

Chapter 3

Putting fiscal policy back on track*

Fiscal policy outcomes in the euro area are mixed: several countries are characterised by large deficits and high debt, while others have managed to keep their public finances sound. This chapter assesses the fiscal performance and takes stock of the redesigned Stability and Growth Pact (SGP). It discusses how fiscal policy can be reformed to improve outcomes. It emphasizes the urgency of seizing the opportunity that the favourable cyclical situation provides to introduce changes – starting with expenditure restraint – that would restore the sustainability of public finances, especially in high-debt countries. A key requirement for better fiscal outcomes in the euro area is that member states should embrace the EU objectives of achieving budget balance and keeping debt in check as national priorities. National medium-term fiscal frameworks and EU surveillance can play helpful roles in supporting progress in this direction.

* This chapter is based on information up to 29 November 2006.

There has been no improvement in the area-wide fiscal position since 1999

A sound fiscal policy is characterised by a strong focus on the sustainability of government finances. It should also contribute to stabilise the economy and ensure efficiency in taxation and expenditure programmes. For the euro area as a whole, the debt level is almost unchanged as a proportion of GDP and the budget deficit has increased since the adoption of the single currency in 1999 while the fiscal stance has been predominantly pro-cyclical. Some euro area countries have made great strides in reforming their public finances towards more sustainability, better quality and more counter-cyclicality, but there is still room for others to follow their lead.

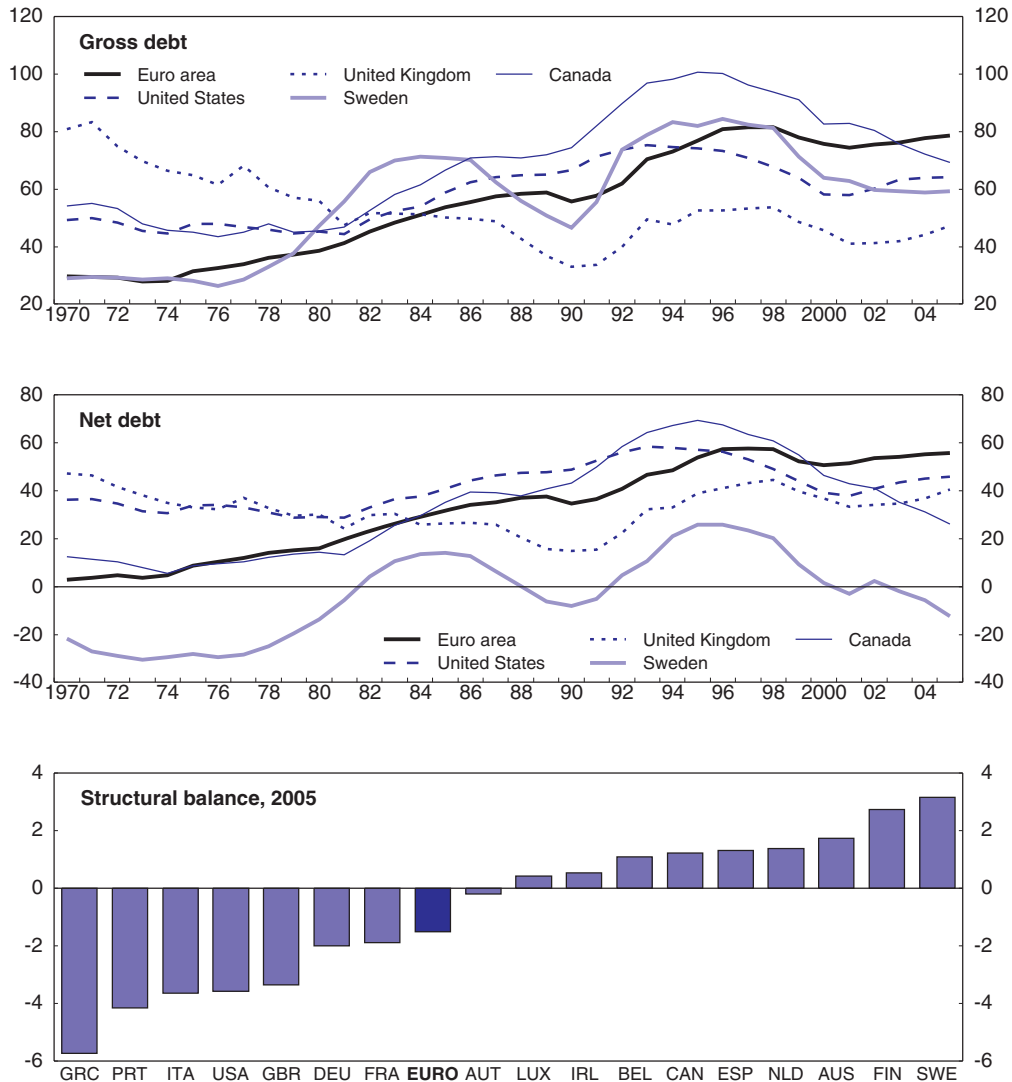
Sustainability is not ensured

Current policy settings are not enough to deliver a decisive fall in government debt in the euro area from the high level reached after decades of debt accumulation (Figure 3.1). Projections incorporating policy settings as of spring 2006 show that, despite a modest fall in the next few years, the public debt-GDP ratio would still amount to 72% in 2010 (Table 3.1). Similarly, public debt net of government financial assets is anticipated to remain at high levels relative to GDP (48% in 2010).

While this is no consolation, the euro area is not alone in having debt levels which are high and projected to remain so over the medium-term. In the United Kingdom and the United States, the latter starting from nearly as high levels, public debt is projected to rise. But there are OECD countries, such as Australia, Canada, Denmark, New Zealand and Sweden that do much better. They have reduced their debt-GDP ratios rapidly and are close to or have already reached a positive net asset position. These top-performing countries are not relying only on nominal GDP growth to cut their debt-GDP ratios but are also reducing their debt stocks in nominal terms. Within the euro area, debt developments could differ markedly across the member countries. The already worrisome net debt positions of Italy and Portugal are set to deteriorate further while the Belgian and Spanish situation should improve so long as they maintain sound budget positions.

In the coming decades, public expenditure will come under considerable pressure. Population ageing will bring about sizeable increases in public expenditure on pensions, health care and long-term care for the elderly. In addition, non-demographic factors will also raise health and long-term care costs further: these factors include a widening of the range of pathologies that can be treated and the rising relative price of health and long-term care (OECD, 2006a). Table 3.2 shows the spending increases as projected by the EU Economic Policy Committee (2006) and the OECD (2006a). The projections differ considerably: the estimated increase in health and long-term care in the euro area ranges from 2% of GDP in the EU projections to about 6% in the OECD projections. The main reason behind the difference is that the reference scenarios in the EU projections use different assumptions for non-demographic trends such as the rising preference for health care with income and the falling share of informal long-term care which results from increases in labour force participation.

Figure 3.1. **Fiscal indicators**
As a percentage of GDP



Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database.

Current fiscal policy settings are not sustainable as, on unchanged policies, long-term spending pressures will put government debt on an explosive path in nearly every euro area country. On unchanged fiscal policy settings, the spending projections reported in Table 3.2 for health, long-term care and pensions (first, third and fifth columns) would bring the euro area-wide debt-GDP ratio to 93% of GDP in 2025 and 255% in 2050.¹ This area-wide average masks the fact that a number of individual countries face even more daunting challenges: on current policy settings, by 2050 the debt ratio is set to rise to 365% in Italy and 489% in Portugal. While a number of reforms have improved the long-term prospects for public finances in the euro area (e.g. the pension reforms in France, Germany and Italy), much more remains to be done in most euro area countries to secure sustainability. Austria is one

Table 3.1. **The debt-GDP ratio is set to remain high in the euro area in the medium-term**

	Gross debt					Net debt				
	2005	2010	Change	Contribution to the change from nominal		2005	2010	Change	Contribution to the change from nominal	
				Debt	GDP				Debt	GDP
Euro area	79	72	-7	8	-15	52	48	-5	5	-10
Austria	70	66	-3	10	-13	42	41	-1	7	-8
Belgium	95	79	-16	1	-17	81	66	-15	0	-15
Finland	48	42	-6	3	-9	-57	-66	-9	-19	11
France	76	72	-5	9	-14	44	42	-2	6	-8
Germany	71	67	-4	7	-11	51	49	-2	6	-8
Greece	124	108	-16	17	-33	90	78	-13	12	-24
Ireland	32	27	-5	4	-10	7	0	-7	-5	-2
Italy	120	120	-1	18	-19	95	96	1	16	-15
Luxembourg	6	6	0	2	-2	6	6	0	2	-2
Netherlands	61	51	-11	1	-11	36	27	-9	-3	-6
Portugal	73	75	3	14	-12	45	50	6	13	-7
Spain	50	35	-15	-2	-13	30	17	-13	-6	-8
Australia	17	8	-9	-4	-5	-2	-8	-7	-7	0
Canada	71	57	-14	0	-14	30	20	-11	-5	-6
Denmark	41	28	-13	-5	-8	9	-3	-11	-10	-2
Japan	173	178	5	22	-18	86	97	10	19	-9
New Zealand	28	21	-7	-2	-5	-1	-9	-8	-8	0
Sweden	59	40	-20	-7	-13	-13	-22	-9	-12	3
United Kingdom	47	51	4	14	-10	40	45	5	14	-8
United States	62	63	1	15	-14	43	46	3	13	-10

Note: Debt refers to gross financial liabilities, measured at market prices.

Source: OECD (2006), OECD Economic Outlook: Statistics and Projections – online database and Medium-Term Baseline – online database and OECD calculations.

exception, where pension reform has been deep enough to bring government debt close to a stable path despite large anticipated increases in public health spending.

Fiscal policy has been pro-cyclical

Fiscal policy has not contributed to stabilising the cycle in the euro area. When the economy was above potential at the start of the decade, several fiscal authorities did not allow the automatic stabilisers to operate fully as they used cyclical tax receipts to finance tax cuts and expenditure increases (Cotis, 2004). The *cyclically-adjusted* deficit thus widened for several years in a row and further stimulated the economy (Figure 3.2). This brought many countries perilously close to, and some above, the 3% deficit limit following the cyclical downturn. Some countries ignored the 3% limit, while others tightened the fiscal stance pro-cyclically. These developments are in contrast with those in the United States, where changes in the fiscal stance have been counter-cyclical and broadly stabilising since 1999 (Figure 3.2). More systematic investigations using longer time series confirm the observation that fiscal policy tends to act pro-cyclically in euro area countries and counter-cyclically in other most OECD countries (OECD, 2006b and EC, 2006b).

The quality of public finances can be improved

Efficient expenditure management is a central determinant of the overall quality of public finances. Because they are not the outcome of voluntary individual decisions, publicly financed consumption and investment differ fundamentally from their private

Table 3.2. **Projected changes in public spending on health care, long-term care and pensions**

	2005-50, in percentage points of GDP				
	Health care		Long-term care		Pensions
	OECD	EU	OECD	EU	
Euro area	3.7	1.5	2.2	0.7	3.1
Austria	3.8	1.5	2.0	0.9	-1.0
Belgium	3.3	1.4	1.9	0.9	5.1
Finland	3.6	1.4	2.4	1.8	3.3
France	3.5	1.8	1.7	..	2.1
Germany	3.6	1.1	1.9	1.0	2.0
Greece	3.9	1.7	2.7	..	10.3
Ireland	4.0	2.0	3.8	0.6	6.5
Italy	3.8	1.3	2.9	0.7	1.1
Luxembourg	3.7	1.2	3.1	0.6	7.4
Netherlands	3.8	1.3	2.0	0.6	3.8
Portugal	4.2	0.5	2.0	..	9.3
Spain	4.1	2.2	2.4	0.3	7.0
Comparator countries					
Australia	4.2	..	2.0	..	1.7
Canada	4.1	..	2.1	..	1.7
Denmark	3.5	0.9	1.5	1.1	3.2
Japan	4.3	..	2.2	..	0.6
New Zealand	4.2	..	2.0	..	5.9
Sweden	3.2	1.0	1.1	1.7	0.8
United Kingdom	3.6	1.9	1.9	0.8	1.7
United States	3.4	..	1.7	..	1.8

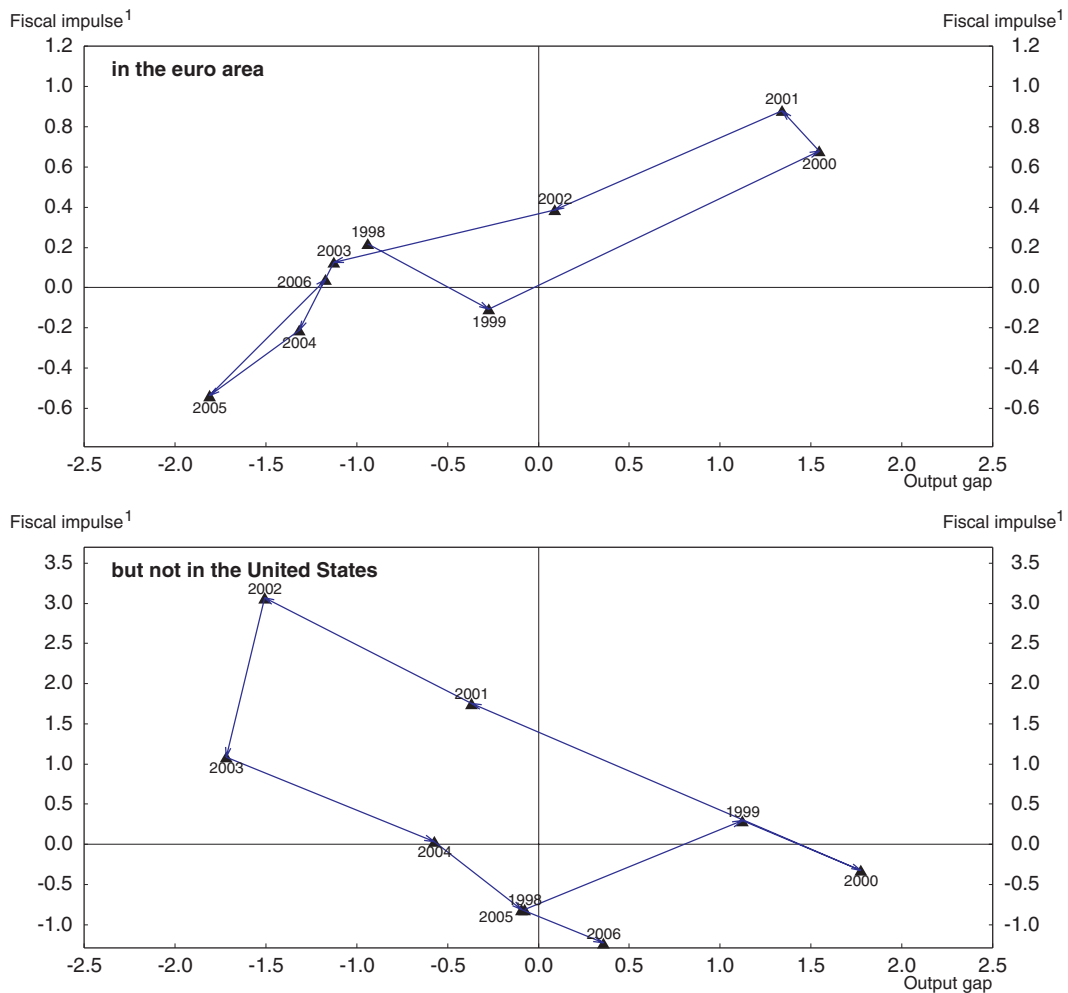
1. OECD projections for increases in the costs of health and long-term care have been derived assuming unchanged policies and structural trends. The corresponding hypotheses are detailed in OECD (2006a) under the heading "cost-pressure scenario". Projections of public pension spending are taken from EU EPC (2006) for EU countries, from OECD (2005a) for Canada, Japan, Switzerland and the United States and Dang et al. (2001) for Australia and New Zealand.

Source: OECD (2006a), "Projecting OECD Health and Long-term Care Expenditures: What Are the Main Drivers?", *OECD Economics Department Working Papers*, No. 477, Paris ; OECD (2005a), "Ageing and Pension System Reform: Implications for Financial Markets and Economic Policies", *Financial Market Trends*, November 2005 Supplement, Paris ; EU EPC (2006), *Impact of Ageing Populations on Public Spending*, European Commission, Brussels and Dang et al. (2001), "Fiscal Implications of Ageing: Projections of Age-Related Spending", *OECD Economics Department Working Papers*, No. 305, Paris.

counterparts. The contribution of public expenditure to social welfare is not automatic but hinges on the capacity of the fiscal authorities to meet three requirements:

- They must allocate public funds where they produce the highest returns for society.
- They must ensure value for money in spending programmes.
- They must take fully into account the excess burden of taxation.

While the responsibility for high-quality spending lies at the heart of the mandate of national governments, EU-wide success on this dimension of fiscal policy is also necessary to reach the common economic goals set by the Lisbon strategy. In recognition of this need, the European authorities have been working to more tightly integrate the monitoring of the quality of public expenditure in the EU framework for economic policy co-ordination (EC, 2004). The Stability and Growth Pact (SGP) also requires the European Commission to provide an assessment of the quality of public finances since it is one of the "other relevant factors" to consider when deciding whether a public deficit temporarily and slightly larger than 3% of

Figure 3.2. **Fiscal policy has been pro-cyclical**

1. Change in the cyclically-adjusted primary deficit from the previous year.

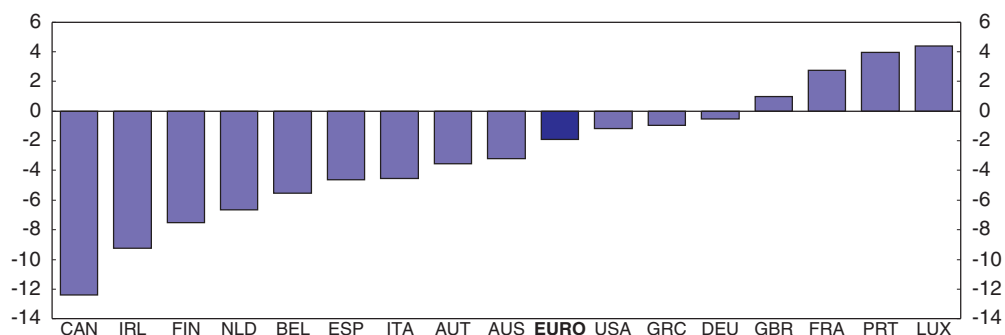
Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database.

GDP is excessive or not. In this light, it is illustrative that 9 out of 12 member states identified “sustainability and quality of public finances” as one of their national priorities.

Economic and monetary union set in motion by the 1992 Maastricht Treaty has reduced interest payments considerably and therefore provided opportunities to cut or redeploy public spending. The amount of interest payments on outstanding debt has fallen from 5% of GDP in 1991 to 3% in 2006. The savings have been mostly used to reduce the ratio of public expenditure to GDP from 49% to 47% (in cyclically-adjusted terms). This average fall hides two important exceptions: the ratio of public spending to GDP increased by around 4 percentage points in France and Portugal (Figure 3.3).

Government consumption and social transfers absorb rising shares of public spending even though they are unlikely to represent the most productive items of expenditure (OECD, 2003). The share of social security transfers in government outlays increased by 5 percentage points during the last decade. And in recent years, the share of government consumption in government expenditure has been rising steadily (Figure 3.4).

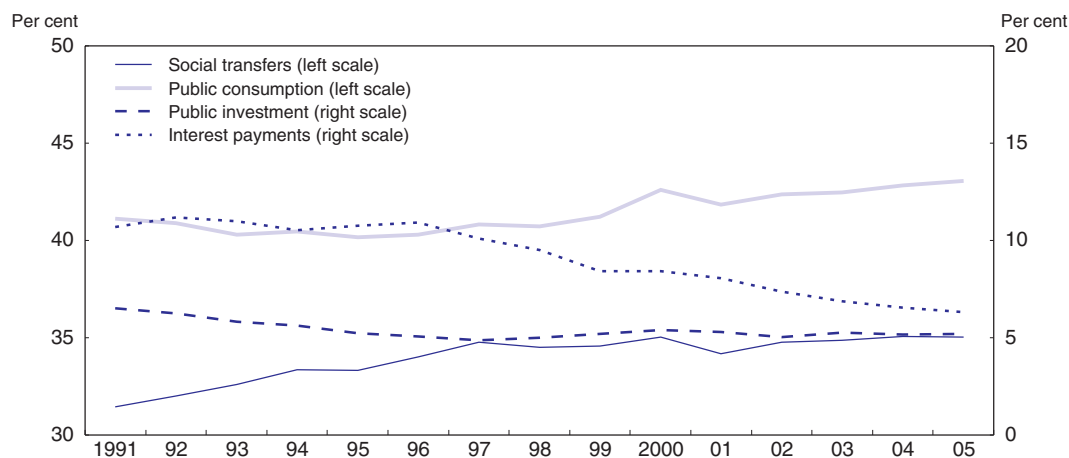
Figure 3.3. **The expenditure ratio¹ has fallen in many countries**
1991-2006, percentage points of potential GDP



1. The ratio of public spending to GDP is calculated in cyclically-adjusted terms as the share of cyclically-adjusted current disbursements and net capital outlays of the government sector in potential GDP. See Girouard and André (2005) for more details on the method used for cyclical adjustment.

Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database; Girouard, N. and C. André (2005), “Measuring Cyclically-Adjusted Budget Balances for OECD Countries”, *OECD Economics Department Working Papers*, No. 434, Paris.

Figure 3.4. **Consumption and transfers make up a rising share of public spending**



Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database.

Expenditure control in the run-up to the euro from 1992 to 1998 was partly achieved through cutbacks in public investment that have not been reversed since then: the share of investment in government spending has stayed low. Since the start of the decade, gross government investment amounted to 5% of the estimated stock of public capital, which broadly corresponds to the minimum needed to offset its depreciation.² An implication is that, on current policy settings, the stock of public capital is set to decline slowly relative to GDP. If this current trend was sustained, it would ultimately lead to inefficiently low levels of public capital – even more so if the expenditure restraint needed to restore sustainability involved further cutbacks in investment and therefore a faster decline in the stock of public capital to GDP.

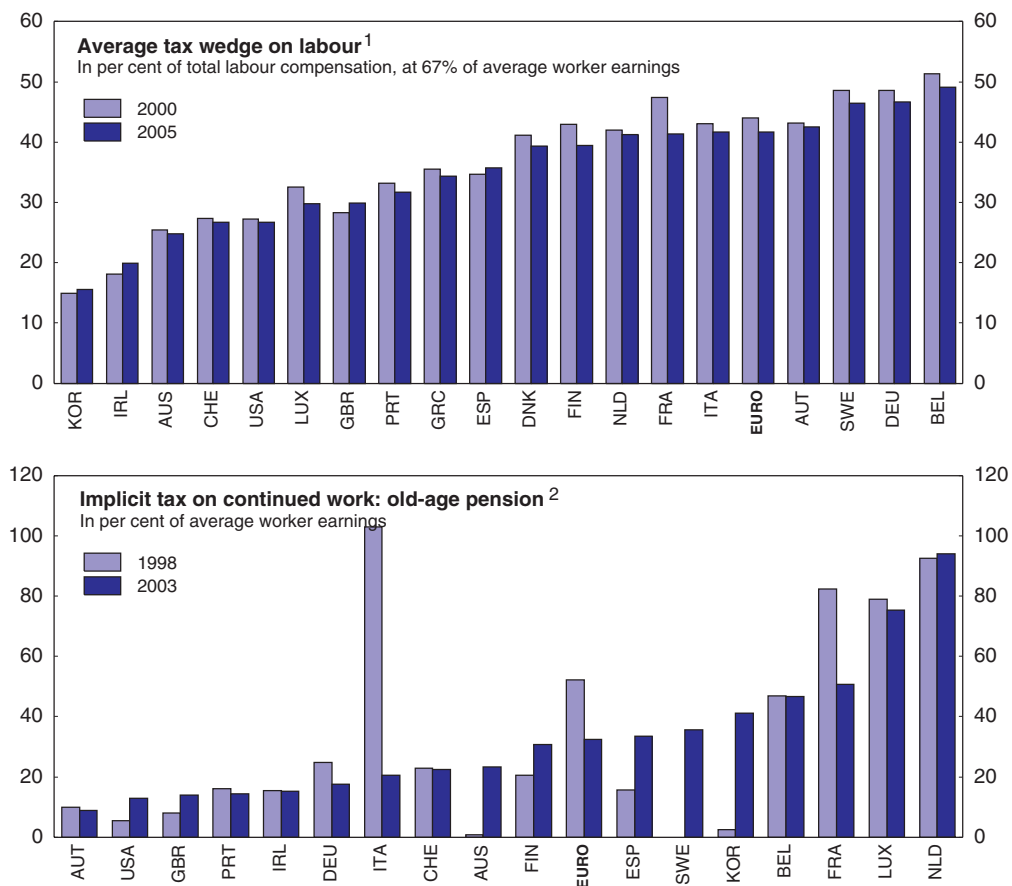
In contrast, government investment in human capital has been preserved. As a share of GDP, government funding of education has remained stable at slightly above 5% between 1993 to 2002 (the latest year for which data are available). Young cohorts have become smaller over

the same period, implying that real public education spending per student has risen by 17% between 1993 and 2002. In crude accounting terms, euro area countries have maintained a stable amount of government investment in human capital through education as a share of GDP but it has become more concentrated on fewer individuals.

On the revenue side, there has been a moderate shift towards less distortive sources of financing. The share of social contributions in general government receipts has come down by more than 2 percentage points in euro area countries since the signing of the Maastricht Treaty. Payroll taxes can interact negatively with minimum wages as they raise the cost of unskilled labour (OECD, 2001). If the link between contributions and entitlements is weak, social contributions levied on wages can also reduce labour supply and investment in human capital (Leibfritz *et al.*, 1997).

Governments have lowered effective tax rates on labour, especially for the low-skilled and for older workers (Figure 3.5). The average tax wedge on labour has diminished across the euro area as a result of efforts to boost low-skilled employment by reducing compensation costs while preserving minimum wages. In most euro area countries, public

Figure 3.5. **Labour taxation has been reduced**



1. Measured as the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a ratio of total labour compensation. It therefore includes both employer's and employee's social security contributions.

2. For the 60-year olds in regular old-age pension.

Source: OECD, *Economic Policy Reforms: Going for Growth*, 2006 and *Taxing Wages* – online database.

pension systems and early retirement schemes create disincentives to keep working after potential beneficiaries reach the eligibility age and depress the employment of older workers (OECD, 2005b). Substantial progress has been made, especially in France and Italy, in reducing the implicit tax on continued work that older workers face.

Meanwhile the reliance on indirect taxes has increased from about a quarter to a third of general government revenues since 1992. Consumption taxes, which make up the bulk of indirect taxes, have a number of advantages: i) they are relatively neutral towards saving and investment decisions; ii) they do not discriminate between imports and locally-produced goods and therefore do not affect external competitiveness; and iii) they treat labour, transfer and capital income equally, thus creating fewer disincentives to work than labour taxes (Joumard, 2001 and Bernardi, 2003). However, there can also be distributional consequences because in most countries income taxes are progressive while everyone faces the same consumption tax rate for each product. A rebalancing in favour of consumption taxes may therefore shift part of the tax burden down the income distribution even though the lower value-added tax (VAT) rates on items of first necessity attenuate this effect. Using the model and parameter estimates in Leibfritz et al. (1997), the shift from labour to indirect taxes that has occurred between 1992 and 2005 may have raised employment by 0.6% and GDP by 0.7% in the euro area.

Policy changes are needed

Many member states have not delivered outcomes in line with the area-wide objectives

While the division of labour in the Economic and Monetary Union (EMU) entrusts national authorities with most of the responsibility for fiscal policy, provisions in the Maastricht Treaty and the Stability and Growth Pact (SGP) have instilled some multilateral surveillance. The fiscal rules created by the Maastricht Treaty require *inter alia* that governments should avoid excessive government deficits. In addition, the SGP requires member states to maintain their budget close to balance or in surplus over the cycle. The revised SGP foresees that the corresponding medium-term objectives (MTO) for public finances can be differentiated in light of the prospects for fiscal sustainability.

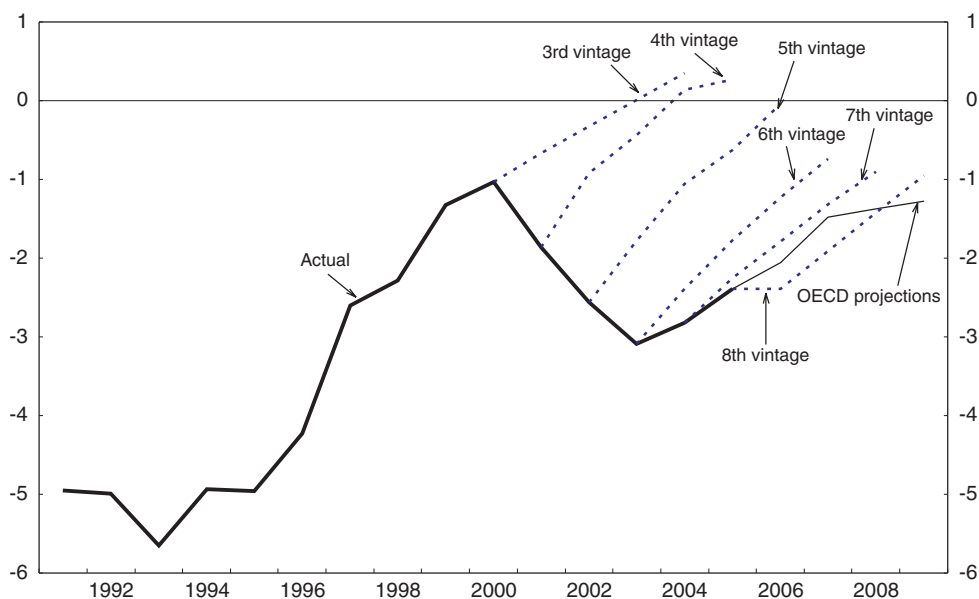
The main motivations for the area-wide fiscal rules are threefold:

- A central goal is to ensure sustainable public debt positions. The rules aim to avoid situations where default risk builds up in one or several countries because it might spill over to the rest of the area or ultimately put pressure on other member countries and the European Central Bank (ECB) to bail them out or inflate the debt away. Financial markets price default and inflation risk in bond yields and thereby apply some disciplining pressure on governments, but they are perceived by some as doing too little, too late (EC, 2004). Fiscal sustainability assessments constitute a key element of EU-wide fiscal surveillance.
- Multilateral surveillance was seen as necessary because entering a monetary union can exacerbate deficit bias at the national level. If a government moves into deficit, the responses of interest rates and the exchange rate will be weaker in a currency union than if it ran its own monetary policy.
- Another important goal is to ensure a consistent fiscal-monetary policy mix. The guiding principle is to limit the cyclical role of fiscal policy in ordinary times to automatic stabilisers. The importance of this “fiscal neutrality” goal was reaffirmed in 2003 when

euro area countries committed themselves to keeping their cyclically-adjusted balances at their medium-term objectives each year after they have reached them (unless faced with large asymmetric shocks).

In most cases, national fiscal outcomes have failed to deliver on the main area-wide objectives of balancing budgets and reducing debt in high-debt countries. Fiscal plans enshrined in the stability programmes transmitted each year to the Commission repeatedly promised consolidation over the medium-term – and failed year after year (Figure 3.6). The general government deficit for the area has averaged –2% since 1999. As a result, the amount of outstanding government debt has risen since 2001.

Figure 3.6. **Balancing the budget: regular annual good resolutions**¹
General government balance in the euro area as a per cent of GDP²



1. The various vintages of the stability programmes were released over the following periods: 3rd 2000/01, 4th 2001/02, 5th 2002/03, 6th 2003/04, 7th 2004/05 and 8th 2005/06.

2. Excluding UMTS licence proceeds.

Source: European Commission/Eurostat and OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database.

There is little evidence that the revised Pact has attracted a greater national “buy-in”

Following implementation difficulties in several member states, the Council of finance ministers substantially reformed the Stability and Growth Pact in March 2005. As described in detail in the previous *Survey*, the original firmest supporters for the SGP became its most vocal opponents, with the result that in November 2003 the Council decided to “hold in abeyance” the excessive deficit procedures for France and Germany. Prompted by the need to reconcile the different opinions on the implementation deadlock, the reform also aimed at putting more focus on long-term sustainability and more economic judgement within the rules-based framework. The main changes are threefold:

- The peer review mechanisms for countries not in the excessive deficit procedure (the “preventive arm” of the SGP) have been made more sophisticated. Instead of the

previous “close to balance or in surplus” norm that applied uniformly, medium-term objectives can now be differentiated according to the debt level and trend growth prospects. The medium-term objective can be set in a range from –1% of GDP for countries with low debt and high trend growth to balance or surplus for countries with high debt and low trend growth.

- More economic judgement has been introduced in the identification of excessive deficits with the aim of increasing the Pact’s ownership and ensuring its effective implementation. The Council can invoke new grounds to refrain from initiating the excessive deficit procedure when the budget deficit is greater than 3%. However, the SGP reform has retained the provision that the Council can consider deficits larger than the 3% reference value as not excessive only if the overshoot is small and expected to be temporary. These new grounds include: i) protracted below-potential growth, ii) the implementation of structural reform, iii) the level of expenditure to foster research and development and innovation, iv) past fiscal consolidation in “good times”, v) the debt sustainability position, vi) the level of public investment, vii) the quality of public finances and viii) the level of financial contributions to fostering international solidarity and to achieving European policy goals.
- The possibility of extending deadlines for compliance has been introduced. With the new rules, the Council can decide to repeat a step before moving to the next one, provided specific conditions are met.

The SGP reform has given several euro area countries more time to correct their excessive deficits. The flexibility introduced by the reform has been used to extend the deadlines facing Germany, Italy and Portugal, three of the five euro area countries with an excessive deficit as of mid-2006. However, the requested structural adjustment is higher than in the past and has to be of permanent nature. In particular, the assessment on the size of structural adjustment excludes one-off measures. Following the reform, countries can have excessive deficits above 3% for four years in a row and still comply with the rules. However, only a permanent and sustainable correction of the excessive deficit, as judged by the Council, will end the procedure.

The increased flexibility of the corrective arm allowed the Council to break the deadlock that was reached when it failed to issue a formal notice to Germany and France in November 2003. The Council followed a new recommendation by the Commission and gave Germany notice to take measures to correct its excessive deficit on 13 March 2006 – two and half years after the initial Commission recommendation and with an extended deadline (2007 instead of 2006). While (if enforced) the initial set-up of the Pact would have required Germany to correct the excessive deficit already in 2006, under the reformed rules the Council allowed Germany to achieve the correction only in 2007.³ However, the financial balance has improved faster than foreseen and is estimated to have fallen below 3% already in 2006 in the *OECD Economic Outlook* No. 80.

The stability programmes submitted in late 2005 adopted under the revised SGP might be considered to lack ambition. However, growth assumptions are more realistic, which could partly explain the perceived lack of ambition. The fiscal balance is set to improve by only 0.2% of GDP in 2006, implying that 82% of the consolidation effort targeted in 2006-08 is put off until the two final years. The extent of back loading has worsened compared with the previous batch of stability programmes in which a lower share of the adjustment effort (71%) was planned to be made in the two final years of the three-year period.

In contrast, more ambition prevails at longer horizons (Tables 3.3 and 3.4). In their medium-term objectives, a majority of countries is targeting surpluses or balanced fiscal positions. The resulting implicit MTO for the euro area is a balanced budget (including interest payments), a position that would stabilise the stock of debt in nominal terms and therefore gradually bring the debt-GDP ratio down. Balancing the budget for the euro area is a challenging objective, even at a medium-term horizon: projections on unchanged policy settings in the *OECD Economic Outlook No. 80* put the cyclically-adjusted financial balance for the euro area at -1.1% in 2010. It remains to be seen whether these ambitious consolidation objectives will be adhered to or if the pattern apparent in Figure 3.6 will be repeated.

The reformed Pact gives countries sufficient time to reach their medium-term objectives (MTO). Some countries have already reached their MTOs (Belgium, Finland, Ireland, the Netherlands and Spain) or plan to do it within their programme period (Luxembourg). Others, according to the 2005 updates of stability programmes, planned to reach it only after the end of the programme period (Austria, France, Germany, Greece, Italy and Portugal). A general principle is that countries without an excessive deficit and that have not reached their targets should improve their cyclically-adjusted balance by $\frac{1}{2}$ per cent of GDP or more as a benchmark. The text of the revised SGP adds that the recommended degree of progress towards the MTO can be smaller in “economic bad times”, which are defined as periods of economic slack.⁴ Since real-time output gap estimates tend to suggest more slack than there really is at the start of upswings (Cotis et al., 2005), the provision for “economic bad times” involves a risk of unduly encouraging some governments to wait before reducing their structural deficits by $\frac{1}{2}$ per cent a year or more.

The cases of Germany, Italy, Greece and Portugal illustrate how distant the medium-term can be under the revised SGP. The stability programmes issued in late 2005-early 2006 target a deficit of $1\frac{1}{2}$ per cent of GDP or even higher in all four countries in 2009, which is consistent with reaching the MTO in 2012. The OECD considers that member countries should consolidate faster to bring down debt ratios quicker.

Table 3.3. **Status of euro area countries regarding the reformed SGP**

A. Countries not subject to the excessive deficit procedure				
	Fiscal balance ¹		Convergence towards the medium-term objective (MTO)	
	2005	MTO	Commission opinion on the trajectory towards the MTO	Commission recommendations
Austria	-1.6	0	In line with the SGP	Further specify measures for 2007 and 2008
Belgium	0.0	0.7	Broadly appropriate but the budget balance is set to deteriorate in 2006	Step up adjustment effort in 2006 Limit use of one-off measures
Finland	2.5	1.5	Provides a safety margin	
Ireland	1.1	0	A good example of policies conducted in compliance with the SGP	Implement measures to address the long-term budgetary implications of ageing populations
Luxembourg	-1.0	-0.8	Measures to reach the objective must be specified	Step up adjustment effort in 2006 Identify measures for 2007 and 2008 Address ageing-related pressures
Netherlands	-0.3	-0.5 to -1	In line with the SGP despite the fall to -1.5% in 2006	Maintain a strong budgetary position in 2006 and thereafter
Spain	1.1	0	Exceeds the MTO by a large margin A good example of policies conducted in compliance with the Pact	Implement the envisaged measures to address the long-term implications of ageing populations

1. General government net lending, per cent of GDP, national accounts definition.

Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database; EU Commission (2006), End-2005 national stability programmes and corresponding European Commission reports and Council opinions.

Table 3.3. **Status of euro area countries regarding the reformed SGP (cont.)**

		B. Countries subject to the excessive deficit procedure (EDP)				
Entry in EDP		Fiscal balance ¹			Direct Commission recommendations	Council opinion
		2005	2009 target	MTO		
France	June 2003	-2.9	-1.0	0	Additional measures seem necessary for 2006 Implement the necessary measures to converge towards the MTO after exiting the EDP Reinforce the expenditure ceiling framework	Ensure the necessary structural adjustment to bring the deficit below 3% in 2006 Ensure the planned fiscal consolidation towards MTO and improve long-term sustainability Strengthen expenditure rules for sub-sectors of the government
Germany	Jan. 2003	-3.2	-1.5	0	Needs further reforms of social security systems to cope with the costs of ageing Reduce the structural balance by ½ per cent a year after exiting the EDP Implement planned expenditure restraints rigorously Implement plans to strengthen budgetary institutions at all government levels	Ensure that the structural budget balance cumulatively improves by at least 1 percentage point in 2006 and 2007 so as to bring deficit below 3% by 2007 at the latest Reduce the structural balance by ½ per cent a year after exiting the EDP Implement plans to strengthen budgetary institutions at all government levels
Greece	July 2004	-5.1		0	Pursue further structural adjustment towards the MTO Ensure that the debt ratio is reduced at a satisfactory pace Control public pension expenditure Implement approved pension reforms Improve public finance statistics	Implement permanent measures leading to correct the excessive deficit by 2006 at the latest Further pursue the reduction of the cyclically-adjusted deficit towards the MTO Identify and control factors other than net borrowing that contribute to changes in the level of debt Control public pension expenditure Improve the collection and processing of the general government data
Italy	July 2005	-4.3	-1.5	0	Achieve the structural consolidation needed in 2006 and 2007 Spell out the budgetary measures that underpin the adjustment in the years beyond 2007 Strengthen the adjustment towards a balanced budget Ensure a more rapid decline in the debt-to-GDP ratio Improve the budgetary process	Achieve the structural efforts envisaged in the programme for 2006 and 2007 Spell out the measures underlying the adjustment path in 2007 and beyond Ensure that the debt-to-GDP ratio is declining towards the reference value Improve the budgetary process by increasing its transparency and an effective implementation of mechanisms to monitor, control and report expenditure
Portugal	Sept. 2005	-6	-1.5	-0.5	Adopt and implement with rigour the structural measures envisaged in the programme Control expenditure and improve the budgetary process Improve long-term sustainability Bring the debt ratio onto a firm downward path	Create margins to deal with the budgetary impact of possible lower-than-projected economic growth Enact decisively the planned measures to control expenditure Improve the long-term sustainability of public finances Bring the government gross debt ratio onto a firm downward path

1. General government net lending, per cent of GDP, national accounts definition.

Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database; EU Commission (2006), End-2005 national stability programmes and corresponding European Commission reports and Council opinions.

As a result of the 2005 reform of the Pact, country-specific medium-term objectives were introduced, which are currently based on the level of government debt and potential growth. According to this framework, countries with high debt levels and low potential growth need to set their MTOs in balance or in surplus, which reflects the need for a rapid decline in the debt to GDP ratio. The analysis of the last round of stability programme updates shows that member states have indeed set their MTOs according to these principles. All other things being equal, countries with higher debt are required to achieve

Table 3.4. **Planned speed of progress towards the medium-term objective for public finances**

	Average annual change in the structural balance			Memorandum item: Debt ratio in 2005 ¹
	Over the full period until the MTO is reached	In EDP	Outside (or after leaving) the EDP	
Austria	0.6	..	0.6	63
Belgium	0.2	..	0.2	93
France	0.7	0.5	0.8	67
Germany	0.5	0.6	0.4	68
Greece	0.8	1.1	0.7	107
Italy	0.7	0.9	0.6	107
Portugal	1.0	1.1	0.6	64
Average	0.6	0.7	0.5	..

1. Debt refers to gross liabilities of the general government measured at face value according to the Maastricht definition. Source: End-2005 stability programmes and EC (2006), "Public Finances in EMU 2006", *European Economy*, Vol. 2006, No. 3, Brussels, for the first three columns; OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database for the debt ratio.

or maintain medium-term objectives which are generally in the upper end of the MTO range. However, while high-debt countries tend to be amongst the ones that have set themselves more demanding MTOs, their planned speed of adjustment towards these benchmarks is no faster than for other countries (Table 3.4). On average, countries intend to improve their structural balance by more (0.7% of GDP) than the benchmark ½ per cent when they are subject to the excessive deficit procedure (EDP). Sensibly, the countries furthest above the 3% limit have announced the largest improvements. Countries outside the EDP plan to reduce their deficits on average by ½ per cent of GDP a year.

On all aspects of the Pact, the 2005 reform allows for more economic judgement within the rules-based framework. The shift away from rules towards more *ad hoc* surveillance is thus expected to enable the EU authorities to make decisions that are better adapted to specific circumstances, ultimately leading to stronger national ownership of the rules and better compliance. Compared with automatic rules, discretion suffers from the well-known weakness that optimal policies are time inconsistent (Kydland and Prescott, 1977). In a more discretionary fiscal framework, pecuniary sanctions are less likely to be applied because they are not optimal *ex post*. An implication is that governments may face a weaker incentive to consolidate their fiscal positions than if faced with a sanction regime that is mechanical. Overall, the possibility of better compliance comes at the price of weaker incentives: the net impact of these two effects is unclear *ex ante*. In any case, the move towards more flexibility and discretion can be beneficial only if it is coupled with more effective enforcement (Calmfors, 2005; Deubner, 2006; Morris *et al.*, 2006).

Only time will tell whether the move towards more flexibility and discretion strengthened or weakened incentives for compliance and prompted member states to embrace area-wide objectives. The *OECD Economic Outlook* No. 80 expects government deficits below 3% of GDP in Germany and France in 2007. The improvement in Germany, which is partly structural in nature, is encouraging even though it cannot be attributed solely to the SGP reform. The improvement in France gives a more blurred signal as the projected fall in the deficit is due to the cyclical upturn. In the *OECD Economic Outlook* No. 80, the structural financial balance is projected to remain broadly stable at –1.9% of GDP in 2005 and –1.8% in 2008, falling well short of the SGP requirement that it should improve by 0.5% a year as a benchmark.⁵ Meanwhile, despite plans to intensify

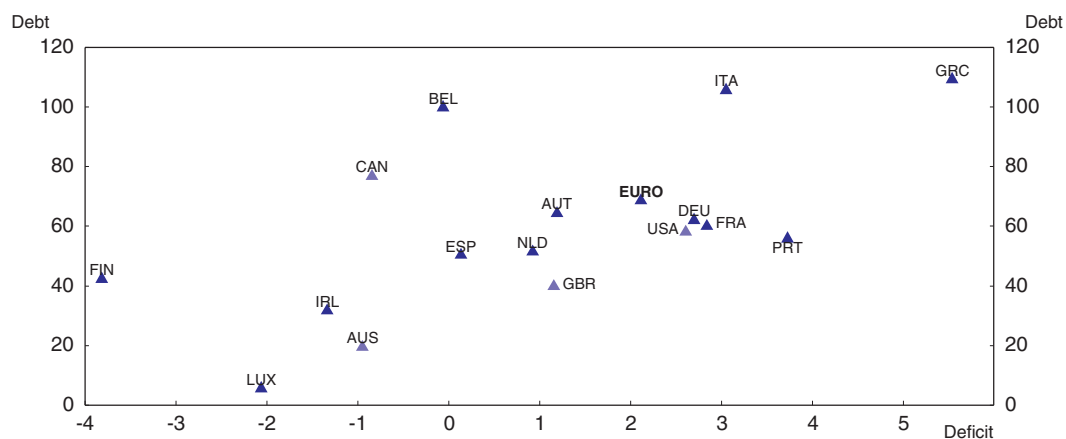
consolidation, Portugal is set to report a deficit well above the 3% mark while Italy should remain in the neighbourhood of 3% in 2007 and 2008 according to OECD *Economic Outlook* No. 80 projections.⁶ On balance, the area-wide cyclically-adjusted primary deficit is expected to diminish by almost 1 percentage point between 2004 and 2007 with higher receipts and lower spending contributing roughly equally to the improvement. This would suggest that consolidation is not very ambitious, but still points to a considerable improvement over earlier years, when the fiscal stance was broadly neutral.

What needs to be done?

Restore sustainability...

Restoring the sustainability of public finances should be the first priority of the fiscal authorities at both the European and national levels. An implication is that Community-level efforts to encourage fiscal consolidation should focus on countries with high levels of government debt or where population ageing threatens future sustainability. Apart from Belgium, countries with high government debt tend to have larger deficits too (Figure 3.7). In procedural terms, this points to the need for stronger pressure on those countries where debt is high and not declining rapidly. Ultimately, greater awareness of the unsustainability of public finances by the public is needed.

Figure 3.7. **Belgium apart, high-debt countries tend to have larger deficits**
In per cent of GDP, 2000-05



Source: OECD (2006), OECD *Economic Outlook: Statistics and Projections* – online database.

Restoring sustainability will require large adjustments in most countries. On current policies, bringing debt to 60% of GDP in 2050 while financing long-term cost pressures would require moving to a structural primary surplus of 4.3% on average over the next ten years in the euro area (Table 3.5). This is in stark contrast with the current situation where the structural primary surplus is 1% of the area's GDP. Particularly large surpluses are needed in highly indebted countries such as Belgium, Greece and Italy. Large surpluses are also required in countries that have less debt but are facing strong spending pressures (e.g. Ireland and Spain). Austria provides a contrasting – and encouraging – example: following the 2003-04 pension reform, the government has little further fiscal adjustment to make in order to put its debt on a sustainable path.

Table 3.5. Large structural primary surpluses are required to stabilise debt
Structural primary surpluses required to bring debt to 60% of GDP by 2050¹

	Period average		Memorandum item: 2006 estimate
	2006-15	2016-25	
Ratio to potential GDP, per cent			
Euro area	4.3	2.6	1.0
Austria	2.7	1.6	1.7
Belgium	5.3	2.9	4.5
Finland	3.7	1.0	2.1
France	3.8	2.3	0.6
Germany	3.8	2.5	0.6
Greece	7.7	3.9	0.7
Ireland	4.9	2.1	0.4
Italy	5.2	3.7	-0.1
Luxembourg	4.6	1.5	-1.1
Netherlands	3.9	1.7	2.6
Portugal	6.2	3.2	0.3
Spain	4.6	2.4	2.9
Comparator countries			
Australia	2.1	0.4	3.9
Canada	3.5	1.9	1.9
Denmark	3.2	1.1	4.2
Japan	6.0	4.3	-3.2
New Zealand	4.0	1.2	2.7
Sweden	2.5	1.6	2.0
United Kingdom	2.5	1.2	-0.8
United States	2.9	1.4	-0.3

1. Assuming that the government primary balance declines mechanically over time under the impact of long-term cost pressures, the calculation determines what level of primary surplus is needed in 2006 to ensure a 60% debt ratio in 2050.

Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database and OECD calculations.

... by adopting medium-term national fiscal frameworks...

There is a need for multi-annual fiscal frameworks to play a greater role at the national level. Annual budgeting does not mesh well with the SGP (and common-sense) requirement to plan reasonably in advance to ensure convergence towards medium-term fiscal objectives. One recurrent problem in stability programmes is that a great deal of the fiscal consolidation effort announced at horizons beyond the following year is not well specified. A well-designed multi-annual fiscal framework can be a powerful tool to enable governments to flesh out the fiscal consolidation strategy, thereby enhancing its credibility over the medium-term. Experience indicates that compliance with medium-term targets generally improves when independent institutions (“external watchdogs”) are entrusted with the responsibility of advising national authorities and the public on the macroeconomic outlook, budgetary forecasts and fiscal policy issues (EC, 2006a).

... and cutting low-priority expenditure items rather than raising taxes...

Given the magnitude of the needed fiscal consolidation, the choice between pruning spending or raising revenues is far from neutral. The calculations underpinning the results in Table 3.5 were made in an accounting framework with no feedback from the budget on the economy. However, if such large adjustments were made by raising taxes, larger tax

distortions would have sizeable effects on economic growth and ultimately living standards. Simulations with a general equilibrium model show that a fully tax-based consolidation reduces consumption per capita in 2050 noticeably compared with scenarios where tax rates are frozen at their 2005 levels and spending programmes are adjusted to secure sustainability (Box 3.1). The simulations also illustrate the complementarity between fiscal consolidation and structural reform: different scenarios of expenditure-based fiscal consolidation can lead to quite different outcomes in the long-term. Relative to the baseline of a fully tax-based fiscal consolidation, an expenditure-based scenario involving increases in the retirement age boosts consumption per capita in 2050 by 16% against only 8% if expenditure restraint is achieved through cuts in pension replacement rates.

Since the Stability and Growth Pact alone can do little to encourage expenditure restraint, national fiscal authorities should adopt multi-annual spending targets. The fundamental rationale behind fiscal co-ordination in a currency union – to prevent the spill-over impact from debt and deficit on monetary policy – warrants basing euro area level fiscal rules on deficits. The common deficit rule should be supplemented with multi-annual expenditure ceilings at the country level where they would present many advantages (Box 3.2). Despite these, expenditure limits could not realistically be used as a fiscal co-ordination device at the supranational level because the share of public spending in national income and its evolution over time partly reflect social preferences that are unlikely to be uniform across the euro area. Furthermore, because it varies with the nature of the constitutional system, the choice of institutions to ensure fiscal discipline is best left at the national level (Hallerberg *et al.*, 2006).

... hand in hand with structural reform...

Fiscal consolidation and structural reform are mutually reinforcing. Many measures that improve production possibilities have favourable implications for the budget: two important examples are cuts in welfare benefits that discourage employment and the rolling back of early retirement provisions. Other measures to boost supply can entail short-term costs for the budget as is the case with increased spending on active labour market policies. On balance, however, econometric analysis suggests that any short-term costs to the budget are very small and are quickly dwarfed by the budgetary gains (Box 3.3).

With the aim of eliminating possible disincentives of structural reforms, the preventive arm of the reformed SGP foresees that, under certain conditions, the implementation of structural reforms can justify a temporary deviation from the MTO or, for member states that have not yet reached their MTO, temporary deviations from the adjustment path towards the MTO. Provided that compliance with the 3% of GDP reference value is not at risk and the budgetary position is expected to return to the MTO within the four-year programme period, the Council is called upon to take major structural reforms into account when it assesses the MTO or the adjustment path towards it. It is important that the European authorities adhere to their intention that only major structural reforms that have direct long-term cost-saving effects and verifiably improve fiscal sustainability over the long-term will be considered (see Box 3.4).

Allowing for systemic pension reforms was an important motivation for the introduction of these possibilities to deviate temporarily from the MTO or the adjustment path towards it. Such reforms can entail budgetary costs in the short run but are expected to lead to lower ageing-related expenditures in the long-term. Other major supply-side reforms that raise potential growth can also be considered. In the corrective arm, structural

Box 3.1. Fiscal surgery without killing the patient

From an accounting point of view, it makes little difference whether the fiscal situation is improved by raising taxes or cutting spending. In the real world, tax hikes and spending cuts alter the incentives facing economic agents in different ways and can result in contrasting outcomes. A general-equilibrium model has been developed to assess the impact of different ways of achieving fiscal consolidation while taking into account a number of feedbacks from taxation on economic activity. Because public finances will have to be consolidated during a period of significant demographic change, the model is based on overlapping generations rather than a single infinitely lived representative agent. At the heart of the model are households that decide how much they work, save and consume in order to maximise their lifetime welfare. Because taxes and social transfers, including pensions, affect their level of income and the returns from working, changes in tax rates and income transfer programmes will affect the behaviour of households. Cournède and Gonand (2006) describe the structure of the model and the methods used to solve it analytically and numerically.

Four scenarios of fiscal consolidation have been modelled. In all scenarios, fiscal consolidation means paying off debt by 2025 so as to bring the fiscal accounts into shape just before the ageing pressures hit with a vengeance.¹ Table 3.6 describes the scenarios to achieve and sustain fiscal consolidation. For the sake of realism, one common assumption has been made in all four scenarios: increases in public health care spending (which the model projects endogenously) are financed by raising labour taxes.

Table 3.6. The four scenarios

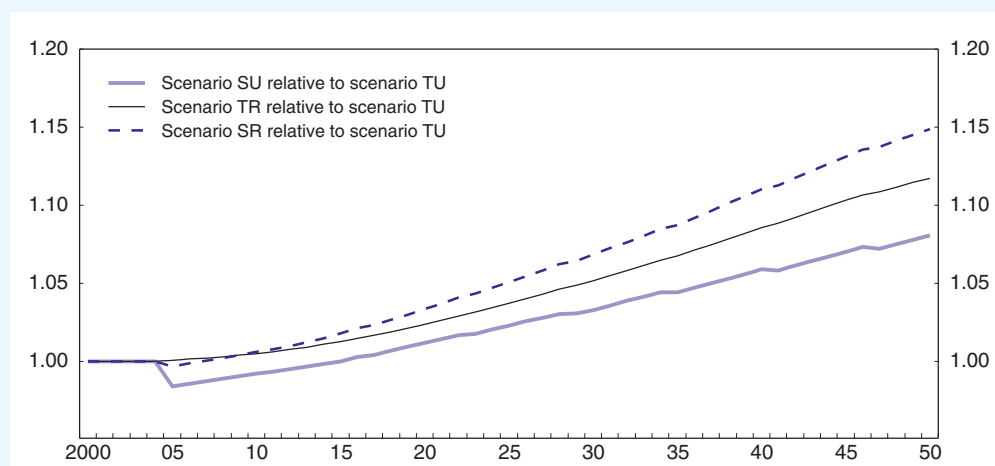
	Unchanged retirement age	Rising retirement age
Tax hikes	TU: Tax hikes and unchanged retirement age	TR: Tax hikes and rising retirement age
Spending restraint	SU: Spending restraint and unchanged retirement age	SR: Spending restraint and rising retirement age

The model results confirm that tax increases have costly economic consequences. This is not surprising since the general-equilibrium nature of the model implies that taxes and government transfers reduce incentives to work and save while no *ad hoc* offsetting positive feedback of public spending on growth has been assumed. What is more interesting is that these costs are particularly large. Tax increases are a much more costly way to achieve fiscal sustainability when compared with spending restraint (Figure 3.8). At the end of the simulation period, spending restraint (scenario SU) brings consumption per head 8% above the level reached by a purely tax-based fiscal consolidation strategy (scenario TU).² Detailed results presented in Cournède and Gonand (2006) attribute the difference primarily to the way in which tax-based strategies depress savings, capital accumulation, the capital-labour ratio and ultimately real wages. Tax-based strategies also exacerbate tax-induced distortions in labour supply but this channel is relatively weak in net terms because income and substitution effects largely cancel out. These results also imply that mechanical or accounting-based exercises of long-term fiscal sustainability (see for instance EU Economic Policy Committee, 2006) may be unrealistically optimistic as they project future sharp increases in public expenditure without taking into account the impact that financing that expenditure will have on the growth rate.

There is a benefit in combining expenditure restraint with appropriate structural reform (here in the form of increases in the retirement age). If expenditure restraint includes gradual increases in the retirement age in line with longevity (scenario SR), consumption per capita is 16% higher than in the purely tax-based scenario TU, and 8% higher than in scenario SU, where spending is curbed without adjusting the retirement age. The simulations are consistent with intuition and empirical evidence that fiscal consolidation and structural reform are to a large extent mutually reinforcing (see also Box 3.3).

Box 3.1. Fiscal surgery without killing the patient (cont.)

Figure 3.8. Consumption per capita under different scenarios



Source: OECD calculations.

An important caveat is that the different estimates have been obtained under conservative assumptions, most of which tend to under-estimate the distortions caused by taxation. All taxes in the model are proportional whereas they are progressive in euro area countries implying that they will be more distortionary. Furthermore, because multi-factor productivity (MFP) is assumed to be exogenous, there is no feedback of higher tax rates on investment in human capital and research and development, which most studies find to be negative and strong (Feldstein, 2006). On the other hand, the assumption that MFP is exogenous is valid only insofar as any cuts in expenditure fall on low-priority items and those that have no or little effect on MFP. Early retirement schemes are a good example whereas high-return infrastructure projects and efficient education programmes are two examples of areas that expenditure-based fiscal consolidation strategies should largely preserve. In other words, the model implicitly assumes that € 1 of public expenditure is “worth” € 1 of income to households in the form of public services received, but it takes more than € 1 of taxes to fund this because taxes have distortionary effects. In reality, there clearly are welfare benefits from funding a number of social programmes collectively – indeed, this is the *raison d’être* for public expenditure in the first place. The problem is that the costs of taxation rise sharply with the tax rate whereas the marginal benefits of public expenditure programmes fall (the best programmes are implemented first). Thus, the appropriate conclusion from the model is not that public spending is bad *per se*, but that cuts to lower-priority spending items can deliver surprisingly large income gains compared with the alternative of raising taxes.

1. There is a strong case based on political economy and inter-generational equity grounds for going further and building a net asset position so as to pre-fund spending pressures associated with the demographic transition but given the difficulty of quantifying the desirable net asset position, aiming at zero debt is a reasonable if conservative assumption.
2. Spending restraint does not mean deep cuts: the expenditure to GDP ratio rises by 8 percentage points in scenario SU.

Source: Cournède and Gonand (2006).

Box 3.2. Multi-annual national expenditure limits would usefully supplement the SGP

At the country level, expenditure limits offer additional benefits that make them desirable complements to the common deficit rule embedded in the SGP. Anderson and Minarik (2006) point out that multi-annual expenditure limits:

- Mitigate the risk inherent to deficit ceilings of running the maximum deficit permitted in good times, leading to excessive deficits when the economy turns down.
- Prevent pro-cyclical spending sprees at cyclical highs (see also Calmfors, 2005).
- Enable automatic stabilisers to operate fully on the revenue side in both upturns and downturns (see also Mills and Quinet, 2001).
- Avoid the need of unanticipated cuts in public spending, as may arise with strictly enforced deficit rules when tax receipts surprise on the downside.
- Can easily safeguard public investment by setting a separate limit for this spending category.
- Facilitate efforts to improve the quality of public spending. First they create a direct incentive to get more bang for the buck in existing programmes. Second they encourage improvements in the setting of priorities.
- Imply that the constraints imposed by the government sector on private agents are more predictable than with deficit rules. The reason is that expenditure limits give clearer indications about long-term trends in the evolution of taxation. Lower uncertainty about future taxes improves social welfare because it enables households to make better informed decisions about their long-term profiles of labour supply, saving and consumption.
- Have an encouraging track record. The experience with multi-annual expenditure limits in Finland, the Netherlands and Sweden has been largely successful (see Tanaka [2005] for additional examples). Econometric investigations by the European Commission (2006a) confirm that the cyclically-adjusted primary expenditure to GDP ratio on average declines markedly after spending rules are introduced.

Source: Anderson and Minarik (2006).

reforms could potentially qualify as one of the “other relevant factors” that can justify exceeding the 3% deficit reference value.⁷ However, this clause can be invoked only if the excess over the 3% reference value is judged to be small and temporary.

In the 2005 batch of stability programmes, no euro area country has invoked this new clause. While the absence of recourse to this new possibility may be a consequence of the slow pace of structural reforms in the area, it may also reflect some recognition by member states that structural reform and fiscal consolidation offer more synergies than trade-offs. Furthermore, case studies suggest that fiscal consolidation is a pre-condition for reaping the full benefits of structural reforms, presumably because it demonstrates that a government is serious about reform, generating confidence in the whole process (Schuknecht and Tanzi, 2005).

If the possibility to exceed the 3% deficit limit to undertake major structural reform were used in the future, the SGP requirement that any such deviation be temporary should be strictly enforced. International experience shows that structural reform programmes often span over many years, if not decades. Allowing deficits for protracted periods would be incompatible with putting the public finances on a sustainable path.

Box 3.3. Structural reform and the budget: little short-term pain for large long-term gains

In general, do structural reforms harm the budget balance? Two budgetary implications of structural reform can be distinguished:

- The initial costs including compensating the expected losers of structural reform;
- The longer-term benefits of structural reform on spending via policy parameters (such as lower benefit rates) and feed-back effects (such as the impact of better economic performance on the budget).

An error-correction equation has been estimated on panel data for 21 OECD countries over the period 1985-2003 to test for the existence of short-term and long-term effects of structural reforms on the budget and to gauge their respective sizes:

$$\Delta PRI_{it} = -\lambda (PRI_{it-1} - \alpha STR_{it} - \sum_k \gamma_k CON_{it-1}^k - \delta_i) + \beta \Delta STR_{it-1} + \varepsilon_{it}$$

The variable PRI_{it} is the level of cyclically-adjusted primary expenditure as a per cent of GDP in country i in year t , and ΔPRI_{it} is its change over the previous period. STR_{it} is the overall structural policy stance, with a higher value denoting a tighter stance, taken from Duval (2006). The term ΔSTR_{it} is the change in the structural policy stance indicator which serves to capture any upfront budgetary effects of structural reform. δ_i are country fixed effects and ε_{it} is the normally distributed residual. Finally, CON_{it-1} is a vector of control variables. Structural reform is expected to generate, *ceteris paribus*, higher expenditure in the short run, hence $\beta < 0$. It is also expected to reduce the size of the public sector and therefore to lower the public expenditure ratio in the long-run, hence $\alpha > 0$.*

The key result in Table 3.7 concerns the impact of the structural stance indicator on primary expenditure. The sign is as expected: a tighter stance leads to higher primary expenditure. The long-run impact is not negligible: a structural reform equivalent to a cut in the stance indicator by one standard deviation (roughly corresponding to half the difference between e.g. France and New Zealand) reduces the primary expenditure ratio by around 4 percentage points. One health warning is in place though, namely that a country with a good regulatory environment for goods and labour markets may typically also have a good fiscal framework in place, in which case the equation may be over estimating the pure impact of structural policy stances on public expenditure. Either way, though, the basic message would be that good policies are associated with less rather than more public expenditure.

Table 3.7. Estimated error-correction equation for the primary expenditure ratio

	Primary expenditure
Error-correction coefficient (λ)	0.15*** (0.03)
Dependency ratio (γ_k)	1.1*** (0.04)
Log of per capita income (γ_k)	7.5*** (0.6)
Trade-openness (γ_k)	-0.12** (0.007)
Debt ratio (γ_k)	-0.14*** (0.004)
Structural policy stance (α)	1.3*** (0.07)
Change in structural policy stance (β)	-0.22 (0.17)
Observations	357

Note: *, ** and *** denote significance at 10, 5 and 1% levels. Standard errors are reported between brackets.

The change in the stance indicator captures possible upfront budgetary costs of structural reform. The sign in the expenditure equation is negative as expected, and the absolute value of the coefficient is relatively high: a one standard deviation reduction in the stringency of regulation is associated with a temporary budgetary cost of $\frac{2}{3}$ per cent of GDP in the following year. Despite its economic significance, however, the coefficient is not statistically significant. The lack of statistical significance suggests that, while occurring, upfront costs are not very stable over time or across countries. As Hoeller and Giorno (2006) and Hauptmeier *et al.* (2006) documented in their case studies, a number of countries have reformed their structural policies successfully at little or no cost to the budget or have even reaped immediate savings.

* The source paper provides further details on the data set and the estimation methodology as well as additional results including on individual spending items and the fiscal balance.

Source: Van den Noord and Cournède (2006).

Box 3.4. **When might structural reform justify temporarily relaxing fiscal targets?**

The recent reform of the Stability and Growth Pact provides more leeway for EU governments to temporarily breach the 3% deficit limit if this can be shown to facilitate the implementation of effective, but initially expensive, structural reform. For this principle to be properly implemented, Hoeller and Giorno (2006) identify several conditions:

- Budgets need to clearly identify the structural policy measures that are being taken and specify their immediate and multi-annual budgetary cost and benefit profiles. So far, this is not happening in a systematic way, with probably the United Kingdom being at the frontier (and even there the picture is not always clear).
- Budgets also need to be explicit about the fiscal cost of inaction, *i.e.* report the budgetary developments in the absence of structural reform. This is a form of transparency that is necessary for the European authorities to call a balanced judgment on countries' trade-offs between the various options available, like reforming health care but not pensions, or any other combination of reform programmes. However, it is rare to find such costing in budgets.
- Budgets would, finally, need to give some indication of the broader economic effects of action or inaction, in order to be able to call a judgment on the *ex ante* effectiveness and efficiency of the proposed measures. However *ex ante* cost-benefit analysis is rare – not to mention *ex post* cost benefit analysis. The experience in countries like Australia and New Zealand has shown that the longer term benefits both in terms of the budget and overall economic performance may be significant. Even so, it is not easy to disentangle the various forces at play. Fundamentally, structural reform and the implementation of smart fiscal frameworks tend to go hand in hand – indeed they may be two sides of the same coin.

Source: Hoeller and Giorno (2006).

... starting now

The problem with fiscal consolidation is that every decision maker knows it has to be done but would rather leave it to the successor to do it. Fiscal consolidation is seen as a necessity that can wait until after the next election because it is perceived as a sure vote-loser. The main reason is that the benefits of sound public finances are spread fairly evenly across the entire society while the pain of expenditure cuts is more concentrated on sub-groups of the electorate and increases in taxes from their current high base could have a substantial negative effect on growth.

A number of euro area countries, however, may have reached the point where the long-term is not so distant and the cost of inaction is rising very rapidly. In other words, the belief that it is politically advantageous to pass the task of consolidating public finances to the next government may be misplaced. Box 3.5 presents estimates of optimal consolidation paths to stabilise the debt-GDP ratio at zero by 2025 (*i.e.* before the shock of ageing kicks in in earnest) at the lowest political cost. In the model, waiting a mere two years raises the political cost of consolidation by 13% for the area.

Feedbacks from financial markets through credit risk premia, which are not incorporated in the calculations reported above, mean that the actual cost of delaying the adjustment may be even higher. Credit risk premia have remained low so far because governments still have a high probability of repaying their ten-year bonds despite

Box 3.5. The political economy of fiscal consolidation: how large is the cost of inaction?

The need to consolidate public finances in order to prepare for long-term cost pressures due primarily to population ageing is widely recognised but progress has been uneven and slow in many countries. A common explanation is that many policy makers consider that consolidation has a high political cost because the impact of tax increases and expenditure cutbacks is felt quickly while the benefits of restored sustainability may be perceived only later. Policy makers may also consider that action can be deferred at little cost because of the long-term nature of the problem. Cournède (2007) questions this perception by modelling the political cost of fiscal consolidation and looking at how it is affected by delaying consolidation by a couple of years.

The model is built on a stylised representation of the costs of consolidation to decision makers, taking two sources of cost into account: the primary balance and its change from the previous period.

- While modest adjustments in the primary balance are fairly benign for policy makers, large swings can entail more than proportionate costs. Sudden changes in the fiscal stance can destabilise the economy. In addition, large fiscal changes usually have significant distributional implications which can impose considerable costs on policy makers (Alesina and Drazen, 1991). A quadratic loss function is used to incorporate this non-linearity in a simple way.
- Similarly, unbalanced budgets are costly to policy makers: deficits convey a perception of bad management while surpluses typically imply that the authorities come under political pressure to spend more and tax less. Running surpluses to repay debt is unpopular as the electorate usually does not appreciate being taxed to cover the cost of past spending programmes. Running primary surpluses to pre-fund future expenditure commitments can be equally unpopular because the people who may benefit are not necessarily the ones who pay. Because also these effects are non-linear, a quadratic loss function is used for this source of political cost too.

The policy maker acts so as to minimise the present value of discounted future political losses under the constraint of fiscal sustainability. For the sake of illustration, consider that consolidation is defined as bringing debt to zero by 2025 in order to make room for ageing-related cost pressures before they really start to bite in earnest. For the euro area, and using a high value for the policy maker's subjective discount rate (6%), waiting for two years before starting to act raises the political cost of consolidation by 13% and more in France, Germany and Italy (Table 3.8). Extensive sensitivity analysis shows that the results are very robust to changes in consolidation scenarios and parameter values including the subjective discount rate, loss function coefficients, the real interest rate and the real GDP growth rate.

Table 3.8. The political cost of delaying consolidation is large in many countries

Per cent¹

Euro area	13	(7/57)	France	15	(8/54)	Netherlands	5	(2/40)
Australia	13	(1/9)	Germany	15	(7/48)	New Zealand	2	(0/22)
Austria	8	(3/35)	Greece	11	(15/133)	Portugal	16	(12/78)
Belgium	3	(2/75)	Ireland	7	(2/23)	Spain	1	(0/26)
Canada	8	(3/42)	Italy	19	(27/140)	Sweden	6	(1/24)
Denmark	0	(0/23)	Japan	24	(67/276)	United Kingdom	22	(6/27)
Finland	4	(1/32)	Luxembourg	17	(3/19)	United States	18	(7/38)

1. Reported ratios indicate by how much the minimum possible political cost of consolidation increases if action starts in 2009 rather than 2007. The corresponding numerator (the absolute cost of delay) and denominator values (the full cost of consolidation) are shown between brackets.

The values reported in Table 3.8 are indicative of the political cost of delaying fiscal consolidation for each country considered individually but they cannot be compared across countries. The reason is that the reported cost of inaction is expressed relative to the full cost of consolidation in the country. As a consequence, a country with a lower absolute cost of delay (e.g. the United Kingdom) than another one (e.g. Italy) can exhibit a higher relative cost of delay (22% against 19%) because it has a lower full cost of consolidation (27 against 140) entering the ratio as a denominator. The full cost of consolidation is tightly linked to the debt burden and the size of long-term cost pressures.

Source: Cournède (2007).

conducting fiscal policies that are not sustainable in the long-term. Rating agencies and financial markets recognise this with high credit ratings and relatively low spreads across the euro area (Table 3.9). Spreads are not zero, however, indicating that financial markets already price in some credit risk. The spread between Italian and German bonds illustrates this point. Because the Italian and German governments have comparable amounts of outstanding debt and issue securities which are traded in an integrated market, the liquidity risk premia can be safely considered to be nearly equal. An implication is that the spread between Italian and German government bonds can be attributed largely to credit risk. The spread suggests that markets operate with an implicit probability of default on government debt that is 8 percentage points higher in Italy than in Germany at a ten-year horizon.⁸ This value is not negligible. Putting off the adjustment towards attaining sound public finances would drive them up and add to the cost of restoring fiscal sustainability – especially if credit risk premia react in a non-linear fashion to increases in the probability of default as recent euro area evidence suggests (Gómez-Puig, 2006).

Table 3.9. **Credit ratings and spreads reflect fiscal conditions**

	Debt		Long-term credit rating			Spread over German bonds (basis points)	
	Ratio to GDP, 2005	Budget balance	S&P	Moody's	Fitch	10 years	30 years
Austria	70	-1.6	AAA	Aaa	AAA	4	4
Belgium	95	0.0	AA+	Aa1	AA	4	6
Finland	48	2.5	AAA	Aaa	AAA	-3	..
France	76	-2.9	AAA	Aaa	AAA	2	4
Germany	71	-3.2	AAA	Aaa	AAA
Greece	124	-5.1	A	A1	A	26	..
Ireland	32	1.1	AAA	Aaa	AAA	-3	..
Italy	120	-4.3	A+	Aa2	AA-	26	37
Luxembourg	6	-1.0	AAA	Aaa	AAA
Netherlands	61	-0.3	AAA	Aaa	AAA	3	2
Portugal	73	-6.0	AA-	Aa2	AA	16	..
Spain	50	1.1	AAA	Aaa	AAA	0	6

Note: Debt refers to the outstanding debt of the general government sector, valued at market prices following SNA 93 methodology. Spreads are as of 29 November 2006.

Source: OECD (2006), *OECD Economic Outlook: Statistics and Projections* – online database; submission by the European Commission and Datastream.

Decision makers may find more reason to embark on fiscal consolidation now by challenging the conventional wisdom that voters always reject governments that reduce deficits. This is not to say that fiscal consolidation is easy: raising taxes or cutting expenditure will always entail political costs as some voters will lose out at least in the short run. The decision maker will have to spend political capital to convince the constituencies needed to pass the changes, but it could be that the electorate at large recognises and rewards such efforts. Using data for 23 OECD countries over the period 1960-2003, which capture 163 re-election campaigns, and controlling for growth, the business cycle and other factors, Brender and Drazen (2006) find evidence that an increased deficit during an incumbent's term in office reduces the probability that the incumbent is re-elected.⁹

The possibility that credible fiscal consolidation may generate favourable confidence effects further underpins the case for not delaying it. In addition to the political difficulty of curtailing spending programmes or raising taxes, decision makers are generally wary about

the implications of tightening the fiscal stance for aggregate demand and short-term growth prospects. With this concern in mind, a broad-based recovery as is now underway provides a window of opportunity that should not be missed since it enables governments to consolidate their budgets and stabilise the cycle at the same time. Besides, because the starting point is a situation of unsustainable fiscal positions and uncertainty among households about future taxes and benefits, embarking on a credible consolidation programme may have a much lower dampening impact on demand than standard, backward-looking models suggest. Cotis and Koen (2005) emphasise that, while temporary deviations of the fiscal stance around a central position perceived as unchanged in most cases influence short-term demand in the standard way, a tightening that reflects a credible policy regime shift can have favourable non-linear effects on demand. Empirical investigations confirm the presence of such effects in a number of fiscal consolidation episodes (see Briotti, 2005 for a recent survey of the available evidence).

Conclusion: a daunting agenda for national and EU authorities

Because fiscal policy is primarily in the hands of national authorities, there is only so much that EU institutions can do to address the pressing challenges confronting euro area member states. Most of the effort will have to be at a national level. The examples of Belgium and Ireland in the 1990s demonstrate that fiscal consolidation in countries with high debt levels is possible. The first priority should be for national governments to fully embrace the goals of balancing their budgets and keeping long-term budgetary cost pressures in check. To implement this priority, member countries should rely more on multi-annual fiscal frameworks to limit the effects of the pro-cyclical bias inherent in annual budgeting and to underscore the fiscal reward of reforms that reduce cost pressures.

Despite the central responsibility of national authorities, EU institutions can play a role in helping to make the necessary adjustments happen. First and foremost, the EU-level fiscal framework should keep the pressure on national governments to at least balance their budgets in structural terms. The implementation of the EU fiscal framework should encourage greater and faster adjustment from countries where the debt ratio is high and not on a clear downward trend. The dynamics of debt is such that, unless they run large primary surpluses, highly-indebted countries are very exposed to the risk of rapid debt explosion if real interest rates shoot up or growth slows down. As a result, high-debt countries create risks of negative cross-border spillovers that deserve attention at the Union level.

Substantial progress towards balanced budgets was made in the run-up to the introduction of the euro but it stalled when the incentives weakened. EU institutions have the responsibility to sharpen incentives to pursue a sound fiscal policy. While the revised rules provide extra room for economic judgement, this should only be used when clearly warranted. An important issue with the rules is that the provisions of the EC Treaty require a qualified majority in the EU Council for each stage of the EDP. It is this provision that enabled a group of countries (forming a blocking minority) to bring the EDP to a halt in November 2003.

In low-debt countries, the main motivation for fiscal co-ordination is to avoid large swings in discretionary measures that could amplify cyclical developments or impair the capacity of automatic stabilisers from working. The reformed SGP aims at delivering this outcome by requiring every country to bring its cyclically-adjusted deficit close to balance. The sophistication and greater reliance on economic analysis introduced with the reform could help improve the capacity of the surveillance process to encourage such outcomes.

In the end, however, the incentive for countries to follow the requirements of the SGP will be influenced by the credibility and ownership of the Pact. It remains to be seen whether the improved surveillance procedure will create an environment conducive to avoiding the pro-cyclical fiscal behaviour that has been observed since 1999.

The main focus of the euro area fiscal framework should shift from the 3% deficit limit to the goal of maintaining balanced budgets in structural terms. Achieving and maintaining fiscal balance is a precondition to restoring and then preserving sustainability in the face of ageing. The recent decision by European authorities to pay greater attention to debt and medium-term prospects and less to the deficit in the current year represents a welcome step in the right direction even if it has yet to be fully translated in fiscal plans.

An important requirement for the necessary fiscal consolidation to deliver its maximum benefits is that it should primarily be achieved through restraining public expenditure and improving its quality. The responsibility for meeting this requirement lies with the national authorities. Expenditure limits provide an effective tool to that end: national fiscal authorities should supplement the European deficit rule with country-specific multi-annual expenditure limits. The limits should provide room for the core functions of government and areas where public spending is most beneficial to growth and social welfare (such as innovation, education and scientific research) while concentrating the cuts on items that offer lower or negative returns (a prime example being early retirement schemes). While expenditure limits create a direct incentive to improve value for money in public programmes, national fiscal authorities should supplement this incentive with specific efforts to maximise the social return on public spending since current arrangements offer many possibilities for improvement (Joumard *et al.*, 2004).

Despite the central role of national authorities in cutting expenditure and improving value for money in public spending, EU institutions can contribute by sustaining the drive for structural reform. The available evidence indicates that the long-term savings brought about by structural reforms outweigh the short-term costs. By its very nature, structural reform is about making institutions, including public institutions, compatible with and conducive to a higher production potential: there are therefore synergies between embarking on structural reform, spending less and getting more value for money in public expenditure programmes. Against this background, it is a welcome development that the possibility of breaching SGP targets on the grounds of structural reform has not been used in recent stability programmes, and that should remain the case. Temporary excesses of SGP targets should be allowed only in exceptional circumstances such as the introduction of a large fully-funded pillar in pension systems.

Finally, there is no reason to wait before embarking on the necessary changes. Putting off the adjustment only raises the risk of a crisis and its large negative implications for economic growth and social welfare. Even without a crisis, the political costs of not reforming are increasing quickly. The earlier the adjustment starts, the lower the short-term contractionary impact on activity (and therefore any electoral cost) will be. In addition, there are indications that the electorate at large tends to reward, rather than penalise, fiscal consolidation that is sufficiently smooth not to compromise economic growth.

Notes

1. The starting point for the calculation consists of medium-term fiscal policy settings in the OECD *Economic Outlook* No. 80 medium-term baseline. In addition to the values reported in columns 1, 3 and 5 of Table 3.2, projections of spending pressures in 2025 have been used to obtain a finer modelling of the debt dynamics.
2. The estimate of the stock of public capital is taken from Kamps (2004).
3. Council opinion No. 7370/06 of 14 March 2006 on the updated stability programme of Germany, 2005-09.
4. "Economic bad times" is the phrase used in the legal text that revised the preventive arm of the SGP, namely Council Regulation (EC) No. 1055/2005. Guidelines for the interpretation and implementation of the SGP are provided by the Code of Conduct (formally an opinion of the EU Economic and Financial Committee that has been endorsed by the Council of finance ministers on 11 October 2005). The guidelines define "economic good times" explicitly. By symmetry, "economic bad times" are defined as "periods where output is below its potential level (unless the output gap is only slightly negative and moving rapidly towards positive values) and periods where the output gap is slightly positive but moving rapidly towards negative values".
5. However, the European Commission Autumn 2006 forecasts project that over the 2006-08 period the average annual change in France's structural balance will be in line with the Treaty requirements of 0.5% of GDP as a benchmark.
6. OECD *Economic Outlook* No. 80 projections are based on announced measures and stated policy intentions where they are embodied in well-defined programmes, all as of November 2006.
7. In the legal text of the revised Pact, "the implementation of policies in the context of the Lisbon agenda" is one of the "other relevant factors" that the European authorities are called upon to consider when deciding whether a deficit larger than 3% is excessive or not.
8. The calculation assumes a recovery rate of 70% on defaulted debt and has been made using Chan-Lau's (2006) methodology.
9. One caveat with this analysis is that controlling for economic growth may distort the view: if fiscal tightening has contractionary effects, the actual probability of being re-elected will be lower than the one estimated after controlling for economic growth. On the other hand, if fiscal consolidations can be expansionary as argued by Giavazzi and Pagano (1990), then the probability of re-election will in such cases be even higher than Brender and Drazen (2006) estimate.

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Glossary

APW	Average production worker
CPI	Consumer price index
ECB	European Central Bank
EDP	Excessive deficit procedure
EMU	Economic and Monetary Union
EMS	European Monetary System
ERM	Exchange rate mechanism
ERM II	Exchange rate mechanism II
EU	European Union
FDI	Foreign direct investment
HICP	Harmonised index of consumer prices
ICT	Information and communication technology
GDP	Gross domestic product
M&A	Mergers and acquisitions
MFP	Multifactor productivity
MPC	Marginal propensity to consume
MTO	Medium-term objectives
NAIRU	Non-accelerating inflation rate of unemployment
PPP	Purchasing power parity
R&D	Research and development
SGP	Stability and Growth Pact
VAT	Value-added tax

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The Secretariat's draft report was prepared for the Committee by David Rae and Boris Cournède under the supervision of Peter Hoeller.

The previous Survey of the euro area was issued in September 2005.

BASIC STATISTICS (2005)

	Euro area	United States	Japan
LAND AND PEOPLE			
Area (thousand km ²)	2 456	9 167	395
Population (million)	313.6	296.4	127.8
Number of inhabitants per km ²	128	32	323
Population growth (1995-2005, annual average % rate)	0.4	1.1	0.2
Labour force (million)	147.9	149.3	66.5
Unemployment rate (%)	8.6	5.1	4.4
ACTIVITY			
GDP (billion USD, current prices and exchange rates)	9 947.6	12 397.9	4 559.0
Per capita GDP (USD, current prices and PPPs)	29 848	41 789	30 541
In per cent of GDP:			
Gross fixed capital formation	20.5	19.5	23.2
Exports of goods and services	20.2	10.5	14.3
Imports of goods and services	19.1	16.2	12.9
PUBLIC FINANCES (per cent of GDP)			
General government:			
Revenue	44.5	32.7	30.3
Expenditure	47.5	36.6	37.0
Balance	-2.4	-3.7	-5.2
Gross public debt (end-year)	77.5	61.8	173.1
EXCHANGE RATE (national currency per euro)			
Average 2005		1.24	136.9
October 2006		1.26	149.7

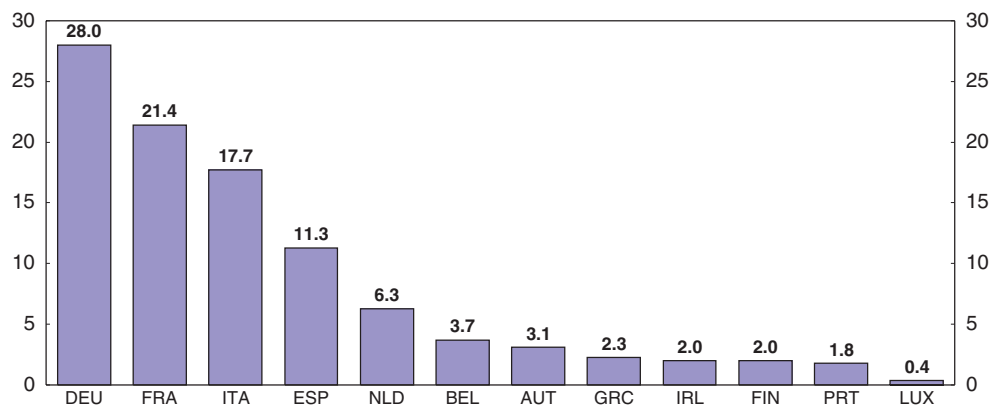
EURO AREA – EXTERNAL TRADE IN GOODS (main partners, % of total flows, in 2004)

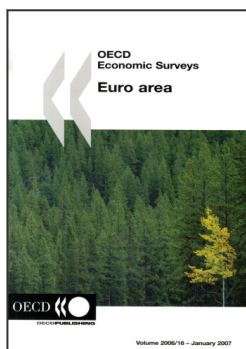
	Exports	Imports
Denmark, Sweden, United Kingdom	22.9	17.4
New European Union member countries	11.0	9.8
Other Europe	16.8	15.9
OECD America	17.4	12.6
OECD Asia/Pacific	5.5	8.6
Non-OECD dynamic Asian ¹ and China	7.8	14.4

1. Chinese Taipei; Hong Kong, China; Indonesia; Malaysia; Philippines; Singapore and Thailand.

SHARE IN EURO AREA GDP

Current market prices, 2005





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