Part I

Current developments and prospects

Summary

In 2003, the fiscal deficit for the euro area continued to increase for a third consecutive year, mainly reflecting lower growth than previously expected. The nominal deficit rose from 2.3 % of GDP in 2002 to 2.7 % of GDP in 2003 and is, according to the latest Commission forecasts, projected to be roughly unchanged in 2004 and 2005. However, this aggregate outcome results from diverse budgetary performances across Member States. In 2003, five euro-area countries had budget positions in balance or in surplus, both in nominal and cyclically adjusted terms. In contrast, in four euro-area Member States actual deficits were equal to or above 3 % of GDP in 2003.

In Germany, despite significant consolidation efforts, the general government deficit continued to deteriorate. The actual deficit increased from 3.5 % of GDP in 2002 to 3.9 % of GDP in 2003. The deficit is projected to remain above 3 % of GDP in 2004 and drop slightly below 3 % in 2005. The actual deficit continued to deteriorate rapidly also in France, where it reached 4.1 % of GDP in 2003. According to the latest Commission forecasts, the actual deficit should remain well above the 3 % of GDP reference value also in 2004 and 2005. Portugal managed to reduce the actual deficit below 3 % of GDP in 2003 (to 2.8 % of GDP), as requested in the recommendations made by the Council. The Portuguese authorities continued, however, to rely on sizeable one-off measures and on the basis of the current policies, Portugal is projected to breach the threshold again in 2004. The deficit remained high in Italy, at 2.4 % of GDP in 2003, in spite of sizeable one-off measures. The deficit is projected to breach the 3 % of GDP reference value by 2004 and to approach 4 % of GDP in 2005. In the Netherlands, the nominal deficit in 2003 amounted to 3.2 % of GDP. Recent forecasts show an even higher deficit for 2004 at 3.5 % of GDP, which should decline to 3.3 % of GDP in 2005. The nominal deficit has worsened sharply in Greece, reaching 3.2 % of GDP in 2003 and, after breaching the reference value in 2004, it is expected to decline slightly below the reference value in 2005. Outside the euro area, nominal deficits breached the reference value in the UK (3.2 % of GDP in 2003), Cyprus (6.3 %), the Czech Republic (12.9 %), Hungary (5.9 %), Malta (9.7 %), Poland (4.1 %) and Slovakia (3.6 %). On a more positive note, compared to the previous year the nominal budget balances in 2003 in the euro area improved in Belgium (improvement of 0.1 percentage points (p.p.)), Spain (0.3 p.p.) and Ireland (0.4 p.p.). Outside the euro area, similar developments can be mentioned for Estonia (0.8 p.p.), Latvia (0.9 p.p.), Hungary (3.4 p.p.), Slovenia (0.1 p.p.), Slovakia (2.1 p.p.) and Sweden (0.7 p.p.).

In cyclically adjusted terms, the deficit in the euro area decreased slightly in 2003 but remained high at 2.2 % of GDP. In particular, it remained high in Germany and France, while it deteriorated in Greece, Austria and the UK. According to the latest Commission forecasts, the cyclically adjusted balances (CABs) in the euro area and EU-15 are projected to be roughly unchanged in 2004 and 2005. The budgetary consolidation process seems therefore to have stalled. Past experience shows, however, that efforts to improve the underlying budget positions should be made as economic conditions recover in order to ensure sufficient room for the automatic stabilisers to operate when necessary.

After several years of moderate decline followed by a stabilisation in 2002, the euro-area government debt/GDP ratio increased to 70.4 % in 2003 and in EU-15 to 64.0 %. According to the Commission's spring 2004 forecasts, the debt ratio is projected to increase slightly in 2004 to 70.9 % of GDP and remain at the same level in 2005. The aggregate average debt ratio in the new Member States is lower than in the euro area. The ratio is nevertheless projected to increase somewhat and reach 45.2 % of GDP in 2005. Among them, improvement is expected only in Estonia and Hungary.

In the medium term, the euro area would, according to the latest updates of the stability and convergence programme, improve its CAB by slightly less than the required 0.5 p.p. of GDP per year in the coming years. Thus, a close-to-balance position in cyclically adjusted terms would almost be reached by 2007 (– 0.7 % of GDP). However, in the case of some Member States, the projected budgetary adjustment is insufficient to ensure that a close-to-balance budgetary position would be achieved and that a sufficient safety margin to prevent a breach of the 3 % of GDP reference value would be reached before 2007. It should also be noted that the medium-term objectives of some Member States are based on growth assumptions which, in light of the Commission's spring forecast, appear to be overly optimistic. Moreover, the implementation record of the programmes has, in several cases, been below expectations, leading to a repeated postponement of the achievement of the close-to-balance objective. Budgetary targets set in the updates seem, in some cases, to be too optimistic, even with growth rates as expected in the updates. It is vital for Member States to reach the SGP's medium-term target in order to ensure that the automatic stabilisers work freely and to decrease the risk of unsustainable public finances in light of ageing populations.

As far as the medium-term plans of the new Member States are concerned, all the May 2004 convergence programmes foresee favourable growth prospects to be continued over the entire programme horizon. According to the countries' own estimates reported in the convergence programmes, the expected development in the projection period indicates a substantial consolidation of public finances for all of them. Thus, by 2007, only the Czech Republic and Hungary foresee general government deficits still above the 3 % of GDP reference value. Particularly strong deficit reductions are expected in the countries with initially high deficits, such as Cyprus, Malta and Hungary. Following a different path, Estonia plans to move from the 2003 government surplus down to balance in 2005. In contrast, Poland's consolidation endeavour looks backloaded as the government is still pursuing an expansionary fiscal policy in 2004, hence generating further deficit increases in the early years of the programme, compensated by a consolidation between 2005 and 2007. According to the convergence programmes, all the new Member States except Latvia and Lithuania are expected to improve their structural balances by 2007. Nevertheless, in Slovakia, Hungary and the Czech Republic, the structural deficits are forecast to stand at or above 3 % of GDP in 2007.

For the third year in a row, the EU budgetary surveillance includes an assessment of the sustainability of public finances on the basis of the updated stability and convergence programmes submitted by EU-15 in late 2003. This year's assessment confirms the track record of continuous improvements in the way the sustainability is assessed. For the quantitative indicators, the cyclical component of the budget has been netted out in the first year of the projection, so the long-term projections are only affected by the more structural components of the budget. Also, greater attention has been devoted this year to qualitative features when making the assessment, which has alleviated the mechanistic interpretation of the results obtained and given the assessment a significantly higher information value. Overall, the analysis shows that risks to long-term sustainability are still present in nine countries, in five of which (Belgium, Greece, Italy, Germany and France) the difficulties are more serious, while the other four (Portugal, Spain, the Netherlands and the UK) face some risks from medium-term budgetary developments or from uncertainties over the long-term projections of pension expenditures (Spain and Portugal). Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem relatively well placed to meet the cost of an ageing society, but nevertheless face budgetary challenges as a result of ageing populations.

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 2003, the budgetary position in the euro area deteriorated for the third year in a row (see Table I.1). Compared to 2002, the nominal deficit increased by 0.4 percentage points and reached 2.7 % of GDP. This development is largely explained by the functioning of the automatic stabilisers in a macroeconomic environment which was considerably less favourable than previously expected. The aggregate nominal deficit also worsened in the case of the new Member States (NMS) by 0.8 percentage points and reached 5.7 % of GDP in 2003 (see Table I.2). Accordingly, the aggregate deficit for EU-25 as a whole amounted to 2.7 % of GDP.

The aggregate outcome for the euro area as a whole results from diverse budgetary performances across Member States. In the case of Germany, France, Italy and Portugal the budgetary positions in 2003 remained weak with nominal deficits ranging from 2.4 % of GDP in Italy to 4.1 % of GDP in France. As a result of the developments in the course of 2002, Germany and France have remained in excessive deficit positions, while in Portugal, the deficit has been kept just under the 3 % of GDP reference value despite a shrinking economy (see Part II.2.3 of this report). In 2003, the nominal deficit has also sharply deteriorated in the Netherlands and Greece, and outside the euro area, in the UK, reaching 3.2 % of GDP. Nevertheless, in spite of a protracted period of low growth, seven EU-15 Member States, of which five are euro-area countries, had nominal budget positions in balance or in surplus. Overall, the nominal budget balances in 2003 did not worsen (or did so only marginally) compared to the previous year in the case of Belgium, Denmark, Spain, Ireland, Sweden, Italy and as already mentioned, in Portugal, although for the latter two this is mainly due to sizeable one-off measures amounting to around 2 % of GDP in each country.

The budgetary performance also differed across the NMS. Nominal budget balances in 2003 varied from a deficit of 12.9 % of GDP in the Czech Republic to a surplus of 2.6 % of GDP in Estonia. In the case of Cyprus, the Czech Republic, Hungary, Malta, Poland and Slovakia, the nominal deficit in 2003 was above the reference value of 3 % of GDP, and only Estonia had a surplus budgetary position. Relative to 2002, the budget position remained roughly unchanged or improved in four countries, while it deteriorated in Cyprus, the Czech Republic, Lithuania, Malta and Poland. The improvement was particularly important in Hungary and Slovakia.

Looking ahead to 2004 and 2005, the Commission's spring 2004 forecasts project that economic growth in the euro area as a whole will return to potential by the end of 2004. The nominal budget balance is expected to remain roughly unchanged in 2004 as well as 2005. In light of an improvement of the economic situation coupled with budgetary consolidation, the aggregate nominal deficit for the NMS is foreseen to decline to 5.0 % of GDP in 2004 and 4.2 % of GDP in 2005. As a result, the aggregate budget position for the EU as a whole would slightly improve during the forecast period and reach 2.5 % of GDP in 2005.

At the Member State level, the budgetary positions in the case of Belgium and Ireland are expected to deteriorate into deficit positions in 2004. Under a no-policy-change assumption, the deficits in both countries would continue to worsen in 2005. In contrast, Spain, Finland, Denmark and Sweden are expected to maintain their budgetary positions in surplus throughout the forecast period. Among the NMS, this is also the case for Estonia.

On the basis of current policies, the Commission forecasts project that the nominal deficits in Germany, Greece, France, Italy, the Netherlands and Portugal will be exceeding the 3 % of GDP reference value in 2004 and, except Germany and Greece, also in 2005. In Germany, the nominal deficit is projected to remain above 3 % of GDP in 2004 and move slightly below the reference value in 2005. Similarly, in Greece, the nominal deficit is expected to breach the 3 % of GDP in 2004 and decline slightly below the reference value in 2005. The period of weak budgetary situation in France is being prolonged, since the nominal deficit is expected to remain well above the 3 % of GDP threshold also in 2005. Although Portugal appears to have complied with the terms of the excessive deficit recommendation addressed to it in 2002, the nominal deficit is foreseen to exceed 3 % of GDP again, in both 2004 and 2005. In Italy and the Netherlands, the nominal deficits are expected to breach the reference value in 2004 and, in the case of Italy, to deteriorate further in 2005.

The nominal deficit is projected to be high also in other Member States. In the UK, it is foreseen to remain well above 2 % of GDP during the forecast period and in Austria, the nominal deficit would be around 2 % of GDP. In the NMS, the nominal deficit is expected to decline or remain unchanged in five countries. In the case of Latvia, Lithuania, Poland and Slovakia it is, however, projected to deteriorate in 2004 and would stabilise or decrease only by 2005.

In cyclically adjusted terms, the deficit in the euro area decreased slightly in 2003, but remained high at 2.2 % of GDP. According to the Commission's spring 2004 forecasts, the cyclically adjusted budget balance is projected to remain stable in 2004 and 2005. The budgetary consolidation process seems thereby to have stalled. At the Member State level, eight EU-15 countries, of which seven are in the euro area, are foreseen to have cyclically adjusted deficits above 0.5 % of GDP by 2005. Among the countries with higher cyclically adjusted deficits, deterioration is expected in Greece, Italy, Austria and Portugal, while improvements are foreseen in Germany, France, the Netherlands and the UK. In the cases of France and Greece, it is still projected to be above 3 % of GDP in 2005.

After several years of moderate decline followed by a stabilisation in 2002, the euro-area government debt/GDP ratio increased to 70.4 % in 2003 (see Table I.3 and Part II.5 in this report). The debt ratio is, according to the Commission's spring 2004 forecasts, projected to increase slightly in 2004 to 70.9 % of GDP and remain at the same level in 2005. The primary surplus would not offset the combined negative contribution from interest payments and growth. The aggregate average debt ratio in the NMS is on average lower in comparison to the euro area. However, the ratio is projected to increase somewhat and

Table I.1

General government budgetary position — euro area, 2000–05

(% of GDP)

	2000 (1)	2001 (1)	2002 (1)	2003	2004	2005
Total receipts (1)	47.3	46.6	46.1	46.3	45.8	45.5
Total expenditure (2)	47.1	48.2	48.4	49.0	48.6	48.1
Actual balance (3) = (1) – (2)	**0.1**	**– 1.6**	**– 2.3**	**– 2.7**	**– 2.7**	**– 2.6**
Interest (4)	4.1	4.0	3.6	3.5	3.4	3.4
Primary balance (5) = (3) + (4)	4.2	2.3	1.4	0.8	0.7	0.8
UTMS proceeds	1.1	1.1	0.0	0.0		
Cyclically adjusted balance (6)	**– 1.9**	**– 2.4**	**– 2.5**	**– 2.2**	**– 2.2**	**– 2.2**
Cyclically adjusted primary balance = (6) + (4)	2.2	1.6	1.2	1.3	1.2	1.2
Change in actual balance	1.5	– 1.8	– 0.6	– 0.4	0.0	0.1
Due to: — cycle	0.5	– 0.2	– 0.5	– 0.7	– 0.1	0.1
— UMTS	1.1	– 1.1	0.0	0.0		
— interest	0.2	0.1	0.3	0.2	0.1	0.0
— cyclically adjusted primary balance	– 0.4	– 0.6	– 0.5	0.1	0.0	0.1

(1) Including UMTS receipts. UMTS receipts as a % of GDP would be equal in 2000 to 2.5 for DE, 0.1 for ES, 1.2 for IT, 0.7 for NL, 0.4 for AT, 0.3 for PT, 2.4 for UK, 1.1 for the euro area and 1.2 for EU-15. In 2001 they would be equal to 0.2 for BE, 0.2 for DK, 0.5 for EL, 0.1 for FR, and 0 for the euro area and EU-15. In 2002 they would be equal to 0 for FR, 0.2 for IE and 0 for the euro area and EU-15.
NB: differences are due to rounding.

Source: Commission's spring 2004 forecasts. For a number of countries, the calculated CABs differ marginally from those of the spring forecast due to data revisions.

Table I.2

Budget balances in EU Member States, 2002–05

(% of GDP)

	Budget balance				Cyclically adjusted budget balance				Cyclically adjusted primary balance			
	2002	**2003**	**2004**	**2005**	**2002**	**2003**	**2004**	**2005**	**2002**	**2003**	**2004**	**2005**
BE	0.1	0.2	– 0.5	– 0.7	0.1	0.7	0.0	– 0.5	6.2	6.3	5.1	4.3
DE	– 3.5	– 3.9	– 3.6	– 2.8	– 3.5	– 3.2	– 2.9	– 2.3	– 0.4	0.0	0.1	0.7
EL(1)	– 1.4	– 3.2*	– 3.2	– 2.8	– 1.7	– 3.6	– 4.1	– 3.8	4.4	2.1	1.5	1.7
ES	0.0	0.3	0.4	0.6	– 0.2	0.4	0.6	0.7	2.6	2.9	2.9	3.0
FR	– 3.2	– 4.1	– 3.7	– 3.6	– 3.8	– 3.9	– 3.4	– 3.3	– 0.7	– 0.8	– 0.3	– 0.3
IE	– 0.2	0.2	– 0.8	– 1.0	– 1.9	0.1	– 0.3	– 0.2	– 0.5	1.5	1.1	1.2
IT	– 2.3	– 2.4	– 3.2	– 4.0	– 2.2	– 1.9	– 2.6	– 3.6	3.5	3.4	2.4	1.6
LU	2.7	– 0.1	– 2.0	– 2.3	2.7	1.3	0.6	1.2	2.9	1.5	0.8	1.3
NL	– 1.9	– 3.2	– 3.5	– 3.3	– 2.6	– 2.0	– 1.7	– 1.3	0.4	0.9	1.1	1.7
AT	– 0.2	– 1.1	– 1.1	– 1.9	– 0.3	– 0.9	– 0.9	– 1.8	3.1	2.2	2.3	1.2
PT	– 2.7	– 2.8	– 3.4	– 3.8	– 2.7	– 1.8	– 2.1	– 2.6	0.3	1.1	0.8	0.5
FI	4.3	2.3	2.0	2.1	3.7	2.3	2.1	2.2	5.9	4.2	3.9	3.9
EUR-12	**– 2.3**	**– 2.7**	**– 2.7**	**– 2.6**	**– 2.5**	**– 2.2**	**– 2.2**	**– 2.2**	**1.2**	**1.3**	**1.2**	**1.2**
CZ	– 6.4	– 12.9	– 5.9	– 5.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
DK	1.7	1.5	1.1	1.5	1.0	2.1	1.4	1.5	3.8	4.7	3.9	3.7
EE	1.8	2.6	0.7	0.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
CY	– 4.6	– 6.3	– 4.6	– 4.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
LV	– 2.7	– 1.8	– 2.2	– 2.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
LT	– 1.4	– 1.7	– 2.8	– 2.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
HU	– 9.3	– 5.9	– 4.9	– 4.3	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
MT	– 5.7	– 9.7	– 5.9	– 4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
PL	– 3.6	– 4.1	– 6.0	– 4.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SI	– 1.9	– 1.8	– 1.7	– 1.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SK	– 5.7	– 3.6	– 4.1	– 3.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SE	0.0	0.7	0.2	0.7	– 0.5	0.7	0.3	0.8	2.4	2.9	2.6	3.2
UK	– 1.6	– 3.2	– 2.8	– 2.6	– 1.5	– 2.9	– 2.6	– 2.3	0.6	– 0.9	– 0.5	– 0.2
EU-25	**– 2.1**	**– 2.7**	**– 2.7**	**– 2.5**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
p.m. EU-15	**– 2.0**	**– 2.6**	**– 2.6**	**– 2.4**	**– 2.2**	**– 2.2**	**– 2.1**	**– 2.1**	**1.1**	**1.0**	**1.0**	**1.0**
p.m. NMS	**– 4.9**	**– 5.7**	**– 5.0**	**– 4.2**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**

(1) For Greece, a revision of the data on general government balance was done in April 2004.
NB: Excluding UMTS receipts for Ireland in 2002.
Cyclically adjusted figures are computed with the production function method, except for Germany, Spain and Austria, where the HP filter method has been used. For a number of countries, the calculated CABs differ marginally from those of the spring forecast due to data revisions.

Source: Commission's spring 2004 forecasts.

reach 45.2 % of GDP in 2005. The large negative contribution from the primary balance and interest payments/growth would only partly be compensated by stock-flow operations. In 2005, the debt ratio for EU-25 is hence expected to amount to 63.4 % of GDP.

Aggregate figures tend to hide different pictures across countries. In 2003, Belgium, Greece and Italy continued to have debt ratios above 100 % of GDP and this would still be the case for the latter two by 2005. In addition to these three countries, six EU-25 Member States are projected to have debt ratios above 60 % of GDP in 2005. Poor growth performance is expected to significantly affect the budgetary situation in Germany and Austria, as well as in France, Portugal and Malta, where in addition, large primary deficits are projected. In Cyprus, the combined positive contribution from interest payments and growth is more than offset by a high primary deficit and stock-flow operations.

Table I.3

Composition of changes in government debt ratio in EU Member States, 2002–05

(% of GDP)

	Government debt				Change in government debt 2003–05	Change in 2003–05 due to:		
	2002	2003	2004	2005		Primary balance	Interest and growth contribution	Stock-flow adjustment
BE	105.8	100.5	97.4	94.3	– 6.2	– 8.7	2.5	0.1
DE	60.8	64.2	65.6	66.1	1.9	0.1	2.9	– 1.1
EL	104.7	103.0	102.8	101.7	– 1.3	– 5.1	– 2.7	6.6
ES	54.6	50.8	48.0	45.1	– 5.7	– 5.6	– 1.5	1.4
FR	58.6	63.7 ([1])	64.6	65.6	2.6	1.2	1.5	0.0
IE	32.3	32.0	32.4	32.6	0.6	– 0.9	– 1.1	2.7
IT	108.0	106.2	106.0	106.0	– 0.2	– 3.0	2.3	0.5
LU	5.7	4.9	4.5	3.8	– 1.1	4.1	– 0.2	– 5.0
NL	52.6	54.8	56.3	58.6	3.8	1.0	3.6	– 0.8
AT	66.6	65.0	65.5	65.3	0.3	– 3.1	1.8	1.7
PT	58.1	59.4	60.7	62.0	2.6	1.3	1.7	– 0.3
FI	42.6	45.3	44.5	44.3	– 0.9	– 7.6	0.5	6.2
EUR-12	**69.2**	**70.4**	**70.9**	**70.9**	**0.5**	**– 1.5**	**1.7**	**0.2**
CZ	28.9	37.6	40.6	42.4	4.7	8.4	– 2.1	– 1.6
DK	47.2	45.0	42.3	40.0	– 5.0	– 7.4	1.2	1.1
EE	5.7	5.8	5.4	5.3	– 0.5	– 1.2	– 0.5	1.2
CY	67.1	72.2	74.6	76.9	4.7	n.a.	n.a.	4.6
LV	15.5	15.6	16.0	16.1	0.5	2.6	– 0.8	– 1.2
LT	22.8	21.9	22.8	23.2	1.3	2.8	– 0.9	– 0.5
HU	57.1	59.0	58.7	58.0	– 1.0	1.4	– 1.0	– 1.4
MT	61.7	72.0	73.9	75.9	3.8	3.6	2.9	– 4.3
PL	41.2	45.4	49.1	50.3	4.9	4.1	0.2	0.7
SI	27.8	27.1	28.3	28.2	1.1	0.2	– 0.2	1.1
SK	43.3	42.8	45.1	46.1	3.3	2.4	– 1.0	1.9
SE	52.6	51.9	51.8	50.5	– 1.3	– 5.6	0.3	4.0
UK	38.5	39.9	40.1	40.6	0.7	1.2	– 0.1	– 0.4
EU-25	61.5	63.1	63.4	63.4	0.3	**– 1.0.**	1.3.	0.1
p.m. EU-15	62.5	64.0	64.2	64.2	0.2	**– 1.2**	1.2	0.2
p.m. EU-10	39.4	42.2	44.4	45.2	3.0	3.9	1.9	**– 2.9**

([1]) For France, this figure was notified by France after the official EDP notification of 1 March 2004.
NB: Aggregates EU-25 and EU-10 for changes in government debt due to primary balances, interest and growth contribution and stock-flow adjustment do not include Cyprus.

Source: Commission's spring 2004 economic forecasts.

1.2. Government revenue and expenditure

The developments in the euro-area budgetary position are derived from changes in expenditure and revenue ratios. On the spending side, the euro-area expenditure-to-GDP ratio increased in 2003, both in nominal and cyclically adjusted terms, compared to the previous year (see Table I.4), which is mainly due to a rise in public expenditures on social transfers. According to the Commission's spring 2004 forecasts, the expenditure ratio is projected to decline during the forecast period. However, interest payments are, after several years of decline, foreseen to remain broadly neutral. On the revenue side, the revenue/GDP ratio slightly increased in 2003, both in nominal and cyclically adjusted terms, but is expected to decline in the coming years.

At Member State level, the patterns are generally similar to that of the euro area (see Table I.5). Only in Ireland

and Luxembourg and outside the euro area, in Lithuania and Poland, are expenditure ratios projected to increase over the 2003–05 period. In contrast, large decreases are expected in Belgium, Germany, the Czech Republic and Estonia over the same period. Revenue ratios are set to increase slightly over 2003–05 in the case of Spain and outside the euro area, in Lithuania and Poland, whereas important reductions are foreseen in Belgium, Italy, Austria and Estonia ([1]).

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, interests, subsidies. Such a development respects 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. In previous years, the reduction in interest payments has particularly contributed to a better allocation of available resources. While these seem to stay at a stable level in the forecasting period, additional savings are expected from collective consumption, social transfers and other expenditures.

([1]) The decreasing expenditure and revenue ratios in the case of Slovakia are based on non-consolidated figures.

1.3. The fiscal stance and policy-mix

1.3.1. 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. Analogously, the policy-mix for the euro area will have an impact on the national policy-mix via the common interest rates with repercussions on economic developments and prospects at national level.

Table I.4

Euro-area government revenues and expenditures, 2001–05

(% of GDP)

	2001	2002	2003	2004	2005
Total revenues	**46.6**	**46.1**	**46.3**	**45.8**	**45.5**
— cyclically adjusted	46.0	46.0	46.7	46.2	45.8
Taxes on imports and production	13.3	13.4	13.4	13.5	13.6
Current taxes on income and wealth	12.6	12.2	11.8	11.6	11.5
Social contributions	16.0	16.0	16.2	16.1	15.9
of which actual social contributions	14.9	14.9	15.0	15.0	14.8
Other resources	4.6	4.6	4.9	4.6	4.5
Total expenditure	**48.2**	**48.4**	**49.0**	**48.6**	**48.1**
— cyclically adjusted	48.4	48.5	49.0	48.5	48.0
Collective consumption	8.2	8.3	8.4	8.3	8.2
Social benefits in kind	11.9	12.1	12.3	12.3	12.1
Social benefits other than in kind	16.6	16.9	17.2	17.1	16.9
Interest	4.0	3.6	3.5	3.4	3.4
Subsidies	1.4	1.3	1.3	1.2	1.2
Gross fixed capital formation	2.5	2.4	2.6	2.5	2.6
Other expenditures	3.6	3.7	3.7	3.7	3.7

NB: Including UMTS receipts, see footnote to General government budgetary position — euro area, 2000–05.

Source: Commission's spring 2004 forecasts.

Table I.5

Total revenue and expenditure in EU Member States, 2002–05

(% of GDP)

	Revenue				Expenditure			
	2002	2003	2004	2005	2002	2003	2004	2005
BE	50.5	51.7	49.4	48.6	50.5	51.5	49.9	49.4
DE	45.0	45.0	44.5	44.3	48.5	48.9	48.0	47.1
EL	45.3	44.2	44.0	44.1	46.7	47.1	47.2	46.9
ES	39.9	39.9	40.0	40.1	39.9	39.5	39.6	39.5
FR	50.2	50.6	50.7	50.5	53.5	54.7	54.4	54.1
IE	33.1	34.6	34.3	33.7	33.3	34.3	35.1	34.7
IT	45.6	46.5	45.4	44.7	47.9	48.9	48.7	48.7
LU	47.0	47.1	46.8	46.8	44.3	47.3	48.8	49.1
NL	45.9	45.6	45.1	44.8	47.8	48.8	48.6	48.1
AT	51.0	49.9	49.5	47.7	51.2	51.0	50.7	49.7
PT	43.4	44.6	43.2	43.0	46.1	47.5	46.6	46.9
FI	54.4	52.7	52.6	52.2	50.1	50.5	50.7	50.1
EUR-12	**46.1**	**46.3**	**45.8**	**45.5**	**48.4**	**49.0**	**48.6**	**48.1**
CZ	45.6	45.0	45.0	44.1	52.0	57.9	50.9	49.2
DK	57.3	57.5	56.9	56.2	54.9	55.4	55.8	54.7
EE	39.6	41.2	43.4	42.2	37.9	38.6	42.8	42.2
CY	n.a.	n.a.	37.5	37.6	n.a.	n.a.	42.1	41.7
LV	41.9	41.5	39.6	38.4	44.6	43.3	41.8	40.4
LT	33.8	33.9	34.7	34.7	35.2	35.6	37.4	37.3
HU	45.0	44.8	47.1	46.8	n.a.	n.a.	n.a.	n.a.
MT	n.a.	n.a.	40.2	40.4	n.a.	n.a.	45.3	44.0
PL	41.3	41.0	40.8	41.2	44.9	45.1	46.8	45.7
SI	n.a.	n.a.	42.3	42.3	n.a.	n.a.	44.0	44.0
SK	45.2	49.1	42.0	43.1	50.9	52.7	46.1	47.0
SE	58.1	59.5	59.1	58.9	58.1	58.8	58.9	58.3
UK	39.5	39.6	39.1	39.2	41.1	42.8	41.8	41.8
EU-25	**n.a.**	**n.a.**	**45.1**	**44.9**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
p.m. EU-15	**45.5**	**45.8**	**45.2**	**45.0**	**47.5**	**48.4**	**47.8**	**47.4**
p.m. EU-10	**n.a.**	**n.a.**	**42.5**	**42.5**	**n.a.**	**n.a.**	**n.a.**	**n.a.**

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

Source: Commission's spring 2004 forecasts.

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 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 for a number of years.

According to the Commission's spring 2004 forecasts, the euro-area fiscal stance was broadly neutral in 2003 even though the output gap deteriorated sharply. This

(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 judgement 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.

development follows after three years of fiscal loosening in a context of a large positive output gap in 2000 that worsened in 2001 and 2002. Looking ahead to 2004 and 2005, the euro-area fiscal stance is projected to continue to be broadly neutral ([1]). Lessons from the past show, however, that efforts to improve the underlying budget positions 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 continued to loosen in 2003, although less than the year before. Overall, in 2003, the euro-area fiscal stance could be seen as neutral, coupled with the growth-supportive monetary stance thus contributing to a recovery of economic activity and closing of the output gap. The policy-mix in the early years of EMU has therefore been broadly appropriate to support growth-enhancing economic conditions and macroeconomic stability.

([1]) The forecasted potential growth rate in the euro area for 2004 is 2 % (the Commission's spring 2004 forecast).

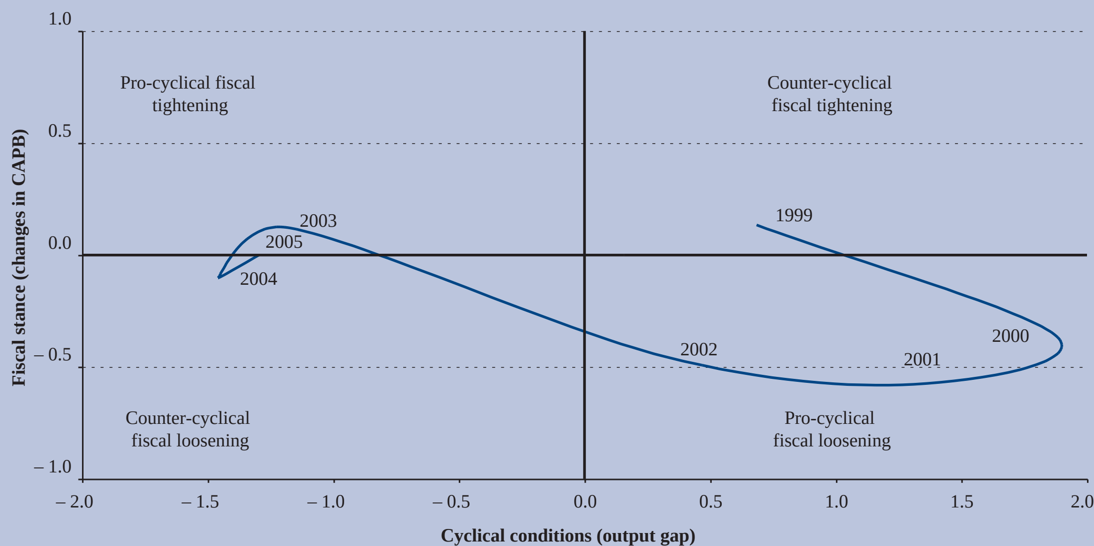
1.3.2. The fiscal stance and policy-mix at the national level

The aggregate fiscal stance for the euro-area results from quite diverse fiscal stances across Member States, despite fairly similar cyclical developments. Graph I.3 shows that most EU countries recorded a negative output gap in 2003, with the exception of Greece, Ireland (where it sharply deteriorated) and Sweden.

In 2003, several EU countries ran moderately counter-cyclical or broadly neutral fiscal policies in a context of negative output gaps. Policies were, however, clearly counter-cyclical in the case of Luxembourg, Austria and the UK. It is worth mentioning that the nominal budget balances in these countries markedly worsened in the course of 2003. Finland, which was benefiting from past consolidation efforts and therefore had a large safety margin, was also easing the fiscal stance.

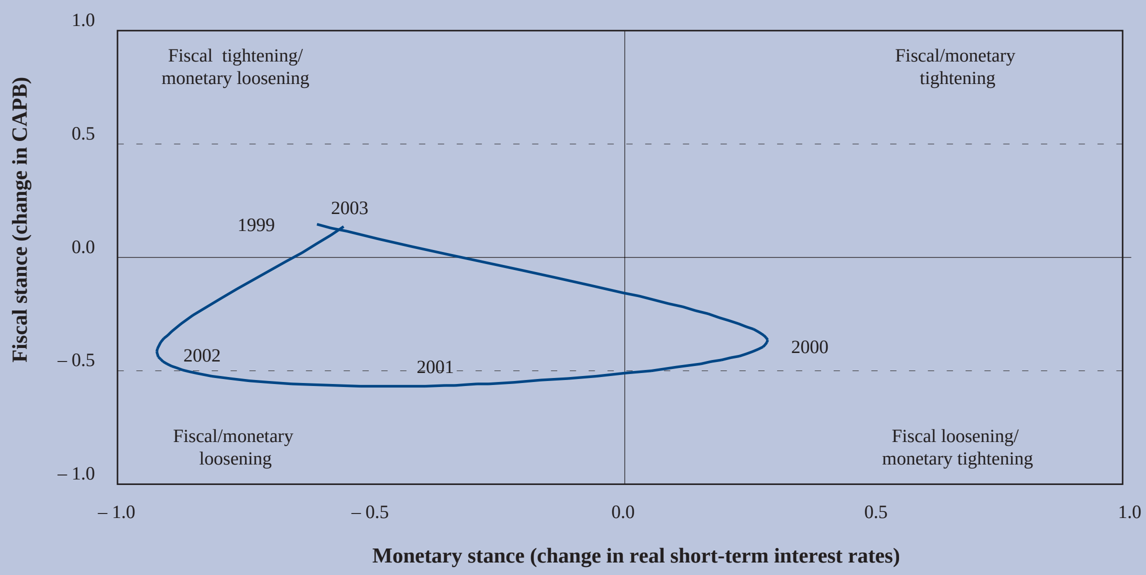
The Netherlands and Portugal ran somewhat pro-cyclical policies in 2003, reflecting consolidation efforts in

Graph I.1: **Euro-area fiscal stance and cyclical conditions, 1999–2005**



Source: Commission's spring 2004 forecasts.

Graph I.2: **Euro-area policy-mix, 1999–2003**



Source: Commission's spring 2004 forecasts.

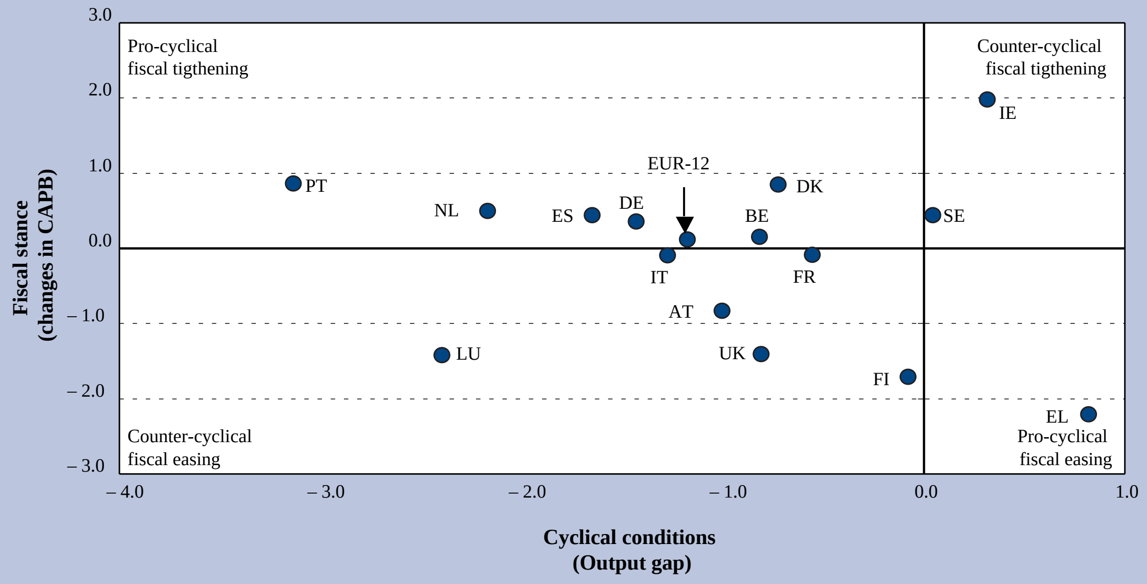
order to keep the nominal deficits below the 3 % of GDP reference value. Denmark and Ireland tightened their fiscal stance, while the output gap quickly deteriorated. Greece stands out for loosening the fiscal stance in spite of a large positive output gap.

As pointed out above, the overall policy-mix in the euro area has been slightly accommodative in 2003 with most Member States experiencing a broadly neutral fiscal stance accompanied by declining real interest rates (see Graph I.4). The real interest rates fell in all countries, with the exception of Finland.

While Graph I.4 refers to the changes in the real short-term interest rates, its level is equally important when assessing the policy-mix. After the reductions in the nominal interest rate decided by the ECB in the course of 2003, the real interest rate for the euro area (i.e. the short-term interest rate corrected by private consumption inflation) amounted to 0.4 % in 2003. However, this aggregate figure for the euro area conceals significant differences across Member States due to disparities in inflation rates across countries. The real interest rates in Germany and Austria were around 1 %, whereas in a number of countries (Greece, Spain, Ireland, Italy, the Netherlands and Portugal) the interest rates were negative.

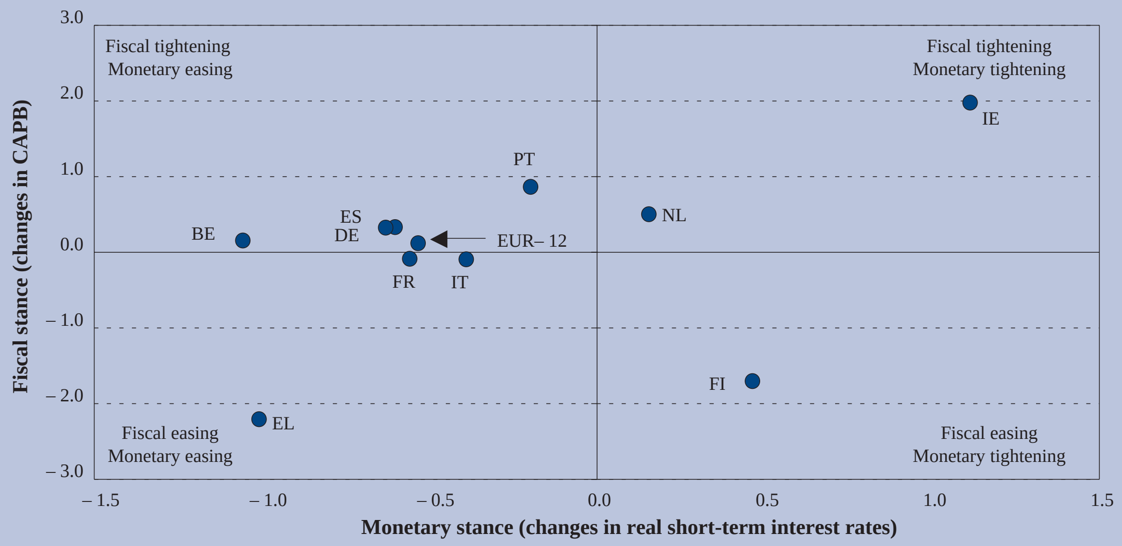
Regarding 2004, the fiscal stance is expected to be broadly neutral in most Member States (see Graph I.5). Belgium, Italy, Luxembourg and Denmark are, however, projected to loosen their fiscal stance, in the case of Italy, as a result of the expiry of the one-off measures. Greece is projected to continue the loosening of its fiscal stance also in 2004, even though the output gap is expected to be positive.

Graph I.3: **Fiscal stance and cyclical conditions in EU Member States, 2003**



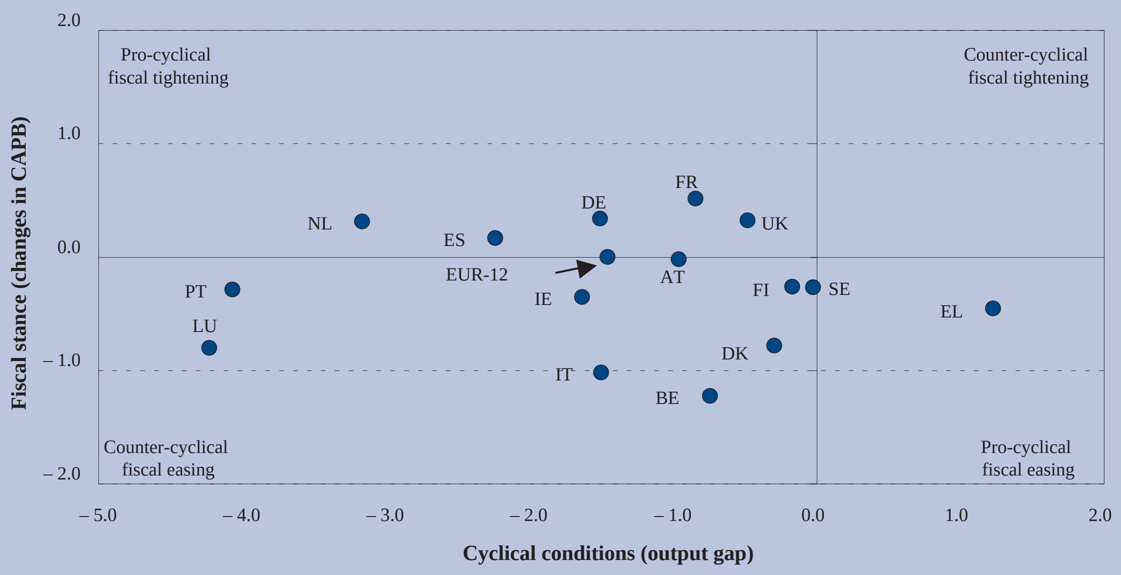
Source: Commission's spring 2004 forecasts.

Graph I.4: **Policy-mix in EU Member States, 2003**



Source: Commission's spring 2004 forecasts.

Graph I.5: **Fiscal stance and cyclical conditions in EU Member States, 2004**



Source: Commission’s spring 2004 forecasts.

2. Overview of the 2003 updates of the stability and convergence programmes

2.1. The medium-term budgetary targets

The examination of the fifth round of updates of stability and convergence programmes, covering the period up to 2007, was completed by March 2004.

In order to make an assessment of the budgetary targets set by Member States in the 2003 updates of the programmes, it is necessary to examine the growth assumptions upon which the budgetary commitments are made. Economic growth is, according to the updates, projected to recover gradually over the coming years. The average GDP growth in the euro area is expected to pick up to 2.0 % in 2004 and to reach around 2.5 % in 2005 and the following years (see Table I.6).

In comparison with the 2002 updates of the programmes, growth projections have been revised downwards (see the lower half of Table I.6 and Table I.7).

The negative revisions concern the whole period, but in particular 2003. Nevertheless, growth projections are still more favourable than the Commission's autumn 2003 forecasts, by on average 0.2 percentage points per year between 2003 and 2005. This has been the case for the previous updates as well ([1]). The growth projections also seem to be optimistic in comparison to the Commission's spring 2004 forecasts (see last row of Table I.6).

The aggregate potential GDP growth in the euro area is projected to be stable, around 2.1 %, throughout the programme period. Accordingly, the euro-area output gap would be – 1.1 percentage points of potential GDP in 2003, widen further in 2004 to – 1.2 % and thereafter decrease in 2005 and onwards (see Graph I.6). In comparison to the 2002 updates, the slowdown is projected to be protracted with a more sizeable negative output gap that does not fully disappear within the programme period.

Based on these growth assumptions, the nominal deficit in the euro area would, according to the updated programmes, amount to 2.7 % of GDP in 2003, which is almost 1 percentage point of GDP higher compared to the previous updates (see Table I.8). The nominal deficit is, however, projected to be gradually reduced to below 1 % of GDP by 2007. The overall improvement relies strongly on the budgetary consolidation projected in the large Member States, such as Germany (2.5 percentage points of GDP over the next four years), France (2.5 percentage points) and Italy (2.5 percentage points). The excessive deficits in Germany and France are foreseen to be corrected by 2005 in the respective stability programme. Also Greece, the Netherlands, and outside the euro area, Sweden and the UK foresee important improvements in the budget balance. Ireland and Luxembourg are the only Member States that project a budgetary deterioration between 2003 and the end of the programme period.

A comparison between the projections provided by the Member States (the left panel of Table I.8) and the Commission's autumn 2003 and spring 2004 forecasts (right panels) shows that most updates are more optimistic about budgetary developments in 2004 and 2005 than the Commission forecasts, in particular those of Greece, Italy, the Netherlands and Portugal. The only countries projecting less favourable budgetary developments are Spain, Ireland and Finland reflecting among other things more cautious growth assumptions.

The differences in budget balance projections between the updates and the Commission forecasts are particularly relevant for 2005. One obvious explanation for this is that the budgetary projections in several programmes are based on more optimistic growth assumptions. More-

([1]) The difference in the real GDP growth for the euro area between the 2001, 2002 and 2003 updates of the stability programmes and the Commission's autumn forecasts has for each period been on average 0.2 percentage points of GDP.

Table I.6

Euro area: Growth projections and macroeconomic developments in the 2003 updates (percentage change on preceding year) and comparison with the 2002 updates and the Commission forecasts

(% of GDP)

Macroeconomic developments	2002	2003	2004	2005	2006	2007
2003 updates of the stability programmes						
Real GDP growth	0.9	0.6	2.0	2.5	2.6	2.5
GDP deflator	2.4	2.1	1.7	1.6	1.6	1.5
HICP change	2.3	2.1	1.7	1.6	1.6	1.5
employment growth	0.3	0.0	0.6	1.1	1.2	1.1
labour productivity growth	0.5	0.8	1.7			
2002 updates of the stability programmes						
Real GDP growth	1.0	2.1	2.6	2.6	2.6	
Difference with the 2003 updates (1)	– 0.1	– 1.5	– 0.6	– 0.1	– 0.1	
Commission's autumn 2002 forecast						
Real GDP growth	0.9	0.4	1.8	2.3		
Difference with the 2003 updates (1)	0.0	0.2	0.2	0.2		
Commission's spring 2004 forecast						
Real GDP growth	0.9	0.4	1.7	2.3		
Difference with the 2003 updates (1)	0.0	0.2	0.3	0.2		

(1) A positive value implies a higher growth forecast in the 2003 updates.
NB: Commission calculations. Discrepancies are due to rounding. The growth rates used for France are based on the cautious scenario. Since figures for the HICP were not available in the German programme, the Commission forecasts have been used in order to obtain a representative aggregate. In the case of Greece (for 2004–06) and Spain the private consumption deflator was used instead of the HICP.

Source: Commission services.

over, in some cases Member States incorporate in their projections intended policy measures, whereas the Commission forecasts for 2005 are on a no-policy-change basis.

All countries, except Spain, provided figures for the CABs in the updates of the programmes (see left panel of Table I.9). The central panel of Table I.9 shows the CAB derived by the Commission, on the basis of the figures provided by Member States in the updates.

According to these figures, the cyclically adjusted deficit for the euro area, which amounted to 2.1 % of GDP in 2003, is projected to improve by on average 0.4 percentage points of GDP annually in the coming years. This is clearly more optimistic than the Commission forecasts.

According to the Commission calculations, of the eight euro-area countries showing a cyclically adjusted deficit in 2003, Ireland, Italy, the Netherlands and Austria are projecting to be in a close-to-balance position by 2007. Some deficit countries plan to achieve an annual adjustment in cyclically adjusted terms of 0.5 percentage points of GDP over the coming years. However, the projected budgetary adjustment is in some cases insufficient to ensure that a budgetary position close-to-balance is achieved within the programme period and that a sufficient safety margin to prevent a breach of the 3 % of GDP reference value is reached before 2007.

Particular attention should be paid to the planned adjustments in Member States in excessive deficits positions. At the Ecofin Council of 25 November 2003, Germany and France committed to reducing the cyclically adjusted budget deficit by specified amounts. Respectively, for 2004 and 2005, the adjustment in Germany should be of at least 0.6 and 0.5 percentage points of GDP, while in France of at least 0.8 and 0.6 percentage points of GDP. According to the Commission calculations, Germany projects an improvement in the CAB by 0.7 and 0.4 percentage points of GDP in 2004 and 2005, respectively. Concerning France, the Commission calculations indicate improvements in the CAB of 0.6 percentage points of GDP for both 2004 and 2005. In Portugal the projected improvement in the CAB is, according to the Commission calculations, slightly lower than the

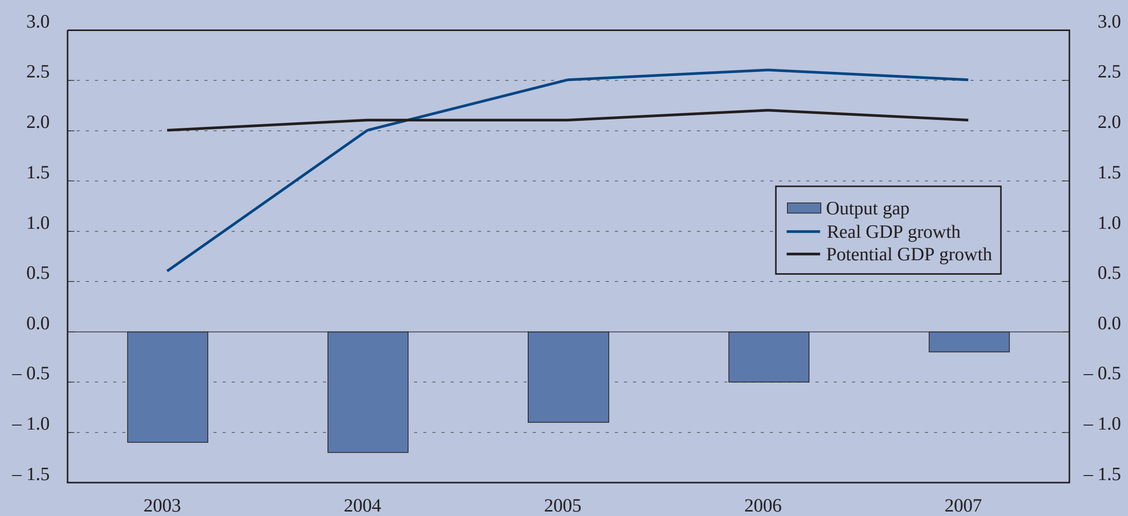
Table I.7

GDP growth projections in the 2003 updates

	2002	2003	2004	2005	2006	2007	Revision (1)
BE	0.7	0.9	1.8	2.8	2.5	2.1	– 0.5
DE	0.2	– 0.1	1.7	2.25	2.25	2.25	– 0.7
EL	3.8	4.0	4.2	4.0	3.8		0.2
ES	2.0	2.3	3.0	3.0	3.0	3.0	– 0.2
FR	1.2	0.5	1.7	2.5	2.5	2.5	– 0.9
IE	6.9	2.2	3.3	4.7	5.2		– 0.8
IT	0.4	0.5	1.9	2.2	2.5	2.6	– 1.2
LU	1.3	1.2	2.0	3.0	3.8		– 0.2
NL	0.2	0.0	1.0	2.5	2.5	2.5	– 0.9
AT	1.4	0.9	1.9	2.5	2.5	2.4	– 0.2
PT	0.4	– 0.8	1.0	2.5	2.8	3.0	– 1.5
FI	2.2	1.4	2.7	2.5	2.4	2.4	– 0.4
EUR-12	0.9	0.6	2.0	2.5	2.6	2.5	– 0.8
DK	2.1	1.4	2.3	2.2	1.9	1.7	0.1
SE	1.9	1.4	2.0	2.6	2.5		– 0.4
UK (2)	1.75	2.0	3.25	3.25	2.75		– 0.2
EU-15	1.1	0.9	2.2	2.6	2.6	2.5	– 0.6

(1) Difference with respect to the 2002 updates in average growth over 2003–05.
(2) Mid-point of the range provided in the programme.

Graph I.6: **Real and potential GDP growth and the output gap for the euro area derived from the 2003 updates, 2003–07**



NB: Potential GDP growth and output gap calculated by the Commission on the basis of the data provided in the updates.

Table I.8

Actual budget balances in the 2003 updates and in the Commission forecasts

(% of GDP)

	2003 updates of stability and convergence programmes						Commission's autumn 2003 forecasts (1)			Commission's spring 2004 forecasts		
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
BE	0.1	0.2	0.0	0.0	0.0	0.3	0.2	– 0.4	– 0.4	0.2	– 0.5	– 0.7
DE	– 3.5	– 4.0	– 3	– 2	– 2.0	– 1	– 4.2	– 3.9	– 3.4	– 3.9	– 3.6	– 2.8
EL	– 1.2	– 1.4	– 1.2	– 0.5	0.0		– 1.7	– 2.4	– 2.3	– 3.0	– 3.2	– 2.8
ES	0.1	0.5	0.0	0.1	0.2	0.3	0.0	0.1	0.2	0.3	0.4	0.6
FR	– 3.1	– 4.0	– 3.6	– 2.9	– 2.2	– 1.5	– 4.2	– 3.8	– 3.6	– 4.1	– 3.7	– 3.6
IE (2)	– 0.2	– 0.4	– 1.1	– 1.4	– 1.1		– 0.9	– 1.2	– 1.1	0.2	– 0.8	– 1.0
IT	– 2.3	– 2.5	– 2.2	– 1.5	– 0.7	0.0	– 2.6	– 2.8	– 3.5	– 2.4	– 3.2	– 4.0
LU	2.4	– 0.6	– 1.8	– 2.3	– 1.5		– 0.6	– 2.1	– 2.5	– 0.1	– 2.0	– 2.3
NL	– 1.6	– 2.3	– 2.3	– 1.6	– 0.9	– 0.6	– 2.6	– 2.7	– 2.4	– 3.2	– 3.5	– 3.3
AT	– 0.1	– 1.3	– 0.7	– 1.5	– 1.1	– 0.4	– 1.0	– 0.6	– 0.2	– 1.1	– 1.1	– 1.9
PT	– 2.7	– 2.9	– 2.8	– 2.2	– 1.6	– 1.1	– 2.9	– 3.3	– 3.9	– 2.8	– 3.4	– 3.8
FI	4.2	2.3	1.7	2.1	2.1	2.2	2.4	1.7	1.9	2.3	2.0	2.1
EUR-12	**– 2.2**	**– 2.7**	**– 2.3**	**– 1.8**	**– 1.2**	**– 0.7**	**– 2.8**	**– 2.7**	**– 2.7**	**– 2.7**	**– 2.7**	**– 2.6**
DK (3)	1.7	1.4	1.5	2.0	2.0	2.3	0.9	1.3	1.9	1.5	1.1	1.5
SE	1.1	0.2	0.4	1.2	1.6		0.2	0.5	1.0	0.7	0.2	0.7
UK (4)	– 2.1	– 3.3	– 2.6	– 2.4	– 2.1	– 2.0	– 2.8	– 2.7	– 2.4	– 3.2	– 2.8	– 2.6
EU-15	– 2.1	– 2.6	– 2.2	– 1.7	– 1.2	– 0.9	– 2.7	– 2.6	– 2.4	– 2.6	– 2.6	– 2.4

(1) Based on pre-budget figures for Ireland and the UK. For 2005, on the assumption of unchanged policies.
(2) Including UMTS receipts of 0.2 % of GDP in 2002.
(3) Data relative to 2010 have been used for 2007 in the convergence programme.
(4) Financial years ending the following March for data in the convergence programme.

required minimum of 0.5 percentage points of GDP per year. However, a close-to-balance position in cyclically adjusted terms is almost reached by the end of the period.

The development in the general government balance can be decomposed by sectors of government (see Table I.10) (1). For the euro area as a whole, the budget deficit of the general government is mainly the result of a large deficit for the central government, with a far smaller deficit for the local governments. The social security sector is estimated to record a small surplus, in particular in the case of Luxembourg, Finland and, outside the euro area, Sweden. France is the only Member State expecting a deficit in the social security sector.

The government debt/GDP ratio in the euro area is, after the increase recorded in 2003, projected to gradually decline to just below 68 % of GDP by 2007 (see Table I.11). The adjustment path is, however, slower in comparison to the 2002 updates due to smaller primary surpluses and lower nominal GDP growth.

Table I.11 shows also that the estimated stock-flow component on average increases the debt ratio over the programme period. *Inter alia*, this could stem from plans to build up financial assets in some countries (for example public pension reserve funds which are invested in non-governmental assets) (2).

Table I.12 shows that six Member States expect the debt level to be above the 60 % of GDP ceiling in 2006 (Belgium, Germany, Greece, France, Italy and Austria). With the notable exception of Germany,

(1) To simplify the presentation, Table I.10 presents the two sectors of State and local government in one single row, given that the State government sector is relevant only for four Member States.

(2) As in the previous updates, large contributions of the stock-flow over the programme period are identified in Finland (with a yearly average around 4 % of GDP), Greece (around 3 %), Sweden (around 1.5 %) and Ireland (around 1 %).

Table I.9

Cyclically adjusted balances in the 2003 updates and in the Commission forecasts on the basis of the production function method

(% of GDP)

	2003 updates of the programmes (¹)					Commission calculations based on the 2003 updates (²)					COM autumn 2003 forecasts (²)			COM spring 2004 forecasts(²)(⁴)		
	2003	**2004**	**2005**	**2006**	**2007**	**2003**	**2004**	**2005**	**2006**	**2007**	**2003**	**2004**	**2005**	**2003**	**2004**	**2005**
BE	0.8	0.6	0.1	– 0.1	0.2	0.8	0.6	0.2	0.0	0.3	0.8	0.1	– 0.2	0.7	0.0	– 0.5
DE	– 3.1	–2.5	– 2.0	–1.5	– 1.0	– 3.2	– 2.5	– 2.1	– 1.6	– 1.4	– 3.5	– 3.3	– 3.0	– 3.2	– 3.0	– 2.5
EL	– 2.0	– 1.8	– 1.1	– 0.5		– 1.7	– 1.7	– 1.2	– 0.9		– 2.2	– 3.1	– 3.2	– 3.6	– 4.1	– 3.8
ES						0.6	0.1	0.1	0.2	0.3	0.1	0.3	0.3	0.4	0.6	0.7
FR	– 2.8	– 2.0	– 1.4	– 0.8	– 0.2	– 3.8	– 3.2	– 2.6	– 1.9	– 1.3	– 3.9	– 3.3	– 3.2	– 3.9	– 3.4	– 3.3
IE	– 0.8	– 0.5	– 0.4	– 0.1		– 0.5	– 0.7	– 0.8	– 0.5		– 1.0	– 0.6	– 0.2	0.1	– 0.3	– 0.2
IT	– 1.9	– 1.6	– 1.1	– 0.5	0.1	– 1.8	– 1.6	– 1.0	– 0.4	0.1	– 2.1	– 2.3	– 3.2	– 1.9	– 2.6	– 3.6
LU	2.4	1.0	0.6	1.2		1.1	0.9	1.0	2.2		1.8	1.4	1.7	1.3	0.6	1.2
NL	– 1.3	– 0.7	– 0.5	– 0.3	– 0.5	– 1.3	– 0.7	– 0.5	– 0.3	– 0.5	– 1.3	– 0.7	– 0.6	– 2.0	– 1.7	– 1.3
AT	– 1.0	– 0.4	– 1.3	– 1.1	– 0.5	– 1.0	– 0.4	– 1.4	– 1.1	– 0.5	– 0.7	– 0.3	– 0.1	– 0.9	– 0.9	– 1.8
PT	– 1.7	– 1.1	– 0.6	– 0.1	0.4	– 2.1	– 1.7	– 1.3	– 0.9	– 0.7	– 2.0	– 2.1	– 2.6	– 1.8	– 2.1	– 2.6
FI	3.0	2.4	2.4	2.3	2.2	2.7	2.0	2.4	2.3	2.2	2.8	2.1	2.0	2.3	2.1	2.2
EUR-12	**– 1.9**	**– 1.5**	**– 1.2**	**– 0.7**	**– 0.4**	**– 2.1**	**– 1.8**	**– 1.4**	**– 1.1**	**– 0.7**	**– 2.3**	**– 2.2**	**– 2.2**	**– 2.2**	**– 2.2**	**– 2.2**
DK (³)	1.9	1.7	2.1	2.0	2.3	1.3	1.3	1.7	1.8	2.4	1.0	1.4	1.9	2.1	1.4	1.5
SE	1.2	1.3	1.8	2.0		0.5	1.0	1.8	2.3		0.4	0.9	1.5	0.7	0.3	0.8
UK	– 2.4	– 2.0	– 2.2	– 2.1	– 2.0	– 2.8	– 2.4	– 2.4	– 2.2	– 2.0	– 2.4	– 2.3	– 2.1	– 2.9	– 2.6	– 2.3
EU-15	**– 1.8**	**– 1.4**	**– 1.2**	**– 0.8**	**– 0.6**	**– 2.1**	**– 1.7**	**– 1.4**	**– 1.0**	**– 0.8**	**– 2.2**	**– 2.0**	**– 2.0**	**– 2.2**	**– 2.1**	**– 2.1**

(¹) Since figures for the CAB were not available in the Spanish stability programme, the Commission calculations have been used to have a representative aggregate for EUR-12 and EU-15.
(²) On the basis of the PF method, except in the case of Germany, Spain and Austria, where the HP filter method has been used.
(³) The structural budget balance (i.e. net of special items) in Denmark is, according to the programme, expected to be: 2.0 % of GDP in 2003, 1.7 % in 2004, 1.8 % in 2005, 1.9 % in 2006 and 2.1 % in 2010.
(⁴) For a number of countries, the calculated CABs differ marginally from those of the spring forecast due to data revisions.
NB: Footnotes to Table I.8 apply here.

Source: Commission services.

Table I.10

Euro area: Net lending by subsectors in the 2003 updates

% of GDP	2003	2004	2005	2006	2007
General government	– 2.7	– 2.3	– 1.8	– 1.2	– 0.7
Central government	– 2.1	– 2.1	– 1.8	– 1.5	– 1.3
State plus local governments	– 0.6	– 0.5	– 0.5	– 0.3	– 0.2
Social security funds	0.0	0.2	0.2	0.3	0.4

NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes.

France, Ireland and the UK, all Member States project a lower debt level in 2006–07 compared to 2003. In EU-15, the debt level is expected to be below 50 % of GDP in seven Member States, namely Luxembourg, Denmark, Ireland, the UK, Spain, Finland and Sweden, of which the former three will have debt ratios below 40 % of GDP.

2.2. 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.13). In the

Table I.11

Euro area: Government debt level and changes in the 2003 updates

(% of GDP)

	2002	2003	2004	2005	2006	2007
Government debt level	69.1	70.1	70.0	69.4	68.4	67.6
Change in government debt	– 0.1	1.0	0.0	– 0.6	– 1.0	– 1.2
Previous updates of the programmes	69.7	68.7	67.0	65.7	63.7	
Difference	– 0.6	1.4	3.0	3.7	4.6	
Contributions to change in government debt:						
Primary balance	– 1.4	– 0.8	– 1.0	– 1.5	– 2.1	– 2.5
Interest payments	3.6	3.5	3.4	3.4	3.4	3.4
Nominal GDP growth	– 2.1	– 1.8	– 2.4	– 2.7	– 2.7	– 2.6
Other factors influencing the debt ratio (1)	– 0.1	0.2	0.1	0.4	0.6	0.7

(1) 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.
NB: Commission calculations. Discrepancies are due to rounding or inconsistencies in the data provided in the programmes.

Table I.12

Debt levels in the 2003 updates

(% of GDP)

	2002	2003	2004	2005	2006	2007
BE	106.1	102.3	97.6	93.6	90.1	87.0
DE	60.8	64.0	65.0	65.5	65.5	65.0
EL	104.7	101.7	98.5	94.6	90.5	
ES	54.5	51.8	49.6	47.7	45.7	43.8
FR	59.0	61.4	62.8	63.2	62.8	61.8
IE	32.4	33.1	33.3	33.5	33.3	
IT	106.7	106.0	105.0	103.0	100.9	98.6
LU	5.7	4.9	5.2	5.0	4.4	
NL	52.4	54.0	54.5	53.7	53.0	52.2
AT	66.7	66.4	65.8	64.1	62.3	59.9
PT	58.1	59.5	60.0	59.7	58.6	57.0
FI	42.7	45.1	44.7	44.9	45.0	44.6
EUR-12	**69.1**	**70.1**	**70.0**	**69.4**	**68.4**	**67.6**
DK (1)	45.5	42.7	41.2	38.7	36.4	27.5
SE	52.7	51.7	51.5	50.0	48.3	
UK (2)	37.9	39.3	40.2	40.8	41.1	41.4
EU-15	**62.6**	**63.8**	**63.8**	**63.3**	**62.5**	**61.9**

(1) Data relative to 2010 have been used for 2007 in the convergence programme.
(2) Financial years ending in the following March.

euro area, total receipts are expected to fall by 1 percentage point of GDP between 2003 and 2006 to around 45 % of GDP in 2006. This is more than compensated by reductions in the expenditure ratio which, over the same period, are expected to amount to 2.1 percentage points. Revenue ratios are projected to decline in all Member States with the exception of Spain and France, where they will remain unchanged and outside the euro area in the UK, where it is set to increase. Strong reductions in revenue ratios are projected in Belgium, Luxembourg and Austria. In the case of France, Finland, Denmark and Sweden revenue ratios are still expected to exceed 50 % of GDP. Almost all Member States are set to decrease the expenditure ratio, with the exception of Spain, Finland and the UK. Strong reductions are planned by Germany, Austria and Portugal.

Although the information in the updates of the programmes on the budget components is not always complete ([1]), it would seem that the reduction in taxes which has taken place in earlier years in most euro-area countries is not expected to continue. The tax-to-GDP ratio is projected to remain constant at around 27 % over the programme period (see Table I.14). Important reductions are expected in Luxembourg (in 2004 and 2005), Austria (in 2005) and Finland (in 2004), while the UK plans to increase the tax ratio. Social contributions in the euro area are projected to be reduced as a share of GDP in the medium term, in particular in Germany and the Netherlands. Other revenues as a share of GDP are expected to decrease slightly over the period.

As to the components of public expenditures, very limited data are provided for collective consumption.

([1]) No information was given in the French programme and only partial information was given by Spain.

Table I.13

Expenditure and revenue ratios in the 2003 updates

	Total revenues			Total expenditures		
	2003	**2006 ([1])**	**2003–06 ([2])**	**2003**	**2006 ([1])**	**2003–06 ([2])**
BE	50.5	48.4	– 2.1	50.2	48.4	– 1.8
DE	45.0	43.5	– 1.5	49.0	45.5	– 3.5
EL	43.7	43.5	– 0.2	45.2	43.5	– 1.7
ES	40.0	40.0	0.0	39.6	39.8	0.2
FR	50.3	50.3	0.0	54.3	52.4	– 1.9
IE	34.1	32.5	– 1.6	34.6	33.6	– 1.0
IT	45.8	44.4	– 1.4	48.4	47.0	– 1.4
LU	47.1	44.9	– 2.2	47.7	46.6	– 1.1
NL	45.5	44.8	– 0.7	47.6	45.9	– 1.7
AT	50.6	48.3	– 2.3	51.9	49.4	– 2.5
PT	44.1	42.9	– 1.2	47.0	44.5	– 3.5
FI	51.0	50.8	– 0.2	48.7	48.8	0.1
EUR-12	**46.0**	**45.1**	**– 1.0**	**48.7**	**46.6**	**– 2.1**
DK	55.2	54.2	– 1.0	54.0	52.3	– 1.7
SE	56.4	56.0	– 0.4	56.3	54.3	– 2.0
UK ([3])	37.7	39.2	1.5	40.2	40.7	0.5
EU-15	**45.1**	**44.7**	**– 0.4**	**47.6**	**46.5**	**– 1.1**

([1]) Concerns 2005–06 for the UK and 2005 for the EU.
([2]) Concerns the period between 2003–04 and 2005–06 for the UK and between 2003 and 2005 for the EU.
([3]) Financial years ending in the following March. Concerns total current revenue.
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 other tables.

According to the updates, social transfers in the euro area are projected to decrease by on average 0.3 percentage points of GDP annually, mainly reflecting decreases in Germany. Gross capital formation in the euro area is projected to remain constant around 2.4 % of GDP across the programme period. For the countries with high deficits, the budgetary consolidation strategy, based on expenditure restraint, should not be achieved at the expenses of the most 'productive' components of public spending (such as public investment, education and research expenditures). However, the composition of expenditure adjustment in the case of Portugal suggests that about a quarter of it falls on investment expenditures. Public investment is also expected to decline somewhat in Luxembourg and Finland, while a relatively important increase is foreseen in the UK.

Graph I.7 presents the contribution to the change in the budget balances from four budget components, namely primary current expenditures, interest payments, gross fixed capital formation and total revenues. A number of remarks can be made.

Firstly, Germany, France, Italy, the Netherlands and Portugal, which had large deficits in 2003, project to improve budget balances substantially via cuts in primary current expenditures. However, excluding France, further cuts on the revenue side are also foreseen. In the case of Portugal the budgetary adjustment involves a decline in public investments. In contrast, the UK plans to increase the expenditure ratio (notably public investments). This is financed by an increase in the revenue ratio, which should help reduce the deficit to closer to balance. Secondly, deterioration in the budget balance over the period is expected in Ireland and Luxembourg. The reduction in revenues is partially compensated by cuts in primary current expenditures as well as public investments. Thirdly, several Member States with budgets close-to-balance or in surplus in 2003 (Belgium, Denmark, Austria 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.

Table I.14

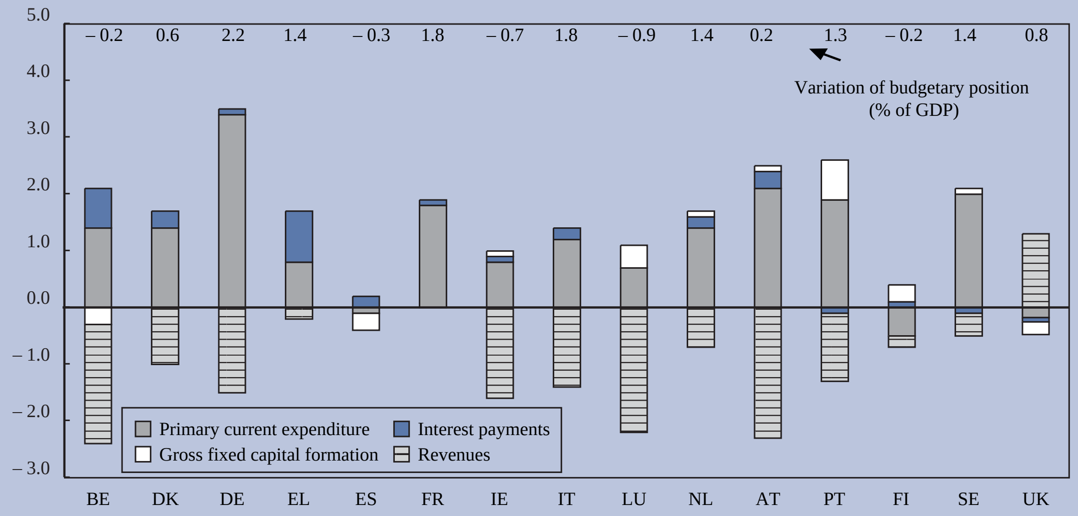
Euro area: Budget developments for the general government

% of GDP	2002	2003	2004	2005	2006	2007
Components of revenues						
Taxes	27.1	26.8	26.8	26.8	26.8	26.9
Social contributions	15.4	15.4	15.4	15.1	14.9	15.1
Interest income						
Other	4.1	4.5	4.0	3.7	3.7	3.5
Total receipts	**46.1**	**46.0**	**45.7**	**45.3**	**45.0**	**45.1**
Components of expenditures						
Collective consumption						
Social transfers in kind	14.7	14.0	13.6	13.5	13.3	13.7
Social transfers other than in kind	17.4	17.6	17.4	17.0	16.7	16.6
Interest payments	3.7	3.5	3.4	3.4	3.4	3.4
Subsidies	1.4	1.3	1.4	1.3	1.1	1.1
Gross fixed capital formation	2.2	2.4	2.3	2.4	2.4	2.3
Other	3.1	3.2	3.1	3.2	2.9	2.9
Total expenditures	**47.6**	**48.7**	**47.9**	**47.3**	**46.6**	**46.3**

NB: Totals might not correspond to the sum of the components: while for totals information is available for all countries, several countries are not included in the aggregation concerning budgetary components, which affects the ratio of the components.

Source: 2003 updates of the stability and convergence programmes.

Graph I.7: **Contributions to change in budgetary position, 2003–06 (% of GDP)**



NB: A positive value indicates a positive contribution to the change in the budgetary position. A positive value in total variation of the budgetary position (value is presented on top of columns) implies an improvement of the balance. For UK data refer to 2003–05. For France values of primary current expenditures refer to primary expenditure. Net lending for Italy includes unspecified measures totalling 1.8 percentage points of GDP in 2006.
Source: 2003 updates of the stability and convergence programmes.

3. Overview of the 2003 updates of the pre-accession economic programmes and the 2004 convergence programmes

3.1. Introduction

The third set of pre-accession economic programmes (PEPs) covering the period 2002–06 was submitted by acceding countries in August 2003. Their assessment was completed by the Commission in November 2003. All documents followed the guidelines and principles set up by the document '2003 pre-accession economic programme: consolidated outline and external assumptions', ensuring cross-country consistency and comparability. The programmes presented data according to ESA 95 methodology.

The PEPs outlined the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. In doing so, the programmes strengthen the institutional and analytical capacity necessary to participate in EMU with a derogation from the adoption of the euro upon accession, particularly in the areas of multilateral surveillance and coordination of economic policies. All programmes foresee an improvement in the economic climate in the period covered by the plans. The areas of structural reforms to be undertaken are well defined, although their cost is not always quantified. As a result, the impact of these reforms on the presented budgetary framework cannot be fully assessed.

In mid-May 2004, the first set of convergence programmes covering in most Member States the period 2004–07 was submitted. The programmes present the medium-term framework for fiscal adjustment. In some countries, the aim is to obtain a budgetary position of close to balance or in surplus to allow them to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 % of GDP. A brief comparison with the 2003 updates of the pre-accession economic programmes on growth assumptions, budgetary targets and structural deficits as well as debt levels is offered in the last section of this chapter.

3.2. 2003 updates of the pre-accession economic programmes

3.2.1. Medium-term budgetary developments

According to the PEPs, average growth in the NMS in the 2003–06 period is expected to be the same as in the period 1998–2002, which is overall somewhat more confident than the growth prospects outlined in the 2002 programmes, although there are country differences. Latvia, Lithuania and Poland revised the economic growth projections for the period 2003–06 upwards, while Cyprus, the Czech Republic, Hungary, Malta and Slovenia revised them downwards. In the period 2002–06, the level of inflation is expected to decline in all the countries, except in Lithuania and Latvia. In Lithuania, deflation will be replaced with moderate inflation. The current account balance is to remain negative in all the NMS, according to the PEPs, except in Slovenia, where a continuous surplus is foreseen over the entire programme period (see Table I.15).

In 2002, all the countries, with the exception of Estonia (1.3 % of GDP surplus), were running general government deficits (see Table I.16), in the one digit range, varying from the lowest deficit of Lithuania (1.4 % of GDP) to the highest of Hungary and Slovakia (9.2 and 5.7 % of GDP, respectively).

The expected developments in the PEPs period indicate for all the NMS a substantial consolidation of their public finances. Thus, by 2006, only the Czech Republic, Malta and Poland foresaw general government deficits above the 3 % of GDP reference value. Hungary is estimated to deploy the strongest consolidation effort to reduce its fiscal imbalance by 6.7 percentage points to 2.5 % of GDP by 2006, followed by Slovakia, expecting to shrink its deficit in the same period by 4.3 percentage points. Displaying a different path, Estonia plans to bring the 2002 government surplus down to balance by 2006, while Poland's consolidation endeavour looks weak as the government is still engaged in expansionary fiscal policy leading to further deficit increases in 2003 and 2004.

Contrary to such a general improvement, comparing the latest data available with the Commission's spring 2004 forecast, the adjustment path projected in the 2003 PEPs may prove too optimistic. The spring 2004 fiscal notification presented by the Czech authorities reported the registration of one single imputed State guarantee of about 6.3 % of GDP, which brought the general government deficit to 12.9 % of GDP in 2003. In Malta, the general government deficit went up to 9.7 % of GDP in 2003 due to a one-off outlay of 3.2 % of GDP related to the restructuring operation of the shipyards. Similarly, taking 2005 for comparison for most countries (e.g. not the Czech Republic) deficit projections were lower in the 2004 PEPs than in the Commission's spring 2004 forecast.

In 2002, Hungary and the Czech Republic ran the highest primary deficit (5.5 and 5 % of GDP, respectively), while Estonia and Cyprus reached a primary surplus (1.6 and 1.4 % of GDP, respectively). Although Estonia and Lithuania presented projections for a deterioration in their respective primary balance at the end of the period, their overall fiscal position is to remain relatively strong. All other countries are expected to improve their primary balance, albeit the Czech Republic, Latvia, Lithuania, Poland and Slovakia will keep primary deficits.

When comparing the budgetary objectives between the PEPs of 2002 and 2003, Estonia and Slovenia are the only countries to revise their fiscal balance upwards, whilst all other countries made downward revisions, thus implying larger deficits. These modifications were particularly significant in Slovakia and Cyprus. In some countries, the upward revision of the deficit is partially related to the downward revision of growth, but in others, such as Poland, the projected deterioration of the fiscal balance reflects an easing of the budgetary stance.

Table I.15

Macroeconomics projections in the 2003 PEPs

	Real GDP growth (Annual percentage change)			Consumer price inflation (Annual percentage change)		Current account balance (% of GDP)	
	1998–2002 (1)	2003–06 (2)	Revision (3)	2002	2006	2002	2006
CZ	1.5	3.0	– 0.7	4.7	3.4	– 6.5	– 6.2
EE	4.7	5.5	0.0	5.8	3.5	– 12.3	– 9.0
CY	4.2	3.8	– 0.4	2.0	2.0	– 5.3	– 1.4
LV	4.4	6.2	0.7	2.5	3.0	– 7.8	– 7.6
LT	5.8	6.4	1.1	1.3	4.1	– 5.3	– 5.6
HU	4.3	4.0	– 0.6	9.2	3.0	– 4.0	– 5.0
MT	2.8	2.7	– 0.8	2.9	2.4	– 4.7	– 4.4
PL	5.4	4.7	1.1	5.5	3.1	– 3.5	– 5.1
SI	2.8	3.9	– 0.6	8.4	4.6	1.7	1.1
SK	4.2	4.3	0.0	7.1	4.5	– 8.2	– 3.3
EU-10	4.3	4.3	0.3	5.8	3.3	– 4.4	– 4.9

(1) Annual average over the period 1998–2002.
(2) Annual average over the period 2003–06.
(3) Difference between the average rate of growth over the period 2003–05 in the 2002 and 2003 PEPs.

Source: 2002 and 2003 PEPs, Commission services.

Table I.16

General government balances in the 2003 PEPs

(% of GDP)

	Nominal balance				Primary balance			Cyclically adjusted balance [2]		
	2002	2006	Change	Revision [1]	2002	2006	Change	2002	2006	Change
CZ	– 6.7	– 4.0	2.7	– 0.1	– 5.0	– 2.4	2.6	– 6.5	– 4.1	2.4
EE	1.3	0.0	– 1.3	0.3	1.6	0.3	– 1.3	n.a.	n.a.	n.a.
CY	– 3.5	– 2.2	1.3	– 1.8	1.4	2.5	1.1	– 2.5	– 2.2	0.3
LV	– 3.0	– 2.0	1.0	– 0.8	– 2.6	– 1.3	1.3	– 3.1	– 2.3	0.8
LT	– 1.4	– 1.8	– 0.1	– 0.2	– 0.2	– 0.5	– 0.3	– 1.7	– 1.6	0.1
HU	– 9.2	– 2.5	6.7	– 0.7	– 5.5	0.4	5.9	– 9.1	– 2.4	6.7
MT	– 6.2	– 3.4	2.8	– 0.6	– 1.4	1.5	2.9	n.a.	n.a.	n.a.
PL	– 3.8	– 3.4	0.4	– 0.7	– 1.0	– 0.8	0.2	– 3.4	– 3.8	– 0.4
SI	– 2.4	– 1.3	1.1	2.2	– 0.2	0.0	0.2	– 2.2	– 1.1	1.1
SK	– 5.7	– 2.9	4.3	– 3.0	– 3.5	– 0.6	2.9	– 7.2	– 3.7	3.5
EU-10	**– 5.1**	**– 3.1**	**2.1**	**– 0.6**	**– 2.4**	**– 0.7**	**1.7**	**– 4.8**	**– 3.2**	**1.6**

(1) Difference between the average nominal balances over the period 2003–05 in the 2002 and 2003 PEPs.
(2) Countries' own estimates as presented in the 2003 PEPs.
NB: Nominal balances for Lithuania and Slovakia for 2002 were revised subsequently.

Source: 2003 PEPs and Commission services.

The estimations presented for CABs over the 2002–06 period (not submitted by Malta and Estonia) suggest that the Czech Republic, Hungary and Slovenia foresee substantial general government deficit reductions as a result of the implementation of policy changes. On the other side, Cyprus and Poland seem to rely on the effect of the cycle for their respective fiscal position, while Slovakia anticipates a narrowing of its budget deficit due to both fiscal consolidation and upbeat economic developments. Save for Poland, all the countries expect improved structural balances by 2006 as compared to 2002. In Slovakia, Poland and the Czech Republic the cyclically adjusted deficits are forecast to stand above 3.5 % of GDP in 2006. Overall, the NMS seem to be making some effort for structural changes in the budget's revenue and expenditure to reach the targets set in the 2003 PEPs, and the favourable economic conditions are also expected to contribute to the planned adjustment

3.2.2. Government debt

The general government debt position widely contrasts among the NMS. Most of them hold low levels of foreign debt and some programmes show a preference for a steady reduction in external financing in order to lower exchange risk exposure, widen domestic capital markets and decrease the issuing costs. Thus, Estonia and Latvia post very low levels of debt, in absolute and relative terms (5.8 and 14.6 % of GDP, respectively), and their debt is mainly owned by foreign creditors. On the other side, the latest data available for 2003 [1] showed Cyprus government debt running at 72.2 % of GDP and Malta's government debt attained 72 % of GDP, clearly exceeding the 2003 PEP estimates and the 60 % of GDP threshold. In addition, the level of government debt in Hungary (56.3 % of GDP) is slightly below the Maastricht reference value.

Six countries anticipated in their PEPs a worsening of their debt levels over the period. The Czech Republic's PEP reported a further deterioration of 12.4 percentage points of GDP between 2003 and 2006, this projection being worse than the one made in last year's programme. The reasons for this are the upward revision of the deficit and the imputation of a State guarantee in 2003. Poland's government debt is forecast to increase by 7.3 percentage points up to 2005 and stabilise in 2006. This mainly results from financing the high deficit of the State budget, leading not only to debt increase in a given year but also, due to debt servicing costs and refinancing, to

(1) Fiscal notification presented in March 2004.

Table I.17

General government debt in the 2003 PEPs

(% of GDP)

	2002	2006	Change
CZ	26.9	39.4	12.4
EE	5.8	4.6	– 1.2
CY	59.7	56.1	– 3.6
LV	14.6	17.4	2.8
LT	22.7	23.3	0.6
HU	56.3	54.0	– 2.3
MT	66.6	68.4	1.8
PL	41.8	49.1	7.3
SI	27.8	25.9	– 1.9
SK	44.3	48.5	4.2
EU-10	**39.8**	**45.1**	**5.3**

Source: 2003 PEPs and Commission services.

an increase in future debt levels. Despite gradually lower deficits, Slovakia estimates an increase in its debt level by 2006. Malta, already running a debt/GDP ratio well above 60 % of GDP, expects after an initial deterioration, the debt/GDP ratio to come down to 68.4 % of GDP by 2006. This estimation seems somewhat optimistic in light of the above mentioned one-off increase which occurred in 2003.

Cyprus, Estonia, Hungary and Slovenia expect a gradual improvement of their debt ratios in accordance with their fiscal consolidation path.

3.2.3. Composition of the adjustment

Unlike in the 2002 PEPs, where most countries proposed to reduce the general government revenue in terms of GDP, the programmes presented in 2003 indicate that only Hungary, Malta and Slovakia are planning to shrink public revenue. Slovakia reports the highest decline by 3.5 percentage points between 2002 and 2006, stemming from a sizeable reduction in direct tax collection brought about by tax reform. The most important increase takes place in Cyprus, where revenues are expected to rise by 2.2 percentage points during the programme period, due to a renewed effort by the current government to carry out fiscal consolidation, improving tax administration and collection and higher fees and royalties levied by the government. Lithuania also plans to boost revenues by 1.8 percentage points by 2006, as the key points of a tax reform are to be implemented by the end of 2004 and the EU grants will contribute to the increase. Estonia estimates an increase in revenues of 1 percentage point by 2006, as the revenue item — other receipts — compensates for diminishing of both income tax revenues and social contributions. Lithuania, Slovakia and Cyprus will have budgetary revenues below 40 % of GDP, with Lithuania the lowest, at 35.6 % of GDP in 2006. Other countries' revenues will exceed 40 % of GDP, Hungary having the highest share (43.6 % of GDP), while still below the EU-15 average (46.4 % of GDP in 2002).

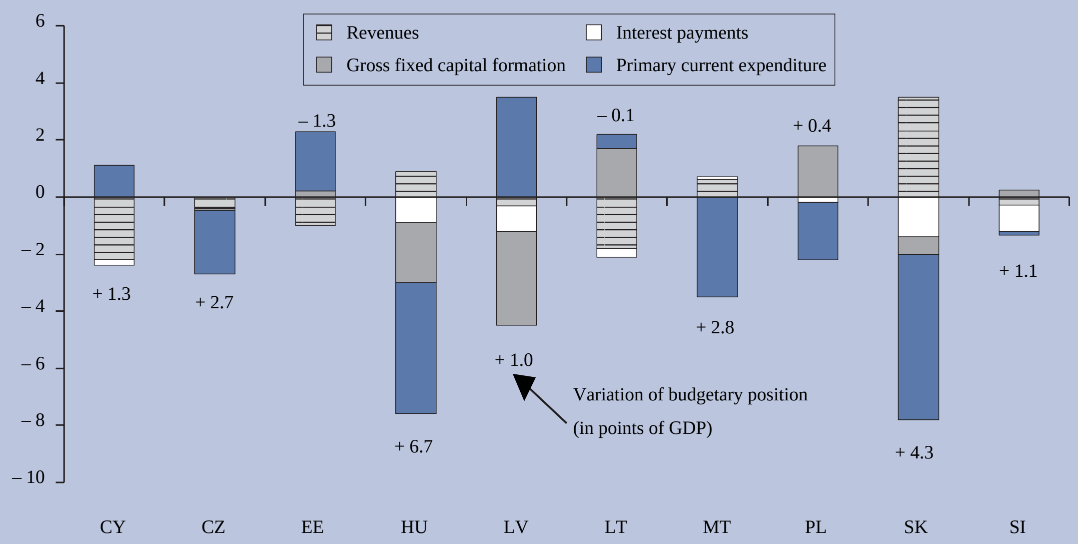
On the expenditure side, Cyprus, Estonia and Lithuania foresee higher spending in terms of GDP in 2006, reflecting comparatively favourable starting conditions for the relative weight of expenditure. The three countries had expenditure-to-GDP ratios below 40 % of GDP in 2002 (the EU-15 average being 47.2 % of GDP), however, only Lithuania foresees to stay below this level by 2006. At 46.8 % of GDP, the Czech Republic is expected to post the highest level of expenditure by 2006, stemming from the cost of industrial and financial restructuring and from the burden of mandatory and quasi-mandatory expenditures. The biggest reductions in the period are listed by Slovakia, Hungary and Malta. Downward adjustments in expenditure in the period come from reductions in social transfers in Slovakia (– 3.2 percentage points) and Poland (– 2.8 percentage points), in gross fixed capital formation in Hungary (– 2.1 percentage points) and collective consumption in Cyprus (– 1.6 percentage points). Poland and Lithuania project to increase capital formation by 1.8 and 1.7 percentage points, respectively, and Cyprus reports an increase in interest payments of 2.3 percentage points over the period 2003–06.

3.2.4. Risk considerations

Most PEPs have submitted a budgetary risk analysis over the period with consideration of explicit and implicit contingent liabilities. Also, the programmes contained an analysis of the long-term sustainability of public finances in the light of the envisaged trends in pension and healthcare expenditures, although the extension and detail of the assessment varies among the countries.

The main source of risk is the existence of State guarantees extended to semi-government institutions. Their amount, composition and assessment of the actual risk level are unevenly appraised among the acceding countries. The guarantees seem to be relatively high in Malta (22 % of GDP) and somewhat more bearable in Cyprus and the Czech Republic (around 10 and 12.2 % of GDP, respectively), Slovenia (6.6 % of GDP) and Hungary

Graph I.8: **Contribution to change in budgetary position 2002–06 according to the 2003 PEPs (% of GDP)**



Source: 2003 PEPs and Commission services.

Table I.18

General government revenue and expenditure in the 2003 PEPs

(% of GDP)

	Revenue			Expenditure		
	2002	**2006**	**Change**	**2002**	**2006**	**Change**
CZ	42.4	42.7	0.4	49.1	46.8	– 2.3
EE	39.7	40.7	1.0	38.4	40.7	2.3
CY	36.3	38.5	2.2	39.8	40.7	0.9
LV	41.9	42.2	0.3	44.9	44.2	– 0.7
LT	33.8	35.6	1.8	35.6	37.4	1.8
HU	44.5	43.6	– 0.9	53.7	46.1	– 7.6
MT	43.8	43.2	– 0.6	50.0	46.6	– 3.4
PL	42.1	42.1	0.0	45.9	45.5	– 0.4
SI	41.5	41.7	0.3	43.9	43.0	– 0.8
SK	41.8	38.3	– 3.5	49.0	41.2	– 7.8
EU-10	**42.0**	**41.9**	**– 0.1**	**47.2**	**45.0**	**– 2.2**

Source: 2003 PEPs and Commission services.

(5.4 % of GDP). In the case of Lithuania, other sources of fiscal risk are related to deposit insurance, restitution of real State ownership rights, debt of State-owned enterprises to banks and privatisation of State-owned assets. In the Czech Republic, legal disputes potentially involving large compensation payments by the State are also considered as a possible risk to the budget. In Poland, a relatively prominent share of foreign debt, high risk of servicing the domestic debt due its short-term average maturity and the compensations to former real estate

Table I.19

Composition of general government expenditure in the 2003 PEPs

(% of GDP)

	Collective consumption			Social transfers			Subsidies			Gross fixed capital formation			Others, including interest		
	2002	2006	Change	2002	2006	Change	2002	2006	Change	2002	2006	Change	2002	2006	Change
CZ	9.4	9.1	– 0.4	25.0	24.4	– 0.7	3.5	3.2	– 0.3	4.6	4.5	– 0.1	6.5	5.6	– 0.9
EE	7.2	7.3	0.1	14.4	15.0	0.6	1.1	1.3	0.2	4.3	4.5	0.2	11.4	12.6	1.2
CY	10.6	9.0	– 1.6	15.4	16.0	0.6	1.0	0.6	– 0.4	3.7	3.7	0.0	9.1	11.4	2.3
LV	9.3	-	-	23.1	-	-	0.8	-	-	3.3	-	-	8.4	-	-
LT	8.0	7.9	– 0.1	22.0	22.2	0.2	0.7	1.1	0.4	2.5	4.2	1.7	2.5	2.0	– 0.5
HU	7.5	7.4	– 0.1	23.7	23.3	– 0.4	2.5	2.7	0.2	6.2	4.1	– 2.1	13.8	8.6	– 5.2
MT	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	3.0	2.6	– 0.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
PL	10.4	9.9	– 0.5	25.4	22.6	– 2.8	0.3	0.2	– 0.1	2.9	4.7	1.8	7.0	8.1	1.1
SI	8.1	7.6	– 0.5	n.a.	n.a.	n.a.	1.1	1.4	0.3	2.5	2.7	0.2	n.a.	n.a.	n.a.
SK	11.0	9.5	– 1.5	21.1	17.9	– 3.2	1.6	1.5	– 0.1	2.4	1.8	– 0.6	12.9	10.5	– 2.4
EU-10	**9.5**	**8.9**	**– 0.7**	**22.9**	**20.8**	**– 2.1**	**2.6**	**2.4**	**– 0.2**	**3.7**	**4.2**	**0.5**	**7.9**	**7.2**	**– 0.7**

Source: 2003 PEPs and Commission services.

owners expropriated in the years 1944–62 contribute to an important fiscal risk as well.

3.2.5. Social security reform

Almost all the countries indicated their awareness of the negative impact of population ageing on the financing of their social security, notably pension and healthcare systems. Through increases in pension and healthcare expenditures, population ageing is expected to have a negative impact on the medium and long-term fiscal sustainability. This is one of the major fiscal risks as pension and healthcare spending are in many countries the biggest single items among all budget expenditures.

When facing this problem, most countries have been adapting their statutory pay-as-you-go (PAYG) pension pillars with the primary objective of securing the future financial balance of these schemes frequently through linking pension benefits closer to pension contributions. The measures include cuts in pension benefits, increases in the retirement age, increases in pension contributions in varying combinations. There are, however, some exceptions to this general trend: in order to improve the social situation of pensioners, the first pillar old-age pensions are being improved in Hungary by introducing a 13th monthly pension payment gradually over four years. Latvia plans to improve the indexation of pensions.

In addition to these changes to the PAYG schemes, several of the new Member States from central and eastern Europe introduced mandatory funded pillars managed by the private sector and created the legislative framework for voluntary funded provision. In the 2003 PEP, Lithuania and Slovakia presented plans to move towards such a ‘multi-pillar’ pension system (in 2004 and 2005, respectively). The introduction of the second (obligatory-funded) pillar requires a high degree of administrative preparation in order to avoid implementation problems. For instance in Poland, the transfers of social insurance contributions from the Social Insurance Institution (ZUS) to private pension funds were affected by serious delays. In addition, the channelling of part of the contribution revenue into privately managed funded schemes reduces government revenues and increases deficits. ESA 95 methodology places these schemes outside the general government sector.

Major motives behind reform steps in healthcare are to increase the quality of healthcare services and to cut healthcare costs that are likely to further increase in the process of population ageing. Many countries mention improvements in the healthcare sector as being important for human capital development. Another motive for healthcare reforms is to contribute to sound general government finances. Radical reform measures are in progress in Slovakia, including private co-financing. Cyprus plans to introduce a general health insurance scheme.

Table I.20

Main measures in the PEPs concerning pension reform

	Funded pillar — developed	Planned reforms
CZ	×	First pillar: parametric reforms within fiscal consolidation, notional defined contribution reform foreseen for 2010. No plans for a compulsory funded pillar.
EE	✓	
CY	✓	Parametric reforms in the first pillar.
LV	✓	More generous indexation rule in the NDC pillar.
LT	✓	Introduction of a voluntarily pillar as of 2004.
HU	✓	Gradual introduction of the 13th month pension. Increase contribution rate to mandatory-funded pillar.
MT	×	Reform of the first pillar planned. No plans for the compulsory funded pillar.
PL	✓	
SI	×	Parametric reforms in the first pillar.
SK	✓	Introduction of a compulsory funded-pillar planned for 2005.

Source: 2003 PEPs and Commission services.

3.3. 2004 convergence programmes

3.3.1. Growth projections

According to the programme projections, the average GDP growth of the new Member States in 2004 is expected to improve for a second consecutive year. Compared to the average GDP growth rate in 2003 (3.6 %), an important acceleration is expected in the course of 2004, to reach the average growth rate of 4.2 % (see Table I.21). Further increases are expected in the future as the average growth rate is estimated to reach 4.4 % in 2005 and 4.8 % in subsequent years.

Of the six new Member States for which an increase in growth rates is expected in 2004, the acceleration is particularly important in Malta (2.8 percentage points), Cyprus (1.5 percentage points), Slovenia and Poland (both 1.3 percentage points). Deceleration of growth in the same period is expected in four new Member States, although marginally in the Czech Republic and Slovakia. In Latvia and Lithuania, despite the expected cooling off, the economic growth is expected to remain very buoyant. According to the convergence programmes, favourable growth prospects are to be continued over the entire programme horizon. In sum, the new Member States with the lowest per capita GDP are expected to grow at the fastest pace, accelerating the catching-up process with higher-income Member States.

In comparison with the 2003 updates of the PEPs, growth projections over the medium-term period have been revised downwards in most new Member States (see Table I.21). While downward revisions for the entire period 2004–06 were made in five countries (Estonia, Cyprus, Hungary, Malta and Slovenia), the Czech Republic and Slovakia marginally lowered their expected growth prospects for 2005 and the former also for 2006. The growth projections presented in the convergence programmes by the Member States are largely in line with the Commission's spring 2004 forecast although somewhat higher in the cases of Latvia, Lithuania, Poland and Slovenia, and lower in the case of Malta.

3.3.2. Budgetary developments and targets

The expected budgetary developments according to the convergence programmes indicate a substantial consolidation of public finances in all new Member States with budgetary deficits. In aggregate terms, the deficit is expected to decrease from its current level, estimated at 5.8 % of GDP in 2003, to 2.1 % of GDP in 2007. Both in 2004 and 2005, the aggregate budget deficit is expected to decrease by 1 percentage point. The overall improvement over the programme period relies strongly on the expected budgetary consolidation in six new Member States for which the excessive deficit procedure was started in May 2004. Among these, particularly strong reductions are expected in the countries with initially high deficits, such as Cyprus (4.7 percentage points over the period 2003–07), Malta (3.8 percentage points over the period 2004–07) and Hungary (2.8 percentage points over the period 2003–07). It has to be noted that the 2003 deficits in the Czech Republic and Malta were high due to one-off measures (an imputed State guarantee in the Czech Republic and a one-off outlay related to the shipyards restructuring operation and the appropriate accounting treatment of associated debt assumed by the general government sector in Malta). On the other hand, in Poland and Slovakia, following an expected increase in their deficits in 2004, the programmes foresee considerable consolidation efforts for the rest of the programme period (respectively, 4.2 percentage points and 2.0 percentage points).

Of the countries with budgetary deficits below the 3 % of GDP reference value, Slovenia and Lithuania are expected to reduce their deficits over the programme period, however, in the latter, only after a substantial worsening in 2004. Displaying a different path, the budgetary deficit in Latvia is expected to fall only marginally, while Estonia plans to move from the 2003 government surplus to a balanced budget in 2005.

A comparison between the budgetary projections provided by the new Member States in their convergence programmes and the 2003 PEPs (see Table I.22) shows that nominal budgetary balances tend to be similar in the medium term (by 2006). Only Hungary and Malta present significant revisions compared to their PEPs. Hungary reports higher deficits in the convergence programme than in the 2003 PEP, while Malta foresees lower deficits in its convergence programme. Slovenia and Slovakia present slightly higher deficits in their programmes than in their PEPs by 2006.

All the countries provided figures for cyclically adjusted budget balances (CAB) in the programmes. They are presented in the left panel of Table I.23. The right panel of the table shows the CABs submitted in the 2003 update of the PEPs. According to the programme figures, the aggregate CAB of the new Member States, amounted to – 5.5 % of GDP in 2003 and is projected to reach – 2.3 % of GDP in 2007.

This reflects the expected decline in the CABs from the 2003 levels in all new Member States, apart from Lithuania and Latvia, where a modest increase is expected, and Estonia, where the surplus in cyclically adjusted terms (2.3 % of GDP) is forecast to decline and converge to balance.

On the whole, despite the general plans for adjustment in cyclically adjusted terms over the period 2003–07, only Malta and Estonia are projecting to balance their budgets by 2007, while in the Czech Republic, Hun-

Table I.21

Growth projections in the May 2004 convergence programmes and differences with the 2003 PEPs ([1])

(% of GDP)

	2003		2004		2005		2006		2007
	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP
CZ	2.9	0.5	2.8	0.0	3.1	– 0.1	3.3	– 0.3	3.5
EE	4.7	0.2	5.3	– 0.3	5.8	– 0.2	5.6	– 0.4	5.9
CY	2.0	0.0	3.5	– 0.5	4.3	– 0.3	4.4	– 0.2	4.5
LV	7.5	1.0	6.7	0.6	6.7	0.7	6.5	0.5	6.5
LT	9.0	2.2	7.0	0.8	7.3	0.8	6.6	0.6	6.3
HU	2.9	– 0.6	3.3	– 0.2	3.6	– 0.4	4.0	– 0.5	4.3
MT	– 1.7	– 3.0	1.1	– 1.4	1.7	– 1.5	2.1	– 1.5	2.1
PL	3.7	0.7	5.0	0.0	5.0	0.0	5.6	0.0	5.6
SI	2.3	– 0.8	3.6	– 0.3	3.7	– 0.3	3.8	– 0.6	3.9
SK	4.2	0.2	4.1	0.0	4.3	– 0.1	5.0	0.2	4.7
EU-10	**3.6**	**0.3**	**4.2**	**0.0**	**4.4**	**– 0.1**	**4.8**	**– 0.2**	**4.8**

([1]) A positive value implies higher growth forecasts in the May 2004 convergence programme.

Source: Commission services.

Table I.22

Budget balances in the May 2004 convergence programmes and differences with the 2003 PEPs ([1])

(% of GDP)

	2003		2004		2005		2006		2007
	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP	CP-PEP	CP
CZ	– 12.9	– 5.3	– 5.3	0.6	– 4.7	0.1	– 3.8	0.2	– 3.3
EE	2.6	2.2	0.7	0.7	0.0	0.0	0.0	0.0	0.0
CY	– 6.3	– 0.9	– 5.2	– 1.5	– 2.9	– 0.1	– 2.2	0.0	– 1.6
LV	– 1.8	1.1	– 2.1	0.3	– 2.2	0.0	– 2.0	0.0	– 2.0
LT	– 1.7	0.7	– 2.7	0.2	– 2.5	0.0	– 1.7	0.1	– 1.5
HU	– 5.9	– 1.1	– 4.6	– 0.8	– 4.1	– 1.3	– 3.6	– 1.1	– 3.1
MT	– 9.7	– 2.3	– 5.2	0.6	– 3.7	0.4	– 2.3	1.1	– 1.4
PL ([2])	– 4.1	0.0	– 5.7	– 0.7	– 4.2	– 0.2	– 3.3	0.1	– 1.5
SI	– 1.8	0.2	– 1.9	– 0.3	– 1.8	– 0.2	– 1.5	– 0.2	– 0.9
SK ([3])	– 3.6	1.4	– 4.0	– 0.1	– 3.4	0.0	– 3.0	– 0.1	– 2.0
EU-10	**– 5.8**		**– 4.8**		**– 3.9**		**– 3.2**		**– 2.1**

([1]) A positive value implies lower deficits in the May 2004 convergence programme.
([2]) The deficit figures will have to be adjusted upwards if the open pension funds are excluded from the general government sector following the Eurostat decision on the classification of funded pension schemes.
([3]) The figures are net of the effect of the introduction of a funded pension pillar in 2005. The programme estimates this revenue-decreasing and hence, ceteris paribus, deficit-increasing effect at 0.5 % of GDP in 2005, 0.9 % of GDP in 2006 and 1 % of GDP in 2007.

Source: Commission services.

Table I.23

Cyclically adjusted budget balances in the May 2004 convergence programmes and the 2003 PEPs ([1])

(% of GDP)

	2004 convergence programmes					PEPs 2003			
	2003	2004	2005	2006	2007	2003	2004	2005	2006
CZ ([2])	– 12.9	– 5.3	– 4.6	– 3.8	– 3.4	– 7.5	– 5.8	– 4.8	– 4.1
EE	2.3	0.6	0.0	0.1	0.1	n.a.	n.a.	n.a.	n.a.
CY	– 4.0	– 4.7	– 2.8	– 2.4	– 1.9	– 4.3	– 3.5	– 2.8	– 2.2
LV	– 1.7	– 2.0	– 2.2	– 2.0	– 2.0	– 2.9	– 2.5	– 2.4	– 2.3
LT	– 1.5	– 2.7	– 2.6	– 2.0	– 1.8	– 2.6	– 3.0	– 2.5	– 1.6
HU	– 5.9	– 4.5	– 3.9	– 3.5	– 3.0	n.a.	n.a.	n.a.	n.a.
MT	– 8.6	– 3.6	– 2.1	– 0.9	– 0.2	n.a.	n.a.	n.a.	n.a.
PL	– 3.7	– 5.5	– 4.1	– 3.4	– 1.7	– 3.6	– 4.7	– 4.0	– 3.8
SI	– 1.3	– 1.4	– 1.3	– 1.1	– 0.7	– 1.4	– 1.1	– 1.1	– 1.1
SK	– 3.5	– 4.0	– 3.9	– 4.1	– 3.1	– 5.1	– 4.1	– 4.2	– 3.7
EU-10	**– 5.5**	**– 4.7**	**– 3.8**	**– 3.2**	**– 2.3**	**– 4.4**	**– 4.5**	**– 3.8**	**– 3.5**

([1]) Countries' own estimates as presented in the May 2004 convergence programmes and the 2003 PEPs.
([2]) Due to the 2004 revision of the statistical methodology regarding the calculation of GDP, the CABs from the two sources are not fully comparable.

Source: Commission services.

gary and Slovakia, the cyclically adjusted deficits are forecast to stand at or above 3 % of GDP in 2007. Moreover, of the countries forecasting an improvement in the CAB over the programme period, Slovakia is the only one projecting an improvement after 2006.

3.3.3. Debt levels

In general, government debt is low in the new Member States and is expected to increase steadily over the programme period from 44.3 % of GDP in 2003 to 47.8 % of GDP in 2006 before declining in 2007 (see Table I.24). Overall, apart from the Czech Republic, Latvia, Poland and Slovakia, new Member States are expected to have lower debt levels in 2007 than in 2003. In Cyprus and Malta, government debt is expected to stay above the 60 % of GDP reference value over the entire programme period, while although remaining below the reference value, a relatively rapid increase in debt levels is projected in the Czech Republic and Poland. Finally, in four countries, namely, Estonia, Latvia, Lithuania and Slovenia, debt levels are expected to be kept below 30 % of GDP.

Table I.24

Debt levels in the May 2004 convergence programmes

(% of GDP)

	2003	2004	2005	2006	2007
CZ	37.6	38.4	39.7	41.0	41.7
EE	5.8	5.4	5.1	4.7	3.4
CY	72.6	75.2	74.8	71.5	68.4
LV	15.3	16.2	16.8	17.3	17.7
LT	21.5	22.4	22.2	21.4	21.0
HU	59.1	59.4	57.9	56.8	55.6
MT	72.0	72.1	72.4	70.5	70.4
PL (1)	45.3	49.0	51.9	52.7	52.3
SI	28.6	29.1	29.5	29.4	28.4
SK	42.8	45.1	46.4	46.1	45.5
EU-10	**44.3**	**46.2**	**47.5**	**47.8**	**47.3**

(1) The debt figures will have to be adjusted upwards if the open pension funds are excluded from the general government sector following the Eurostat decision on the classification of funded pension schemes.

Source: Commission services.

4. The sustainability of public finances based on the 2003 updates of stability and convergence programmes

4.1. Introduction

Due to the growing concerns regarding the impact of ageing populations, ensuring the long-term sustainability of public finances is a key objective in the EU. 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.

The Commission therefore regularly produces the assessment of long-term sustainability of public finances in the context of the Stability and Growth Pact. This chapter presents an overview of the assessment of the long-term sustainability of the public finances based on the 2003 updates of stability and convergence programmes carried out by the Commission for the third year in the row.

The assessment of long-term sustainability of public finances is a multi-faceted issue and there is no unique indicator which gives a clear response on whether a country's public finances are sustainable in the long run. Thus, on the basis of the EPC 2003 report ([1]), the Commission assessed long-term sustainability of public finances using both quantitative indicators and qualitative information. Although the approach followed was broadly similar to the one used in previous assessments (see European Commission, 2002a and 2003a for a review of the first two assessments), it is important to note a number of improvements undertaken in order to enhance the quality of the assessment.

For what concerns the quantitative indicators, the cyclical component of the budget has been netted out in the first year of the projection, so the long-term projections are only affected by the more structural components of the budget. In practice, the tax to GDP ratio in the last year of the programme has been corrected by the cyclical component of the budget ([2]).

Also, a greater attention has been devoted to qualitative features when making the assessment, which alleviated the mechanistic interpretation of the results obtained. The main qualitative features shaped into the assessment are (i) current debt/GDP ratio; (ii) how the use of one-off measures or contribution to pension reserve funds affect the budget balance; (iii) the current level of tax ratios; and (iv) the robustness of the long-term budgetary projections.

4.2. How the sustainability of public finances was assessed

4.2.1. The quantitative indicators

Table I.25 summarises the data included in the 2003 updates of stability and convergence programmes that were used to run the sustainability indicators. The priority has been given to the national projections reported in the programmes, complemented if necessary with the commonly agreed EPC projections.

([1]) See the report 'The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme' (October 2003), available at: http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf.

([2]) This makes this year's results of the quantitative indicators not fully comparable with last year.

Table I.25

Data used to run the sustainability indicators

	Age-related expenditure						Others		Total non-age-related exp.	Total revenue	
	Pensions		Healthcare		Education						
	2008	2050	2008	2050	2008	2050	2008	2050	const.	2008	2050
BE	8.8	12.6	7.1	9.9	4.1	3.7	6.7	5.0	16.5	48.1	48.1
DK	5.5	6.9	8.0	10.4	8.7	8.4	9.3	11.2	18.1	53.1	55.6
DE	11.0	14.9	5.9	7.1	5.3	5.5	0.9	0.7	18.3	43.4	44.3
EL	12.3	22.6	5.1	6.6	3.3	3.2	0.4	0.2	17.2	43.0	43.0
ES	8.0	13.0	5.7	7.2	4.0	3.7	0.6	0.4	19.0	40.0	40.0
FR	12.7	14.5	6.4	7.4	5.9	5.5	1.0	0.7	22.8	51.6	51.6
IE	4.0	7.7	6.1	7.8	4.0	3.2	1.0	1.0	17.0	33.5	33.5
IT	14.0	14.1	6.4	8.1	4.6	4.2	0.4	0.3	13.4	44.1	44.1
LU	7.4	9.3	n.a.	n.a.	n.a.	n.a.	0.3	0.2	38.9	48.0	48.0
NL	5.2	8.7	7.5	10.5	5.0	4.9	6.6	6.9	18.4	44.7	47.6
AT	14.6	15.0	5.2	6.4	5.6	5.0	1.5	2.0	18.3	47.9	47.9
PT	11.3	12.1	5.3	6.1	5.4	5.1	0.5	0.5	18.1	43.9	43.9
FI	11.6	14.5	4.8	5.8	5.8	5.4	3.3	4.8	21.3	51.0	51.0
SE	9.0	9.9	11.0	13.4	8.2	8.7	6.8	9.7	16.8	56.3	56.7
UK	**5.1**	**5.3**	**7.7**	**9.7**	**5.4**	**5.4**	**1.4**	**1.5**	**20.4**	**40.0**	**40.0**

NB: Data refer to the first year of projections, 2008, unless specified differently. In all the countries, other age-related expenditure includes unemployment benefits; where relevant, additional items are specified below. Total revenues refer only to the programme scenario. BE: Other expenditures include family allowances, unemployment and early retirement transfers, work-related accidents and sickness and residual regimes. DK: The starting data refer to 2011. Other expenditure items are childcare and old-age care. Concerning the change in tax revenues, the net tax on net pension payments is projected to increase by 2.5 percentage points of GDP by 2050. Also, pension assets are projected to increase from 124 % of GDP in 2005 to 217 % of GDP in 2050. DE: Pension projections were made by the BMGS (Statutory Pension Insurance and Public Service Workers Pension). Tax revenues only concern taxation of future pension payments to private households made by the German Institute for Economic Research. EL: The starting data refer to 2007. Healthcare only concerns acute healthcare. FR: Pension expenditures are calculated from last year's programme, including the impact of the pension reform as reported by the national authorities. IE: The starting data refer to 2007. LU: The starting data refer to 2007. No projections on healthcare and education expenditures were reported. Equally, the EPC projections for Luxembourg do not include information on these two items. NL: Projections on age-related items from a report of CPB Netherlands, 'Ageing in Netherlands', 2003. Other age-related expenditure includes disability benefits. Net old-age-related direct tax revenues are projected to increase by 2.8 percentage points between 2010 and 2050. AT: Other age-related expenditure includes care expenditure. PT: The pension expenditure projections were reported in the national strategy report on the future of pension schemes. FI: Long-term care expenditure is included in other age-related expenditures. Pension system assets are projected to increase from 67.3 % of GDP in 2006 to 78.4 % of GDP in 2050. SE: The starting data refer to 2007. Healthcare expenditure includes ill health and medical care expenditure. Other age-related expenditures also includes labour market training grants and wage guarantee, childcare and care of elderly. The net old-age-related tax revenues are projected to increase by 0.4 percentage points between 2010 and 2050. Pension system assets are projected to increase from 28.4 % of GDP in 2006 to 29.6 % of GDP in 2050. UK: The starting data refer to 2009. Long-term care expenditure is included in other age-related expenditures. The non-age-related expenditures are expected to decline by 0.9 percentage points between 2009 and 2050.

Source: EPC and national updated stability and convergence programmes (2003).

This year, the EPC projections on unemployment benefits and education, carried out for the first time in 2003, were added to the age-related expenditures for all countries that did not provide such information in the programme ([1]). Thus, at least four different age-related expenditure items — pensions, healthcare, education and unemployment benefits were included in the calculations of all the Member States which contributed to increased comprehensiveness of the quantitative assessment.

On the revenue side, the level of revenue-to-GDP ratio was kept constant at the (cyclically adjusted) level reached in the last year of the programme period for most countries ([2]).

([1]) For a detailed analysis of long-term education expenditure see EPC (2003) and Montanino, Przywara and Young (forthcoming, 2004).

([2]) Changes in the tax ratio were included for four Member States (Denmark, Germany, the Netherlands and Sweden) as these can largely be attributed to the deferred tax revenues from contributions to funded pension systems as well as accumulated earnings prior to disbursement.

Table I.26

Projected changes in the expenditure and revenues between the first year of projections and 2050

	Age-related expenditure						
	Pension	Healthcare	Education	Other age-related expenditure	Total	Tax revenues	Net change
BE	3.8	2.8	– 0.4	– 1.7	4.5	0.0	4.5
DK ([1])	1.4	2.4	– 0.3	1.9	5.4	2.5	2.9
DE	3.9	1.2	0.2	– 0.2	5.1	0.9	4.2
EL([2])	10.3	1.5	– 0.1	– 0.2	11.5	0.0	11.5
ES	5.0	1.5	– 0.3	– 0.2	6.0	0.0	6.0
FR	1.8	1.0	– 0.4	– 0.3	2.1	0.0	2.1
IE ([2])	3.7	1.7	– 0.8	– 0.1	4.5	0.0	4.5
IT	0.1	1.7	– 0.4	– 0.1	1.3	0.0	1.3
LU ([2])	1.9	0.0	0.0	– 0.1	1.8	0.0	1.8
NL	3.5	3.0	– 0.1	0.3	6.7	2.9	3.8
AT	0.4	1.2	– 0.6	0.5	1.5	0.0	1.5
PT	0.8	0.8	– 0.3	0.0	1.3	0.0	1.3
FI	2.9	1.0	– 0.4	1.5	5.0	0.0	5.0
SE ([2])	0.9	2.4	0.5	2.9	6.7	0.4	6.3
UK ([3])	0.2	2.0	0.0	0.1	2.3	0.0	1.4

([1]) 2011 replaces 2008 for Denmark.
([2]) 2007 replaces 2008 for Greece, Ireland, Luxembourg and Sweden.
([3]) 2009 replaces 2008 for the United Kingdom.

Source: EPC and national updated stability and convergence programmes (2003).

Table I.26 presents projected changes in the expenditure and revenues between the first year of projections and 2050. As expected, the projections of age-related expenditures show that the pension and healthcare-related expenditures are of the highest concern for the long-term sustainability of public finances. In Denmark, Italy, Austria, Sweden and the UK, healthcare spending is projected to grow faster than pension spending. In turn, other age-related expenditures — one of which is education — are projected to decline in the majority of countries, although insufficiently to offset the increase in pension and healthcare expenditures.

Table I.27 and Table I.28 present, respectively, the extrapolation of debt/GDP ratio and the sustainability gaps under two scenarios. Under a so-called ‘programme’ scenario, the starting position in terms of the cyclically-adjusted budget balance, the level of the debt/GDP ratio, the primary spending and the tax revenues are the figures reported by the Member State for the final year of their 2003 updated stability or convergence programme; for most Member States this is 2007.

The extrapolation of the debt/GDP ratio relies on several assumptions:

- The tax burden remains constant as a share of GDP unless there are foreseen increases of revenues due to the design of the pension system. Thus, future additional pension income resulting from the accumulation of non-taxable contributions is included while changes in revenues due to assumptions on future trends in private consumptions or due to special sources are not considered.

- Age-related expenditures evolve in line with the available projections.

- Non-age-related primary expenditures remain constant as a share of GDP at the 2007 level over the projection period ([1]). These include mainly public investment, other social expenditure apart from education, health and pensions, purchases of goods and services not due to age-related expenditures, com-

([1]) Only in the case of the UK did the Commission take into account the decline in non-age-related expendituresn, namely, the dynamics reflect the current set of legislation in place. In addition, most non-pension social benefits will rise in line with prices after 2007–08, reducing their share of GDP.

pensation of employees (excluding the staff in education and healthcare sectors).

- The GDP deflator is fixed at 2 % for the whole projection period.

- The GDP real growth rate is country-specific and relies on agreed EPC assumptions ([1]). It results from both assumptions on employment trends and labour productivity trends. However, labour productivity growth is assumed to converge towards an annual rate level of 1.75 % by 2030, although some leeway for higher rates is provided for catching-up countries.

- The nominal interest rate converges towards an EU average level of around 5–6 % in 2015. It is calculated as the sum of the EU average real growth rate plus the ECB inflation target (2 %) plus an interest rate growth differential of 2. To avoid a discrete jump in the debt projections, it is assumed that the implicit interest rate on debt in the final year of the stability/convergence programme converges towards the common nominal interest rate in a linear fashion within 10 years.

The 'programme' scenario assumes that Member States actually achieve the budget targets set down in their programmes. However, such an outcome is by no means assured. In order to assess the relevance of the consolidation processes in the medium term to achieve long-term sustainability, a '2003 position' scenario was run in the same way as the 'programme' scenario, excepting that the starting budget position is different since it is based on budgetary data for 2003. Debt levels are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance in 2008 remains the same as the 2003 level and no stock-flow operations take place.

It is important to recall that the purpose of the debt extrapolation is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of 'no policy change'.

Table I.27

Results of the sustainability gap indicators

	Programme scenario		2003 budget scenario	
	S1	**S2**	**S1**	**S2**
BE	– 0.3	0.3	– 5.1	– 1.0
DK	– 0.6	– 0.6	– 2.0	– 1.3
DE	2.2	2.6	4.4	4.4
EL	1.9	3.3	2.3	3.8
ES	0.4	1.3	– 0.3	0.6
FR	0.7	0.8	3.6	3.5
IE	1.6	2.2	2.2	2.5
IT	– 0.7	– 0.7	1.1	1.3
LU	0.0	– 0.1	– 1.2	– 1.1
NL	2.0	2.2	2.6	2.7
AT	0.1	0.3	0.2	0.5
PT	– 0.8	– 0.4	1.6	1.8
FI	0.2	– 1.8	– 1.1	– 2.8
SE	0.6	0.2	1.4	1.0
UK	2.2	2.4	2.8	3.1

NB: S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualised flow of revenues and expenses over an infinite horizon.

Source: Commission services.

Findings from the results of the quantitative assessment can be summarised as follows.

Firstly, even assuming that all Member States achieve their medium-term budgetary targets (programme scenario) there is a risk of unsustainable public finances (measured against the 60 % of GDP reference value) emerging in at least one third of the EU-15 Member States.

Secondly, debt developments for most EU-15 Member States follow a U-shaped pattern. In the coming 20 or 25 years, debt levels are projected to decrease due to the effect of maintaining balanced budget positions: however,

([1]) See EPC (2001).

this trend would start to reverse once the budgetary impact of ageing starts to take hold, with the largest increase in most countries expected between 2030 and 2050 (see Table I.29 for the EU-15 aggregate).

Given the projected increase of debt levels, it is important to use this window of opportunity and to contain the emerging risks of increasing age-related expenditures and debt levels.

Thirdly, the risk of unsustainable public finances increases considerably if the Member States do not achieve the SGP goal of budget positions of 'close to balance or in surplus'. An indication of this can be seen by comparing the projected debt levels under the 'programme scenario' with the '2003 budgetary position' scenario. This issue is especially relevant for the six euro-area countries with highest underlying cyclically adjusted deficits in 2003, i.e. Germany, Greece, France, Italy, the Netherlands and Portugal.

Fourthly, the sustainability gap indicators provide some order of magnitude to the budgetary adjustment needed to ensure sustainable public finances. The sustainability gap under the 'programme scenario' indicates that an additional permanent budgetary adjustment of between 1.5 and 2.5 percentage points of GDP is needed in Member States where the sustainability of public finances is a concern (see Table I.27). The scale of budgetary adjustment efforts could be even greater if account is taken of the stated budgetary objectives of some Member States such as a reduction in the tax ratio.

4.2.2. The qualitative considerations

The 2003 updated programmes contain useful information to better qualify the long-term sustainability of public finances. The level of government debt/GDP ratio in 2003 is a source of concern in at least three countries, namely Italy, Greece and Belgium. In order to run it down towards 60 % before the impact of ageing takes place, these countries have to run sustained primary surplus (above 4 %) over the next 10 to 15 years. Such a requirement is subject to risk even if it cannot be excluded a priori: pressures to reduce the tax burden or to increase some expenditure items can arise in the near future, putting at risk long-term sustainability.

Table I.28

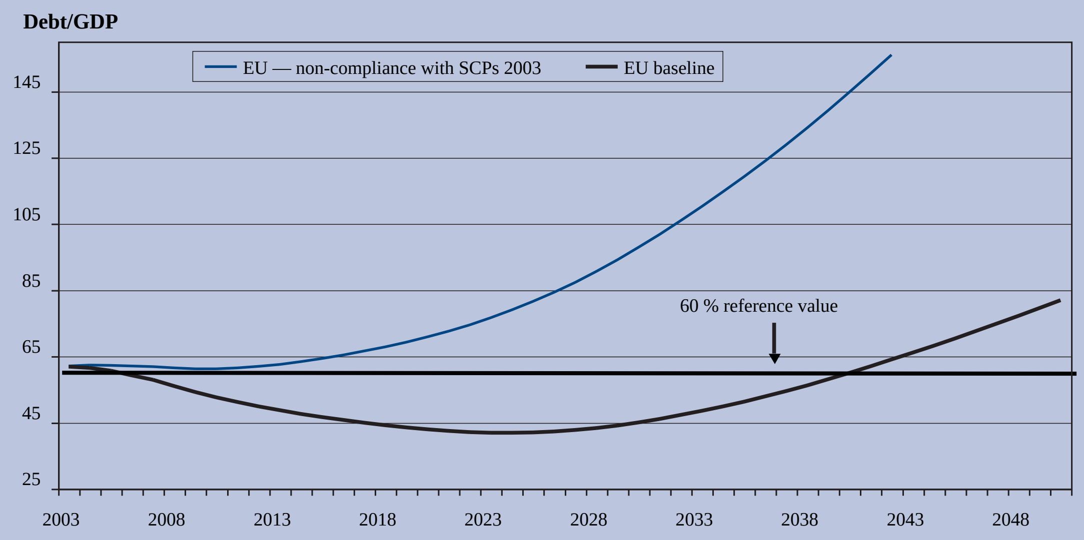
Projected evolution of debt levels up to 2050 (1)

	2003	Programme scenario			2003 budget scenario		
		2010	2030	2050	2010	2030	2050
BE	102.3	74.8	11.5	– 5.0	67.2	– 35.7	– 114.0
DK	42.7	24.6	– 19.5	– 34.8	6.9	– 65.5	– 131.9
DE	64.0	62.2	86.5	175.7	74.3	156.5	336.6
EL	101.7	75.1	42.2	151.0	72.2	52.4	181.0
ES	51.8	36.3	– 1.6	36.6	31.6	– 21.4	– 12.4
FR	61.4	56.0	52.2	72.0	71.8	142.1	288.0
IE	33.1	26.7	36.4	105.0	27.0	50.1	138.4
IT	106.0	86.6	28.9	– 27.8	92.0	82.7	107.8
LU	4.9	– 0.9	– 9.4	1.2	– 3.9	– 35.7	– 47.8
NL	54.0	49.1	67.6	140.0	53.8	88.7	185.9
AT	66.4	53.9	24.4	15.9	55.1	26.1	18.4
PT	59.5	48.0	5.3	– 42.4	60.9	72.1	127.6
FI (2)	– 4.6	– 33.4	– 30.1	6.0	– 52.8	– 79.5	– 88.6
SE (2)	33.0	16.4	– 0.4	46.7	15.2	19.8	97.6
UK	39.3	42.5	71.6	138.7	45.3	89.5	177.5

(1) The Commission took on board information on financial assets (other than government bonds) in designated pension funds, which are available for future debt reduction. This is because these financial assets are either earmarked for financing future pension payments or debt reduction, and the amounts involved are sizeable and thus have a material impact on the assessment of the sustainability of public finances. It was assumed that the yield on assets is the same as on debt.
(2) Adjusted government debt.

Source: Commission services.

Graph I.9: **Projection of future development in EU-15 (weighted average)**



Source: Commission services.

The medium-term dynamic of the debt/GDP ratio is affected, in particular in Italy and Greece, by stock-flow operations. In the case of Greece, these financial operations are expected to run down the debt slower than projected from the pure development of the budget balance. Should these operations continue in the future, imbalances in the long-term will be amplified.

The current debt level puts several countries in a safer position than what the purely quantitative indicators could show. Ireland, the UK, Finland, Luxembourg, Denmark and Spain have a relatively low level of debt/GDP ratio. This gives some room to tackle the problem if future imbalances arise. For other countries (namely Germany, France and Portugal) a source of concern is not the very high level of debt/GDP ratio but rather its recent upward trend. The budgetary deterioration pushed debt up since 2001 (2000 in Portugal) and it has quickly reached levels close to or above the reference value of the Maastricht Treaty ([1]).

Another important issue to consider when assessing sustainability is the role accumulated assets held by the public sector can play to cope with future pension liabilities. Several countries are accumulating liquid financial assets for these specific purposes. In some cases (such as Denmark, Sweden and Finland) the value of these assets is particularly large (around or above 50 % of GDP). Clearly, having prepared in time the impact of an ageing population puts these countries on safer ground, regardless of the future trend of government debt. Other countries such as Spain and Ireland are also accumulating funds. Their amount is still relatively limited but increasing.

These assets are not netted out in the calculation of the quantitative indicators because they are based on the Maastricht definition of government debt ([2]). In principle, the most appropriate measure would be the government net worth but in practice most of the information is not easily available, and more importantly difficult to project into the future. A different solution could be to consider the government debt development net of those assets that are fully liquid (and therefore immediately disposable) and locked up for future pension payments. However, in practice it is difficult to project future flows to these funds over the very long term because assuming a no-policy change scenario can lead to an implausible high level of assets. How the indicators of long-term sustainability of

([1]) In particular in Germany the debt/GDP ratio has been on an increasing path since the beginning of the 1990s.

([2]) Exceptions are Finland and Sweden.

public finances can incorporate the impact of pension funds on debt sustainability needs to be explored.

Budget balance trends in the medium term are affected not only by the accumulation of reserve funds but also by one-off measures with a temporary impact on the budgetary positions. A great recourse to one-off measures helps in containing current imbalances but does not improve significantly long-term sustainability. Indeed, if one-off measures are put in place instead of structural measures, the long-term sustainability of public finances can even worsen. The cases of Italy and Portugal raise particular concern due to the large recourse to one-off measures in recent years. Since what counts for the long-term trends of the debt/GDP ratio is the underlying budget balance, i.e. net of all transitory effects on the budget, the projected debt trend for these two countries could be partially affected by the impact of these transitory measures. In running the quantitative indicators, the cyclically adjusted tax-to-GDP ratio at the end of the programme period is kept constant, as are the non-age-related expenditures. If at least one of these two components of the budget is affected by one-off measures, the application of the debt dynamic equation can lead to a faster debt reduction than would be observed on the basis of the underlying budget balance.

Another factor to be considered as a potential risk is whether debt projections rely on a very high tax burden compared with EU average or other industrialised countries. This is the case in Denmark and Sweden where the tax burden is around 50 % of GDP. Even if each Member State can decide over its optimal level of taxation, pressures to reduce the tax burden cannot be excluded in the future. In addition, there is less room to increase taxes should imbalances appear in the future.

A final qualitative feature identified as critical in making the assessment of long-term sustainability is the robustness of projections. While uncertainty surrounds any projection in the long term, there are cases where this is a greater source of concern. In Spain, the projected pension expenditure by Spanish authorities is much lower than what is projected by the EPC in its common exercise (the difference is around 2.8 percentage points in 2050). These differences rely on a more favourable demographic scenario regarding the future flows of immigrants in active age and the assumption that average pensions will increase at only half the projected increase of labour productivity (while the EPC assumes an increase in the average pension equal to labour productivity) ([1]). Given the uncertainties related to these two assumptions, the possibility of having an even larger increase in pension expenditure over the projected period cannot be ruled out.

The projected increase of pension expenditure in France and Portugal also warrants consideration. In both cases, national authorities provided a set of projections up to 2050 which include the impact of the recent pension reforms. This impact accounts for around 1 % of GDP. For Portugal, it is not sufficiently clear if the pension reforms already introduced will actually curb future pension expenditure. The calculation reported in the programme update seems not to have taken into consideration the impact of some measures which have already been taken or are planned, notably the changes to the civil servants' pension regime ratified at the beginning of 2004, the phased convergence of the lowest pensions towards fractions of the minimum wage, and the planned capping of social security contributions. Therefore it is doubtful that the pension reforms already introduced will actually suffice to curb future growth in pension expenditure.

Thanks to the recent pension reform, France is in a considerably better position to meet the budgetary costs of an ageing population. The reform will indeed not only increase the average retirement age and thus reduce pension expenditures but it will also probably lead to an increase in participation rates among the elderly with positive effects on potential growth. However, it is too early to draw firm conclusions on the related savings and the implementation of the reform should be monitored.

Concerns on the robustness of the projections regard also those included in the UK updated programme, and in particular the scenario for the next 10 years (age-related expenditures are expected to have only a slight impact on public finances). Healthcare and education expenditure are expected to increase by more than 2 percentage points of GDP in the next 10 years. This is compensated by an increase of revenues of 1.8 percentage points of GDP during the same period. The increase in revenue takes place in a no-policy change scenario and it is mainly due to fiscal drag, i.e. the increase of revenues (as a share of GDP) resulting from a higher median income. While spending plans are hard to change once approved, the revenue gains are instead only hypothetical. In addition, implicit nominal interest rates are assumed to

([1]) This is a common assumption in the EPC projections.

decrease substantially within the programme period. They move from 5.1 to 4.6 % despite the increase, during the same period, of the GDP deflator which would be expected to push up the nominal interest rates.

4.3. Policy conclusions per Member State

Despite the fact that each country faces country-specific problems, for the purpose of summarising the main results it is possible to group countries according to the main source of potential budget imbalances and the seriousness of the risk as follows.

Very high-debt countries (Belgium, Italy). The source of risks for these countries is mainly the level of debt/GDP ratio. At first sight, the quantitative indicators suggest that these countries appear to be relatively well placed to meet the costs of ageing populations. This is because they are currently running high primary surpluses in order to meet their Treaty and SGP commitments: hence there is more scope to reduce interest payments in the future and thus offset future expected increases in spending due to ageing populations. However, this result needs to be interpreted with caution, as the assumption of a constant tax ratio introduces a degree of fiscal illusion based on an implicit assumption that very high-debt countries are able to sustain large primary surpluses over several (15–20) years. This will imply running actual budget surpluses, which inevitably leads to the challenge of competing budgetary pressures for tax cuts and/or increased public expenditures.

High-deficit countries (France, Portugal and Germany). These countries recently passed a number of pension reforms which aim at better controlling expenditure in the long run and the projections run by the Commission fully included the savings estimated by Member States. However, there are uncertainties regarding the budgetary impact of the pension reforms. In addition, a comprehensive strategy to ensure long-term sustainability must include budgetary consolidation in the medium term. Otherwise, any effort to control age-related expenditures will be offset by raising interest payments and debt/GDP ratio is likely to show explosive paths.

Countries with risks due to pension developments (Greece and Spain). These two countries face a similar pattern in age-related expenditure in the long term. In particular, pension expenditure is foreseen to increase at a faster pace than any other EU country. This means that in addition to a policy of running down debt (where Spain is performing particularly well) measures to better control future trends of pension expenditure should be envisaged. Risks rely also on the uncertainties surrounding pension projections. A number of factors contribute to put Spain in a safe position but there are large differences between the EPC projections and the Spanish projections on future pension expenditures.

Countries with some risks due to the uncertainties over the medium term (UK, Netherlands). These countries face risks mainly linked to the medium-term budgetary developments. Both the UK and the Netherlands appear relatively well placed to meet the cost of an ageing population. However, the increasing deficit in the medium term raises concern and the current safe position can easily become less stable. Also, projections in the medium term rely on several assumptions. In the case of the Netherlands, the assumption that current policies will lead to sustainability over the long run relies upon the costs of the pension reform that temporally increases the actual deficit. Since these transitional additional costs are protracted beyond the programme period, there is some element of uncertainty on when the costs will be fully contained. For the UK, the medium-term projections foresee a shift from a slight primary deficit in 2003 to a primary surplus (of less than 1 %) in 2012 despite a high increase of healthcare and education spending implied by the spending review during the same period and no policy changes on the revenue side.

Countries with limited or no risk (Finland, Sweden, Luxembourg, Austria, Ireland and Denmark). They share a number of common characteristics, including sound budget positions, and reforms of their pension systems that have strengthened the link between contributions and entitlements, increased the share of pensions that are financed on a funded basis, and increased the capacity of pension systems to cope with demographic developments such as changes in life expectancy. For some of these countries the development of government debt does not reflect properly the soundness of their budgetary position due to the accumulation of liquid financial assets to cope with future challenges. This is particularly relevant for Ireland.

The following table summarises the main conclusions reached by the Ecofin Council in its opinion on the stability/convergence programmes on the basis of the Commission assessment. It shows how, for a number of countries, the long-term budgetary position improved thanks to structural reforms or the increased focus on long-term challenges.

Table I.29

Policy conclusions on the sustainability of public finances

	Are public finances sustainable?	What are the sources of concern?	Do policy conclusions differ from last year?
BE	It still presents some risks of long-term unbalances, linked to the consequences of ageing.	The outstanding level of debt requires attention and maintaining high primary surpluses in the next 10 to 15 years as planned is necessary to keep Belgium on a sustainable path.	Policy conclusions do not differ so much and rely on the fact that a high debt/GDP ratio will entail budgetary challenges for still some time before considering Belgium in a safe position. This year's assessment puts more emphasis on healthcare expenditure trends, which warrant consideration since they are increasing at a faster pace than expected.
DK	Denmark is in a good position to handle the impact of the ageing population.	The large net assets projected for both the government and pension funds put Denmark in a safe position.	No.
DE	Risks of imbalances in the long term cannot be ruled out.	Germany made progress in the reform of the public pension system and to a smaller extent in reforming the health sector. Although such reform steps are welcomed, the expected effects may not suffice to offset the long-term demographic impact on pension and healthcare expenditures. Also, the high deficit and the rising debt are sources of concern.	This year's policy conclusions are very similar. The budgetary strategy outlined in the programme is only partially compatible with improving the sustainability of public finances.
EL	There is a serious risk of severe budgetary imbalances emerging in Greece in the future due to an ageing population.	Taking also into account the high debt ratio, the budgetary challenges posed by an ageing population should be tackled through a comprehensive strategy that includes further reform of the pension system.	The assessment is in line with last year's conclusions, i.e. that a deficit adjustment towards close to balance is not sufficient.
ES	Spain seems relatively well placed to cope with the budgetary costs of ageing populations but several uncertainties surround the future budgetary trends.	Given the risks surrounding long-term projections and the large increase of pension expenditure projected in the very long term, current policies need to be supplemented by measures to prevent the emergence of unsustainable trends, in particular a comprehensive reform of the pension system.	This year's policy conclusions are rather different. The Commission concluded that Spain is placed relatively well to meet the budgetary costs of an ageing population. Differences are mainly due to an even better medium-term budgetary scenario than last year, the accumulation of reserve funds to meet future budgetary challenges, the regular review by the Permanent Commission of the Toledo Pact on progress in the pension system towards financial sustainability, the development of supplementary private pension schemes and the new system for setting medicine prices should improve healthcare expenditure controls and help contain expenditures.
FR	Risks of imbalances in the long term cannot be ruled out.	While France is in a considerably better position than before the reform to meet the budgetary costs of an ageing population, securing an adequate primary surplus will be essential to ensure that the public finances are on a sustainable footing. This should be complemented, particularly in the context of the reform of the health insurance system to be designed and implemented in the course of 2004, by measures aimed at controlling the evolution of age-related spending.	Not very different. Despite improvements due to the pension reform, France still presents risks of imbalances due to the high deficit.
IE	There is a risk of budgetary imbalances emerging in the future due to an ageing population but it has to be noted that the Irish debt ratio is currently quite low and that assets are being built up at a rate of 1 % of GNP annually in the National Pensions Reserve Fund.	Securing an adequate primary surplus is essential to ensure that the public finances are on a sustainable footing.	This year's policy conclusions are the same. While some risks cannot be excluded, the low level of taxation gives enough room to cover possible financing gap. As with last year, they suggest pursuing a policy of budget balance.
IT	There is a risk of budgetary imbalances emerging in the future due to an ageing population.	Securing an adequate primary surplus is essential if the debt reduction is to make a noticeable contribution towards meeting the costs of ageing. This should be complemented by measures to raise employment rates, especially among older workers and women, and control the evolution of age-related spending. The plans to reform the pension system unveiled in late 2003, if implemented, would contribute to achieve these objectives.	This year's policy conclusions are very similar, pointing out risks of imbalances. Among others, the actual level of debt/GDP ratio, the recent trends of healthcare expenditures, the outstanding projected increase in female participation rates are the main factors behind the risks.

(Continued on the next page)

Table I.29 (continued)

	Are public finances sustainable?	What are the sources of concern?	Do policy conclusions differ from last year?
LU	No risks of unsustainable public finances in the long term.	The total net asset position is favourable in view of the substantial financial assets accumulated over past years with fiscal surpluses.	No.
NL	The risk of budgetary imbalances emerging in the future cannot be ruled out.	Securing an adequate improvement in the primary surplus before ageing reaches its peak, together with the necessary measures to stem the long-term increase in expenditure, is essential to ensure that the public finances are kept on a sustainable footing.	This year's policy conclusions stress higher risks of imbalances and are somewhat different from last year. The higher deficit foreseen in the programme for the period (2003–05) and the failure to reach a budgetary position of 'close to balance or in surplus' by the end of the programme period raises concern, deteriorating the long-term trend of the debt/GDP ratio.
AT	Austria appears to be in a considerably better position than before to meet the budgetary costs of an ageing population.	The improved outlook after the 2003 pension reform needs to be confirmed by actual developments. Firstly, projections assume a reform-induced strong increase in participation rates. Secondly, the 10 % cap on benefit losses compared with the *status quo ante* renders long-term budgetary effects rather uncertain. Moreover, exonerating effects on government finances are unnecessarily delayed due to a disproportionately long transition period for abolishing early retirement until 2017.	This year's policy conclusions welcome the improvements due to the pension reform.
PT	Risks of imbalances in the long term cannot be completely ruled out.	The high deficit and the rising debt/GDP ratio may undermine the sustainability of public finances in the longer term, hence the timely achievement of a budgetary position close to balance is imperative. Moreover, an early assessment of the effects of the 2001 reform of the general social security pension regime seems to suggest that its long-term sustainability has not been improved.	Very similar, even if the efforts to complete the process of pension reform and to make the healthcare sector more efficient are recognised.
SE	Sweden should be able to meet the projected budgetary costs of an ageing population.	The increase of healthcare expenditure, including expenditure related to ill health, foreseen in the projections needs to be addressed as the update notes that further measures are necessary in order to achieve the target of half the number of sick days. Moreover, the medium-term target has to be reached; failure to do so can cause some budgetary imbalances in the very long term.	No.
FI	Public finances appear to be on a sustainable footing to meet the budgetary costs of ageing populations.	Public finances benefit from the sustained running of budget surpluses and a reformed pension system that is to a large extent pre-funded.	No.
UK	There are still, in the light of the current and projected deficits, some risks of imbalances in the long term.	A prudent budgetary position kept in the medium term would help avoid a risk of emerging budget imbalances in the context of ageing populations.	This year's policy conclusions put more emphasis on strength concerns expressed last year since the medium-term scenario worsened.

Source: Based on the Commission's assessment of the 2003 updates to stability and convergence programmes and the respective opinions of the Council.

4.3.1. Comparison with the last year's results

The historical record of the quantitative assessments contributes to the understanding of the developments related to the long-term sustainability of public finances. In making the comparison with last year's results, the two main changes in the input data should be borne in mind: (i) other age-related expenditures than pension and healthcare were included in the exercise for all EU-15 countries; (ii) budgetary positions at the end of the programme have been adjusted to net out the cyclical component (see above).

Both factors tend to reduce the impact of ageing. As shown in Table I.26, projected education and other age-related expenditures show a decline over the period and at least partly counter the projected increase in pension and healthcare expenditures. In addition, most countries forecast a positive output gap at the end of the programme period so that the cyclically adjusted balance is better than actual figures.

Table I.30 presents why this year's results of the quantitative indicators differ from last year's ones. It analyses reasons for such development, based on pure comparison of the projections used in the two years for the 'programme' scenario.

4.4. Conclusion

This year's assessment of the long-term sustainability of public finances confirms the track record of continuous improvements in the way the sustainability is assessed. Thus, besides the inclusion of additional age-related expenditure items and of cyclically adjusted revenues, a more systematic analysis of qualitative features significantly contributed to a higher information value of the assessment.

Overall, the results show that risks to long-term sustainability are still present in nine countries of which in five (Belgium, Greece, Italy, Germany and France) the difficulties are more serious, while another four (Portugal, Spain, the Netherlands and the UK) face some risks due to the medium-term budgetary development or, as is the case for Spain and Portugal, due to the uncertainties over the long-term projections of pension expenditures. Finally, six countries (Ireland, Denmark, Finland, Austria, Luxembourg and Sweden) seem relatively well placed to meet the cost of an ageing society.

Table I.30

The 2003 projections on long-term age-related expenditures compared to the 2002 projections

	Results as compared to the last year	What are the differences between this and last year's projections?
BE	Slightly worse	• Higher pension expenditures (1.2 p.p. higher at the end of the period). • Lower total revenues.
DK	Similar	• Higher primary expenditure and higher increase in healthcare expenditures (1.1 p.p. at the end of the period). • Higher total revenues (0.4 p.p. over the period). • Higher initial debt level.
DE	Slightly improved	• Lower growth of pension expenditures due to the effect of the pension reform (– 1.9 p.p. at the end of the projection period). • Higher initial debt level.
EL	Similar	• Lower increase in total primary expenditures. • Lower total revenues (according to the programme and cyclical adjustment) • Slightly lower initial debt level.
ES	Improved	• Higher total revenues. • Lower initial debt level.
FR	Improved	• Gains from the pension reform (app. 1 p.p. per year). • Significantly higher total revenues.
IE	Improved	• Lower increase in age-related spending. • Higher total revenues (0.6 p.p. over the period). • Lower initial debt.
IT	Similar	• Lower primary expenditures due to favourable trends in age-related expenditures. • Lower total revenues. • Higher initial debt level.
LU	Improved	• Significantly higher total revenues.
NL	Slightly worse	• Lower tax revenues. • Higher initial debt level.
AT	Improved	• Lower pension expenditures from the expected impact of the pension reform (1.5 p.p. lower at the end of the projection period). • Slightly lower total revenues. • Lower initial debt level.
PT	Improved	• Lower pension expenditures from the expected impact of the pension reform (at least 1 p.p. lower between 2020 and the end of the projection period). • Significantly higher total revenues (by 0.9 p.p. over the entire period).
SE	Slightly worse	• Higher total primary expenditure due to higher increases in pension and healthcare expenditures. • Higher total revenues (0.9 at the start and 1.8 p.p. at the end of the period).
FI	Improved	• Higher total revenues (2.1 p.p. over the projection period).
UK	Slightly worse	• Significantly higher increase in age-related expenditures. • Lower total revenues (0.8 p.p. lower at the end of the period). • Higher initial debt level.

Source: Commission services.