EMU AND THE CONDUCT OF FISCAL POLICIES

This article reviews fiscal policy experiences in the euro area since the early 1990s. For the euro area as a whole, there is a clear difference in the fiscal experience between the period before the decision was taken on which countries would initially participate in the single currency (1992-1997) and the period thereafter (1998-2003). The first period was very successful in terms of eliminating excessive government deficits, as mandated by the Maastricht Treaty (the Treaty). A long trend of large and persistent budgetary imbalances and mounting public debt ratios was reversed. However, most of the consolidation was revenue-based, and non-interest expenditure ratios even rose slightly further.

The second period (1998-2003) provides a more mixed picture as it was only partially successful in terms of meeting the objectives of the Stability and Growth Pact. While many countries had reached sound budgetary positions by 2000, a number of countries undertook insufficient consolidation at the time of robust economic growth and even relaxed their fiscal policies, with the result that fiscal imbalances remained or re-emerged. When economic activity slowed down and the automatic stabilisers operated as intended, safety margins were in some cases insufficient to avoid excessive deficits. Debt ratios remained very high in a number of countries. Fiscal strategies continued to place too little emphasis on restraining primary expenditure, and the interest expenditure savings on public debt (the “EMU premium”) were not assigned to public finance consolidation.

One lesson which emerges from this is that a rigorous implementation of the EU fiscal framework is needed in all circumstances, and particularly in times of higher economic growth. At the current juncture, progress towards attaining sound budgetary positions is needed to firmly set the euro area’s deficit and debt dynamics on a sustainable path. An ambitious, expenditure-based reform strategy would be instrumental in achieving such consolidation, while at the same time allowing further tax cuts to be financed and economic dynamism to increase.

I INTRODUCTION: THE RATIONALE FOR FISCAL RULES IN EMU

After years of deteriorating public finances, euro area countries experienced exceptional budgetary improvements in the mid- to late 1990s. Declining budget deficits also caused public debt-to-GDP ratios to fall.

Recent years, however, have seen countries experience difficulties in honouring policy commitments and there has been insufficient compliance with EU fiscal rules. These difficulties, which have been accompanied by slow progress in structural reforms, raise two important questions: how successful has the EU framework of fiscal rules been in promoting sound budgetary policies in the euro area, and what lessons does this hold for the future?

Before embarking on this assessment, it is worth recalling the main elements of the EU’s institutional framework for fiscal policy. The commitment to sound public finances is enshrined in the Maastricht Treaty, which entered into force in November 1993 and provides that Member States shall avoid excessive deficits. Such deficits are defined in relation to reference values set at 3% of GDP for government deficits and 60% of GDP for government debt.

In the run-up to Stage Three of EMU (the adoption of the single currency) the convergence process required strict compliance with the 3% deficit limit and a sufficiently diminishing debt ratio, if above 60%. To improve fiscal coordination in Stage Three, an operational clarification of the Treaty’s budgetary rules was agreed in 1997 with the Stability and Growth Pact (SGP). The SGP requires Member States to aim for the medium-term budgetary objective of positions close to balance or in surplus and lays down procedures...
for the surveillance and coordination of fiscal policies. It also defines the excessive deficit procedure in more detail. The latter aims to dissuade governments from incurring excessive deficits by means of a number of procedural steps involving peer pressure and ultimately also the possibility of sanctions. It further specifies that an exceptional and temporary breach of the deficit reference value resulting from events outside the control of the government or from a severe economic downturn would not be considered an excessive deficit. 1

The basic rationale for fiscal discipline lies in the need for sound and sustainable public finances as a prerequisite for macroeconomic stability. In combination with price stability-oriented monetary policy, this allows economic agents to form expectations of low inflation and favourable financing conditions which, in turn, encourages long-term planning and investment. The effects are reinforced when combined with structural fiscal reforms. These are necessary to eliminate impediments to efficiency and growth embedded in tax-benefit systems and to deal with longer-term challenges such as population ageing.

Sound public finances also enhance the stabilising role of fiscal policies. There is a risk that the demand-supporting effects of automatic stabilisers during economic downturns could be neutralised if the public is concerned about persistently high deficits and mounting public debt and their implications for future tax burdens and growth prospects.

The need for fiscal discipline becomes even stronger in a monetary union comprising sovereign states retaining responsibility for their fiscal policies. First, there are no longer national monetary and exchange rate policies to respond to country-specific shocks, and fiscal policies can better cushion such shocks if they start from a sound position. Second, countries might be more inclined to run deficits in a monetary union, if their policy-makers fail to take a long-term view. It is primarily the country relaxing its budgetary constraints that enjoys the short-term political benefits of deficits, whereas negative consequences for the level of interest rates affect all member countries. Third, financial markets are not likely to discourage expansionary fiscal policies sufficiently. Bond markets react to expectations of errant fiscal policies, but there is no evidence to suggest that the discipline exerted by financial markets is sufficient. 2 With the disappearance of exchange rate risks within a monetary union, the sanctioning role of financial markets, as reflected in bond yield spreads, declines. The reaction of increasingly globalised markets to the deviant fiscal policy of a single country in a monetary union is, hence, likely to be slow and only partially reflected in bond yield differentials, even if governments – as in EMU – are not obliged to bail each other out in the event of fiscal difficulties (as laid down in the “no bail-out” clause contained in the Treaty). Financial market signals are, therefore, normally far too weak a deterrent to encourage governments to take full account of long-term budgetary constraints. A common fiscal framework, such as that set out in the Treaty and the SGP, helps to correct political-economic biases and supplements the dissuasive effects of market forces.

2 FISCAL POLICIES IN THE RUN-UP TO MONETARY UNION

The 1970s and 1980s were characterised by high fiscal deficits and growing public debt ratios in many euro area countries, which contributed to unfavourable financing conditions and crowding out of the private sector. At the beginning of the 1990s, most euro area countries showed sizeable imbalances in their public finances. In 1991, the

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2 See also the box entitled “Recent developments in spreads between euro area government bond yields” in the November 2003 issue of the ECB’s Monthly Bulletin.
average general government deficit-to-GDP ratio in the euro area was 4.6%, with a majority of countries recording a deficit above the reference value subsequently laid down in the Treaty. In many countries the debt ratio also exceeded the reference value, and the euro area average was only slightly below 60% of GDP (see Table 1).

Budget balance and debt ratios worsened further in the following years. This reflected the budgetary impact of the economic recession of 1992-1993, while the average cyclically adjusted balance was already slowly starting to improve. A substantial deficit reduction took place later in the run-up to monetary union. This was particularly true in 1997, when the average general government budget deficit ratio in the euro area declined sharply, by 1.7 percentage points to 2.6% of GDP. In the same year, the upward trend in the government debt ratio that had persisted since the early 1970s also came to a halt. In other words, in 1997, budget deficits were at levels not seen for long periods, marking a watershed when compared with the experience of previous decades.

It is worth noting that the large deficit reduction of 2 percentage points of GDP achieved from 1991 to 1997 took place in a relatively unfavourable economic environment. This is reflected in the negative effect of the cyclical component on the budget balance, which totalled more than 1 percentage point of GDP over that period (see Chart 1a). The change in the cyclically adjusted primary balance, i.e. the budget balance net of interest expenditure and cyclical effects, is the indicator used in this article to measure consolidation efforts (despite some caveats due to measurement problems). It is denoted as “consolidation” in Charts 1b and 2b. The charts illustrate how countries have distributed their consolidation efforts over time. From 1992 until 1995 there was, on average, progress in consolidation. This is evidenced by the cumulative increase in the cyclically adjusted primary surplus of 1.4 percentage points of GDP over that period.

In an accelerated drive to fulfil the fiscal convergence criteria for participation in stage Three of EMU, the euro area average government deficit ratio was significantly reduced in 1996 and 1997. In those two years, the cyclically adjusted primary surplus improved by a total of 2.0 percentage points of GDP in the euro area.

Despite these resolute and sustained consolidation efforts, the cost of servicing public debt (i.e. the ratio of interest expenditure to GDP) only started to decline in 1997. This was because the gradual, albeit sizeable, drop in the implicit interest rate paid on public debt (the ratio of interest expenditure to debt) did not compensate for the fact that the debt ratio continued to rise (see Chart 1c).

The change in the fiscal positions of the countries of the euro area can be characterised by breaking down the change in the budget balance into contributions from revenue, non-interest (primary) expenditure and interest expenditure. Revenue-based adjustment preceded, and in some instances outweighed, the change in the cyclically adjusted primary balance. This is illustrated in Chart 2b, which plots the contribution of each of these components to the change in the cyclically adjusted primary surplus over the period 1992 to 1997.
expenditure-based adjustment in many countries in the years until 1997. Over the period 1992-1997, the revenue-to-GDP ratio for the euro area increased by 2.9 percentage points to 47.6% in 1997. Net of the effect of the cycle, the revenue ratio shows an even stronger bias towards a tax-based adjustment, with an increase of 4.1 percentage points over the same period. However, in a number of countries some discretionary tax increases were implemented by means of temporary measures that did not have lasting consolidation effects.

The total expenditure ratio remained slightly above 50% of GDP for most of the period. An increase of more than 2 percentage points between 1991 and 1995 was partly reversed during 1996 and 1997. Hence, the trend of rising public expenditure ratios that had prevailed in most countries during the 1980s was at least halted.

All in all, the major consolidation efforts undertaken between the early 1990s and 1997 suggest that the signing of the Maastricht Treaty and the adoption of the EU fiscal framework successfully promoted fiscal discipline during that period. However, consolidation was largely based on revenue increases, while primary expenditure rose slightly on average in the euro area.

3 FISCAL POLICIES SINCE 1998

Since the decision on which Member States would initially participate in Stage Three of EMU was adopted in the spring of 1998, fiscal policies have been only partially successful in terms of meeting the objectives of the Stability and Growth Pact. The average euro area deficit initially continued to decline and many countries reached sound budgetary positions. Subsequently, however, a majority of countries experienced a deterioration of their budgetary balances, due not only to the weakening economic environment. In some cases, including the largest euro area countries, significant fiscal disequilibrria have resurfaced. In 2001,
Portugal’s budget deficit exceeded the reference value of 3% of GDP, with Germany and France following in both 2002 and 2003.

The average government deficit ratio for the euro area, having declined gradually from 1997 until 2000, has been on an upward trend since then (see Table 2). In 2003, the average budget deficit ratio is estimated to have reached 2.8% of GDP, broadly the same level as in 1997. The general government debt ratio was put on a downward path in almost all countries and the euro area average declined from its peak value of 75.4% of GDP in 1997 to 69.0% in 2002. In 2003, however, the average debt ratio is expected to have increased for the first time since the launch of the single currency and to have slightly exceeded 70% of GDP.

Over the period 1998-2003, the impact of the cycle on the budget balance turned from being positive in the years from 1998 until 2000 to being negative in the years from 2001 until 2003 (see Chart 2a). Thus, strong growth initially contributed to the improvement of the overall budget balance before the economic downturn and its adverse effects on fiscal balances set in.

Although fiscal experiences differed from country to country over the 1998-2003 period, the fiscal stance in the euro area as a whole was relaxed. Chart 2b shows that the cyclically adjusted primary surplus declined, in particular in the years 2000 to 2002. It is also worth noting that interest expenditure declined markedly over the 1998-2003 period, by 1.6 percentage points of GDP taking 1997 as the reference year (see Chart 2c). This was driven mainly by the significant reduction in short and long-term interest rates. The decline of roughly 5 percentage points in the debt ratio had a much smaller effect on interest spending.

The examination of the main budget components, i.e. revenue and expenditure, over the 1998-2003 period is also revealing. There was a sizeable decline in revenue, by almost 1.5 percentage points of GDP, which brought
the revenue ratio to an expected 46.2% of GDP in 2003. The impact of the underlying tax cuts on the budget balance was exacerbated by a further, albeit modest, rise in primary expenditure to an expected 45.4% of GDP in 2003. As a result, the primary surplus declined strongly, by 1.8 percentage points of GDP.

The evolution of these ratios can be further analysed by extracting the effect of the cycle on revenue and expenditure. This helps to shed some light on the trend evolution of these key budget components. Between 1998 and 2003 the average cyclically adjusted revenue ratio for the euro area declined by about 1½ percentage points, while the cyclically adjusted primary expenditure ratio remained broadly stable.

Public finance developments thus present at best a mixed picture since 1998. Fiscal deficits initially continued to decline in the euro area and automatic stabilisers operated to a large extent by means of induced adjustments in budget items that are sensitive to the cyclical position of the economy. However, fiscal balances did not improve sufficiently during the high growth period. This was coupled with a substantial deterioration of the cyclically adjusted primary balances in the subsequent slowdown of the euro area economy. The relaxation was masked by lower interest expenditure brought about by the single currency combined with price stability, declining interest rates and fading interest rate differentials. Again, on average in the euro area, no significant expenditure restraint was exercised. These developments are largely responsible for the fact that the average deficit for the euro area is estimated to have been close to 3% of GDP in 2003, with some countries in excessive deficit.

### Table 2 Fiscal developments in the euro area, 1998-2003

<table>
<thead>
<tr>
<th>(as a percentage of GDP)</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budget balance</strong></td>
<td>-2.3</td>
<td>-1.3</td>
<td>-0.9</td>
<td>-1.6</td>
<td>-2.2</td>
<td>-2.8</td>
</tr>
<tr>
<td>Cyclical component</td>
<td>0.0</td>
<td>0.4</td>
<td>0.9</td>
<td>0.6</td>
<td>0.1</td>
<td>-0.6</td>
</tr>
<tr>
<td>Interest payments</td>
<td>4.8</td>
<td>4.3</td>
<td>4.1</td>
<td>4.0</td>
<td>3.6</td>
<td>3.6</td>
</tr>
<tr>
<td>Cyclically adjusted primary balance</td>
<td>2.5</td>
<td>2.6</td>
<td>2.3</td>
<td>1.7</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td><strong>Gross debt</strong></td>
<td>73.7</td>
<td>72.7</td>
<td>70.2</td>
<td>69.2</td>
<td>69.0</td>
<td>70.4</td>
</tr>
</tbody>
</table>


The favourable development of public finances in the run-up to monetary union, the continued but not always sufficient progress in deficit reduction in the subsequent high growth years and the re-emergence of significant budgetary imbalances in recent years have brought to the fore two key issues. The first is the extent to which countries have implemented sufficient and lasting budgetary adjustments to attain sound budgetary positions and speed up the decline of the public debt ratio. The second issue is whether countries have applied an appropriate fiscal policy strategy. A body of literature examining fiscal consolidation episodes has looked at the conditions under which budgetary adjustments produce an effective and lasting improvement in public finances that is also most conducive to economic growth. The main message is that the success of a fiscal consolidation strategy depends critically on its size, its quality (namely the composition of the budgetary adjustment) and the initial situation of the public finances. The composition of the budgetary adjustment is particularly relevant, there being evidence that an expenditure-based adjustment tends to be more growth-friendly and long-lived than a tax-based adjustment without expenditure retrenchment.
On the first issue, concerning continued and sufficient consolidation efforts, experiences have been only partially positive, as consolidation has come to a halt or even reversed in recent years. As to the second issue, consolidation strategies also reveal important shortcomings, especially in light of the high spending and tax ratios that distort economic decision-making and thwart economic dynamism in the euro area (see Chart 3). The early to mid-1990s were characterised by major consolidation through tax increases. In recent years, some of this consolidation was reversed through tax cuts that offset the EMU premium derived from falling interest rates and debt service payments. On average over the period 1992-2003, primary expenditure restraint was not sufficiently ambitious to complete the consolidation process and allow tax cuts to be introduced without compromising sound public finances.

A glance at the fiscal adjustment undertaken by individual euro area countries confirms the overall picture with regard to the underlying consolidation strategies. Chart 4 plots...
tax-based adjustments against expenditure-based adjustments (measured by changes in, respectively, the cyclically adjusted revenue ratio and the cyclically adjusted primary expenditure ratio) between 1992 and 1997 for the individual countries and the euro area average. The points below the diagonal line indicate a budgetary improvement over the period considered and those above it a deterioration. The observations below the diagonal in the first quadrant indicate those countries that achieved budget adjustments by means of tax increases partly offset by increases in expenditure. Observations in the second quadrant indicate countries that implemented both tax-based and expenditure-based policies in order to consolidate their budget. The third quadrant contains, below the diagonal, observations for countries that succeeded in consolidating their budget by reducing expenditure, in spite of the implemented tax reduction.

It is interesting to note that almost all euro area countries fall in the first and second quadrants. This indicates a tax-based consolidation strategy, which was in most cases weakened by increases in the expenditure ratio (Greece, France, Austria and Portugal in particular), and in others reinforced by a diminishing or stable expenditure ratio (Italy, Spain and Belgium). By contrast, the Netherlands lies in the third quadrant, showing a reduction of both its tax and expenditure ratios, which implies both fiscal consolidation and downsizing of the government sector.

In recent years, strategies changed in many countries as regards revenue but not as regards expenditure policies. Discretionary measures aimed at reforming countries' tax systems and reducing the tax burden were in most countries not accompanied by sufficient measures restraining the growth of expenditure. Tax cuts were prompted by the consideration that an excessively high tax burden on the factors of production (labour and capital) was detrimental to economic activity. Concerns about the distortionary effects of heavy taxes on incentives, in addition to optimistic estimates of the beneficial effects expected from a lower tax burden, led to a policy strategy giving priority to tax cuts over the need for budgetary discipline.

The largest tax reductions have been implemented in both the personal and corporate sectors, particularly in countries recording comparatively high revenue ratios within the euro area. In some cases, buoyant temporary revenues from the cyclical upturn obscured the impact that discretionary tax reductions had on the deficit. As a result, there was excessive confidence in the self-financing possibilities of income tax cuts and the changes were not always adequately financed through budgetary retrenchment. The full effect of this policy priority did not become apparent until the economic boom had already begun to falter. In the wake of the economic slowdown and the decline of asset prices beginning in 2000, revenues started declining and most countries experienced a worsening of their budgetary position.
As a consequence of this tax-cutting strategy, most countries recorded a deterioration in their cyclically adjusted primary balance in recent years or at best managed merely to keep it at the same level. Chart 5, which covers the 1998-2003 period, confirms this picture as a majority of the observations lie above the diagonal and indicate a worsening of countries’ budget balances through tax reductions. Moreover, most countries are above the horizontal axis, revealing expansionary expenditure policies.

The most pronounced budget deterioration (as measured by the distance between a country observation and the diagonal in Chart 5), in conjunction with tax cuts, took place in some of the largest countries, namely Germany, France, Italy and the Netherlands, but also in Greece and Ireland. In these countries, the introduction of significant tax reforms was accompanied by hardly any measures to stabilise the primary expenditure ratio. Hence, to some extent, these countries – which comprise most of those that experienced deficits near or above the reference value in 2003 – reversed the budget adjustment implemented in previous years. By contrast, the other countries either financed discretionary tax cuts by restraining expenditure or adopted a strategy of broadly equal increases in both, thus maintaining a broadly neutral fiscal stance. The only general exception was Finland, which continued to pursue significant budget consolidation.

Insufficient fiscal consolidation and low economic growth over the most recent period is also reflected in the development of the debt ratio. After having declined for a number of years, the average euro area debt-to-GDP ratio is expected to have increased again in 2003. At the individual country level, France and Germany joined the group of countries with debt ratios above the 60% reference value (Belgium, Greece, Italy and Austria).

To summarise, both the size and the composition of policy measures appear to have had an effect on the durability and overall effectiveness of fiscal consolidation. Fiscal consolidation was significant until 1997, but since then further progress has not been robust enough in all countries to build adequate safety margins against unforeseen and adverse economic developments. Since 2001, therefore, the combined effects of tax cuts and the cyclical downturn have quickly produced sizeable imbalances. Some countries which relied heavily on tax-based adjustments in the period 1992 to 1997, such as Italy and Germany, also suffered most from consolidation fatigue in the years that followed. Most importantly, the lack of expenditure restraint in many countries has undermined consolidation, safety margins for stabilisation and the outlook for public finance sustainability.

5 CONCLUSION

The review of fiscal policies in the euro area has shown that there was much progress in the strengthening of the sustainability of public finances after the Maastricht Treaty was signed. In particular, fiscal consolidation efforts brought the average euro area deficit down to
below 3% of GDP in 1997. A long trend of rising public debt ratios came to a halt. A number of countries experienced a return to sounder budgetary positions and created adequate margins for automatic stabilisers to operate without a high risk of incurring excessive deficits. In some countries, debt ratios were put on a firmly declining path, helping to prepare for population ageing. A few countries exercised expenditure restraint, which allowed both fiscal consolidation and tax cuts.

However, progress as regards the attainment of targets under the EU fiscal framework and in the quality of fiscal adjustment was uneven over time and across the various countries. In the period between 1992 and 1997 most progress was achieved by means of revenue-based adjustment, including temporary measures in some cases. After 1997, the average deficit initially continued to decline during the high growth period until 2000. However, in some countries this proved insufficient for the safe operation of automatic stabilisers when growth slowed thereafter. Additional fiscal loosening due to insufficient expenditure restraint, together with savings on interest expenditure being used to finance tax cuts rather than consolidation, resulted in the re-emergence of significant imbalances. Some countries have in recent years even breached the reference value for excessive government deficits, and public debt ratios remain in some cases very high. This has begun to have an adverse effect on the implementation of the fiscal rules themselves.

A majority of euro area countries must now make progress towards attaining sound budgetary positions so that the deficit and debt ratio dynamics are firmly set on a sustainable path. Consolidation needs and the long-term challenges to public finances also require ambitious fiscal structural reform. Here the fiscal strategy is key: given that the EMU premium in the form of interest expenditure savings has largely been spent, further consolidation must be achieved and tax cuts need to be fully financed by primary expenditure restraint. Moreover, well-designed expenditure reform can boost economic growth in the medium term by increasing the incentives to invest and work. In such an environment, confidence in economic prospects will also boost demand and minimise, if not eliminate, any trade-off between fiscal consolidation and economic growth even in the short term.

Last but not least, the insufficient progress in fiscal consolidation since the launch of the single currency also emphasises the importance of strictly enforcing the fiscal rules in EMU. Reinvigorating the implementation of the fiscal framework in good times, as expected ahead, can set in motion a virtuous circle of sound public finances, structural reform and high growth that supports macroeconomic and price stability.