PUBLIC DEBT, SUSTAINABILITY AND THE FISCAL POLICY FRAMEWORK OF THE EMU

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Introduction

During the first five years of EMU useful experiences have been gained from the functioning of the economic policy coordination and the fiscal policy framework. The ECOFIN council reported on this issue to the Helsinki European Council already in November 1999. The debate concentrating mainly on the Stability and Growth Pact has continued since. Now it is time to take stock and try to draw conclusions and make some proposals.

A common view is that the current institutional framework is appropriate but more focus should be given to policy implementation and sustainability issues. This was also more or less the outcome of the EU Convention and similar conclusion has been drawn in the context of the ongoing ICG in which only small amendments have been proposed to the Treaty.

There is no willingness to open the key provisions and to change competences. When trying to improve the EU-level policy coordination and to strengthen the credibility of the Stability and Growth Pact (SGP), the question is how to improve the existing framework. At the end of the day, if the legal requirements and provisions are considered to be in place, strengthening of the political commitments will be the key.

One important avenue in this respect is the common interest which the Member States have in maintaining the long-term sustainability of public finances. In recent years there has been a clear trend to focus increasingly on sustainability and debt issues. This has been endorsed in several occasions both by the Heads of States and Governments and by the Council of Ministers.

It is a major paradox that no explicit and operational link between the SGP and the sustainability of the public finances exists. The aim of the medium term target of "close to balance or in surplus" was to strengthen long-term sustainability of public finances and to ensure reduction of indebtedness. However, the Pact, as such, is silent on the public debt criterion which has in practice remained rather inoperational. The discrepancy and inconsistency between short and long-term considerations has been one of the central reasons behind the difficulties experienced in the implementation of the SGP.

The aim of this paper is to discuss debt and sustainability issues in the context of the SGP. A lot of work has been done to study these questions further. It is especially important to try to understand the politics involved. Despite the strong

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commitments, the outcome of the SGP has recently been less satisfactory. The question is why the performance has been so poor despite of all the political will invested.

The SGP and the existing fiscal framework have failed to provide the result which is most important from the point of view of the euro area, *i.e.* strengthening of long-term sustainability and reduction of debt levels. Attention has been given mostly to the three high debt countries (Belgium, Greece, Italy) which have been expected to maintain their primary surpluses at an appropriate level in order to ensure rapid debt reduction. In this respect, the outcome has been disappointing. These three countries have not been able to deliver what they promised in their original stability programmes in 1998, *i.e.* their initial commitments when joining the euro area. The Commission and the Council have been unable to tackle this problem and to make the debt criterion operational. In 2003 the debt ratio of the euro area exceeded 70 per cent. Furthermore, there has been no improvement during the five year period.

Even more disturbing is, however, that in recent years the large euro area countries have moved away from their original targets and have again exceeded the 60 per cent benchmark. Indeed, too much attention has been given to their excessive deficits and too little to the fact that the public finances of these countries are increasingly on an unsustainable footing. In general, it seems that the coordination has focused too much on short-term issues and on secondary issues in which the common interest is less important, like the quality aspects of the public finances.

1. The framework

The euro area Member States prepared their first stability programmes in 1998 before adopting the common currency. The programmes were based on the Council regulation which defined their minimum data requirements. These requirements were further specified in the code of conduct on the content and format of stability and convergence programmes endorsed by the ECOFIN Council in 1998. Since then the programmes have been updated on an annual basis. In 2001 the sustainability aspect was strengthened when the code of conduct was revised. According to the new rules the programmes were expected to outline in an explicit way the Member States' ageing strategies and provide information on how they were planning to tackle the longer-term budgetary implications of ageing populations.

This change reflected the conclusions of the Stockholm European Council in March 2001 endorsing a "three pronged strategy" of ageing population. The Member States are expected to review regularly the long-term sustainability of public finances, including the expected strains caused by the demographic changes ahead and to take measures in three areas in order to improve the long term sustainability. The three areas where efforts should be made are increasing of employment rates, speeding up reduction of the debt burden and implementing

pension and health care reforms. The "three pronged strategy", which has been frequently referred to, is politically highly useful and an important commitment to promote sustainability.

In November 2002 the Commission gave a communication on strengthening the coordination of budgetary policies. One of its proposals was that the sustainability of public finances should become a core policy objective. This aspect should be, according to the Commission, explicitly taken into account when assessing the budget positions of Member States under the SGP. Furthermore, the Commission announced that the debt criterion of the excessive deficit procedure, which requires debt levels above 60 per cent of GDP to approach the reference value "at satisfactory pace", should made operational. Countries with debt levels well above the 60 per cent level should outline a detailed strategy on how to reduce their indebtedness. Commission argued that these Member States should consider running budget surpluses in coming years, *i.e.* over and above the "close to balance or in surplus" requirement of the SGP (European Commission 2002). The communication led to an intensive debate on common fiscal targets both at the level of high officials and by the ministers in their informal Euro Group.

In 2003, the Commission deepened its analysis on the debt criteria and on excessive deficit procedure further in its annual public finance report (European Commission 2003). The background was that the European Council had concluded in March 2003 – in line with the Commission communication and ECOFIN conclusions – that the pace of decline in public debt should play an important role in budgetary surveillance, especially in highly indebted countries, and that the excessive deficit procedure should contribute to ensuring a satisfactory pace of debt reduction. This was again a clear and strong commitment at the highest political level.

Unfortunately the Commission analysis on how to operationalize the debt criterion remained rather open-ended. Developing undisputable, quantitative criteria for debt reduction in EU level policy coordination proved to be difficult.

In November 2003 the Council discussed the impact of ageing population on public finances and endorsed the report of Economic Policy Committee (EPC 2003). The EPC assessment was based on quantitative indicators backed with qualitative information. The EPC defined the sustainability of Member States' public finances meaning a continued compliance with the Treaty requirement to keep debt levels below 60 per cent of GDP. On that basis, a "clear risk of emerging budgetary imbalances" exist in seven Member states (Germany, Greece, Spain, France, Italy, Austria, Portugal). According to the EPC conclusions this demonstrates the long-term impact of failing to achieve the "close to balance or in surplus" target.

This politically rather strong assessment is particularly noteworthy, as the working group consisted of representatives of the Member State governments. This indicates that there should be readiness to adopt more obliging and far-reaching conclusions and policy recommendations on sustainability issues at the Council level. The Council also confirmed the mandate to the EPC to produce new common

budgetary projections by mid-2005 on the basis of the approach outlined in the report.

2. Commission recommendations and Council opinions

There is a general understanding that the weaknesses in the functioning of the SGP and the lack of credibility are due to the final decision making role which the Treaty gives to the Council in the excessive deficit procedure. It can be expected that the Council/Member States will, at the end of the day, water down efforts to strengthen fiscal discipline at the EU level and to prevent the use of sanctions for this purpose. This can be seen as the major underlying reason behind the problems in economic policy coordination. These common views – which are challenged in this paper – have also led to quite radical proposals how to reform the SGP. See, e.g., Fatás *et al.* (2003).

Largely this expectation has also been behind the proposed Treaty amendments aiming to increase the competences of the Commission. If the Commission received right to put forward formal proposals concerning orientations on economic policies instead of recommendations it would be more difficult for the Member States to soften the common policy line and to blur fiscal discipline.

Legally there is a significant difference between proposals and recommendations put forward by the Commission. According to the EU decision making rules, unanimity of the Member States is always needed to change the Commission proposals whereas a recommendation can be changed by a qualified majority. On these issues see also Buti, Eijffinger and Franco (2003). This question has become particularly topical after the decisions of 25 November 2003. The question is basically whether an enhanced role of the Commission in economic policy coordination would promote fiscal discipline in the Member States and especially the long-term sustainability of public finances.

It is not clear that a change in the division of competences between the Community and the Member States would strengthen the credibility of the Stability and Growth Pact and improve policy coordination. This is doubtful because at the end of the day the main bulk of the budgetary decision making will remain in capitals. According to the new Treaty text the national parliaments should ensure that legislative acts proposed by the Commission are in compliance with the principles of subsidiarity and proportionality. It is clear that any proposal for new secondary legislation on economic policy coordination would be carefully checked by the national parliaments and be vetoed if needed. Indeed. the final responsibility of fiscal stability and long-term sustainability is in the hands of national governments and parliaments, which is one argument why in the future the national parliaments should be linked more closely with the economic policy coordination at the EU-level. Any attempt to change the institutional balance would lead to a major conflict with the national parliaments.

Thanks to the increased openness and transparency of the EU institutions, the availability of key documents has improved in recent years. Therefore, one can more easily observe what have been the respective roles of the Commission, on the one hand, and the Council/Member States, on the other, when formulating the recommendations and policy orientations. Of course, the final test whether the policy coordination has failed or not, are the budgetary developments and the sustainability of public finances in individual countries. The question is, however, whether the common interest represented by the Commission and the peer review exercised by the Council/Member States have had any effect on fiscal discipline or sustainability.

After what happened on 25 November 2003, when the ECOFIN Council decided against to the recommendation of the Commission to suspend the excessive deficit procedures for France and Germany for the time being, the use sanctions has been largely excluded. This option has been reserved for cases where the country in excessive deficit procedure is not cooperative. The conflict between the Commission and the Council could also be interpreted reflecting different attitudes concerning the budgetary autonomy of the Member States and division of competences in this respect. Therefore, the events of 25 November 2003 could be seen mainly as an institutional dispute, not a question of substance. The verdict of the European Court which is expected to clarify the respective competences and responsibilities in the policy coordination, will be of key importance.

Despite adverse developments in major countries and difficulties in implementing the SGP, it has to be taken into account that there are also some encouraging signs which reflect increased concern on the long term sustainability of public finances and the financing of welfare systems e.g the growing determination to implement pension and health care reforms in various countries.

Also, the Finnish experience on how to enhance commitment at the domestic front has been encouraging. The growing concern about the long-term sustainability of public finances and pension systems because of ageing populations were communicated by the government at a very early phase. The message was received well. In the late Nineties the obligations of the coming EMU membership and the need to fulfil the Maastricht criteria were never used as an excuse to consolidate public finances. It was always emphasized that these challenges have to be met because of demographic challenges regardless of participation in the euro area.

There has been a strong element of continuation in the Finnish budgetary policies. In March 2003, when taking the office, the present government decided in its coalition agreement on a budgetary framework for the next four years. It was agreed that the government will keep the central government finances on a sustainable basis both in order to be able to cope with the burden of ageing populations and to have an adequate fiscal leeway. For these purposes, the reduction of the central government debt-to-GDP ratio (excluding cyclical deviations) was considered to be crucial. The agreement continues:

"To ensure the sustainability of the public finances, the Government aims to secure balanced central government finances under normal conditions of economic growth at the end of the electoral period, measured in terms of national accounting. There would then be an overall surplus in the general government finances equivalent to some three per cent of GDP. Cyclical or other short-term deviations from the path of balanced central government finances are permitted, provided that they do not jeopardize overall reduction of the central government debt-to-GDP ratio."

In line with the requirements of the Growth and Stability Pact, the Finnish Government committed to take corrective action if the central government deficit approaches the 3 per cent ceiling. At the general government level this implies that further measures will be taken if the overall financial position turns into deficit.

The new expenditure rules were tested for the first time when discussing the year 2005 budget framework in March 2004. The results were satisfactory. Accordingly, the general government surplus is expected to strengthen during the four year election period so as to reach 2.7 per cent in 2008. During the same period there will also be a reduction in the debt ratio from 44.1 per cent in 2003 to 40.4 per cent in 2008. At the same time the Government is also committed to implement further cuts in taxation of labour in order to strengthen employment and growth.

When exploring new avenues to strengthen the SGP and its credibility, the importance of explicit political commitments should not be underestimated. It seems that there is increased willingness and capacity in the Member States to strengthen the sustainability in the long run. This might reflect the fact – which has been generally recognized – that the room for manoeuvre is increasingly limited and the real challenges are approaching as the structure of population becomes unfavourable.

The following analysis is based on observations made in the context annual examination of stability and convergence programmes in 2003-2004. Country examinations consist on Commission assessments and recommendations for Council opinions which the Council adopts after a discussion in the Economic and Financial Committee (EFC). The Commission has published press releases of its assessments on the web site since 1999. In 2003 it started to publish not only press releases but also the assessments as working documents. The Council opinions on the programmes are public and can be found both on its own and on the Commission web sites.

The analysis concentrates on debt and sustainability issues. To concentrate the analysis on debt and sustainability issues, two cases are considered: namely France and Italy.

2.1 France

In the 2002 stability programme, the risk of breaching the 60 per cent debt ratio ceiling in 2003 was not identified. This problem was noted in the Commission assessment of the French programme and it was also mentioned in the Council opinion, but without any comments. As regards achieving sustainability, the Commission concluded that it will require maintaining a balanced budget position in underlying terms over the very long run: "this implies running large primary surpluses for many years so that a large reduction in the debt ratio is recorded prior to the budgetary impact of ageing populations taking hold". The Council opinion followed similar lines emphasizing the role of debt reduction which should make "a noticeable contribution towards meeting the budgetary cost of ageing populations, then reaching a balanced budget position by 2006 is essential... and may have to include the running of surpluses." There is slight difference in the wording but the policy advice given by the Council is quite clear. Only when the Council welcomes the pension and health care reforms is the wording chosen more political, but not less demanding. France was urged to proceed rapidly with these reforms "given the limited window of opportunity".

As regards the 2004 examination the debt issue became even more topical because the 60 per cent ceiling was breached in 2003. The assessment of the Commission emphasises the speeding up of budgetary adjustment to ensure an earlier and larger decline in the debt to GDP ratio, "which is projected to remain above 60 per cent throughout the programme period, and to start to decline only in 2006". The Council opinion is in similar lines but adds a warning that "the evolution of the debt ratio might be less favourable than projected given the risks to the deficit outcomes mentioned above".

In 2004, the Commission changed its approach by taking into account not only quantitative factors affecting debt and sustainability. This reflected the recommendations of the ageing working group of the EPC according to which also reforms strengthening the long-term sustainability of public finances should be taken into account. The Commission gives credit to measures which improve the sustainability and facilitate meeting of budgetary costs of ageing populations but emphasises also that risks of imbalances cannot be ruled out and that securing adequate primary surpluses will be essential. These key messages were not challenged by the Council opinion. As regards the reduction in public debt, the Council opinion is in line with the Commission text according to which the debt is expected to start declining only after 2006 and remain above 60 per cent through the period covered by the stability programme. The Council opinion also repeats the concern expressed by the Commission that the evolution of the debt ratio is likely to be less favourable given the risk related to deficit outcomes. The Council, however, strengthened the Commission text by pointing out that at least 0.5 percentage point improvement is needed to achieve the medium term position of government finances close to balance or in surplus and to bring the debt ratio back to declining path.

2.2 Italy

Because of the initially high level of debt in Italy the Commission and the Council have had a clear position on these issues emphasising especially maintenance of high primary surpluses. Achievement of a position of underlying budget balance in the medium-term has considered being critical in order to place public finances on a sustainable footing. These views have been shared both by the Commission and the Council. In 2003 the Council was very explicit and stated that the pace of debt reduction should be significantly faster that has been the experience of the past years. It urged Italy to act to ensure that the debt is sufficiently diminishing. The relatively slow pace of debt reduction during the programme period has been linked by the Commission to persistence of large and unexplained "below-the-line" operations. This is a rather sensitive issue. The Council recommended that the measures of transitory nature should be considered as a means to accelerate the reduction of debt and not as a substitute for corrective action on the deficit side. Both the Commission and the Council have had also concerns related to required increases in participation rates and the long transition period in pension reform.

In 2003 there were unexpectedly large reductions in debt ratio. This was noted both by the Commission and the Council. The Council opinion was, however, rather critical and pointed out that the projected decline during the programme period is less ambitious than in the previous update. Given the risks to deficit outcomes and expected proceeds from privatisation, a warning was added according to which the evolution of debt ratio may be less favourable during the programme period. All in all, both the Commission and the Council assessed that risks of budgetary imbalances emerging due to ageing populations cannot be ruled out. The Council opinion emphasises also the importance of implementation of the draft legislation on pension reform the postponement of which "is not consistent with the pursuit of sustainability-oriented fiscal strategy".

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All in all it seems that the fiscal policy coordination and the peer review conducted by the ECOFIN Council has been rather straightforward and functioned well from the procedural point of view. There is no evidence that the Council would like to soften the recommendations prepared by the Commission. Sometimes the Council has even strengthened the message further. This has, however, not been able to prevent the excessive deficits from emerging and the indebtedness from rising. It is suggested in this paper that this is largely because of the missing link between the long-term orientations and the short and medium term policy recommendations. Strengthening this link and making it more explicit could also lead to an enhanced credibility of the SGP and more sustained public finances.

3. Conclusions and suggestions

Despite the well known problems in implementing the SGP, the Council/Member States seems to be committed to long-term sustainability of the public finances. Obviously, there is a common concern which should motivate the decision makers more than the policy coordination in a short-term context on which the SGP and the multilateral surveillance have mostly focused. Currently, there are too many targets to be met so that the final aim of the coordination is at risk to be lost. The debt criterion has not been made operational enough to trigger the excessive deficit procedures. In the German and French cases the debt levels exceeding the critical threshold were not the key problem. It was mentioned only shortly as an additional outcome of breaching the 3 per cent ceiling.

Against this background, the coherence between short- and medium-term orientations and long run sustainability issues should be increased. This is evident when considering the Council opinions on stability and convergence programmes. In the short- and medium-term context Member States are urged to take additional (one-off?) measures whenever it turns out that the economic outlook and budgetary situation will deviate from what has been expected and the 3 per cent ceiling might be breached. This is a bad substitute to policy orientations aiming at strengthening the sustainability in the long run by adopting clear-cut budgetary strategies and orientations. Hence, increasing attention should be directed to budgetary processes, frameworks and fiscal rules on enhancing sustainability.

One further avenue by which the commitments of the Member States could be strengthened is increasing the involvement of the national parliaments on the economic policy coordination. Because of the importance of budgetary issues in domestic policy making the EU-level coordination should be more closely linked with the democratic processes in each Member State. Adoption of binding multiannual budgetary rules and expenditure ceiling should be encouraged and developed as a standard procedure in the context of the multilateral policy coordination framework. This has also been argued by Brunila (2002). National, multiannual expenditure rules are likely to facilitate the policy coordination also at the EU level and to strengthen, not weaken the SGP.

The challenges related to long-term sustainability of the public finances differ in the Member States. The approach could be developed further so that the general SGP framework will be accompanied with country specific targets. Accordingly, each Member State could define its own medium and long term targets to be endorsed by the Council. These targets should focus on the long term sustainability of public finances and reforms implemented to strengthen it. The question is whether the impact of major reforms affecting the long term sustainability could be translated into budgetary figures in a reliable way. This might be the next challenge of the EPC ageing working group.

There are both quantitative and qualitative aspects involved. The trend that the quality of public finances has been increasingly linked with multilateral surveillance has tended to blur competences and responsibilities. This approach was

tested when the stability and convergence programmes were examined last time. Politically, it is important to give the appropriate credit to reform efforts and to learn from good practices but risks may emerge if this leads to a development where gradually the "hard coordination" softens and "soft coordination" hardens so that the conduct of budgetary policies becomes more and more difficult.

The HM Treasury presents in its recent discussion paper (2004) three principles for reform of the SGP. They are long-term objectives, pre-commitment to sound institutional arrangements and maximum transparency. These principles are difficult to dispute as such, but they should be seen as complement, not as substitute for firm criteria and clear, binding rules. Too flexible interpretation of the 3 per cent reference value could further undermine the credibility of the rules based approach and the SGP. The public finances are rather fragile and budgetary situations may change quite rapidly. Excepting virtuous countries from the SGP or loosening the multilateral surveillance could lead to unpleasant surprises later (Berglöf *et al.*, 2003).

In the context of the ongoing IGC it is expected that to a certain degree the powers of the Commission in the policy coordination will be increased. This concerns especially the implementation of the excessive deficit procedure. However, defining basic orientation and final design of economic policies still remains in the hands of the Member State governments and the Council. It should be kept in mind that also the EMU was an achievement of the Member State governments and an end result of a political process. One should not underestimate the importance of the political will and energy when tackling the necessary reforms. The evidence presented above indicates that the Member States are under considerable pressure to take action to strengthen the sustainability of public finances.

It would be important to clarify and solve the open issues related to the SGP before they will be topical again due to the enlargement. The new Member States are expected to join the EMU in due course. As regards the public debt levels their initial starting point has been quite favourable. Only two of them (Cyprus and Malta) exceed the 60 per cent reference value. On the other hand debt levels are increasing in several countries and may gradually approach the reference value (Hungary, Poland, Czech Republic and Slovakia). Before they are ready to access the euro area, the new Member States should be able to show that they have achieved – in line with the Treaty language – "high degree of sustainable convergence". This includes the sustainability of the public finances. The precedent is not too encouraging. The three highly indebted, euro area Member States have not been able to keep up the time table of debt reduction which was agreed in 1998.

The stability and convergence programmes have been updated now five times. One could wonder whether a new generation of programmes would be needed so that especially the challenges of ageing populations could be taken into account in an appropriate manner reflecting the methodological innovations in the area of structural deficits and sustainability indicators. Against our experiences from the past it might be too optimistic to expect that one day the Member States could totally agree with numbers and methods. One of the problems concerning the

multilateral surveillance and the early warning procedures has been the still poor quality of budgetary figures and forecasts.

In order to improve fiscal discipline and long term sustainability a renewed commitment at the political level is needed. There seems to be wide consensus that the long-term sustainability should be the core. A lot of proposals in these lines have been made. One of the most prominent is the idea of "Debt Sustainability Pact" by Pisani-Ferry (2002). The proposal has its merits but the problem with it as with most of the models presented seems to be that the importance of budgetary policies in domestic policy making and democratic processes has been more or less ignored. In this respect, most of the proposals discussed have remained unrealistic and impractical. This is also the problem with the "sustainability council" suggested by Fatás *et al.* (2003). An independent panel of experts reporting to the European Parliament also nominating the body, would concentrate only on debt and sustainability issues in the euro area and have judgemental powers in the EDP.

There is also final avenue to be explored if reforming the SGP proves to be impossible. Then one should ask whether – after the recent experiences – the time is ripe to reopen the debate on budget discipline and reinforcing the impact of market pressures. If the conclusion is that the deteriorating fiscal discipline of the major countries will lead to further weakening of credibility of the common policy coordination framework and long term sustainability of public finances (default risk), radical measures should be taken in order to restore the confidence and to ensure that the medium term targets will be met in due course. This question is likely to become even more topical because of the enlargement and the convergence game.

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