Part V

Member State developments

1. Belgium

Recent developments and medium-term prospects

In 2004, the general government accounts posted a slight surplus of 0.1% of GDP, close the original target of a balanced budget in the 2003 update of the stability programme. However this hides a considerable overrun in health expenditure (which grew by some 7.8% in real terms instead of the planned 4.5%). The (one-off) proceeds of the tax amnesty law (0.2% of GDP) were 0.1% of GDP lower than anticipated in the budget. These negative developments were more than compensated by higher-than-expected tax income (mainly VAT and direct taxes), supported by strong economic growth (2.7% against 1.8% projected in the 2003 update of the stability programme). In 2004 the debt-to-GDP ratio decreased further by 4.4 percentage points to 95.6%, which is lower than foreseen in the 2003 update of the stability programme (97.6%), mainly as a result of higher-than-anticipated economic growth and a number of financial operations such as the sale of government participations in the telephone company Belgacom and the Brussels airport corporation BIAC.

Table V.1 Budgetary developments 2003-2008, Belgium (% of GDP)

Outturn and forecast*	**2003**	**2004**	**2005**	**2006**		
General government balance	0.4	0.1	-0.2	-0.6		
- Total revenues	51.3	49.6	49.1	48.5		
Of which : - current taxes	*29.9*	*30.3*	*30.7*	*30.3*		
- social contributions	*16.5*	*16.0*	*15.8*	*15.5*		
- Total expenditure	50.9	49.5	49.3	49.0		
Of which : - collective consumption	*8.4*	*8.4*	*8.3*	*8.1*		
*- social transfers***	*30.6*	*30.4*	*30.4*	*30.2*		
- interest expenditure	*5.4*	*4.7*	*4.5*	*4.2*		
- gross fixed capital formation	*1.6*	*1.5*	*1.8*	*2.0*		
Primary balance	5.7	4.8	4.3	3.6		
Pm Tax burden	45.7	45.9	45.8	45.1		
Government debt	100.0	95.6	94.9	91.7		
Pm Cyclically-adjusted balance	1.2	0.6	0.3	-0.2		
Pm Cyclically-adjusted primary balance	6.5	5.3	4.7	4.0		
*Pm Real GDP****	1.3	2.7	2.2	2.3		
Stability programme******	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	0.4	0.0	0.0	0.0	0.3	0.6
Primary balance	5.7	4.9	4.5	4.4	4.5	4.7
Government debt	100.0	96.6	95.5	91.7	88.0	84.2
*Pm Real GDP****	1.3	2.4	2.5	2.5	2.1	2.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

** In kind and other than in kind.

*** Annual % change.

**** Submitted in December 2004.

Source: Commission services and stability programme of Belgium.

Table V.2. Main measures in the budget for 2005, Belgium

Revenue measures	Expenditure measures
• Continued implementation of the 2001 tax reform (-0.2% of GDP) • Reduction of social security contributions on labour, especially for low income workers (-0.1% of GDP) • Broadening the base for revenue of the social security system, e.g. social security contributions on the use of corporate cars and a levy on tobacco (+0.2% of GDP)	• Real growth of federal primary expenditure limited to 1% (zero growth in defense, reduced expenditure by ministries, …) • Several measures to limit real growth in health care expenditure to 4.5%, e.g. by freezing medical fees or by reducing the cost of medicine and medical treatment in hospitals (+0.2% of GDP)
• Rearrangement of the budgetary calendar for a number of government programmes, both on revenue and expenditure side, e.g. some planned tax-cuts on energy products have been delayed (+0.1% of GDP).	

Source: Commission services, 2005 Budget.

The 2005 budget was presented in October 2004 and finally approved by Parliament on 23 December 2004. The budget aims at limiting the real growth of federal primary expenditure to 1% and at maintaining a balance in the social security system through improved expenditure control and a broadening of the tax base, while avoiding new taxes on labour. Although less than in 2004 (0.7% of GDP), one-off measures still account for some 0.3% of GDP in the 2005 budget. The initial target of a balanced budget for 2005 was confirmed in the latest update of the stability programme[154] (submitted on 6 December 2004). The Commission services' spring 2005 forecast foresees a small deficit (0.2% of GDP), based on somewhat less optimistic growth assumptions (GDP growth of 2.2% against 2.5% in the budget) and because of some uncertainty regarding the impact of new measures to control spending in health care. Accordingly, it projects the cyclically adjusted balance to decrease to 0.3% of GDP in 2005 (same figure as that based on the latest update of the stability programme).

As for 2006, a deficit of 0.6% of GDP is projected in the Commission services' 2005 spring forecast, on the basis of a no-policy-change scenario. At this stage, no one-off measures are planned for 2006. Moreover, the implementation of the 2001 direct tax reform will have its main impact in 2006 (over 0.3% of GDP). So far the government has not yet announced any new measures that could compensate for these income losses in 2006. This explains the difference with the latest update of the stability programme, which foresees a balanced budget for 2006. For 2007 the government is planning a surplus of 0.3% of GDP.

According to the spring forecast, the debt ratio is expected to decrease to 94.9% of GDP in 2005, despite the take-over of a EUR 7.4 billion debt (2.5% of GDP) from the national railway company SNCB.[155] In 2006, the debt ratio is forecast to reach 91.7% of GDP, as also foreseen in the 2004 update of the stability programme.

The ageing fund

As in many European countries, Belgium will be confronted with the budgetary impact of an ageing population. The Belgian authorities estimate that the share of people older than 60 will increase from 22% in 2003 to 31% by 2030. As a result, the dependency ratio (i.e. ratio of the number people under 20 or older than 60 to the number of people between 20 and 59) is expected to increase from 82% to 106%.

The Belgian High Finance Council has estimated the direct annual budgetary impact of ageing at 3.4% of GDP by 2030, mainly as a result of increased pensions (+2.8% of GDP) and health care cost (+2.4% of GDP). This should be partly compensated by lower expenditure in other social benefits (-1.8% of GDP, mainly as a result of lower unemployment and family benefits). Indirectly, the demographic evolution could also reduce the budget for education by some 0.7% of GDP. However, the High Finance Council's estimate of the budgetary impact of ageing can be considered as somewhat optimistic, since it would entail a significant drop in the annual real growth rate of health care expenditure to 2.8% on average for the period 2008-2030. The official target for 2003-2007 is still 4.5%, whereas in 2004 this figure was overrun with an annual growth rate of 7.8%. OECD projections also suggest that the Belgian authorities' assumptions on the increase in the employment rate and productivity growth could be on the high side. More cautious estimates lead to an additional 1% of GDP impact stemming from ageing.

[154] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[155] The Belgian programme law of 24 December 2002 stipulates a number of conditions for the take-over of the SNCB debt, among which the condition that it can only take place if it does not affect the deficit and does not increase the debt ratio above 100% of GDP. According to the programme law of 22 December 2003 and the corresponding royal decree of 30 December 2004, the debt transfer to the state-owned 'fund for railway infrastructure', is effective since 1 January 2005.

Table V.3. Financing sources of the ageing fund until 2004 (in million EUR)

Year	Source	Amount	Cumulative
2001	UMTS	437.8	
	Surplus value of gold reserves of the National Bank	177.1	
	Short-term interests	9.2	624.0
2002	Profits National Bank	429.0	
	Short-term interests	2.7	1 055.8
2003	Dividend 2002 Belgacom	237.3	
	Value of unreturned Belgian banknotes after the introduction of the euro	214.0	
	Credibe	2 645.7	4 152.7
2004	Dividend 2003 Belgacom	290.0	
	Short-term interests	6.2	
	Belgacom pension fund	5 000.0	
	Fadels	2 500.0	11 948.9

Source: 2005 Budget.

In order to prepare for the budgetary impact of ageing, the Belgian High Finance Council has estimated that increasing the structural budget balance to 0.3% of GDP in 2007 and further to 1.5% of GDP over 2011-2018 would put public finances on a sustainable path. The structural balance would then fall back close to zero by 2030, affected by the increasing effects of ageing. Meanwhile, the government debt would fall from about 94% of GDP in 2007 to around 30% of GDP by 2030, when it would stabilise.

The Belgian authorities have been reducing the debt considerably from 137.9% of GDP in 1993 to 95.6% in 2004 (according to the latest EDP notification), mainly by securing relatively high primary balances and by using the proceeds of a number of 'below the line' one-off operations. The proceeds of these one-off operations could have been used to reduce the debt directly, but instead the Belgian authorities decided to direct most of them to the 'ageing fund'.

The Belgian ageing fund was created by law on 5 September 2001. It was to be funded with the proceeds from (below-the-line) one-off operations and/or from budget surpluses. A medium-term objective was formulated in 2003 in an agreement between the government partners, when a target of EUR 10 billion (some 3.2% of GDP) by 2007 was envisaged. In 2004 the government increased its target to EUR 13 billion (about 4.1% of GDP) in 2007. The ageing fund law of 2001 provided for the fund to be gradually dissolved starting at the moment the debt ratio falls below 60%, in order to 'finance' the increasing cost of pension schemes over the period 2010-2030. However, the law of 2001 did not foresee any form of yearly mandatory funding, which remained at the full discretion of the federal government.

In 2001 the starting capital of the fund was EUR 615 million (0.2% of GDP, see table 3). The following years the fund benefitted from the proceeds of several one-off operations. Major contributions came from the sale of the state mortgage credit corporation Credibe (1% of GDP) in 2003 and the proceeds from the Fadels operation (in which a state-owned social housing financing corporation was dissolved) in 2004 (0.1% of GDP). The most important source of funding so far stemmed from the transfer of the Belgacom pension fund (1.9% of GDP) in 2004. However, contrary to all previous cases, this transfer to the ageing fund was accompanied by a similar increase in government pension liabilities.

In 2005 the ageing fund could also benefit from the proceeds of a number of one-off operations, such as the sale of Belgacom shares (0.2% of GDP), the tax amnesty law (0.2% of GDP) and the privatisation of the Brussels airport operator BIAC (0.2% of GDP, including the transfer of the BIAC pension fund). For a number of measures the government has not yet decided to which extent the proceeds will be used to finance the ageing fund, but the target of EUR 13 billion is well within reach. On 25 February 2005 the government proposed to change the ageing fund law, to provide a fixed contribution to the ageing fund in the period 2007-2012. Hence, in 2007 the fund should grow by 0.3% of GDP. This amount would be increased by 0.2% of GDP annually to reach a yearly contribution of 1.3% of GDP in 2012. The share of below-the-line operations would be limited to EUR 250 million (some 0.1% of GDP) annually until 2010 and to EUR 500 million (0.2% of GDP) afterwards. The rest of the contribution should come from the government surplus. On the other hand, since the proposed contributions are less than the surpluses considered necessary by the High Finance Council to put Belgian public finances on a sustainable path, additional direct debt reduction will be required.

Assessment

From an economic point of view, investing in the ageing fund is similar to a direct debt reduction. In the case of a direct debt reduction, the government uses a surplus or the proceeds from a below-the-line operation to repay outstanding debt. In the case of an investment in the ageing fund, the public debt is converted into a debt to the ageing fund by means of a tailor-made 'ageing fund treasury bond'.

Since the ageing fund falls within the government perimeter, the debt of the treasury to the ageing fund is internal to the government sector. Consequently, according to the Maastricht definition, the Belgian debt ratio is net of all assets owned by the ageing fund (contrary to an 'external' pension fund, which constitutes an additional buffer against the cost of ageing). When the ageing fund is used for age-related spending in the future, the debt will increase accordingly.

Nevertheless, although an investment in the ageing fund is equivalent to a direct debt reduction of the same magnitude, it has the advantage that it reinforces the political commitment of the Belgian government to maintain the necessary (primary) surplus to prepare for the budgetary impact of population ageing.

The strategy for coping with the budgetary cost of an ageing population outlined by the Belgian High Finance Council is mainly based on gross debt reduction through building up budget surpluses (itself relying primarily on primary expenditure restraint) and an ageing fund. Containing primary expenditures might prove difficult, especially in the health care sector, but is important in view of the government's strategy of reducing the tax burden in order to create employment. Given the projected increase in the old-age dependency ratio, pursuing this broad strategy with determination is crucial to the achievement of long-term sustainability.

2. Czech Republic

Recent developments and medium-term prospects

Developments in public finances in 2004 were better than expected, as a result of stronger growth and of a change in budgetary rules in mid-2004 which made it possible for the first time to roll-over unspent funds into 2005. This change of budgetary rules led to a more prudent behaviour of spending departments. The general government deficit was 3.0% of GDP, far below the target foreseen in the May 2004 convergence programme (5.3% of GDP).

The State budget for 2005 was approved by Parliament on 15 December 2004. It reflected the fiscal measures presented in the May 2004 convergence programme. The 2005 budget is the second based on medium-term expenditure ceilings for central government.

On the expenditure side, several discretionary cuts were introduced in order to meet the 2005 expenditure ceiling. On the revenue side, personal and corporate tax relief is to some extent offset by an increase in revenues from VAT and excise duties, partly linked to tax harmonisation after EU accession.

Table V.4. Budgetary developments 2003-2006, Czech Republic (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance		-11.7	-3.0	-4.5	-4.0	
- Total revenues		41.6	42.7	41.8	41.0	
Of which :	*- current taxes*	*21.1*	*21.3*	*20.1*	*19.7*	
	- social contributions	*15.1*	*14.8*	*14.8*	*14.6*	
- Total expenditure		53.3	45.7	46.3	45.1	
Of which :	*- collective consumption*	*12.3*	*11.6*	*11.7*	*12.1*	
	*- social transfers***	*24.0*	*23.2*	*22.7*	*21.9*	
	- interest expenditure	*1.3*	*1.3*	*1.3*	*1.4*	
	- gross fixed capital formation	*4.2*	*3.9*	*3.9*	*3.9*	
Primary balance		-10.3	-1.8	-3.2	-2.6	
Pm Tax burden		36.2	36.1	34.9	34.4	
Government debt		38.3	37.4	36.4	37.0	
*Pm Real GDP****		3.7	4.0	4.0	4.2	
Convergence programme****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance		-12.6	-5.2	-4.7	-3.8	-3.3
Primary balance		-11.3	-4.0	-3.3	-2.3	-1.7
Government debt		37.8	38.6	38.3	39.2	40.0
*Pm Real GDP****		3.1	3.8	3.6	3.7	3.8

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and convergence programme of the Czech Republic.

Table V.5. Main measures in the budget for 2005, Czech Republic

Revenue measures	Expenditure measures
personal and corporate tax relief (-1.1% of GDP): • a decrease in the corporate income tax rate from 28% in 2004 to 26% in 2005 • shortening of depreciation periods for investment • tax allowances for R&D (up to 10% of the company's tax base) • joint income taxation for married couples (lowering average taxable income) • replacing tax deductible child allowances with tax credits	• reduction of social expenditures, notably in the areas of low income support and unemployment and sickness benefits (0.15% of GDP) • discretionary measures in order to meet the 2005 expenditure ceiling (0.1% of GDP)

Source: Commission services and the December 2004 convergence programme.

The deficit target for 2005 set in the most recent convergence programme (submitted on 1 December 2004) is 4.7% of GDP.[156] This target is likely to be increased by about 0.3% of GDP as a consequence of the recent decision to account the spending on military jets as one-off expenditures in 2005. Given a track record of expenditure overestimation and revenue underestimation in the Czech budget, the Commission services forecast for the 2005 general government deficit is 4.5% of GDP. This projection assumes that half of the funds rolled over from 2004 will be spent in 2005 and it also takes into account one-off military expenditures. If, however, the budget is implemented rigorously and the room for spending, as foreseen in the 2005 budget, is not fully used, like in 2004, the deficit could be lower.

The deficit target for 2006 set in the December 2004 convergence programme is 3.8% of GDP. The Commission services projection for that year is a deficit of 4.0% of GDP, based on the no-policy change assumption. In the absence of specific measures which are necessary to reach the official target in the election year 2006, the expenditure ceilings for 2006 are not taken into account in the spring forecast. The convergence programme further foresees to reduce the deficit to 3.3% of GDP in 2007 and to below 3% of GDP by 2008.

Gross public debt is expected to decline in 2005 to 36.4% of GDP, mainly thanks to privatisation proceeds. In 2006, debt is projected to reach 37% of GDP.

Quality of the central government budgetary process

Fiscal targeting through medium-term expenditure ceilings was formally introduced by the new Law on Budgetary Rules as of 2005. The introduction of expenditure ceilings is a major institutional innovation which should considerably enhance the quality of the budgetary process, in particular the medium term budgetary planning. The Czech government intends to use expenditure ceilings as a key instrument for deficit reduction. The expenditure ceilings apply only to central government. The reason is not only the direct control of central government over those expenditures, but also the fact that the central government is the sub-sector of general government which historically exhibits the highest deficits. Medium-term ceilings thus apply to total expenditures of both the state budget and seven state "extra-budgetary" funds (State Fund for Environment, State Fund for Land Fertilization, State Fund for Culture, State Fund for Czech Cinematography Support and Development, State Fund for Transport Infrastructure, State Fund for Housing Development, State Agriculture Intervention Fund).

Despite this important progress, the central government expenditures are not under the full control of the Ministry of Finance which directly controls only the state budget expenditure. The spending of the seven state funds is under the control of individual ministries. This is also reflected in the process of budgetary approval. Budgets of the seven state funds are approved both by the government and by the parliament not only separately from the state budget, but often also individually. This prevents their joint consideration in the context of the overall central government budget. Whereas the state budget is usually subject to an intense political debate, the state funds' budgets are usually passed without significant opposition, which allows their managers to bid for high budget allocations. High budget allocations tend to result in underspending as was particularly observed for the largest fund (State Fund for Transport Infrastructure). This may lead, on the one hand, to an overestimation of central government expenditures, thus lowering the quality of the Ministry's of Finance medium-term budgetary planning. On the other hand, if budget allocations are unrealistically high, it creates difficulties for the assessment of progress towards the fiscal targets.

The absence of voting on the central government budget as a whole does not fully match the requirements of the central government expenditure ceilings. In particular, it reduces the transparency of the budgetary procedure by making the trade-offs between individual spending items less explicit.

[156] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Another major innovation of the budgetary process introduced by the Law on Budgetary Rules is the possibility to roll-over unspent funds to the following year. The main motivation of this modification was to change the behaviour of the spending ministries, in particular to minimise wasteful spending towards the end of the fiscal year.

As a result of this change, state budget allocations of about 1% of GDP were unspent in 2004 and led to a better-than-expected deficit. However, the possibility to roll over the unspent funds creates a challenge for the fulfilment of the budgetary ceiling in 2005 and possibly in the following years. To mitigate this, the government agreed that at most 50% of the expenditures unspent in 2004 can be rolled over to 2005. While the change in the budgetary rules was designed to avoid overspending at the end of the year, the surprisingly large amount of unspent allocations in 2004 questions the economic efficiency of some expenditures.

3. Denmark

Recent developments and medium-term prospects

Public finances in Denmark in 2004 were substantially stronger than expected. In the March 2005 EDP notification, the general government surplus is estimated to have been 2.8% of GDP, compared to the target of 1.3% of GDP estimated in the 2003 update of the convergence programme. The main factors behind this outcome were higher than expected revenues from corporate taxes as well as from the pension fund yield tax, which tend to be volatile as they are linked to financial market developments. The level of the debt ratio continued to decline and stood at 42.7% of GDP in 2004.

Table V.6. Budgetary developments 2003-2010, Denmark (% of GDP)

Outturn and forecast*	**2003**	**2004**	**2005**	**2006**		
General government balance**	1.2	2.8	2.1	2.2		
- Total revenues	56.6	57.7	56.5	55.7		
Of which : - current taxes	*46.8*	*47.9*	*47.0*	*46.5*		
- social contributions	*2.7*	*2.7*	*2.7*	*2.6*		
- Total expenditure	55.3	55.0	54.3	53.5		
Of which : - collective consumption	*7.6*	*7.6*	*7.5*	*7.4*		
*- social transfers****	*37.1*	*36.9*	*36.5*	*36.0*		
- interest expenditure	*2.5*	*2.3*	*2.2*	*2.0*		
- gross fixed capital formation	*1.7*	*1.7*	*1.8*	*1.7*		
Primary balance	3.8	5.1	4.3	4.2		
Pm Tax burden	48.9	50.1	49.1	48.6		
Government debt	44.7	42.7	40.5	38.2		
Pm Cyclically-adjusted balance	2.0	3.4	2.5	2.4		
Pm Cyclically-adjusted primary balance	4.5	5.7	4.7	4.4		
Pm *Real GDP**** *	0.4	2.4	2.3	2.1		
Convergence programme*****	**2003**	**2004**	**2005**	**2006**	**2007**	**2010**
General government balance	1.2	1.2	2.0	1.6	1.7	2.0
Primary balance	4.6	4.3	4.8	4.5	4.6	4.4
Government debt	44.7	42.3	39.4	37.4	35.3	28.8
Pm *Real GDP**** *	0.5	2.2	2.5	1.3	1.9	1.8

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

** In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second pillar pension funds, these funds can continue to be classified inside the general government sector until the March 2007 EDP notification. This is the case in Denmark and has an estimated positive effect on the general government balance of 1.1% of GDP in 2003, 1.0% in 2004 and 1.0% in 2005 and 2006 and on the debt of 1.2% of GDP in 2003-2006.

*** In kind and other than in kind.

**** Annual % change.

***** Submitted in November 2004.

Source: Commission services and convergence programme of Denmark.

Table V.7. Main measures in the budget for 2005, Denmark

Revenue measures	Expenditure measures
• Adjusted excise duties (within framework of tax freeze) e.g. lower duties on beer, wine, higher on cigarettes. • Lower taxes on "green" fuels (-0.04% of GDP)	• High technology fund (impact in 2005: 0.2% of GDP) • Increased pension and health spending (0.04% of GDP) • Strengthening science education (0.05% of GDP)

Source: Commission services, Danish Ministry of Finance.

The budget for 2005 was adopted on 15 December 2004. The expenditure measures in the budget were limited and included setting up a high technology fund and spending targeted at health and education (see table 3.2). On the revenue side, the tax reform was fully implemented in the context of the March 2004 spring fiscal package. The so-called tax freeze remains in force (see following section). Against the background of an expected continued robust GDP growth, a general government surplus of 2.0% of GDP is foreseen in 2005. This is close to the Commission services' spring 2005 forecast. As measured by the change in the cyclically-adjusted balance, the fiscal stance in 2005 in the spring 2005 forecast is an easing, but this needs to be interpreted with caution[157].

In 2006, a general government surplus of 2.1% of GDP is foreseen in the Commission services' spring 2005 forecast. This is overall in line with the projection in the November 2004 update of the convergence programme[158]. Beyond 2006, the projected evolution of the general government balance in the convergence programme update is of surpluses between 1¾% and 2% of GDP. This is within the Government's medium-term average target interval for the general government balance.

As a consequence of the successive general government surpluses, the government debt ratio is set to decline further and in the spring 2005 forecast reach around 38% of GDP in 2006.

Achieving the objective of modest real public consumption growth

address the long-term challenge of an ageing population, Denmark's fiscal strategy aims at substantially reducing the gross government debt ratio between 2000 and 2010 by running yearly general government surpluses of 1½ - 2½% of GDP on average to 2010. General government surpluses have been recorded since 1998 and continued sizeable surpluses are foreseen in the coming years. This strategy also foresees a lowering of taxes. To this end, income taxes were reduced in 2004 to the tune of ¾% of GDP in the context of the tax reform. In addition, the burden of taxation is being continuously lowered in real terms as a consequence of the so-called nominal principle of the tax freeze in force since 2002, which implies that taxes, whether expressed in fixed nominal *krone* terms or in percentage terms, cannot be raised. This includes residential property value taxes, where a nominal ceiling has been set for tax payments of homeowners. The revenues from these taxes and duties are thus eroded as a share of GDP as a consequence of inflation and growth.

An important element in the fiscal strategy to create room for the tax reductions is to set strict targets for the growth of real public consumption. Public consumption represents around a quarter of Denmark's GDP and its development therefore has a large impact on public finances. Looking back, average yearly real public consumption growth since 1980 has been some 1.6%. This is only slightly less than real GDP growth (1.7%). In the present strategy, the targets for public consumption are a maximum growth of 0.5% a year on average from 2005 to 2010. The target is thus markedly lower than the projected growth of the economy. The projected modest real growth rate of public consumption is a key target variable in the fiscal strategy and a failure to comply with the targets could compromise the strategy, including the fiscal leeway for the implemented tax reductions.

The largest share of public consumption, including health and elderly care, is the responsibility of local governments. Direct control by the central government of local government public expenditure is therefore difficult. Aggregate public expenditure at local government level is determined in a system of formalised co-operation in the framework of the yearly budget negotiations between the local government associations and the central government. The agreements resulting from these negotiations include the aggregate expenditure levels and tax rates as well as the size of the block grants from central to local governments. This agreement is then part of the basis for the central government budget and the projections for the development of government finances as a whole.

Danish local governments have autonomous taxing powers. Against this background, a key instrument for achieving expenditure restraint is the tax freeze, in force

[157] Based on the fiscal projections at the time of the presentation of the budget, the budget for 2005 was set to be broadly neutral. However, mainly due to the exceptionally high tax revenues in 2004 mentioned above (not necessarily linked to the cycle), the surplus in 2004 has been revised upwards and the fiscal stance in 2005 thus appears as an easing.

[158] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

for all levels of government since 2002. As borrowing by local governments is restricted, the tax freeze implies that local governments cannot raise taxes to finance additional expenditure and it thus promotes a stricter prioritisation of expenditures. Apart from preventing tax increases, the tax freeze is thus also intended as a disciplining factor in achieving the objective of modest growth in public consumption. However, the tax freeze is an indirect instrument and does not legally bind individual local governments. A sanction mechanism was therefore introduced, also as from 2002, which implies that local governments and counties could be penalised if they fail to respect the tax freeze. If the local governments' budgets imply a breach of the tax freeze, the block grants to local governments may be reduced or postponed. To keep total public sector revenues unaffected, central government taxation will in such a case be lowered correspondingly.

Overall, compliance with the expenditure and tax agreements across government levels seems to have improved in recent years and there have been no significant breaches of the tax freeze by local governments. Real public consumption growth has been on a downward trend since 2003. From 2.1% in 2002, it fell to 0.7% in 2003. While this outcome exceeded the official target of an average yearly growth of 1% for 2002 and 2003, there seems to have been a shift towards more modest growth. This is confirmed by the growth of real public consumption in 2004 which is estimated to have been around the 0.7% target for that year. The tax freeze thus seems to have been successful as a disciplining force for public consumption expenditure at local government level. Nevertheless, in view of past trends the targets for the coming years remain ambitious. Restraining the growth of public consumption substantially below the growth of income and overall standard of living may prove challenging over time.

In this context, structural factors may also play a role. Increased efficiency in public services could potentially alleviate the pressure on public consumption spending. In this vein, a reform of Denmark's public sector structure has been adopted and will be implemented in 2007. In order to create larger units, more appropriate for dealing effectively with the tasks assigned to them, the number of municipalities will be reduced from 271 to around 100 and the 13 counties transformed into 5 regions. While spending increases in a context of a transition phase cannot be excluded, by creating larger administrative units this reform has the potential to improve efficiency in the provision of public services in the medium term through economies of scale.

4. Germany

Recent developments and medium-term prospects

The general government deficit edged down to 3.7% of GDP in 2004 against a target of 3.3% according to the 2003 update of the stability programme. The major measure on the revenue side was the income tax cuts worth 0.7% of GDP implemented at the beginning of 2004 as part of the tax relief laws passed in 2000, which were partly financed by a broadening of the tax base. The deviation from target has several causes: The increase in the tobacco tax rate in March 2004 did not generate as much revenue as expected. A tax amnesty, aimed at repatriating savings currently deposited undeclared abroad, fell short of plans by 0.2% of GDP. Also, the Bundesbank profit of 2003 was below government expectations. Expenditures on transfers such as unemployment and social assistance benefits were higher than expected but this was offset by savings on the public sector wage bill. The deficit slippage translated into public debt at 66.0% of GDP, higher than expected in the 2003 update of the stability programme.

Table V.8. Budgetary developments 2003-2008, Germany (% of GDP)

Outturn and forecast*			**2003**	**2004**	**2005**	**2006**		
General government balance			-3.8	-3.7	-3.3	-2.8		
- Total revenues			45.0	43.8	43.6	43.4		
Of which :		*- current taxes*	*22.6*	*22.1*	*22.0*	*22.1*		
		- social contributions	*18.6*	*18.2*	*18.0*	*17.8*		
- Total expenditure			48.8	47.5	47.0	46.2		
Of which :		*- collective consumption*	*7.9*	*7.7*	*7.5*	*7.3*		
		*- social transfers***	*31.1*	*30.4*	*30.2*	*29.7*		
		- interest expenditure	*3.1*	*3.0*	*3.0*	*3.0*		
		- gross fixed capital formation	*1.5*	*1.4*	*1.4*	*1.4*		
Primary balance			-0.7	-0.6	-0.3	0.2		
Pm	Tax burden		40.7	39.9	39.6	39.5		
Government debt			64.2	66.0	68.0	68.9		
Pm	Cyclically-adjusted balance		-3.2	-3.3	-2.8	-2.3		
Pm	Cyclically-adjusted primary balance		-0.1	-0.3	0.3	0.7		
Pm	*Real GDP****		-0.1	1.6	0.8	1.6		
Stability programme****			**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance			-3.8	-3 ¾	-2.9	-2½	-2.0	-1½
Primary balance			-0.7	-½	0.0	½	1½	2.0
Government debt			64.2	65½	66.0	66.0	65½	65.0
Pm	*Real GDP****		-0.1	1.8	1.7	1 ¾	2.0	2.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure. Note that the data do not include the recalculation of 'financial intermediation services indirectly measured' (FISIM) in GDP.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and stability programme of Germany.

Table V.9. Main measures in the budget for 2005, Germany

Revenue measures	Expenditure measures
• Third and last stage of the 2000 tax reform enters into force. The linear-progressive income tax rate falls from 16% to 15% at the bottom, while falling from 45% to 42% at the top. (-0.3% of GDP). • Introduction of road toll for lorries (0.1% of GDP). • "Old-age income law": Gradually from 2005 on, pension contributions will be tax-free for all pillars and types of pensions, while pension payments will be fully taxed (in 2005: -0.05% of GDP). • Changes in contribution rates to social security: The "pension sustainability law" (adopted in 2005) aims at a medium-term rate of 19.5% (same as in 2004). From 1 July 2005, the contribution rate for persons insured in the public health system rises by 0.9% to cover dental replacements. The law expects public health insurers to lower the contribution rate by the same amount for other health services as a consequence of the 2004 health reform. The contribution rate to the old-age care insurance rises for pensioners and persons without children. • *Länder* budgets: subsidy repayments by *Landesbanken* (0.1% of GDP).	• One-off measure by postal pension office will require no transfer from federal budget to the office (-0.25% of GDP). • A "sustainability factor" is introduced in the public pay-as-you-go pension system that should automatically dampen pension payments (and hence the contribution rate) when the number of recipients rises relative to the number of contributors. However, the factor is capped so that nominal decreases in individual pension payments do not occur. With low nominal wage growth, the dampening effect of this factor is likely to be low in 2005. • The wage agreement for the federal and local levels was concluded in February 2005, will be implemented on 1 October 2005 and last until December 2007. It foresees a fixed payment for employees for each year in the federal service and in municipalities in western Germany and a gradual wage increase for employees in eastern German municipalities. Bonus payments are frozen at current levels. Working hours are extended slightly.

Source: Federal Ministry of Finance, Commission services estimates.

The federal budget for 2005 was adopted retroactively on 18 February 2005. Tax receipts will be dampened by the implementation of the last stage of the tax relief law dating back to 2000, whereas the introduction of the road toll will add to revenues. Subsidy repayments by several *Landesbanken* add to several *Länder* budgets. The moderate wage agreements in the public sector, concluded in February 2005, were anticipated in the 2005 draft federal budget. Finally in 2005, the cash settlement office for the former postal civil servants plans to securitise future transfer income from the post office's successor companies, so that the cash office would not require a transfer from the federal budget to cover its liquidity deficit. If compatible with ESA95 accounting rules – a specific Eurostat decision is still pending – this transaction would reduce government expenditure by 0.25% of GDP. The 2004 update of the stability programme[159] targets the general government deficit at 2.9% of GDP, compared with the Commission services spring forecast at 3.3% of GDP. The update projected the cyclically-adjusted balance to decline by 0.6 percentage point in 2005, broadly in line with the Commission services projection of a decline by 0.5pp. Compared with the 2004 update of the stability programme, the widening of the headline deficit as projected by the Commission services is consistent with the estimated impact of the considerable downward revision of GDP growth since then.

[159] The programme (submitted on 1 December 2004), as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

The Commission services spring forecast expects the deficit to fall to 2.8% of GDP in 2006, compared with the update's projection of 2½% of GDP. Growing private consumption is expected to bolster tax revenues, while the forecast assumes no further tax cuts, consistent with the usual assumption of unchanged policies. Subsequently, on 4 May 2005, the government presented a draft law proposing to reduce the corporate tax rate from 25% to 19% from 2006 on. It expects the rate cut to be financed by repatriation of taxable income, by limiting tax set-off from loss carry-forward and closed-end funds and by tax incentives for uncovering hidden real estate assets. A further draft law proposed inheritance tax relief upon transfer of business to relatives. The public sector wage agreements concluded in 2005 provide budgetary relief also in 2006. Expenditure growth should accelerate moderately. The 2004 update of the stability programme projects the deficit to decline to 1½% of GDP in 2008. This path of budgetary adjustment seems rather optimistic, in particular as regards the expected surpluses of the social security system. Furthermore, tax revenues seem to be estimated somewhat favourably from 2006 on. It should also be noted that the one-off measures by the postal pension cash office has a negative impact on the budgetary position in the outer years.

The Commission services spring forecast projects public debt to increase to 68.0% of GDP in 2005, compared with the 2004 update's target of about 66%. About 1 percentage point of the difference is due to the considerably lower GDP growth expected by the Commission services. The remaining difference can be explained by the different deficit projections and by

below-the-line operations. In contrast to the update, the Commission services expect the debt ratio to increase further to 68.9% of GDP in 2006.

Health sector reform: cost reduction in 2004, but more efforts needed

The public health system has been subject to repeated reforms in the past, with the most recent having entered into force in 2004, in response to an ageing population and technical progress in health technology. Rising expenditures by the system, which is organised as pay-as-you-go and covers about 90% of the population, are driving up non-wage labour costs and contribute to the increasing wedge between gross and net wages.

Expenditure by the public health system rose from 6.3% of GDP in 1991 to 7.0% in 1995, then dropped to 6.6% after several cost-cutting measures but rose again to 6.8% in 2003. The 2000 reform of the public sector strengthened global budgeting in the sectors ambulatory treatment, medication and hospitals, but also contained extensions in refundable services. In 2003, it emerged that the public health insurers had accumulated debt of about 0.5% of GDP (according to the national accounts) between 2001 and 2003. By law, the public health insurers are independent units setting their own contribution rates, and were in general not allowed to run a deficit at the end of any year.

Thus further health reforms became one of the central elements of the "Agenda 2010" announced by the government in March 2003. The law on "modernisation of the health sector" was passed in October 2003 and entered into force on 1 January 2004.

Overall, the draft law foresaw a relief for the health sector budget amounting to € 9.8bn (0.5% of GDP) in 2004, of which € 7.2bn (0.3% of GDP) are expenditure-related. The total relief is expected to be rising to € 23bn in 2007 (also roughly 0.5% of GDP then) compared to an unspecified baseline.[160] However, from the draft law it appears that the expenditure savings arise to a large extent in 2004, with only small lasting "structural effects" from independent benefit analysis of medication (see below). The draft law further reckons with savings of "several billion euro" from better incentives for service providers and consumers. However, as illustrated below, after 2004, the expenditure dynamics can be expected to be roughly unchanged from the trend before 2004. The expected rising nominal budgetary relief after 2004 is almost entirely due to expected receipts from increasing the tobacco excise duty and, from 2006 on, higher contributions.

The insurers were obliged by law to pass on the savings to patients via lowering the contribution rates; however, they were also held to reduce their debt by at least one quarter annually until the end of 2007.

[160] Draft law, 8 September 2003, Bundestags-Drucksache Number 15/1525.

In detail, the 2004 law involved cuts in the catalogue of goods and services refundable by the system, a better incentive structure to raise cost-awareness with patients and providers, and some steps to strengthen competition in the sector. In the public health system, expenses for medical treatment are usually fully settled between service providers and insurers without involvement of the patients. To mitigate disincentives, a fixed quarterly fee for ambulatory health services was introduced. In addition, patients were offered the choice to switch to a system in which they receive the bill first and get reimbursed by the public insurer, which met faint response. Although the number of medical consultations fell in 2004, incentives for cost-containment do not seem strong enough without some financial participation of patients for each ambulatory treatment.

The 2004 law foresaw also that from 2005 on dental replacements would be taken out of the statutory public health system and funded through a separate, still mandatory, system. Patients would have had to pay an amount per head (thus independent of the individual wage), having the choice between public and private insurers. As a result of the ongoing controversy over the financing mode of the system, this reform element was reversed before it was implemented.

Co-payments to prescribed medication were increased and the price regulation on prescription medication extended. Also, the remuneration of chemists was altered such as to provide incentives to sell lower-priced medication of the same class. Yet, despite permitting mail-order and small chains of pharmacies, barriers to entry into the retailing of medication remain. A newly established institute will provide producer-independent benefit analysis of medication and guidelines for treatment. The public health system is still characterised by collective contracting of fees between insurers and service provider organisations. Although a fair amount of competition takes place between public health insurers, it is almost absent between service providers. Individual contracting has now been permitted in limited areas, but this is only a first step in the right direction.

In 2004, expenditure in the public health sector fell by 3.3% compared with 2003 (in financial accounts), equalling a y-o-y expenditure reduction of about 0.2% of GDP. A reduction in medication expenditure by 9.5% provided the largest contribution, reflecting both cost-cutting measures and reduced demand due to co-payments. Expenditure on ambulatory treatment declined by 5.8% y-o-y, reflecting the positive allocation effect of the fixed quarterly fee. This matches roughly the projected expenditure reduction by 0.3% of GDP compared with the (unspecified) "baseline" as projected in the draft law, if it is assumed that without reform expenditures would have risen by 0.1% of GDP, as they did annually between the reform 2000 and 2003.

According to the financial accounts, the public health insurers ran a surplus of almost 0.2% of GDP in 2004. This points to a debt reduction of more than the minimum legal requirement. Whether in 2005 contribution rates will indeed fall, is not certain, however. If most of the expenditure savings in 2004 were indeed a one-time effect with unchanged dynamics, expenditures could be expected to continue rising by 0.1% of GDP annually. It is not certain whether this leaves large room for lowering contribution rates, in particular as the contribution base, the gross wage sum, is expected to rise only slightly. To hold future health care expenditure below past growth rates, further efficiency-enhancing measures are necessary in the medium-term, not only for patients but also for health care providers and insurers.

At the same time, this underlines the still unresolved structural problem of the public health system, namely that its funding depends on the gross wages. This will have to be tackled by future reforms.

5. Estonia

Recent developments and medium-term prospects

The general government posted a surplus of 1.8% of GDP in 2004. This compares with a targeted surplus of 0.7% of GDP in the 2004 budget. The overshooting was due to public revenues being boosted by stronger-than-anticipated real growth coupled with nominal expenditure ceilings, and improving tax collection (see special topic section on e-tax below). The country's public debt ratio further declined to 4.9% of GDP at the end of 2004, which is the lowest in the EU.

The budget for 2005 was adopted by the Parliament on 8 December 2004. The main measures on the revenue side are a cut of the flat income tax rate by 2 percentage points to 24%, combined with an increase of the tax-free threshold which both entered into force on 1 January 2005. On the expenditure side, EU co-financing requirements and increases to family allowances as well as funding of an ongoing labour market policy package are the main budgetary measures.

Table V.10. Budgetary developments 2003-2008, Estonia (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**		
General government balance		3.1	1.8	0.9	0.5		
- Total revenues		38.9	40.9	40.8	39.2		
Of which :	*- current taxes*	*21.9*	*21.4*	*21.2*	*20.4*		
	- social contributions	*11.5*	*11.2*	*11.2*	*10.9*		
- Total expenditure		35.8	39.1	40.0	38.7		
Of which :	*-collective consumption*	*8.8*	*8.7*	*9.0*	*8.8*		
	*-social transfers***	*19.5*	*20.2*	*20.9*	*20.8*		
	- interest expenditure	*0.3*	*0.2*	*0.2*	*0.2*		
	- gross fixed capital formation	*3.4*	*3.6*	*4.3*	*4.2*		
Primary balance		3.3	2.0	1.1	0.7		
Pm	Tax burden	33.4	32.9	32.7	31.7		
Government debt		5.3	4.9	4.3	4.0		
Pm	*Real GDP****	5.1	6.2	6.0	6.2		
Convergence programme****		**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		3.1	1.0	0.0	0.0	0.0	0.0
Primary balance		-3.4	-1.3	-0.2	-0.2	-0.2	-0.2
Government debt		5.3	4.8	4.6	4.3	3.1	2.9
Pm	*Real GDP****	5.1	5.6	5.9	6.0	6.0	6.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and convergence programme of Estonia.

Table V.11. Main measures in the budget for 2005, Estonia

Revenue measures	Expenditure measures
• Personal income tax: increase of tax-free threshold for low income bracket (-0.3% of GDP); • Personal income tax: lowering of tax deduction limit by half (effect from 2006 only: +0.05% of GDP); • Personal income tax: reduction of income tax rate from 26% to 24% (-0.8% of GDP). • Increases in excise duties on tobacco, alcohol and fuel (+ 0.2% of GDP) • Increase of gambling taxes (+ 0.1% of GDP)	• Increase of various labour market measures (+0,1% of GDP) • Increase of family allowances (+0,1% of GDP) • Increase of agricultural subsidies and support to farmers (+0,2% of GDP) • Support to local governments incl. investment grants etc. (+0,3% of GDP)

Source: Commission services, Estonian Ministry of Finance.

The target for the general government balance in 2005 according to the December 2004 update of the Convergence Programme[161] is a balanced position; whereas the Commission services' 2005 spring forecast expects a surplus of 0.9% of GDP, allowing for the upside risk to the cautious macroeconomic scenario underlying the Estonian budget forecast, which suggests that revenues could be higher and expenditure somewhat lower than budgeted. A strong echo effect from delayed VAT tax collection related to EU accession can be expected to provide an additional boost to budgetary revenues. On the other hand, unexpected revenue shortfalls from the tax cut, or an adverse impact on growth from exogenous shocks cannot be excluded altogether. Although committed to continued fiscal discipline, the recent coalition agreement of a centre-left government which took office in April 2005 increases the possibility of a supplementary budget later in the year, using up some of the fiscal room for manoeuvre contained in the 2005 budget forecast to finance pension increases which are planned still this year. But on the whole, the new government will have little impact on the implementation of the 2005 budget, given the nominal expenditure ceilings. It will be rather with the 2006 budget currently under discussion that an impact will be made.

According to the Commission services' spring 2005 forecast, the general government balance in 2006 is expected at a reduced surplus of 0.5% of GDP. Again, this is somewhat more optimistic than the December update of the Estonian Convergence Programme, which projects balanced budgets over the entire period 2005-2008. The rationale for this assumption in the Commission services' forecast lies with Estonia's track record of prudent forecasting and repeated overshooting of fiscal targets over the past few years. Accordingly, the same caveats as for 2005 apply. The Commission services' forecast is based on the customary no-policy change assumption. The 2005 income tax cut by 2 percentage points was planned as a first step of three successive tax cuts, which should lead to a 20% flat tax rate by 2007. However, the new government's programme foresees a more gradual reduction of the tax rates from 2006 onwards, by just one percentage point per year, thereby reaching the 20% rate by 2009 instead, while raising the tax-exempt threshold.

On the whole, there is still a considerable amount of uncertainty surrounding the economic policy of the new Estonian government, notably with regard to the possible introduction of a motor vehicle tax from 2006, in order to create higher revenues for increased expenditure on pensions, disability and other social benefits.. Local government deficits have started to come down, and can be expected to further decline as a result of a new legal framework which will enter into force in 2006.

Estonia's public debt is forecast to further decline to 4.3% of GDP in 2005 and to 4% in 2006, according to the Commission services' spring 2005 forecast.

Improving tax collection in Estonia: the e-tax

Tax collection in Estonia is probably the most advanced e-government feature in place in the EU. In 2000, the government established the so-called 'e-tax board', allowing for the entire tax declaration and collection cycle to be processed over the internet, via email, and through internet banking. Both the income and corporate flat tax, and VAT are collected through simple and partly pre-filled forms which are available both in electronic and paper versions. The electronic version can be downloaded from the government's websites or via the internet portals of the country's leading banks. The forms for income tax are identical for employees and self-employed, thus companies are not burdened with the income tax administration of their employees. After just five years following its introduction, the e-tax system enjoys wide popularity among taxpayers. In 2005, already 78% of total personal income tax returns for the year 2004 are being collected over the internet. Also companies rapidly embraced the new system. In 2004, 65.8% of Income and Social Tax declarations and 74.8% of VAT declarations were submitted electronically to the tax authorities. The system is completed by a highly efficient Tax Fraud Investigation Centre, which has been granted powers of surveillance

[161] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/ectivities/sgp/main_en.htm

and pre-trial investigation. In order to counteract tax evasion, a statistical risk analysis of the average tax duties per industry and company size is carried out each year by the tax authorities. Companies or individuals that deviate strongly from these benchmarks or fail to declare at all receive a warning letter from the competent tax authority, and get into focus for on-site inspections. Sanctions are, however, not applied immediately, so the tax subject has a grace period for filing a new tax return after the expiry date. The system has not only simplified the burden of tax administration for both sides, it also greatly speeded up the process. Repayments of tax to individuals are processed within a maximum of 3 working days following reception of the electronic declaration, although in reality this is often done within just 1-2 days. There are no hard estimates about the impact of this taxpayer-friendly system on tax returns available. However, the high flow of revenues in both 2003 and 2004 (which was one reason for the higher-than-forecast budget surpluses in each of these years) is most likely at least partly accounted for by these improvements in tax collection. A desirable side effect is that parts of the country's grey economy (which is still estimated at 12-15% of GDP) are being successfully whitened by this combination of simplicity in declaration and efficiency in surveillance.

6. Greece

Recent developments and medium-term prospects

According to the March 2005 EDP notification communicated by the Greek authorities but not validated by Eurostat (see box xx, in chapter xx), the general government balance recorded a deficit in 2004 of 6.1% of GDP, despite strong economic growth of 4.2% achieved during the year. This compares with a deficit target of 1.2% of GDP in the December 2003 update of the stability programme. The slippage of 4.9% of GDP is only partly attributed to the statistical revisions of September 2004 amounting to 1.1% of GDP. The bulk is explained by tax shortfalls and expenditure overruns, of which Olympic Games account for 0.7% of GDP. On top of the slippages unveiled in the September 2004 EDP notification, which at that time estimated a deficit of 5.3% of GDP, the EDP March 2005 notification shows additional slippages stemming from higher interest payments (0.3% of GDP), tax shortfalls (0.1% of GDP), as well as primary expenditure overruns (0.5% of GDP). The debt ratio reached in 2004 at 110.5% of GDP, well above the figure of 98.5% projected in the 2003 update of the stability programme. The difference is the result of the statistical revisions of the debt figures over the period 2000-2003 (7.7% of GDP on average per year) and a higher deficit.

Table V.12. Budgetary developments 2003-2007, Greece (% of GDP)

Outturn and forecast*			**2003**	**2004**	**2005**	**2006**	
General government balance			-5.2	-6.1	-4.5	-4.4	
- Total revenues			43.5	43.9	44.3	44.3	
Of which :		*- current taxes*	*23.5*	*23.2*	*23.2*	*23.1*	
		- social contributions	*15.5*	*16.3*	*16.8*	*17.2*	
- Total expenditure			48.0	50.0	48.8	48.7	
Of which :		*- collective consumption*	*10.2*	*10.9*	*10.8*	*10.5*	
		*- social transfers***	*24.1*	*24.8*	*25.7*	*26.4*	
		- interest expenditure	*5.8*	*5.8*	*5.5*	*5.5*	
		- gross fixed capital formation	*4.0*	*4.1*	*3.3*	*3.1*	
Primary balance			0.6	-0.4	1.0	1.0	
Pm	Tax burden		36.5	36.9	37.4	37.6	
Government debt			109.3	110.5	110.5	108.9	
Pm	Cyclically-adjusted balance		-5.7	-7.1	-5.5	-5.3	
Pm	Cyclically-adjusted primary balance		0.1	-1.4	0.0	0.1	
Pm	*Real GDP****		4.7	4.2	2.9	3.1	
Stability programme****			**2003**	**2004**	**2005**	**2006**	**2007**
General government balance			-5.2	-6.1	-3.7	-2.9	-2.4
Primary balance			0.6	-0.4	1.8	2.7	3.3
Government debt			109.3	110.5	109.5	107.2	104.7
Pm	*Real GDP****		4.7	4.2	2.9	3.0	3.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in March 2005.
Source: Commission services and stability programme of Greece.

Table V.13. Main measures in the budget for 2005, Greece

Revenue measures	Expenditure measures
• Gradual reduction of corporate tax rates over the period 2005-2007. • Implementation of Law No 3259/2004 (settlement of tax disputes including delinquent obligations to the state. • Streamlining of the existing system of tax exemption • Restructuring of tax brackets and increase of non-taxable income threshold of certain categories of employees. • Increased efforts to fight tax evasion, illegal trade and financial crime	• Permanent reduction of expenditure linked to the completion of the Olympic Games. • Reduction in investment grants. • Moderate increase in public wages. • Restrictive hiring policy and reductions in current operating expenditure. • Moderate increase in pensions

Source: Commission services.

On 22 December 2004 the parliament adopted the 2005 budget. Based on an optimistic growth forecast of 3.9% the 2005 budget targets a general government deficit of 2.8% of GDP and a debt ratio of 109.5% of GDP. The 2005 budget includes a number of new measures. On the revenue side, a tax reform will be carried out, the main characteristics of which are: an increase in non-taxable income threshold of certain categories of employees, a gradual reduction of corporate tax rates over the next three years, and the implementation of Law No 3259/2004, providing for a settlement of tax disputes including delinquent obligation to the state. On the expenditure side the policy measures include a permanent reduction of expenditure following the completion of the Olympic Games, a reduction in investment grants, moderate increases in wages and pensions and an extremely restrictive hiring policy in the public sector.

On 29 March 2005, the government announced a package of additional measures, which should lead to a deficit reduction of 0.5% of GDP in 2005 and 0.9% in 2006. The target for the general government deficit in 2005 set in the March 2005 update of the stability programme[162] is 3.7% of GDP with economic growth at 2.9%. In the Commission services spring 2005 forecast, a similar growth rate is projected for 2005 but the projected deficit outcome is significantly worse, at 4.5% of GDP. The difference is explained partly by the budgetary impact of the additional fiscal measures to be implemented in 2005, which were announced after the cut-off date of the Commission forecast and partly by a more cautious assessment of social security contributions and expenditures on public health and wages.

According to the Commission services spring 2005 forecast, the cyclically adjusted balance (CAB) in 2005 will improve by 1.6 percentage points of GDP. Despite this improvement, the deficit, net of cyclical factors, will be above 5% of GDP, still far from a budgetary position of close-to-balance or in surplus. The estimated improvement in the CAB in 2005 according to Commission services calculations on the basis of the projections in the updated stability programme is 2.6 percentage points. The difference of 1.0 percentage point with the Commission services forecasts is due to (i) the fact that the additional fiscal package was not taken into account to the Commission services forecasts and (ii) a lower Commission services estimate of potential output.

Under the usual assumption of unchanged policy, the Commission services spring forecast expects a marginal improvement in the deficit in 2006 reflecting the moderate acceleration of economic growth. The general government deficit is projected to reach 4.4% of GDP compared with a target of 2.9% of GDP in 2006 set out in the reference scenario of the March 2005 update of the stability programme According to the update the general government deficit is projected to attain 2.4% of GDP in 2007

According to the Commission services spring 2005 forecast, the debt ratio is expected to stabilise at 110.5% of GDP in 2005 and to decline slightly in 2006 to 108.9% of GDP. This compares with the projections in the updated stability programme of 109.5% of GDP in 2005 and 107.2% in 2006. The difference is due to higher deficit projections and to lower nominal growth featured in the Commission services' outlook.

[162] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

7. Spain

Recent developments and medium-term prospects

In 2004, according to the March 2005 EDP notification, the general government deficit is estimated to have been 0.3% of GDP. This compares with a close-to-balance position projected in the 2004 Budget Law and a surplus of 0.1% of GDP in the January 2004 updated stability programme. However, by the end of 2004 the authorities expected a deficit of 0.8% of GDP due to one-off statistical operations. The better-than-expected outturn of the most recent estimation is explained by unexpectedly higher revenues, partially offsetting the effect of two one-off statistical operations, consisting of the reclassification of RTVE (the public broadcasting company), as requested by Eurostat, and the assumption of RENFE's (the railway network company) debt, decided by government. Except for the annual RTVE deficit (at around 0.1% of GDP), the reclassification of RTVE does not affect the general government balance and translates directly into a debt increase by the amount of RTVE's cumulated debt (about € 8 billion or around 1 percentage point of GDP).

Table V.14. Budgetary developments 2003-2008, Spain (% of GDP

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**		
General government balance		0.3	-0.3	0.0	0.1		
- Total revenues		40.0	40.2	40.4	40.5		
Of which :	*- current taxes*	*22.6*	*23.1*	*23.2*	*23.3*		
	- social contributions	*13.7*	*13.6*	*13.7*	*13.7*		
- Total expenditure		39.7	40.5	40.4	40.4		
Of which :	*- collective consumption*	*n.a.*	*7.9*	*8.0*	*8.1*		
	*- social transfers***	*n.a.*	*22.6*	*22.7*	*22.7*		
	- interest expenditure	*2.5*	*2.2*	*2.1*	*2.0*		
	- gross fixed capital formation	*3.6*	*3.7*	*3.7*	*3.7*		
Primary balance		2.8	1.9	2.1	2.1		
Pm	Tax burden	36.3	36.6	36.8	36.8		
Government debt		51.4	48.9	46.5	44.2		
Pm	Cyclically-adjusted balance*****	0.2	-0.3	0.0	0.2		
Pm	Cyclically-adjusted primary balance	2.7	1.8	2.1	2.2		
Pm	*Real GDP****	2.5	2.7	2.7	2.7		
Stability programme****		**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		0.4	-0.8	0.1	0.2	0.4	0.4
Primary balance		2.9	1.5	2.2	2.2	2.3	2.3
Government debt		50.7	49.1	46.7	44.3	42.0	40.0
Pm	*Real GDP****	2.5	2.6	2.9	3.0	3.0	3.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
***** Calculated using the HP filter.
Source: Commission services and stability programme of Spain.

Table V.15. Main measures in the budget for 2005, Spain

Revenue measures	Expenditure measures
• Freeze of non-taxable income threshold (0.06% of GDP) • Freeze of fuel duties (-0.03% of GDP)	• Increase in R&D spending (0.06% of GDP) • Increase in investment in transport infrastructure, namely roads and railways (0.1% of GDP) • Increase in minimum non-contributory-pensions (0.04% of GDP)

Source: Commission services and 2005 Budget Law.

Conversely, the assumption of RENFE's debt results in higher than initially planned gross fixed capital formation and capital transfers by the general government sector with an impact on the 2004 deficit of 0.7% of GDP. This reclassification neither involves any backward revision nor has carryover effects in the coming years. After netting out such one-off operations, the budgetary outcome would have been a surplus of half a percentage point of GDP. Regarding the composition of the 2004 balance, the deficit of central government (1.3% of GDP) is partially compensated by the surplus of the social security sector (1.0% of GDP), whereas regional and local authorities are broadly in balance. Public debt is estimated at 48.8% of GDP in 2004.

In 2005, according to the most recent update of the stability programme[163], a surplus for the general government of 0.1% of GDP is projected. This coincides with the target set in the 2005 Budget Law adopted by the government on 27 December 2004. The central government presents a deficit of 0.6% of GDP, whereas regional and local authorities are in balance and the social security sector expects a surplus of 0.7% of GDP. This is in line with the Commission services spring 2005 forecast, which projects a balanced budget in nominal and cyclically-adjusted terms for the general government.

More in detail, according to the 2005 Budget Law, revenues should increase by 6.4% in nominal terms. Direct taxes and social security contributions are expected to grow by 9.4% due to strong job creation, while economic growth should increase indirect tax revenues by 8.1%. Total expenditures are targeted to grow by 6.6%. Particular efforts are devoted to productivity-enhancing budgetary measures on the expenditure side, which will concentrate on R&D, innovation, education and investment in infrastructure. Specifically, the budget encompasses a 25% increase of funds devoted to R&D policies, including an endowment of € 3 billion (about 0.4% of GDP), which will be allocated to research on information technologies (IT). Most of this endowment is meant to translate into loans to selected projects at low or zero interest rates. The government is committed to doubling expenditure on R&D within four years in order to catch up with the euro area average. Expenditure on education will increase by 6% with respect to the total amount allocated in the previous year. Most of this increase will translate into more and higher grants. Finally, the budget gives priority to investment in infrastructure, with spending planned to increase by 9.1%. Special attention will be paid to improving terrestrial transport, notably motorways and the promotion of high-speed railway network.

In 2006, the most recent update of the stability programme targets a surplus of 0.2% of GDP for the general government This is comparable with the Commission services spring 2005 forecast, in which, under a no-policy change scenario, the general government balance is expected to achieve a surplus of 0.1% of GDP. In 2007 and 2008, small but increasing surpluses are projected in the updated stability programme, reaching 0.4% of GDP in 2008.

Concerning gross public debt, the Commission services spring 2005 forecast foresees a gradual decline over the forecast horizon, towards around 44% of GDP in 2006. This is in line with the projections in the updated stability programme.

Is public consumption too high?

Since 2000, public consumption has been growing above GDP, feeding both government total expenditure and domestic demand. This increase has been so far compatible with a consolidation process, which allowed Spain to reach the close-to-balance fiscal position already in 2003. The rise in public consumption has been offset by savings from interest payments. However, according to the Commission services spring 2005 forecast, this might not be the case in the medium term. Furthermore, the expansion of public consumption is taking place in a context in which a buoyant domestic demand translates into higher imports, widening the trade deficit.

The story of public consumption during the last decade can be divided in two periods. Between 1995 and 1999, when within a process of strong expenditure retrenchment, public consumption fell, albeit marginally, in terms of GDP. This contrasts with the 2000-2004 period in which the previous trend was reversed and government consumption accelerated sharply to come back to the levels observed in 1995 (see Graph V.1). Within this context, the issue of the

[163] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

compatibility of a high rising public consumption with the maintenance of the close-to-balance position and with the need to rebalance the external sector appears relevant since government consumption encompasses, not only the operational costs of the administration, but also items subject to long-run trends or drifts, such as health care and public wages, which may be difficult to revert.

Public consumption and fiscal consolidation

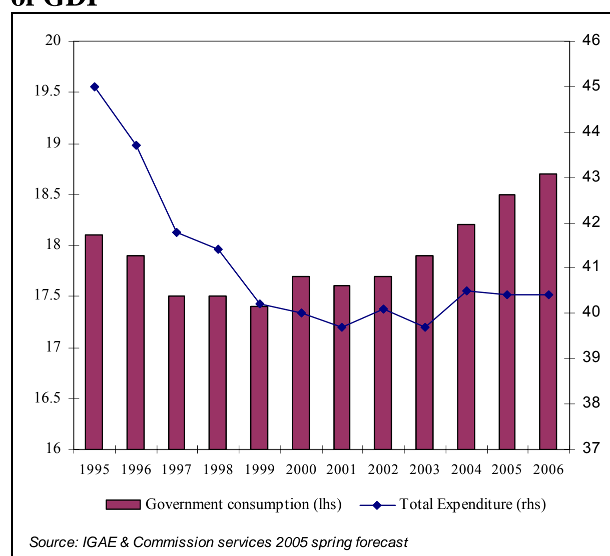
Between 1995 and 1999 public consumption fell from 18.1% in 1995 to 17.4% in 1999, the strongest phase of the consolidation process leading to a drastic deficit reduction. Total expenditures fell by 4.8 percentage points of GDP, from 45.0% of GDP in 1995 to 40.2% of GDP in 1999. With a reduction of only 0.7p.p. of GDP, the contribution of public consumption to spending retrenchment was not particularly relevant. Interest payments, social benefits and capital expenditure reduced its share in the nominal GDP by around 1.5 p.p. each one. During this period, the components of public consumption presented a different behaviour. Whereas social transfers in kind, remained roughly stable in terms of GDP at around 10% (which includes among others health care and education) collective consumption, fell from 8% of GDP in 1995 to 7.3% in 1999[164].

In line with its decreasing participation in GDP, public consumption grew in real terms by 2.9% per year, which compares with a real GDP growth rate of 3.6% per year (see Graph V.2). The contribution of public consumption to growth between 1995 and 1999 reached 0.5p.p per year. With a positive output gap during this first period, the behaviour of public consumption remained therefore anti-cyclical and helped to contain domestic demand. Public consumption explained around 1/6 of domestic demand growth between 1995 and 1999, while private consumption explained around ½ and gross fixed capital formation the rest ⅓ (see Graph V.3)[165].

A dynamic economy

Between 2000 and 2004, government final consumption gained momentum (0.6p.p. of GDP along the period) to reach 18.2% in 2004, 0.1p.p. above the level recorded in 1995. In parallel, government total expenditure retrenchment was fading out since 2000. Total expenditures remained barely unchanged in terms of GDP during the period and a re-composition took place between interest payments and public consumption. While interest payments were falling, driven by debt reduction and decreasing interest rates, no other spending items recorded a significant reduction. In fact, savings from interest payments were used to finance government consumption.

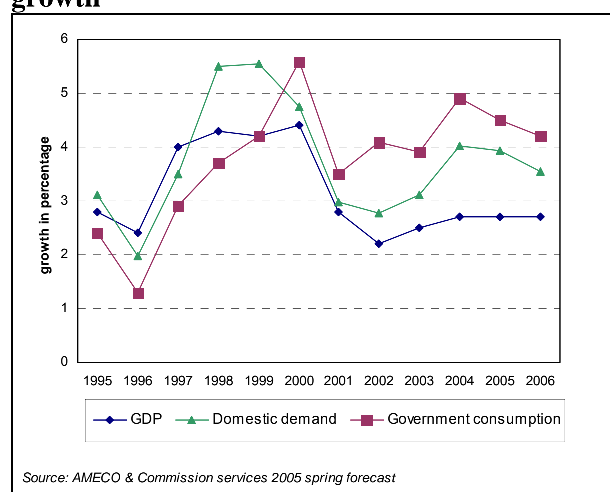
Graph V.1. General government total expenditure and government consumption as % of GDP



Source: IGAE & Commission services 2005 spring forecast

During this period, the two main components of public consumption, collective consumption and social transfers in kind, increased from 7.6% of GDP in 2000 to 7.9% in 2004 and from 10.1% in 2000 to 10.4% in 2004 respectively.

Graph V.2. Comparison between real GDP, domestic demand and government consumption growth



Source: AMECO & Commission services 2005 spring forecast

In real terms, public consumption grew by 4.3% per year, well above the average growth rate of 2.9% per year recorded by real GDP. Consequently, the contribution of public consumption to GDP growth jumped from 0.5% over 1995-1999 to 0.8% per year between 2000 and 2004. Public consumption explained around 1/5 of domestic demand growth, compared with 1/6 in the period before. This is less than half the

[164] Public wages, which are also part of public consumption, and are included in both social transfers in kind and collective consumption, fell from 11.3% of GDP in 1995 to 10.6% in 1999.

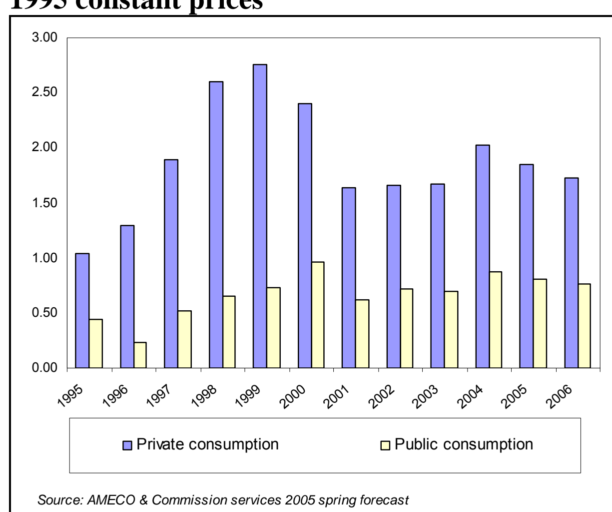
[165] It is worth noting at this point that the external balance of goods and services deteriorated along the period, entering negative territory in 1999 (-1.3% of GDP) after three consecutive years in surplus

contribution of private consumption and slightly below the contribution of gross fixed capital formation. Consequently, the expansion of public consumption has been feeding more than in the previous period an already highly dynamic domestic demand, which is not fully translating into higher growth but into higher imports, thus steadily deteriorating the external position of the country.

The future outlook

According to the Commission services spring 2005 forecast, public consumption is expected to increase by 0.5p.p. of GDP until 2006[166]. Specifically, public consumption should reach 18.5% of GDP in 2005 to record 18.7% in 2006, compared with 18.2% in 2004. In contrast, interest payments are projected to fall by only 0.2 percentage points of GDP (2.1% of GDP in 2005 and 2% in 2006, from 2.2% in 2004), while no other expenditure item is projected to decrease significantly in terms of GDP. Therefore, since the fiscal position is projected to remain at close to balance, 3/5 of the increase in public consumption will be financed by additional revenues, coming from a particularly tax-friendly growth composition. Supported by strong domestic demand, total revenues are expected to slightly increase in terms of GDP (from 40.2% in 2004 to 40.4% and 40.5% in 2005 and 2006 respectively). This is enough to finance the public consumption increases along the forecast period. However, should this trend continue in the future, keeping a balanced budget would require higher tax rates. Both collective consumption and social transfers in kind are projected to grow above nominal GDP, increasing each one around 1/4 p.p of GDP along the forecast period.

Graph V.3. Private and public consumption. Contribution to domestic demand growth at 1995 constant prices



Source: AMECO & Commission services 2005 spring forecast

Public consumption is expected to grow in real terms by 4.5% and 4.2% in real terms in 2005 and 2006 respectively, while GDP would grow by 2.7% in both years. In parallel, domestic demand should grow at around 4% and 3.5% in 2005 and 2006 respectively. Slightly over 1/5, the relative contribution of public consumption is projected to remain broadly stable compared with the period 2000-2004, while the trade deficit is projected to widen to 7.7% of GDP in 2005 and 8.3% of GDP in 2006, compared with 6.8% in 2004. Therefore, there might be a case to ask whether such trends in current public consumption are adequate at the current juncture when a dynamic domestic demand is widening external imbalances, while high inflation and low productivity are dragging competitiveness.

[166] Commission services projections for 2006 are based on the usual no-policy change scenario.

8. France

Recent developments and medium-term prospects

The general government deficit declined from 4.2% of GDP in 2003 to 3.7% of GDP in 2004, in line with the Commission's services autumn 2004 forecast. In view of the robust growth performance, the cyclically-adjusted deficit improved by only 0.4 percentage point of GDP in 2004, as against a targeted 0.8 percentage point of GDP. The limited improvement in the 2004 deficit despite the additional revenues stemming from higher-than-expected growth (actual GDP growth was 2.6% compared to 1.7% expected in the December 2003 update of the stability programme) is due to a number of factors. First, the 2003 deficit estimate was revised slightly upward (0.1% of GDP), causing an unfavourable base effect. Second, the government decided not to compensate for the loss of revenues (0.1% of GDP) triggered by the non-validation by the *Conseil d'Etat* of the tightening of eligibility conditions of the unemployment insurance system. Finally, although the expenditure target was met in the State sector, there were expenditure overruns in other sub-sectors and notably in the local authorities sector.

Table V.16. Budgetary developments 2003-2008, France (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**		
General government balance		-4.2	-3.7	-3.0	-3.4		
- Total revenues		50.4	50.8	51.5	51.1		
Of which :	*- current taxes*	26.3	26.7	26.9	26.8		
	- social contributions	18.5	18.2	18.4	18.4		
- Total expenditure		54.6	54.5	54.5	54.4		
Of which :	*- collective consumption*	9.5	9.4	9.3	9.3		
	*- social transfers***	33.2	33.2	33.2	33.0		
	- interest expenditure	2.9	2.9	2.9	3.0		
	- gross fixed capital formation	3.2	3.3	3.4	3.4		
Primary balance		-1.3	-0.8	-0.1	-0.4		
Pm	Tax burden	43.8	44.1	44.3	44.2		
Government debt		63.9	65.6	66.2	67.1		
Pm	Cyclically-adjusted balance	-4.0	-3.6	-2.8	-3.1		
Pm	Cyclically-adjusted primary balance	-1.0	-0.7	0.2	-0.1		
Pm	*Real GDP****	0.5	2.5	2.0	2.2		
Stability programme****			**2004**	**2005**	**2006**	**2007**	**2008**
General government balance			-3.6	-2.9	-2.2	-1.6	-0.9
Primary balance			-0.7	0.1	0.8	1.5	2.2
Government debt			64.8	65.0	64.6	63.6	62.0
Pm	*Real GDP****		2.5	2.5	2.5	2.5	2.5

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and stability programme of France.

Table V.17. Main measures in the budget for 2005, France

Revenue measures	Expenditure measures
• Increase in social contributions to finance the health reform (0.2% of GDP) • Increase in pensions contributions of public employees (0.2% of GDP) • Exonerations of taxes on inter-generational transfers • Alleviations of social charges (-0.1% of GDP) • One-off additional revenue (0.5% of GDP) as a counterpart of the transfer to the general social security sector of the pensions payments of the employees in public electricity and gas companies	• Stabilisation of State expenditure in real terms • Specific measures aimed at curbing the rapid growth of health care spending (stricter reimbursement of medicines, increase in the *forfait hospitalier* and in consultations prices by 1€, etc.)

Source: Commission services, Ministry of Finance of France.

The increase in the 2004 general government debt ratio from 63.9% in 2003 to 65.6% of GDP is 0.3 percentage point of GDP larger than projected in the 2003 update of the stability programme.

This was due to a higher deficit (0.15 percentage point of GDP) and higher stock flow adjustment, partly offset by a more negative contribution stemming from stronger nominal GDP growth.

The budget for 2005 adopted by parliament in December 2004 plans a marked slowdown in public spending through (i) a stabilisation of State expenditures in real terms; (ii) a deceleration in health expenditure growth (to 3.2% from 4.9% in 2004); and (iii) a slowdown in local authorities' expenditures. On the revenue side, exonerations of taxes on intergenerational transfers and alleviation of social charges have been introduced. However, because of the introduction of other measures the overall tax burden would raise by 0.1 percentage point of GDP: notably increases in social security contributions from civil servants and contributions of electricity and gas companies' (EDF/GDF) employees following the transfer of the responsibility for the payment of their pensions to the general social security regime. Finally, non-fiscal revenues are planned to increase by 0.5 percentage point of GDP, due to one-off measures related to the above-mentioned transfer of EDF/GDF pensions. The Commission services spring 2005 forecast projects the general government deficit in 2005 at 3% of GDP, against an estimate of 2.9% of GDP by the French authorities. The slight difference between the two deficit forecasts stems from two factors: (i) a more cautious macroeconomic scenario (2.0% GDP growth foreseen by the Commission services as against 2.0-2.5% by the French authorities), and (ii) a smaller positive impact of the health insurance reform in the short term. The macroeconomic and budgetary projections of the spring 2005 Commission services forecast are consistent with an improvement in the cyclically-adjusted balance by 0.8 percentage point of GDP (in line with the adjustment included in the 2004 update of the stability programme), the largest part of which reflects the impact of the one-off measures cited above.

In 2006, based on the usual no-policy-change assumption, the Commission services project the general government deficit to increase to 3.4% of GDP despite expected real GDP growth close to its potential rate. This reflects the fact that the exceptional payments contributing to the deficit reduction in 2005 will vanish in 2006 and that tax cuts are planned for that year (0.2% of GDP based on the information available so far). Accordingly, real government expenditures are assumed to increase by about 2% in the spring forecasts, compared with a projection of 1.2% in the December 2004 update of the stability programme[167]; the update targets a general government deficit of 2.2% of GDP in 2006, which the government revised to 2.7% of GDP in March 2005[168] In the subsequent years, the deficit is projected in the stability programme update to steadily decline by 0.6-0.7 percentage point of GDP per year to 0.9% of GDP in 2008. Based on Commission services calculations, the cyclically-adjusted balance would accordingly also improve by 0.6-0.7 percentage point per year and have reached -0.7% of GDP in 2008.

The Commission services project the debt-to-GDP ratio to increase further in 2005-06. This ratio would reach 66.2% in 2005 and 67.1% in 2006. Developments in the debt are projected to reflect those of the deficit and nominal GDP, since no significant stock-flow operations are incorporated in the forecast. This is worse than projected in the 2004 update of the stability programme, where the debt ratio is envisaged to stabilise, reflecting the higher deficit and lower GDP growth rate in the spring 2005 forecast.

Ageing of population: a major challenge ahead

[167] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[168] Figures mentioned in the March 2005 report "perspectives economiques 2005-2006" published by the French Ministry of Economy and Finance.

As in many other EU countries, large demographic changes will occur in the next few decades in France as a result of several developments: (i) post-war baby-boom cohorts will enter their retirement years; (ii) life expectancy is expected to continue increasing by approximately one year per decade; (iii) past fertility rates, although slightly better in France than in some other countries, have been insufficient to stabilise the age structure of the population implying notably that smaller cohorts will enter the labour force in coming decades; and (iv) net inward migration flows, which could partially offset the impact on the age structure of the population, are expected to remain limited.

According to Insee[169], these developments will have two major consequences. First, the population of working-age will start declining as from the end of the current decade. In its most recent projections, Insee forecasts a decline in population aged between 15 and 64 by about 2.5 millions between 2007 and 2040. Second, the number of persons aged 65 and above will increase faster in the coming decades[170]. The changes of the rate of growth of these two groups have not yet started. They will occur simultaneously in a short transition period between 2010 and 2015.

As a consequence, the old-age dependency ratio (persons aged 65 or more to persons in working age 15-64) is projected to increase from 24% today to 46% in 2040. Consequently, the ratio of working-age to elderly citizens will increase from four to one at present to two to one by 2040.

These changes in the demographic structure will exert strong pressures on government expenditure in pensions, health care and long-term care. In order to limit the magnitude of the shock, France implemented in recent years major reforms so as to curb the dynamics of pension and health expenditure.

The pension and health care reforms

France adopted in summer 2003 a comprehensive reform of the pension system, which increased the number of contribution years entitling to a full pension in two steps. First, until 2008, the number of contribution years will progressively increase by 6 months per year in the public sector from 37.5 years to 40 years, the level currently prevailing in the private sector. In a second step starting in 2008, the contribution period is foreseen to increase for all workers proportionally with life expectancy, with the aim of keeping constant the ratio between the number of contribution years and the number of pension years. The reform also aims at raising the financial incentives for workers to remain active until and after the legal retirement age, although the legal retirement age has been maintained at 60.[171]

Following the pension reform, a reform of the health system was adopted in summer 2004 aimed at reaching budgetary balance by 2007 (from a deficit of about 0.8% of GDP in 2004). About one third of the effort is planned to be achieved through tax increases representing ¼% of GDP, the remainder through expenditure savings. These savings are supposed to stem notably from (i) the introduction of a charge of one euro payable by patients for every medical consultation; (ii) measures aimed at tackling fraudulent sick leave and at facilitating the development of generic drugs; and (iii) better control of medical cost control supposed to stem notably from financial incentives for patients to use general practitioners rather than going straight to specialists and from the introduction of a personal medical record in order to improve cooperation between health professionals. The reform also aims at improving the management of the system through a clarification of the roles of the different parties involved (government, social partners, health insurance schemes) and the creation of an independent alert committee in charge of formulating recommendations in case of slippages from the official target.

Impact of the reforms on government finances

According to the French authorities, the pension reform will reduce by around 40% the financial needs of the pension system in 2020. The remainder is expected to be financed through two channels. In the private sector, social contributions will be increased. In the public sector, the remaining financial needs will be met by a decline in other government expenditures. Expressed in terms of reduction of the *tax gap*, budgetary savings resulting from the pension reform would be equivalent to a permanent reduction in the deficit of 1.5 percentage point of GDP, 0.5 percentage point of which is attributed to a rise in the participation rate.

The quantification of the effects of the pension reform in the long term appears plausible. However, these effects are subject to some uncertainties. First, after 2008 the increase in the contribution period entitling to a full pension foreseen by the reform will not be fully automatic since it will be conditional upon the agreement of an independent commission. Although unlikely, it cannot be excluded that this commission

[169] The demographic projections used here represent the baseline projection of Insee, in which the fertility rate is projected to remain at 1.8 per thousand in line with the average level of the last 25 years, life expectancy is projected to rise by about 7 years by 2050 and net inward migration is projected to be of 50000 persons annually over the projection period, in line with the average of the last 10 years.

[170] Of this group, the biggest increase will be amongst the very elderly, that is persons aged 80 or over, whose number will triple from now to 2050. This is relevant because this group is the most intensive user of health care and long-term care services.

[171] This is among the lowest legal retirement ages in OECD countries.

may not endorse the foreseen increases in the contribution period. Second, there are some uncertainties regarding the reaction of workers to the incentives introduced by the reform to postpone retirement. This is especially relevant since the reform did not modify the legal retirement age (60 years) which is relatively low.

Although the health reform is also likely to trigger substantial savings, the precise budgetary impact of some measures is more uncertain. While an impact should be visible in the short run, notably through the effect of the tax increases and of some well-defined measures on the expenditure side, assuming that new financial incentives and improvement in the governance of the system will imply a permanent reduction in the pace of growth of health expenditure appears overly optimistic. Notably, the large savings expected from the control of medical cost - representing one-third of the total expected savings over 2005-2007 - are conditional on a change in behaviour of the economic agents. The changes introduced in the structure of incentives could not be sufficient to trigger a permanent inflexion in the growth rate of health expenditure.

On the basis of the 2004 update of the stability programme and additional information provided by the EPC[172], age-related spending is foreseen to increase by 5.5% of GDP between 2009 and 2050, despite the expected impact of the 2003 pension reform. Indeed, the increase of public spending on pensions, health care and long-term care will be only partly compensated by a decline in expenditure on education and unemployment benefits.

France adopted important measures on pensions and health that should help improve the long-term sustainability of public financing without however fully securing it. Given the projected increase in the old-age dependency ratio, fiscal consolidation, along with structural reforms, are key factors to put France on a sustainable path.

Table V.18. Projected budgetary impact of ageing on public expenditures between 2009 and 2050 (as a % of GDP)

% of GDP	*Total impact*
Total age-related spending	**5.5**
Of which:	
Pension expenditure	1.6
Health care expenditure	4.6
Education expenditure	-0.4
Unemployment benefits	-0.3

Source: Ageing Working Group of the EU Economic Policy Committee and 2004 update of the stability programme.

[172] In October 2003, the Economic Policy committee provided an overview of analyses carried out at EU level on the impact of ageing populations on public finances. The report took into account the expected impact of the 2003 pension reform, not obviously that of the 2004 health reform.

9. Ireland

Recent developments and medium-term prospects

For 2004, the general government is estimated to have recorded a surplus of 1.3% of GDP, compared with the deficit of 1.1% of GDP targeted in the December 2003 update of the stability programme.

This significantly better-than-expected outturn is mainly due to a sizeable tax overshoot, including the impact of one-off factors, notably receipts arising from the special investigations (of potential tax evasion) by the Revenue Commissioners (estimated to have yielded around 0.5% of GDP). General government expenditure in 2004 is also estimated to have been lower than budgeted, especially investment and interest expenditure.

Table V.19. Budgetary developments 2003-2007, Ireland (% of GDP)

Outturn and forecast*	**2003**	**2004**	**2005**	**2006**	
General government balance	0.2	1.3	-0.6	-0.6	
- Total revenues	34.6	35.7	34.5	34.0	
Of which : - current taxes	*24.8*	*25.7*	*24.8*	*24.5*	
- social contributions	*6.0*	*6.2*	*6.2*	*6.1*	
- Total expenditure	34.4	34.3	35.1	34.6	
Of which : - collective consumption	*5.6*	*5.6*	*5.6*	*5.6*	
*- social transfers***	*19.2*	*19.6*	*19.9*	*19.6*	
- interest expenditure	*1.3*	*1.2*	*1.1*	*1.0*	
- gross fixed capital formation	*3.9*	*3.6*	*3.9*	*3.9*	
Primary balance	1.5	2.5	0.5	0.5	
Pm Tax burden	30.0	30.9	30.0	29.7	
Government debt	32.0	29.9	29.8	29.6	
Pm Cyclically-adjusted balance	0.2	1.6	-0.1	0.1	
Pm Cyclically-adjusted primary balance	1.5	2.8	1.0	1.1	
Pm *Real GDP****	3.7	5.4	4.9	5.1	
Stability programme****	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	0.1	0.9	-0.8	-0.6	-0.6
Primary balance	1.4	2.1	0.6	0.6	0.7
Government debt	32.1	30.5	30.1	30.1	30.0
Pm *Real GDP****	3.7	5.3	5.1	5.2	5.4

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and stability programme of Ireland.

Table V.20. Main measures in the budget for 2005, Ireland

Revenue measures	Expenditure measures
• Personal income tax measures: a widening of the tax band for personal income tax and an increase in employee and personal tax credits (-0.4% of GDP). • Stamp duty measures: relief for the first-time purchasers of existing properties (less than -0.1% of GDP).	• Social welfare package: increase in social welfare benefit rates and measures to reinforce equal participation in society by people with disabilities (0.4% of GDP). • Investment: addition to the available envelope for Exchequer-funded capital spending (around 0.2% of GDP) plus a carry-over from unspent allocations in 2004 (0.2% of GDP).

Source: Commission services and Department of Finance, Ireland (2005 budget).

The budget for 2005 was unveiled on 1 December 2004[173][174] together with the stability programme update covering the period to 2007. The target for the general government deficit in 2004 in the updated stability programme is 0.8% of GDP[175]. The main 2005 budget measures on the revenue side include an upward adjustment of the standard tax band for personal income and some relief through changes in stamp duty. On the expenditure side, the increase in current discretionary spending[176] (of 10.1% after 6.7% in 2004), reflects a somewhat more generous social welfare package than in 2004. A significant rise in capital spending has also been budgeted, focusing in particular on improvements in transport infrastructure. Given the measures in the budget, in 2005 the Commission services' spring forecast projects the general government position to turn into a deficit of 0.6% of GDP[177]. Nevertheless, risks exist. In particular, a February 2005 court ruling on nursing home payments might entail significant government costs, though the exact implications are not yet known. On the other hand, the general government deficit might turn out lower that projected because of stronger than expected receipts from strengthened tax compliance (particularly as a consequence of further Revenue Commissioners special investigations) and some under-spending in capital outlays.

For 2006 the Commission services' spring forecast projects a deficit of 0.6% of GDP, identical with the target set in the updated stability programme. This target includes a contingency provision against unforeseen developments of 0.4% of GDP. Given the non-indexed nature of the tax and social benefit systems, the forecast's no-policy change assumption is made operational, in the absence of previously announced measures, by freezing average tax rates and adjusting social transfer payments by the forecast of CPI inflation (with a small top-up).

Government gross debt is projected to stabilise at around 30% of GDP. In the absence of the accumulation of non-general government assets in the National Pensions Reserve Fund (NPRF)[178], which was established in 2001 to pre-fund future pension liabilities, the gross debt ratio would be falling over the period to end-2006.

Recent initiatives to improve public expenditure control

Frequent expenditure overruns associated with the massive increase in government spending in the second half of the 1990s raised concerns about the effectiveness of control and management of public expenditure.

This created the basis for the recommendation in the 2003-2005 Broad Economic Guidelines (BEPGs) that Ireland should '*enhance the efficiency of public expenditure and improve revenue and expenditure planning in a stability-oriented medium-term framework building on the range of measures recently introduced to improve the planning, management and control of expenditure*'.

Measures taken by the Irish government up to 2002 to address the occurrence of spending overruns and concerns about securing 'value for money' have been previously reviewed.[179] In 2003 and 2004, measures to

[173] The detailed Exchequer cash data for 2004 reveal that personal income tax, VAT and stamp duty significantly exceeded budget forecasts, while corporation tax and excise duties were broadly on target.

[174] The 2005 Finance Bill was signed into law by the President of Ireland on 25 March 2005.

[175] In the March 2005 reporting of government deficits and debt levels, the Irish authorities forecasted for 2005 a slightly lower deficit of 0.7% of GDP.

[176176] This refers to the concept of 'voted' current spending, for which annual approval by Parliament is needed and which excludes, *inter alia*, the service of national debt and the contribution to the EU budget.

[177] The cyclically-adjusted balances presented in Table V.19 show planned fiscal loosening of around 1¾% of GDP However, one-off factors boosting revenues in 2004 should be also taken into account (see above).

[178] The National Reserve Pensions Fund (NPRF) receives annually around 1% of GNP from general government resources. At the end of 2004 assets represented around 8% of GDP.

[179] For a review of the measures taken between 1997 and 2002 aiming at the improvements of the expenditure management, see Public finances in EMU 2003, *Ireland.* These measures included in particular moving to multi-annual budgeting, the *expenditure*

strengthen the monitoring and control of expenditures included[180]:

- *the publication of intra-year* monthly profiles of expenditures (published in January);
- *monthly expenditure management reports on the trends in the public finances* submitted by the Minister of Finance to the Cabinet;
- *bi-monthly reports* submitted by the *four key government departments*[181] to the *Cabinet on emerging spending trends;*
- *improvements in risk assessment measures and contingency planning to cater for unforeseen intra-year expenditure pressures;*
- *further structural measures to improve expenditure management and control*, including revised arrangements for managing capital spending and the provision of incentives for departments to produce savings.

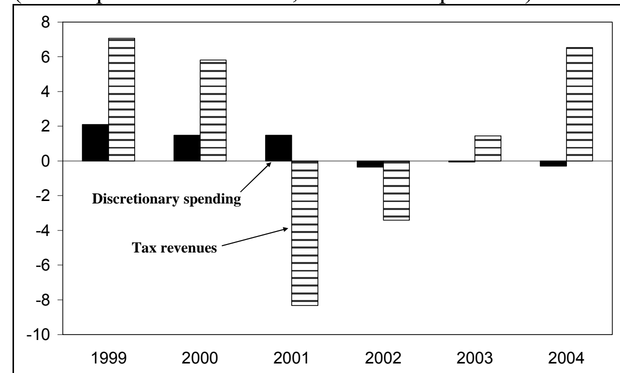
The Irish authorities have also taken several steps to improve the multi-annual medium-term framework for capital expenditures. In particular, the system of rolling five-year spending envelopes was extended from public transport to all areas of capital spending as from 2004, which should significantly strengthen the efficiency of planning of infrastructural investment. In addition, from 2004 departments were permitted to carry over to the following year up to 10 per cent of their voted capital allocations.[182]

The figure below compares targets and actual outturns for discretionary spending and tax revenues. Taxes appear to be much more volatile than discretionary expenditure[183], but this reflects frequent swings in economic growth and unexpected one-off revenues[184]. On the other hand, as regards the management of expenditure, discretionary spending has been maintained closer to plans in recent years.

The outturns for discretionary spending have gradually become closer to target over time, being marginally below target since 2002. In 2004, the detailed Exchequer cash data reveal that the outturn in year 2004 is, in particular, due to capital under-spending. This is partly due to the new provision for limited carryover of capital expenditure (see above).[185]

Graph V.4. Ireland - outturn vs. target for discretionary spending and taxes

(Exchequer cash accounts; deviation in per cent)



Source: Commission services, Department of Finance.

In conclusion, the measures taken to improve public expenditure management have proven to be successful and have delivered an improvement in expenditure control. The introduction of the multi-annual capital envelopes should allow for better budgeting of infrastructural projects, but the medium-term planning of current spending still requires ongoing attention since announced multi-annual targets are apparently routinely revised. On a positive note, several initiatives are continuing in order to analyse in a more systematic manner the expenditure impact and to ensure the delivery of high-quality services, in particular in the health sector.[186]

review initiative (ERI) and setting up an *Independent Estimates Review Committee* (IERC).

[180] Measures announced by the Minister of Finance in his 2003 budget speech, (http://www.budget.gov.ie/2003/speech03.asp).

[181] The four departments with the largest current spending allocations are (i) Education and Science, (ii) Health and Children, (iii) Justice, Equality and Law Reform, and (iv) Social and Family Affairs.

[182] The 2004 Finance Act.

[183] The deviations from revenue targets led the Irish authorities to a review of tax forecasting procedures. In particular, a new provisional methodology for forecasting corporation tax revenues in the multi-annual projections was introduced in the budget for 2004 (BEPGs - Implementation Report, 2004).

[184] A significant one-off factor that significantly influenced tax revenues in 2004 were receipts arising from the special investigations by the Revenue Commissioners, currently estimated to have yielded EUR 685 mil. (just below 0.5% of GDP).

[185] The carryover under the multi-annual capital envelope from 2004 to 2005 was around 4 per cent of the 2004 discretionary capital allocation or 0.2% of GDP.

[186] For further details, see chapter 7 of the stability programme update of Ireland (December, 2004).

10. Italy

Recent developments and medium-term prospects

According to the EDP notification communicated by the Italian authorities on 1 March 2005 but not validated by Eurostat[187], the general government balance recorded a deficit of 3.0% of GDP in 2004, compared with a targeted deficit of 2.2% of GDP set in the 2003 update of the stability programme.

Table V.21. Budgetary developments 2003-2008, Italy (% of GDP)

Outturn and forecast*			**2003**	**2004**	**2005**	**2006**		
General government balance			-2.9	-3.0	-3.6	-4.6		
- Total revenues			46.3	45.4	44.6	44.0		
Of which :		*- current taxes*	*28.2*	*28.2*	*28.0*	*27.7*		
		- social contributions	*13.0*	*12.9*	*12.9*	*12.9*		
- Total expenditure			49.2	48.4	48.2	48.5		
Of which :		*- collective consumption*	*7.6*	*7.4*	*7.3*	*7.2*		
		*- social transfers***	*29.1*	*29.2*	*29.2*	*29.1*		
		- interest expenditure	*5.3*	*5.0*	*4.9*	*5.0*		
		- gross fixed capital formation	*2.6*	*2.6*	*2.4*	*2.9*		
Primary balance			2.4	2.0	1.3	0.4		
Pm	Tax burden		42.9	41.9	41.1	40.6		
Government debt			106.3	105.8	105.6	106.3		
Pm	Cyclically-adjusted balance		-2.6	-2.4	-2.9	-4.0		
Pm	Cyclically-adjusted primary balance		2.7	2.6	2.0	1.0		
Pm	*Real GDP****		0.3	1.2	1.2	1.7		
Stability programme****			**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance			-2.4	-2.9	-2.7	-2.0	-1.4	-0.9
Primary balance			2.9	2.4	2.5	3.3	4.0	4.7
Government debt			106.2	106.0	104.1	101.9	99.2	98.0
Pm	*Real GDP****		0.3	1.2	2.1	2.2	2.3	2.3

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and stability programme of Italy.

[187] Eurostat did not validate the deficit figures for Italy notably because of the recording of payments by 'concessionari d'imposta', of a securitisation operation, of transactions with the EU budget, of the classification of government-owned entities, inconsistencies between cash and accrual data and large statistical discrepancies. The clarification of these issues may lead to an upward revision in the deficit figures, notably for 2003 and 2004.

Table V.22. Main measures in the budget for 2005, Italy

Revenue measures	Expenditure measures
• Reduction in the number of personal income tax rates and increases in tax deductions (-0.3% of GDP) • New schemes aimed at widening the tax base of companies and self-employed people (*studi di settore*) (0.3% of GDP) • Postponement to 2005 of the tax amnesty for zoning regulation violations originally foreseen in 2004 (0.2% of GDP)	• Savings on health care expenditure (0.3% of GDP) • Disposal of publicly-owned real assets (0.5% of GDP) • Implementation of a 2% cap on the annual increase in nominal expenditure (0.4% of GDP)

Source: Ministry of the Economy and Finance.

Overestimation of economic growth and the upward revisions of the deficits in the years from 2001 to 2003 largely explain the slippage from the budgetary objective.

At the ECOFIN Council of 5 July 2004, Italy agreed to undertake additional fiscal measures worth around ½% of GDP, of which expenditure cuts amounting to around 0.3% of GDP. Despite these savings, a postponement of wage agreement renewals and lower than officially projected interest payments, overall spending ended up 1.1% of GDP higher than targeted in the 2003 update of the stability programme. Part of the slippage was due to higher than expected health care expenditure and significantly lower than expected proceeds from sales of publicly-owned real estate (classified as negative capital expenditure). In contrast, on the revenue side, some receipts (mainly a temporary rebate of taxation on capital gains from revaluation of firms' assets and revenues from lotteries) turned out higher than initially planned by the government. Thus total revenue was 0.3% of GDP above the amount expected in the 2003 update of the stability programme. The primary surplus decreased to 2.0% of GDP, down from 2.4% in 2003. Overall, the impact of temporary measures on the 2004 budgetary position is estimated at around 1½ percentage points of GDP, down from around 2 percentage points in 2003. Also thanks to privatisation proceeds amounting to around 0.6% of GDP, the debt-to-GDP ratio declined by 0.5 percentage points to 105.8%. The original target in the 2003 update of the stability programme was 105.0%.

The 2005 budget law was adopted by Parliament on 29 December 2004. Measures aiming to reduce expenditure include a 2% cap on the annual increase of nominal expenditure (excluding pensions, health care and local government expenditure), a new system of ceilings on sub-national government expenditure and further sales of publicly-owned real assets, including some state roads. On the revenue side, the budget law comprises cuts in personal income tax, an increase in indirect taxation and a strengthening of the schemes that aim at widening the tax base of small companies and self-employed people.

On 29 April, the Ministry of the Economy and Finance released a new target of 2.9% of GDP for the general government deficit in 2005, while in the meantime listing a series of circumstances which could lead the deficit to reach 3.5% of GDP. The Italian authorities explain the revision of the deficit target from the previous target of 2.7% of GDP, set in the 2004 update of the stability programme[188], to 2.9% of GDP on the basis of lower growth forecast (1.2% as against 2.1%), postponement of renewal of public wage agreement from 2004 to 2005 and lower dividend receipts. The negative impact of these items on the deficit would be partially offset by interest payments expected to be lower than previously projected. According to the Italian authorities the deficit could increase from 2.9% of GDP to 3.5% of GDP as (i) the capital injections into the state-owned railway company amounting to 0.23% of GDP could have to be classified as capital transfers; (ii) ANAS, the joint-stock company in charge of the maintenance of the state road network, could not meet the criteria to be classified outside the public administration, thus increasing the deficit by 0.14% of GDP; (iii) the sale of publicly-owned real assets could fall short of 0.35% of GDP; (iv) some government institutions may not respect the 2% cap on annual increase in nominal expenditure introduced by the 2005 budget law, with a negative impact on the fiscal balance of 0.1% of GDP. All these factors would increase the deficit to 3.75% of GDP, however, the renewal of some wage agreements concerning public employees could be postponed to 2006, thus improving this figure by 0.25% of GDP.

In the Commission services spring 2005 forecast, the projected budgetary outturn is a deficit of 3.6% of GDP.[189] The difference of one decimal point with respect to the upper range limit of the deficit target of 3.5% of GDP is explained by the different assessment of several items, which partially offset each other (proceeds from the sale of real estates, interest payments, compensation

[188] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

[189] This forecast is based on the 2004 deficit notified on 1 March 2005. It does not include possible carry-over effects of potential upward revisions.

of public sector employees, intermediate consumption, revenue, ANAS's expenditure and capital transfers the railways company).

Table V.23. General government: decomposition of stock-flow adjustment (in % of GDP)

ITALY	2000	2001	2002	2003	2004	stability programme				Average	
						2005	2006	2007	2008	2000-2004	2005-2007
Difference due to time of recording: cash and accruals											
1. Differences in the recording of revenue and primary expenditure (accounts receivable and payable) and statistical discrepancies	1.4	1.6	1.2	1.1	0.6	0.9	0.9	0.9		**1.2**	**0.9**
2. Difference between cash and accruals interest expenditure	-0.5	-0.5	-0.7	-0.5	-0.2	0.0	0.2	0.2	-0.2	**-0.5**	**0.1**
3. Total (1+2)	**1.0**	**1.1**	**0.5**	**0.6**	**0.4**	**0.9**	**1.0**	**1.1**		**0.7**	**1.0**
Accumulation of financial assets											
4. Liquidities	-0.7	0.3	0.0	-0.6	0.3	0.0	0.0	0.0		**-0.1**	**0.0**
5. Securities other than shares	0.1	-0.2	0.0	0.0	0.0	0.0	0.0	0.0		**0.0**	**0.0**
6. Loans	0.4	0.3	0.2	0.1	0.2	0.4	0.6	0.7		**0.2**	**0.6**
7. Capital injections in state-owned companies	0.1	0.1	0.0	0.0	0.3	0.5	0.5	0.3		**0.1**	**0.4**
8. Privatisation proceeds	-0.4	-0.4	-0.1	-1.3	-0.6	-2.1	-2.0	-1.9	-0.6	**-0.5**	**-2.0**
9. Other shares and equity	0.4	0.0	0.0	0.2	0.0	0.1	0.0	0.0		**0.1**	**0.0**
10. Total (4+5+6+7+8+9)	**-0.2**	**0.1**	**0.0**	**-1.6**	**0.1**	**-1.1**	**-0.9**	**-0.9**		**-0.3**	**-1.0**
Valuation effects and residual adjustments											
11. Redemption effects	0.0	0.0	-1.7	0.0	0.0	0.0	0.0	0.0		**-0.3**	**0.0**
12. Exchange rate adjustment	0.1	0.0	-0.3	-0.3	-0.1	0.0	0.1	0.1		**-0.1**	**0.1**
13. Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0		**0.0**	**0.0**
14. Total (11+12+13)	**0.1**	**0.0**	**-2.0**	**-0.3**	**-0.1**	**0.0**	**0.1**	**0.1**		**-0.5**	**0.1**
15. STOCK-FLOW adjustment (3+10+14)	**0.9**	**1.2**	**-1.5**	**-1.3**	**0.4**	**-0.1**	**0.2**	**0.2**	**2.1**	**-0.1**	**0.1**
16. SFA excluding changes in liquidities, privatization proceeds, and valuation effects and residual adjustments (15-4-8-14)	**1.9**	**1.2**	**0.6**	**0.9**	**0.8**	**2.0**	**2.1**	**2.0**	**2.7**	**1.1**	**2.1**

Source: Ecfin calculations on March 2005 reporting of government deficits and debt levels (Table 3A), information provided by the Ministry of the Economy and Finance, and 2004 updated stability programme.

One-off measures are estimated to improve the budget balance by around ¾ percentage point of GDP. Net of cyclical factors, both the deficit and the primary balance are projected to worsen by around ½ of a percentage point of GDP. By contrast, the cyclically-adjusted budget deficit resulting from the application of the commonly agreed methodology by the Commission services to the projections in the most recent update of stability programme remains unchanged compared to 2004, while the cyclically-adjusted primary surplus worsens by 0.2 percentage points of GDP.

The Commission services forecast for 2006 is based on legislation currently in force. This approach does not account for increases in some spending items, namely compensation of public sector employees and government investment, to be adopted by the next budget law and thus tends to underrate expenditures compared to plausible developments. On this basis the deficit would reach 4.6% of GDP, reflecting the expiry of one-off measures and the higher cost of the 2005 personal income tax relief in the year 2006. A very sizeable budgetary correction would be needed to achieve the official target of a deficit of 2% of GDP set in the stability programme update submitted in December 2004. The latter plans the deficit to gradually decline to reach 0.9% of GDP in 2008.

In the Commission services spring 2005 forecast, the (gross) debt ratio is projected to decline marginally to 105.6% of GDP in 2005, while the new target set on 29 April is 105.3% of GDP, up from the 104.1% in the 2004 update of the stability programme. The difference between the new official target and the Commission services' projection reflects the higher deficit forecast by the Commission services. Based on unchanged legislation, the debt ratio is expected to increase in 2006 to 106.3% of GDP, well above the 101.9% of GDP targeted in the stability programme.

The pace of debt reduction and the stock-flow adjustment

Since the late 1990s, the pace of debt reduction in Italy has been slower than warranted by the size of the primary surplus and privatisation proceeds. The inertia chiefly reflects persistent debt-increasing components in the so called stock-flow adjustment (SFA). The SFA is the difference between the Maastricht deficit, which is recorded in accrual terms, and the change in the government debt, which is recorded in cash terms and gross of financial transactions. A positive SFA is the normal outcome for low-debt countries with a surplus, as they invest their surpluses and accumulate financial assets. By contrast persistent debt-increasing components in the SFA are cause of concern in a high-debt and deficit country like Italy (see also Chapter 2 Section 2.1). To understand the underlying debt dynamics it is essential to analyse the different components of the SFA. The SFA can be divided into

three aggregate components: (a) difference due to time of recording: cash and accruals; (b) accumulation of financial assets; and (c) valuation effects and residual adjustments. The table above provides a detailed breakdown of the actual SFA in Italy over the 2000-2004 period. It also includes the available indications about future SFA developments as presented in the stability programme update submitted in December 2004 and details made available by the Ministry of the Economy.

The upward revision of the deficit-to-GDP ratio in 2001-2003 included in the notification of March 2005 resulted from moving a part of debt-increasing SFA above the line. In particular, capital injections into the state-owned railway company *Ferrovie dello Stato* are now considered as capital transfers and not as financial transactions. In spite of these reclassifications, debt-increasing elements of the SFA continue to be particularly high in Italy.

Concerning the recent past, the data show that in the 2000-2004 period the debt-reducing components of the SFA amounted on average to 1½% of GDP per year. They chiefly consisted of (i) privatisation proceeds realised in part thanks to the classification of *Cassa Depositi e Prestiti* (the state-owned savings and loans bank) outside the general government sector in 2003, (ii) an exceptional conversion of Treasury bonds held by the Bank of Italy in 2002, and (iii) interest expenditure accrued but not yet paid on postal bonds.

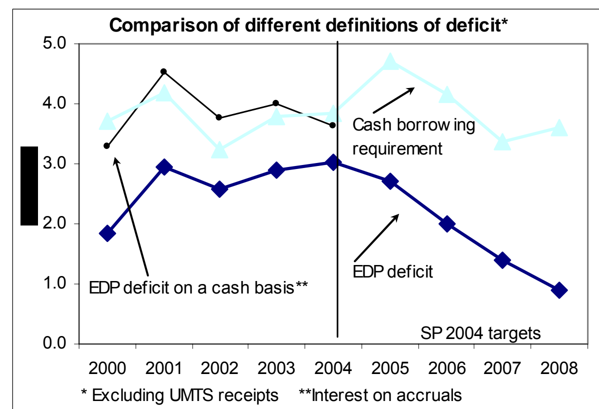
However, over the same 2000-2004 period the above mentioned debt-reducing factors have been offset by components producing the opposite result, i.e. an average increase in the government gross debt of 1½ percentage points of GDP per year. Specifically, around 1¼ percent of GDP per year was due to the difference between cash versus accrual accounting in primary items and large statistical discrepancies. This represents a cause of concern and was also mentioned in the Eurostat press release of 18 March 2005 (see footnote 187). In addition, accumulation of financial assets (excluding liquidities and privatisation proceeds) affected the government gross debt on average by ¼ pp of GDP per year.

Data about future years presented in the 2004 update of the stability programme suggest that the pattern observed over the recent past is expected to persist. In particular, cash versus accrual accounting in primary items is expected to continue producing a debt-increasing effect at least up until 2007.

An indicator gauging the actual debt dynamics is the so called cash borrowing requirement (*Fabbisogno delle Amministrazioni Pubbliche*). It is regularly used by the Italian Ministry of the Economy and Finance. On top of the Maastricht deficit, the indicator includes the difference between cash and accrual accounting and the accumulation of financial assets excluding privatisation proceeds. As shown in the graph the cash borrowing requirement has been above the 3% of GDP reference value over the recent past.

Concerning future years, the implicit cash borrowing requirement, i.e. the indicator derived excluding from the projected change in the gross debt level the effect of the privatisation proceeds envisaged in the 2004 update of the stability programme, continues to stay significantly above the targeted EDP deficit. As depicted in the graph below, the difference would even seem to increase in 2008.

Graph V.5. Comparison of different definitions of deficit



Source: Commission services.

If the difference between the deficit and the cash borrowing requirement continued to be as high as implicitly assumed in the 2004 update of the stability programme, it would represent a serious cause of concern for the quality of statistical indicators in Italy and above all for the sustainability of public finances over the medium and long term.

11. Cyprus

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit for 2004 attained 4.2% of GDP. Compared with the 2003 deficit outturn, this figure represents a reduction of more than two percentage points. Moreover, it is better than the estimated 4.8% of GDP in the updated convergence programme submitted on 7 December 2004, which, in turn, compares with the 2004 deficit target of 5.2% of GDP in the May 2004 convergence programme. This positive outcome is attributed to the impact of the fiscal consolidation measures affecting both expenditure and revenue. Extra revenues came from a more domestic-demand based growth composition, which more than offset some revenue shortfalls arising from delays in the introduction of a number of measures initially planned for 2004. The debt ratio in 2004 attained 71.9% of GDP, still higher than the 69.8% of GDP recorded in 2003, but lower than the 74.9% estimated in the updated convergence programme. This difference is explained by extra debt repayment in that year and by the lower than expected deficit.

Table V.24. Budgetary developments 2003-2008, Cyprus (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**		
General government balance		-6.3	-4.2	-2.9	-1.9		
- Total revenues		39.1	39.4	39.4	38.9		
Of which :	*- current taxes*	*26.6*	*25.3*	*25.97*	*25.5*		
	- social contributions	*7.1*	*8.4*	*8.2*	*8.0*		
- Total expenditure		45.4	43.6	42.3	40.7		
Of which :	*- collective consumption*	*11.0*	*10.1*	*9.9*	*9.7*		
	*- social transfers***	*20.4*	*19.9*	*19.8*	*19.2*		
	- interest expenditure	*3.4*	*3.4*	*3.3*	*3.2*		
	- gross fixed capital formation	*3.4*	*3.9*	*3.6*	*3.5*		
Primary balance		-2.8	-0.9	0.4	1.4		
Pm	Tax burden	33.3	33.9	34.1	33.6		
Government debt		69.8	71.9	69.1	66.6		
Pm	*Real GDP****	2.0	3.7	3.9	4.2		
Convergence programme******		**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		-6.3	-4.8	-2.9	-1.7	-1.5	-0.9
Primary balance		-2.8	-1.3	0.7	1.8	2.0	2.5
Government debt		69.8	74.9	71.9	69.2	65.7	58.1
Pm	*Real GDP****	1.9	3.6	4.0	4.4	4.5	4.5

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and convergence programme of Cyprus.

Table V.25. Main measures in the budget for 2005, Cyprus

Revenue measures	Expenditure measures
• implementation of legislation on bank secrecy and a tax amnesty on undeclared bank accounts (0.6% of GDP); • regularisation of dividend income policy for semi-government organizations (0.6% of GDP); • issuance of title deeds for buildings erected with minor irregularities (0.4% of GDP).	• introduction of overall annual ceilings on current expenditure increases (of at most 3%) and on capital expenditure growth (of at most 4%); • freeze in public sector employment and wage increases (0.3 % of GDP) and increase in the retirement age in the public sector (0.2% of GDP); • increase in the minimum retirement age for eligibility for outlays form the Social Insurance Fund (0.2% of GDP); • containment of current transfers and subsidies (pensions, allowances) in line with inflation (0.2% of GDP).

Source: Commission services and updated convergence programme Cyprus.

The 2005 budget was approved by the Cypriot Parliament on December 10, 2004. It is consistent with the commitments and plans set out in the convergence programme to bring down the budget deficit to 2.9% of GDP for 2005 and in line with the Commission services spring 2005 forecast. The deficit reduction is achieved both through revenue increases and expenditure restraint. Some of the expenditure measures are permanent. This is the case of the increase in the retirement age for public sector employees. Caps on current expenditures have also been introduced. Overall, nominal expenditure growth is kept at 3%. However, two items are projected to grow above this ceiling. Nominal wages and salaries, which account for 25% of government expenditure, are set to grow by 5% in 2005, while capital expenditure is planned to rise by 6%. The budget foresees a nominal revenue increase of 9.5%. Main revenue growth elements are social security contributions and indirect taxes. VAT rates were revised upward, in line with the EU acquis, which indeed has carryover effects in 2005. Revenues from direct taxes and social security contributions are expected to be pushed up by higher GDP growth. Additional revenues would be provided by some one-off measures (such as a tax-amnesty and the introduction of fees for issuance of title deeds for certain real estate). It should also be noted that the updated convergence programme prudently takes revenues from a number of measures, not included in the 2005 budget, as a safety margin to offset the impact of possible delays in other measures planned for 2005. As a consequence, the deficit target of 2.9% of GDP is considered as an “upper limit”.

For 2006, based on the usual no-policy change scenario, the Commission services spring 2005 forecast projects a further reduction of the deficit to 1.9% of GDP. This figure is marginally above the deficit target of 1.7% of GDP set in the update of the convergence programme. The difference arises from the Commission services’ slightly lower GDP growth projection for 2006. For 2007 and 2008 the updated convergence programme targets a further deficit reduction to 1.5% and 0.9% of GDP, respectively.

The spring 2005 forecast projects the general government debt level for 2005 to decrease to 69.1% of GDP, with a further decline to 66.6% by 2006. This drop is mainly driven by positive primary balances and an annual nominal GDP growth above the average nominal interest rate over 2005-2006. Furthermore, debt-reducing stock-flow adjustments (SFAs) further push the debt ratio down, reversing earlier debt-increasing SFAs in 2000-2003. The projected debt path in the Commission services forecast is similar to that in the updated convergence programme, although the levels in the former are lower because the forecast already incorporates the lower starting debt level in 2004.

12. Latvia

Recent developments and medium-term prospects

In 2004, according to the March 2005 fiscal notification, the general government deficit was 0.8% of GDP. This is about 1¼ percentage points lower than the targeted deficit of 2.1% set in the May 2004 convergence programme and more than 1 percentage point better than the budgeted deficit of 2.2%. The difference was mainly due to better-than-expected tax revenues coming from output growth significantly higher than foreseen (8.5% instead of 6.7% foreseen in the 2004 budget law) and improvements in tax collection. The 2004 budget was amended twice, in August and in December. The first budget amendments, with a cost of nearly 0.9% of GDP, provided for additional increases in teachers' salaries and subsidies to farmers. The second set of amendments, with a cost of more than 0.4% of GDP, included a number of one-off payments previously intended for 2005, such as direct payments to farmers, contributions to the 2005 EU budget and advances for financing development and structural projects. The debt-to-GDP ratio at end-2004 was 14.4%. The 2005 budget law was presented to Parliament on 13 December 2004 and adopted on 20 December. The budget, in line with the December 2004 convergence programme, targets a deficit of 1.6% of GDP, significantly more ambitious than the 2.2% of GDP deficit target set in the May 2004 convergence programme though with an unchanged underlying growth assumption of 6.7%.

Table V.26. Budgetary developments 2003-2007, Latvia (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance		-1.5	-0.8	-1.6	-1.5	
- Total revenues		34.2	35.2	35.4	35.3	
Of which :	*- current taxes*	*19.9*	*19.7*	*19.4*	*19.2*	
	- social contributions	*9.2*	*8.8*	*8.2*	*7.8*	
- Total expenditure		35.7	35.9	37.0	36.8	
Of which :	*- collective consumption*	*11.0*	*10.9*	*10.7*	*10.5*	
	*- social transfers***	*20.3*	*18.9*	*18.5*	*18.1*	
	- interest expenditure	*0.8*	*0.8*	*0.8*	*0.8*	
	- gross fixed capital formation	*1.5*	*1.7*	*2.6*	*3.1*	
Primary balance		-0.7	0.0	-0.8	-0.7	
Pm	Tax burden	n.a.	n.a.	n.a.	n.a.	
Government debt		14.4	14.4	14.0	14.3	
Pm	*Real GDP****	7.5	8.5	7.2	6.9	
Convergence programme****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance		-1.5	-1.7	-1.6	-1.5	-1.4
Primary balance		-0.7	-0.9	-0.9	-0.8	-0.7
Government debt		14.4	14.2	14.5	14.8	15.0
Pm	*Real GDP****	7.5	8.1	6.7	6.5	6.5

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and convergence programme of Latvia.

Table V.27. Main measures in the budget for 2005, Latvia

Revenue measures	Expenditure measures
• Increase in the personal income tax-free threshold from LVL 21 per month to LVL 26 per month and the setting of income tax rebates for dependants at LVL 18 per month (-0.2% of GDP); • Application of the reduced VAT rate (5% instead of 18%) to domestic public transport services (-0.08% of GDP); • Increase in excise duties on oil and tobacco products (+0.3% of GDP)	• Expenditures based largely on financing from EU structural funds and other financial instruments (+ 3.6% of GDP); • Reform of the National Armed Forces and NATO integration-related requirements (+1.9% of GDP mainly financed through restructuring of the budget); • Modernization and restructuring of the healthcare system (+ 0.4% of GDP); • Increased teachers' wages (+0.3% of GDP); • Other measures to improve social conditions including pension indexation (+0.7% of GDP).

Source: Commission services and the explanations to the 2005 budget law (2005 gada budžeta paskaidrojumi).

Compared to the May programme, in the 2005 budget both expenditure and revenue ratios are projected to increase substantially. This is, most importantly, a result of the front-loading of EU funds-related budgeting programmed for the period 2004-2007. Furthermore, starting from 2005, the government plans to commence the modernisation and restructuring of the healthcare system, requiring a 10-15% annual increase of public financing over the medium term. Strong growth, changes to the spending structure including administrative reform, improved tax-collection and VAT increases implied by EU accession are expected to provide for financing of these reforms. In the Commission services spring 2005 forecast, the projected outcome is line with the targeted deficit. Nonetheless, it is based on higher growth assumptions (a 7.2% annual growth rate rather than 6.5%) and a more cautious estimate of revenues from EU funds.

Based on a no-policy change assumption, the Commission services spring 2005 forecast projects the general government deficit to decrease slightly to 1.5% of GDP in 2006. This is in line with the December 2004 convergence programme[190] that aims at a slight reduction of the general government budget deficit from 1.6% of GDP in 2005 to 1.4% of GDP in 2007.

The debt-to-GDP ratio is expected to remain broadly stable in 2005 and 2006 (with a small fall to 14.0% in 2005 before rising to 14.3% in 2006), a profile that is slightly more optimistic than in the December 2004 update of the Convergence Programme.

Public expenditure prospects: the case of a strongly-growing catching-up economy

The 2005 budget is the first to be legally embedded within a multi-annual budget framework, in this case covering the period 2005-2009 in line with the government's policy document, *Medium-term key concepts for macroeconomic development and fiscal policy, 2005-2009*. This document sets out key funding priorities and outlines annual general government deficit and debt targets. For the period up to 2007 this document largely corresponds to the December convergence programme update. The 2005 budget provides for more funding for the defence, healthcare and education sectors. This is consistent with the government's medium-term policy priorities and financial obligations related to EU accession and NATO membership. However, the budget preparation process in Latvia still shows signs of a relatively weak planning process, in particular an unclear link between policy priorities and the allocation of resources. Budget allocations tend to be subject to inertia and structural rigidities, with only marginal adjustments. Achievement of the budgetary targets in turn depends on cash rationing of resources for line ministries. Adjustments of expenditure in form of freezing of programmes take place during the budget year, even without revenue shortfalls. This indicates underestimation of some expenditure categories during the budget preparation phase. The practice of putting on hold programmes that have been approved by Parliament and government dates back to the 1998 Russian crisis. These accumulated "frozen" commitments are the main reason why budget negotiations are so cumbersome despite high growth rates of nominal and real expenditure.

Access to EU funds could help in the very short term to achieve closer alignment between policy priorities and budget expenditure. However, budgetary expansion implies a further stimulus to demand.[191]

[190] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

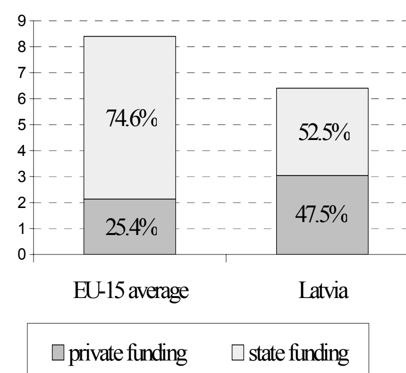
[191] However, the disbursement on EU-supported programmes can be expected to impact directly mainly on the domestic business sector, and within this sector on less tradable sub-sectors (in particular construction) with access to currently unused or underused resources. While there will clearly be some primary and secondary effects in terms of higher imported inputs and bidding up of factor costs, these should be more muted relative to a "classic" budget deficit expansion in a fully-employed economy.

Table V.28. General Government expenditure by function Latvia 2003, EU-15 2002

	% GDP		% of total expenditure	
	Latvia	EU-15	Latvia	EU-15
General public services	5.3	6.8	15.0	14.3
Defence	1.3	1.8	3.6	3.8
Public order and safety	2.4	1.7	6.8	3.6
Economic affairs	3.7	4.1	10.3	8.6
Environment protection	0.4	0.7	1.2	1.5
Housing and community amenities	0.9	0.9	2.6	1.9
Health	3.3	6.5	9.1	13.6
Recreation, culture and religion	1.4	0.9	3.8	1.9
Education; total expenditure	6.2	5.2	17.3	10.9
Social protection	10.8	19.1	30.2	40.0
Total expenditure	35.7	47.7	100	100

Source: Eurostat, the World Health Organization.

Graph V.6. Total healthcare expenditure in 2001 as % of GDP



While the general government deficit is capped at some 1½ percent of GDP, spending (financed largely by EU grants) is budgeted to increase substantially. In all, the annual EU grants and related expenditures are expected to total some 5-7 percent of GDP over next few years.

These EU-financed expenditures do not widen the measured deficit; nonetheless they represent a sizable increase in claims on available resources that could add to pressures on inflation and the external balance. Thus, the challenge for fiscal policy is not only to aid restructuring of the economy, but also to avoid or contain cyclically-undesirable stimulus. The savings necessary to increase funding for priority programmes will have to be addressed in a manner conducive to sustainable, cost-effective results without disruptions to service delivery.

The announced government priorities include: the modernization and restructuring of the healthcare system; support for institution-building and strengthening of public administration to ensure greater efficiency (including the civil service pay reform initiated in 2002 but stalled for lack of resources); a significant increase in the financing of fundamental research and higher education; pension indexation; and an increase of childcare allowances. Pressure to implement these various reforms arises from relatively low salaries in the public sector, the high share of employment in public sector (estimated at 40% of total employment), unfavourable health outcomes and the very high share of private financing of healthcare (affecting vulnerable social groups), and a dangerously low fertility rate (in 2003, total fertility rate in Latvia was 1.29 compared with 1.52 in the EU-15).

Inflexible expenditures, those budget components that are either non-discretionary or not adjustable within the span of a few months, include the wage bill, interest payments, subsidies and transfers. Subsidies are mainly agriculture subsidies, and transfers are primarily to households (social protection) and grants for healthcare. As evident from Table V.29, the inflexible part of the budget is rather substantial although proportionally smaller than in the EU-15. While these obligations are to be expected, they limit the government's margin for manoeuvre in the event of exogenous shocks or a decision to fund new policies. The budget's non-discretionary portion is growing as a result of EU accession. Most importantly the portion of the capital expenditure covering counterpart funds for implementation of the EU-funds financed project can be considered as non-flexible expenditure. Furthermore, ever increasing participation of Latvia in various international organizations and projects claims a growing share of the budget (estimated at 1.2% of GDP in 2005). Unless action is taken to review sector policies in the direction of increased cost-effectiveness, pressures on the overall fiscal stance will be felt.

Two expenditure posts in particular stand out, namely, collective consumption expenditure and compensation of employees. The first could be curbed by rationalizing and restructuring the currently prolific system of state managed agencies (more than 200) and companies (mainly utilities). The wage bill can only be curbed by reducing the total number of public sector employees. The share of public sector employment in total employment is rather high: according to the Central Bureau of Statistics the public sector accounted for around 40% of the total employment. Nonetheless, high growth and the recent inflation hikes will intensify pressures to increase wages for public sector employees. Thus savings from reducing the number of employees might be outweighed by increases in wages. In this respect the current discussion among the Latvian authorities on future budget planning seems to favour restricting growth of expenditures on wages, goods and services, and transfers to below nominal GDP growth.

Table V.29. General government expenditure by national account categories in 2003 Latvia and EU-15

	% GDP		% of total expenditure	
	Latvia	**EU-15**	**Latvia**	**EU-15**
Collective consumption expenditure	11.0	8.3	29.7	17.3
Social transfers in kind	10.8	12.7	29.0	26.6
Final consumption expenditure of general government	21.8	21.0	58.7	44.0
Of which compensation of employees	11.1	11.0	29.8	23.0
Other current expenditure	0.8	2.1	2.0	4.3
Social benefits other than social transfers in kind	9.6	16.6	25.8	34.8
Subsidies	0.8	1.2	2.4	2.6
Interest	0.8	3.2	2.2	6.7
Gross fixed capital formation	1.5	2.4	4.0	5.1
Other capital expenditure, including capital transfers	1.9	1.3	5.1	2.6
Total expenditure, general government*	37.1	47.80	100.0	100.0
Inflexible expenditure**	22.3	32.0	62.4	67.0

Source: Eurostat.
*The definition of government expenditure differs from the harmonized definition used in Table V.28.
*Inflexible expenditure i.e. budget components that are either non-discretionary or not adjustable within the span of a few months, include the wage bill, interest payments, subsidies and social benefits other than transfers in kind.

13. Lithuania

Recent developments and medium-term prospects

The general government deficit increased from 1.9% of GDP in 2003 to 2.5% in 2004. The outturn was slightly better than the 2.7% of GDP target set in the budget for 2004. The main factor underlying the lower-than-projected deficit was a cautious forecasting of several categories of budgetary revenues by the authorities. As in recent years, revenues (excluding EU funds) were higher than expected, while expenditure related to co-financing of EU funds turned out lower than budgeted. These factors more than offset additional expenditure decided in June and December. A budgetary amendment allocated some 0.3% additional spending in June, while in December, when it was clear that the deficit target would be met very comfortably, the decision was taken to raise 2004 spending by some 0.7% of GDP. The lion's share of these expenditure adjustments were outlays related to compensations for lost savings and real estate restitutions. Despite the increase of the general government deficit, the debt ratio decreased slightly in 2004, thanks to strong growth and privatisation receipts, and remained relatively low at 19.7% of GDP.

Table V.30: Budgetary developments 2003-2007, Lithuania (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance		-1.9	-2.5	-2.4	-1.9	
- Total revenues		32.3	31.8	32.3	31.6	
Of which :	*- current taxes*	*19.9*	*19.0*	*18.5*	*18.1*	
	- social contributions	*8.7*	*8.4*	*8.6*	*8.5*	
- Total expenditure		34.2	34.3	34.8	33.6	
Of which :	*- collective consumption*	*7.6*	*7.3*	*7.3*	*7.0*	
	*- social transfers***	*20.0*	*19.6*	*19.5*	*18.8*	
	- interest expenditure	*1.3*	*1.0*	*0.9*	*0.9*	
	- gross fixed capital formation	*3.0*	*3.2*	*3.4*	*3.4*	
Primary balance		-0.6	-1.5	-1.5	-1.1	
Pm Tax burden		28.6	27.4	27.1	26.6	
Government debt		21.4	19.7	21.2	20.9	
Pm *Real GDP****		9.7	6.7	6.4	5.9	
Convergence programme****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance		-1.9	-2.5	-2.5	-1.8	-1.5
Primary balance		-0.6	-1.5	-1.4	-0.8	-0.5
Government debt		21.4	20.1	20.9	20.3	20.1
Pm *Real GDP****		9.7	6.5	6.5	6.2	6.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted on 14 January 2005.
Source: Commission services and convergence programme of Lithuania.

Table V.31. Main measures in the budget for 2005, Lithuania

Revenue measures	Expenditure measures
• Abolition of the turnover tax (-0.4% of GDP)	• Increase of subsidies to agriculture (0.6% of GDP) • Compensation for lost property and savings (0.4% of GDP) • Salary increases for public sector employees (0.2% of GDP)

Source: Commission services and January 2005 update of the convergence programme.

The budget for 2005 was approved by the Parliament on 9 November 2004. The budget did not contain significant tax changes, apart from the planned abolition of the turnover tax in July 2005, which has not been replaced so far through compensating measures. In addition to a substantial increase in public investment and the costs of the pension reform, several measures are foreseen to entail a significant additional spending in 2005 (e.g. increases of subsidies to agriculture, salary increases for public sector employees and payments related to the restitution of real estate assets and lost savings). Tax revenue growth, particularly that of corporate and personal income taxes, is expected to remain strong and, together with increasing EU transfers, broadly compensate for the expected increase of expenditure. The authorities' target for the general government deficit in 2005, as established in the January 2005 update of Lithuania's convergence programme, is 2.5% of GDP[192]. The target is in line with the Commission services' spring 2005 forecast.

The Commission services' spring 2005 forecast foresees the general government deficit to decrease to 1.9% of GDP in 2006. The forecast was derived on a no-policy change basis. The projected deficit is marginally higher than the 1.8% of GDP target set in the January 2005 update of Lithuania's convergence programme. The update foresees a further reduction of the deficit to 1.5% of GDP in 2007.

The debt ratio is expected to remain close to 21% of GDP in 2005 and 2006 according to the Commission services' spring 2005 forecast.

The compensation for lost savings and restitution of property rights

In the aftermath of independence, the government decided to restore real estate assets confiscated during the Soviet times. In 1991, a law regulating the procedure and conditions for restoration of property was published. An amendment to the law in 1996 established that liabilities related to residential houses should be fully paid by 2011. Restoration of property has been primarily made in actual or equivalent property, or by pecuniary compensations. The outstanding amount to be repaid in relation with the restitution of real estate assets was estimated at 1.7% of GDP in December 2004.

During the early years of transition, the Lithuanian economy endured a difficult process of hyperinflation, shortages of consumer goods and administrative restrictions in the form of freezing of saving deposits. Deposits denominated in roubles (and the surrogate currency talonas) depreciated rapidly during that period. Following the introduction of the litas in 1993, the government decided to compensate for the losses of savings held in state banks by Lithuanian citizens due to the sharp currency depreciations. Initially, there was no formal calendar for repayments. A first wave of compensations started in 1993 and, after some interruptions, saving restitutions continued under the 1997 Law on the Restoration of Savings of the Population. Privatisation receipts were used as the main source of financing for these liabilities. As of December 2004, the amounts of saving compensations pending to be paid were estimated at some 2.5% of GDP.

Compensations related to both real estate property confiscations and lost savings has so far taken place according to a schedule decided each year by the government, and the repaid amounts have typically differed from the budgeted amounts. In recent years, the government was flexible in the repayment of the savings and real estate liabilities in order to contain expenditure during cyclical downturns. This was particularly evident during the period following the 1998 Russian crisis, when the savings compensation and real estate restitution programmes were almost fully interrupted. In contrast, the government has recurrently repaid higher-than-budgeted amounts during the cyclical upswing of the last few years.

In Lithuania's first convergence programme submitted to the European Commission in May 2004, the government presented for the first time a medium-term plan for the payment of lost rouble savings and real estate assets for the period 2004-2007, increasing transparency about the medium-term budgetary plans.

The January 2005 update of the convergence programme foresees the amounts to be paid related to compensations for lost savings and restitution of property rights to account for 0.4% of GDP in 2005, 0.8% in 2006 and 1.2% in 2007.

Compensations for lost savings and confiscated real estate assets have been so far recorded in the

[192] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

government accounts as government expenditure in the year when they are paid, therefore increasing the general government deficit in the same year. The amounts yet to be paid are not included in the government debt at this moment. Classification changes in the future cannot be excluded, as there are ongoing discussions between Eurostat and Lithuania's statistical authorities on the recording of transactions related to the compensations. According to Eurostat news release of 18 March 2005[193], such classification changes could lead to a downward revision in the government deficit for 2004 and earlier years and a corresponding adjustment in the debt. It would also entail a revision of the budgetary and debt targets presented in the update of the convergence programme, as payments related to these liabilities are included in the budgetary targets (under the assumption that no other categories of expenditure would be increased to compensate for the statistical effect of removing these liabilities from the budgetary targets).

[193] Eurostat euro indicators news release 39/2004 – 18 March 2005 on "First notification of deficit and debt data for 2004".

14. Luxembourg

Recent developments and medium-term prospects

Following a sharp reduction in the general government surplus from a record 6.2% of GDP both in 2000 and 2001 to 0.5% of GDP in 2003, a deficit of 1.1% of GDP was recorded in 2004, according to the March 2005 reporting by the Luxembourg authorities. This is however better than the 1.8% of GDP deficit projected in the 2003 update of the stability programme and the 1.4% deficit estimated in the 2004 update : tax revenues significantly exceeded projections whereas, at the same time, investment expenditure figures had to be revised upwards in order to take into account some big projects based on a public-private partnership that previously had not been recorded in the government sector; as a result, public spending figures were pushed up by about half a percentage point of GDP.

Table V.32. Budgetary developments 2003-2007, Luxembourg (% of GDP)

Outturn and forecast*	**2003**	**2004**	**2005**	**2006**	
General government balance	0.5	-1.1	-1.5	-1.9	
- Total revenues	45.5	44.9	44.4	44.2	
Of which : - current taxes	29.3	28.9	28.7	28.7	
- social contributions	12.4	12.2	12.0	11.9	
- Total expenditure	45.1	46.0	46.0	46.0	
Of which : - collective consumption	7.3	7.2	7.1	7.1	
*- social transfers***	26.7	26.7	26.8	27.1	
- interest expenditure	0.3	0.2	0.2	0.2	
- gross fixed capital formation	4.9	5.0	5.1	5.1	
Primary balance	0.8	-0.9	-1.3	-1.7	
Pm Tax burden	41.3	40.9	40.5	40.4	
Government debt	7.1	7.5	7.8	7.9	
Pm Cyclically-adjusted balance	1.3	-0.3	-0.6	-0.6	
Pm Cyclically-adjusted primary balance	1.6	-0.1	-0.3	-0.5	
Pm *Real GDP****	2.9	4.2	3.8	4.0	
Stability programme****	**2003**	**2004**	**2005**	**2006**	**2007**
General government balance	0.8	-1.4	-1.0	-0.9	-1.0
Primary balance	1.0	-1.2	-0.9	-0.8	-0.9
Government debt	5.3	5.0	5.0	4.6	4.5
Pm *Real GDP****	2.9	4.4	3.8	3.3	4.3

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in November 2004.
Source: Commission services and stability programme of Luxembourg.

Table V.33. Main measures in the budget for 2005, Luxembourg

Revenue measures	Expenditure measures
• rise in the excise duty on diesel fuel (1 cent per litre) • increase from 12% to 15% of the VAT on car fuel and tobacco products. According to the budget, these measures should yield together about 0.2% of GDP. Moreover, it was decided in November to raise contributions for health care in kind from 5.1% to 5.4% of gross compensations, which should also yield about 0.2% of GDP.	• encouragement of alternative sources of energy (0.1% of GDP) • investments in railway infrastructure (0.1% of GDP) • it was also decided to reduce health expenditure by 0.1% of GDP (with respect to its "spontaneous" increase as previously projected). • Pensions of the private sector were raised by 2% in January 2005 in order to follow the rise in real wages, which should lead to a 0.2% of GDP increase in pension expenditure. Such adaptations occur every two years.

Source: Commission services and budget for 2005.

The final outcome for 2004 might well even be more favourable than the March reporting indicates since, according to data made available since then, the State (excluding the special Funds. See footnote 1) recorded a 0.3% of GDP surplus in 2004, while a 0.3% of GDP deficit had been initially projected in the budget. The debt ratio was also revised upwards for the same reason as government investment. It reached 7.5% of GDP in 2004 instead of 5.0% as indicated before (e.g. in the 2004 update of the stability programme), a slight increase with respect to 2003 (7.1% of GDP).

The 2005 budget was adopted by Parliament on December 9 2004. It foresees an increase of about 8% both in the revenues and the expenditure of the State.[194] According to the budget, the general government should record a 1.2% of GDP deficit in 2005, with the central government (including the State and the Special Funds) deficit reaching 3.0% of GDP, the social security surplus 1.8% of GDP and the finances of local authorities being broadly balanced. These projections are close to those presented in the 2004 update of the stability programme, submitted on November 30, 2004 [195], where the 2005 general government deficit was projected at 1.0% of GDP, a 0.4 percentage point of GDP improvement with respect to the 2004 deficit as estimated at that moment. According to the Commission services spring 2005 forecasts, based on the current policy stance, the general government deficit is expected to widen from 1.1% of GDP in 2004 to 1.5% in 2005. Reflecting the relatively strong growth in output and employment, government revenues would be buoyant (and even more than in the recent past), rising by about 6%, compared to 4% in 2003 and 5% in 2004. However, government spending, though decelerating (it rose by 9% in 2004), is still projected to increase by about 7%. The main difference between the projections of the stability programme and the Commission services forecasts is to be found in the evolution of the revenues ratio, which the programme projects to increase by 1.2 percentage point of GDP in 2005, while the Commission services forecast it to decrease slightly. In cyclically adjusted terms, the deficit should deteriorate by 0.3 percentage point of GDP in 2005, a broadly neutral budgetary policy stance after the 1.6 percentage point of GDP worsening recorded in 2004. However, due to the very specific features of the economy, estimates of cyclically adjusted balances in Luxembourg are surrounded by a very high degree of uncertainty.

For 2006 and 2007, the 2004 update of the stability programme does not present a detailed budgetary strategy but rather a technical projection, where the expenditure and revenue-to-GDP ratios are kept broadly constant. Consequently, the deficit is projected to fluctuate in a narrow margin around the 1.0% of GDP level forecast for 2005, decreasing to 0.9% of GDP in 2006 and coming back to 1.0% in 2007. For 2006 the Commission services Spring forecasts, based on a no policy change assumption, project the general government deficit to deteriorate from 1.5% of GDP in 2005 to 1.9%despite a 6% rise in revenues due to a rather fast increase in output and employment, while expenditure should rise by about 7% as in 2005. The deterioration in the government balance should thus occur despite a significant acceleration in revenues and a non-negligible slowdown in spending : for comparison, total government revenues rose by 4 to 5% a year from 2002 to 2004, while total government spending increased by more than 8% in 2003 and 2004. As a result of these widening deficits, the public debt is expected to rise to about 8% of GDP in 2006.

[194] It is difficult to estimate developments in central government spending from the budget because a large part of public investment in Luxembourg is not made by the State itself but by special Funds, financed by the State budget on a pluri-annual basis. Investments made by these Funds do not necessarily take place in the year the financing is provided and do not closely reflect developments in capital spending as presented in the budget.

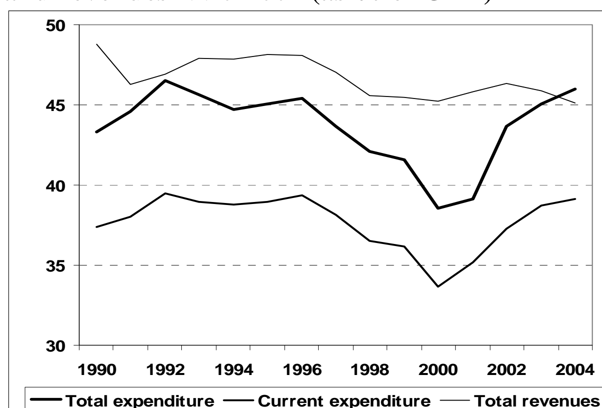
[195] The budget was adopted later, on December 9 but the projections presented in the stability programme are more recent than those of the budget since the draft budget was submitted to Parliament on October 20. The updated stability programme can be found at http://www.fi.etat.lu/6th_update_of_the_luxembourg_stability_and_growth_programme_2003_2007.pdf.

Government spending in a medium-term perspective

In recent years government finances experienced major changes in Luxembourg : the general government surplus, which had been fluctuating around 2 or 3% of GDP since the early 1990's, rose sharply at the end of the decennium, reaching 6.2% of GDP both in 2000 and 2001. As indicated above, it then declined abruptly and turned into a 1.1% of GDP deficit in 2004, a 7.3 percentage points of GDP deterioration in only 3 years. These sharp fluctuations were related to the extremely high volatility in GDP growth, which reached 9.0% in 2000 and then abruptly slowed down to 1.5% in 2001. However, as shown by chart 1, fluctuations in the government balance in recent years were much more caused by developments in expenditure than by changes in revenues, as the buoyancy in revenues induced by the record growth of the late 1990's was for a large part compensated by important tax cuts The biggest decline in the revenues ratio observed over the period occurred between 1996 and 2000, when the surplus was surging.

On the contrary, the expenditure ratio exhibited important fluctuations throughout the period, partly - but not exclusively - due to the volatility in real and nominal GDP growth : as shown by Graph V.7, government expenditure in Luxembourg has gone through three different phases since the beginning of the 1990's : from 1990 to 1996 the expenditure ratio fluctuated in a narrow margin around 45% of GDP, from 1996 to 2000 it fell by almost 7 percentage points of GDP and since 2000 it has been increasing again, coming back to similar levels as in the period 1990-1996. During the first phase, only social transfers, especially transfers in cash, rose significantly in relative terms, increasing by 2.4 percentage points of GDP from 1990 to 1996. During the same period, all other main categories of public expenditure hardly rose by more than 0.2 or 0.3 percentage point of GDP and even often declined in relative terms.

Graph V.7. General government expenditure and revenues 1990-2004 (as % of GDP)



Source: Commission services.

From 1996 to 2000, all categories of public spending sharply declined in relative terms, with the exception of the residual item "other current expenditure" Overall, general government expenditure fell by 6.9 percentage points of GDP in 4 years, of which 5.7 percentage points of GDP were accounted for by current expenditure. This sharp fall did not result from spending cuts since the rise in government spending was only slightly slower than during the previous years but from a "denominator effect": the main factor behind this strong fall in the expenditure ratio was the record real and nominal GDP growth of the late 1990's.[196]

The reverse happened from 2000 to 2004: in 4 years, general government total expenditure rose by 7.5 and current expenditure by 5.5 percentage points of GDP. The sudden slowdown in real and nominal GDP growth played a major role in this evolution. However, there was an additional factor: as shown in Table V.34, the rise in all categories of government expenditure, with the sole exceptions of the interest payments and the item "other current expenditure", accelerated with respect to the period 1996-2000. This acceleration was especially marked for social transfers (9.5% a year on average as against 6.6% for social transfers in kind and 8.6% instead of 6.4% for transfers other than in kind) and for capital expenditure (12.0% as against 5.5% for government investment and 21.2% instead of 4.9% for other capital expenditure).

It is often argued that the fast rise in public spending in Luxembourg in recent years is due to the very high and rapidly increasing investment by the government. This is only part of the explanation: capital expenditure explains 2.0 and current expenditure 5.5 out of the 7.5 percentage points of GDP increase in total government spending from 2000 to 2004. Over the same period, social transfers (both in kind and in cash) rose by 3.9 percentage points of GDP, which means that they contributed nearly twice as much as capital expenditure to the global increase in government spending. They also accounted for about three quarters of the rise in current government expenditure. The rise in unemployment (the Eurostat harmonised unemployment rate rose from 2.0% in the Spring of 2001 to 4.4% in the latest months) resulting from the economic slowdown played a role in this increase in social transfers but this role was limited as total government expenditure related to unemployment only rose from 1.0% of GDP in 2000 to 1.2%in 2004.

[196] The annual growth rates in real GDP recorded from 1997 to 2000 ranged from 6.9% in 1998 to 9.0% in 2000 and the rate of increase in nominal GDP varied from 9.8% in 1998 to 13.6% in 2000.

Table V.34. Main categories of government expenditure 1990-2004, Luxembourg

	levels (% of GDP)			differences (% of GDP)		average annual growth rates	
	1996	**2000**	**2004**	**1996-2000**	**2004-2000**	**1996-2000**	**2004-2000**
1. Total government consumption (1) = (2) + (3)	18.9	15.7	18.2	- 3.2	+ 2.5	6.2	8.6
1a. of which : compensation of employees	*9.7*	*7.8*	*8.6*	*- 1.9*	*+ 0.8*	*5.4*	*7.4*
2. Collective consumption	8.0	6.5	7.2	- 1.5	+ 0.7	5.7	7.4
3. Social transfers in kind	10.9	9.2	11.0	- 1.7	+ 1.8	6.6	9.5
4. Social transfers other than in kind	16.2	13.6	15.7	- 2.6	+ 2.1	6.4	8.6
5. Total social transfers (5) = (3) + (4)	**27.1**	**22.8**	**26.7**	**- 4.3**	**+ 3.9**	**6.5**	**9.0**
6. Interest payments	0.5	0.3	0.2	- 0.2	- 0.1	0.8	-3.3
7. Subsidies	2.0	1.6	1.7	- 0.5	+ 0.1	4.1	6.7
8. Other current expenditure	1.8	2.4	3.3	+ 0.7	+ 0.8	20.6	12.7
9. Current expenditure (9) = (1) + (4) + (6) + (7) + (8)	**39.4**	**33.7**	**39.1**	**- 5.7**	**+ 5.5**	**6.9**	**8.8**
10. Gross fixed capital formation	4.7	3.8	5.0	- 0.9	+ 1.2	5.5	12.0
11. Other capital expenditure (including capital transfers)	1.3	1.0	1.9	- 0.3	+ 0.8	4.9	21.2
12. Capital expenditure (12) = (10) + (11)	**6.0**	**4.9**	**6.9**	**- 1.2**	**+ 2.0**	**5.4**	**14.2**
13. Total expenditure (13) = (9) + (12)	**45.4**	**38.5**	**46.0**	**- 6.9**	**+ 7.5**	**6.7**	**9.5**
p.m. : real GDP	-	-	-	-	-	*8.0*	*2.8*
p.m. : nominal GDP	-	-	-	-	-	*11.2*	*4.8*

Source : Commission services.

A much more important factor was some discretionary measures taken in the early years of the century, like the creation of the dependency insurance[197] or the major rise in pensions decided in 2002 and known as the "Rentendësch" (altogether with a large increase in family allowances), which, according to some estimates, increased pensions expenditure by about 10%.

The situation of Luxembourg public finance is certainly not bad: public debt remains extremely low despite its recent upwards revision and assets held by the general government amount to about 50% of GDP, according to most estimates. However, the experience of recent years shows that a sharp deterioration of the government balance can occur quite rapidly in period of slower growth (and despite the fact that, during the recent slowdown, growth has remained significantly more robust in Luxembourg than in neighbouring countries). This pleads for some restraint in spending in the years to come, in order to ensure that government expenditure remains in line with revenues and that sufficient security margins may be kept to cope with a possible slowdown in growth in the medium term and with the burden that the ageing population will inevitably impose on public finance.

[197] It was created in 1998 but only progressively resulted in large outlays.

15. Hungary

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the deficit was reduced by 1.7 percentage point of GDP in 2004, reaching 4.5% of GDP. This is worse than the 3.6% of GDP deficit target of the May 2004 convergence programme. It should be noted that the 2004 deficit is significantly affected by an adjustment in the recording of VAT revenue, increasing the 2003 deficit by 0.7 percentage point of GDP while reducing the 2004 deficit accordingly, which may be subject to further revision. The debt-to-GDP ratio increased from 56.9% of GDP to 57.6% of GDP.

Table V.35. Budgetary developments 2003-2008, Hungary (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**		
General government balance**		-6.2	-4.5	-3.9	-4.1		
- Total revenues**		44.5	47.5	44.0	43.2		
Of which :	*- current taxes*	*25.5*	*26.0*	*25.2*	*25.5*		
	*- social contributions***	*135*	*13.6*	*13.6*	*13.4*		
- Total expenditure		50.7	52.0	47.9	47.3		
Of which :	*- collective consumption*	*10.8*	*10.6*	*10.2*	*10.0*		
	*- social transfers****	*27.5*	*27.3*	*26.7*	*26.5*		
	- interest expenditure	*4.2*	*4.3*	*3.8*	*3.4*		
	- gross fixed capital formation	*3.4*	*3.5*	*2.3*	*3.1*		
Primary balance**		-2.2	-0.2	0.0	-0.7		
Government debt**		56.9	57.6	57.8	57.9		
Pm	*Real GDP***	3.0	4.0	3.9	3.8		
Convergence programme*****		**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance**		-5.5	-4.4	-3.6	-2.9	-2.2	-1.6
Primary balance**		-1.6	0.4	0.0	0.2	0.6	1.0
Government debt**		57.0	56.7	55.5	53.0	50.6	48.3
Pm	*Real GDP***	3.0	3.9	4.0	4.2	4.3	4.6

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

** In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second pillar pension funds, these funds can be classified inside the general government sector until the March 2007 EDP notification. The figures indicated in this table take into account the decision by the Hungarian authorities to avail themselves of this possibility. The official general government deficit figures and targets have therefore been reduced by the estimated impact of the pension reform (as notified in March 2005) compared to the figures provided in the May convergence programme. According to the March 2005 EDP notification, the budgetary effect for Hungary was of 0.9% of GDP in 2003 and 2004 and on the debt of 2.2% of GDP in 2003 and 3.1% of GDP. According to the Hungarian national sources, the effect in 2005 and 2006 is expected to be of 1.1% of GDP in 2005 and 1.2% of GDP p.a. for the period until 2008.

*** In kind and other than in kind.

**** Annual % change.

***** Submitted in December 2004; the figures indicated as coming from the convergence programme have been adjusted by the change in the pension reform burden as notified in March 2005.

Source: Commission services and convergence programme of Hungary.

Table V.36. Main measures in the budget for 2005, Hungary

Revenue measures	Expenditure measures
• Changes in the tax and contribution system, mainly in the personal income tax system and in some smaller tax categories (impact on tax revenues: -0.35% of GDP); two thirds of the impact due to one-off effects (such as the vanishing of customs revenues after EU-accession and the non-ajdustment of some excise taxes) • Revenues from the extension of expiring GSM licences	• decrease in public investment expenditures (1.7% of GDP) • expected decline in interest expenditures (0.5% of GDP) • a number of institutional changes to better control operational expenditure and the public sector wage bill • the freeze of the level of unused appropriations at their end-2004 level • increase in "emergency" reserve (from 0.5 to 0.8 percentage point of GDP) against a possible departure from the 2005 target

Source: Commission services.

The 2005 budget was adopted by parliament on 20 December 2004, targeting a deficit of 3.6 % of GDP. The expenditure reduction would be mainly based on a 0.5 percentage point decline in the interest burden and a 1.7 percentage point reduction of public investment expenditure (which would be largely compensated by an increased recourse to PPP projects).

In the light of the existing risks, notably a repeated shortfall in VAT revenues as in 2004 and the uncertain budgetary impact of the intended PPP projects, the Commission services spring 2005 forecast projects an outcome of 3.9 % of GDP. This takes already into account the 0.3 percentage point of GDP increase in the "emergency" reserve against a possible missing of the 2005 target contained in the budget, and some limited additional revenues, which are expected to result from the measures announced by the Hungarian government in March 2005.

The Commission services spring forecast projects the deficit to rise to 4.1% of GDP in 2006, compared to a target of 2.9% in the December 2004 update of the convergence programme[198]. The difference is due to the usual no-policy change assumption underlying the Commission services forecast. In particular, the increase in public investment projected in the update is not assumed to be compensated as the expenditure-saving effects of the measures contained in the 2005 budget were not backed by sufficient reforms. The convergence programme update plans a further deficit reduction in 2007 and 2008, to 2.2% and 1.6% of GDP respectively (figures including the pension reform burden would be 3.4% and 2.8% of GDP).

The Commission services spring forecast projects the debt ratio to broadly stabilise in 2005-06, at around 58% of GDP, rather than slightly decline, as targeted in the updated convergence programme, which is explained by the higher deficit forecasts in the spring forecast.

[198] Taking into account the revised pension reform burden as explained in the second comment in Table V.35.

16. Malta

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit for 2004 attained 5.2% of GDP. This is half the 2003 outcome (10.5% of GDP) and consistent with the deficit target set out in both the May 2004 convergence programme and the updated version submitted on 7 December 2004. Part of the deficit reduction in 2004 (3.2 percentage points of GDP) reflects a one-off operation related to the restructuring of the shipyards in 2003. Another part is the result of the fiscal consolidation measures undertaken in the budget (around 1.5 percentage points of GDP). The rest is due to higher tax collection brought about by stronger economic growth. The debt ratio in 2004 increased to 75% of GDP, which is above the 72.1% estimated in the convergence programme. The difference is explained by the upward revision of the 2003 general government deficit.

Table V.37. Budgetary developments 2003-2007, Malta (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance		-10.5	-5.2	-3.9	-2.8	
- Total revenues		40.5	49.0	48.8	48.6	
Of which :	*- current taxes*	*25.6*	*27.2*	*29.4*	*29.3*	
	- social contributions	*8.3*	*8.3*	*8.6*	*8.7*	
- Total expenditure		50.9	54.1	52.6	51.4	
Of which :	*- collective consumption*	*10.1*	*10.2*	*10.1*	*10.0*	
	*- social transfers***	*24.4*	*24.5*	*24.3*	*23.5*	
	- interest expenditure	*3.8*	*4.1*	*4.3*	*4.3*	
	- gross fixed capital formation	*5.3*	*4.3*	*3.9*	*3.7*	
Primary balance		-6.7	-1.1	0.5	1.5	
Pm Tax burden		32.5	35.7	38.1	37.8	
Government debt		71.8	75.0	76.4	77.1	
Pm *Real GDP****		*-1.8*	*1.5*	*1.7*	*1.9*	
Convergence programme****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance		-9.7	-5.2	-3.7	-2.3	-1.4
Primary balance		-6.0	-1.4	0.3	1.6	2.4
Government debt		72.0	73.2	72.0	70.5	70.4
Pm *Real GDP****		*-1.7*	*0.6*	*1.5*	*1.8*	*2.2*

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and convergence programme of Malta.

Table V.38. Main measures in the budget for 2005, Malta

Revenue measures	Expenditure measures
• Inherited real estate within a specified period will be able to adjust the declared value in order to reflect the change in the value of the real state up to 25 November 2003; • Broadening of items subject to eco-contribution; • Introduction of excise duty and VAT on kerosene; • Doubling of passenger departure tax payable on outgoing air fares; • Introduction of excise duty on mobile telephony; • Strengthening the fight against tax and benefit fraud.	• Restructuring of public entities; • Sale of Government property in 2005; • Limiting public sector hiring and reducing administrative costs.

Source: Commission services and updated convergence programme Malta.

The Maltese Parliament approved the 2005 budget in December 2004. The budget seems consistent with the commitments spelled out in the convergence programme to cut the budget deficit to below 4% of GDP in 2005. The Commission services' spring 2005 forecast projects the deficit to fall to 3.9% of GDP in 2005, compared to a target of 3.7%. The deficit reduction is reached through revenue-enhancing measures and expenditure restraint. Only part of the revenue-enhancing measures are permanent (adjustments in taxes and strengthening of the fight against tax and benefit fraud) whilst others are one-offs (other minor receipts). On the revenue side, the measures announced in the budget are projected to lower the deficit ratio for 2005 by 1.5 percentage points of GDP. Expenditure cutbacks are expected from the restructuring of public entities, limiting public sector hiring and reducing administrative costs. The revenue and expenditure ratios are foreseen to decline by 0.8 and 1.5 percentage points of GDP, respectively. As a result, the primary balance is expected to turn positive to 0.5% of GDP, from a negative 1.1% of GDP in 2004. The major revenue sources are current taxes, which are projected to grow by 2.2 percentage points of GDP, and social security contributions fuelled by gradually increasing job creation, which increase by 0.3 percentage points of GDP. However, the rise in taxes and social security receipts are more than offset by the fall in other current resources. On the expenditure side, while both social transfers and collective consumption marginally decline, gross fixed capital formation drops by 0.4% of GDP, as project implementation linked to the Italian Protocol[199] comes to an end. The bulk of the expenditure reduction come from other current and capital expenditures.

For 2006, based on a no-policy change assumption, the Commission services spring 2005 forecast projects a further decrease in the general government deficit to 2.8% of GDP. This is above the deficit target of 2.3% of GDP presented in the update of the convergence programme. For 2007 the updated convergence programme targets a further fall in the deficit to 1.4% of GDP.

The spring 2005 forecast projects the general government debt level for 2005 to increase to 76.4% of GDP, with a further increase to 77.1% by 2006. These projections do not take into account possible stock-flow adjustments produced by some privatization operations foreseen by the government.

The reform of the pension system

In November 2004, the Maltese government presented as a White Paper the report prepared by the Pensions Working Group. The government aims at launching a process of discussion and consultations among the social partners leading to the reform of the Maltese pension system.

The White Paper identifies three crucial issues that concurrently threaten the future viability of the current system: i) demographic developments; ii) inefficiencies in the Maltese labour market, and iii)the financial constraints caused by the inadequacy and lack of sustainability of the existing scheme. The Paper recommends the change of the current PAYG scheme to a three pillar system. The main principle is that health funding should be separated from social security funding. The retirement age is gradually increased to 65 years of age for both men and women.

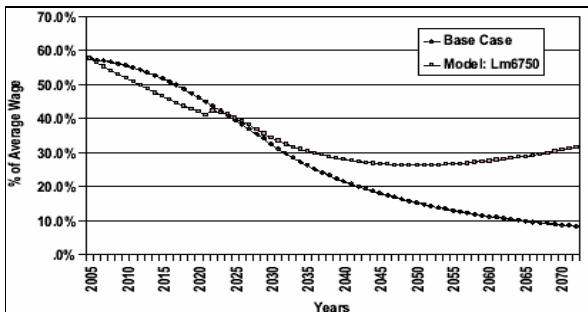
The first pillar should be mandatory and guarantee a minimum pension as a safety-net against poverty for those individuals with short careers or very low earnings during their working lives. Recipients of the first pillar pension would have their retirement pension indexed to the Retail Price index. The contribution period should be increased from 30 to 40 years, while the baseline for the calculation of the pension should be changed from the best consecutive three years from the last ten years to the average of the 40 year contributions accumulation history. The Second Pillar should also be mandatory but introduced in a gradual manner, first on a voluntary basis as from January 2006, to become fully mandatory

[199] Co-operation agreement between Malta and Italy to finance works in Malta on a grant basis.

by 2010, subject to an assessment to determine whether the prevailing conditions at that time require such step. The second pillar should be devoted to supplement pension benefits received. The third pillar should also provide for voluntary individual retirement provisions and should be introduced as from January 2006. The annual contribution to this pillar up to a capped value should not be taxed, while income tax on the basis of the individual's rate of PAYE (pay as you earn) will be paid upon maturity of the investment.

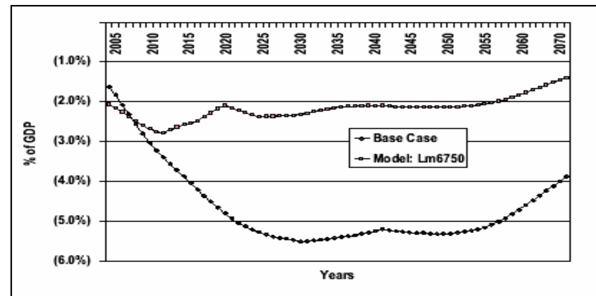
The demographic and economic projections modelled by the World Bank compare a baseline scenario of no change and a model scenario with the introduction of the proposed changes. The baseline case shows a social security deficit deterioration within a relatively short period of time, while in the model scenario this deficit increases steeply in the first 10 years, but less than in the base case, due to the transfer of First Pillar contributions to the health fund. However, under the proposed reform the social security deficit will decrease from 3% of GDP to 2% of GDP by 2025.

Graph V.8. Sustainability



Source: World Bank, October 2004.

Graph V.9. Adequacy



Source: World Bank, October 2004.

The implementation of the reform should also notably smooth the deterioration of the benefits as a percentage of the average wage, stabilizing at 30% of average wage by 2023 to gradually improve to 40% of average wage.

The White Paper draws a gradual and long term scenario for the implementation of the reform of the pension system in order to make the transition to the new system easier and to smooth the impact on individuals, employers and the economy as a whole. It is noted that the reform must be managed in an gradual manner with structured periodic reviews to allow for the adoption of parametrical changes as and when appropriate. It is also pertinent to mention that the well developed financial sector in Malta paves the way for the risk diversification of pension assets generated for a funded pillar and, at the same time, contributes to the expansion of the domestic financial market. The first measures to implement the reform of the Maltese pension system are expected in the forthcoming months.

17. Netherlands

Recent developments and medium-term prospects

According to the March 2005 EDP notification, the general government deficit fell to 2.5% of GDP in 2004. This is a slightly higher deficit than the 2.3% of GDP foreseen in the October 2003 update of the stability programme. The composition of the deficit in 2004 was different from what was anticipated in the 2004 budget. Tax revenues were weaker, even though they recovered sharply towards the end of 2004, but receipts from the sale of natural gas were higher in the wake of rising oil and gas prices.

Table V.39. Budgetary developments 2003-2007, Netherlands (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance		-3.2	-2.3	-2.0	-1.6	
- Total revenues		45.8	45.5	45.8	47.6	
Of which :	*- current taxes*	*23.9*	*24.1*	*24.5*	*24.5*	
	- social contributions	15.5	15.1	15.0	16.9	
- Total expenditure		48.9	48.0	47.9	49.2	
Of which :	*- collective consumption*	*11.4*	*11.4*	*11.4*	*11.4*	
	*- social transfers***	*26.2*	*25.8*	*25.8*	*27.6*	
	- interest expenditure	*2.9*	*2.9*	*2.8*	*2.8*	
	- gross fixed capital formation	*3.6*	*3.6*	*3.5*	*3.4*	
Primary balance		-0.3	0.4	0.8	1.2	
Pm Tax burden		39.3	39.6	39.8	41.7	
Government debt		54.3	55.7	57.6	57.9	
Pm Cyclically-adjusted balance		-2.6	-1.7	-1.0	-0.8	
Pm Cyclically-adjusted primary balance		0.3	1.1	1.9	2.0	
*Pm Real GDP****		367.1	372.0	375.6	383.0	
Stability programme******		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance		-3.2	-3.0	-2.6	-2.1	-1.9
Primary balance		-0.3	-0.1	0.3	0.7	0.8
Government debt		54.1	56.3	58.1	58.6	58.3
*Pm Real GDP****		-0.9	1.25	1.5	2.5	2.5

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in November 2004.
Source: Commission services and stability programme of the Netherlands.

Table V.40. Main measures in the budget for 2005, the Netherlands

Revenue measures (increases by 0.2% of GDP)	Expenditure measures (savings of 0.3% of GDP)
• Increase in the tax rate for the two lowest brackets of income tax • Higher disability insurance premia • Increases in public health insurance premia • New obligation to pay corporate taxes for two independent public sector agencies	• Reduction in unemployment benefits • Wage freeze for civil servants • Introduction of own risk in public health insurance • Phasing out of subsidies on low-paid labour • Reductions in expenditure of ministries

Source: Commission services, 2005 budget.

Some expenditure overruns were largely offset by non-recurrent lower public infrastructure investment and lower payments to the EU. The debt ratio increased by 1.4 percentage point of GDP, to 55.7% at the end of 2004.

The budget for 2005 was presented to Parliament on 21 September 2004, and adopted shortly afterwards with some modifications that did not have an appreciable impact on the main budgetary aggregates. The 2005 budget contains substantial increases in the tax burden and expenditure cuts, aimed at further reducing the deficit (see table for a more detailed overview of the main measures). The 2005 budget targets a general government deficit of 2.6% of GDP in 2005. However, the March 2005 EDP reporting expects a lower deficit of 2.1% of GDP[200]. The Commission services' spring 2005 forecast also projects a lower deficit of 2.0% of GDP, mainly on account of the more favourable starting position in 2004, higher receipts from the sale of natural gas, and tax receipts picking up due to the gradual cyclical upturn.

According to the Commission services' spring forecast the fiscal stance as measured by the change in the cyclically adjusted balance will tighten markedly. The cyclically adjusted deficit is expected to fall from 1.2% of GDP in 2004 to 0.4% of GDP in 2005, in response to fiscal tightening. The improvement in the underlying budgetary position between 2004 and 2005 is stronger than was calculated using the data in the 2004 stability programme update. On the basis of the latter, the cyclically adjusted deficit would fall from 1.6% of GDP in 2004 to 1.2% of GDP this year, in view of a higher projected nominal deficit than in the Commission services' spring 2005 forecast, and a somewhat different profile for the determinants of potential growth.

Public finances are expected to further improve in 2006. This reflects the forecast economic upturn, as the fiscal stance will be broadly neutral under the no policy change assumption. The Commission services' spring forecast projects a deficit of 1.6% of GDP in 2006, which is lower than the target of 2.1% of GDP set in the November 2004 update of the stability programme. This is mainly due to the differences in the starting point of the projections [201]. The stability programme update projects the general government balance to marginally further improve in 2007, to 1.9% of GDP.

According to the spring 2005 forecast, the debt ratio will rise further in 2005 and 2006, to 57.6% and 57.9% of GDP respectively. This is due to the still significant nominal deficit, fairly weak nominal GDP growth, and, in 2005, to the purchase of gas transport infrastructure equivalent to 0.6% of GDP, an operation which is not reflected in the deficit.

Erosion of the income tax base

The Dutch tax system allows for the deduction or exemption of certain items from taxable income. The tax reform of 2001 considerably reduced the number of exemptions, which was compensated by lowering the social security contribution and income tax rates. However, the two most important tax-deductible or tax-exempt items which were in place already before the 2001 tax reform still remain in place. They are 1) pension premia paid into the private pension system (tax exemption applies to both employers and employees for their respective payments, up to a certain limit, but pensions paid are taxed on retirement) and 2) payments of mortgage interest for the first house owned and occupied by the tax-payers (without an upper limit). Since the early 1990s, the combined value of tax-deductible and tax-exempt items in household income has been on an upward trend. This has led to a considerable narrowing of the tax base, as summarised in Table V.41.[202] In 2003, the estimated total loss in revenue on account of these two items amounted to more than 4% of GDP, with the tax-exemption of pension premia accounting for the largest share. To put the figures in the table in perspective: in 1991 the estimated revenue loss was equivalent to slightly over 11 % of total receipts from taxes on income from employment and social security premia.

200 http://www.minfin.nl/default.asp?CMS_ITEM=MFCWDEF1AE0ADB8604FACA9E090D8745D48C1X2X59419X91

201 The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

202 Note that the table shows *net* deductions of mortgage interest. This means that the (taxed) imputed income from owner-occupied housing, which is higher than in most EU Member States and which to some extent offsets the tax-deductibility of mortgage interest, has been deducted.

Table V.41. Deductions of mortgage interest and exemption of pension premia (% of GDP)

	1991-1996	1997-2001	2002	2003	2004
deduction of mortgage interest	2.2	3.2	3.5	3.7	3.8
deduction of pension premia	6.9	6.9	6.8	7.3	n.a.
estimated loss in revenue					
due to mortgage interest	*0.8*	*1.1*	*1.2*	*1.3*	*1.3*
due to deduction of pension premia	*2.7*	*2.8*	*2.7*	*2.9*	*n.a.*
Total estimated loss in revenue	3.6	3.9	4.0	4.2	n.a.
yearly loss in revenue due to narrowing of the base	0.2	0.3	0.3	0.3	n.a.

Source: CPB, CBS, Ministry of Finance, own estimates. Figures may not add up due to rounding.
Note: due to the denominator effect, cumulated yearly losses in revenue do not add up to the change in the total.

By 1996, this share had increased to 16.5% and by 2003, it had reached 19.1%. Hence, that the fiscal treatment of private pension premia and mortgage interest in the Netherlands has led to a significant narrowing of the income tax base. That said, there is a clear ratio for the tax exemption of pension premia: since pension payments are taxed this adds to the stability of tax revenue in an ageing society.

The amount of tax-exempt private pension premia paid has been influenced by events in global financial markets. The fall in financial asset prices depleted the financial buffers of private pension funds managing mandatory pension savings in the so-called second pillar of the pension system (the public pension system is the first pillar, the third pillar consists of non-obligatory pension savings made by individuals, which, up to a certain threshold, may also be tax-exempt if the people concerned can prove that they lack a full pension build-up under the other two pillars). The value of assets managed by pension funds fell from 114.2% of GDP in 2001 to 98.7% of GDP in 2003. This made it necessary for pension funds to raise their premia, translating into further shortfalls in income tax receipts. In addition, the fall in financial buffers affected public finances in a more direct way. Net pension premia paid by the government to the public sector pension fund (ABP) increased from 0.5% of GDP in 2001 to 0.7% of GDP in 2003. However, the effect of restoring financial buffers should be temporary and contribution rates might decrease again as financial markets recover.

Tax-deductible mortgage interest payments have grown particularly rapidly since the mid-1990s, in line with rising house prices, falling interest rates and the consequent ongoing rapid growth of mortgage credit to households. Another important upward impact has been the spread of mortgage products where no amortisation is paid during the period of the loan, but only interest. These mortgage forms have become increasingly popular since the mid-1990s, and were developed by banks in order to let tax payers benefit as much as possible from the tax deduction. In 2003 the total mortgage debt of Dutch households reached around 86% of GDP. As an illustration: the tax deductions due to net mortgage interest (after allowing for the taxes levied on imputed income from house ownership) in that year amounted to 1.3% of GDP, and can be viewed as a kind of implicit interest paid by the government on behalf of house owners with a mortgage debt. Especially middle and higher income groups benefit from the deductibility of mortgage interest, as there is no upper limit to the amount that can be deducted and as marginal rates are highest in the higher tax brackets.

The upward trend in the deduction of mortgage interest has been mitigated, but not halted, by several government measures taken since the late 1990s to limit deductibility. Under the new, more stringent, rules a mortgage on a second house is no longer deductible. Furthermore, tax payers now have to prove that the mortgage is indeed used for the purchase and/or improvement of an own house, while capital gains on selling a house have to be deducted from the amount that can be financed with a tax-favoured mortgage. The high mortgage debt of Dutch households has raised concerns on their financial position, should interest rates rise in the future. However, since most Dutch households still finance their mortgages against fixed long-term interest rates the impact of higher interest rates would be spread over time and relatively limited.

The progressive ageing of Dutch society in the next few decades will put increasing pressure on the sustainability of public finances. With ageing the ratio of economically active to inactive persons will worsen considerably. Under current arrangements, no pension contributions for the first (public) pillar of the pension system (equivalent to an earmarked income tax) are levied on the income of those who are 65 years or older. In other words, the marginal tax rate that people over 65 have to pay in the first bracket of income is relatively low, not only on their pension income, but also on other sources of income. This will be a substantial financing burden for the public part of the pension system as ageing progresses. This risks putting upward pressure on the tax rates charged to the population in the working age (as a possible shortfall in first pillar pension premia has to be supplemented from general resources), which could be detrimental to labour supply and economic activity. Admittedly, though, the situation in the Netherlands in this respect may be considered as more favourable than in some other Member States where demographic trends are more adverse. Moreover, the

Dutch pension system does not depend only on the public (first) pillar, the so-called AOW, which is financed on a pay-as-you-go basis. There also exist substantial second- and third pillar funded pension schemes with sizable financial assets built up over the last decades. Furthermore, pension income from the second and third (private and funded) pillars of the pension system is taxed just like other sources of income. Marginal and average rates paid by those over 65 will be lower, since they do not have to pay AOW-contributions. Hence, the sharp rise in the number of pensioners will also lead to the delayed taxation of the pension premia deducted over the working lives of the people receiving them.

Several policies can be pursued to ensure the sustainability of public finances. Among them are measures to increase labour participation, and enhance productivity growth. As regards fiscal policy, the achievement and maintenance of a sound fiscal position and lowering the public debt are very important. Broadening the tax base (or avoiding a further erosion) helps achieve this aim.

In this respect, stemming the marked increase in tax-deductible mortgage interest payments – or even reversing it – may be a promising avenue to explore. This may mean abolishing entirely the tax-deductibility of mortgage interest payments, or, alternatively, limiting the maximal deductible amount. This can be defended on the grounds that the tax exemption for mortgage interest payments is inefficient, and arguably leads to the diversion of capital from more productive uses. In any case, it may be advisable to opt for a gradual transition, in order to dampen large negative shocks to disposable income for many households, and to avoid disruption in the housing market. The latter may have serious macro-economic consequences in view of sharp rises in house prices in recent years and the associated increase in the ratio of mortgage debt to disposable income of Dutch households. This suggests that private consumption and economic activity in the Netherlands has become increasingly sensitive to changes in net household wealth.

As regards pensions, one may consider limiting the tax-deductibility of private pension premia. However, on closer inspection this may not be advisable. As said above, the present system for the treatment of pension savings has more desirable properties than the tax deductions of mortgage interest. Since the premia paid are not taxed, but future pension income from the second and third pillar is, albeit at a lower average rate, the mechanism helps to spread tax revenue over time, thus mitigating the adverse effect of ageing on Dutch public finances. Nevertheless, under current arrangements there remains a negative impact of the narrowing of the tax base on sustainability, due to the future rise in public expenditure on first-pillar pensions. This may be partly compensated by levying AOW-contributions (used to finance the first, public pillar of the pension system) on sources of income of people over 65 years of age other than their public pension. The ensuing broadening of the tax base would allow to lower marginal tax rates in the lowest brackets of income tax. Such a reduction of the marginal tax wedge could be positive for labour participation, and will also help limit the impact on the purchasing power of elderly people who have a relatively low pension income. Again, it seems advisable to phase this gradually in over an extended transition period, allowing future pensioners to build up additional pension rights and thus mitigate negative income effects.

18. Austria

Recent developments and medium-term prospects

The 2003 update of the stability programme targeted a general government deficit of 0.7% of GDP for 2004.

Table V.42. Budgetary developments 2003-2008, Austria (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**		
General government balance		-1.1	-1.3	-2.0	-1.7		
- Total revenues		50.0	49.4	48.1	47.4		
Of which :	*- current taxes*	28.3	28.0	26.9	26.4		
	- social contributions	16.5	16.4	16.4	16.3		
- Total expenditure		51.2	50.7	50.1	49.2		
Of which :	*- collective consumption*	7.2	7.0	6.9	6.8		
	*- social transfers***	29.9	29.9	29.7	29.4		
	- interest expenditure	3.1	3.0	2.9	2.8		
	- gross fixed capital formation	1.2	1.2	1.2	1.1		
Primary balance		2.0	1.7	0.9	1.1		
Pm	Tax burden	43.5	43.2	42.1	41.6		
Government debt		65.4	65.2	64.4	64.1		
Pm	Cyclically-adjusted balance	-0.8	-1.1	-1.9	-1.6		
Pm	Cyclically-adjusted primary balance	2.3	1.9	1.1	1.2		
Pm	*Real GDP****	0.8	2.0	2.1	2.1		
Stability programme******		**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance		-1.1	-1.3	-1.9	-1.7	-0.8	0.0
Primary balance		-2.1	1.9	1.2	1.3	2.2	2.9
Government debt		64.5	64.2	63.6	63.1	61.6	59.1
Pm	*Real GDP****	0..8	1.9	2.5	2.5	2.2	2.4

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in November 2004.
Source: Commission services and stability programme of Austria.

It was missed by a considerable margin as the 2004 general government deficit turned out to be 1.3%[203] of GDP in spite of the fact that the update had already taken into account the carrying-forward of parts of the 2005 tax reform.

[203] According to the data received from the Austrian statistical office after the publication of the Commission services' spring 2005 forecast, the 2004 deficit was slightly lower due to unexpectedly high VAT receipts in February 2005 attributed still to the year 2004.

Table V.43. Main measures in the budget for 2005, Austria

Revenue measures	Expenditure measures
• The 2004/2005 tax reform (-0.8% of GDP). The reform's second stage in force since 1 January 2005 foresees: The personal income tax schedule is reduced to four brackets, including a zero tax bracket up to an income of 10,000 euro; The corporate tax rate is reduced from 34% to 25%; In addition, tax rules for holdings (domestic and foreign) are simplified. • Health care reform (0.1% of GDP); increase in the contribution rate and increase in the tobacco tax	• Savings in expenditure due to administrative reforms in the health care system (0.1% of GDP)

Source: Commission services and Ministry of Finance.

The deviation by 0.6 percentage point cannot be attributed to negative surprises in GDP growth. Part of it can be explained by the fact that the profit of the central bank turned out 0.1% of GDP lower than in the budgetary plans. However, the slippage mainly stems from the expenditure side. A major factor for this was the additional investment premium *(Investitionszuwachsprämie)*. This fiscal benefit was taken up by businesses to a much larger extent than expected by the authorities, resulting in additional expenditure of about ¼% of GDP. In addition, expenditure targets were missed across all levels of government. At 65.2% of GDP, the public debt ratio was 0.2 percentage point lower in 2004 than in the previous year.[204]

The budget for 2005 was adopted on 17 November 2004. The main measure consists in the implementation of the second stage of the tax reform 2004/2005. According to the 2004 update of the stability programme, the general government deficit will amount to 1.9% of GDP in 2005. This is in line with the Commission services' spring 2005 forecast. In the same forecast the Commission services upheld their last autumn's prediction that the cyclically-adjusted general government deficit would amount to 1.9% of GDP in 2005 (up from an estimated 1.1% of GDP in 2004).

Assuming no change in policy, the Commission services spring forecast sees the general government deficit falling by ¼ percentage point to 1.7% of GDP in 2006. This is in line with the target presented in the update of the stability programme submitted by the Austrian authorities on 30 November 2004[205]. The update also foresees the deficit at 0.8% of GDP in 2007 and a balanced budget in 2008. However, it does not specify how this consolidation is supposed to be achieved.

According to the Commission services' spring 2005 forecast, the debt-to-GDP ratio will fall to 64.4% and 64.1% of GDP in 2005 and 2006 respectively.

The National Stability Pact

The three layers of government in Austria coordinate their medium-term budgetary plans in the Revenue Sharing Act (*Finanzausgleich*), usually for a period of four years, which allocates the revenues to territorial authorities. The 1999 national stability pact (NSP) set up an enforcement mechanism on how the general government deficit was to be allocated to the different levels of government. A more detailed NSP was passed for the period 2001-2004, temporarily suspending the 1999 NSP.

This 2001 NSP foresaw a consolidation path leading to a balanced budget of general government in 2002-2004, for which deficit targets (so-called 'stability contributions') are allocated to the federal, state and local levels of government, flanked by a sanctioning mechanism.

Table V.44 shows the budgetary evolution during the 2001 NSP. The column "NSP target" lists the budgetary balance targets in % of GDP given in the 2001 NSP. "Outcome (unadj.)" shows the ex-post budgetary outcome according to the updates of the stability programme. However, this is subject to two adjustments before compliance with the NSP target is assessed. First, the NSP is fixed in terms of ESA95 as of October 2000, which do not take into account the decision taken later by Eurostat that property sales are not considered as deficit-reducing. Second, revised deficit targets can be negotiated between the governments in case of an exceptional burden, in particular revenue shortfalls and expenditure increases due to a severe economic slowdown. These exceptional circumstances are not specified more precisely in the NSP. The column "outcome adj." shows the budgetary outcome adjusted in such way, according to the Austrian authorities.

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[204] Note that this does not include the recalculation of "financial intermediation services indirectly measured" (FISIM) in GDP.

[205] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Table V.44. National Stability Pact 2001-2004, budgetary targets and results, % of GDP

	2001			2002			2003			2004	
	NSP	outcome		NSP	outcome		NSP	outcome		NSP	outcome
Level	target	adj.	(unadj.)	target	adj.	(unadj.)	target	adj.	(unadj.)	target	(unadj.)
Gen.Gov	-1.3	0.7	(0.3)	0.0	0.4	(-0.2)	0.0	-0.6	(-1.1)	0.0	(-1.3)
Federal	-2.05	-0.2	(-0.5)	-0.75	-0.5	(-0.9)	-0.75	-1.4	(-1.7)	-0.75	(-1.7)
Lower	0.78	0.9	(0.8)	0.76	0.9	(-0.7)	0.75	0.8	(-0.6)	0.75	(-0.4)
Soc.sec.	n.a.	n.a.	(0.0)	n.a.	n.a.	(0.0)	n.a.	n.a.	(0.0)	n.a.	(0.0)

Note: Explanation in the text. Figures may not add up due to rounding.
Source: Federal Ministry of Finance on data by Statistics Austria.

The federal budget for 2003 may be illustrative. The NSP targeted the deficit at 0.75% of GDP. The deficit according to the 2004 update of the stability programme amounted to 1.7% of GDP Thus the difference between the federal deficit reported in the stability programme update and the NSP target equalled 0.95 pp. The actual deficit was adjusted down to 1.4% of GDP by property sales, which are not considered as deficit-reducing by a Eurostat decision taken only after October 2000, and by exceptional expenditure related to the floods of 2002.

The difference between the target of 0.75% and the adjusted outcome now implies a shortfall from the NSP target of 0.65 pp.

However, the NSP foresees a further margin of tolerance. For the federal level, an (approx.) 0.25 pp deviation from a given year's target is acceptable and may be offset in future years. Thus, after the acceptable tolerance for 2003 the shortfall from the target is reduced to 0.4 pp. The notes accompanying the NSP law seem to rule out that a budgetary performance better than the target can be carried over to future years.[206]

Thus it may be the case that for 2003, the federal level might have exceeded the tolerable deficit by the 0.4 pp calculated above. A coordination committee between the different levels of government monitors compliance and would, if necessary, ask the Court of Auditors to establish a violation. Following a (non-public) report by the latter, a mediation committee would need to decide unanimously by February in the second year after the violation whether sanctions are due. The committee consists of two representatives of the federal government and two representatives of Länder/local governments. The latter cannot come from the state or commune that failed to comply with the pact. The NSP fixes the amount of the sanction, which takes the form of an interest-bearing deposit. If in the following year the respective target is not reached, the deposit is transferred to those governments in compliance, and reimbursed otherwise. However, the NSP does not foresee publicity of procedures and the 2004 report of the Court of Auditors is silent on the compliance.

However, compliance with the NSP seems now understood by the federal and state levels as that the required stability contribution should be respected only on average over the pact's duration. The average of the federal targets (columns "NSP target") for the four years amounts to 1.1% of GDP. The average of the adjusted outcomes from 2001 to 2004 (columns "outcome adj." 2001-03 and "outcome (unadj.)" for 2004) equals 0.95% of GDP, which would imply that on average, the targets would have been met. In effect, this calculation implies that the better-than-required adjusted outcome in 2001 would ensure compliance, even though the federal deficit in all subsequent years exceeded the NSP target.

The 2005 NSP concluded for the years 2005-2008, which is the baseline for the 2004 update of the stability programme, resembles very much the 2001 NSP. For 2005 and 2006, only the ESA accounting rules as of October 2000 continue to be applicable. However, the 2005 NSP does not foresee a tolerance margin for exceeding the deficit target by 0.25% of GDP for the years 2005 and 2006, but only for 2007 and 2008. The recent update of the stability programme takes the targets of the 2005 NSP at face value. In particular, the 2005 NSP targets the general government to be balanced by 2008. However, given the room for manoeuvre that the NSP seems to offer, substantial deviations may be possible before the NSP becomes binding.

In conclusion, the NSP is a useful tool aimed at involving all levels of government in the consolidation of public finances. In providing for legally enshrined budgetary commitments across various government levels, Austria may serve as a benchmark in the EU. However, there is still room for improvement in terms of clarity of the NSP rules and transparency of the procedures accompanying it. Moreover, it still remains to be seen how enforceable the pact is, once there is a case where the sanction mechanism needs to be activated.

[206] 829 der Beilagen XXI. GP, Materialien – Regierungsvorlage Stabilitätspakt 2001-2004, available at www.parlament.gv.at. A. Matzinger: "Finanzausgleich", in: G. Steger (ed.), *Öffentliche Haushalte in Österreich*, Wien 2002: 51 – 94. L. Diebalek, W. Köhler-Töglhofer, D. Prammer: *The Austrian Internal Stability Pact – its Effectiveness Revisited*, preliminary paper presented at the Workshop on Fiscal Rules, Madeira, 9-10 December 2004.

19. Poland

Recent developments and medium-term prospects

At 4.8% of GDP, the general government deficit in 2004 is considerably lower than targeted in the 2004 budget (5.7% of GDP). The downward revision of the deficit results mainly from a better-than-expected performance by the social security sub-sector. A better-than-expected position of the central government due to higher revenue from corporate income tax also contributed to the positive outcome. The level of the debt ratio in 2004 at 43.6% of GDP is considerably lower than expected in the May 2004 convergence programme (49% of GDP). The better outcome is due to stronger-than-expected nominal GDP growth, favourable valuation effects following the appreciation of the zloty and higher-than-expected privatisation proceeds.

Table V.45. Budgetary developments 2003-2007, Poland (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance**		-4.5	-4.8	-4.4	-3.8	
- Total revenues		44.3	43.8	44.2	44.2	
Of which :	*- current taxes*	*22.3*	*22.1*	*22.3*	*22.5*	
	- social contributions	*14.1*	*13.1*	*12.9*	*12.7*	
- Total expenditure		48.8	48.7	48.6	48.0	
Of which :	*- collective consumption*	*9.1*	*8.8*	*8.5*	*8.3*	
	*- social transfers****	*26.1*	*25.9*	*25.3*	*24.6*	
	- interest expenditure	*2.9*	*2.6*	*2.6*	*2.5*	
	- gross fixed capital formation	*3.4*	*3.4*	*4.2*	*4.7*	
Primary balance		-1.6	-2.2	-1.9	-1.3	
Pm	Tax burden	36.6	n.a.	n.a.	n.a.	
Government debt		45.4	43.6	46.8	47.6	
Pm	*Real GDP*** **	3.8	5.3	4.4	4.5	
Convergence programme*****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance**		-3.9	-5.4	-3.9	-3.2	-2.2
Primary balance		-0.8	-2.6	-1.3	-0.5	0.4
Government debt**		45.4	45.9	47.6	48.0	47.3
Pm	*Real GDP*** **	3.8	5.7	5.0	4.8	5.6

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.

** In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second pillar pension funds, these funds can continue to be classified inside the general government sector until the March 2007 EDP notification. The budgetary effect on the deficit for Poland was, according to the March 2005 EDP notification, of 1.7% of GDP in 2003 and 2.0% of GDP in 2004 and on the debt of 3.3% of GDP in 2003, and 4.1% of GDP in 2004. According to the Polish national sources, the effect on deficit in 2005 and 2006 is expected to be of 1.9% of GDP p.a. and on debt of 6% of GDP p.a.

*** In kind and other than in kind.

**** Annual % change.

***** Submitted in December 2004.

Source: Commission services and convergence programme of Poland.

Table V.46. Main measures in the budget for 2005, Poland

Revenue measures	Expenditure measures
Approved by Parliament or not requiring legislative changes: • Restructuring of state-owned enterprises (railways sector, coal mining) (0.1% of GDP) In the legislative process or rejected by Parliament: • Change in the social security contributions of self-employed (0.17% of GDP) • Reform of the farmers' pension scheme (KRUS) (0.10% of GDP) Not specified in the Budget Law for 2005: • Widening of the taxation base (0.35% of GDP) (Hausner plan measure, mentioned in the May and December 2004 convergence programmes)	Approved by Parliament or not requiring legislative changes: • Changes in pension indexation (0.42% of GDP) • Changes in defence financing (0.14% of GDP) • Changes in pre-retirement benefits (0.05% of GDP) • Reductions in administrative costs (0.05% of GDP) In the legislative process or rejected by Parliament: • Some changes in the social security system (e.g. employment of disabled) (0.13% of GDP)

Source: Commission services and convergence programme of Poland.

The most recent update of the convergence programme, submitted on 1 December 2004, foresees a general government deficit of 3.9% of GDP in 2005 compared to 4.2% in the May 2004 convergence programme. The budget law for 2005, approved by Parliament on 22 December 2004, confirms the target.

The budget does not contain significant tax changes, apart from an increase in excise taxes. It incorporates not only the savings measures from the public finance reform package (so-called *Hausner plan*) which have been endorsed by Parliament, but also the ones that are still being discussed. All these measures taken together have an estimated total impact of 1.2% of GDP in 2005. The 2005 budget does not specify or quantify the other sources of revenue that should result from the implementation of the "widening of the taxation base" announced in the convergence programme with an expected yield of 0.35% of GDP.

According to the Commission services' spring 2005 forecasts, the general government deficit is projected to decrease from 4.8% of GDP in 2004 to 4.4% in 2005 and 3.8% in 2006 compared to respectively 3.9% and 3.2% of GDP in the updated convergence programme. The forecast takes into account the information on the implementation of the public finance reform package provided in the updated programme. Based on the no-policy change assumption, it includes, however, only the measures that have been approved by Parliament (estimated budgetary impact of approximately 0.75% of GDP in 2005 and 0.6% in 2006). The updated programme foresees a reduction of the deficit to 2.2% of GDP in 2007. The deficit figures in both the Commission services' forecast and the updated convergence programme still include the surplus of the second-pillar funded pension funds, which is estimated at around 2% of GDP annually in the period 2004-2006, within the general government sector.

From 43.6% of GDP in 2004, the debt-to-GDP ratio would increase to 46.8% in 2005 and reach 47.6% in 2006. The Polish debt figures will have to be adjusted upwards by between 3 and 6 percentage points in the period 2003-2006 to reflect the March 2004 Eurostat decision on the classification of the second-pillar pension funds, which needs to be implemented by March 2007.

High share of non-flexible expenditure in the budget and the response of the authorities

One of the challenges for Poland's public finances is the relatively high share of fixed expenditure, out of which legally determined expenditure constitute a major part. This rigidity hampers the increase of investment outlays and earmarking money for co-financing structural funds. It prevents also the authorities to decrease faster the tax burden on labour. The high deficit of the Social Insurance Fund (FUS) is a barrier for the decrease of the tax wedge. Eventually, the high share of fixed expenditure makes it more difficult to ensure a sustainable reduction of the general government deficit under the constraint of continuous pressure from on-going and foreseen structural reforms and EU-related spending.

The December updated convergence programme discusses the evolution of the structure of general government expenditure: non-flexible expenditure is defined as that resulting from legal provision or international agreements, inter alia retirement and disability pensions, unemployment benefits, housing allowances, contribution to the EU budget and debt servicing costs. Flexible expenditure includes mainly salaries, expenditures on purchases of goods and services and subsidies to companies outside the general government.

Still before EU accession, the Polish authorities adopted the "*Programme of Rationalisation and Reduction of Public Spending*" (so-called *Hausner plan*) designed to tackle the need of public finance restructuring and to ensure a fiscal consolidation in a sustainable manner. It was also meant to contribute to broader discussions on future economic policy and structural reforms in Poland touching upon a rationalisation of public expenditure in

the fields of (i) functioning of the State and its administration; (ii) functioning of inefficient sectors in the economy – resulting from the consequences of the on-going restructuring in the mining, railways and health sectors; (iii) social policy– among which entitlement programs including de-indexation, raising the pension age, reforming the disability pensions schemes and the highly inefficient and costly farmers' social security system (KRUS).

If the *Hausner plan* was fully implemented, the share of non-flexible expenditure in the general government budget would decrease from 42.5% in 2003 to 39.3% in 2007. The modification of the indexation rule makes an important contribution to this. Indexation is likely not to take place every year, as was the case when retirement benefits were linked to the average wage increase in the economy, but only when the compounded inflation rate exceeds 5%. Still, an important number of measures was rejected or blocked in the parliament.

Table V.47. Share of non-flexible (legally determined) expenditure in the general government budget

	2003	2004	2005	2006	2007
Non-flexible	42.5	40.7	40.7	39.1	39.3
Flexible	57.5	59.3	59.3	60.9	60.7

Source: Updated convergence programme, December 2004

The Ministry of Finance unveiled on 11 March 2005 main ideas of a "*Public finance management strategy for 2005-2008*", which introduces complementary measures to the *Hausner plan* and includes measures affecting the public finance management and reforming the tax system.

The strategy aims at:

- An introduction of a tax system (flat rate of 18% for VAT and corporate and income tax) that would stimulate growth and competitiveness of the Polish economy and lead to a reduction of labour costs;
- A reform of the public finance management that would improve its efficiency, increase the share of non-legally determined (or flexible) expenditure and allow a better absorption of the EU structural funds;
- Meeting the 3% deficit reference value in 2007. An additional fiscal tightening compared to the one described in the December 2004 convergence programme would lead to a deficit of 2.8% of GDP in 2007 with the second-pillar pension funds being excluded from the general government sector.

The strategy implies a strengthening of the fiscal adjustment beyond 2005 and constitutes a direct answer to the Council Opinion of 17 February 2005 on Poland's 2004 December convergence programme (the updated programme contained a 2007 deficit target of 2.2% of GDP, but with the second-pillar pension funds classified within the general government sector).[207]

[207] Not approved by the government, the strategy has not been taken into account in the Commission services 2005 spring forecasts.

20. Portugal

Recent developments and medium-term prospects

The general government deficit for 2004 is estimated at 2.9% of GDP.[208] This figure compares with a target of 2.8% of GDP set in the December 2003 update of the stability programme. In 2004, a deficit below 3 per cent of GDP was achieved through the one-off transfer to the government of pension liabilities for the employees of four state-owned enterprises in exchange of lump-sum payments worth almost 2.3 per cent of GDP.

Table V.48. Budgetary developments 2003-2007, Portugal (% of GDP)

Outturn and forecast*			**2003**	**2004**	**2005**	**2006**		
General government balance			-2.9	-2.9	-4.9	-4.7		
- Total revenues			44.8	45.5	43.2	43.2		
	Of which :	*- current taxes*	24.9	24.4	24.1	24.2		
		- social contributions	12.7	12.7	12.7	12.7		
- Total expenditure			47.6	48.4	48.2	47.9		
	Of which :	*- collective consumption*	8.6	8.4	8.4	8.3		
		*- social transfers***	26.8	27.8	28.3	28.5		
		- interest expenditure	2.9	2.8	2.9	3.1		
		- gross fixed capital formation	3.3	3.3	3.2	3.0		
Primary balance			0.0	-0.1	-2.0	-1.6		
Pm	Tax burden		37.1	36.7	36.4	36.5		
Government debt			60.1	61.9	66.2	68.5		
Pm	Cyclically-adjusted balance		-2.2	-2.1	-3.9	-3.7		
Pm	Cyclically-adjusted primary balance		0.7	0.8	-1.0	-0.7		
Pm	*Real GDP****		-1.1	1.0	1.1	1.7		
Stability programme****			**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance			-2.8	-2.9	-2.8	-2.5	-1.8	
Primary balance			-0.1	-0.1	-0.1	-0.6	-1.3	
Government debt			--	62.0	63.1	62.7	61.4	
Pm	*Real GDP****		-1.2	1.0	2.4	2.7	2.8	

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
Source: Commission services and stability programme of Portugal.

[208] In releasing the data following the March 2004 EDP notification, Eurostat added that there are ongoing discussions which may lead to a subsequent revision of the data.

Table V.49. Main measures in the budget for 2005, Portugal

Revenue measures	Expenditure measures
• Cut in personal tax rates for most income brackets by 0.5 to 1.5 percentage points • Elimination of tax subsidies on individual saving plans, which is expected to fully compensate for the above mentioned cuts in the personal income tax rates • Limit to the use of fiscal benefits by corporations with the setting of a minimum effective corporate tax rate at 60% of the nominal tax rate of 25%. • Transfer of a pension fund to the government sector (0.3% of GDP)	• Reduction of public investment in real terms

Source: Commission services, 2005 budget, Ministry of Finance.

Therefore, the underlying deficit was 5.2 per cent of GDP in 2004, which compares with a target of 4 per cent in the budget for 2004, with the divergence being caused by a slippage on expenditure. In 2004, the public debt stood at 61.9 per cent of GDP, which is above the 60 per cent target set in the December 2003 update of the stability programme. The deviation from the target is accounted for by an upward revision of the 2003 debt outturn by 0.6 percentage point of GDP and debt-increasing stock-flow adjustments amounting to 0.9 percentage points of GDP, against -0.4 percentage points of GDP assumed in the 2003 update.

The budget for 2005 was presented to the Parliament on 15 October and approved on 6 December 2004. The target for the 2005 general government deficit set therein is 2.8 per cent of GDP, which was confirmed in the December 2004 stability programme update. However, it remains to be seen whether the new government, which took office on 12 March, will: i) stick to the targets and measures set by the former cabinet, in particular on the envisaged implementation of revenue-raising one-off operations worth 1.4 per cent of GDP[209]; ii) adopt new measures with a significant budgetary impact. The Commission services' spring 2005 economic forecast projects a deficit of 4.9 per cent of GDP. The difference with the 2005 budget is due to three factors: first, the consideration of lower revenues from one-off measures (just 0.3 per cent of GDP from a transfer of a pension fund to the government sector); second, lower tax proceeds in the context of a significantly lower economic growth; third, a less optimistic evaluation of expenditure developments, in particular on social transfers. The cyclically-adjusted balance according to the Commission services' spring 2005 economic forecast will widen to -3.9 per cent of GDP. This weakening is wholly attributed to the significantly lower revenues from one-off operations, since the underlying cyclically-adjusted position, i.e. excluding any of those revenues in both years, is expected to remain broadly constant (-4.3 per cent of GDP in 2004 and -4.2 per cent in 2005). The new government is committed to submitting a new update of its stability programme by end-May. This will, with high likelihood, provide new information on the Portuguese authorities' intentions for 2005 (and beyond) as regards budget targets and new policy measures. The government is also considering the submission to the Parliament of a corrective budget for 2005 by early summer.

In 2006, the Commission services' spring 2005 economic forecast projects a deficit of 4.7 per cent of GDP on the customary no-policy change assumption and abstracting from any one-off revenue-raising measures. This figure compares with a target deficit of 2.5 per cent of GDP set in December 2004 update of the stability programme.[210] The stability programme update foresees a further reduction of the deficit in 2007 to 1.8 per cent of GDP.

According to the Commission services' spring 2005 economic forecast, the debt ratio will continue to increase, as a consequence of the high government deficits, low nominal GDP growth, and of one-off debt-increasing stock-flow adjustments as foreseen in the Portuguese stability programme of last December and as confirmed in the debt and deficit figures in the March 2005 EDP notification. It is expected to reach 66.2 and 68.5 per cent of GDP at the end of 2005 and 2006, respectively. Such trajectory for public debt is well above the one projected in the stability programme of Portugal of December 2004 on account of lower growth and higher deficit figures.

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[209] Three one-off measures were envisaged to raise those proceeds. The Commission services were able to take on board one of them, worth 0.3% of GDP, in the Commission services' spring 2005 economic forecast, another measure, with an expected revenue of 0.5% of GDP, was considered by Eurostat as a financial operation with no impact on the deficit, and finally the third measure (0.6% of GDP) was not announced with a sufficient degree of detail to allow a proper assessment by the Commission services.

[210] The programme can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

21. Slovenia

Recent developments and medium-term prospects

In 2004, the general government deficit fell slightly, to 1.9% of GDP. Established within the new methodological framework, including the two extra-budgetary funds re-classified in the general government sector, the outturn was higher than the initial target (1.6% of GDP according to the 2003 pre-accession programme). The national authorities raised the deficit forecast to 2.1% of GDP in the middle of 2004, when the budget incurred a substantial revenue shortfall linked to the loss in VAT resources, following the dismantling of border controls after EU accession. Moreover, taxes on labour came in lower than budgeted due to the increase in the minimum threshold for payment of payroll tax, adopted in July and effective as of September.

Table V.50. Budgetary developments 2003-2007, Slovenia (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance		-2.0	-1.9	-2.2	-2.1	
- Total revenues		46.2	45.8	45.4	45.1	
Of which :	*- current taxes*	*25.2*	*25.2*	*24.8*	*24.5*	
	- social contributions	*15.2*	*14.8*	*14.5*	*14.2*	
- Total expenditure		48.2	47.7	47.6	47.2	
Of which :	*- collective consumption*	*8.4*	*8.2*	*8.1*	*8.1*	
	*- social transfers***	*29.1*	*28.8*	*28.5*	*28.2*	
	- interest expenditure	*2.1*	*1.9*	*1.7*	*1.6*	
	- gross fixed capital formation	*2.8*	*2.8*	*2.9*	*2.9*	
Primary balance		0.1	0.0	-0.5	-0.5	
Pm Tax burden		40.1	39.8	39.0	38.5	
Government debt		29.4	29.4	30.2	30.4	
Pm *Real GDP****		2.5	4.6	3.7	4.0	
Convergence programme****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance		-2.0	-2.1	-2.1	-1.8	-1.1
Primary balance		0.5	0.6	0.6	0.3	-0.3
Government debt		29.4	30.2	30.7	30.9	29.7
Pm *Real GDP****		2.5	4.0	3.8	3.9	4.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in January 2005.
Source: Commission services and convergence programme of Slovenia.

Table V.51. Main measures in the budget for 2005, Slovenia

Revenue measures	Expenditure measures
• Further harmonisation of excise duties on tobacco with the *acquis* • New personal income tax regime, introducing five tax brackets with rates ranging from 16% to 50%, designed to disburden the lowest income classes • New corporate income tax regime, broadening the tax base and eliminating loopholes in the legislation	• Containing the rise in public wages and social benefits • Increasing cost effectiveness of the public administration (rationalisation of material costs)

Source: Commission services.

Furthermore, in September excise duties on fuel were set at the lowest level permitted by the EU to buffer the negative consequences of the oil price hike on inflation.[211] However, the revenue shortfall was contained by the good economic performance – with the highest real GDP growth rate in five years – coupled with a firm determination to safeguard the deficit target. In October, when the shortfall approached the limit set in the Implementation Bill to the 2004 budget, the government refused claims for any further expenditure.[212] At the end of 2004, the gross general government debt accounted for roughly 29.5% of GDP.

The 2005 budget, adopted by Parliament in December 2003 (as per Slovenia's budgetary procedure with a two-year planning horizon), is largely based on revenue measures, improving tax administration and reforming the direct tax regime. In 2004, new personal and corporate income tax legislation was adopted, coming into effect on 1 January 2005. The new personal income tax regime was estimated to reduce government revenues by 0.2% of GDP in 2005. This was expected to be compensated by an increase in corporate income tax. On the expenditure side, the main measures concern cost effectiveness and flexibility while additional spending commitments related to EU membership were envisaged. The change in government following the October 2004 parliamentary elections prompted the decision to amend the budget in line with the priorities of the centre-right coalition, such as the intention to further reduce the tax burden on wages while aiming to keep the fiscal targets unchanged. The March 2005 EDP notification projects the deficit to remain 1.9% of GDP in 2005. However, in the absence of corrective measures in a pending supplementary budget, the Commission services foresee that, taking into account the plans announced by the new government, the deficit would increase to 2.2% of GDP.

In the medium term, the deficit is expected to gradually decline as the positive net inflow from the EU budget outweighs the negative fiscal effect of the direct tax regime reform. Under a no-policy change assumption the Commission services are, however, more cautious than the national authorities as regards the budgetary consolidation. At 2.1% of GDP in 2006, the Spring 2005 forecast sets the deficit slightly above 1.8% of GDP as projected in the first update of the convergence programme, covering the period 2004-2007, which was submitted in January 2005.[213] The programme anticipates a considerable fiscal adjustment from 2006 onwards, narrowing the general government deficit to 1.1% of GDP by 2007.

The gross general government debt is expected to increase further but will remain contained over the forecasting horizon. The Commission services spring 2005 forecast projects the debt ratio to gradually rise to 30.4 % of GDP in 2006.

Budgetary procedure: the two-year planning horizon

In December 2001, Slovenia started adopting budgets for two consecutive years simultaneously in an effort to drive greater certainty into the planning of public finances, aiming to enhance fiscal prudence. In the first stage, the government sets out the overall expenditure framework for the next two years. Subsequently, it confirms the budget appropriations within the agreed expenditure limits. The execution provisions are decided on for each year separately and stipulated in the accompanying Budget Implementation Bill. Included in the bill are the specific conditions allowing to amend the budget as the existing budgetary procedure does not maintain expenditure ceilings fixed over the two-year horizon regardless of the changing economic circumstances.

On the whole, budgetary targets have been relatively well met. However, disappointing growth in 2002-2003 led to budgets being revised in the middle of the year.

[211] Adjustments in fuel excise duties are carried out every fortnight as a standard procedure to avoid inflation to be excessively affected by world market price fluctuations.

[212] As stipulated in the Implementation Bill to the 2004 supplementary budget, it was within the government's discretion to reduce expenditure proportionally – up to 15 billion tolars (0.25% of GDP) – to a revenue shortfall in the course of the year, without having to propose the budget to be amended.

[213] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

For 2003, the general government deficit was much higher than initially planned. In order to limit the budgetary impact of adverse cyclical developments, the implementation bill attached to the 2004 budget introduced a novel measure. The government was given discretion to suspend new spending commitments in case of a revenue shortfall within the limits set in the bill. A revenue undershooting of up to 15 billion tolars (0.25% of GDP) due to unfavourable economic conditions was to be compensated by a proportional reduction of expenditure in the course of the year, without introducing a supplementary budget. In case unfavourable macroeconomic conditions persisted, an up to 10 billion tolar (0.17% of GDP) higher budget deficit was nevertheless to be accepted at the end of the year. By invoking the right to refuse claims for further expenditure as of October 2004, the government was successful in safeguarding the deficit target for 2004.

In evaluating the performance of such budgetary setting methodological adjustments also need to be taken into account. In the framework of the March 2004 EDP reporting, Eurostat noted an inadequate delimitation of general government and urged the Ministry of Finance to correct it in time for the September 2004 notification. On that occasion, two entities hitherto classified outside the government, the so-called extra-budgetary funds, have been included in the government accounts.

The Capital Fund helps to finance the pay-as-you-go system by managing assets to cover for the liabilities of the Pension and Disability Insurance Fund. The Restitution Fund was established for restoration of nationalised and confiscated properties to the original owners and for compensation of damages to war and post-war victims. While the inclusion of the former has not had any budgetary effect, the general government balance deteriorated due to the latter running persistent deficits since its creation in 1993. In 2002 and 2003, the Restitution Fund incurred a deficit of 0.2 % of GDP.

The methodological adjustment of the government accounting system has also involved the exclusion of certain institutions, such as pharmacies, homes for the elderly and student residences, from the general government sector. The impact on the budget, though, was negligible. This comprehensive ex-post revision of budgetary data has increased the general government deficit for the period 2000-2003 by 0.2-0.5% of GDP, the most significant correction being in 2000, when the deficit was raised from 3.0% of GDP to 3.5% of GDP.

Table V.52. The general government deficit initial targets, revisions and the outcome

	Initial targets (Budget prepared in t-2)	**Revised targets (Supplementary budget in t-1)**	**Outcome (March 2005 notification)**
Budget for the year	**ESA-95**	**ESA-95**	**ESA-95**
2002*	2.4°	2.6°	2.4
2003	*1.0°*	*1.9°*	*2.0*
2004	*n.a.*	*1.6*	*1.9*
2005	1.6		

* The launch of the new budgetary procedure at the end of 2001 with a two-year planning horizon, setting initial targets for the 2002 and 2003 budgets.

Source: Budgets 2002-2005, Supplementary budgets 2002-2004, Pre-accession and convergence programmes, March 2005 EDP notification, °Report to the July 2003 Association committee meeting.

22. Slovakia

Recent developments and medium-term prospects

The general government deficit for 2004 was 3.3% of GDP. This is significantly lower than the 4% of GDP included in the budget for 2004 (and even the 3.8% of GDP estimated in the November 2004 convergence programme). The better outturn is mostly due to spending postponements, including related to co-payments for EU-funds. The debt ratio in 2004 amounted to 43.6% of GDP. The budget for 2005 was adopted by parliament in December 2004 and targets a deficit of 3.8% of GDP. This includes the revenue-decreasing and hence, ceteris paribus, deficit-increasing effect of the introduction of a funded pension pillar in 2005, estimated at 0.4% of GDP at the time when the budget was passed. Both revenue- and expenditure-to-GDP ratios are foreseen to rise in 2005, mainly due to an assumed increased inflow of transfers from the EU on the revenue side and the associated spending (including co-financing) and the contributions to the EU budget on the expenditure side.

Table V.53. Budgetary developments 2003-2007, Slovakia (% of GDP)

Outturn and forecast*		**2003**	**2004**	**2005**	**2006**	
General government balance**		-3.7	-3.3	-3.8	-4.0	
- Total revenues**		35.4	35.1	36.1	34.8	
Of which :	*- current taxes*	18.7	17.5	17.4	16.9	
	*- social contributions***	12.4	12.4	12.5	12.0	
- Total expenditure		39.2	38.5	39.9	38.8	
Of which :	*- collective consumption*	11.0	10.8	10.8	10.7	
	*- social transfers****	20.3	18.4	18.0	17.7	
	- interest expenditure	2.5	2.2	2.4	2.2	
	- gross fixed capital formation	2.6	2.6	2.6	2.4	
Primary balance**		-1.2	-1.1	-1.4	-1.7	
Pm Tax burden		31.1	30.0	29.9	28.9	
Government debt		42.6	43.6	44.2	44.9	
*Pm Real GDP*****		4.5	5.5	4.9	5.2	
Convergence programme*****		**2003**	**2004**	**2005**	**2006**	**2007**
General government balance**		-3.7	-3.8	-3.8	-3.9	-3.0
Primary balance**		-1.1	-1.5	-1.4	-1.6	-0.7
Government debt		42.8	43.0	44.2	45.3	45.5
*Pm Real GDP*****		4.2	5.0	4.5	5.1	5.4

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** Includes the revenue-decreasing and hence, ceteris paribus, deficit-increasing effect of the introduction of a funded pension pillar in 2005 (estimated at around ½% of GDP in 2005; 1% of GDP in 2006; and 1.1% of GDP in 2007.
*** In kind and other than in kind.
**** Annual % change.
***** Submitted in November 2004.
Source: Commission services and convergence programme of Slovakia.

Table V.54. Main measures in the budget for 2005, Slovakia

Revenue measures	Expenditure measures
• Introduction of a funded pension pillar ("2nd pillar") at the beginning of 2005, leading to a re-direction of 9% of gross wages away from the pay-as-you-go pillar (½% of GDP)	• Second tranche of reforms in the health care system, leading to an upfront increase of the GDP-share of expenditures by health insurance companies of around ½ percentage point in 2005 but a stable share thereafter. The GDP-share of health insurance contributions is expected to increase in 2005 as well (by 0.4 percentage points), including due to improved contribution compliance. Major reform elements are: • introduction of individual private health insurance; • adjustments in the assessment base for health insurance contributions; • better conditions for streamlining of the health care benefit package; • more competition, better incentives, and harder budget constraints

Source: Commission services and November 2004 convergence programme of the Slovak Republic.

On the revenue side, after the major tax reforms in 2004 (unified rate of 19% for income and value-added tax) and the associated shift from direct to indirect taxation, changes to the tax legislation in 2005 are marginal. However, social contributions are significantly affected by the introduction of a funded pension pillar at the beginning of 2005. On the expenditure side, the major reform measure included in the budget 2005 is a second tranche of health care reforms. The budget target of 3.8% of GDP is in line with the Commission services' spring 2005 forecast.

According to the Commission services' spring 2005 forecast, the general government deficit for 2006 is projected at 4.0% of GDP on a no-policy-change basis. This is broadly in line with the target of 3.9% of GDP set in the most recent update of the convergence programme submitted on 30 November 2004.[214] The programme does not foresee major reform measures in the election year 2006. It projects a major fiscal adjustment in 2007 when the deficit is planned to be reduced to the 3% of GDP Treaty reference value.

In the Commission services' spring 2005 forecast, the debt-to-GDP ratio is predicted to increase from 43.6% in 2004 to 44.2% in 2005 and to 44.9% of GDP in 2006.

Pension reform in Slovakia

Slovakia has reformed its pension system in two steps: in a first step, it introduced several changes to the parameters of the pay-as-you-go pillar ("first pillar") that became effective in 2004. These parametric changes reduced the scope of entitlements and, hence, the (implicit) debt of the first pillar. They prepared the ground for the second (systemic) reform step, i.e. the introduction of a funded pension pillar ("second pillar") at the beginning of 2005. Furthermore and in parallel to these reforms, the possibilities for voluntary old-age provisions ("third pillar") have been expanded.

The main parametric changes to the pay-as-you-go pillar were the following: (1) an annual stepwise increase of the retirement age by 9 months to 62 for both men (to be completed by 2006) and women (to be completed by 2012) from 60 for men and 53 to 57 for women (depending on the number of children); (2) the introduction of a close link between contribution history and pension benefits; (3) and the institution of an automatic indexation mechanism for benefits, with the adjustment based half on inflation and half on the average nominal wage increase in the previous year.

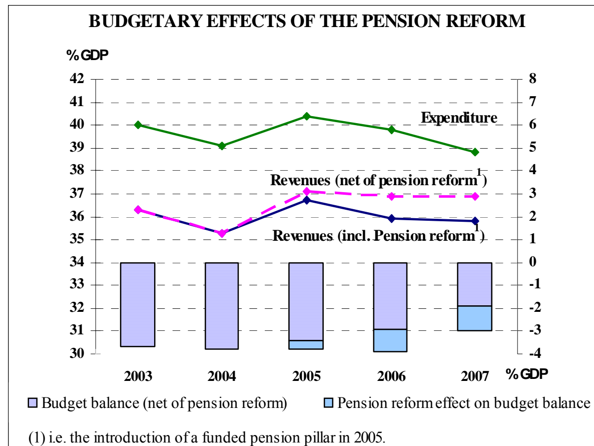
The funded pension pillar introduced at the beginning of 2005 is sizeable and receives contributions by participants of 9% of their gross wages, which are otherwise paid into the public PAYG-pillar. Participation in the funded pillar is compulsory for new labour market entrants. Further pension-related social contributions, which are paid into the public pension system consist of: (1) another 9% of gross wages for old-age pensions; (2) 6% for disability pensions; and (3) 4.75% for a reserve fund which is envisaged to cover potential shortfalls in the public pension system. Roughly ¾ of the contribution total are paid by employers.

The November 2004 convergence programme update estimates the revenue flow to the new funded pillar at 0.4% of GDP in the first year, at 0.9% of GDP in 2006 and at 1.1% in 2007 (see Graph V.10). The risks attached to these estimates seem to be largely balanced. Specific uncertainties relate to the share of incumbent workers who will actually opt to switch to the new

[214] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

system and the exact timing of the switching (as the decision can be taken during a period spanning from the beginning of 2005 to mid-2006).

Graph V.10. Budgetary effects of the pensions reform



Source: Commission services.

The pension reforms implemented to date considerably improve the long-term sustainability of the pension system. In addition, the reforms diversify the risk for beneficiaries and are likely to foster contribution compliance and to enhance work incentives. The introduction of a funded pillar may also have a favourable effect on financial market development. Nevertheless, sustainability considerations suggest that further reforms should be considered in the medium-term. These include additional increases in the retirement age and further changes in the indexation mechanism.

23. Finland

Recent developments and medium-term prospects

In 2004, the general government balance continued to be in surplus, at 2.1% of GDP. This was almost a ½ percentage point higher than the target of 1.7% set in the original 2004 budget and November 2003 update of the stability programme. The overall budgetary outturn was better than expected as central government finances posted a surplus 0.4% of GDP compared with a projected deficit of 0.7%. This positive outcome derived from higher overall tax receipts and increased dividend revenues and lower interest expenditure. However, the deficit in local government finances at 0.7% of GDP was higher than the envisaged 0.4%, while the social security surplus at 2.4 % of GDP turned out lower than the target of 2.8%.

Table V.55. Budgetary developments 2003-2008, Finland (% of GDP)

Outturn and forecast*	**2003**	**2004**	**2005**	**2006**		
General government balance	2.5	2.1	1.7	1.6		
- Total revenues	53.3	52.5	51.9	51.3		
Of which : - current taxes	*32.2*	*31.7*	*31.2*	*30.5*		
- social contributions	*12.1*	*12.0*	*12.3*	*12.6*		
- Total expenditure	50.9	50.7	50.5	50.0		
Of which : - collective consumption	*7.8*	*7.8*	*7.9*	*7.9*		
*- social transfers***	*31.4*	*31.4*	*31.4*	*31.3*		
- interest expenditure	*2.1*	*2.1*	*1.9*	*1.7*		
- gross fixed capital formation	*3.0*	*2.9*	*2.8*	*2.7*		
Primary balance	4.5	4.0	3.3	3.1		
Pm Tax burden	44.9	44.3	44.0	43.7		
Government debt	45.3	45.1	44.3	43.7		
Pm Cyclically-adjusted balance	3.2	2.4	1.9	1.8		
Pm Cyclically-adjusted primary balance	5.2	4.3	3.5	3.4		
Pm *Real GDP****	2.4	3.7	3.3	2.9		
Stability programme****	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance	2.1	2.0	1.8	2.1	2.2	2.0
Primary balance*****	4.1	3.7	3.4	3.8	3.9	3.7
Government debt	45.6	44.6	43.4	42.5	41.7	41.1
Pm *Real GDP****	2.0	3.2	2.8	2.4	2.2	2.0

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
***** The Finnish authorities provide primary balances on the basis of net interest payments rather than gross interest payments. The Commission services have recalculated the figures based on the data given in the stability programme.
Source: Commission services and stability programme of Finland.

Table V.56. Main measures in the budget for 2005, Finland

Revenue measures	Expenditure measures
• Inflation adjustment of 2% in the central government income tax scale and an increase in earned income deductions in municipal taxation and lowering the state income tax scale (0.3% of GDP). • Reducing corporate income tax rate from 29% to 26% and capital income tax rate by 1 percentage point to 28% (0.4% of GDP). • Extending the domestic help credit in order to improve employment possibilities in domestic services (0.01% of GDP).	• Increasing development cooperation spending (0.04% of GDP). • Providing grants and subsidies for municipality mergers. • Increasing funding for research and technology and financing of universities (0.04% of GDP). • Increasing active labour market policy measures.

Source: Commission services and the Ministry of Finance (Budget for 2005).

Despite the positive outcome in the general government surplus, the debt ratio in 2004 was 45.1% of GDP, while the target in the updated 2003 stability programme was 44.7%. This higher-than-expected debt ratio follows mainly from the fact that local governments increased their borrowing, whereas central government accumulated less debt than originally planned.

The state budget for 2005 was approved by the parliament on 22 December. The main measures of the budget are the income tax cuts which supplement the new centralised two-and-half-year wage agreement settled in late 2004 and the capital and corporate taxation reform. Expenditures excluding interest expenditure will go up by 1.3% in real terms from 2004. Most of the increases derive from higher health care costs and increased transfers to local governments. Revenues are set to grow by 0.6% in real terms, as the government has cut both the capital and corporate, and income taxation.

The target for the general government surplus in 2005 in the semi-annual economic survey of the Ministry of Finance[215] is 1.6% of GDP (1.8% in the December 2004 update of the stability programme)[216]. The Commission services spring 2005 forecast of the general government surplus is 1.7% of GDP[217] for 2005. On May 17, the government adopted the first supplementary budget for 2005. Based on current information, the budgetary projections for 2005 in the Commission services' spring forecast are still valid, but might be on the cautious side. In the first supplementary budget proposal, the Government revised upwards the revenue projections by € 610 million (i.e. 0.4% of GDP) for 2005 as tax receipts, dividend income and revenues from financial asset sales are foreseen to be higher than originally expected. As expenditure will be increased by € 160 million (i.e. 0.1% of GDP), the central government finances should end the year better than the 0.5% of GDP deficit presented in the original budget. In 2005, the cyclically-adjusted surplus will decrease by some ½ percentage point from 2004 to 1.9% of GDP, indicating an expansionary stance in fiscal policy.

Given the no-policy change assumption in the forecast for 2006, the general government finances are foreseen to record a surplus of 1.6% of GDP, which is a ½ percentage point lower than the surplus target presented in the December 2004 update of the stability programme[218]. This derives from the fact that the update of the stability programme took only partially into account the centralised two-and-half-year wage agreement settled in late 2004, which was supplemented by the government with income tax cuts worth of €1.2 billion i.e. 0.8% of GDP for 2005-2006. This has now been fully incorporated into the Commission services' spring forecast, which explains part of the discrepancy. Also, higher central government spending plans for 2006 explain the difference. Moreover, the financial position of local governments turned out to be weaker than expected in 2004 and this has had its effect on the current fiscal outlook for 2005-2006. Beyond 2006, the update of the stability programme foresees the general government balance to remain in comfortable surplus, at 2.2% of GDP and 2.0% for 2007 and 2008, respectively.

According to the spring 2005 forecast, the debt ratio is seen to decrease moderately from 44.3% of GDP to 43.7% during 2005-2006. This is broadly in line with the projections in the update of the stability programme. However, based on the better–than- anticipated revenue flow, the debt ratio may be lower than projected in the Commission spring forecast for 2005.

[215] The semi-annual economic survey is published in February and September.

[216] Starting from 2003, the national accounts definition and the EDP definition of the general government balance has differed due to swap-interest payments. The difference in 2004 was 0.2 percentage points, the EDP definition of general government surplus being at 2.1% of GDP and the national accounts definition at 1.9%.

[217] EDP definition, the Ministry of Finance will continue to use the national accounts definition.

[218] The programme, as well as its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

Spending ceilings

Multi-annual spending ceilings were first introduced to the Finnish budgetary process in 1991, but after identified malfunction and recurrent overruns during the period of 1999-2003[219], the current government, which took office in June 2003, redesigned the spending ceilings and made them politically more binding. Under the new arrangement, the government at the beginning of its term agrees on the budget expenditure ceilings covering the entire four-year electoral period. The government's overall guiding premise is that the deficit in central government finances, as measured in national accounting terms, must not exceed 2¾% of GDP even during weak economic growth. About ¾ of the budget appropriations (i.e. 19.0% in relation to GDP), including the supplementary budgets, are under the binding spending limits. Excluded from the ceilings are mainly cyclically fluctuating expenditure (e.g. unemployment subsidies), interest expenses on central government debt and certain items which are not deemed appropriate to tie to spending limits.

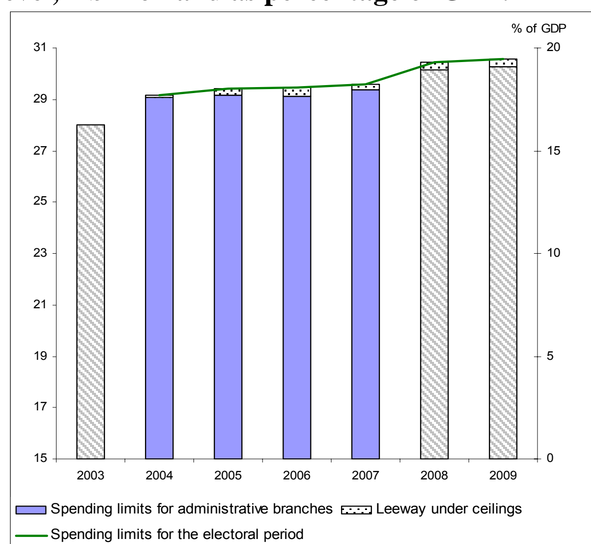
The spending limits are broken down for the ministries when preparing their annual appropriation proposals for the following year's budget. All additional spending items have to be accommodated within the ceilings. Each year, the government carries out a technical review so that ceilings are in line with the budget proposal's cost and price level and also to include changes that have been made to the structure of the budget. In 2005, these adjustments revised upwards the spending ceilings by about € 940 million i.e. 0.6% of GDP per year between 2006 and 2007 compared with the level decided in 2003.

Experience so far

The spending ceilings worked well in 2004, their first year in operation, when final expenditure remained below the spending limits by € 84 million or 0.1% of GDP. Also, the 2005 budget is within the ceilings, with expenditures of € 212 million or 0.1% of GDP below the ceilings. This leeway will be used to cover any supplementary budgets.

According to the spending limits, total expenditure by the central government is allowed to increase by nearly 1% a year in real terms on average in 2004-2007. For the coming years, there will be testing times for the ceilings as they leave only limited scope for further expenditure increases, after spending in administrative branches in 2004 increased by 3.8% in real terms from 2003. Also the fact that there will be parliamentary elections in spring 2007 may exert additional pressure to the expenditure ceilings. Currently, the average leeway under the ceilings for 2006 and 2007 is € 280 million i.e. 0.2% of GDP and beyond the current electoral period for 2008-2009 the average is € 300 million.

Graph V.11. Budget and spending limits for the electoral period of 2003-2007, at the 2006 price level, €billion and as percentage of GDP.



Source: Ministry of Finance.
Notes: Value for 2003 is the final budget, 2004 includes original and supplementary budgets and 2005 comprises of original budget. Ceilings for 2008-2009 are indicatives ones, as the electoral period ends in 2007.

[219] See analysis of the previous expenditure frames in the Public Finances in EMU - 2003, which can be found at :

http://europa.eu.int/comm/economy_finance/publications/european_economy/public_finances2003_en.htm.

24. Sweden

Recent developments and medium-term prospects

The general government recorded a surplus of 1.4% of GDP in 2004 (1.2% of GDP in the national accounts where the impact of swaps in the calculation of interest is excluded). This was an unexpectedly high surplus against a target of 0.4% surplus given in the November 2003 updated convergence programme and against even the 0.7% of GDP surplus estimated in the convergence programme submitted in November 2004. The better outcome is not surprising given the target was set using a cautious 2% growth assumption while the realised growth, mainly due to a better export performance, was 3.5%. However, revenues developed close to expectations in nominal terms. Instead, expenditures were lower than foreseen in the 2003 update, both in nominal terms and more prominently in shares of GDP. Lower than expected interest expenditure and consumption are key explanatory components. The general government debt-to-GDP ratio continued to fall and was 51.2% of GDP in 2004.

Table V.57. Budgetary developments 2003-2007, Sweden (% of GDP)

Outturn and forecast*			**2003**	**2004**	**2005**	**2006**		
General government balance**			0.2	1.4	0.8	0.8		
- Total revenues			58.6	58.4	57.8	57.4		
	Of which :	*- current taxes*	*36.0*	*36.3*	*35.8*	*35.5*		
		- social contributions	*15.0*	*14.7*	*14.7*	*14.7*		
- Total expenditure			58.4	57.0	57.0	56.6		
	Of which :	*- collective consumption*	*8.2*	*8.0*	*8.0*	*7.9*		
		*- social transfers****	*38.3*	*37.8*	*37.6*	*37.2*		
		- interest expenditure	*2.1*	*1.8*	*2.0*	*2.1*		
		- gross fixed capital formation	*3.1*	*3.0*	*3.0*	*3.0*		
Primary balance			2.3	3.2	2.9	2.9		
Pm	Tax burden		50.8	50.7	50.1	49.8		
Government debt			52.0	51.2	50.3	49.2		
Pm	Cyclically-adjusted balance		1.3	1.7	0.8	0.7		
Pm	Cyclically-adjusted primary balance		3.4	3.5	2.9	2.8		
Pm	*Real GDP*****		1.5	3.5	3.0	2.8		
Convergence programme*****			**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
General government balance			0.5	0.7	0.6	0.4	0.9	
Primary balance			2.7	2.8	2.8	2.7	3.3	
Government debt			52.0	51.7	50.5	50.0	49.0	
Pm	*Real GDP*****|		1.6	3.5	3.0	2.5	2.3	

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In line with the transition period granted by Eurostat for the implementation of its March 2004 decision on the classification of second pillar pension funds, these funds can continue to be classified inside the general government sector until the March 2007 EDP notification. This is the case in Sweden and has an estimated positive effect on the budget balance of about 1% of GDP per year.
*** In kind and other than in kind.
**** Annual % change.
***** Submitted in November 2004.
Source: Commission services and convergence programme of Sweden.

Table V.58. Main measures in the budget for 2005, Sweden

Revenue measures	Expenditure measures
• Half of the fourth and last step of the income tax reform (0.3% of GDP) • Abolishment of inheritance and gift taxes (0.1% of GDP) • Further steps in “green tax swap”.	• Increase in grants to local government to support employment (volume 0.6% of GDP)

Source: Commission services, Swedish Ministry of Finance.

The budget for 2005 was presented on September 22 and received parliamentary approval on 16 December 2004. The updated convergence programme for the period 2004-2007, drawing fully on the draft budget, was submitted to the Commission on 18 November 2004 with a surplus target of 0.6% of GDP for 2005. The lower surplus in 2005 as compared to the 2004 outcome mainly reflects the expansionary measures introduced in the 2005 budget, most importantly reductions in income taxes. The Commission services’ spring forecast, taking into account the better than expected 2004 outcome, projects a slightly higher surplus of 0.8% of GDP in 2005. On April 14 the government presented it Spring budget bill with an updated surplus forecast of 0.7% of GDP.

The Commission spring forecast projects the cyclically-adjusted surplus to narrow by around 1 percentage point of GDP in 2005. This suggests a slightly more expansionary fiscal stance than indicated by the calculations made in the Commission’s assessment of the updated programme, mainly reflecting the stronger than expected 2004 surplus.

Based on a “no-policy change” assumption, the Commission spring forecast projects an unchanged surplus of 0.8% of GDP in 2006. This is higher than the projection in the updated convergence programme of a surplus of 0.4% of GDP, and reflects the upward revisions in the 2004 budget outcome and more favourable growth assumptions. In the Spring budget bill, the government forecast a 0.6% surplus in 2006 and 1.1% in 2007 (compared to a 0.9% surplus target for 2007 in the 2004 updated convergence programme).

The general government debt ratio is projected to continue to decline in 2005-06, to slightly below 50% of GDP, though the nominal level of debt is projected to rise. The moderate pace of decline in the debt ratio reflects the 2% of GDP surplus in the pension system being mainly invested in non-government financial assets.

Local government: the setting

Local government in Sweden consists of 290 municipalities and 20 county councils. By long tradition they enjoy a strong political and financial independence. While independent, local governments are nevertheless required by law to provide a large part of general public services. For example, municipalities are responsible for the provision of social services including child care, environmental and health protection as well as primary and secondary education. The county councils mainly deal with healthcare. Municipalities and county councils share responsibility for public transport. The municipalities account for 70% of local government expenditure while the county councils cover the remaining 30%. Overall, local government is responsible for roughly 40% of general government primary expenditures and 70% of general government investment and consumption. More than half of the costs are for personnel and local governments employ about 25% of the employees in the economy.

For its financing local governments have the right to levy direct tax. Tax revenues cover roughly two-thirds of total revenues. They are raised through a flat rate tax on income, that is, salaries, unemployment and illness benefits and pensions. The average municipality tax is about 21% and the average county council tax 10.5% making the average local tax about 31.5% (varying across local governments, in 2003 the highest local tax rate was 33.3% while the lowest was 28.9%).

Local governments may also raise income through fees for some provided services. However, most of the remaining revenues consist of general grants and grants directed towards a specific use (special-purpose grants). The level of the grants does not follow any indexation rule but is decided each year on a discretionary basis. As from 2005, general grants are provided within an “equalisation” system administered by the central government. This consists of an “income equalisation” system and a “cost equalisation” system. On the income side, local governments with low income per capita are compensated by central government general grants (there is also a small co-financing by local governments with very high income per capita).

On the cost side there is compensation for structural differences in the cost structure (for example due to differences in demography). The cost equalisation system only redistributes across local governments and there is no financial contribution from central government. The special purpose grants are mainly directed towards education and employment where the latter have been increased substantially in the 2005 budget.

Table V.59. Local government finances 1997-2004, Sweden (% of GDP)

Outturn	1997	1998	1999	2000	2001	2002	2003	2004
Revenue	**22,3**	**23,6**	**23,2**	**22,4**	**22,8**	**23,2**	**23,6**	**23,3**
Taxes	15,5	15,5	15,5	15,3	15,8	16,1	16,5	16,5
C.G. grants	4,3	5,5	5,3	5,0	5,0	5,1	5,0	4,8
Other	2,5	2,5	2,4	2,0	1,9	2,1	2,0	2,0
Expenditure	**22,8**	**23,4**	**23,1**	**22,2**	**23,0**	**23,7**	**23,8**	**23,3**
Consumption	18,5	19,4	19,3	18,7	19,3	20,0	20,3	20,0
Other	4,3	4,0	3,9	3,5	3,7	3,7	3,5	3,2
Net lending	**-0,5**	**0,2**	**0,1**	**0,2**	**-0,2**	**-0,5**	**-0,3**	**0,1**

Source: Swedish Ministry of Finance.

Since 2000, budgetary developments at local level have been guided by a "budget balance requirement". This stipulates that budgets must be planned with revenues (taxes, fees and grants) higher than or equal to expenditures. Borrowing is allowed to finance investments but the costs to finance the loans are covered through the budget. As from 2005, a number of changes have been introduced to make the rules slightly more flexible. It is now possible to present a budget in deficit if there are "special reasons" such as a healthy balance sheet or a particular need for large structural measures. Should a deficit materialise despite a planned surplus or balance, a consolidation rule specifies that the deficit must be compensated by surpluses in the following three years (as from 2005 – the period was two years up to 2004). There is, however, no explicit sanction mechanism in the case of non-compliance.

Budgetary problems: a pro-cyclical bias?

Table 3 shows the budgetary situation in local governments over the 1997-2004 period. In the 1998-2000 period, tax bases grew relatively strongly in line with overall growth and employment. At the same time central government grants were higher than before. Backed by the healthy growth in revenues, local government activity expanded relatively strongly in volume terms. The impact on costs from the increasing activity gradually started to show on the budget balance and in 2002 the sector recorded a 0.5% of GDP net lending deficit. Hence, in 2003, a year of weak GDP growth and falling employment in the economy as a whole, measures were taken to curb the growth in consumption while at the same time the average local tax rate were increased by 0.65 percentage-points.

In 2004, the measures to curb the growth in consumption had an increased effect as mirrored by a negative local government employment growth. Even so, the average local tax rate had to be raised again, this time by an additional 0.34%. During this period, the yearly increase in central government grants merely followed nominal GDP growth. In 2004, the sector showed a surplus again, partially explained by an increased sale of real estate. In the 2005 budget bill, the government introduced sizeable increases in transfers targeted towards supporting employment. This should limit the need for further tax increases while allowing for a positive employment growth in a context of controlled consumption growth (but lower the surplus of general government). The key financial problems of the sector as a whole therefore seem to be largely under control even though the situation remains quite disparate across local governments. About 40% of municipalities and 60% of county councils did not meet the balance requirement in 2004. Effectively, to recuperate the realised deficits there is still a need for consolidation in the coming years and margins remain small.

Concluding remarks

The recent experience with the problems in the local government budgetary situation has led to some debate on the budgetary framework and the role of local government. First, the balance requirement has not been able to prevent pro-cyclical budget policies. When income growth was cyclically healthy, expenditures were increased and when the economic conditions later deteriorated it has been necessary to reduce employment and increase taxes. It is noteworthy that the local tax increases to a large extent have neutralised the government efforts to lower income taxes in order to promote incentives to work. The efforts to introduce some more flexibility in the rules can be seen as an attempt to alleviate this problem: that is, the longer time allowed compensating for deficits and the increased possibilities to have exceptions from the balanced budget requirement. Second, the financial problems at local level quickly feed through to central level. There is arguably an implicit commitment by the central government to ensure that the provision of general public services is secured. If local governments can count on being "bailed out", it may create a moral hazard problem[220]. By deciding the level of grants only by discretion, the government puts pressure on local authorities to plan cautiously. The discretion also allows the government a higher degree of control and freedom to adjust measures and priorities across expenditure

[220] See J. Fischer "Swedish budget rules: praise from Brussels, pressure at home" European Commission, Country Focus, volume II, issue 4

areas. In particular, central government expenditures must meet the nominal expenditure ceilings set by parliament. However, the discretionary allocation of grants creates uncertainty at local level which may make effective planning more difficult. This is so even if general grants have in practice been raised to cover increases in prices and wage costs in a seemingly semi-automatic way[221]. Thirdly, the recent budgetary pressure has increased awareness of the medium- to longer-term budgetary challenges from the ageing of the population. Given the demographic outlook, the cost pressures from the provision of public services will to a large extent show at local level. The government's long-term survey 2003/04[222] pointed to the budgetary pressures stemming from the ageing of the population. To be able to finance the higher demand for welfare services it will be necessary to increase productivity and employment participation since the scope to increase tax rates is limited. Furthermore, a government committee on public sector responsibilities is currently studying the structure and division of responsibilities across different layers of government with a view to securing the public welfare commitment. Thus, even if the outlook for local government finances look beneficial in the short term, the major budgetary challenges remain.

[221] See NIER (The National Institute of Economic Research) 2004: The Swedish Economy, December 2004

[222] The SOU (2004), The long-term survey of the Swedish economy, Swedish government official report 2004:19

25. United Kingdom

Recent developments and medium–term prospects

The outturn for the general government balance in financial year 2004/05[223] is estimated in the March 2005 Budget to be a deficit of 3.0% of GDP, a worse outturn than the 2.7% deficit projected in the March 2004 Budget (and also the 2.9% projected in the December 2004 update of the UK convergence

Table V.60. Budgetary developments 2003-2008/2009, United Kingdom (% of GDP)

Outturn and forecast*	**2003**	**2004**	**2005**	**2006**		
General government balance	-3.4	-3.2	-3.0	-2.7		
- Total revenues	40.0	40.4	40.9	41.4		
Of which : - current taxes	*28.4*	*29.0*	*29.6*	*30.0*		
- social contributions	*8.0*	*8.1*	*8.1*	*8.1*		
- Total expenditure	43.4	43.6	44.0	44.1		
Of which : - collective consumption	*8.0*	*8.1*	*8.2*	*8.3*		
*- social transfers***	*26.4*	*26.5*	*26.5*	*26.5*		
- interest expenditure	*2.1*	*2.1*	*2.1*	*2.1*		
- gross fixed capital formation	*1.7*	*1.8*	*2.0*	*2.1*		
Primary balance	-1.3	-1.1	-1.0	-0.7		
Pm Tax burden	36.5	37.2	37.8	38.2		
Government debt	39.7	41.6	41.9	42.5		
Pm Cyclically-adjusted balance	-3.0	-3.0	-2.9	-3.0		
Pm Cyclically-adjusted primary balance	-0.9	-1.0	-0.8	-0.5		
Pm *Real GDP****	2.2	3.1	2.8	2.8		
Convergence programme****	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**	**2008/09**
General government balance*****	-3.2	-2.9	-2.8	-2.3	-2.1	-1.7
Primary balance******	-1.2	-0.8	-0.7	-0.2	-0.1	n.a.
Government debt	39.5	40.9	41.8	42.4	42.8	42.8
Pm *Real GDP****	2¾	3¼	3	2½	2¼	2¼

* Commission services' spring 2005 economic forecasts. Interest expenditure, total expenditure and balances include swaps in line with the definitions used in the excessive deficit procedure.
** In kind and other than in kind.
*** Annual % change.
**** Submitted in December 2004.
***** The UK authorities include, in their projections for the general government balance, annual receipts of around £1.0 billion from the sale of UMTS licences in 2000. All figures in the table are after adjusting for this, to bring the projections onto an EDP basis (in line with the Eurostat decision set out in News Release 81/200 of 14 July 2000); this has the effect of subtracting around 0.1pp from the balance (i.e. increasing the deficit) in each year.
****** The UK authorities provide primary balances excluding net interest rather than only interest payments as done by the Commission. Figures shown above are as recalculated by Commission services.
Source: Commission services and convergence programme of the United Kingdom.

[223] The financial year runs from April to March.

programme) (all figures reported here are after adjustment by Commission services: see footnote ***** in Table V.60).

This deterioration appears to reflect both revenue growth slightly weaker than expected, in spite of robust GDP growth, and strength in current spending. On the revenue side, general government current receipts are estimated to have been £3.8 billion (0.3% of GDP) lower than expected in the 2004 Budget, even though the rising price of oil led to stronger revenues from North Sea oil production. Disappointing growth of corporation tax receipts during the first half of the financial year was a significant factor in the shortfall, which the authorities suggest may have reflected a previous underestimate of the backlog in unused losses accumulated by financial companies that have depressed taxable profits in the short term, a legacy of the earlier collapse in equity markets. More recently, however, receipts of corporation tax have picked up sharply, reflecting a combination of continued strength in corporate profitability and the introduction of a number of measures designed to reduce tax avoidance. On the expenditure side, general government current expenditure is estimated to have been £1.4 billion (around 0.1% of GDP) higher than expected in the 2004 Budget: central government departments appear to have made use of accumulated under-spends from previous years, available to them under the UK's system of "End Year Flexibility". The authorities argue this reflects a smoothing of expenditure given that the rate of growth in spending planned for 2004/05 had been slower than for either the preceding or following financial years. The authorities also note higher-than-expected expenditure on the UK's international commitments, including Iraq. However, this is offset by lower net investment than projected in the 2004 Budget: investment is now estimated to have been some £2 billion (0.2% of GDP) less than planned through 2004/05. The debt ratio, meanwhile, is estimated to have reached 41.0% of GDP by the end of 2004/05.

The latest Budget, presented on 16 March 2005, sets out a number of discretionary policy changes which have a broadly neutral impact on the UK's fiscal position in both 2005/06 and 2006/07. The largest expenditure measure was a one-off £200 contribution to all households containing someone over 65 with an obligation to pay the local government tax levied on property values ("council tax"). The biggest revenue measure was a one-off change to the payment profile of North Sea corporation tax (expected to bring in over £1 billion or 0.1% of GDP) over the coming financial year. The 2005 Budget also set out new estimates and projections for the public finances, updating those set out in the December 2004 convergence programme update. The general government balance is now expected to improve modestly to a deficit of 2.7% for 2005/06. In the Commission services' spring 2005 forecast, the projected outcome for calendar year 2005 is also for a modest improvement, but to a slightly less optimistic 3.0% of GDP. This largely reflects a more conservative estimate of revenue recovery, despite forecasts for GDP growth broadly similar to the macroeconomic forecasts used by the government to forecast the public finances. Nonetheless, as measured by the change in the cyclically-adjusted balance, the fiscal stance in 2005 is broadly unchanged or very slightly tighter than in 2004.

In 2006, under a no-policy change assumption, the Commission services' spring 2005 forecast projects a further modest improvement in the general government balance, to a deficit of 2.7% of GDP, though remaining higher than the authorities' projection of 2.3% in financial year 2006/07.

Table V.61. Main measures in the budget for 2005, United Kingdom

Revenue measures	Expenditure measures
• Changes to advance the payment profile of North Sea corporation tax (0.1% of GDP in 2005/06) • Changes in property transactions tax regime ("stamp duties"): ending relief for commercial transactions in disadvantaged areas (0.03% of GDP); doubling of the zero-rate threshold from £60,000 to £120,000 for residential transactions (- 0.03% of GDP) • Specific counter-measures preventing tax-avoidance through: the use of financial product based schemes (0.03% of GDP); the exploitation by companies of differences within and between tax codes (0.01% of GDP) • Deferral of the previously planned inflation-based increase in main road fuel duties to 1 September 2005 (- 0.02% of GDP)	• Payments of £200 to over-65 households to defray local government property ("council") tax charges (0.08% of GDP) • Overseas obligations including in Iraq (0.04% of GDP)

Source: Commission services and Budget 2005.

Table V.62. Annual public service efficiency savings expected or achieved in the UK since July 2004

Department	How	Amount (% of GDP)
Health	Negotiating a new procurement deal for generic medicines	0.07 expected
	Negotiation of a new procurement deal for branded medicines	0.03
Home Office	Better use of police time, smarter procurement, improvements to the National Offender Management Service, substantial reductions in the cost of asylum	0.06
Defence	Improving defence logistics	< 0.03
Office of the Deputy Prime Minister	Reforms to the delivery of new supply, capital works, commodity procurement and management and maintenance	> 0.02
Work and Pensions	Paying the benefits and pensions of 90% of its customers directly into their bank accounts	< 0.02

Source: Commission services, Pre-Budget Report 2004, Budget 2005.

Thereafter, the authorities assume that the balance will continue to improve steadily, to 1.6% of GDP by 2009/10. This is broadly in line with the profile envisaged in the December 2004 update of the UK's convergence programme.[224]

According to the Commission services' spring forecast, the general government gross debt-to-GDP ratio is expected to rise over the forecast period, from 41.6% of GDP in 2004 to reach 42.5% in 2006.

Improving the efficiency of public services

Recent policy priorities in the UK aim to overturn a legacy of under-investment and under-provision in public services by increasing government current and capital spending. Consequently, though remaining within the overall constraints of the UK's domestic fiscal policy rules, total general government spending has risen from around 39½% of GDP in 1999 to around 43½% in 2004, while a reduction in debt interest costs has also allowed spending to be redirected from servicing debt to public services – interest payments fell from 3.6% of GDP to 2.1% between 1996 and 2002, reflecting consolidation of the public finances from 1997 to 1999 and improvements to the macroeconomic framework. The rise in general government spending (plus slower growth in 2002) has contributed to the general government balance deteriorating from surplus as recently as 2001 to a 3.2% of GDP deficit in 2004.

The authorities have introduced a series of reforms to ensure public services are provided efficiently. These include the introduction of Public Service Agreements (PSAs) which set out the outcomes each government department is committed to achieving (detailed in the 2002 Public Finances in EMU Report), and service delivery agreements (SDAs) which outline the steps that will be taken to achieve these objectives. Building on this, and reflecting the increased pressure on the public finances, the 2003-2005 BEPGs included a recommendation for the UK authorities to ensure that the public services accompanying the planned increase in spending "…are delivered efficiently and with a view to ensuring cost-effectiveness".

The 2003 Budget made achieving efficiency savings in public service delivery a key objective, savings which the government intended to redirect to increase the direct provision of public services. Potential savings were identified in a report commissioned by the government and published in July 2004, *Releasing resources to the front line: Independent Review of Public Sector Efficiency*, (the Gershon Report[225]). Its results and recommendations were accepted by the government and fed directly into both the 2004 Budget and the 2004 Spending Review which, in July 2004, set out detailed spending plans for the financial years 2005/06 to 2007/08.

Taking its figures directly from the Gershon Report, the 2004 Spending Review identified potential annual public sector efficiency gains of over £21.5 billion (roughly 2% of GDP) by 2007/08. This was based on departments achieving annual efficiency savings relative to their baseline expenditure[226] of at least 2.5% per year over the period from 2005/06. Contributing to that end, the Spending Review set each government department's administration budget for 2006/07 and 2007/08 at, or below, its 2005/06 nominal level, implying a real terms

[224] The programme and its assessment by the Commission and the Council, can be found at: http://europa.eu.int/comm./economy_finance/about/activities/sgp/main_en.htm.

[225] Prepared by Sir Peter Gershon, a former chief executive of the Office of Government Commerce (the government's centralised procurement agency set up in 2000).

[226] Baseline expenditure is defined as the departmental expenditure limit (DEL) plus additional spending by local government in particular policy areas for which they are responsible (e.g. education), in financial year 2004/05. Departments are expected to achieve a 2.5% saving relative to that baseline in each of the three years covered by the 2004 Spending Review, i.e. 2005/06 through to 2007/08, implying a cumulative efficiency gain equivalent to 7.5% of expenditure in 2004/05.

reduction in administration costs alone of at least 5% over the two-year period.[227]

The Gershon savings include a net reduction in civil service employment of 70,600 posts (roughly 13.5 per cent of the April 2004 total of 523,580) by 2008; 84,000 posts are to be cut, of which just under 14,000 post-holders are intended to be moved to direct service provision. A further 20,000 jobs were expected to be cut by the devolved administrations of Scotland, Wales and Northern Ireland, while just over 20,000 posts were identified for relocation away from the south-east of England to lower-cost locations.

Six areas were identified as providing scope for the efficiency savings and job reductions. The first is improving the efficiency of "back office" facilities by such means as pooling administrative functions to eliminate job duplication amongst departments. Another is to get better value out of public procurement. The third is by improving processes associated with government transactions, including the operation of benefit payments. The fourth and fifth are by lightening the monitoring and regulation of the public and private sectors. The final area is by increasing the time spent by staff on service delivery, including by improving sickness absence management.

The government has set out a formal process for assessing departmental progress against the targets set in the 2004 Spending Review. Departmental reports setting out how performance will be measured have been scrutinised by the National Audit Office (NAO) and the Audit Commission, and are have been made public. Departments will be required to report formally on their progress against efficiency targets in their Departmental Reports, published each spring. In addition, all departments will be required to have, by December 2006, a professional finance director reporting to the Head of Department (the Permanent Secretary), with a seat on the departmental board.

Measures to reap the efficiency savings identified in the Gershon Report were only initially understood to start from financial year 2005/06 – i.e., April 2005 on. However, the December 2004 Pre-Budget Report and the March 2005 Budget claim that substantial progress has already been made, with £2 billion already saved. Details of some of the biggest savings are provided in Table V.62.

Of the 84,000 civil service posts the government intends to try to eliminate by 2008, it expects 12,500 to have gone by the end of 2005. The bulk of these are being eliminated from the Department of Work and Pensions. On the relocation of posts away from south-east England, the government claims that by the end of 2004/05 it will have achieved 4,300 of the 20,000 due by the end of 2008 and that another 3,500 posts are already firmly planned for relocation.

This "input-oriented" approach should complement the existing focus by Public Service Agreements on outputs/results – indeed, the Treasury has a specific PSA objective of "*working with departments to help them meet their ... efficiency targets amounting to £20 billion a year by 2007/08"*. Fully assessing the ultimate success of the initiative will, however, only become evident over the medium term, not least because some identified potential savings are difficult to assess ex ante. In addition, a successful outcome, one that is easily demonstrable to the wider public, requires clear, rigorous and accessible assessments.

[227] It is important to note that the spending plans set out in the 2004 Spending Review - and the government's fiscal rules - do not rely on the efficiency targets being met. The overall spending plans have been set consistent with the authorities' view that the spending is affordable even without the efficiency savings. Instead, if the savings are achieved, the government intends to use all of the released resources for further provision of public services, leaving the overall level of expenditure unchanged.