ARTICLES

THE IMPORTANCE OF PUBLIC EXPENDITURE REFORM FOR ECONOMIC GROWTH AND STABILITY

Public expenditure can promote growth by financing essential public services, such as security, infrastructure and education. It can also smooth economic fluctuations by means of automatic stabilisers, for example, supporting the incomes of unemployed or retired workers. Stability requires, nevertheless, that expenditure is fully financed by revenue in the medium term, guaranteeing in this way that current policies, as reflected in government accounts, are sustainable.

This article shows that public expenditure-to-GDP ratios have steadily increased in the euro area countries since the 1960s before peaking and, in some cases, declining in more recent years. Public expenditure is, nevertheless, much higher than in most industrialised countries outside the euro area. According to many observers, it exceeds the levels required for the efficient provision of essential public services. The increasing levels of spending coincided with rising taxes and disincentives to work and invest, as well as growing fiscal imbalances. More recently, population ageing is pointing to additional expenditure pressures that risk undermining fiscal sustainability.

Several euro area countries have already made important progress with regard to expenditure reform. They have experienced remarkably strong fiscal and growth performance. But more progress is needed in a number of countries, notably in those Member States which have been in excessive deficit over recent years. Expenditure reform should be underpinned by compliance with the EU fiscal and policy coordination framework and by improvements in national fiscal institutions.

1 INTRODUCTION

In recent years, the expenditure side of public budgets has gradually received greater attention in the economic policy debate, both at the national and the EU level. On the theme of the "quality" of public finances there has been growing debate on how much governments should spend and on what, and how expenditure reform can contribute to more economic growth and stability. Awareness of the importance of expenditure reform has also been raised by persistent deficits and high debt, coupled with tax rates that are comparatively high from an international perspective and strong spending pressures stemming from population ageing.

This article focuses on the relevance of public expenditure for growth and stability. Naturally, public spending can also pursue other objectives, such as redistribution or social cohesion, which can be seen as contributing to economic welfare.

Section two reviews expenditure trends and patterns in the euro area. Section three examines the conceptual and empirical linkages between public expenditure, economic growth and fiscal sustainability. Expenditure reform experiences are addressed in Section four. Section five discusses expenditure reform in the context of fiscal institutions and European economic policy coordination. Section six provides concluding remarks.

2 EXPENDITURE TRENDS AND PATTERNS IN THE EURO AREA

The importance of public expenditure and the potential for reform in the euro area economies becomes apparent when looking at trends and international comparisons in public expenditure developments. The expenditure-to-GDP ratio of the euro area increased significantly from 30.4% of GDP in 1960 to 45.0% of GDP in 1980 and gradually rose further to 49.0% of GDP in 1998, before declining somewhat to stand at 47.7% of GDP in 2004 (see Table 1). From an international

Table 1 Total general government expenditure

(percentages of GDP)

	1960	1980	1998	2004	Maximum (year)
Belgium	33.2	56.1	51.2	50.2	61.0 (1983)
Germany	31.8	47.1	48.7	47.5	50.2 (1996)
Greece	20.6	29.0	49.5	49.9	52.0 (2000)
Spain	20.3 [1]	31.5	41.0	39.0	47.6 (1993)
France	33.4	45.7	53.5	54.0	55.4 (1996)
Ireland	26.0	46.1	34.8	34.2	49.8 (1982)
Italy	28.1	43.0	49.6	48.6	57.1 (1993)
Luxembourg	25.4	48.4	42.1	45.6	51.7 (1981)
Netherlands	29.3	53.3	46.0	47.1	57.1 (1983)
Austria	34.1	46.8	53.9	50.4	56.7 (1995)
Portugal	14.7	34.8	42.3	46.5	46.5 (2004)
Finland	26.3	39.1	52.8	51.5	61.0 (1993)
Euro area	30.4	45.0	49.0	47.7	51.9 (1993)
United Kingdom	36.1	43.2	40.0	44.1	45.4 (1984)
Japan	16.6	31.5	42.5	38.6	42.5 (1998)
United States	28.2	33.8	33.0	34.3	37.2 (1992)

Sources: European Commission, OECD for Spain in 1964, and ECB for euro area aggregated data.
1) Data for 1964.

perspective, public expenditure-to-GDP ratios in the euro area are very high. They exceed those of the United States and Japan by a wide margin. These two countries' public spending is roughly one-quarter lower than that of countries in the euro area.

This general picture, however, masks significant differences between countries. Spending ratios ranged from approximately 35% of GDP in Ireland to well above 50% of GDP in France in 2004. The overall increase of 17.3 percentage points of GDP for the euro area between 1960 and 2004 corresponds to a rise in spending ratios in all countries. However, this average reflects a minimum increase of 8.2 percentage points of GDP in Ireland and a maximum increase of 31.8 percentage points of GDP in Portugal.

There was an important break in the upward trend in expenditure as expenditure-to-GDP ratios peaked at some point in the 1980s or 1990s in most euro area countries. In the majority of cases, this maximum level exceeded 50% of GDP. Following the peaks in public expenditure, a few countries started to reduce public spending ratios in the 1980s, and most other euro area countries curtailed their spending commitments from the early to mid-1990s. In some cases, this reduction was very significant, exceeding 10 percentage points of GDP compared with peak levels.

When looking at the composition of public expenditure at the euro area level in 2004, one can see that broadly two-fifths of total public spending was dedicated to public consumption, the main component of which is constituted by the wages of government employees (see Table 2). One-tenth of public expenditure or about 5% of GDP was for public education. A further two-fifths of total spending was allocated to transfers and subsidies to households and enterprises. This mainly consisted of social security-related spending and, to a much smaller extent, industrial support. Only about 5% of government spending related to public investment. The servicing of public debt fell strongly in recent years to little more than 6% of total spending.

The small reduction in the euro area expenditure ratio since the start of Stage Three of EMU was mainly achieved thanks to a decrease in interest payments. This is above all the consequence of declining long-term interest rates implicit in the outstanding stock of government debt after entering Monetary Union (the "EMU premium").

Table 2 Composition of total general government expenditure in the euro area

(percentages of GDP)

	1998	2004
Total expenditure	49.0	47.7
Interest	4.6	3.2
Primary expenditure	44.4	44.5
Compensation of employees	10.6	10.5
Current transfers	25.4	25.3
of which: subsidies	2.1	1.8
Investment	2.4	2.5
Capital transfers	1.4	1.4
Other expenditure	4.6	4.8
Memo item: government consumption	19.7	20.3

Source: ECB.

By contrast, the primary expenditure-to-GDP ratio remained broadly stable.

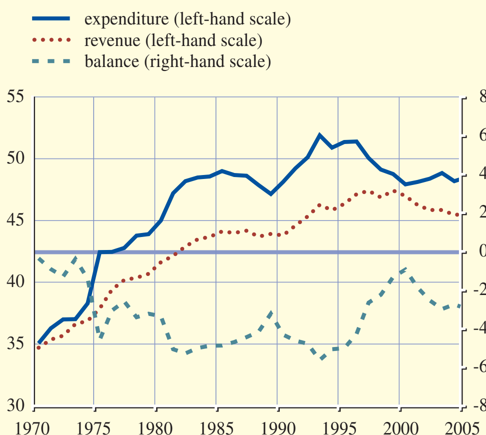
In analysing the link between public expenditure and the impact of public finances on economic stability and growth, it is useful to look at the relationship between public spending and deficit and debt developments. The emergence of chronic deficits in Europe coincided with strong expenditure increases in the 1970s and early 1980s (see Chart 1). It was only when expenditure ratios started to decline more markedly in the second half of the 1990s that fiscal deficits were also significantly corrected. The reversal in aggregate deficits after the year 2000 came about when tax cuts were not accompanied by a corresponding decline in the expenditure ratio.

Indirectly, expenditure developments also influence debt developments. Chart 2 shows that the public debt ratio of the euro area continued to rise as long as expenditure remained on a steep upward path and deficits were high. This trend briefly reversed in the second half of the 1990s but the recent period has again seen increasing debt ratios.

When discussing public expenditure and related challenges, it is also crucial to anticipate future developments that could strongly affect government commitments. In this regard, the most important factor is the fiscal cost of population ageing. This can be expected to burden public budgets over the decades to come in Europe in the form of pension, health care and long-term care spending. Age-related public expenditure projections point to a future increase in total pension expenditure in most countries of between 3% and 8% of GDP, but in

Chart 1 General government balance, expenditure and revenue ratios in the euro area

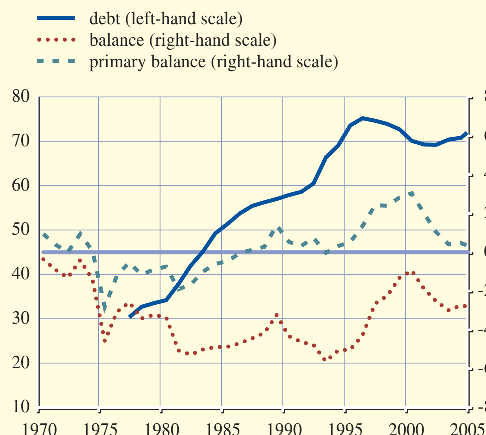
(percentages of GDP)



Source: European Commission.

Chart 2 General government debt and balance ratios in the euro area

(percentages of GDP)



Source: European Commission.

Table 3 Projected changes in selected age-related expenditure-to-GDP ratios between 2004 and 2050

	Pensions (1)	Health (2)	Long-term care (3)	Total [1] (1+2+3)
Belgium	5.1	1.4	1.0	7.5
Germany	1.7	1.2	1.0	3.9
Greece	na	1.7	na	na
Spain	7.1	2.2	0.2	9.5
France	2.0	1.8	na	na
Ireland	6.4	2.0	0.6	9.0
Italy	0.4	1.3	0.7	2.4
Luxembourg	7.4	1.2	0.6	9.2
Netherlands	3.5	1.3	0.6	5.4
Austria	-1.2	1.6	0.0	0.4
Portugal	9.7	0.5	na	na
Finland	3.1	1.4	1.8	6.3
Euro area	2.6	1.5	0.5	4.6

Sources: Economic Policy Committee, Ageing Working Group, January 2006.
Note: na = not available.
1) Small expenditure reductions may be expected due to lower spending on education and unemployment.

Box 1

EXPENDITURE COMPARABILITY ISSUES

A number of drawbacks in the measurement of public finances and a lack of consistent cross-country information make it difficult to fully compare public spending behaviour across different countries, in terms of both levels and composition.[1] In particular:

– Some countries substitute direct spending with tax expenditure, for example by providing tax allowances for married couples and children instead of direct transfers.

– Whereas some countries tax social transfers in the same way as wage income, others exempt them partially or completely from taxation. As a result, expenditure and revenue levels in this category are on average higher in the first group of countries.

– Mandatory private insurance schemes for pensions, unemployment or health care reduce the headline figures for public expenditure in some countries. Conversely, state contributions to voluntary payments into social security funds increase spending levels.

– Public-private partnerships (PPPs) are treated differently across countries and can temporarily reduce the level of public investment spending, especially if cost accounting for a PPP project is spread over a longer time period than for a conventional public investment.

– In some cases, contingent liabilities like state-backed loan guarantees may not be reflected in public expenditure figures, therefore, the potential future spending commitments of the government may be understated. Additionally, the size of contingent liabilities varies considerably across different countries.

1 See, for instance, "Enhancing the Effectiveness of Public Spending: Experience in OECD Countries", by I. Joumard, P. Kongsrud, Y.-S. Nam and R. Price, OECD Economics Department Working Paper No 380, 2004.

These factors can explain differences between countries in the figures for total spending and on certain categories of up to several percentage points of GDP. Fiscal reforms can also increase or reduce such differences over time. However, a correction of expenditure data for such influences over time and across countries is not available.

certain euro area countries this ratio may be even higher (see Table 3). If unchecked, these obligations would again put public expenditure on a significant upward trend in the coming decades.

3 LINKAGES BETWEEN PUBLIC EXPENDITURE, ECONOMIC GROWTH AND FISCAL SUSTAINABILITY

Public expenditure policies are key for promoting economic growth and preserving a stable macroeconomic environment, which require sustainable public finances. From this perspective, expenditure policies are of high quality if they (i) provide essential goods and services, (ii) make efficient use of public resources in undertaking these activities, and (iii) underpin macroeconomic stability, being medium-term oriented, predictable and sustainable. While the first two conditions refer to objectives of effectiveness and efficiency, the third one is instrumental for the attainment of the other two. Moreover, expenditure policies can underpin the institutional framework in which an economy operates and which itself is the fundamental precondition for growth and stability.

A minimum of public spending is indispensable to allow a market economy to function. Legal constraints and rules that secure property rights and efficient markets minimise political uncertainty, promote competition, secure adequate information and allow efficient risk management. This, in turn, induces economic agents to work, save, invest, specialise and innovate, which is conducive to employment and growth. Expenditure policies that, for example, secure sufficient funds for internal and external security and public administration, favour a high quality civil service, and abstain from undue subsidies, also ensure that institutions and private markets work smoothly and that the wheels of the economy are well oiled.

Core public spending includes mainly essential expenditure for administrative services and justice, basic research, basic education and health, public infrastructure and internal and external security. Spending on these categories can raise the growth potential of an economy not only through the institutional channel mentioned before but also by increasing the labour supply and the quality and stock of human and physical capital. Infrastructure spending may not only be beneficial by itself but may also crowd in additional private investment. However, the benefits of additional expenditure must also be assessed against the costs of the required taxation – a dimension that is often neglected.

The limits of core spending are hard to assess precisely. If it is assumed to be approximated by the sum of government consumption, in the euro area the level was around 20% of GDP during the last decade (see Table 2 above). However, not all spending included under these categories is likely to be core or essential. It is not a given that the government should be the principal provider of higher education, electricity or other services. Moreover, some public investment spending may go into projects motivated by other political aims, including prestige, rather than responding to genuine infrastructure needs.

The remaining main spending category is transfers and subsidies which is of a redistributive nature and is typically considered “unproductive”, as it does not stimulate growth,

but may have significant economic costs due to distortive taxes and adverse incentives effects. Public spending on early retirement or to maintain inefficient industries is particularly noteworthy in this regard as such measures reduce incentives to work and invest in productive activities. Nevertheless, spending on basic social safety nets could be seen as productive. They reduce the need for precautionary savings and enhance the ability of economic agents to take risks. Redistributive social spending, as noted above, has been the fastest growing spending category in recent decades and reached an average of around 20% of GDP in the euro area.

Public spending is managed in the most efficient way when it minimises the need for financing to attain a certain policy objective. The efficiency of public spending can be improved through a number of techniques, such as performance budgeting, human resource management tools and market-like pricing mechanisms. Audit and public procurement rules and cost-benefit analysis can also help in this regard. For some services, public financing (or financial support) can be combined with the private provision of services if this allows a better use of public money. In the area of social spending, efficiency can be increased if outlays are better targeted to the poor.

In order to promote growth and stability, expenditure policies have to be sustainable. Sustainability enhances the confidence of economic agents in the stability of the future economic environment and their willingness to invest. This, in turn, supports growth, which further boosts sustainability. If governments want to enhance sustainability by lowering deficits and debt without raising taxes, expenditure restraint and reform are the only option. If additional tax cuts are found to be warranted, this would require further expenditure retrenchment. Moreover, public expenditure may stabilise demand in periods of economic fluctuation via automatic stabilisers. However, the resulting higher deficits can stabilise demand effectively only if public accounts are perceived to be sustainable. Agents are then less likely to react to rising deficits with increased savings that would undo the stabilising effect.

Empirical evidence abounds that higher public spending *per se* does not always translate into better outcomes.[1] Above a certain point, public spending can even be harmful to growth and sustainability. Moreover, there is clear evidence that spending-induced fiscal deficits are detrimental to attaining these objectives. In any case, the existing literature does not allow for the determination of an objective and unambiguous classification of "high quality"

1 For a survey of results see "Quality of public finances and growth", by A. Afonso, W. Ebert, L. Schuknecht and M. Thöne, ECB Working Paper No 438, February 2005.

Box 2

MEASURING AND ASSESSING EXPENDITURE EFFICIENCY

The adequate measurement and assessment of public sector efficiency is a difficult empirical issue, and related literature that includes international comparisons is particularly scarce. One possible approach is to compute indicators of public sector performance, which can then be assessed against the amount of public resources used. The resulting efficiency indicators allow comparisons to be made between countries.[1] Such indicators can measure performance and efficiency in providing opportunities and a level playing-field in the market process and the

1 See "Public Sector Efficiency: An International Comparison", by A. Afonso, L. Schuknecht and V. Tanzi, 2005. *Public Choice* 123 (3-4), pp. 321-347.

traditional "Musgravian" tasks of government: macroeconomic stabilisation, income redistribution and efficient resource allocation. These indicators can then be aggregated to form composite performance and efficiency measures.

Most studies on public spending efficiency analysis apply non-parametric approaches, such as Data Envelopment Analysis. They look at measures of public sector outputs/outcomes, and compare these to the inputs measured in monetary terms or quantitative input measures. For instance, countries, municipalities or schools are seen as decision management units, which use inputs (the number of teachers or public spending on education) and produce education services whose quality can be measured through the level of student proficiency (e.g. in tests conducted by the Programme for International Student Assessment – PISA).[2] Using these approaches it is possible to derive a theoretical production frontier and the distance of each observation (decision management unit) from the frontier is used to obtain efficiency scores.

On the whole, this literature finds some differences in the effectiveness and major differences in the efficiency of public spending across industrialised countries. A better public sector "performance" is largely not correlated with more public spending. This points to declining marginal returns of higher public spending and the possibility of attaining favourable outcomes for key policy objectives with much lower spending than is the case today in many countries.

2 For an example see "Non-Parametric Approaches to Public Education and Health Efficiency in OECD Countries", by A. Afonso and M. St. Aubyn, 2005. *Journal of Applied Economics* 8 (2), pp. 227-246.

expenditure items, their optimum level, and their precise impact on sustainability and growth. Nevertheless, empirical studies and simulation models have facilitated a better understanding of the transmission mechanisms and the effects of expenditure policies on the economy. Quality indicators for public finances and commonly used methodologies for their assessment and international comparison can be illustrative and helpful for assessing expenditure efficiency (see Box 2).

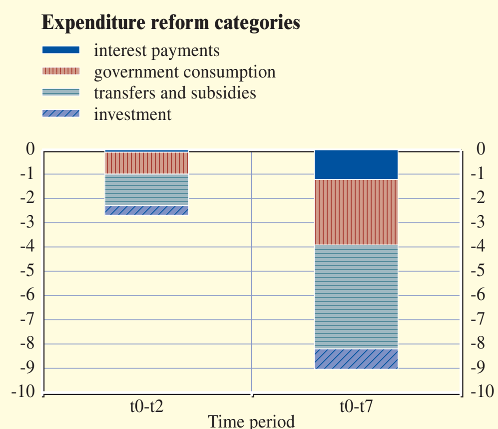
4 EXPENDITURE REFORM EXPERIENCES

National experiences of public expenditure reform in the euro area over recent decades are very heterogeneous. Some euro area countries have significantly reduced their total and primary expenditure ratios. Others have made little visible progress in curtailing public spending, despite the fact that interest payments have declined significantly since the early 1990s due to the structural fall in interest rates (the "EMU premium").

Seven euro area countries embarked on sizeable expenditure retrenchment and reform programmes of public spending. These "reform countries" are characterised by primary expenditure cuts exceeding 5% of GDP compared with their respective historic spending peaks. Expenditure reforms, however, were typically not undertaken in isolation but as part of a broader, comprehensive agenda of reforms. Historically, two "waves" of reform can be discerned, one starting in the early 1980s, and another commencing in the early to mid-1990s in the context of the EMU convergence process and following the signing of the Maastricht Treaty. Four countries began reforms in the first wave (Belgium, Ireland, Luxembourg and the Netherlands), and another three countries started reforms in the second wave (Spain, Austria and Finland), with the Netherlands and Ireland also engaging in a second major reform effort during this period. By contrast, the other five euro area countries made little or no progress on primary expenditure reform and currently report public expenditure ratios near or at their all time high. These also happen to be the five countries that

Chart 3 Reductions in individual expenditure categories over 2 and 7 years following historic spending peaks in the reform countries

(changes in GDP ratios)



Source: European Commission.
Note: Luxembourg is not included due to lack of data.

are subject to an excessive deficit procedure at the time of writing. To illustrate both short-term reform efforts and the efforts made over a full "reform wave", Chart 3 shows the expenditure reductions that the reform countries (excluding Luxembourg) have undertaken within two and seven years after their respective expenditure peaks.

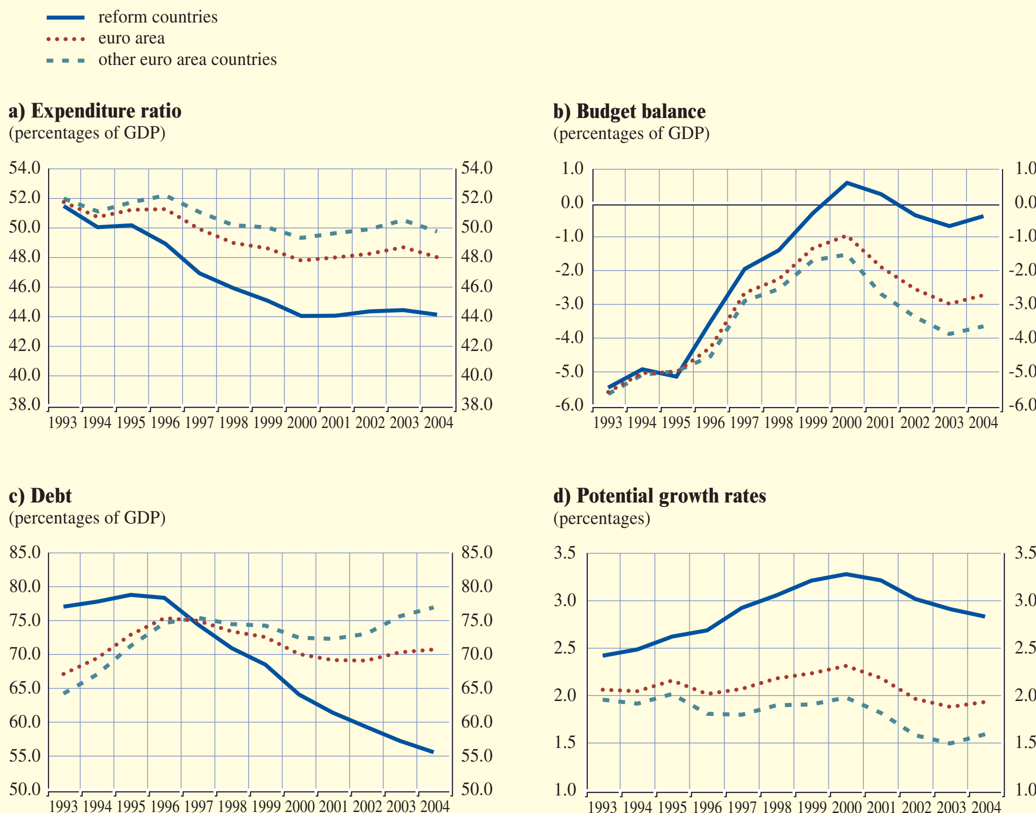
The empirical evidence suggests that on average the reform countries were able to cut total expenditure by nearly 3% of GDP within two years and by about 9% of GDP over seven years. The reductions have occurred mostly in the area of primary expenditure. While falling interest payments did contribute to some extent to the overall decrease in public spending over time, the bulk of the expenditure retrenchment was achieved by discretionary cuts in the areas of government consumption and income transfers and subsidies. This indicates that a strong effort was made to streamline government commitments in these reform countries. Reductions in government consumption were often accomplished by lower spending on the public wage bill, which, in turn, was brought about by a combination of wage restraint and personnel reductions. Cuts in income transfers were achieved by the adjustment and/or better targeting of benefits. Despite some decline, productive spending such as on investment and education has typically not been affected disproportionately, so that these reforms also resulted in an improved composition of public expenditure. Furthermore, the reforms have on average allowed substantial and fully financed tax cuts.

On the whole, the countries that undertook sizeable expenditure retrenchment as part of broader reform agendas have been remarkable success stories when looking at the post-reform development of macroeconomic indicators. Chart 4 presents fiscal and economic indicators for this group compared with the other euro area countries as well as with the euro area as a whole in the period following the adoption of the Maastricht Treaty.

Since 1993, the reform countries have on average reduced their public expenditure-to-GDP ratios from 52% to around 44%. The remaining five euro area countries continued registering expenditure ratios that, on average, stayed above or close to 50% of GDP. In recent years, however, expenditure ratios have broadly stagnated in both groups.

Expenditure reforms generally coincided with an overall stronger and more persistent improvement in the fiscal balance. This can clearly be seen from the comparison of the reform countries with the other five shown in Chart 4b. While most reforms helped to correct what were at times grave fiscal imbalances, some were associated with remarkable turnarounds in debt dynamics, which then enabled further favourable developments of the debt-to-GDP ratio (see Chart 4c). These charts also provide an interesting picture of recent years. The reform countries on average experienced some deterioration in their fiscal balances during the recent period of weak economic growth as automatic stabilisers were allowed to operate. But they were able to maintain deficits at reasonably low levels that still enabled the downward debt trend to continue. The five other countries, however,

Chart 4 Indicators for reform countries and other euro area countries as well as the euro area average



Source: European Commission.
Notes: Country groups are GDP-weighted. Luxembourg is not included. Expenditure ratios exclude proceeds from the sale of UMTS licences. The European Commission estimates potential output via a production function.

experienced a re-emergence of major imbalances and renewed upward debt dynamics. This suggests that expenditure retrenchment can be a highly effective way to secure lasting fiscal consolidation.[2]

Expenditure retrenchment and reform coincided with a significant rebound in employment and potential growth. For the reform countries, potential growth increased by almost 1 percentage point to well above 3% during the reform period between the early and late 1990s (see Chart 4d). The other countries, by contrast, experienced a flat potential growth rate of around 2%. In recent years, the gap in potential growth between the two country groups has remained broadly stable.

There are also two important features regarding the timing of reform. Front-loading the adjustment effort is a remarkable common characteristic of these expenditure reform experiences. A significant share of retrenchment measures was usually implemented in the initial two years, when primary expenditure came down by an average of 1.5% of GDP per year. Moreover, expenditure reforms started in a context of low economic growth or recession.

2 For further related discussions and empirical evidence, see for instance "Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects", by A. Alesina and R. Perotti, 1997, IMF *Staff Papers*, 44 (2), pp. 210-248; "Non-Keynesian fiscal consolidation in the EU? *Ex post* evidence and *ex ante* analysis", by G. Giudice, A. Turrini and J. in't Veld, 2004, CEPR Discussion Paper 4388; "Reforming Public Expenditure in Industrialised Countries. Are there Trade-Offs?", by L. Schuknecht and V. Tanzi, 2005, ECB Working Paper No 435.

Box 3

EXAMPLES OF SUCCESSFUL EXPENDITURE REFORMS

Ireland faced a persistent slowdown in GDP growth in the early 1980s, accompanied by rising unemployment and inflation as well as widening fiscal deficits. Following some retrenchment after 1982, a comprehensive turnaround was undertaken from 1987 which, under the "Programme for National Recovery", centred on a deep-rooted expenditure reform. These reforms resulted in a decline in primary spending of over 11% of GDP up to 1989 compared with the maximum level of 41.6% of GDP in 1982. Total spending was lastingly reduced by more than 15% of GDP, to stand at 34.2% of GDP in 2004 compared with the peak level of 49.8% of GDP in 1982.

The Irish expenditure reform comprised fiscal consolidation with comprehensive structural reform measures. On the fiscal side, public consumption was brought down by a combination of wage constraint and a significant reduction in civil service personnel. Public employment declined by almost 14% between 1982 and 1989. In addition, expenditure reforms involved sizeable reductions in income transfers and subsidies, the latter being cut by almost two-thirds in 1988 alone. Furthermore, social spending and specifically health and pension expenditure was reduced to a considerable extent. Eligibility for social security benefits was tightened and targeting was improved while the real value of benefits was frozen. This enhanced labour market incentives. Economic growth picked up in the wake of the reform and delivered fiscal surpluses, enabling a rapid decline in public debt and significant tax cuts to be achieved.

Spain entered a period of growth slowdown in 1992 and went into recession the year after, contributing to significant fiscal deficits and an unemployment rate of close to 24%. The government implemented an ambitious and comprehensive reform programme in the mid-1990s. Total and primary expenditure declined by almost 3% of GDP in the first two years of adjustment after 1993 and fell by over 8% and close to 6% respectively by 2004.

The main reform period was 1994-97. The biannual budget for 1994 and 1995 focused on restraint in public sector wages and reductions in public employment and lowered spending on subsidies and social transfers (especially in the areas of unemployment, pensions and disability benefits). For 1996 and 1997, discretionary expenditure was compressed further with a particular squeeze on government consumption and subsidies. The determined expenditure reform, coupled with significant structural reforms, laid the groundwork for a broad-based fiscal consolidation, improved labour market performance and economic recovery. The achievement was facilitated by institutional improvements as well as by constructively engaging in the Maastricht convergence process.

These features are understandable from a perspective of political economy if one considers that the urgency of reform is more imminent in bad times and, once the political will is mustered to undertake bold spending cuts, it appears natural to implement these quickly and early in the reform process.

5 THE IMPORTANCE OF THE INSTITUTIONAL FRAMEWORK FOR EXPENDITURE REFORM

Despite their economic benefits, expenditure reforms are often politically difficult to implement. From a political economy perspective, the time it takes for benefits to materialise and the resistance of special interests

that fear to lose from such reforms can bias the political process against expenditure rationalisation. One way to remedy such biases is via fiscal institutions. Effective institutions are crucial for maintaining a high degree of effectiveness, efficiency and affordability in public spending and for countering opportunistic (e.g. election-oriented) expenditure policies. In the euro area, European and national institutions each have a role in supporting sound expenditure policies and reform.

The design of Monetary Union has kept public expenditure and its institutional underpinning a prerogative of national sovereignty. Nevertheless, at the European level there are rules and institutions that underpin the different national systems in strengthening the "quality" of public finances. The Stability and Growth Pact, based on the Treaty, not only specifies a 3% of GDP reference value as a limit for government deficits, but essentially provides a medium-term framework for multilateral budgetary surveillance. It provides for the monitoring of the development of fiscal variables (including public expenditure) across the EU and presents Member States with a structured process and methodology to define a multi-annual fiscal policy perspective and commit to budgetary targets. This, at least indirectly, also influences and constrains public spending.

The revised Stability and Growth Pact places great emphasis on further improvements to the governance of fiscal policy at the national level. The ECOFIN Council, in its report entitled "Improving the implementation of the Stability and Growth Pact", stated that "national budgetary rules should be complementary to the Member States' commitments under the Stability and Growth Pact". The report also points to the possibility of extending the multilateral surveillance process to the matter of how to implement and improve existing national rules. Finally, the ECOFIN report includes specific references to the overall quality of public finances as elements to be taken into account when assessing fiscal developments in the EU.[3]

At the structural level, the Broad Economic Policy Guidelines and the Employment Guidelines, which are now subsumed under the Integrated Guidelines, jointly formulate a comprehensive and integrated strategy of macroeconomic, microeconomic and employment policies, geared to improve Member States' growth performance. These include advice on public expenditure policies and their institutional underpinning. In the new set of Integrated Guidelines for 2005-2008, Member States are asked to direct the composition of public spending towards growth-enhancing items, adapt tax structures and benefit systems to strengthen potential growth, and properly assess the relationship between public spending and the achievement of policy objectives. It was also agreed that "Member States should, in view of the projected costs of ageing populations, reform pension and health care systems to ensure that they are financially viable". This agreement is fully in line with the so-called "three-pronged strategy" to deal with the budgetary challenges of population ageing, which calls for countries to raise employment, reduce public debt and reform pension systems.[4]

More recently, the ECOFIN Council (24 January, 2006) has argued that "improving the quality of public finances can contribute to increasing growth and employment" and mandated further work on improving the efficiency and effectiveness of public spending. The ECOFIN Council also invited a comprehensive analysis of fiscal rules and institutions in the EU and asked for reinforced efforts to improve the availability of fiscal data. Moreover, it called for further progress to be made on the measurement of public expenditure efficiency and in the information content of public budgets. Hence, Member States can avail themselves of the EU framework to embed national expenditure reform efforts in a multilateral context, benefiting from peer review and benchmarking mechanisms.

3 "Improving the implementation of the Stability and Growth Pact (SGP)", Presidency Conclusions of the Brussels European Council, 22-23 March 2005.
4 See the article entitled "The need for comprehensive reforms to cope with population ageing" in the ECB Monthly Bulletin of April 2003.

Complementary to and with the help of the fiscal policy framework at the European level, national budgetary institutions can and should be strengthened through fiscal rules that enshrine expenditure discipline and efficiency at all levels of government. Such expenditure rules are already widespread in the euro area and provide additional tools to control public spending, thereby complementing the EU rules-based fiscal policy framework. In most cases, they allow the fixing of expenditure targets "ex ante" in the process of budgetary formation. However, clear implementation mechanisms and "ex post" control and enforcement are indispensable for such rules to be effective.

Expenditure reforms in a number of euro area countries were arguably boosted by the establishment of the European fiscal framework. The fiscal convergence required to enter Monetary Union and the need to comply with the rules of the Stability and Growth Pact thereafter induced countries to reconsider their expenditure commitments. But in the countries that significantly reformed public expenditure, the incentives deriving from European rules were typically complemented by institutional improvements to the national budgetary procedures. These included (i) the introduction of effective expenditure ceilings and budgetary control mechanisms in Spain and Finland, (ii) the strengthening of fiscal rules in Belgium, the Netherlands and Austria, (iii) the conclusion of an ambitious fiscal contract within the coalition government of the Netherlands, (iv) legal changes to the budgetary legislation process and enhanced control over expenditure in Finland, (v) the introduction of a fiscal council in Belgium, (vi) multi-year budgeting e.g. in the Netherlands and (vii) far-reaching delegation of fiscal control to the Minister of Finance as implemented in Ireland.

Box 4

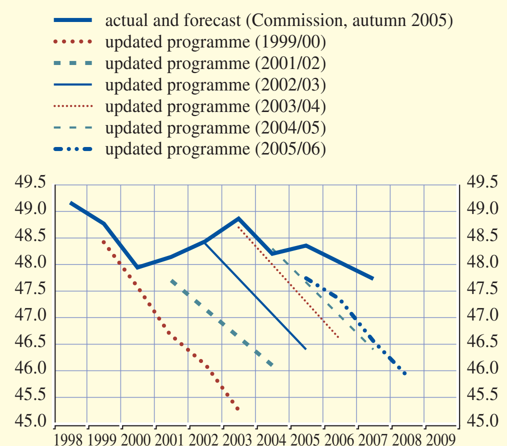
EXPENDITURE RETRENCHMENT IN STABILITY PROGRAMMES

All euro area countries report their medium-term budget plans including expenditure policies in annual updates of their stability programmes. However, implementation of expenditure plans in the euro area has been persistently disappointing. The stability programmes foresaw sizeable reductions in the ratio of government expenditure each year, with which the actual development compares poorly (see the chart).

The disappointing discrepancy between plans and actual developments was mainly due to the poor performance of countries that did not significantly reform public expenditure. Higher expenditure ratios were also in part due to overoptimistic growth forecasts. However, insufficient expenditure adjustment measures and overruns on spending compared with plans have contributed even more substantially.

Euro area general government total expenditure, planned and actual

(percentages of GDP)



Sources: European Commission and EU Member States' Stability and Convergence Programmes.

These experiences show that institutional innovations are typically country-specific and, in order to be effective, have to be tailor-made for the national set-up of budgetary procedures. However, despite considerable progress in some Member States, the overall development of public expenditure in the euro area still points to a clear need for improvement, in particular in those countries that have not yet reformed public expenditure sufficiently (see Box 4).

6 CONCLUSION

Public expenditure policies respecting sound government finances are key to fostering growth and preserving macroeconomic stability. Public expenditure supports growth via public services, such as security, infrastructure, education and basic social safety nets. If public expenditure enhances growth and is appropriately financed, it also guarantees the sustainability of fiscal accounts and it can smooth economic fluctuations via automatic stabilisers.

This article shows that public expenditure ratios have steadily increased in the euro area countries since the 1960s before peaking and, in some cases, declining in more recent years. Public expenditure in the euro area is, moreover, much higher than in most other industrialised countries. According to many observers, it exceeds the levels required for the efficient provision of essential public services. The increasing levels of spending coincided with rising taxes and disincentives to work and invest, as well as growing fiscal imbalances. More recently, population ageing is pointing to additional expenditure pressures that risk undermining fiscal sustainability.

This article explains that further expenditure reforms are needed in many countries to reduce the level of spending on non-core tasks of the public sector, enhance the efficiency and incentive effects of public spending and prioritise productive objectives within public sector activity. Moreover, spending reductions would alleviate fiscal imbalances while also allowing for lower taxes. Such measures would support macroeconomic stability, promote growth and create a better environment for price stability.

The positive experiences of some euro area countries with expenditure reforms have received too little attention in the past. They point to a virtuous circle of expenditure reform, growth and sustainability when the strategy is ambitious and comprehensive. These cases also show that institutional reforms of domestic budgetary procedures and compliance with the European governance framework for fiscal and structural policies can support the reform process decisively. Such countries have experienced strong fiscal and growth performance.