	Total expenditure	42.8	43.1	44.3	45.9	46.4	47.8	48.0	48.0
22.	Tax burden	32.7	35.1	35.5	36.1	35.6	36.6	37.4	37.6
23.	Net lending (+) or net borrowing (-)	-5.2	-2.9	-2.9	-2.9	-3.2	-6.0	-5.0	-4.9

[1]   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.12

Resources and expenditure of general government (% of GDP)

(% of GDP)

Finland		1995	2000	2002	2003	2004	2005	2006	2007
		ESA 95 definitions (¹)							
1.	Taxes on production and imports	13.5	13.6	13.4	13.9	13.8	14.0	14.0	14.0
2.	Current taxes on income and wealth	17.2	21.3	18.8	17.7	17.6	17.8	17.2	17.0
3.	Social contributions	14.7	12.2	12.0	11.9	11.8	12.2	12.4	12.3
4.	*Of which* actual social contributions	14.4	12.2	12.0	11.9	11.8	12.2	12.4	12.3
5.	Other current resources	7.2	6.0	5.9	5.8	5.9	5.9	6.1	5.9
6.	Total current resources	52.5	53.2	50.1	49.4	49.1	49.9	49.7	49.1
7.	Government consumption expenditure	22.7	20.5	21.0	21.7	21.9	22.5	22.5	22.5
8.	*Of which* compensation of employees	15.1	13.1	13.2	13.6	13.6	13.8	13.8	13.7
9.	Collective consumption	8.5	7.5	7.4	7.6	7.6	7.8	7.7	7.7
10.	Social benefits in kind	14.3	13.1	13.6	14.1	14.3	14.7	14.8	14.8
11.	Social transfers other than in kind	21.9	16.4	16.3	16.7	16.6	16.6	16.4	16.2
12.	Interest payments	4.0	2.8	2.1	1.7	1.5	1.5	1.4	1.3
13.	Subsidies	2.7	1.5	1.3	1.3	1.3	1.3	1.3	1.3
14.	Other current expenditure	2.0	2.5	2.5	2.7	2.7	2.8	2.8	2.8
15.	Total current expenditure	53.3	43.7	43.3	44.2	44.0	44.8	44.4	44.2
16.	Gross savings	-0.7	9.5	6.8	5.0	4.9	5.0	5.1	4.8
17.	Capital transfers received	0.2	0.4	0.4	0.4	0.4	0.4	0.3	0.3
18.	Total resources	55.3	55.8	52.9	52.4	52.4	53.1	52.7	52.1
19.	Gross fixed capital formation	2.7	2.5	2.7	2.9	2.9	2.8	2.7	2.7
20.	Other capital expenditure	2.9	0.4	0.4	0.2	0.3	0.1	0.1	0.1
21.	Total expenditure	61.4	48.8	48.8	50.0	50.3	50.7	50.1	49.8
22.	Tax burden	46.0	47.6	44.4	43.9	43.5	44.3	43.8	43.5
23.	Net lending (+) or net borrowing (-)	-6.2	7.0	4.1	2.5	2.3	2.6	2.8	2.5

(¹) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
   Line 6 = line 1 + line 2 + line 3 + line 5
   Line 7 = line 9 + line 10
   Line 15 = total of lines 9 to 14
   Line 16 = line 6 - line 15
   Line 18 = line 6 + line 17
   Line 21 = line 15 + line 19 + line 20
   Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.13

Resources and expenditure of general government (% of GDP)

	Czech Republic	ESA 95 definitions [1]							
		1995	2000	2002	2003	2004	2005	2006	2007
1.	Taxes on production and imports	12.1	11.4	10.9	11.1	11.7	12.0	11.9	11.8
2.	Current taxes on income and wealth	9.5	8.3	9.2	9.6	9.7	9.5	9.5	9.5
3.	Social contributions	14.2	14.3	15.0	15.1	15.0	15.2	15.2	15.1
4.	*Of which* actual social contributions	14.2	14.3	15.0	15.1	15.0	15.2	15.2	15.1
5.	Other current resourses	6.8	6.6	6.3	6.3	6.2	5.9	6.1	6.0
6.	Total current resources	42.7	40.7	41.4	42.0	42.7	42.5	42.8	42.4
7.	Government consumption expenditure	21.5	21.8	22.5	23.4	22.4	22.4	21.7	20.8
8.	*Of which* compensation of employees	7.3	7.1	7.8	8.3	8.0	8.1	8.0	7.9
9.	Collective consumption	10.4	11.4	11.1	11.8	11.1	11.2	10.7	10.3
10.	Social benefits in kind	11.0	10.5	11.4	11.5	11.3	11.3	11.0	10.6
11.	Social transfers other than in kind	10.6	12.1	12.5	12.2	11.8	11.6	11.7	12.8
12.	Interest payments	1.1	0.9	1.3	1.2	1.2	1.2	1.4	1.4
13.	Subsidies	2.8	2.8	2.3	2.6	2.1	1.9	2.7	2.7
14.	Other current expenditure	1.0	0.9	0.9	1.2	1.2	1.4	1.5	1.4
15.	Total current expenditure	37.0	38.5	39.4	40.6	38.7	38.5	39.0	39.1
16.	Gross savings	5.7	2.2	2.0	1.4	4.1	4.1	4.0	3.3
17.	Capital transfers received	0.5	0.2	0.2	0.3	0.4	0.2	0.2	0.2
18.	Total resources	40.5	38.0	39.9	40.7	41.4	41.1	40.8	40.4
19.	Gross fixed capital formation	5.0	2.9	3.9	4.5	4.9	4.5	6.5	6.8
20.	Other capital expenditure	14.4	3.0	5.1	3.7	2.4	2.4	0.9	0.1
21.	Total expenditure	53.8	41.6	46.7	47.3	44.3	43.7	44.1	43.9
22.	Tax burden	35.8	34.1	35.1	35.7	36.7	37.0	37.1	36.9
23.	Net lending (+) or net borrowing (-)	-13.2	-3.6	-6.8	-6.6	-2.9	-2.6	-3.2	-3.4

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.14

Resources and expenditure of general government (% of GDP)

Denmark		ESA 95 definitions (1)							
		1995	2000	2002	2003	2004	2005	2006	2007
1.	Taxes on production and imports	16.8	17.0	17.4	17.1	17.4	17.6	17.2	16.9
2.	Current taxes on income and wealth	30.7	30.3	29.1	29.1	30.0	30.9	29.4	29.0
3.	Social contributions	2.9	3.6	3.1	3.2	3.1	2.9	2.9	2.8
4.	*Of which* actual social contributions	1.9	2.8	2.2	2.3	2.2	2.1	2.0	2.0
5.	Other current resources	5.2	4.2	4.1	4.2	4.5	4.1	3.8	3.6
6.	Total current resources	55.6	55.0	53.7	53.6	54.9	55.5	53.2	52.3
7.	Government consumption expenditure	25.2	25.1	26.2	26.3	26.5	25.8	25.3	25.0
8.	*Of which* compensation of employees	17.2	17.1	17.8	17.9	17.8	17.3	17.0	16.8
9.	Collective consumption	8.2	8.0	8.0	8.0	8.0	7.7	7.6	7.5
10.	Social benefits in kind	17.0	17.2	18.2	18.4	18.5	18.1	17.7	17.6
11.	Social transfers other than in kind	19.5	16.2	16.4	17.0	16.9	16.2	16.0	15.8
12.	Interest payments	5.9	3.6	2.9	2.5	2.2	1.9	1.8	1.5
13.	Subsidies	2.7	2.4	2.5	2.3	2.3	2.3	2.3	2.2
14.	Other current expenditure	2.4	2.8	2.7	2.7	2.7	2.6	2.4	2.3
15.	Total current expenditure	55.7	50.1	50.8	50.9	50.6	48.9	47.7	46.8
16.	Gross savings	-0.1	4.8	2.8	2.5	4.1	6.4	5.3	5.3
17.	Capital transfers received	0.5	0.5	0.6	0.5	0.8	0.5	0.5	0.5
18.	Total resources	57.2	56.8	55.7	55.6	57.2	57.4	54.7	53.8
19.	Gross fixed capital formation	1.8	1.7	1.8	1.6	1.9	1.7	1.7	1.6
20.	Other capital expenditure	0.7	0.5	0.6	0.6	0.5	0.5	0.3	0.3
21.	Total expenditure	59.2	53.6	54.7	54.8	54.6	52.7	50.9	50.0
22.	Tax burden	50.6	51.0	49.7	49.6	50.7	51.6	49.6	49.0
23.	Net lending (+) or net borrowing (-)	-2.0	3.3	1.2	1.0	2.7	4.9	3.9	4.0

(¹)   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
      Line 6 = line 1 + line 2 + line 3 + line 5
      Line 7 = line 9 + line 10
      Line 15 = total of lines 9 to 14
      Line 16 = line 6 - line 15
      Line 18 = line 6 + line 17
      Line 21 = line 15 + line 19 + line 20
      Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.15

Resources and expenditure of general government (% of GDP)

(% of GDP)

		ESA 95 definitions [1]							
Estonia		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	13.9	12.9	13.1	13.0	12.8	14.0	13.7	13.3
2.	Current taxes on income and wealth	10.9	8.1	7.9	8.6	8.5	7.4	7.2	7.1
3.	Social contributions	13.1	11.6	11.6	11.4	11.2	11.0	10.6	10.4
4.	*Of which* actual social contributions	13.1	11.6	11.5	11.3	11.1	10.9	10.5	10.3
5.	Other current resources	8.9	4.1	4.4	4.2	4.3	3.5	3.1	2.9
6.	Total current resources	46.8	36.7	36.9	37.2	36.7	35.9	34.6	33.7
7.	Government consumption expenditure	27.4	20.2	19.2	19.4	19.0	18.2	17.7	17.5
8.	*Of which* compensation of employees	11.7	11.0	10.1	10.5	10.3	9.8	9.5	9.2
9.	Collective consumption	12.0	9.4	8.8	8.7	8.4	8.1	7.9	7.8
10.	Social benefits in kind	15.4	10.8	10.4	10.7	10.6	10.1	9.8	9.7
11.	Social transfers other than in kind	10.0	9.8	9.2	9.4	10.0	9.6	9.5	9.6
12.	Interest payments	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
13.	Subsidies	0.7	1.0	0.9	0.9	1.5	1.0	0.8	0.7
14.	Other current expenditure	1.4	0.9	0.7	0.8	1.3	1.8	1.1	1.2
15.	Total current expenditure	39.7	32.3	30.2	30.7	32.0	30.9	29.3	29.1
16.	Gross savings	7.1	4.6	6.7	6.5	4.8	5.0	5.2	4.6
17.	Capital transfers received	0.0	0.3	0.2	0.8	0.2	0.7	1.4	1.5
18.	Total resources	44.0	37.9	37.8	39.1	37.9	37.5	37.3	36.8
19.	Gross fixed capital formation	5.0	3.9	4.7	4.3	3.0	4.0	4.0	4.1
20.	Other capital expenditure	1.8	1.4	1.2	0.7	0.5	0.1	1.1	1.2
21.	Total expenditure	43.6	38.3	36.8	36.7	36.4	35.9	35.8	35.9
22.	Tax burden	37.9	32.6	32.5	33.0	32.6	32.7	31.6	31.1
23.	Net lending (+) or net borrowing (-)	0.4	-0.4	1.0	2.4	1.5	1.6	1.4	0.8

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.16

Resources and expenditure of general government (% of GDP)

Cyprus		1995	2000	2002	2003	2004	2005	2006	2007
					ESA 95 definitions (¹)				
1.	Taxes on production and imports	:	12.7	13.4	16.5	17.4	17.5	17.4	17.3
2.	Current taxes on income and wealth	:	11.1	11.2	9.7	8.2	9.4	9.5	9.5
3.	Social contributions	:	6.7	6.8	7.1	7.8	8.4	8.1	8.1
4.	*Of which* actual social contributions	:	6.7	6.8	7.1	7.8	8.4	8.1	8.1
5.	Other current resourses	:	3.2	2.9	4.0	3.7	4.2	4.7	4.7
6.	Total current resources	:	33.7	34.4	37.2	37.1	39.5	39.6	39.6
7.	Government consumption expenditure	:	16.4	18.4	19.9	18.2	18.3	18.0	18.0
8.	*Of which* compensation of employees	:	13.8	13.9	15.7	15.1	14.9	14.5	14.4
9.	Collective consumption	:	8.4	10.1	10.9	9.9	10.0	9.8	9.8
10.	Social benefits in kind	:	8.0	8.3	9.0	8.2	8.3	8.2	8.2
11.	Social transfers other than in kind	:	9.1	10.3	11.4	12.2	12.9	11.4	11.4
12.	Interest payments	:	3.4	3.2	3.4	3.2	3.4	3.1	3.0
13.	Subsidies	:	1.4	1.1	1.2	1.1	0.7	0.7	0.7
14.	Other current expenditure	:	2.3	2.4	3.5	3.0	3.8	4.8	4.8
15.	Total current expenditure	:	32.6	35.3	39.5	37.8	39.1	38.0	37.9
16.	Gross savings	:	1.1	-0.9	-2.3	-0.6	0.4	1.6	1.7
17.	Capital transfers received	:	0.1	0.0	0.1	0.8	1.0	0.3	0.3
18.	Total resources	:	35.3	36.1	39.1	39.7	42.3	41.8	41.8
19.	Gross fixed capital formation	:	3.0	3.0	3.4	4.1	3.2	3.4	3.4
20.	Other capital expenditure	:	0.6	0.6	0.7	0.2	0.7	0.6	0.6
21.	Total expenditure	:	37.7	40.6	45.3	43.8	44.7	43.9	43.8
22.	Tax burden	:	30.5	31.4	33.2	33.4	35.3	34.9	34.9
23.	Net lending (+) or net borrowing (-)	:	-2.4	-4.5	-6.3	-4.1	-2.4	-2.1	-2.0

(¹)   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
  Line 6 = line 1 + line 2 + line 3 + line 5
  Line 7 = line 9 + line 10
  Line 15 = total of lines 9 to 14
  Line 16 = line 6 - line 15
  Line 18 = line 6 + line 17
  Line 21 = line 15 + line 19 + line 20
  Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.17

Resources and expenditure of general government (% of GDP)

(% of GDP)

Lithuania		**ESA 95 definitions** [1]							
		1995	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	12.3	12.6	12.4	11.8	11.1	11.2	11.2	11.0
2.	Current taxes on income and wealth	8.8	8.4	7.5	8.0	8.7	9.1	9.0	8.7
3.	Social contributions	7.6	9.4	8.7	8.6	8.7	8.6	8.3	8.2
4.	*Of which* actual social contributions	7.6	9.3	8.6	8.5	8.4	8.3	8.1	8.0
5.	Other current resourses	6.3	5.8	3.9	3.2	2.9	3.1	3.1	2.9
6.	Total current resources	34.9	36.1	32.6	31.5	31.5	32.0	31.6	30.8
7.	Government consumption expenditure	21.9	21.7	19.4	18.4	18.0	16.8	16.3	16.0
8.	*Of which* compensation of employees	10.1	12.7	11.4	10.8	10.8	10.4	10.1	10.0
9.	Collective consumption	9.9	9.0	7.8	7.6	7.5	7.1	6.9	6.8
10.	Social benefits in kind	12.0	12.7	11.6	10.8	10.5	9.7	9.4	9.2
11.	Social transfers other than in kind	8.6	10.6	9.3	9.1	9.1	9.0	8.8	8.7
12.	Interest payments	0.4	1.7	1.3	1.2	0.9	0.8	0.7	0.7
13.	Subsidies	1.1	0.8	0.8	0.8	0.5	0.7	0.7	0.7
14.	Other current expenditure	0.0	0.3	0.1	0.2	1.1	2.3	2.7	2.7
15.	Total current expenditure	32.0	35.1	30.9	29.8	29.6	29.6	29.3	28.8
16.	Gross savings	2.9	1.0	1.6	1.8	1.8	2.4	2.3	2.0
17.	Capital transfers received	:	0.1	0.5	0.4	0.5	0.8	0.8	0.8
18.	Total resources	34.2	35.8	32.9	31.9	31.9	33.1	32.0	30.7
19.	Gross fixed capital formation	3.4	2.4	2.9	3.0	3.4	3.5	3.5	3.5
20.	Other capital expenditure	:	2.3	0.6	0.4	0.3	0.2	0.2	0.2
21.	Total expenditure	36.1	39.3	34.3	33.2	33.4	33.7	32.6	31.7
22.	Tax burden	28.6	30.3	28.6	28.3	28.7	29.1	28.7	28.1
23.	Net lending (+) or net borrowing (-)	-1.9	-3.6	-1.4	-1.2	-1.5	-0.5	-0.6	-0.9

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
   Line 6 = line 1 + line 2 + line 3 + line 5
   Line 7 = line 9 + line 10
   Line 15 = total of lines 9 to 14
   Line 16 = line 6 - line 15
   Line 18 = line 6 + line 17
   Line 21 = line 15 + line 19 + line 20
   Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.18

Resources and expenditure of general government (% of GDP)

(% of GDP)

Latvia		**ESA 95 definitions** (¹)							
		1995	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	14.1	12.3	11.2	12.1	11.8	12.6	12.4	12.4
2.	Current taxes on income and wealth	7.1	7.3	7.7	7.5	7.9	8.0	8.1	8.1
3.	Social contributions	12.0	10.1	9.5	9.1	8.9	8.7	8.6	8.5
4.	*Of which* actual social contributions	12.0	9.9	9.3	8.9	8.7	8.5	8.4	8.3
5.	Other current resourses	6.3	7.4	6.6	6.0	5.7	4.9	4.6	4.4
6.	Total current resources	39.5	37.1	35.0	34.7	34.3	34.4	33.7	33.3
7.	Government consumption expenditure	24.1	20.8	21.0	21.4	19.6	17.8	17.9	17.6
8.	*Of which* compensation of employees	11.2	10.8	10.5	10.7	10.5	10.2	10.0	9.9
9.	Collective consumption	11.8	10.3	10.6	11.2	10.3	9.4	9.4	9.3
10.	Social benefits in kind	12.3	10.5	10.3	10.3	9.3	8.4	8.5	8.4
11.	Social transfers other than in kind	12.7	12.4	10.1	9.4	9.2	8.8	8.7	8.6
12.	Interest payments	1.2	1.0	0.7	0.7	0.7	0.6	0.6	0.6
13.	Subsidies	1.2	1.0	0.7	0.8	0.6	0.5	0.6	0.6
14.	Other current expenditure	0.1	1.7	1.5	0.7	1.3	2.5	2.4	2.3
15.	Total current expenditure	39.3	36.8	34.0	33.1	31.5	30.2	30.3	29.7
16.	Gross savings	0.2	0.2	1.0	1.6	2.8	4.2	3.5	3.6
17.	Capital transfers received	0.5	0.7	0.3	0.1	0.5	1.3	1.6	2.0
18.	Total resources	36.8	34.7	33.4	33.5	34.9	36.4	36.1	36.1
19.	Gross fixed capital formation	1.9	1.3	1.3	1.5	1.9	2.1	2.7	3.2
20.	Other capital expenditure	0.8	2.4	2.3	1.4	2.4	3.2	3.3	3.4
21.	Total expenditure	38.8	37.5	35.6	34.6	35.9	36.2	37.1	37.1
22.	Tax burden	33.2	29.7	28.4	28.7	28.8	29.4	29.0	28.8
23.	Net lending (+) or net borrowing (-)	-2.0	-2.8	-2.3	-1.2	-0.9	0.2	-1.0	-1.0

(¹) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.19

Resources and expenditure of general government (% of GDP)

Hungary		**ESA 95 definitions** [1]							
		1995	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	17.7	16.3	15.1	15.8	16.2	15.6	14.8	14.4
2.	Current taxes on income and wealth	9.3	9.8	10.3	9.7	9.2	9.2	9.1	9.0
3.	Social contributions	15.5	13.2	13.7	13.6	13.6	14.1	13.8	13.1
4.	*Of which* actual social contributions	:	13.1	13.7	13.5	13.5	14.0	13.7	13.0
5.	Other current resourses	:	6.0	5.7	5.6	6.1	6.3	6.1	5.8
6.	Total current resources	:	45.3	44.8	44.6	45.1	45.2	43.7	42.3
7.	Government consumption expenditure	23.4	21.4	23.4	24.6	23.8	23.7	23.6	23.3
8.	*Of which* compensation of employees	12.1	10.7	12.4	13.3	12.8	12.7	12.7	12.5
9.	Collective consumption	10.9	10.1	10.9	11.2	10.7	10.5	10.4	10.2
10.	Social benefits in kind	12.5	11.2	12.4	13.4	13.1	13.1	13.2	13.0
11.	Social transfers other than in kind	15.7	12.7	13.5	14.0	14.1	14.8	15.4	15.3
12.	Interest payments	:	5.4	3.9	3.9	4.2	3.8	3.7	3.7
13.	Subsidies	2.1	1.7	1.8	1.5	1.6	1.6	1.5	1.5
14.	Other current expenditure	:	1.6	2.0	1.9	2.3	3.1	3.2	3.2
15.	Total current expenditure	:	42.7	44.6	45.9	46.1	46.9	47.4	46.9
16.	Gross savings	:	2.5	0.2	-1.2	-1.0	-1.8	-3.8	-4.6
17.	Capital transfers received	:	0.4	0.5	0.4	0.5	0.8	0.9	1.3
18.	Total resources	:	44.3	43.7	43.4	44.1	44.5	43.1	42.2
19.	Gross fixed capital formation	:	3.3	5.0	3.5	3.6	3.4	2.7	2.6
20.	Other capital expenditure	:	2.7	4.1	2.1	1.3	1.7	1.2	1.1
21.	Total expenditure	:	46.7	52.0	49.8	49.5	50.6	49.8	49.2
22.	Tax burden	42.5	39.3	39.1	39.0	39.0	38.9	37.6	36.5
23.	Net lending (+) or net borrowing (-)	:	-2.3	-8.4	-6.4	-5.4	-6.1	-6.7	-7.0

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.20

Resources and expenditure of general government (% of GDP)

(% of GDP)

Malta		1995	2000	2002	2003	2004	2005	2006	2007
					ESA 95 definitions [1]				
1.	Taxes on production and imports	:	12.6	13.4	11.4	13.3	17.5	13.2	15.5
2.	Current taxes on income and wealth	:	9.2	11.2	7.9	12.1	9.4	10.0	11.9
3.	Social contributions	:	7.6	6.8	7.5	8.2	8.4	8.4	8.7
4.	*Of which* actual social contributions	:	6.4	6.8	6.1	6.7	8.4	6.9	7.1
5.	Other current resourses	:	5.7	2.9	6.5	6.3	4.2	6.0	4.5
6.	Total current resources	:	35.1	34.4	33.3	39.9	39.5	37.7	40.6
7.	Government consumption expenditure	:	19.2	18.4	20.1	21.8	18.3	20.6	21.4
8.	*Of which* compensation of employees	:	13.0	13.9	14.4	15.2	14.9	14.8	14.5
9.	Collective consumption	:	8.9	10.1	9.3	10.2	10.0	9.9	10.0
10.	Social benefits in kind	:	10.3	8.3	10.9	11.6	8.3	10.7	11.5
11.	Social transfers other than in kind	:	11.9	10.3	12.6	12.9	12.9	12.5	13.3
12.	Interest payments	:	3.6	3.2	3.2	3.7	3.4	3.5	3.8
13.	Subsidies	:	1.4	1.1	2.2	2.2	0.7	1.6	2.1
14.	Other current expenditure	:	1.3	2.4	0.6	1.5	3.8	1.6	1.9
15.	Total current expenditure	:	37.5	35.3	38.7	42.1	39.1	39.8	42.7
16.	Gross savings	:	-2.4	-0.9	-5.4	-2.2	0.4	-2.1	-2.2
17.	Capital transfers received	:	1.1	0.0	0.9	0.6	1.0	0.3	4.2
18.	Total resources	:	35.0	36.1	33.2	39.2	42.3	36.8	42.4
19.	Gross fixed capital formation	:	4.2	3.0	4.9	5.2	3.2	3.7	4.6
20.	Other capital expenditure	:	0.8	0.6	0.5	3.4	0.7	0.8	0.5
21.	Total expenditure	:	41.2	40.6	43.1	49.4	44.7	43.2	45.3
22.	Tax burden	:	29.4	31.4	26.8	33.6	35.3	31.7	36.3
23.	Net lending (+) or net borrowing (-)	:	-6.2	-4.5	-9.9	-10.2	-2.4	-6.4	-2.9

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.21

Resources and expenditure of general government (% of GDP)

Poland		1995	2000	2002	2003	2004	2005	2006	2007
				ESA 95 definitions (¹)					
1.	Taxes on production and imports	14.2	12.6	13.2	13.2	12.8	13.9	14.3	14.9
2.	Current taxes on income and wealth	11.7	7.2	6.9	6.6	6.4	7.1	7.1	7.0
3.	Social contributions	11.3	14.4	14.5	14.0	13.4	13.8	14.2	13.6
4.	*Of which* actual social contributions	11.3	14.4	14.5	14.0	13.4	13.8	14.2	13.6
5.	Other current resources	5.7	4.9	5.7	5.5	5.6	5.7	5.2	4.6
6.	Total current resources	42.9	39.0	40.3	39.3	38.3	40.5	40.8	40.1
7.	Government consumption expenditure	18.7	17.5	18.0	18.3	17.9	18.7	17.5	17.2
8.	*Of which* compensation of employees	10.7	10.1	10.8	10.7	10.2	10.1	10.1	9.8
9.	Collective consumption	9.2	7.5	8.0	8.0	8.2	8.7	8.0	7.9
10.	Social benefits in kind	9.5	10.0	10.0	10.2	9.7	10.0	9.5	9.3
11.	Social transfers other than in kind	17.0	16.0	17.0	17.0	16.1	15.9	16.3	15.8
12.	Interest payments	5.7	3.0	2.7	2.8	2.6	2.4	2.5	2.6
13.	Subsidies	0.8	0.5	0.4	0.3	0.3	0.3	1.0	0.9
14.	Other current expenditure	1.1	0.5	1.2	1.2	1.2	1.8	2.2	2.2
15.	Total current expenditure	43.3	37.8	39.3	39.5	38.1	39.1	39.5	38.7
16.	Gross savings	-0.4	1.5	1.0	-0.2	0.2	1.3	1.4	1.4
17.	Capital transfers received	0.1	-0.1	-0.2	-0.1	-0.2	0.0	0.5	0.3
18.	Total resources	43.3	39.6	41.0	39.9	38.6	40.8	41.6	40.7
19.	Gross fixed capital formation	3.3	2.4	3.4	3.3	3.4	3.1	4.0	4.1
20.	Other capital expenditure	0.8	0.5	0.5	1.1	0.5	0.7	0.8	0.7
21.	Total expenditure	47.7	41.0	44.2	44.6	42.5	43.3	44.6	43.7
22.	Tax burden	37.2	34.2	34.6	33.8	32.7	34.8	35.6	35.5
23.	Net lending (+) or net borrowing (-)	-2.2	-1.5	-3.2	-4.7	-3.9	-2.5	-3.0	-3.0

(¹) The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.22

Resources and expenditure of general government (% of GDP)

(% of GDP)

	Slovenia		ESA 95 definitions [1]							
		1995	2000	2002	2003	2004	2005	2006	2007
1.	Taxes on production and imports	:	16.3	16.4	16.6	16.2	16.2	16.1	16.0
2.	Current taxes on income and wealth	:	7.5	7.9	8.2	8.4	8.6	8.8	9.0
3.	Social contributions	:	15.0	15.1	15.0	15.0	15.2	15.0	14.8
4.	*Of which* actual social contributions	:	14.7	14.8	14.7	14.7	14.9	14.8	14.5
5.	Other current resourses	:	3.7	3.9	3.7	4.0	4.0	4.0	4.0
6.	Total current resources	:	42.5	43.3	43.4	43.7	44.0	44.0	43.8
7.	Government consumption expenditure	:	19.3	19.7	19.6	19.5	19.6	19.4	19.1
8.	*Of which* compensation of employees	:	11.6	12.0	12.1	12.0	12.1	11.9	11.7
9.	Collective consumption	:	7.9	7.9	7.8	7.7	7.8	7.6	7.5
10.	Social benefits in kind	:	11.4	11.8	11.8	11.8	11.9	11.7	11.6
11.	Social transfers other than in kind	:	17.0	17.1	17.0	16.9	16.9	16.8	16.9
12.	Interest payments	:	2.5	2.4	2.1	1.9	1.6	1.5	1.4
13.	Subsidies	:	1.5	1.3	1.7	1.6	1.6	1.6	1.6
14.	Other current expenditure	:	1.3	1.5	1.2	1.8	1.9	2.3	2.5
15.	Total current expenditure	:	42.1	42.0	41.6	41.6	41.7	41.6	41.5
16.	Gross savings	:	0.9	1.4	1.8	2.1	2.2	2.4	2.3
17.	Capital transfers received	:	0.2	0.2	0.1	0.2	0.2	0.2	0.2
18.	Total resources	:	44.3	45.4	45.2	45.3	45.5	45.5	45.3
19.	Gross fixed capital formation	:	3.1	3.0	3.3	3.4	3.3	3.4	3.3
20.	Other capital expenditure	:	1.8	1.2	1.4	1.2	0.9	1.0	0.8
21.	Total expenditure	:	48.1	48.0	48.1	47.6	47.3	47.3	47.0
22.	Tax burden	:	38.8	39.4	39.7	39.9	40.0	40.0	39.8
23.	Net lending (+) or net borrowing (-)	:	-3.9	-2.7	-2.8	-2.3	-1.8	-1.9	-1.6

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.23

Resources and expenditure of general government (% of GDP)

		ESA 95 definitions [1]							
Sweden		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	15.4	16.3	16.8	17.0	16.9	17.0	17.0	16.9
2.	Current taxes on income and wealth	19.9	22.2	17.8	18.6	19.4	19.9	19.3	19.2
3.	Social contributions	13.6	15.0	15.3	15.0	14.6	14.7	14.5	14.4
4.	*Of which* actual social contributions	13.0	14.4	14.6	14.2	13.9	13.9	13.8	13.7
5.	Other current resources	8.1	5.8	4.9	4.9	4.7	4.9	4.8	4.7
6.	Total current resources	57.0	59.3	54.9	55.4	55.6	56.5	55.6	55.2
7.	Government consumption expenditure	27.0	26.4	27.8	28.1	27.4	27.3	27.3	27.1
8.	*Of which* compensation of employees	16.6	15.6	16.1	16.5	16.3	16.1	15.9	15.8
9.	Collective consumption	8.3	8.3	8.3	8.3	8.0	8.0	8.0	7.9
10.	Social benefits in kind	18.7	18.0	19.5	19.8	19.3	19.3	19.3	19.2
11.	Social transfers other than in kind	20.4	17.3	17.3	18.1	17.8	17.4	17.2	16.9
12.	Interest payments	6.7	4.0	2.9	2.0	1.6	1.6	1.8	1.8
13.	Subsidies	3.7	1.6	1.5	1.5	1.4	1.5	1.6	1.5
14.	Other current expenditure	2.0	2.3	2.3	2.5	2.5	2.6	2.9	2.8
15.	Total current expenditure	59.7	51.5	51.9	52.3	50.9	50.6	50.6	50.2
16.	Gross savings	-2.6	7.7	2.7	2.9	4.5	5.7	4.8	4.9
17.	Capital transfers received	0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.1
18.	Total resources	60.2	61.8	57.5	58.0	58.3	59.1	58.2	57.7
19.	Gross fixed capital formation	3.9	2.9	3.2	3.1	3.0	3.0	3.0	3.0
20.	Other capital expenditure	0.6	0.1	0.2	0.2	0.1	0.2	-0.1	-0.1
21.	Total expenditure	67.1	56.8	57.9	58.2	56.7	56.4	56.1	55.6
22.	Tax burden	49.5	54.0	50.3	50.9	51.2	51.9	51.1	50.8
23.	Net lending (+) or net borrowing (-)	-7.0	5.0	-0.2	0.1	1.8	2.9	2.2	2.3

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
   Line 6 = line 1 + line 2 + line 3 + line 5
   Line 7 = line 9 + line 10
   Line 15 = total of lines 9 to 14
   Line 16 = line 6 - line 15
   Line 18 = line 6 + line 17
   Line 21 = line 15 + line 19 + line 20
   Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.24

Resources and expenditure of general government (% of GDP)

		ESA 95 definitions [1]							
Slovakia		**1995**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
1.	Taxes on production and imports	15.6	13.0	11.8	12.0	11.5	11.8	11.8	11.5
2.	Current taxes on income and wealth	11.6	7.6	7.4	7.4	7.2	5.7	5.6	5.4
3.	Social contributions	14.4	13.8	13.7	13.6	12.4	12.4	12.5	12.0
4.	*Of which* actual social contributions	14.3	13.7	13.7	13.5	12.3	12.4	12.5	12.0
5.	Other current resourses	13.8	15.1	14.3	13.8	6.0	4.8	5.7	5.5
6.	Total current resources	55.4	49.5	47.2	46.9	37.2	34.7	35.6	34.4
7.	Government consumption expenditure	20.5	19.8	20.1	20.1	19.9	19.4	19.4	19.2
8.	*Of which* compensation of employees	9.5	8.8	8.9	9.2	9.0	8.6	8.5	8.2
9.	Collective consumption	16.2	10.9	11.3	11.3	11.0	10.8	10.8	10.7
10.	Social benefits in kind	4.4	8.9	8.9	8.8	8.9	8.7	8.6	8.6
11.	Social transfers other than in kind	12.2	12.3	12.0	11.8	11.4	9.7	9.4	9.1
12.	Interest payments	2.3	4.1	4.0	3.6	2.5	2.2	2.4	2.2
13.	Subsidies	4.8	2.5	2.2	1.6	1.7	1.7	1.7	1.7
14.	Other current expenditure	8.0	10.1	9.0	10.6	2.2	2.1	3.1	2.7
15.	Total current expenditure	47.9	48.9	47.3	47.6	37.8	35.2	35.9	34.9
16.	Gross savings	7.5	0.6	-0.1	-0.7	-0.6	-0.5	-0.3	-0.5
17.	Capital transfers received	1.0	0.4	0.4	0.5	0.0	0.4	0.5	0.4
18.	Total resources	53.3	47.6	45.5	45.2	35.4	35.1	36.1	34.8
19.	Gross fixed capital formation	2.3	2.8	3.1	3.3	2.6	2.6	2.6	2.4
20.	Other capital expenditure	6.9	10.5	3.1	2.2	0.5	0.7	1.4	1.5
21.	Total expenditure	54.1	59.9	51.5	50.9	39.2	38.5	39.9	38.8
22.	Tax burden	41.6	34.3	32.9	33.1	31.2	:	:	:
23.	Net lending (+) or net borrowing (-)	-0.9	-12.3	-6.0	-5.7	-3.7	-3.3	-3.8	-4.0

[1] The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
Line 6 = line 1 + line 2 + line 3 + line 5
Line 7 = line 9 + line 10
Line 15 = total of lines 9 to 14
Line 16 = line 6 - line 15
Line 18 = line 6 + line 17
Line 21 = line 15 + line 19 + line 20
Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.25

Resources and expenditure of general government (% of GDP)

		ESA 95 definitions [1]							
United Kingdom		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	12.9	13.3	13.0	13.0	13.1	12.9	12.8	13.0
2.	Current taxes on income and wealth	14.7	16.4	15.4	14.9	15.2	16.1	17.0	17.3
3.	Social contributions	7.4	7.6	7.4	8.0	8.2	8.5	8.5	8.6
4.	*Of which* actual social contributions	6.7	6.8	6.6	7.4	7.6	7.9	8.0	8.0
5.	Other current resources	2.9	2.4	2.3	2.2	2.1	2.0	2.2	2.3
6.	Total current resources	37.8	39.7	38.0	38.0	38.5	39.5	40.5	41.1
7.	Government consumption expenditure	19.2	18.5	19.8	20.7	20.9	21.4	22.0	22.1
8.	*Of which* compensation of employees	10.6	9.9	10.1	10.2	10.7	11.0	11.3	11.4
9.	Collective consumption	8.2	7.5	7.8	8.2	8.1	8.3	8.5	8.5
10.	Social benefits in kind	11.0	10.9	12.0	12.5	12.8	13.1	13.5	13.6
11.	Social transfers other than in kind	15.1	13.0	13.0	13.1	13.1	13.2	13.0	12.8
12.	Interest payments	3.6	2.8	2.0	2.0	2.0	2.2	2.0	2.1
13.	Subsidies	0.7	0.5	0.5	0.6	0.6	0.6	0.5	0.5
14.	Other current expenditure	1.7	2.2	2.6	2.9	3.1	3.4	3.2	3.4
15.	Total current expenditure	40.5	36.9	37.9	39.2	39.6	40.7	40.8	40.8
16.	Gross savings	-2.7	2.8	0.1	-1.2	-1.1	-1.2	-0.2	0.2
17.	Capital transfers received	0.2	0.3	0.3	0.3	0.4	0.6	0.4	0.4
18.	Total resources	38.5	40.6	39.3	39.3	39.9	41.3	42.2	42.7
19.	Gross fixed capital formation	2.2	1.2	1.5	1.6	1.8	2.0	2.2	2.4
20.	Other capital expenditure	1.2	-1.9	0.6	0.7	0.7	0.8	1.0	1.0
21.	Total expenditure	44.3	36.8	40.9	42.5	43.2	44.8	45.2	45.5
22.	Tax burden	35.9	37.9	36.2	36.2	36.7	37.8	38.6	39.1
23.	Net lending (+) or net borrowing (-)	-5.8	3.7	-1.6	-3.3	-3.3	-3.5	-3.0	-2.8

[1]   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
  Line 6 = line 1 + line 2 + line 3 + line 5
  Line 7 = line 9 + line 10
  Line 15 = total of lines 9 to 14
  Line 16 = line 6 - line 15
  Line 18 = line 6 + line 17
  Line 21 = line 15 + line 19 + line 20
  Line 23 = line 18 - line 21.

Source: Commission services.

Table A.1.26

Resources and expenditure of general government (% of GDP)

		ESA 95 definitions [2]							
Euro area [1]		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
1.	Taxes on production and imports	12.2	13.3	13.1	13.1	13.3	13.4	13.5	13.8
2.	Current taxes on income and wealth	11.1	12.7	11.8	11.5	11.4	11.6	11.6	11.4
3.	Social contributions	17.1	15.9	15.7	15.8	15.6	15.6	15.6	15.3
4.	*Of which* actual social contributions	15.7	14.8	14.6	14.7	14.5	14.5	14.4	14.2
5.	Other current resources	4.0	3.4	3.6	3.4	3.4	3.4	3.4	3.4
6.	Total current resources (1 + 2 + 3 + 5)	44.3	45.2	44.2	43.8	43.6	44.1	44.1	43.9
7.	Government consumption expenditure (9 + 10)	20.2	19.6	20.2	20.5	20.3	20.4	20.4	20.3
8.	*Of which* compensation of employees	10.9	10.4	10.4	10.5	10.4	10.4	10.3	10.2
9.	Collective consumption	8.5	8.0	:	:	:	:	:	:
10.	Social benefits in kind	11.7	11.6	:	:	:	:	:	:
11.	Social transfers other than in kind	16.9	16.2	16.5	16.7	16.6	16.7	16.7	16.5
12.	Interest	5.4	3.9	3.5	3.3	3.1	3.0	2.9	3.0
13.	Subsidies	1.7	1.4	1.4	1.4	1.3	1.2	1.2	1.2
14.	Other current expenditure	1.5	1.8	1.9	2.0	2.0	2.0	2.0	2.1
15.	Total current expenditure (9 to 14)	45.6	43.0	43.5	43.8	43.3	43.3	43.3	43.0
16.	Gross savings (6 - 15)	-1.3	2.2	0.7	-0.1	0.3	0.7	0.7	0.9
17.	Capital transfers received	0.6	0.5	0.5	0.9	0.7	0.7	0.6	0.5
18.	Total resources (6 + 17)	45.5	46.3	45.1	45.1	44.7	45.2	45.0	44.8
19.	Gross fixed capital formation	2.6	2.5	2.4	2.5	2.4	2.4	2.5	2.5
20.	Other capital expenditure	1.7	0.2	1.3	1.4	1.3	1.3	1.2	1.2
21.	Total Expenditure (15 + 19 + 20)	50.5	46.3	47.7	48.2	47.5	47.6	47.4	47.2
22.	Tax burden	41.2	42.5	41.0	40.8	40.5	41.0	40.9	40.8
23.	Net lending (+) or net borrowing (-) (18 - 21)	-5.0	0.0	-2.5	-3.0	-2.8	-2.4	-2.4	-2.3

[1]   Due to problem with availability of the data, Luxembourg data are not included.
[2]   The table is based on ESA 95 definitions. The totals are obtained in ESA 95 as follows:
    Line 6 = line 1 + line 2 + line 3 + line 5
    Line 7 = line 9 + line 10
    Line 15 = total of lines 9 to 14
    Line 16 = line 6 - line 15
    Line 18 = line 6 + line 17
    Line 21 = line 15 + line 19 + line 20
    Line 23 = line 18 - line 21.

Source: Commission services.

Table A.2.1

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Belgium									
1.	Net borrowing ([1])	4.4	0.0	0.1	0.0	0.1	0.1	0.4	1.0
2.	Interest payments	8.9	6.6	5.8	5.4	4.9	4.5	4.3	4.0
3.	Implicit interest rate ([2])	7.0	6.1	5.6	5.3	5.1	4.8	4.6	4.6
4.	Nominal GDP growth rate (%)	3.6	5.7	3.4	2.6	4.9	3.5	4.3	4.2
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) ([1])	4.4	0.0	0.1	0.0	0.1	0.1	0.4	1.0
6.	Contribution of nominal GDP growth	-4.6	-6.1	-3.5	-2.6	-4.6	-3.2	-3.8	-3.6
7.	Stock-flow adjustment ([3])	-1.5	0.3	0.4	-2.0	0.8	1.9	0.0	0.0
Budgetary constraint based on the primary deficit									
8.	Primary deficit ([4])	-4.5	-6.7	-5.7	-5.4	-4.8	-4.5	-3.8	-3.1
9.	Snow-ball effect	4.3	0.5	2.3	2.7	0.2	1.2	0.3	0.3
10.	Stock-flow adjustment ([3])	-1.5	0.3	0.4	-2.0	0.8	1.9	0.0	0.0
11.	Change in gross debt ([5])	-1.8	-5.9	-3.1	-4.7	-3.8	-1.4	-3.5	-2.8
12.	Level of gross debt (end of year)	129.7	107.7	103.2	98.5	94.7	93.3	89.8	87.0
Germany									
1.	Net borrowing ([1])	3.2	-1.3	3.7	4.0	3.7	3.3	3.1	2.5
2.	Interest payments	3.5	3.2	2.9	3.0	2.8	2.8	2.8	2.8
3.	Implicit interest rate ([2])	7.6	5.4	5.1	5.0	4.6	4.4	4.2	4.2
4.	Nominal GDP growth rate (%)	3.8	2.5	1.5	0.9	2.4	1.3	2.1	2.1
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) ([1])	3.2	-1.3	3.7	4.0	3.7	3.3	3.1	2.5
6.	Contribution of nominal GDP growth	-1.8	-1.5	-0.9	-0.5	-1.5	-0.9	-1.4	-1.4
7.	Stock-flow adjustment ([3])	6.1	1.9	-1.3	0.1	-0.5	-0.2	-0.6	-0.6
Budgetary constraint based on the primary deficit									
8.	Primary deficit ([4])	-0.3	-4.5	0.8	1.0	0.8	0.5	0.3	-0.3
9.	Snow-ball effect	1.7	1.7	2.1	2.5	1.3	1.9	1.4	1.4
10.	Stock-flow adjustment ([3])	6.1	1.9	-1.3	0.1	-0.5	-0.2	-0.6	-0.6
11.	Change in gross debt ([5])	7.5	-0.9	1.5	3.6	1.7	2.2	1.1	0.4
12.	Level of gross debt (end of year)	55.5	59.2	60.3	63.8	65.5	67.7	68.9	69.2

([1])   Line 1 = line 5, a minus sign means a surplus
([2])   Actual interest payments as a percentage of gross debt at the end of t-1
([3])   Line 7 = line 10
([4])   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
([5])   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.2

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Greece									
1.	Net borrowing (¹)	10.2	4.1	5.0	5.8	6.8	4.4	2.9	3.5
2.	Interest payments	12.7	8.1	6.1	5.5	5.3	4.8	4.8	4.9
3.	Implicit interest rate (²)	13.2	7.9	5.7	5.3	5.5	5.0	4.9	5.0
4.	Nominal GDP growth rate (%)	12.1	10.4	7.8	8.4	8.3	7.5	6.6	6.5
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (¹)	10.2	4.1	5.0	5.8	6.8	4.4	2.9	3.5
6.	Contribution of nominal GDP growth	-11.6	-10.6	-8.2	-8.6	-8.2	-7.6	-6.7	-6.4
7.	Stock-flow adjustment (³)	2.2	5.8	0.8	-0.1	2.0	2.1	1.2	0.0
Budgetary constraint based on the primary deficit									
8.	Primary deficit (⁴)	-2.6	-4.0	-1.1	0.3	1.5	-0.5	-1.9	-1.4
9.	Snow-ball effect	1.1	-2.5	-2.2	-3.1	-2.8	-2.6	-1.8	-1.5
10.	Stock-flow adjustment (³)	2.2	5.8	0.8	-0.1	2.0	2.1	1.2	0.0
11.	Change in gross debt (⁵)	0.8	-0.8	-2.5	-2.9	0.7	-1.0	-2.5	-2.9
12.	Level of gross debt (end of year)	108.7	111.6	110.7	107.8	108.5	107.5	105.0	102.1
Spain									
1.	Net borrowing (¹)	6.5	0.9	0.3	0.0	0.2	-1.1	-0.9	-0.4
2.	Interest payments	5.1	3.2	2.7	2.4	2.1	1.8	1.7	1.5
3.	Implicit interest rate (²)	9.2	5.7	5.2	4.8	4.5	4.2	4.1	4.1
4.	Nominal GDP growth rate (%)	7.8	8.7	7.2	7.1	7.3	8.0	7.5	6.4
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (¹)	6.5	0.9	0.3	0.0	0.2	-1.1	-0.9	-0.4
6.	Contribution of nominal GDP growth	-4.3	-4.9	-3.8	-3.5	-3.3	-3.4	-3.0	-2.4
7.	Stock-flow adjustment (³)	0.5	1.7	0.4	-0.2	0.7	1.3	0.8	0.7
Budgetary constraint based on the primary deficit									
8.	Primary deficit (⁴)	1.4	-2.4	-2.4	-2.3	-1.9	-2.9	-2.6	-1.9
9.	Snow-ball effect	0.8	-1.7	-1.1	-1.1	-1.3	-1.7	-1.3	-0.9
10.	Stock-flow adjustment (³)	0.5	1.7	0.4	-0.2	0.7	1.3	0.8	0.7
11.	Change in gross debt (⁵)	2.7	-2.4	-3.1	-3.7	-2.5	-3.2	-3.1	-2.1
12.	Level of gross debt (end of year)	62.5	59.2	52.5	48.9	46.4	43.2	40.0	37.9

(¹) Line 1 = line 5, a minus sign means a surplus
(²) Actual interest payments as a percentage of gross debt at the end of t-1
(³) Line 7 = line 10
(⁴) Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(⁵) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.3

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
France									
1.	Net borrowing (^{1})	5.5	1.5	3.2	4.2	3.7	2.9	3.0	3.1
2.	Interest payments	3.5	2.9	2.9	2.8	2.7	2.7	2.7	2.7
3.	Implicit interest rate (^{2})	7.4	5.2	5.3	4.9	4.4	4.2	4.0	4.1
4.	Nominal GDP growth rate (%)	3.4	5.5	3.4	2.4	4.0	2.8	3.4	3.9
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	5.5	1.5	3.2	4.2	3.7	2.9	3.0	3.1
6.	Contribution of nominal GDP growth	-1.6	-3.0	-1.9	-1.7	-2.4	-1.7	-2.2	-2.5
7.	Stock-flow adjustment (^{3})	2.3	0.0	0.8	1.6	0.8	1.2	-0.7	-0.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	2.0	-1.4	0.3	1.4	1.0	0.2	0.4	0.4
9.	Snow-ball effect	1.9	-0.2	1.0	1.1	0.3	0.9	0.4	0.1
10.	Stock-flow adjustment (^{3})	2.3	0.0	0.8	1.6	0.8	1.2	-0.7	-0.4
11.	Change in gross debt (^{5})	6.2	-1.6	2.1	4.1	2.1	2.3	0.1	0.2
12.	Level of gross debt (end of year)	55.1	56.7	58.2	62.4	64.4	66.8	66.9	67.0
Ireland									
1.	Net borrowing (^{1})	2.1	-4.4	0.4	-0.2	-1.6	-1.0	-0.1	0.4
2.	Interest payments	5.3	1.9	1.3	1.2	1.2	1.2	1.2	1.2
3.	Implicit interest rate (^{2})	6.7	4.7	4.2	4.0	4.1	4.3	4.6	4.6
4.	Nominal GDP growth rate (%)	13.0	15.2	11.4	6.6	6.8	7.9	7.8	8.1
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	2.1	-4.4	0.4	-0.2	-1.6	-1.0	-0.1	0.4
6.	Contribution of nominal GDP growth	-10.2	-6.3	-3.6	-2.0	-2.0	-2.2	-2.0	-2.0
7.	Stock-flow adjustment (^{3})	0.6	0.5	0.0	1.2	1.9	1.3	1.7	1.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-3.2	-6.3	-0.9	-1.4	-2.7	-2.2	-1.3	-0.8
9.	Snow-ball effect	-4.9	-4.4	-2.3	-0.8	-0.8	-1.0	-0.8	-0.9
10.	Stock-flow adjustment (^{3})	0.6	0.5	0.0	1.2	1.9	1.3	1.7	1.4
11.	Change in gross debt (^{5})	-7.6	-10.2	-3.2	-1.0	-1.6	-1.9	-0.4	-0.2
12.	Level of gross debt (end of year)	81.0	37.8	32.1	31.1	29.4	27.6	27.2	27.0

(^{1})   Line 1 = line 5, a minus sign means a surplus
(^{2})   Actual interest payments as a percentage of gross debt at the end of t-1
(^{3})   Line 7 = line 10
(^{4})   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5})   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.4

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Italy									
1.	Net borrowing (^{1})	7.4	0.8	3.0	3.5	3.5	4.3	4.1	4.5
2.	Interest payments	11.2	6.4	5.7	5.2	4.8	4.7	4.5	4.8
3.	Implicit interest rate (^{2})	10.0	5.9	5.3	5.0	4.7	4.5	4.4	4.6
4.	Nominal GDP growth rate (%)	7.9	5.7	3.7	3.1	4.0	2.0	3.4	3.3
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	7.4	0.8	3.0	3.5	3.5	4.3	4.1	4.5
6.	Contribution of nominal GDP growth	-8.9	-6.1	-3.9	-3.2	-4.0	-2.1	-3.5	-3.4
7.	Stock-flow adjustment (^{3})	1.2	0.8	-2.1	-1.6	0.2	0.5	0.5	-0.8
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-3.8	-5.6	-2.7	-1.7	-1.3	-0.4	-0.5	-0.2
9.	Snow-ball effect	2.3	0.2	1.6	2.0	0.7	2.5	1.0	1.3
10.	Stock-flow adjustment (^{3})	1.2	0.8	-2.1	-1.6	0.2	0.5	0.5	-0.8
11.	Change in gross debt (^{5})	-0.3	-4.6	-3.2	-1.3	-0.4	2.6	1.1	0.3
12.	Level of gross debt (end of year)	121.2	109.2	105.5	104.2	103.8	106.4	107.4	107.7
Luxembourg									
1.	Net borrowing (^{1})	-2.3	-5.9	-2.0	-0.2	1.1	1.9	1.8	1.5
2.	Interest payments	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1
3.	Implicit interest rate (^{2})	8.1	6.8	4.8	3.4	2.9	2.3	2.3	1.7
4.	Nominal GDP growth rate (%)	3.8	10.6	6.4	6.9	5.3	5.6	7.6	7.5
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	-2.3	-5.9	-2.0	-0.2	1.1	1.9	1.8	1.5
6.	Contribution of nominal GDP growth	-0.2	-0.5	-0.4	-0.4	-0.3	-0.4	-0.4	-0.6
7.	Stock-flow adjustment (^{3})	2.8	6.1	2.4	0.4	-0.6	-2.0	0.3	-0.6
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-2.7	-6.2	-2.3	-0.4	1.0	1.8	1.7	1.4
9.	Snow-ball effect	0.2	-0.2	-0.1	-0.2	-0.1	-0.2	-0.3	-0.4
10.	Stock-flow adjustment (^{3})	2.8	6.1	2.4	0.4	-0.6	-2.0	0.3	-0.6
11.	Change in gross debt (^{5})	0.3	-0.3	0.0	-0.2	0.3	-0.4	1.7	0.3
12.	Level of gross debt (end of year)	5.8	5.3	6.5	6.3	6.6	6.2	7.9	8.2

(^{1}) Line 1 = line 5, a minus sign means a surplus
(^{2}) Actual interest payments as a percentage of gross debt at the end of t-1
(^{3}) Line 7 = line 10
(^{4}) Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5}) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.5

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
The Netherlands									
1.	Net borrowing (^{1})	4.0	-2.1	2.0	3.2	2.1	0.3	1.2	0.7
2.	Interest payments	5.6	3.7	2.8	2.7	2.6	2.4	2.4	2.3
3.	Implicit interest rate (^{2})	8.1	6.5	5.9	5.5	5.2	4.9	4.6	4.7
4.	Nominal GDP growth rate (%)	5.1	7.5	3.9	2.4	2.6	2.7	3.9	4.0
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	4.0	-2.1	2.0	3.2	2.1	0.3	1.2	0.7
6.	Contribution of nominal GDP growth	-3.6	-4.2	-1.9	-1.2	-1.3	-1.4	-2.0	-2.0
7.	Stock-flow adjustment (^{3})	0.4	-0.6	-0.2	-0.6	0.1	1.5	-0.9	0.4
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-1.7	-5.8	-0.8	0.5	-0.5	-2.2	-1.2	-1.6
9.	Snow-ball effect	2.1	-0.6	1.0	1.5	1.3	1.1	0.3	0.3
10.	Stock-flow adjustment (^{3})	0.4	-0.6	-0.2	-0.6	0.1	1.5	-0.9	0.4
11.	Change in gross debt (^{5})	0.8	-6.9	-0.2	1.4	0.7	0.4	-1.7	-0.9
12.	Level of gross debt (end of year)	74.0	53.6	50.5	51.9	52.6	52.9	51.2	50.3
Austria									
1.	Net borrowing (^{1})	5.7	1.6	0.7	1.7	1.2	1.6	2.0	1.5
2.	Interest payments	3.9	3.7	3.3	3.1	2.9	2.9	2.8	2.7
3.	Implicit interest rate (^{2})	6.3	5.5	4.8	4.5	4.6	4.5	4.4	4.4
4.	Nominal GDP growth rate (%)	3.9	5.2	2.2	2.8	4.4	4.0	4.4	4.0
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	5.7	1.6	0.7	1.7	1.2	1.6	2.0	1.5
6.	Contribution of nominal GDP growth	-2.4	-3.3	-1.4	-1.8	-2.7	-2.4	-2.6	-2.4
7.	Stock-flow adjustment (^{3})	1.3	1.1	0.8	-1.3	0.8	0.3	0.2	0.2
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	1.8	-2.0	-2.6	-1.4	-1.7	-1.2	-0.8	-1.3
9.	Snow-ball effect	1.4	0.2	1.7	1.1	0.1	0.3	0.0	0.2
10.	Stock-flow adjustment (^{3})	1.3	1.1	0.8	-1.3	0.8	0.3	0.2	0.2
11.	Change in gross debt (^{5})	4.6	-0.7	-0.2	-1.6	-0.8	-0.6	-0.5	-0.9
12.	Level of gross debt (end of year)	67.9	65.8	66.0	64.4	63.6	62.9	62.4	61.6

(^{1})   Line 1 = line 5, a minus sign means a surplus
(^{2})   Actual interest payments as a percentage of gross debt at the end of t-1
(^{3})   Line 7 = line 10
(^{4})   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5})   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.6

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Portugal									
1.	Net borrowing (^{1})	5.2	3.0	2.9	3.0	3.2	6.0	5.0	4.9
2.	Interest payments	5.9	3.1	2.9	2.8	2.7	2.7	2.9	3.1
3.	Implicit interest rate (^{2})	10.9	6.2	5.6	5.0	4.8	4.8	4.7	4.7
4.	Nominal GDP growth rate (%)	7.9	7.1	4.7	1.5	3.9	3.1	2.7	3.9
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	5.2	3.0	2.9	3.0	3.2	6.0	5.0	4.9
6.	Contribution of nominal GDP growth	-4.3	-3.4	-2.4	-0.8	-2.1	-1.8	-1.7	-2.6
7.	Stock-flow adjustment (^{3})	1.2	-0.5	2.1	-0.6	0.5	1.0	1.1	0.0
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-0.7	-0.1	0.0	0.2	0.5	3.3	2.1	1.8
9.	Snow-ball effect	1.6	-0.4	0.5	1.9	0.5	1.0	1.3	0.5
10.	Stock-flow adjustment (^{3})	1.2	-0.5	2.1	-0.6	0.5	1.0	1.1	0.0
11.	Change in gross debt (^{5})	2.1	-1.0	2.6	1.5	1.6	5.2	4.5	2.3
12.	Level of gross debt (end of year)	61.0	50.4	55.5	57.0	58.7	63.9	68.4	70.6
Finland									
1.	Net borrowing (^{1})	6.2	-7.0	-4.1	-2.3	-2.1	-2.4	-2.6	-2.4
2.	Interest payments	3.9	2.8	2.1	1.9	1.8	1.7	1.5	1.5
3.	Implicit interest rate (^{2})	7.5	6.6	5.1	4.3	3.6	3.4	3.5	3.5
4.	Nominal GDP growth rate (%)	8.4	8.2	3.2	2.1	4.1	3.7	4.4	3.7
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	6.2	-7.0	-4.1	-2.3	-2.1	-2.4	-2.6	-2.4
6.	Contribution of nominal GDP growth	-4.4	-3.5	-2.3	-0.6	-1.8	-1.0	-1.7	-1.5
7.	Stock-flow adjustment (^{3})	-2.6	8.2	4.3	6.1	4.0	0.4	3.0	2.7
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	2.2	-9.8	-6.2	-4.2	-3.8	-4.1	-4.1	-3.9
9.	Snow-ball effect	-0.5	-0.7	-0.1	1.2	-0.2	0.5	-0.3	-0.1
10.	Stock-flow adjustment (^{3})	-2.6	8.2	4.3	6.1	4.0	0.4	3.0	2.7
11.	Change in gross debt (^{5})	-0.9	-2.3	-2.1	3.1	-0.1	-3.2	-1.4	-1.3
12.	Level of gross debt (end of year)	56.5	44.3	41.3	44.3	44.3	41.1	39.7	38.3

(^{1})   Line 1 = line 5, a minus sign means a surplus
(^{2})   Actual interest payments as a percentage of gross debt at the end of t-1
(^{3})   Line 7 = line 10
(^{4})   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5})   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.7

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Czech Republic									
1.	Net borrowing (^{1})	13.2	3.6	6.8	6.6	2.8	2.6	3.1	3.4
2.	Interest payments	1.1	0.9	1.2	1.1	1.2	1.2	1.3	1.4
3.	Implicit interest rate (^{2})	:	5.7	5.2	4.2	4.3	4.0	4.9	4.8
4.	Nominal GDP growth rate (%)	16.8	5.3	4.3	5.8	8.3	5.9	6.6	6.9
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	13.2	3.6	6.8	6.6	2.8	2.6	3.1	3.4
6.	Contribution of nominal GDP growth	:	-0.8	-1.0	-1.5	-2.2	-1.7	-1.7	-2.0
7.	Stock-flow adjustment (^{3})	:	0.5	-2.3	-3.8	0.0	-1.0	-0.6	-0.5
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	12.1	2.8	5.6	5.5	1.7	1.4	1.8	2.0
9.	Snow-ball effect	:	0.1	0.2	-0.4	-1.1	-0.5	-0.2	-0.6
10.	Stock-flow adjustment (^{3})	:	0.5	-2.3	-3.8	0.0	-1.0	-0.6	-0.5
11.	Change in gross debt (^{5})	:	3.3	3.5	1.3	0.6	-0.2	1.0	0.9
12.	Level of gross debt (end of year)	:	19.1	28.8	30.0	30.6	30.5	31.5	32.4
Denmark									
1.	Net borrowing (^{1})	2.0	-3.2	-1.0	-0.8	-2.5	-4.7	-3.8	-3.9
2.	Interest payments	5.9	3.7	3.0	2.7	2.4	2.1	1.9	1.6
3.	Implicit interest rate (^{2})	8.1	6.6	6.3	5.6	5.2	4.8	5.2	5.1
4.	Nominal GDP growth rate (%)	4.4	6.6	2.8	2.7	4.1	5.7	6.5	4.7
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	2.0	-3.2	-1.0	-0.8	-2.5	-4.7	-3.8	-3.9
6.	Contribution of nominal GDP growth	-3.2	-3.6	-1.3	-1.2	-1.8	-2.4	-2.1	-1.4
7.	Stock-flow adjustment (^{3})	-2.9	1.2	1.9	-0.2	2.7	0.5	0.3	1.9
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-3.9	-6.8	-4.1	-3.6	-5.0	-6.8	-5.7	-5.5
9.	Snow-ball effect	2.7	0.0	1.6	1.3	0.5	-0.5	-0.4	0.1
10.	Stock-flow adjustment (^{3})	-2.9	1.2	1.9	-0.2	2.7	0.5	0.3	1.9
11.	Change in gross debt (^{5})	-4.0	-5.7	-0.6	-2.5	-1.8	-6.8	-5.8	-3.5
12.	Level of gross debt (end of year)	72.5	51.7	46.8	44.4	42.6	35.8	30.0	26.5

(^{1})   Line 1 = line 5, a minus sign means a surplus
(^{2})   Actual interest payments as a percentage of gross debt at the end of t-1
(^{3})   Line 7 = line 10
(^{4})   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5})   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.8

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Estonia									
1.	Net borrowing (^{1})	-0.4	0.4	-1.0	-2.4	-1.5	-1.6	-1.4	-0.8
2.	Interest payments	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
3.	Implicit interest rate (^{2})	:	4.2	4.7	4.6	4.6	4.1	4.0	4.7
4.	Nominal GDP growth rate (%)	37.4	13.6	11.9	8.9	11.1	16.6	12.9	11.3
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	-0.4	0.4	-1.0	-2.4	-1.5	-1.6	-1.4	-0.8
6.	Contribution of nominal GDP growth	:	-0.7	-0.5	-0.5	-0.6	-0.8	-0.5	-0.4
7.	Stock-flow adjustment (^{3})	:	-0.8	2.4	3.3	1.5	1.8	0.8	0.6
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-0.6	0.2	-1.2	-2.6	-1.8	-1.8	-1.6	-1.0
9.	Snow-ball effect	:	-0.5	-0.3	-0.2	-0.4	-0.6	-0.4	-0.2
10.	Stock-flow adjustment (^{3})	:	-0.8	2.4	3.3	1.5	1.8	0.8	0.6
11.	Change in gross debt (^{5})	:	-1.2	0.9	0.4	-0.6	-0.6	-1.2	-0.6
12.	Level of gross debt (end of year)	:	5.1	5.5	6.0	5.4	4.8	3.6	3.0
Cyprus									
1.	Net borrowing (^{1})	:	2.4	4.5	6.3	4.1	2.4	2.1	2.0
2.	Interest payments	:	3.4	3.2	3.4	3.2	3.4	3.1	3.0
3.	Implicit interest rate (^{2})	:	6.2	5.3	5.7	4.9	5.1	4.7	4.6
4.	Nominal GDP growth rate (%)	9.4	8.9	4.4	7.0	6.5	6.7	6.2	6.2
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	:	2.4	4.5	6.3	4.1	2.4	2.1	2.0
6.	Contribution of nominal GDP growth	:	-4.9	-2.6	-4.3	-4.2	-4.5	-4.1	-4.0
7.	Stock-flow adjustment (^{3})	:	2.8	1.5	2.5	2.0	0.8	0.8	0.7
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	:	-1.1	1.3	2.8	0.9	-1.0	-1.0	-1.0
9.	Snow-ball effect	:	-1.5	0.6	-0.8	-1.0	-1.1	-1.0	-1.0
10.	Stock-flow adjustment (^{3})	:	2.8	1.5	2.5	2.0	0.8	0.8	0.7
11.	Change in gross debt (^{5})	:	0.2	3.3	4.5	1.9	-1.3	-1.2	-1.3
12.	Level of gross debt (end of year)	:	59.9	65.2	69.7	71.7	70.3	69.1	67.8

(^{1})   Line 1 = line 5, a minus sign means a surplus
(^{2})   Actual interest payments as a percentage of gross debt at the end of t-1
(^{3})   Line 7 = line 10
(^{4})   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5})   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.9

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Latvia									
1.	Net borrowing (¹)	2.0	2.8	2.3	1.2	0.9	-0.2	1.0	1.0
2.	Interest payments	1.2	1.0	0.7	0.7	0.7	0.6	0.6	0.6
3.	Implicit interest rate (²)	:	8.7	5.8	5.7	5.7	5.1	5.5	5.7
4.	Nominal GDP growth rate (%)	14.0	10.9	10.3	11.0	16.0	20.1	16.4	14.3
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (¹)	2.0	2.8	2.3	1.2	0.9	-0.2	1.0	1.0
6.	Contribution of nominal GDP growth	:	-1.2	-1.3	-1.3	-2.0	-2.4	-1.7	-1.4
7.	Stock-flow adjustment (³)	:	-1.7	-1.5	1.1	1.2	0.0	0.0	0.0
Budgetary constraint based on the primary deficit									
8.	Primary deficit (⁴)	0.8	1.8	1.5	0.5	0.2	-0.8	0.5	0.4
9.	Snow-ball effect	:	-0.2	-0.6	-0.6	-1.3	-1.8	-1.1	-0.9
10.	Stock-flow adjustment (³)	:	-1.7	-1.5	1.1	1.2	0.0	0.0	0.0
11.	Change in gross debt (⁵)	:	-0.1	-0.5	1.0	0.1	-2.6	-0.6	-0.4
12.	Level of gross debt (end of year)	:	12.3	13.5	14.4	14.6	11.9	11.3	10.9
Lithuania									
1.	Net borrowing (¹)	1.9	3.6	1.4	1.2	1.5	0.5	0.6	0.9
2.	Interest payments	0.4	1.7	1.3	1.2	0.9	0.8	0.7	0.7
3.	Implicit interest rate (²)	:	8.0	6.1	6.1	4.9	4.8	4.4	3.9
4.	Nominal GDP growth rate (%)	51.3	5.7	7.0	9.3	10.0	13.8	11.4	9.2
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (¹)	1.9	3.6	1.4	1.2	1.5	0.5	0.6	0.9
6.	Contribution of nominal GDP growth	:	-1.2	-1.5	-1.9	-1.9	-2.4	-1.9	-1.6
7.	Stock-flow adjustment (³)	:	-1.6	-0.4	-0.4	-1.3	1.1	1.5	1.5
Budgetary constraint based on the primary deficit									
8.	Primary deficit (⁴)	1.5	1.8	0.1	0.0	0.5	-0.3	-0.1	0.2
9.	Snow-ball effect	:	0.5	-0.2	-0.7	-1.0	-1.6	-1.2	-0.9
10.	Stock-flow adjustment (³)	:	-1.6	-0.4	-0.4	-1.3	1.1	1.5	1.5
11.	Change in gross debt (⁵)	:	0.7	-0.5	-1.1	-1.7	-0.8	0.2	0.8
12.	Level of gross debt (end of year)	:	23.6	22.3	21.2	19.5	18.7	18.9	19.7

(¹)   Line 1 = line 5, a minus sign means a surplus
(²)   Actual interest payments as a percentage of gross debt at the end of t-1
(³)   Line 7 = line 10
(⁴)   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(⁵)   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.10

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Hungary									
1.	Net borrowing (^{1})	:	3.0	8.4	6.4	5.4	6.2	6.7	7.0
2.	Interest payments	:	5.5	3.9	3.9	4.2	3.9	3.7	3.7
3.	Implicit interest rate (^{2})	:	10.4	8.6	7.8	8.1	7.2	6.8	6.6
4.	Nominal GDP growth rate (%)	28.6	15.6	12.8	10.3	9.5	6.7	7.0	7.1
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	:	3.0	8.4	6.4	5.4	6.2	6.7	7.0
6.	Contribution of nominal GDP growth	:	-8.1	-5.9	-5.1	-4.9	-3.6	-3.8	-4.0
7.	Stock-flow adjustment (^{3})	:	0.0	0.8	0.4	0.0	-1.3	-1.4	-0.9
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	:	-2.4	4.4	2.5	1.2	2.3	3.0	3.3
9.	Snow-ball effect	:	-2.7	-1.9	-1.2	-0.7	0.2	-0.1	-0.3
10.	Stock-flow adjustment (^{3})	:	0.0	0.8	0.4	0.0	-1.3	-1.4	-0.9
11.	Change in gross debt (^{5})	:	-5.7	3.3	1.7	0.5	1.2	1.5	2.1
12.	Level of gross debt (end of year)	:	54.3	55.0	56.7	57.1	58.4	59.9	62.0
Malta									
1.	Net borrowing (^{1})	:	6.2	5.6	10.2	5.1	3.3	3.0	3.4
2.	Interest payments	:	3.6	3.7	3.7	4.1	4.0	3.9	3.9
3.	Implicit interest rate (^{2})	:	7.0	6.3	6.1	5.7	5.5	5.4	5.2
4.	Nominal GDP growth rate (%)	11.4	8.2	3.4	1.8	0.1	5.3	5.3	4.9
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	:	6.2	5.6	10.2	5.1	3.3	3.0	3.4
6.	Contribution of nominal GDP growth	:	-4.3	-2.0	-1.1	-0.1	-3.8	-3.7	-3.4
7.	Stock-flow adjustment (^{3})	:	-2.4	-4.0	1.0	-0.2	-1.0	0.1	0.2
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	:	2.6	1.8	6.5	1.1	-0.7	-0.9	-0.5
9.	Snow-ball effect	:	-0.6	1.7	2.6	4.0	0.1	0.1	0.2
10.	Stock-flow adjustment (^{3})	:	-2.4	-4.0	1.0	-0.2	-1.0	0.1	0.2
11.	Change in gross debt (^{5})	:	-0.4	-0.5	10.1	4.9	-1.5	-0.7	-0.1
12.	Level of gross debt (end of year)	:	56.0	61.2	71.3	76.2	74.7	74.0	74.0

(^{1})   Line 1 = line 5, a minus sign means a surplus
(^{2})   Actual interest payments as a percentage of gross debt at the end of t-1
(^{3})   Line 7 = line 10
(^{4})   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5})   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.11

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Poland									
1.	Net borrowing (¹)	4.4	1.5	3.2	4.7	3.9	2.5	3.0	3.0
2.	Interest payments	5.7	3.0	2.7	2.8	2.6	2.4	2.5	2.6
3.	Implicit interest rate (²)	:	8.4	7.9	7.3	6.4	6.0	6.1	6.1
4.	Nominal GDP growth rate (%)	36.9	11.8	3.7	4.2	9.5	4.9	4.9	6.2
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (¹)	4.4	1.5	3.2	4.7	3.9	2.5	3.0	3.0
6.	Contribution of nominal GDP growth	:	-4.1	-1.3	-1.6	-3.8	-2.0	-2.0	-2.6
7.	Stock-flow adjustment (³)	:	-0.8	2.0	1.0	-2.1	0.1	2.0	0.8
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (⁴)	-1.3	-1.5	0.4	1.9	1.3	0.1	0.5	0.4
9.	Snow-ball effect	:	-1.2	1.5	1.2	-1.3	0.4	0.5	0.0
10.	Stock-flow adjustment (³)	:	-0.8	2.0	1.0	-2.1	0.1	2.0	0.8
11.	Change in gross debt (⁵)	:	-3.5	3.9	4.1	-2.0	0.6	3.0	1.2
12.	Level of gross debt (end of year)	:	35.9	39.8	43.9	41.9	42.5	45.5	46.7
Slovenia									
1.	Net borrowing (¹)	:	3.9	2.7	2.8	2.3	1.8	1.9	1.6
2.	Interest payments	:	2.5	2.4	2.1	1.9	1.6	1.5	1.4
3.	Implicit interest rate (²)	:	11.1	9.3	7.7	6.9	5.9	5.5	5.0
4.	Nominal GDP growth rate (%)	28.0	9.7	11.6	8.6	7.5	4.9	6.5	6.6
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (¹)	:	3.9	2.7	2.8	2.3	1.8	1.9	1.6
6.	Contribution of nominal GDP growth	:	-2.2	-2.9	-2.3	-2.0	-1.4	-1.8	-1.9
7.	Stock-flow adjustment (³)	:	1.3	1.7	-1.1	0.1	-0.8	0.8	-0.1
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (⁴)	:	1.4	0.3	0.7	0.5	0.1	0.4	0.2
9.	Snow-ball effect	:	0.3	-0.6	-0.2	-0.2	0.3	-0.3	-0.4
10.	Stock-flow adjustment (³)	:	1.3	1.7	-1.1	0.1	-0.8	0.8	-0.1
11.	Change in gross debt (⁵)	:	3.0	1.4	-0.6	0.4	-0.4	0.9	-0.3
12.	Level of gross debt (end of year)	:	27.6	29.7	29.1	29.5	29.1	29.9	29.7

(¹)   Line 1 = line 5, a minus sign means a surplus
(²)   Actual interest payments as a percentage of gross debt at the end of t-1
(³)   Line 7 = line 10
(⁴)   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(⁵)   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.12

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
Slovakia									
1.	Net borrowing (^{1})	0.8	12.2	7.7	3.7	3.0	2.9	2.7	2.1
2.	Interest payments	2.3	4.0	3.5	2.5	2.2	1.7	1.8	1.7
3.	Implicit interest rate (^{2})	:	9.4	7.9	6.4	5.7	4.6	5.6	5.5
4.	Nominal GDP growth rate (%)	16.3	10.7	8.8	9.3	10.3	8.6	10.3	9.5
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	0.8	12.2	7.7	3.7	3.0	2.9	2.7	2.1
6.	Contribution of nominal GDP growth	:	-4.6	-3.9	-3.6	-4.5	-3.3	-3.2	-3.0
7.	Stock-flow adjustment (^{3})	:	-5.0	-9.2	-0.7	0.4	-6.7	0.4	1.3
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	-1.5	8.1	4.1	1.2	0.8	1.1	0.9	0.4
9.	Snow-ball effect	:	-0.5	-0.4	-1.1	-2.3	-1.5	-1.4	-1.2
10.	Stock-flow adjustment (^{3})	:	-5.0	-9.2	-0.7	0.4	-6.7	0.4	1.3
11.	Change in gross debt (^{5})	:	2.6	-5.5	-0.6	-1.1	-7.2	-0.2	0.4
12.	Level of gross debt (end of year)	:	50.0	43.3	42.7	41.6	34.5	34.3	34.7
Sweden									
1.	Net borrowing (^{1})	6.9	-5.0	0.5	0.2	-1.6	-2.7	-2.1	-2.2
2.	Interest payments	6.5	4.0	3.2	2.4	1.9	1.9	1.9	1.9
3.	Implicit interest rate (^{2})	9.8	6.8	5.5	4.0	3.2	3.3	3.7	4.1
4.	Nominal GDP growth rate (%)	7.6	5.8	3.6	3.7	4.6	3.9	5.0	5.2
Budgetary constraint based on the deficit									
5.	Deficit (net borrowing) (^{1})	6.9	-5.0	0.5	0.2	-1.6	-2.7	-2.1	-2.2
6.	Contribution of nominal GDP growth	-5.2	-3.4	-1.9	-1.9	-2.3	-1.9	-2.4	-2.3
7.	Stock-flow adjustment (^{3})	-2.0	-1.4	-0.2	1.7	2.8	4.6	1.9	1.8
Budgetary constraint based on the primary deficit									
8.	Primary deficit (^{4})	0.3	-9.0	-2.8	-2.2	-3.5	-4.6	-4.0	-4.1
9.	Snow-ball effect	1.5	0.6	1.0	0.2	-0.7	-0.3	-0.7	-0.5
10.	Stock-flow adjustment (^{3})	-2.0	-1.4	-0.2	1.7	2.8	4.6	1.9	1.8
11.	Change in gross debt (^{5})	-0.2	-9.8	-1.9	-0.2	-1.3	-0.2	-2.7	-2.8
12.	Level of gross debt (end of year)	73.0	52.3	52.0	51.8	50.5	50.3	47.6	44.8

(^{1}) Line 1 = line 5, a minus sign means a surplus
(^{2}) Actual interest payments as a percentage of gross debt at the end of t-1
(^{3}) Line 7 = line 10
(^{4}) Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(^{5}) Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.13

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2002	2003	2004	2005	2006	2007
	United Kingdom								
1.	Net borrowing (¹)	5.8	-3.7	1.6	3.3	3.3	3.5	3.0	2.8
2.	Interest payments	3.6	2.7	2.0	2.0	2.0	2.1	2.1	2.1
3.	Implicit interest rate (²)	8.0	6.6	5.5	5.6	5.4	5.5	5.0	4.9
4.	Nominal GDP growth rate (%)	5.6	5.3	5.2	5.5	5.3	3.8	4.6	5.3
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (¹)	5.8	-3.7	1.6	3.3	3.3	3.5	3.0	2.8
6.	Contribution of nominal GDP growth	-2.5	-2.2	-1.9	-2.0	-2.0	-1.5	-1.9	-2.2
7.	Stock-flow adjustment (³)	-0.1	3.0	-0.2	0.1	0.5	0.0	0.1	0.0
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (⁴)	2.1	-6.5	-0.4	1.3	1.3	1.3	0.9	0.7
9.	Snow-ball effect	1.1	0.6	0.2	0.1	0.0	0.7	0.2	-0.1
10.	Stock-flow adjustment (³)	-0.1	3.0	-0.2	0.1	0.5	0.0	0.1	0.0
11.	Change in gross debt (⁵)	3.2	-2.9	-0.5	1.5	1.8	2.0	1.3	0.6
12.	Level of gross debt (end of year)	51.0	41.2	37.6	39.0	40.8	42.8	44.1	44.7

(¹)   Line 1 = line 5, a minus sign means a surplus
(²)   Actual interest payments as a percentage of gross debt at the end of t-1
(³)   Line 7 = line 10
(⁴)   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(⁵)   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.2.14

Contributions to the change in the general government gross debt ratio (% of GDP)

(% of GDP)

		1995	2000	2001	2002	2003	2004	2005	2006
	EUR-12 (¹)								
1.	Net borrowing (²)	5.0	0.0	2.6	3.1	2.8	2.4	2.4	2.4
2.	Interest payments	5.4	3.9	3.5	3.3	3.1	3.0	3.0	3.0
3.	Implicit interest rate (³)	8.3	5.7	5.3	5.0	4.7	4.4	4.3	4.3
4.	Nominal GDP growth rate (%)	4.7	5.2	3.5	2.7	4.0	3.1	3.8	3.8
	Budgetary constraint based on the deficit								
5.	Deficit (net borrowing) (²)	5.0	0.0	2.6	3.1	2.8	2.4	2.4	2.4
6.	Contribution of nominal GDP growth	-3.0	-3.6	-2.3	-1.9	-2.7	-2.1	-2.6	-2.6
7.	Stock-flow adjustment (⁴)	2.7	1.1	-0.4	0.0	0.4	0.7	0.0	-0.2
	Budgetary constraint based on the primary deficit								
8.	Primary deficit (⁵)	-0.4	-3.9	-0.9	-0.3	-0.3	-0.6	-0.6	-0.6
9.	Snow-ball effect	2.4	0.3	1.1	1.4	0.4	0.9	0.4	0.4
10.	Stock-flow adjustment (⁴)	2.7	1.1	-0.4	0.0	0.4	0.7	0.0	-0.2
11.	Change in gross debt (⁶)	4.6	-2.5	-0.2	1.2	0.5	1.0	-0.2	-0.4
12.	Level of gross debt (end of year)	72.4	69.4	68.3	69.5	70.0	71.0	70.7	70.3

(¹)   Due to problems with availability of the data, Luxembourg data are not included
(²)   Line 1 = line 5, a minus sign means a surplus
(³)   Actual interest payments as a percentage of gross debt at the end of t-1
(⁴)   Line 7 = line 10
(⁵)   Net borrowing excluding interest payments, line 8 = line 1 - line 2. A minus sign means a primary surplus
(⁶)   Line 11 = total of lines 5, 6 and 7 or 8, 9 and 10

Source: Commission services.

Table A.3.1

Cyclical adjustment of general government receipts, expenditures and budget balances

	ESA 95 definitions							
Belgium	**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)								
1. Actual data	47.6	49.1	49.8	51.2	49.4	50.1	49.3	48.5
2. Cyclical component	-0.2	0.9	0.2	-0.3	0.0	-0.3	-0.2	-0.1
3. Cyclically adjusted data	47.8	48.2	49.5	51.4	49.4	50.4	49.5	48.6
Total uses (% of GDP)								
4. Actual data	51.9	49.1	49.8	51.1	49.5	50.1	49.7	49.5
5. Cyclical component	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
6. Cyclically adjusted data	51.9	49.2	49.8	51.1	49.4	50.0	49.6	49.4
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-4.4	0.0	-0.1	0.0	-0.1	-0.1	-0.4	-1.0
8. Cyclical component	-0.2	1.1	0.3	-0.3	0.0	-0.4	-0.2	-0.1
9. Cyclically adjusted balance	-4.1	-1.0	-0.3	0.4	0.0	0.4	-0.1	-0.7
— as % of potential GDP	-3.9	-0.9	-0.2	0.4	0.0	0.6	0.1	-0.3
10. GDP at 1995 market prices (annual % change)	2.4	3.9	1.5	0.9	2.6	1.2	2.3	2.1
11. Potential GDP at 1995 market prices (annual % change)	2.1	2.2	2.0	1.9	1.9	2.1	2.2	2.2
12. Gap between actual and potential GDP (% of potential GDP)	-0.8	1.9	0.3	-0.7	0.0	-0.9	-0.9	-1.0
Germany	**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)								
1. Actual data	45.1	46.4	44.3	44.4	43.2	43.4	43.1	43.0
2. Cyclical component	0.1	0.7	0.1	-0.4	-0.2	-0.3	-0.2	-0.3
3. Cyclically adjusted data	45.0	45.7	44.2	44.8	43.4	43.8	43.2	43.3
Total uses (% of GDP)								
4. Actual data	48.3	45.1	48.1	48.4	46.8	46.7	46.1	45.5
5. Cyclical component	0.0	-0.2	0.0	0.1	0.1	0.1	0.0	0.1
6. Cyclically adjusted data	48.3	47.8	48.1	48.3	46.8	46.6	46.1	45.4
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-3.2	1.3	-3.7	-4.0	-3.7	-3.3	-3.1	-2.5
8. Cyclical component	0.2	0.9	0.2	-0.5	-0.3	-0.4	-0.2	-0.3
9. Cyclically adjusted balance	-3.4	-2.0	-3.9	-3.5	-3.4	-2.9	-2.9	-2.1
— as % of potential GDP	-3.0	-1.7	-3.7	-3.3	-3.4	-3.0	-3.0	-2.3
10. GDP at 1995 market prices (annual % change)	1.9	3.2	0.1	-0.2	1.6	0.9	1.7	1.0
11. Potential GDP at 1995 market prices (annual % change)	2.2	1.5	1.1	1.0	0.8	1.1	1.2	1.2
12. Gap between actual and potential GDP (% of potential GDP)	-0.4	1.0	-0.1	-1.2	-0.4	-0.6	-0.1	-0.3

Source: Commission services.

Table A.3.2

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions							
Greece		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	40.9	47.0	43.9	43.2	42.0	41.8	41.9	41.3
2.	Cyclical component	-0.7	-0.2	0.2	0.5	0.7	0.6	0.4	0.3
3.	Cyclically adjusted data	41.6	47.2	43.8	42.7	41.3	41.2	41.5	41.1
Total uses (% of GDP)									
4.	Actual data	51.0	51.1	49.0	49.0	48.8	46.2	44.8	44.9
5.	Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	51.0	51.0	48.9	48.9	48.9	46.4	44.9	44.9
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-10.2	-4.1	-5.0	-5.8	-6.8	-4.4	-2.9	-3.5
8.	Cyclical component	-0.7	-0.2	0.2	0.5	0.7	0.6	0.4	0.3
9.	Cyclically adjusted balance	-9.4	-3.8	-5.1	-6.3	-7.7	-5.1	-3.4	-3.8
	— as % of potential GDP	-8.9	-3.4	-5.0	-6.3	-7.9	-5.4	-3.8	-4.5
10.	GDP at 1995 market prices (annual % change)	2.1	4.5	3.8	4.8	4.7	3.7	3.5	3.4
11.	Potential GDP at 1995 market prices (annual % change)	2.2	3.8	3.7	3.9	3.8	3.7	3.5	3.4
12.	Gap between actual and potential GDP (% of potential GDP)	-2.6	-1.3	0.2	1.0	1.9	1.9	1.9	1.9
Spain		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	37.6	38.1	38.4	38.3	38.7	39.3	39.3	38.8
2.	Cyclical component	-0.8	0.7	0.4	0.3	0.1	0.1	-0.1	-0.4
3.	Cyclically adjusted data	38.3	37.4	38.0	38.0	38.6	39.2	39.3	39.2
Total uses (% of GDP)									
4.	Actual data	44.1	39.0	38.7	38.3	38.8	38.2	38.3	38.5
5.	Cyclical component	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	43.9	39.2	38.7	38.3	38.8	38.2	38.3	38.4
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-6.5	-0.9	-0.3	0.0	-0.2	1.1	0.9	0.4
8.	Cyclical component	-0.9	0.8	0.5	0.3	0.1	0.1	-0.1	-0.4
9.	Cyclically adjusted balance	-5.6	-1.7	-0.8	-0.3	-0.3	1.0	1.0	0.8
	— as % of potential GDP	-5.0	-2.0	-0.8	-0.2	0.0	1.3	1.3	1.0
10.	GDP at 1995 market prices (annual % change)	2.8	5.0	2.7	3.0	3.1	3.4	3.1	2.8
11.	Trend GDP at 1995 market prices (annual % change)	2.6	3.4	3.7	3.8	3.8	3.8	3.6	3.3
12.	Gap between actual and trend GDP (% of potential GDP)	-3.2	2.3	1.3	0.4	-0.2	-0.5	-1.0	-1.5

Source: Commission services.

Table A.3.3

Cyclical adjustment of general government receipts, expenditures and budget balances

	ESA 95 definitions							
France	**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)								
1. Actual data	49.0	50.2	49.5	49.2	49.6	51.0	51.0	50.7
2. Cyclical component	-0.5	0.9	0.5	-0.1	0.1	-0.1	-0.1	-0.1
3. Cyclically adjusted data	49.5	49.2	49.0	49.2	49.5	51.1	51.1	50.8
Total uses (% of GDP)								
4. Actual data	54.5	51.6	52.6	53.4	53.2	53.9	54.1	53.8
5. Cyclical component	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
6. Cyclically adjusted data	54.4	51.7	52.7	53.3	53.2	53.9	54.0	53.8
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-5.5	-1.5	-3.2	-4.2	-3.7	-2.9	-3.0	-3.1
8. Cyclical component	-0.6	1.0	0.5	-0.1	0.1	-0.1	-0.1	-0.1
9. Cyclically adjusted balance	-4.9	-2.5	-3.7	-4.1	-3.7	-2.7	-2.9	-3.0
— as % of potential GDP	-4.7	-2.7	-3.8	-4.1	-3.6	-2.5	-2.5	-2.4
10. GDP at 1995 market prices (annual % change)	2.4	4.1	1.2	0.8	2.3	1.4	1.9	2.0
11. Potential GDP at 1995 market prices (annual % change)	2.0	2.5	2.1	2.1	2.2	2.1	2.2	2.3
12. Gap between actual and potential GDP (% of potential GDP)	-1.4	2.4	1.2	-0.1	0.0	-0.7	-1.0	-1.3
Ireland	**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)								
1. Actual data	39.0	35.9	33.0	33.6	35.2	35.5	35.1	34.7
2. Cyclical component	3.3	6.1	5.1	4.7	4.4	4.2	4.1	4.2
3. Cyclically adjusted data	35.8	29.9	27.9	28.9	30.8	31.3	30.9	30.6
Total uses (% of GDP)								
4. Actual data	41.1	31.5	33.4	33.4	33.7	34.5	34.9	35.1
5. Cyclical component	-0.4	-0.6	-0.7	-0.6	-0.5	-0.5	-0.5	-0.5
6. Cyclically adjusted data	41.5	32.2	34.2	34.0	34.2	35.0	35.4	35.6
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-2.1	4.4	-0.4	0.2	1.6	1.0	0.1	-0.4
8. Cyclical component	3.7	6.7	5.7	5.3	5.0	4.8	4.6	4.7
9. Cyclically adjusted balance	-5.7	-2.3	-6.3	-5.1	-3.4	-3.7	-4.5	-5.1
— as % of potential GDP	-0.8	2.6	-1.9	-0.5	1.4	1.5	1.1	0.8
10. GDP at 1995 market prices (annual % change)	9.8	9.2	6.1	4.4	4.5	4.7	4.9	5.1
11. Potential GDP at 1995 market prices (annual % change)	7.1	7.9	6.7	6.0	5.9	6.4	6.1	5.6
12. Gap between actual and potential GDP (% of potential GDP)	-2.6	4.9	3.3	1.7	0.3	-1.3	-2.4	-2.9

Source: Commission services.

Table A.3.4

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions							
Italy		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	44.6	45.3	44.4	44.8	44.3	44.0	44.0	43.8
2.	Cyclical component	-0.1	0.8	0.6	0.0	0.0	-0.5	-0.3	-0.2
3.	Cyclically adjusted data	44.7	44.5	43.8	44.7	44.2	44.4	44.3	44.0
Total uses (% of GDP)									
4.	Actual data	52.0	46.0	47.4	48.3	47.8	48.2	48.1	48.4
5.	Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	52.0	47.2	47.3	48.2	47.7	48.1	48.1	48.4
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-7.4	-0.8	-3.0	-3.5	-3.5	-4.3	-4.1	-4.5
8.	Cyclical component	-0.1	0.8	0.6	0.0	0.0	-0.5	-0.3	-0.2
9.	Cyclically adjusted balance	-7.3	-2.7	-3.5	-3.5	-3.5	-3.6	-3.8	-4.4
	— as % of potential GDP	-7.3	-2.9	-3.4	-3.4	-3.3	-3.3	-3.4	-3.8
10.	GDP at 1995 market prices (annual % change)	2.8	3.6	0.3	0.0	1.1	0.0	1.3	1.2
11.	Potential GDP at 1995 market prices (annual % change)	1.4	1.5	1.3	1.2	1.2	1.2	1.2	1.4
12.	Gap between actual and potential GDP (% of potential GDP)	-0.3	1.8	1.1	0.0	-0.2	-1.4	-1.3	-1.4
Luxembourg		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	42.1	43.5	43.4	42.2	42.1	42.4	42.2	42.3
2.	Cyclical component	-0.8	1.7	0.6	-0.3	-0.2	-0.2	0.0	0.3
3.	Cyclically adjusted data	42.9	41.8	42.8	42.5	42.3	42.6	42.2	42.1
Total uses (% of GDP)									
4.	Actual data	39.8	37.7	41.4	42.1	43.2	44.3	44.0	43.8
5.	Cyclical component	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	39.7	37.7	41.4	42.1	43.2	44.3	44.0	43.8
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	2.3	5.9	2.0	0.2	-1.1	-1.9	-1.8	-1.5
8.	Cyclical component	-0.9	1.8	0.6	-0.3	-0.3	-0.2	0.0	0.3
9.	Cyclically adjusted balance	3.1	4.1	1.4	0.5	-0.9	-1.7	-1.8	-1.8
	— as % of potential GDP	3.0	4.3	1.7	0.9	-0.5	-1.2	-1.2	-1.0
10.	GDP at 1995 market prices (annual % change)	1.4	8.4	3.6	2.0	4.2	4.2	4.4	4.5
11.	Potential GDP at 1995 market prices (annual % change)	4.6	5.0	4.5	4.4	4.1	4.2	4.1	4.2
12.	Gap between actual and potential GDP (% of potential GDP)	-1.9	4.2	0.7	-1.6	-1.5	-1.5	-1.2	-1.0

Source: Commission services.

Table A.3.5

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions							
The Netherlands		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	45.3	45.6	44.2	43.9	44.5	45.4	46.5	46.4
2.	Cyclical component	1.5	3.4	2.3	1.5	1.4	1.1	1.2	1.4
3.	Cyclically adjusted data	43.9	42.1	42.0	42.4	43.1	44.4	45.3	45.0
Total uses (% of GDP)									
4.	Actual data	49.3	43.4	46.2	47.1	46.6	45.7	47.7	47.1
5.	Cyclical component	-0.6	-1.3	-1.0	-0.6	-0.6	-0.4	-0.5	-0.6
6.	Cyclically adjusted data	49.9	45.4	47.1	47.7	47.0	46.1	48.2	47.7
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-4.0	2.1	-2.0	-3.2	-2.1	-0.3	-1.2	-0.7
8.	Cyclical component	2.1	4.7	3.2	2.1	2.0	1.5	1.8	2.0
9.	Cyclically adjusted balance	-6.1	-3.3	-5.2	-5.2	-3.9	-1.8	-2.9	-2.7
	— as % of potential GDP	-3.3	-0.3	-1.9	-2.0	-0.9	1.0	-0.2	-0.2
10.	GDP at 1995 market prices (annual % change)	3.0	3.5	0.1	-0.1	1.7	1.1	2.6	2.6
11.	Potential GDP at 1995 market prices (annual % change)	2.6	2.8	2.1	1.7	1.6	1.7	1.9	2.0
12.	Gap between actual and potential GDP (% of potential GDP)	-1.1	3.3	-0.1	-1.9	-1.8	-2.3	-1.6	-1.0
Austria		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	50.3	49.8	50.0	49.2	48.8	48.0	46.6	46.8
2.	Cyclical component	-0.3	0.9	-0.1	-0.4	-0.2	-0.2	0.0	0.1
3.	Cyclically adjusted data	50.6	48.9	50.2	49.6	49.0	48.2	46.7	46.7
Total uses (% of GDP)									
4.	Actual data	56.0	51.4	50.7	50.9	50.0	49.6	48.7	48.3
5.	Cyclical component	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	55.9	51.7	50.5	50.7	49.9	49.5	48.6	48.2
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-5.7	-1.6	-0.7	-1.7	-1.2	-1.6	-2.0	-1.5
8.	Cyclical component	-0.3	1.0	-0.1	-0.4	-0.2	-0.3	0.0	0.1
9.	Cyclically adjusted balance	-5.3	-2.8	-0.4	-1.1	-0.9	-1.3	-1.9	-1.4
	— as % of potential GDP	-5.2	-2.9	-0.3	-1.0	-0.8	-1.0	-1.7	-1.2
10.	GDP at 1995 market prices (annual % change)	1.9	3.4	1.0	1.4	2.4	1.9	2.5	2.2
11.	Potential GDP at 1995 market prices (annual % change)	2.2	2.4	2.1	2.2	2.0	2.2	1.9	2.1
12.	Gap between actual and potential GDP (% of potential GDP)	-0.9	2.2	-0.4	-1.2	-0.7	-1.0	-0.4	-0.3

Source: Commission services.

Table A.3.6

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions							
Portugal		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	37.6	40.2	41.4	42.9	43.2	41.8	43.0	43.1
2.	Cyclical component	-1.1	1.3	0.9	0.0	0.0	-0.2	-0.1	0.1
3.	Cyclically adjusted data	38.7	38.9	40.4	42.9	43.2	42.0	43.1	43.0
Total uses (% of GDP)									
4.	Actual data	42.8	43.1	44.3	45.9	46.4	47.8	48.0	48.0
5.	Cyclical component	0.1	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	42.7	43.5	44.3	45.8	46.4	47.8	47.9	48.0
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-5.2	-3.0	-2.9	-3.0	-3.2	-6.0	-5.0	-4.9
8.	Cyclical component	-1.2	1.4	1.0	0.0	0.0	-0.2	-0.1	0.1
9.	Cyclically adjusted balance	-4.0	-4.6	-3.9	-2.9	-3.2	-5.8	-4.9	-5.0
	— as % of potential GDP	-4.1	-4.6	-3.6	-2.5	-2.6	-5.0	-3.9	-3.7
10.	GDP at 1995 market prices (annual % change)	4.3	3.9	0.8	-1.1	1.1	0.3	0.9	1.1
11.	Potential GDP at 1995 market prices (annual % change)	2.7	2.7	2.0	1.4	1.3	1.1	1.1	1.2
12.	Gap between actual and potential GDP (% of potential GDP)	-2.6	3.2	1.6	-0.9	-1.2	-1.9	-2.2	-2.3
Finland		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	55.3	55.8	52.9	52.4	52.4	53.1	52.7	52.1
2.	Cyclical component	-2.0	1.6	0.3	0.0	0.2	-0.1	0.1	0.1
3.	Cyclically adjusted data	57.3	54.3	52.6	52.4	52.2	53.3	52.6	52.0
Total uses (% of GDP)									
4.	Actual data	61.4	48.8	48.8	50.0	50.3	50.7	50.1	49.8
5.	Cyclical component	0.5	-0.3	-0.1	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	60.9	49.2	48.8	49.9	50.2	50.5	49.9	49.6
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-6.2	7.0	4.1	2.3	2.1	2.4	2.6	2.4
8.	Cyclical component	-2.5	1.9	0.3	0.0	0.3	-0.2	0.2	0.1
9.	Cyclically adjusted balance	-3.6	5.1	3.8	2.5	2.0	2.8	2.7	2.4
	— as % of potential GDP	-4.2	5.5	4.4	3.0	2.5	3.2	3.0	2.7
10.	GDP at 1995 market prices (annual % change)	3.4	5.0	2.2	2.4	3.6	2.1	3.6	2.9
11.	Potential GDP at 1995 market prices (annual % change)	1.8	3.7	3.3	3.0	2.9	2.9	2.8	2.8
12.	Gap between actual and potential GDP (% of potential GDP)	-3.4	3.3	-0.4	-1.0	-0.3	-1.1	-0.4	-0.4

Source: Commission services.

Table A.3.7

Cyclical adjustment of general government receipts, expenditures and budget balances

	ESA 95 definitions							
Czech Republic	**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)								
1. Actual data	40.5	38.0	39.9	40.7	41.4	41.1	40.8	40.4
2. Cyclical component	0.8	-0.4	-1.0	-1.1	-0.7	0.0	0.4	0.5
3. Cyclically adjusted data	39.8	38.4	40.9	41.7	42.1	41.1	40.5	39.9
Total uses (% of GDP)								
4. Actual data	53.8	41.6	46.7	47.2	44.2	43.7	44.0	43.8
5. Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6. Cyclically adjusted data	53.8	41.6	46.7	47.2	44.2	43.7	44.1	43.9
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-13.2	-3.6	-6.8	-6.6	-2.8	-2.6	-3.1	-3.4
8. Cyclical component	0.8	-0.4	-1.0	-1.1	-0.8	0.0	0.4	0.5
9. Cyclically adjusted balance	-14.0	-3.2	-5.8	-5.5	-2.1	-2.6	-3.6	-4.0
— as % of potential GDP	:	-2.9	-5.7	-5.3	-2.0	-2.5	-3.6	-4.0
10. GDP at 1995 market prices (annual % change)	5.9	3.9	1.5	3.2	4.7	6.0	5.3	4.7
11. Potential GDP at 1995 market prices (annual % change)	:	1.8	2.9	3.6	3.8	3.7	4.0	4.2
12. Gap between actual and potential GDP (% of potential GDP)	:	-1.9	-2.8	-3.2	-2.3	-0.2	1.0	1.4
Denmark	**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)								
1. Actual data	57.2	56.8	55.7	55.6	57.2	57.4	54.7	53.8
2. Cyclical component	0.1	1.4	-0.2	-0.8	-1.0	-0.5	0.0	0.1
3. Cyclically adjusted data	57.1	55.4	55.9	56.4	58.1	57.9	54.7	53.8
Total uses (% of GDP)								
4. Actual data	59.2	53.6	54.7	54.8	54.6	52.7	50.9	50.0
5. Cyclical component	0.0	-0.4	0.0	0.2	0.3	0.1	0.0	0.0
6. Cyclically adjusted data	59.2	53.8	54.5	54.3	54.2	52.4	50.8	49.8
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-2.0	3.2	1.0	0.8	2.5	4.7	3.8	3.9
8. Cyclical component	0.1	1.7	-0.2	-1.1	-1.2	-0.6	0.0	0.1
9. Cyclically adjusted balance	-2.1	1.6	1.4	2.1	3.9	5.5	3.9	4.0
— as % of potential GDP	-2.0	1.7	1.4	2.0	3.8	5.4	3.9	4.0
10. GDP at 1995 market prices (annual % change)	3.1	3.5	0.5	0.7	1.9	3.1	3.2	2.3
11. Potential GDP at 1995 market prices (annual % change)	2.3	2.3	2.0	1.9	2.0	2.2	2.3	2.3
12. Gap between actual and potential GDP (% of potential GDP)	-0.1	2.5	-0.4	-1.6	-1.7	-0.8	0.0	0.1

Source: Commission services.

Table A.3.8

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions							
Estonia		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	44.0	37.9	37.8	39.1	37.9	37.5	37.3	36.8
2.	Cyclical component	0.5	-0.6	-0.6	-0.7	-0.6	0.0	0.3	0.4
3.	Cyclically adjusted data	43.5	38.4	38.4	39.8	38.5	37.5	36.9	36.4
Total uses (% of GDP)									
4.	Actual data	43.6	38.3	36.8	36.7	36.4	35.9	35.8	35.9
5.	Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	43.6	38.2	36.8	36.8	36.4	35.9	35.9	35.9
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	0.4	-0.4	1.0	2.4	1.5	1.6	1.4	0.8
8.	Cyclical component	0.5	-0.6	-0.6	-0.7	-0.6	0.0	0.4	0.4
9.	Cyclically adjusted balance	-0.1	0.2	1.6	2.9	2.1	1.6	1.1	0.4
	— as % of potential GDP	2.7	0.1	1.2	2.5	1.8	1.5	1.1	0.6
10.	GDP at 1995 market prices (annual % change)	4.5	7.9	7.2	6.7	7.8	9.8	8.9	7.9
11.	Potential GDP at 1995 market prices (annual % change)	:	5.1	6.8	7.3	7.6	8.4	8.1	8.1
12.	Gap between actual and potential GDP (% of potential GDP)	-6.7	-1.5	-0.5	-1.1	-0.9	0.4	1.1	1.0
Cyprus		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	:	35.3	36.1	39.1	39.7	42.3	41.8	41.8
2.	Cyclical component	:	0.5	0.2	-0.4	-0.2	-0.1	0.0	0.2
3.	Cyclically adjusted data	:	34.8	35.9	39.5	40.0	42.4	41.7	41.6
Total uses (% of GDP)									
4.	Actual data	:	37.7	40.6	45.3	43.8	44.7	43.9	43.8
5.	Cyclical component	:	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	:	37.7	40.6	45.4	44.1	44.7	43.9	43.8
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	:	-2.4	-4.5	-6.3	-4.1	-2.4	-2.1	-2.0
8.	Cyclical component	:	0.5	0.2	-0.4	-0.2	-0.1	0.0	0.2
9.	Cyclically adjusted balance	:	-2.9	-4.6	-5.9	-4.1	-2.3	-2.1	-2.2
	— as % of potential GDP	:	-3.0	-5.0	-6.0	-3.9	-2.1	-1.9	-2.0
10.	GDP at 1995 market prices (annual % change)	9.9	5.0	2.1	1.9	3.9	3.8	3.8	3.8
11.	Potential GDP at 1995 market prices (annual % change)	:	3.5	3.5	3.8	4.4	3.6	3.3	3.3
12.	Gap between actual and potential GDP (% of potential GDP)	1.1	1.8	1.2	-0.6	-1.1	-0.9	-0.5	0.0

Source: Commission services.

Table A.3.9

Cyclical adjustment of general government receipts, expenditures and budget balances

					ESA 95 definitions				
Latvia		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	36.8	34.7	33.4	33.5	34.9	36.4	36.1	36.1
2.	Cyclical component	0.8	-0.7	-0.6	-0.6	-0.3	0.3	0.6	0.6
3.	Cyclically adjusted data	36.0	35.4	33.9	34.0	35.2	36.0	35.5	35.5
Total uses (% of GDP									
4.	Actual data	38.8	37.5	35.6	34.6	35.9	36.2	37.1	37.1
5.	Cyclical component	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	38.9	37.4	35.6	34.6	35.9	36.3	37.1	37.1
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-2.0	-2.8	-2.3	-1.2	-0.9	0.2	-1.0	-1.0
8.	Cyclical component	0.8	-0.7	-0.6	-0.6	-0.3	0.3	0.6	0.6
9.	Cyclically adjusted balance	-2.8	-2.0	-1.7	-0.6	-0.6	-0.3	-1.6	-1.6
	— as % of potential GDP	-1.0	-2.2	-2.1	-1.0	-0.9	-0.2	-1.2	-0.8
10.	GDP at 1995 market prices (annual % change)	-0.9	6.9	6.5	7.2	8.5	10.2	8.5	7.6
11.	Potential GDP at 1995 market prices (annual % change)	:	6.1	6.9	7.3	8.2	8.6	9.1	8.9
12.	Gap between actual and potential GDP (% of potential GDP)	-3.1	-1.8	-0.5	-0.7	-0.4	1.0	0.5	-0.7
Lithuania		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	34.2	35.8	32.9	31.9	31.9	33.1	32.0	30.7
2.	Cyclical component	-11.4	-14.5	-13.3	-11.7	-11.6	-11.4	-11.2	-11.0
3.	Cyclically adjusted data	45.6	50.3	46.2	43.6	43.6	44.6	43.3	41.8
Total uses (% of GDP)									
4.	Actual data	36.1	39.3	34.3	33.2	33.4	33.7	32.6	31.7
5.	Cyclical component	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4
6.	Cyclically adjusted data	35.7	38.8	33.8	32.8	33.0	33.3	32.3	31.3
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-1.9	-3.6	-1.4	-1.2	-1.5	-0.5	-0.6	-0.9
8.	Cyclical component	-11.8	-15.1	-13.7	-12.1	-12.0	-11.8	-11.6	-11.4
9.	Cyclically adjusted balance	9.9	11.5	12.3	10.8	10.5	11.3	11.0	10.5
	— as % of potential GDP	:	-2.2	-0.9	-1.8	-2.0	-1.2	-1.1	-1.0
10.	GDP at 1995 market prices (annual % change)	3.3	3.9	6.8	10.5	7.0	7.5	6.5	6.2
11.	Potential GDP at 1995 market prices (annual % change)	:	3.5	5.7	6.6	7.2	6.8	7.4	7.4
12.	Gap between actual and potential GDP (% of potential GDP)	:	-4.3	-1.5	2.0	1.8	2.4	1.6	0.4

Source: Commission services.

Table A.3.10

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions						
Hungary		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	:	44.3	43.7	43.4	44.1	44.5	43.1	42.2
2.	Cyclical component	0.6	0.2	0.1	-0.2	0.0	0.0	0.3	0.4
3.	Cyclically adjusted data	:	44.2	43.6	43.6	44.1	44.5	42.9	41.9
Total uses (% of GDP)									
4.	Actual data	:	47.4	52.0	49.8	49.5	50.7	49.8	49.2
5.	Cyclical component	:	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	:	46.7	52.0	49.8	49.7	50.6	49.8	49.2
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	:	-3.0	-8.4	-6.4	-5.4	-6.2	-6.7	-7.0
8.	Cyclical component	:	0.2	0.1	-0.2	0.0	0.0	0.3	0.4
9.	Cyclically adjusted balance	:	-2.5	-8.4	-6.2	-5.6	-6.2	-6.9	-7.4
	— as % of potential GDP	:	-2.3	-8.0	-5.7	-5.2	-5.8	-6.6	-7.1
10.	GDP at 1995 market prices (annual % change)	1.5	5.2	3.8	3.4	4.6	4.1	4.6	4.2
11.	Potential GDP at 1995 market prices (annual % change)	:	4.3	4.4	4.1	4.1	4.0	3.9	3.8
12.	Gap between actual and potential GDP (% of potential GDP)	2.5	-0.2	-0.7	-1.4	-0.9	-0.7	-0.1	0.3
Malta		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	:	35.0	38.7	39.2	43.4	44.2	42.4	40.2
2.	Cyclical component	:	1.6	1.3	-0.1	-1.2	-0.7	-0.4	-0.1
3.	Cyclically adjusted data	:	33.4	37.5	39.3	44.5	44.9	42.8	40.3
Total uses (% of GDP)									
4.	Actual data	:	41.2	44.3	49.4	48.5	47.5	45.4	43.6
5.	Cyclical component	:	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	:	41.3	44.3	49.4	48.5	47.5	45.3	43.4
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	:	-6.2	-5.6	-10.2	-5.1	-3.3	-3.0	-3.4
8.	Cyclical component	:	1.7	1.3	-0.1	-1.2	-0.7	-0.4	-0.1
9.	Cyclically adjusted balance	:	-7.9	-6.9	-10.1	-3.9	-2.6	-2.5	-3.1
	— as % of potential GDP	:	-8.1	-7.0	-10.0	-3.8	-2.4	-2.1	-2.6
10.	GDP at 1995 market prices (annual % change)	6.2	6.4	1.5	-2.5	-1.5	2.5	1.7	1.9
11.	Potential GDP at 1995 market prices (annual % change)	:	3.3	0.8	1.3	1.3	1.7	1.5	1.4
12.	Gap between actual and potential GDP (% of potential GDP)	-3.5	5.0	3.5	-0.4	-3.1	-2.3	-2.1	-1.6

Source: Commission services.

Table A.3.11

Cyclical adjustment of general government receipts, expenditures and budget balances

			ESA 95 definitions						
Poland		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	43.3	39.6	41.0	39.9	38.6	40.8	41.6	40.7
2.	Cyclical component	-1.1	0.8	-0.7	-0.6	-0.1	-0.2	0.1	0.5
3.	Cyclically adjusted data	44.4	38.8	41.7	40.5	38.8	41.0	41.5	40.2
Total uses (% of GDP)									
4.	Actual data	47.7	41.0	44.2	44.6	42.5	43.3	44.6	43.7
5.	Cyclical component	0.2	-0.2	0.1	0.1	0.0	0.0	0.0	-0.1
6.	Cyclically adjusted data	47.5	42.2	44.1	44.4	42.5	43.3	44.6	43.8
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-4.4	-1.5	-3.2	-4.7	-3.9	-2.5	-3.0	-3.0
8.	Cyclical component	-1.4	1.0	-0.8	-0.7	-0.1	-0.2	0.1	0.6
9.	Cyclically adjusted balance	-0.9	-3.5	-2.3	-4.0	-3.8	-2.3	-3.1	-3.6
	— as % of potential GDP	-0.2	-2.7	-2.2	-4.1	-4.2	-2.7	-3.3	-3.5
10.	GDP at 1995 market prices (annual % change)	7.0	4.2	1.4	3.8	5.3	3.2	4.5	4.6
11.	Potential GDP at 1995 market prices (annual % change)	:	3.2	2.9	2.9	3.2	3.6	4.1	4.3
12.	Gap between actual and potential GDP (% of potential GDP)	-4.8	0.6	-2.2	-1.3	0.7	0.4	0.8	1.1
Slovenia		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	:	44.3	45.4	45.2	45.3	45.5	45.5	45.3
2.	Cyclical component	:	0.5	0.0	-0.4	-0.2	-0.2	0.1	0.2
3.	Cyclically adjusted data	:	43.7	45.4	45.6	45.5	45.7	45.4	45.1
Total uses (% of GDP)									
4.	Actual data	:	48.1	48.0	48.1	47.6	47.3	47.3	47.0
5.	Cyclical component	:	-0.1	0.0	0.1	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	:	48.2	48.0	48.0	47.6	47.3	47.4	47.0
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	:	-3.9	-2.7	-2.8	-2.3	-1.8	-1.9	-1.6
8.	Cyclical component	:	0.6	0.0	-0.5	-0.3	-0.2	0.1	0.3
9.	Cyclically adjusted balance	:	-4.5	-2.7	-2.4	-2.1	-1.6	-2.0	-1.9
	— as % of potential GDP	:	-4.3	-2.4	-2.1	-1.8	-1.4	-1.8	-1.7
10.	GDP at 1995 market prices (annual % change)	4.1	4.1	3.5	2.7	4.2	3.9	4.3	4.1
11.	Potential GDP at 1995 market prices (annual % change)	:	4.3	3.7	3.7	3.7	3.6	3.6	3.7
12.	Gap between actual and potential GDP (% of potential GDP)	:	1.0	-0.5	-1.6	-1.1	-0.9	-0.3	0.1

Source: Commission services.

Table A.3.12

Cyclical adjustment of general government receipts, expenditures and budget balances

		ESA 95 definitions							
Slovakia		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	52.6	47.1	35.7	35.6	35.9	33.9	33.0	32.5
2.	Cyclical component	-0.2	-0.5	-0.6	-0.6	-0.5	-0.3	-0.1	0.1
3.	Cyclically adjusted data	52.8	47.6	36.3	36.3	36.4	34.2	33.1	32.3
Total uses (% of GDP)									
4.	Actual data	53.5	59.3	43.3	39.4	38.9	36.8	35.7	34.6
5.	Cyclical component	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
6.	Cyclically adjusted data	53.5	59.2	43.6	39.3	38.9	36.8	35.7	34.6
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-0.8	-12.2	-7.7	-3.7	-3.0	-2.9	-2.7	-2.1
8.	Cyclical component	-0.2	-0.6	-0.6	-0.7	-0.5	-0.3	-0.1	0.2
9.	Cyclically adjusted balance	-0.7	-11.6	-7.3	-3.1	-2.5	-2.6	-2.6	-2.2
	— as % of potential GDP	:	-11.8	-7.7	-3.0	-2.3	-2.4	-2.5	-2.2
10.	GDP at 1995 market prices (annual % change)	5.8	2.0	4.6	4.5	5.5	6.0	6.1	6.5
11.	Potential GDP at 1995 market prices (annual % change)	:	2.5	4.7	6.0	5.4	5.2	5.3	5.4
12.	Gap between actual and potential GDP (% of potential GDP)	:	-1.1	-1.0	-2.4	-2.4	-1.6	-0.8	0.2
Sweden		**1995**	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Total resources (% of GDP)									
1.	Actual data	60.2	61.8	57.5	58.0	58.3	59.1	58.2	57.7
2.	Cyclical component	-0.5	1.3	0.1	-0.4	0.0	-0.1	0.2	0.3
3.	Cyclically adjusted data	60.7	60.5	57.4	58.4	58.3	59.1	58.0	57.4
Total uses (% of GDP)									
4.	Actual data	67.1	56.8	57.9	58.2	56.7	56.4	56.1	55.6
5.	Cyclical component	0.1	-0.2	0.0	0.1	0.0	0.0	0.0	-0.1
6.	Cyclically adjusted data	67.1	57.0	57.7	57.8	56.5	56.2	56.0	55.5
Net lending (+) or net borrowing (-) (% of GDP)									
7.	Actual balance	-6.9	5.0	-0.5	-0.2	1.6	2.7	2.1	2.2
8.	Cyclical component	-0.6	1.6	0.1	-0.5	0.0	-0.1	0.3	0.4
9.	Cyclically adjusted balance	-6.4	3.4	-0.3	0.6	1.8	3.0	2.0	1.9
	— as % of potential GDP	-5.8	3.9	0.0	0.8	1.9	3.0	2.1	2.1
10.	GDP at 1995 market prices (annual % change)	3.9	4.3	2.0	1.7	3.7	2.7	3.4	3.0
11.	Potential GDP at 1995 market prices (annual % change)	2.2	2.9	2.7	2.6	2.6	2.7	3.0	2.9
12.	Gap between actual and potential GDP (% of potential GDP)	-1.8	2.0	-0.3	-1.2	-0.1	-0.1	0.3	0.4

Source: Commission services.

Table A.3.13

Cyclical adjustment of general government receipts, expenditures and budget balances

United Kingdom	ESA 95 definitions							
	1995	2000	2002	2003	2004	2005	2006	2007
Total resources (% of GDP)								
1. Actual data	38.5	40.6	39.3	39.3	39.9	41.3	42.2	42.7
2. Cyclical component	1.7	2.7	2.1	2.1	2.3	2.1	2.2	2.4
3. Cyclically adjusted data	36.8	37.9	37.2	37.2	37.6	39.2	40.0	40.3
Total uses (% of GDP)								
4. Actual data	44.3	36.8	40.9	42.5	43.2	44.8	45.2	45.5
5. Cyclical component	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
6. Cyclically adjusted data	44.4	39.3	41.0	42.6	43.3	44.9	45.3	45.6
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-5.8	3.7	-1.6	-3.3	-3.3	-3.5	-3.0	-2.8
8. Cyclical component	1.8	2.8	2.2	2.2	2.4	2.2	2.3	2.5
9. Cyclically adjusted balance	-7.6	-1.4	-3.8	-5.5	-5.7	-5.7	-5.3	-5.3
— as % of potential GDP	-5.5	0.8	-1.7	-3.4	-3.6	-3.3	-2.7	-2.5
10. GDP at 1995 market prices (annual % change)	2.9	4.0	2.0	2.5	3.1	1.8	2.4	2.8
11. Potential GDP at 1995 market prices (annual % change)	2.4	3.0	2.7	2.6	2.7	2.8	2.8	2.7
12. Gap between actual and potential GDP (% of potential GDP)	-0.7	1.5	0.2	0.1	0.5	-0.4	-0.7	-0.7

Source: Commission services.

Table A.3.14

Cyclical adjustment of general government receipts, expenditures and budget balances

EUR-12 (¹)	ESA 95 definitions							
	1995	2000	2002	2003	2004	2005	2006	2007
Total resources (% of GDP)								
1. Actual data	45.5	46.3	45.1	45.1	44.7	45.2	45.0	44.8
2. Cyclical component	-0.1	1.1	0.6	0.1	0.2	-0.1	0.0	0.0
3. Cyclically adjusted data	45.6	45.3	44.6	45.0	44.6	45.2	45.0	44.8
Total uses (% of GDP)								
4. Actual data	50.5	46.3	47.7	48.2	47.5	47.6	47.4	47.2
5. Cyclical component	0.0	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0
6. Cyclically adjusted data	50.5	47.5	47.8	48.2	47.5	47.5	47.4	47.2
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	-5.0	0.0	-2.6	-3.1	-2.8	-2.4	-2.4	-2.4
8. Cyclical component	-0.1	1.3	0.7	0.1	0.2	-0.1	0.1	0.0
9. Cyclically adjusted balance	-4.9	-2.2	-3.2	-3.1	-2.9	-2.3	-2.4	-2.4
— as % of potential GDP	-4.4	-2.0	-2.9	-2.8	-2.6	-1.9	-2.0	-1.9
10. GDP at 1995 market prices (annual % change)	2.5	3.8	0.9	0.7	2.0	1.3	2.0	1.8
11. Potential GDP at 1995 market prices (annual % change)	2.1	2.2	1.9	1.8	1.8	1.9	1.9	2.0
12. Gap between actual and potential GDP (% of potential GDP)	-1.1	1.9	0.6	-0.5	-0.3	-0.9	-0.8	-0.9

EU-25 (¹)	1995	2000	2002	2003	2004	2005	2006	2007
Total resources (% of GDP)								
1. Actual data	:	45.7	44.4	44.5	44.3	44.9	44.9	44.7
2. Cyclical component	:	1.3	0.7	0.3	0.5	0.3	0.4	0.4
3. Cyclically adjusted data	:	44.4	43.7	44.2	43.8	44.6	44.5	44.3
Total uses (% of GDP)								
4. Actual data	:	44.9	46.8	47.5	47.0	47.2	47.2	46.9
5. Cyclical component	:	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0
6. Cyclically adjusted data	:	46.3	46.9	47.5	47.0	47.2	47.2	47.0
Net lending (+) or net borrowing (-) (% of GDP)								
7. Actual balance	:	0.8	-2.4	-3.0	-2.7	-2.3	-2.3	-2.2
8. Cyclical component	:	1.5	0.8	0.3	0.5	0.3	0.4	0.5
9. Cyclically adjusted balance	:	-1.9	-3.2	-3.3	-3.1	-2.6	-2.7	-2.7
— as % of potential GDP	:	-1.3	-2.5	-2.7	-2.5	-1.9	-1.9	-1.8
10. GDP at 1995 market prices (annual % change)	2.7	3.9	1.2	1.2	2.4	1.6	2.3	2.2
11. Potential GDP at 1995 market prices (annual % change)	:	2.4	2.2	2.1	2.1	2.2	2.2	2.3
12. Gap between actual and potential GDP (% of potential GDP)	:	1.7	0.4	-0.5	-0.2	-0.7	-0.7	-0.8

(¹) Due to problem with availability of the data, Luxembourg data are not included.

Source: Commission services.

Table A.4.1

Current tax burden; total economy — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	45.5	46.9	47.0	46.6	46.7	47.3	47.0	46.4
DE	41.2	43.2	40.8	40.9	39.8	39.8	39.6	39.6
EL	34.4	39.7	39.3	38.5	37.4	37.2	37.4	37.4
ES	33.3	35.0	35.0	35.0	35.4	36.4	36.5	36.3
FR	44.4	45.7	44.7	44.3	44.5	45.5	45.6	45.4
IE	34.7	32.7	29.6	30.3	31.6	32.1	31.9	31.9
IT	41.3	42.1	41.0	40.3	40.4	40.7	40.8	40.8
LU	38.1	39.8	39.7	38.9	38.7	39.3	39.2	39.4
NL	39.8	40.5	38.4	38.1	38.5	39.1	39.4	39.2
AT	43.5	44.7	45.5	44.7	44.2	43.4	42.1	42.4
PT	32.7	35.1	35.5	36.1	35.6	36.6	37.4	37.6
FI	46.0	47.6	44.4	43.9	43.5	44.3	43.8	43.5
EUR-12	41.2	42.5	41.0	40.8	40.5	41.0	40.9	40.8
CZ	35.8	34.1	35.1	35.7	36.7	37.0	37.1	36.9
DK	50.6	51.0	49.7	49.6	50.7	51.6	49.6	49.0
EE	37.9	32.6	32.5	33.0	32.6	32.7	31.6	31.1
CY	:	30.5	31.4	33.2	33.4	35.3	34.9	34.9
LV	33.2	29.7	28.4	28.7	28.8	29.4	29.0	28.8
LT	28.6	30.3	28.6	28.3	28.7	29.1	28.7	28.1
HU	42.5	39.3	39.1	39.0	39.0	38.9	37.6	36.5
MT	:	29.4	33.6	33.6	35.9	36.7	36.3	36.2
PL	37.2	34.2	34.6	33.8	32.7	34.8	35.6	35.5
SI	:	38.8	39.4	39.7	39.9	40.0	40.0	39.8
SK	41.1	33.9	32.5	31.5	30.5	29.7	29.1	28.9
SE	49.5	54.0	50.3	50.9	51.2	51.9	51.1	50.8
UK	35.9	37.9	36.2	36.2	36.7	37.8	38.6	39.1
EU-25	:	41.8	40.3	40.2	40.1	40.7	40.7	40.6

Source: Commission services.

Table A.4.2

Social contributions received; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	16.4	16.0	16.6	16.6	16.3	16.2	16.0	15.7
DE	18.3	18.3	18.1	18.2	17.8	17.7	17.4	16.6
EL	12.6	13.7	14.9	15.3	14.6	14.3	14.8	14.8
ES	12.7	12.9	13.0	13.0	13.0	13.0	12.9	12.8
FR	20.3	17.9	18.0	18.1	18.0	18.3	18.4	18.5
IE	6.7	5.6	5.7	5.8	6.1	6.2	6.3	6.3
IT	14.4	12.4	12.5	12.6	12.7	12.9	12.7	12.7
LU	10.9	10.9	11.7	11.7	11.7	11.8	11.7	11.8
NL	16.5	16.4	14.3	14.8	15.0	14.3	15.7	15.4
AT	17.1	16.6	16.3	16.3	16.1	16.1	16.0	15.9
PT	10.4	11.2	11.7	12.3	12.4	12.5	12.4	12.3
FI	14.7	12.2	12.0	11.9	11.8	12.2	12.4	12.3
EUR-12	17.0	15.9	15.7	15.8	15.6	15.6	15.6	15.3
CZ	14.2	14.3	15.0	15.1	15.0	15.2	15.2	15.1
DK	2.9	3.6	3.1	3.2	3.1	2.9	2.9	2.8
EE	13.1	11.6	11.6	11.4	11.2	11.0	10.6	10.4
CY	:	6.7	6.8	7.1	7.8	8.4	8.1	8.1
LV	12.0	10.1	9.5	9.1	8.9	8.7	8.6	8.5
LT	7.6	9.4	8.7	8.6	8.7	8.6	8.3	8.2
HU	15.5	13.2	13.7	13.6	13.6	14.1	13.8	13.1
MT	:	7.6	8.2	8.2	8.5	8.9	8.7	8.6
PL	11.3	14.4	14.5	14.0	13.4	13.8	14.2	13.6
SI	:	15.0	15.1	15.0	15.0	15.2	15.0	14.8
SK	14.2	13.6	13.5	13.0	12.1	11.1	11.0	10.7
SE	13.6	15.0	15.3	15.0	14.6	14.7	14.5	14.4
UK	7.4	7.6	7.4	8.0	8.2	8.5	8.5	8.6
EU-25	:	14.1	13.9	14.1	14.0	14.0	14.0	13.8

Source: Commission services.

Table A.4.3

Current taxes on income and wealth (direct taxes); general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	16.3	17.1	17.1	16.7	16.8	17.1	16.9	16.6
DE	10.8	12.3	10.6	10.4	10.0	10.1	10.0	9.9
EL	7.4	10.6	9.3	8.7	8.7	9.1	9.1	9.1
ES	9.9	10.2	10.4	10.1	10.2	11.0	11.0	10.9
FR	8.1	12.0	11.3	10.9	11.1	11.4	11.4	11.0
IE	13.5	13.3	11.5	11.8	12.3	12.2	12.0	12.0
IT	14.5	14.4	13.9	13.4	13.3	13.3	13.6	13.5
LU	15.3	14.9	15.2	14.7	13.2	13.7	14.0	14.4
NL	11.9	11.6	11.4	10.7	10.5	11.7	11.0	11.1
AT	11.6	13.1	14.0	13.5	13.4	12.8	11.5	12.0
PT	8.4	9.8	9.3	8.7	8.7	8.6	8.9	9.1
FI	17.2	21.3	18.8	17.7	17.6	17.8	17.2	17.0
EUR-12	11.1	12.7	11.9	11.5	11.4	11.6	11.6	11.4
CZ	9.5	8.3	9.2	9.6	9.7	9.5	9.5	9.5
DK	30.7	30.3	29.1	29.1	30.0	30.9	29.4	29.0
EE	10.9	8.1	7.9	8.6	8.5	7.4	7.2	7.1
CY	:	11.1	11.2	9.7	8.2	9.4	9.5	9.5
LV	7.1	7.3	7.7	7.5	7.9	8.0	8.1	8.1
LT	8.8	8.4	7.5	8.0	8.7	9.1	9.0	8.7
HU	9.3	9.8	10.3	9.7	9.2	9.2	9.1	9.0
MT	:	9.2	11.5	12.1	12.2	11.9	11.9	11.9
PL	11.7	7.2	6.9	6.6	6.4	7.1	7.1	7.0
SI	:	7.5	7.9	8.2	8.4	8.6	8.8	9.0
SK	11.4	7.5	7.1	7.1	6.0	5.6	5.5	5.5
SE	19.9	22.2	17.8	18.6	19.4	19.9	19.3	19.2
UK	14.7	16.4	15.4	14.9	15.2	16.1	17.0	17.3
EU-25	:	13.7	12.8	12.4	12.4	12.8	12.8	12.8

Source: Commission services.

Table A.4.4

Taxes linked to imports and production (indirect taxes); general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	11.9	12.9	12.7	12.7	13.0	13.2	13.3	13.3
DE	11.1	11.9	11.7	11.8	11.7	11.8	11.9	12.9
EL	13.5	14.9	14.1	13.6	12.9	12.6	13.3	13.4
ES	9.9	11.4	11.2	11.5	11.9	12.1	12.2	12.2
FR	15.2	15.2	14.9	15.0	15.3	15.6	15.6	15.6
IE	13.4	13.1	12.0	12.3	13.0	13.4	13.4	13.4
IT	11.8	14.7	14.3	14.0	14.1	14.2	14.2	14.2
LU	11.0	13.5	12.5	12.3	13.6	13.6	13.3	13.0
NL	10.3	11.6	12.1	12.2	12.5	12.7	12.7	12.5
AT	13.9	14.4	14.7	14.5	14.5	14.3	14.3	14.3
PT	12.9	13.5	14.2	14.8	14.3	15.3	16.0	16.1
FI	13.5	13.6	13.4	13.9	13.8	14.0	14.0	14.0
EUR-12	12.2	13.3	13.1	13.1	13.3	13.4	13.5	13.8
CZ	12.1	11.4	10.9	11.1	11.7	12.0	11.9	11.8
DK	16.8	17.0	17.4	17.1	17.4	17.6	17.2	16.9
EE	13.9	12.9	13.1	13.0	12.8	14.0	13.7	13.3
CY	:	12.7	13.4	16.5	17.4	17.5	17.4	17.3
LV	14.1	12.3	11.2	12.1	11.8	12.6	12.4	12.4
LT	12.3	12.6	12.4	11.8	11.1	11.2	11.2	11.0
HU	17.7	16.3	15.1	15.8	16.2	15.6	14.8	14.4
MT	:	12.6	13.9	13.3	15.3	15.6	15.5	15.4
PL	14.2	12.6	13.2	13.2	12.8	13.9	14.3	14.9
SI	:	16.3	16.4	16.6	16.2	16.2	16.1	16.0
SK	15.5	12.9	12.0	11.4	12.3	12.7	12.3	12.3
SE	15.4	16.3	16.8	17.0	16.9	17.0	17.0	16.9
UK	12.9	13.3	13.0	13.0	13.1	12.9	12.8	13.0
EU-25	:	13.5	13.2	13.3	13.4	13.5	13.6	13.8

Source: Commission services.

Table A.4.5

Other current revenue; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	3.3	3.0	3.0	2.9	2.6	2.8	2.7	2.6
DE	3.6	3.0	3.1	3.0	2.8	2.9	2.8	2.7
EL	4.5	3.6	3.0	2.5	2.1	2.3	2.7	2.1
ES	4.0	3.4	3.4	3.3	3.1	3.1	3.1	3.0
FR	4.4	3.7	4.0	3.7	3.8	3.8	3.9	4.0
IE	2.8	2.1	2.1	1.9	2.0	2.0	1.9	1.9
IT	3.0	3.0	3.5	3.4	3.6	3.5	3.5	3.5
LU	4.8	4.3	3.9	3.5	3.5	3.1	3.0	2.9
NL	5.7	4.6	4.9	4.8	4.9	5.2	5.3	5.4
AT	4.9	3.2	3.8	3.8	3.6	3.6	3.6	3.6
PT	3.9	3.3	3.6	3.5	3.7	3.5	3.7	3.7
FI	7.2	6.0	5.9	5.8	5.9	5.9	6.1	5.9
EUR-12	4.0	3.4	3.6	3.4	3.4	3.4	3.4	3.4
CZ	6.8	6.6	6.3	6.3	6.2	5.9	6.1	6.0
DK	5.2	4.2	4.1	4.2	4.5	4.1	3.8	3.6
EE	8.9	4.1	4.4	4.2	4.3	3.5	3.1	2.9
CY	:	3.2	2.9	4.0	3.7	4.2	4.7	4.7
LV	6.3	7.4	6.6	6.0	5.7	4.9	4.6	4.4
LT	6.3	5.8	3.9	3.2	2.9	3.1	3.1	2.9
HU	:	6.0	5.7	5.6	6.1	6.3	6.1	5.8
MT	:	5.7	5.9	6.3	6.6	5.2	4.5	3.5
PL	5.7	4.9	5.7	5.5	5.6	5.7	5.2	4.6
SI	:	3.7	3.9	3.7	4.0	4.0	4.0	4.0
SK	13.6	15.0	5.2	6.0	6.6	6.4	6.2	6.0
SE	8.1	5.8	4.9	4.9	4.7	4.9	4.8	4.7
UK	2.9	2.4	2.3	2.2	2.1	2.0	2.2	2.3
EU-25	:	3.4	3.5	3.4	3.3	3.3	3.4	3.3

Source: Commission services.

Table A.4.6

Total current revenue; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	47.8	49.0	49.4	48.9	48.6	49.3	48.8	48.1
DE	43.9	45.6	43.5	43.5	42.3	42.4	42.1	42.1
EL	38.1	42.7	41.3	40.0	38.4	38.3	39.9	39.3
ES	36.6	37.8	38.0	38.0	38.3	39.2	39.2	38.9
FR	48.0	48.9	48.2	47.7	48.1	49.1	49.4	49.2
IE	36.4	34.1	31.2	31.8	33.3	33.9	33.6	33.6
IT	43.7	44.6	44.1	43.4	43.7	44.0	44.1	44.0
LU	42.0	43.6	43.4	42.2	42.0	42.2	42.0	42.1
NL	44.4	44.2	42.7	42.4	42.9	43.8	44.7	44.6
AT	47.5	47.2	48.8	48.0	47.5	46.7	45.4	45.6
PT	35.7	37.8	38.8	39.3	39.1	39.9	41.0	41.3
FI	52.5	53.2	50.1	49.4	49.1	49.9	49.7	49.1
EUR-12	44.3	45.2	44.2	43.8	43.6	44.1	44.1	43.9
CZ	42.7	40.7	41.4	42.0	42.7	42.5	42.8	42.4
DK	55.6	55.0	53.7	53.6	54.9	55.5	53.2	52.3
EE	46.8	36.7	36.9	37.2	36.7	35.9	34.6	33.7
CY	:	33.7	34.4	37.2	37.1	39.5	39.6	39.6
LV	39.5	37.1	35.0	34.7	34.3	34.4	33.7	33.3
LT	34.9	36.1	32.6	31.5	31.5	32.0	31.6	30.8
HU	:	45.3	44.8	44.6	45.1	45.2	43.7	42.3
MT	:	35.1	39.5	39.9	42.5	41.6	40.6	39.5
PL	42.9	39.0	40.3	39.3	38.3	40.5	40.8	40.1
SI	:	42.5	43.3	43.4	43.7	44.0	44.0	43.8
SK	54.8	48.9	37.8	37.5	37.1	35.7	34.9	34.5
SE	57.0	59.3	54.9	55.4	55.6	56.5	55.6	55.2
UK	37.8	39.7	38.0	38.0	38.5	39.5	40.5	41.1
EU-25	:	44.7	43.4	43.2	43.1	43.7	43.8	43.7

Source: Commission services.

Table A.4.7

Interest; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	1995	2000	2002	2003	2004	2005	2006	2007
BE	8.9	6.6	5.8	5.4	4.9	4.5	4.3	4.0
DE	3.5	3.2	2.9	3.0	2.8	2.8	2.8	2.8
EL	12.7	8.1	6.1	5.5	5.3	4.8	4.8	4.9
ES	5.1	3.2	2.7	2.4	2.1	1.8	1.7	1.5
FR	3.5	2.9	2.9	2.8	2.7	2.7	2.7	2.7
IE	5.3	1.9	1.3	1.2	1.2	1.2	1.2	1.2
IT	11.2	6.4	5.7	5.2	4.8	4.7	4.5	4.8
LU	0.4	0.3	0.3	0.2	0.2	0.1	0.1	0.1
NL	5.6	3.7	2.8	2.7	2.6	2.4	2.4	2.3
AT	3.9	3.7	3.3	3.1	2.9	2.9	2.8	2.7
PT	5.9	3.1	2.9	2.8	2.7	2.7	2.9	3.1
FI	3.9	2.8	2.1	1.9	1.8	1.7	1.5	1.5
EUR-12	5.4	3.9	3.5	3.3	3.1	3.0	3.0	3.0
CZ	1.1	0.9	1.2	1.1	1.2	1.2	1.3	1.4
DK	5.9	3.7	3.0	2.7	2.4	2.1	1.9	1.6
EE	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
CY	:	3.4	3.2	3.4	3.2	3.4	3.1	3.0
LV	1.2	1.0	0.7	0.7	0.7	0.6	0.6	0.6
LT	0.4	1.7	1.3	1.2	0.9	0.8	0.7	0.7
HU	:	5.5	3.9	3.9	4.2	3.9	3.7	3.7
MT	:	3.6	3.7	3.7	4.1	4.0	3.9	3.9
PL	5.7	3.0	2.7	2.8	2.6	2.4	2.5	2.6
SI	:	2.5	2.4	2.1	1.9	1.6	1.5	1.4
SK	2.3	4.0	3.5	2.5	2.2	1.7	1.8	1.7
SE	6.5	4.0	3.2	2.4	1.9	1.9	1.9	1.9
UK	3.6	2.7	2.0	2.0	2.0	2.1	2.1	2.1
EU-25	:	3.7	3.2	3.0	2.9	2.8	2.7	2.7

Source: Commission services.

Table A.4.8

Final consumption expenditure of general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	21.5	21.3	22.5	23.0	22.9	23.1	23.1	23.1
DE	19.6	19.0	19.2	19.2	18.6	18.6	18.4	18.2
EL	15.3	17.4	17.8	16.7	16.6	16.4	15.9	15.9
ES	17.7	17.2	17.2	17.4	17.8	17.8	17.9	18.0
FR	23.6	22.9	23.4	23.7	23.7	23.8	23.8	23.6
IE	16.3	13.8	15.0	15.3	15.6	15.9	16.2	16.3
IT	17.4	17.9	19.2	19.7	19.8	20.3	20.2	20.1
LU	15.9	15.1	16.3	16.5	16.9	17.5	17.4	17.3
NL	23.0	21.8	23.7	24.4	24.3	24.0	25.5	25.3
AT	20.1	18.4	18.2	18.2	18.0	18.0	17.9	17.8
PT	17.7	19.3	20.0	20.4	20.6	21.1	20.9	20.8
FI	22.7	20.5	21.0	21.7	21.9	22.5	22.5	22.5
EUR-12	20.2	19.6	20.2	20.4	20.3	20.4	20.4	20.3
CZ	21.5	21.8	22.5	23.4	22.4	22.4	21.7	20.8
DK	25.2	25.1	26.2	26.3	26.5	25.8	25.3	25.0
EE	27.4	20.2	19.2	19.4	19.0	18.2	17.7	17.5
CY	:	16.4	18.4	19.9	18.2	18.3	18.0	18.0
LV	24.1	20.8	21.0	21.4	19.6	17.8	17.9	17.6
LT	21.9	21.7	19.4	18.4	18.0	16.8	16.3	16.0
HU	23.4	21.4	23.4	24.6	23.8	23.7	23.6	23.3
MT	:	19.2	21.0	21.8	22.7	22.1	21.4	21.1
PL	18.7	17.5	18.0	18.3	17.9	18.7	17.5	17.2
SI	:	19.3	19.7	19.6	19.5	19.6	19.4	19.1
SK	20.3	19.6	20.3	20.5	20.0	18.7	18.1	17.4
SE	27.0	26.4	27.8	28.1	27.4	27.3	27.3	27.1
UK	19.2	18.5	19.8	20.7	20.9	21.4	22.0	22.1
EU-25	:	19.7	20.4	20.8	20.7	20.9	20.9	20.8

Source: Commission services.

Table A.4.9

Compensation of employees; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	11.9	11.5	12.2	12.3	12.0	12.2	12.1	12.0
DE	8.7	8.1	7.9	7.8	7.6	7.4	7.2	7.0
EL	11.3	11.5	12.0	11.7	12.4	12.6	12.3	12.3
ES	11.0	10.3	10.0	10.1	10.1	9.9	9.8	9.7
FR	13.6	13.3	13.5	13.5	13.3	13.3	13.2	13.0
IE	10.1	8.0	8.6	9.0	9.3	9.9	10.1	10.1
IT	10.9	10.4	10.6	10.8	10.8	11.0	11.0	10.9
LU	8.5	7.5	8.0	8.1	8.3	8.2	8.1	8.0
NL	10.3	9.6	9.8	10.1	10.0	9.9	9.6	9.5
AT	12.5	10.9	9.6	9.6	9.3	9.2	9.1	9.0
PT	12.9	14.2	14.7	14.3	14.4	14.5	14.2	14.0
FI	15.1	13.1	13.2	13.6	13.6	13.8	13.8	13.7
EUR-12	10.9	10.4	10.4	10.5	10.4	10.4	10.3	10.2
CZ	7.3	7.1	7.8	8.3	8.0	8.1	8.0	7.9
DK	17.2	17.1	17.8	17.9	17.8	17.3	17.0	16.8
EE	11.7	11.0	10.1	10.5	10.3	9.8	9.5	9.2
CY	:	13.8	13.9	15.7	15.1	14.9	14.5	14.4
LV	11.2	10.8	10.5	10.7	10.5	10.2	10.0	9.9
LT	10.1	12.7	11.4	10.8	10.8	10.4	10.1	10.0
HU	12.1	10.7	12.4	13.3	12.8	12.7	12.7	12.5
MT	:	13.0	14.8	15.2	15.4	14.8	14.5	14.3
PL	10.7	10.1	10.8	10.7	10.2	10.1	10.1	9.8
SI	:	11.6	12.0	12.1	12.0	12.1	11.9	11.7
SK	9.4	8.7	9.0	8.9	8.5	7.4	7.1	6.8
SE	16.6	15.6	16.1	16.5	16.3	16.1	15.9	15.8
UK	10.6	9.9	10.1	10.2	10.7	11.0	11.3	11.4
EU-25	:	10.6	10.7	10.8	10.7	10.8	10.7	10.6

Source: Commission services.

Table A.4.10

Total current expenditure; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	49.8	46.3	47.4	48.1	47.3	47.5	47.3	47.2
DE	44.0	44.0	44.4	44.8	43.6	43.4	43.0	42.4
EL	44.9	42.9	42.0	41.2	40.7	39.5	40.1	40.1
ES	38.4	34.8	34.1	34.0	34.1	33.8	33.9	34.0
FR	48.9	46.7	47.9	48.5	48.3	48.8	48.9	48.6
IE	36.4	26.4	27.9	28.1	28.7	30.0	30.1	30.1
IT	47.4	43.2	43.9	44.3	44.2	44.6	44.6	44.7
LU	34.7	33.0	35.5	36.3	37.3	37.9	37.6	37.4
NL	45.5	39.8	40.9	41.7	41.6	40.9	42.5	41.9
AT	48.5	45.6	46.2	46.4	45.4	44.9	44.1	43.8
PT	37.6	37.2	39.1	40.7	41.4	42.7	43.1	43.3
FI	53.3	43.7	43.3	44.3	44.2	45.0	44.5	44.4
EUR-12	45.6	43.0	43.5	43.8	43.3	43.4	43.3	43.0
CZ	37.0	38.5	39.4	40.6	38.6	38.5	38.9	39.1
DK	55.7	50.2	50.9	51.1	50.8	49.1	47.9	47.0
EE	39.7	32.1	30.2	30.7	32.0	30.9	29.3	29.1
CY	:	32.6	35.3	39.5	37.8	39.1	38.0	37.9
LV	39.3	36.8	34.0	33.1	31.5	30.2	30.3	29.7
LT	32.0	35.1	30.9	29.8	29.6	29.6	29.3	28.8
HU	:	42.8	44.6	45.9	46.0	47.0	47.5	46.9
MT	:	37.5	40.7	42.1	44.4	43.3	42.7	42.4
PL	43.3	37.5	39.3	39.5	38.1	39.1	39.5	38.7
SI	:	41.6	42.0	41.6	41.6	41.7	41.6	41.5
SK	47.4	48.3	38.6	37.8	36.7	34.3	33.6	32.8
SE	59.6	51.5	52.2	52.5	51.1	50.8	50.8	50.3
UK	40.5	36.8	37.9	39.2	39.6	40.7	40.7	40.8
EU-25	:	42.1	42.7	43.3	42.9	43.0	43.0	42.7

Source: Commission services.

Table A.4.11

Gross saving; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	-1.9	2.6	1.9	0.7	1.3	1.8	1.5	1.0
DE	-0.1	1.6	-0.9	-1.3	-1.2	-1.0	-0.9	-0.4
EL	-6.8	-0.2	-0.7	-1.2	-2.4	-1.2	-0.2	-0.8
ES	-1.8	3.0	3.9	3.9	4.2	5.3	5.3	4.9
FR	-0.8	2.2	0.3	-0.8	-0.2	0.3	0.5	0.6
IE	0.0	7.7	3.4	3.7	4.6	3.9	3.5	3.5
IT	-3.7	1.4	0.2	-0.9	-0.4	-0.6	-0.5	-0.8
LU	7.3	10.5	7.9	5.9	4.7	4.3	4.4	4.7
NL	-1.1	4.4	1.8	0.7	1.3	2.9	2.1	2.6
AT	-1.0	1.6	2.7	1.6	2.2	1.8	1.3	1.8
PT	-2.0	0.6	-0.3	-1.4	-2.2	-2.8	-2.1	-2.0
FI	-0.7	9.5	6.8	5.0	4.9	5.0	5.1	4.8
EUR-12	-1.3	2.3	0.7	0.0	0.3	0.7	0.8	0.9
CZ	5.7	2.2	2.0	1.4	4.1	4.1	4.0	3.3
DK	-0.1	4.8	2.8	2.5	4.1	6.4	5.3	5.3
EE	7.1	4.6	6.7	6.5	4.8	5.0	5.2	4.6
CY	:	1.1	-0.9	-2.3	-0.6	0.4	1.6	1.7
LV	0.2	0.2	1.0	1.6	2.8	4.2	3.5	3.6
LT	2.9	1.0	1.6	1.8	1.8	2.4	2.3	2.0
HU	:	2.5	0.2	-1.2	-1.0	-1.8	-3.8	-4.6
MT	:	-2.4	-1.2	-2.2	-1.9	-1.7	-2.2	-3.0
PL	-0.4	1.5	1.0	-0.2	0.2	1.3	1.4	1.4
SI	:	0.9	1.4	1.8	2.1	2.2	2.4	2.3
SK	7.4	0.6	-0.7	-0.3	0.4	1.4	1.3	1.7
SE	-2.6	7.7	2.7	2.9	4.5	5.7	4.8	4.9
UK	-2.7	2.8	0.1	-1.2	-1.1	-1.2	-0.2	0.2
EU-25	:	2.5	0.7	-0.1	0.3	0.7	0.8	1.0

Source: Commission services.

Table A.4.12

Gross fixed capital formation; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	1.9	2.0	1.7	1.6	1.6	1.8	1.7	1.7
DE	2.2	1.8	1.7	1.5	1.4	1.3	1.3	1.3
EL	3.2	4.0	3.7	4.1	4.2	3.5	3.1	3.1
ES	3.6	3.2	3.5	3.6	3.4	3.6	3.6	3.7
FR	3.2	3.1	2.9	3.1	3.1	3.3	3.3	3.4
IE	2.3	3.5	4.2	3.8	3.6	3.4	3.7	4.0
IT	2.1	2.3	1.7	2.5	2.4	2.4	2.5	2.5
LU	3.8	3.8	4.8	4.6	4.4	4.7	4.7	4.8
NL	2.8	3.0	3.5	3.4	3.1	3.0	2.9	2.8
AT	3.0	1.5	1.3	1.2	1.1	1.1	1.1	1.1
PT	3.5	3.8	3.5	3.1	3.0	3.1	2.9	2.8
FI	2.7	2.5	2.7	2.9	2.9	2.8	2.7	2.7
EUR-12	2.6	2.5	2.4	2.5	2.4	2.4	2.5	2.5
CZ	5.0	2.9	3.9	4.5	4.9	4.5	6.5	6.8
DK	1.8	1.7	1.8	1.6	1.9	1.7	1.7	1.6
EE	5.0	3.9	4.7	4.3	3.0	4.0	4.0	4.1
CY	:	3.0	3.0	3.4	4.1	3.2	3.4	3.4
LV	1.9	1.3	1.3	1.5	1.9	2.1	2.7	3.2
LT	3.4	2.4	2.9	3.0	3.4	3.5	3.5	3.5
HU	:	3.3	5.0	3.5	3.6	3.4	2.7	2.6
MT	:	4.2	4.5	5.2	4.5	5.5	4.6	4.1
PL	3.3	2.4	3.4	3.3	3.4	3.1	4.0	4.1
SI	:	3.1	3.0	3.3	3.4	3.3	3.4	3.3
SK	2.3	2.8	3.2	2.6	2.4	2.1	1.9	1.5
SE	3.9	2.9	3.2	3.1	3.0	3.0	3.0	3.0
UK	2.2	1.2	1.5	1.6	1.8	2.0	2.2	2.4
EU-25	:	2.3	2.3	2.4	2.4	2.4	2.5	2.6

Source: Commission services.

Table A.4.13

Total expenditure; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	**2000**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
BE	51.9	49.1	49.8	51.1	49.5	50.1	49.7	49.5
DE	48.3	45.1	48.1	48.4	46.8	46.7	46.1	45.5
EL	51.0	51.1	49.0	49.0	48.8	46.2	44.8	44.9
ES	44.1	39.0	38.7	38.3	38.8	38.2	38.3	38.5
FR	54.5	51.6	52.6	53.4	53.2	53.9	54.1	53.8
IE	41.1	31.5	33.4	33.4	33.7	34.5	34.9	35.1
IT	52.0	46.0	47.4	48.3	47.8	48.2	48.1	48.4
LU	39.8	37.7	41.4	42.1	43.2	44.3	44.0	43.8
NL	49.3	43.4	46.2	47.1	46.6	45.7	47.7	47.1
AT	56.0	51.4	50.7	50.9	50.0	49.6	48.7	48.3
PT	42.8	43.1	44.3	45.9	46.4	47.8	48.0	48.0
FI	61.4	48.8	48.8	50.0	50.3	50.7	50.1	49.8
EUR-12	50.4	46.3	47.7	48.2	47.5	47.5	47.4	47.1
CZ	53.8	41.6	46.7	47.2	44.2	43.7	44.0	43.8
DK	59.2	53.6	54.7	54.8	54.6	52.7	50.9	50.0
EE	43.6	38.3	36.8	36.7	36.4	35.9	35.8	35.9
CY	:	37.7	40.6	45.3	43.8	44.7	43.9	43.8
LV	38.8	37.5	35.6	34.6	35.9	36.2	37.1	37.1
LT	36.1	39.3	34.3	33.2	33.4	33.7	32.6	31.7
HU	:	47.4	52.0	49.8	49.5	50.7	49.8	49.2
MT	:	41.2	44.3	49.4	48.5	47.5	45.4	43.6
PL	47.7	41.0	44.2	44.6	42.5	43.3	44.6	43.7
SI	:	48.1	48.0	48.1	47.6	47.3	47.3	47.0
SK	53.5	59.3	43.3	39.4	38.9	36.8	35.7	34.6
SE	67.1	56.8	57.9	58.2	56.7	56.4	56.1	55.6
UK	44.3	36.8	40.9	42.5	43.2	44.8	45.2	45.5
EU-25	:	44.9	46.8	47.5	47.0	47.2	47.2	46.9

Source: Commission services.

Table A.4.14

Net lending (+) or net borrowing (-); general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	-4.4	0.0	-0.1	0.0	-0.1	-0.1	-0.4	-1.0
DE	-3.2	1.3	-3.7	-4.0	-3.7	-3.3	-3.1	-2.5
EL	-10.2	-4.1	-5.0	-5.8	-6.8	-4.4	-2.9	-3.5
ES	-6.5	-0.9	-0.3	0.0	-0.2	1.1	0.9	0.4
FR	-5.5	-1.5	-3.2	-4.2	-3.7	-2.9	-3.0	-3.1
IE	-2.1	4.4	-0.4	0.2	1.6	1.0	0.1	-0.4
IT	-7.4	-0.8	-3.0	-3.5	-3.5	-4.3	-4.1	-4.5
LU	2.3	5.9	2.0	0.2	-1.1	-1.9	-1.8	-1.5
NL	-4.0	2.1	-2.0	-3.2	-2.1	-0.3	-1.2	-0.7
AT	-5.7	-1.6	-0.7	-1.7	-1.2	-1.6	-2.0	-1.5
PT	-5.2	-3.0	-2.9	-3.0	-3.2	-6.0	-5.0	-4.9
FI	-6.2	7.0	4.1	2.3	2.1	2.4	2.6	2.4
EUR-12	-5.0	0.0	-2.6	-3.1	-2.8	-2.4	-2.4	-2.4
CZ	-13.2	-3.6	-6.8	-6.6	-2.8	-2.6	-3.1	-3.4
DK	-2.0	3.2	1.0	0.8	2.5	4.7	3.8	3.9
EE	0.4	-0.4	1.0	2.4	1.5	1.6	1.4	0.8
CY	:	-2.4	-4.5	-6.3	-4.1	-2.4	-2.1	-2.0
LV	-2.0	-2.8	-2.3	-1.2	-0.9	0.2	-1.0	-1.0
LT	-1.9	-3.6	-1.4	-1.2	-1.5	-0.5	-0.6	-0.9
HU	:	-3.0	-8.4	-6.4	-5.4	-6.2	-6.7	-7.0
MT	:	-6.2	-5.6	-10.2	-5.1	-3.3	-3.0	-3.4
PL	-4.4	-1.5	-3.2	-4.7	-3.9	-2.5	-3.0	-3.0
SI	:	-3.9	-2.7	-2.8	-2.3	-1.8	-1.9	-1.6
SK	-0.8	-12.2	-7.7	-3.7	-3.0	-2.9	-2.7	-2.1
SE	-6.9	5.0	-0.5	-0.2	1.6	2.7	2.1	2.2
UK	-5.8	3.7	-1.6	-3.3	-3.3	-3.5	-3.0	-2.8
EU-25	:	0.8	-2.4	-3.0	-2.7	-2.3	-2.3	-2.2

Source: Commission services.

Table A.4.15

Net lending (+) or net borrowing (-) excluding interest; general government — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	4.5	6.7	5.7	5.4	4.8	4.5	3.8	3.1
DE	0.3	4.5	-0.8	-1.0	-0.8	-0.5	-0.3	0.3
EL	2.6	4.0	1.1	-0.3	-1.5	0.5	1.9	1.4
ES	-1.4	2.4	2.4	2.3	1.9	2.9	2.6	1.9
FR	-2.0	1.4	-0.3	-1.4	-1.0	-0.2	-0.4	-0.4
IE	3.2	6.3	0.9	1.4	2.7	2.2	1.3	0.8
IT	3.8	5.6	2.7	1.7	1.3	0.4	0.5	0.2
LU	2.7	6.2	2.3	0.4	-1.0	-1.8	-1.7	-1.4
NL	1.7	5.8	0.8	-0.5	0.5	2.2	1.2	1.6
AT	-1.8	2.0	2.6	1.4	1.7	1.2	0.8	1.3
PT	0.7	0.1	0.0	-0.2	-0.5	-3.3	-2.1	-1.8
FI	-2.2	9.8	6.2	4.2	3.8	4.1	4.1	3.9
EUR-12	0.4	3.9	0.9	0.3	0.3	0.6	0.6	0.6
CZ	-12.1	-2.8	-5.6	-5.5	-1.7	-1.4	-1.8	-2.0
DK	3.9	6.8	4.1	3.6	5.0	6.8	5.7	5.5
EE	0.6	-0.2	1.2	2.6	1.8	1.8	1.6	1.0
CY	:	1.1	-1.3	-2.8	-0.9	1.0	1.0	1.0
LV	-0.8	-1.8	-1.5	-0.5	-0.2	0.8	-0.5	-0.4
LT	-1.5	-1.8	-0.1	0.0	-0.5	0.3	0.1	-0.2
HU	:	2.4	-4.4	-2.5	-1.2	-2.3	-3.0	-3.3
MT	:	-2.6	-1.8	-6.5	-1.1	0.7	0.9	0.5
PL	1.3	1.5	-0.4	-1.9	-1.3	-0.1	-0.5	-0.4
SI	:	-1.4	-0.3	-0.7	-0.5	-0.1	-0.4	-0.2
SK	1.5	-8.1	-4.1	-1.2	-0.8	-1.1	-0.9	-0.4
SE	-0.3	9.0	2.8	2.2	3.5	4.6	4.0	4.1
UK	-2.1	6.5	0.4	-1.3	-1.3	-1.3	-0.9	-0.7
EU-25	:	4.4	0.8	0.0	0.2	0.5	0.4	0.5

Source: Commission services.

Table A.4.16

General government consolidated gross debt — Excessive deficit procedure (based on ESA 1995)

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	129.7	107.7	103.2	98.5	94.7	93.3	89.8	87.0
DE	55.5	59.2	60.3	63.8	65.5	67.7	68.9	69.2
EL	108.7	111.6	110.7	107.8	108.5	107.5	105.0	102.1
ES	62.5	59.2	52.5	48.9	46.4	43.2	40.0	37.9
FR	55.1	56.7	58.2	62.4	64.4	66.8	66.9	67.0
IE	81.0	37.8	32.1	31.1	29.4	27.6	27.2	27.0
IT	121.2	109.2	105.5	104.2	103.8	106.4	107.4	107.7
LU	5.8	5.3	6.5	6.3	6.6	6.2	7.9	8.2
NL	74.0	53.6	50.5	51.9	52.6	52.9	51.2	50.3
AT	67.9	65.8	66.0	64.4	63.6	62.9	62.4	61.6
PT	61.0	50.4	55.5	57.0	58.7	63.9	68.4	70.6
FI	56.5	44.3	41.3	44.3	44.3	41.1	39.7	38.3
EUR-12	72.2	69.2	68.1	69.3	69.8	70.8	70.5	70.1
CZ	:	19.1	28.8	30.0	30.6	30.5	31.5	32.4
DK	72.5	51.7	46.8	44.4	42.6	35.8	30.0	26.5
EE	:	5.1	5.5	6.0	5.4	4.8	3.6	3.0
CY	:	59.9	65.2	69.7	71.7	70.3	69.1	67.8
LV	:	12.3	13.5	14.4	14.6	11.9	11.3	10.9
LT	:	23.6	22.3	21.2	19.5	18.7	18.9	19.7
HU	:	54.3	55.0	56.7	57.1	58.4	59.9	62.0
MT	:	56.0	61.2	71.3	76.2	74.7	74.0	74.0
PL	:	35.9	39.8	43.9	41.9	42.5	45.5	46.7
SI	:	27.6	29.7	29.1	29.5	29.1	29.9	29.7
SK	:	50.0	43.3	42.7	41.6	34.5	34.3	34.7
SE	73.0	52.3	52.0	51.8	50.5	50.3	47.6	44.8
UK	51.0	41.2	37.6	39.0	40.8	42.8	44.1	44.7
EU-25	:	61.9	60.5	62.0	62.4	63.4	63.2	62.9

Source: Commission services.

Table A.4.17

Cyclically adjusted total revenue of general government — Adjustment based on potential GDP — ESA 1995

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	47.9	48.2	49.6	51.5	49.4	50.5	49.7	49.0
DE	45.3	46.0	44.4	44.9	43.4	43.7	43.1	43.1
EL	41.8	47.5	43.9	42.7	41.2	41.0	41.1	40.6
ES	38.8	37.3	38.0	38.1	38.8	39.5	39.6	39.4
FR	49.6	49.1	49.0	49.2	49.6	51.3	51.5	51.3
IE	40.1	34.2	31.9	33.0	35.1	36.0	35.9	35.8
IT	44.8	44.4	43.8	44.8	44.4	44.7	44.6	44.5
LU	42.8	41.9	43.0	43.0	42.7	43.0	42.8	42.8
NL	45.8	44.3	44.2	44.7	45.2	46.3	47.2	46.8
AT	50.7	48.9	50.2	49.7	49.1	48.4	46.8	46.9
PT	38.5	39.0	40.7	43.3	43.7	42.6	43.9	44.1
FI	56.7	54.4	53.0	52.8	52.6	53.6	52.9	52.3
EUR-12	45.9	45.5	44.8	45.3	44.9	45.5	45.4	45.2
CZ	:	38.7	40.9	41.8	42.2	41.2	40.5	39.9
DK	57.2	55.5	55.9	56.4	58.0	57.8	54.7	53.8
EE	46.4	38.3	38.0	39.4	38.2	37.4	37.0	36.5
CY	:	34.7	35.7	39.3	40.1	42.7	41.9	41.8
LV	37.7	35.2	33.5	33.6	35.0	36.1	35.9	36.2
LT	:	37.0	33.3	31.4	31.5	32.5	31.6	30.6
HU	:	44.4	44.0	44.0	44.5	44.8	43.2	42.1
MT	:	33.6	37.5	39.4	44.5	45.0	43.1	40.8
PL	45.0	39.4	41.8	40.3	38.4	40.7	41.4	40.3
SI	:	43.9	45.6	45.9	45.7	45.9	45.6	45.3
SK	:	47.4	35.9	36.3	36.5	34.4	33.2	32.4
SE	61.1	60.8	57.6	58.6	58.3	59.1	58.1	57.5
UK	38.8	40.0	39.2	39.2	39.7	41.5	42.5	43.0
EU-25	:	44.9	44.2	44.7	44.4	45.2	45.2	45.0

Source: Commission services.

Table A.4.18

Cyclically adjusted total expenditure of general government — Adjustment based on potential GDP - Excessive deficit procedure

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	51.9	49.2	49.8	51.0	49.4	49.9	49.6	49.3
DE	48.3	47.7	48.0	48.2	46.8	46.6	46.1	45.4
EL	51.0	51.0	48.9	48.9	48.9	46.4	44.9	44.9
ES	43.9	39.2	38.8	38.3	38.8	38.2	38.3	38.4
FR	54.4	51.7	52.7	53.3	53.2	53.8	54.0	53.7
IE	41.0	31.7	33.7	33.5	33.7	34.5	34.8	35.0
IT	52.0	47.2	47.3	48.2	47.7	48.1	48.1	48.4
LU	39.7	37.7	41.4	42.0	43.2	44.3	44.0	43.8
NL	49.1	44.6	46.2	46.7	46.1	45.3	47.4	47.0
AT	55.9	51.7	50.5	50.7	49.9	49.4	48.5	48.2
PT	42.7	43.5	44.3	45.8	46.3	47.8	47.9	47.9
FI	61.0	49.1	48.7	49.8	50.1	50.4	49.9	49.5
EUR-12	50.4	47.4	47.7	48.1	47.4	47.4	47.3	47.1
CZ	:	41.6	46.7	47.2	44.2	43.7	44.1	43.9
DK	59.2	53.8	54.5	54.3	54.2	52.4	50.8	49.8
EE	43.5	38.2	36.8	36.9	36.4	35.9	35.9	35.9
CY	:	37.7	40.6	45.4	44.1	44.7	43.9	43.8
LV	38.7	37.5	35.6	34.6	35.9	36.3	37.1	37.0
LT	:	39.3	34.3	33.2	33.4	33.7	32.7	31.7
HU	:	46.7	52.0	49.8	49.7	50.6	49.8	49.2
MT	:	41.3	44.3	49.4	48.5	47.5	45.3	43.4
PL	47.4	42.1	44.1	44.5	42.6	43.3	44.6	43.8
SI	:	48.2	48.0	48.0	47.6	47.3	47.4	47.0
SK	:	59.2	43.6	39.3	38.8	36.8	35.7	34.6
SE	67.0	57.0	57.7	57.8	56.4	56.2	56.0	55.5
UK	44.3	39.2	40.9	42.5	43.2	44.8	45.2	45.5
EU-25	:	46.2	46.8	47.4	46.9	47.1	47.1	46.9

Source: Commission services.

Table A.4.19

Cyclically adjusted net lending (+) or net borrowing (-) of general government — Adjustment based on potential GDP — Excessive deficit procedure

(Percentage of GDP at market prices (excessive deficit procedure))

	ESA 95 definitions 1995	2000	2002	2003	2004	2005	2006	2007
BE	-3.9	-0.9	-0.2	0.4	0.0	0.6	0.1	-0.3
DE	-3.0	-1.7	-3.7	-3.4	-3.4	-3.0	-3.0	-2.3
EL	-9.2	-3.5	-5.0	-6.2	-7.7	-5.3	-3.8	-4.4
ES	-5.1	-1.9	-0.8	-0.2	0.0	1.3	1.3	1.0
FR	-4.8	-2.6	-3.8	-4.1	-3.6	-2.5	-2.5	-2.5
IE	-0.8	2.4	-1.8	-0.5	1.4	1.5	1.1	0.8
IT	-7.3	-2.8	-3.4	-3.4	-3.3	-3.4	-3.4	-3.8
LU	3.1	4.1	1.7	0.9	-0.5	-1.3	-1.3	-1.0
NL	-3.3	-0.3	-1.9	-2.1	-0.9	1.0	-0.3	-0.2
AT	-5.2	-2.8	-0.3	-1.0	-0.8	-1.0	-1.7	-1.2
PT	-4.2	-4.5	-3.5	-2.5	-2.7	-5.1	-4.0	-3.8
FI	-4.3	5.3	4.3	3.0	2.5	3.2	3.0	2.7
EUR-12	-4.5	-1.9	-2.8	-2.8	-2.6	-1.9	-2.0	-1.9
CZ	:	-2.9	-5.8	-5.4	-2.0	-2.5	-3.6	-4.0
DK	-2.0	1.7	1.4	2.1	3.8	5.4	3.9	4.0
EE	2.9	0.1	1.2	2.5	1.8	1.5	1.1	0.5
CY	:	-3.0	-4.9	-6.1	-3.9	-2.1	-1.9	-2.0
LV	-1.0	-2.3	-2.1	-1.0	-0.9	-0.2	-1.2	-0.8
LT	:	-2.3	-1.0	-1.7	-1.9	-1.2	-1.0	-1.0
HU	:	-2.3	-8.0	-5.8	-5.2	-5.8	-6.6	-7.1
MT	:	-7.7	-6.8	-10.0	-3.9	-2.4	-2.2	-2.6
PL	-0.2	-2.7	-2.3	-4.2	-4.2	-2.6	-3.3	-3.5
SI	:	-4.3	-2.4	-2.1	-1.8	-1.4	-1.8	-1.7
SK	:	-11.8	-7.6	-3.0	-2.3	-2.4	-2.4	-2.1
SE	-5.9	3.8	0.0	0.8	1.9	3.0	2.1	2.1
UK	-5.5	0.8	-1.7	-3.3	-3.5	-3.3	-2.7	-2.5
EU-25	:	-1.3	-2.5	-2.7	-2.5	-1.9	-1.9	-1.8

Source: Commission services.

Table A.5.1

Gross domestic product at current market prices

(Billion EUR)

	1995	2000	2002	2003	2004	2005	2006	2007
BE	217.4	251.7	267.6	274.6	288.1	298.2	310.9	324.0
DE	1 929.4	2 062.5	2 145.0	2 163.4	2 215.7	2 245.5	2 292.6	2 341.3
EL	89.9	125.9	143.5	155.5	168.4	181.1	193.1	205.6
ES	456.5	630.3	729.0	780.6	837.3	904.3	971.7	1 034.1
FR	1 201.1	1 441.4	1 548.6	1 585.2	1 648.4	1 694.1	1 752.4	1 821.6
IE	51.3	104.4	130.5	139.1	148.6	160.3	172.9	186.9
IT	861.1	1 191.1	1 295.2	1 335.4	1 388.9	1 417.2	1 465.6	1 514.1
LU	15.8	22.0	24.0	25.7	27.1	28.6	30.7	33.1
NL	330.9	419.5	465.2	476.3	488.6	501.9	521.7	542.6
AT	183.2	210.4	220.7	227.0	237.0	246.5	257.3	267.7
PT	87.0	122.3	135.4	137.5	142.8	147.2	151.2	157.1
FI	100.1	130.9	140.9	143.8	149.7	155.3	162.1	168.2
EUR-12	5 523.9	6 712.3	7 245.6	7 444.0	7 740.6	7 980.3	8 282.1	8 596.2
CZ	42.3	60.4	78.4	80.3	86.8	98.4	109.6	118.0
DK	139.1	173.6	184.7	189.6	197.2	208.2	221.5	232.0
EE	2.9	5.9	7.5	8.1	9.0	10.5	11.9	13.2
CY	7.0	9.9	11.1	11.7	12.5	13.4	14.0	14.9
LV	3.8	8.5	9.9	10.0	11.1	12.8	14.7	16.8
LT	4.9	12.4	15.0	16.4	18.1	20.6	22.9	25.0
HU	34.4	51.0	69.6	73.5	81.1	87.8	88.5	93.5
MT	2.7	4.2	4.4	4.3	4.3	4.5	4.7	5.0
PL	106.4	185.8	209.4	191.4	203.7	240.5	259.4	274.5
SI	15.5	20.8	23.7	24.9	26.1	27.4	29.2	31.1
SK	14.8	21.9	25.7	29.0	33.1	37.3	41.6	45.2
SE	191.6	262.6	258.9	269.5	282.0	288.0	300.2	315.8
UK	866.8	1 564.6	1 667.3	1 598.2	1 715.9	1 768.5	1 822.9	1 899.9
EU-25	6 956.1	9 093.9	9 811.3	9 950.9	10 421.6	10 798.3	11 223.4	11 681.2

Source: Commission services.

Table A.5.2

Gross domestic product at 2000 market prices

(Annual percentage change)

	1995	2000	2002	2003	2004	2005	2006	2007
BE	2.4	3.9	1.5	0.9	2.6	1.2	2.3	2.1
DE	1.9	3.2	0.1	-0.2	1.6	0.9	1.7	1.0
EL	2.1	4.5	3.8	4.8	4.7	3.7	3.5	3.4
ES	2.8	5.0	2.7	3.0	3.1	3.4	3.1	2.8
FR	2.4	4.1	1.2	0.8	2.3	1.4	1.9	2.0
IE	9.8	9.2	6.1	4.4	4.5	4.7	4.9	5.1
IT	2.8	3.6	0.3	0.0	1.1	0.0	1.3	1.2
LU	1.4	8.4	3.6	2.0	4.2	4.2	4.4	4.5
NL	3.0	3.5	0.1	-0.1	1.7	1.1	2.6	2.6
AT	1.9	3.4	1.0	1.4	2.4	1.9	2.5	2.2
PT	4.3	3.9	0.8	-1.1	1.1	0.3	0.9	1.1
FI	3.4	5.0	2.2	2.4	3.6	2.1	3.6	2.9
EUR-12	2.4	3.8	0.9	0.7	2.0	1.3	2.1	1.8
CZ	5.9	3.9	1.5	3.2	4.7	6.0	5.3	4.7
DK	3.1	3.5	0.5	0.7	1.9	3.1	3.2	2.3
EE	4.5	7.9	7.2	6.7	7.8	9.8	8.9	7.9
CY	9.9	5.0	2.1	1.9	3.9	3.8	3.8	3.8
LV	-0.9	6.9	6.5	7.2	8.5	10.2	8.5	7.6
LT	3.3	3.9	6.8	10.5	7.0	7.5	6.5	6.2
HU	1.5	5.2	3.8	3.4	4.6	4.1	4.6	4.2
MT	6.2	6.4	1.5	-2.5	-1.5	2.5	1.7	1.9
PL	7.0	4.2	1.4	3.8	5.3	3.2	4.5	4.6
SI	4.1	4.1	3.5	2.7	4.2	3.9	4.3	4.1
SK	5.8	2.0	4.6	4.5	5.5	6.0	6.1	6.5
SE	3.9	4.3	2.0	1.7	3.7	2.7	3.4	3.0
UK	2.9	4.0	2.0	2.5	3.1	1.8	2.4	2.8
EU-25	2.6	3.9	1.2	1.2	2.4	1.6	2.3	2.2

Source: Commission services.

Table A.5.3

Potential gross domestic product at 2000 market prices

(Annual percentage change)

	1995	2000	2002	2003	2004	2005	2006	2007
BE	2.1	2.2	2.0	1.9	1.9	2.1	2.2	2.2
DE	2.2	1.5	1.1	1.0	0.8	1.1	1.2	1.2
EL	2.2	3.8	3.7	3.9	3.8	3.7	3.5	3.4
ES	2.6	3.4	3.7	3.8	3.8	3.8	3.6	3.3
FR	2.0	2.5	2.1	2.1	2.2	2.1	2.2	2.3
IE	7.1	7.9	6.7	6.0	5.9	6.4	6.1	5.6
IT	1.4	1.5	1.3	1.2	1.2	1.2	1.2	1.4
LU	4.6	5.0	4.5	4.4	4.1	4.2	4.1	4.2
NL	2.6	2.8	2.1	1.7	1.6	1.7	1.9	2.0
AT	2.2	2.4	2.1	2.2	2.0	2.2	1.9	2.1
PT	2.7	2.7	2.0	1.4	1.3	1.1	1.1	1.2
FI	1.8	3.7	3.3	3.0	2.9	2.9	2.8	2.8
EUR-12	2.1	2.2	1.9	1.9	1.8	1.9	1.9	2.0
CZ	:	1.8	2.9	3.6	3.8	3.7	4.0	4.2
DK	2.3	2.3	2.0	1.9	2.0	2.2	2.3	2.3
EE	:	5.1	6.8	7.3	7.6	8.4	8.1	8.1
CY	:	3.5	3.5	3.8	4.4	3.6	3.3	3.3
LV	:	6.1	6.9	7.3	8.2	8.6	9.1	8.9
LT	:	3.5	5.7	6.6	7.2	6.8	7.4	7.4
HU	:	4.3	4.4	4.1	4.1	4.0	3.9	3.8
MT	:	3.3	0.8	1.3	1.3	1.7	1.5	1.4
PL	:	3.2	2.9	2.9	3.2	3.6	4.1	4.3
SI	:	4.3	3.7	3.7	3.7	3.6	3.6	3.7
SK	:	2.5	4.7	6.0	5.4	5.2	5.3	5.4
SE	2.2	2.9	2.7	2.6	2.6	2.7	3.0	2.9
UK	2.4	3.0	2.7	2.6	2.7	2.8	2.8	2.7
EU-25	:	2.4	2.2	2.1	2.1	2.2	2.2	2.3

Source: Commission services.

Table A.5.4

Gap between actual and potential gross domestic product at 2000 market prices

(Annual percentage change)

	1995	2000	2002	2003	2004	2005	2006	2007
BE	-0.8	1.9	0.3	-0.7	0.0	-0.9	-0.9	-1.0
DE	-0.4	1.0	-0.1	-1.2	-0.4	-0.6	-0.1	-0.3
EL	-2.6	-1.3	0.2	1.0	1.9	1.9	1.9	1.9
ES	-3.2	2.3	1.3	0.4	-0.2	-0.5	-1.0	-1.5
FR	-1.4	2.4	1.2	-0.1	0.0	-0.7	-1.0	-1.3
IE	-2.6	4.9	3.3	1.7	0.3	-1.3	-2.4	-2.9
IT	-0.3	1.8	1.1	0.0	-0.2	-1.4	-1.3	-1.4
LU	-1.9	4.2	0.7	-1.6	-1.5	-1.5	-1.2	-1.0
NL	-1.1	3.3	-0.1	-1.9	-1.8	-2.3	-1.6	-1.0
AT	-0.9	2.2	-0.4	-1.2	-0.7	-1.0	-0.4	-0.3
PT	-2.6	3.2	1.6	-0.9	-1.2	-1.9	-2.2	-2.3
FI	-3.4	3.3	-0.4	-1.0	-0.3	-1.1	-0.4	-0.4
EUR-12	-1.1	1.9	0.6	-0.5	-0.3	-0.9	-0.8	-0.9
CZ	:	-1.9	-2.8	-3.2	-2.3	-0.2	1.0	1.4
DK	-0.1	2.5	-0.4	-1.6	-1.7	-0.8	0.0	0.1
EE	-6.7	-1.5	-0.5	-1.1	-0.9	0.4	1.1	1.0
CY	1.1	1.8	1.2	-0.6	-1.1	-0.9	-0.5	0.0
LV	-3.1	-1.8	-0.5	-0.7	-0.4	1.0	0.5	-0.7
LT	:	-4.3	-1.5	2.0	1.8	2.4	1.6	0.4
HU	2.5	-0.2	-0.7	-1.4	-0.9	-0.7	-0.1	0.3
MT	-3.5	5.0	3.5	-0.4	-3.1	-2.3	-2.1	-1.6
PL	-4.8	0.6	-2.2	-1.3	0.7	0.4	0.8	1.1
SI	:	1.0	-0.5	-1.6	-1.1	-0.9	-0.3	0.1
SK	:	-1.1	-1.0	-2.4	-2.4	-1.6	-0.8	0.2
SE	-1.8	2.0	-0.3	-1.2	-0.1	-0.1	0.3	0.4
UK	-0.7	1.5	0.2	0.1	0.5	-0.4	-0.7	-0.7
EU-25	:	1.7	0.4	-0.5	-0.2	-0.7	-0.7	-0.8

Source: Commission services.

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