Editorial: Public finances in a better condition – but sustainability not yet achieved

The sustainability of public finances is a key policy issue for the European Union. Within the EU fiscal framework individual countries are urged to respect the requirements of the Stability and Growth Pact (SGP) by avoiding excessive deficits and keeping debt levels below the 60 percent of GDP reference value. In the case of the Euro area countries, in particular, the fiscal discipline is an important support for the implementation of common monetary policy. Therefore, it has received increased attention in the context of EU fiscal framework over the recent years.

Following a period of substantial fiscal restraint, which led to a marked improvement of budgetary positions, the aggregate Euro area fiscal deficit is expected to register a further significant, albeit more moderate, reduction, in the current year, closing below 1% of GDP. This development is the result of the continuing contractionary fiscal stance in a number of countries but also the result of higher than expected growth rates which helped the improvement of tax revenues. Fiscal balances in 2008 are forecast to reflect the end of this period of fiscal consolidation.

Improved fiscal positions have been recorded in several countries, among them Finland, Austria and Portugal. However, the Euro-area fiscal position has been predominantly the result of striking and somewhat diverse developments in the four major Euro-area countries: Germany, France Italy and Spain.

The strongest improvements in terms of deficits have been realised in Germany and Italy. In Germany, the increase in the standard VAT rate, coupled with contractionary expenditure policies have resulted in significant fiscal consolidation. In Italy, the deficit was reduced in line with government targets, primarily, with the adoption of a set of revenue measures.

On the other hand, budget policies in France and Spain were slightly expansionary with government balances stabilising broadly at the 2006 levels. Nevertheless, while the Spanish budgeting position is strong with a surplus of 1.8% of GDP, in France the deficit remains above 2.5%.

On the basis of the 2008 budgets and other available information the consolidation process is coming to halt in 2008. The overall fiscal stance in the Euro-area is expected to come close to neutrality. In consequence, the aggregate Euro-area deficit is expected to stabilize at the 2007 levels. The outlook of the four major Euro-area countries entails a certain degree of divergence regarding the expected fiscal stance. The most pronounced fiscal stimulus is projected for France but in the case of Italy the fiscal stance is also expected to be expansionary. The fiscal policy in Germany, will take a slightly expansionary stance reflecting mainly the reform of the corporate income tax and a slide acceleration of government expenditures. In Spain, however, a neutral fiscal policy is projected to remain on track. All things considered, the budget balances in 2008 are expected to remain stable in all four countries. Taking, however, into account temporary measures and cyclical factors, the projected structural deficits will probably increase slightly.

In conclusion, it appears that, after a long period of consolidation, public finances in the Euro-area are rather strong at the current juncture. With government deficits quite low by historical standards, the medium term objective of 0 per cent of GDP deficits in 2010 appears feasible, assuming the consolidation process remains on track in the countries with relatively high deficit. Nevertheless, the longer term sustainability of public finances in the Euro-area remains in question, as it depends, to a large extent on long term demographic developments.

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Fiscal policy not very ambitious in 2008

In 2007, public finances improved significantly in the Euro area as a whole. Net lending (general government) continued to decrease. According to European Commissions estimates it will come down to 0.8% in relation to GDP after 1.5% which have been recorded in 2006; IMF expectations are quite similar. This improvement is owed above all to Italy and Germany. The latter will show a budget surplus, whereas a constant deficit was assumed in the Stability Programme. Italy has cut its deficit from 4.4 to 2.3%. In most other countries, being in surplus or not, the situation remained more or less unchanged, in some, e.g. in Belgium and in the Netherlands, the budget balance, contrary to the Stability Programs, deteriorated even somewhat. On average, about half of the improvement was cyclical and by half it was structural. Cyclical adjusted net lending decreased from 1.2% to 0.7% of GDP, which was almost exclusively achieved by Germany and Italy.

For 2008, governments are not very ambitious to reduce deficits further. Net lending will remain more or less constant according to European Commission estimates; in the assessment of the IMF it will even increase slightly. In most countries the structural balance will remain unchanged. In Germany, fiscal policy will even take a slightly expansionary stance because corporate taxes are reduced which is not fully compensated by cutting subsidies or reducing expenditure. Structural measures to reduce the deficit in a sizeable dimension are only planned in Greece. But we are sceptical, as set out below, whether this will be achieved.

The commission's forecasts as well as the assessments of the EUREN institutes for their home countries presented below have not fully taken into account the latest revaluation of the Euro against the Dollar as well as the new oil price hike. Both will most probably have a dampening effect on growth in the Euro area. For that reason, budget plans might be built on too optimistic assumptions; and there the risk is apparent that deficits may rise again. For some countries, such as France, Italy, and Portugal this could even mean they will fall back into an excessive deficit, which do not comply with the Maastricht rules.

Table 1

Stabilty Programme's projections and fiscal policy outcome in the Euro area

Countries	Data		Stability Programme 2006/07		EC Nov 2007		IMF Oct 2007	
	2005	2006	2007	2008	2007	2008	2007	2008
Austria	–1.6	–1.4	–0.9	–0.7	–0.8	–0.7	–0.2	–0.2
Belgium	–2.3	0.4	0.3	0.5	–0.3	–0.4	–0.8	–0.6
Finland	2.7	3.8	2.8	2.7	4.6	4.2	4.3	3.8
France	–2.9	–2.5	–2.5	–1.8	–2.6	–2.6	–2.5	–2.7
Germany	–3.4	–1.6	–1.5	–1.5	0.1	–0.1	–0.2	–0.5
Greece	–5.1	–2.5	–2.4	–1.8	–2.9	–1.8	–2.1	–1.9
Ireland	1.2	2.9	1.2	0.9	0.9	–0.2	0.8	0.2
Italy	–4.2	–4.4	–2.8	–2.2	–2.3	–2.3	–2.1	–2.3
Luxembourg	–1.1	0.7	–1.9	–0.4	1.2	1.0	0.4	0.4
Netherlands	–0.3	0.6	0.2	0.3	–0.4	0.5	–0.6	0.5
Portugal	–6.1	–3.9	–3.7	–2.6	–3.0	–2.6	–3.3	–2.4
Slovenia	–1.5	–1.2	–1.5	–1.6	–0.7	–1.0	–0.9	–1.1
Spain	1.0	1.8	1.0	0.9	1.8	1.2	1.4	0.8
Euro area	–2.5	–1.5			–0.8	–0.9	–0.9	–1.1

Source: European Commission (2007), *Economic Forecast Autum 2007*. Brussels; IMF (2007), *World Economic Outlook Autumn 2007*. Washington, DC.; National Stability Programmes.

Germany: Fiscal policy will take a more expansionary stance

German fiscal policy was restrictive in 2007. A number of measures had been taken to reduce the structural deficit. The VAT and the insurance tax were raised, an additional tax bracket on high incomes was introduced and various subsidies were cut. All in all, we estimate the discretionary measures have reduced the fiscal deficit by 0.9 percentage points. At the same time, corporate tax revenues grew strong, due to high profits in the current year and back payments. In addition, the improved situation in the labour market led to higher receipts and lower unemployment related expenditures. All together, the general budget will by slightly in surplus for the first time since 1989[1].

In 2008, fiscal policy will take a slightly expansionary stance. In part, this reflects the reform of the corporate income tax which will be set into force an January 1st. It will reduce the tax burden on profits below 30%, thus making Germany more attractive for international investors. At the same time the tax write-offs are restricted and measures are taken to restrict tax avoidance.

On balance, the government estimates that the tax burden on corporations will be reduced by 6.6 bn . However, the government also plans additional expenditure on social policy, R&D, public investment, and development aid. Furthermore, the contribution to the unemployment insurance will be reduced.

All together, we estimate that the measures described will increase the structural deficit by 0.4 percentage points. Despite of this, the general government budget can be expected to be in surplus once more, because the business cycle situation continues to be favourable.

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France: stabilisation of the deficit around 2.6% of GDP

In 2006, fiscal deficit reached 2.5% of GDP. This year, it will be marginally higher (2.6% of GDP). As GDP will grow close to its potential (around 2%), there will be no reduction of imbalances due to cyclical reasons. Whereas general government expenditures have remained under control, expenditures of the local authorities increased further; even if at a lower rate than in 2006 which is in line with the electoral cycle. The next elections for municipalities have been postponed from 2007 to 2008. Moreover, social expenditures have still been dynamic, a trend that reflects higher expenditures in the health sector.

In 2008 the economy is forecasted to grow again in line with potential growth. Therefore, the main changes in fiscal balances will come from discretionary measures. After the presidential elections in last May, the government has has passed a "fiscal package" which is deemed to boost the labour supply and to increase the purchasing power of households. The most important measures are:

- Interest paid to finance the purchase of a house can partly be deducted from the income tax.
- Social contributions on overtime work are cut, especially for low wage workers; wage earnings linked to overtime work can be deducted from the income tax.
- The tax on net wealth can partly be transformed in an investment in small and medium enterprise.
- The inheritance and gift taxes are reduced;
- Total direct taxes paid by individuals cannot exceed 60% of their income.

All in all, the ex ante costs of this package would be above 10 bn . Of course, the final impact of those measures on the budget will be lower, if the package is successful to stimulate growth both on the supply and

1 The surplus registered in 2000 was owed to exceptionally high revenues from the UMTS auctions. Without these income the deficit would have reached 1.2% of GDP.

demand sides. Therefore, public deficit is expected to remain unchanged at 2,6% of GDP. This also means that the public debt (64.2% of GDP in 2006) would not be reduced further in 2007 and 2008.

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Italy: Deficit reduction deferred to 2009

The Italian Forecast and Planning Report presented a new forecast on net borrowing, based on unchanged legislation, which takes into account the positive trend in receipts. According to these figures, net borrowing is expected to drop from 4.4% of GDP in 2006 (but excluding the effect of one-off measures the level would have been at 3.1%) to 1.9% in 2007 and 1.8% in 2008, finally reaching 1% of GDP in 2011. In the policy scenario the public finance targets are basically confirmed: net borrowing will decrease in 2008 to 2.2% (from the 2.4% which is the objective for 2007) and to 1.5% in 2009. The balanced budget is set to be reached in 2011.

For 2007 a fiscal package has been set into force which includes higher expenditure on infrastructures (routes, railways, subways, MOSE system in Venice); wage settlements, for the previous two-year period, for civil servants, a social housing program, more spending on cooperation and development; and a one-off allowance for persons under the minimum taxable income. Currently, additional measures are under discussion, which are likely to pass the Parliament. Amongst others, the budget bill contains:

- an increase of the tax relief on the property tax for the main house (the one in which one lives) and a tax reduction on personal income tax for rents (for low income persons);
- the cut in legal tax rate for company income tax from 33% to 27.5% and a widening of the taxable base. Also for the regional tax, the tax rate is lowered from 4.25 to 3.9%, while the taxable base is broadened;
- financing the reform of social security cushions and pension system;
- some measure of rationalization of public expenditure;
- restrictions to the use of flexible contracts for civil servants and new hiring in specific sectors.

Fiscal policy will be expansive in this year and the next. Indeed, compared to the unchanged legislation scenario, once taking into account the fiscal measures the government has decided to take, net borrowing will be increased by 0.5% and 0.4% of GDP in 2007 and 2008 respectively. The additional receipts, coming from higher tax revenues, are assigned to finance an increase of outlays, deferring the deficit reduction to 2009.The 2008 fiscal package will stabilise the tax burden on the 2007 level, when it reached a peak of 43%. Thereafter, it will gradually decline to 42.5% in 2011. A similar pattern is projected for the primary surplus. After having been close to zero in 2005 and 2006, it will rise to 2.5% of GDP in 2007. For 2008 it is projected to stay quite stable (2.6%), and it will increase by 0.4% of GDP in each of the following years. Given this evolution, public debt will come back to its decreasing trend, which was interrupted in 2005 and 2006. After the peak at 106.8% of GDP in 2006, it is forecasted to be at 105% in 2007 and fall under 100% in 2010.

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Spain: Budget will stay in surplus

After having reached a budget surplus in two consecutive years, a new surplus is expected for current year that could be even higher than 1% of GDP. The continued buoyant upswing of the Spanish economy led to a growth of tax receipts during the first three quarters. Direct taxes grew at double digits rates and indirect taxes in line with nominal GDP (around 6.5%). On the other hand, public expenditures were raised by 7.6% in the same period, with capital expenditures growing at double digit rates, too.

For the next year, the government has got support by the parliament to keep fiscal policy on track. Therefore, a new surplus is projected for 2008, which is in line with previous one. However, we doubt whether this will come true, because the forecast is based on a quite optimistic macroeconomic scenario. We forecast GDP to grow at a rate of 2.8%, whereas the government assumption is half a percentage point higher. Nevertheless, even under our less optimistic view a budget surplus can be expected.

Going more into detail, the 2008 budget follows the same direction the former governments have already pursuit since 2005. On the expenditure side, outlays for social security, infrastructure, and R&D and innovation will grow above average. On the revenue said, direct taxes both for households and firms will be reduced. For private households this will mean an expansionary effect in disposable income of about 3 bn , which means about half point of additional growth. These measures will help to compensate the effects of the monetary policy tightening that would have dragged disposable incomes, as most Spanish households are indebted. For firms, an additional cut of the corporate income tax has been implemented. The tax rate for large companies will go down to 30% in 2008, from 32.5% in 2007, and 35% in 2006. For SMEs, the tax rate of 25% introduced in 2007 will be kept constant.

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Greece: Contractionary stance in 2008

The recent revision of Greek national accounts had consequences for the government spending mainly in the form of additional contributions to EU, associated to the GDP revision. The extra contributions for the period 2005-2006 are introduced as arrears in the 2007 government accounts. Additional public expenditure was required in 2007 to account for the organisational costs of the early elections, as well as, the outlay made necessary by the recent fires. Taking into account all these extra items, the budget deficit is estimated to reach 2.9% of GDP, up by about 0.5 percentage points.

The 2008 draft budget target deficit of 1.7% is based on a contractionary fiscal stance. On the one hand, it is planned to reduce government consumption. On the other hand, total revenues are expected to rise, as it is assumed that the tax elasticity has increased because of measures to broaden the tax base. Some discretionary tax measures are contemplated including a unified property tax. This, however may be a rather optimistic outlook and the government has not yet ruled out a rise in the standard VAT rate. The 2008 structural deficit is estimated to be 2.4% of GDP, which is somewhat less optimistic than the official forecast.

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Emilio Fontela, in memoriam

On July 27, our friend and colleague Emilio Fontela passed away in Madrid. Anyone whose research in the field of applied economics brought him into contact with them will always feel professional, and especially, personal gratitude towards him. He was one of the initial founders of the EUREN Network and he was always pushing to improve the relationships between different European research institutions.

Although Emilio was born in France in 1938, he took Spanish citizenship and regarded Seville as his home town. But his outlook was international. In 1962, he received his Ph.D. in Economics in the University of Geneva (Switzerland) where he was Professor in National Accounts and Applied Econometrics from 1974 until his recent retirement a few years ago. His long professional career spawned a vast output: 16 books, 74 book chapters in collected volumes and 113 journal articles.

Whilst he was known around the world for his analysis of current economic prospects, his research also covered the wide field of applied economics (particularly, technological innovation), econometrics and input-output analysis. He was able to pursue his interest in L. Walras and the general equilibrium theory in empirical terms by using input-output techniques. His first contribution in this field was presented with A. Duval in January 1968 at the Fourth International Conference on Input-Output Techniques held in Geneva and published in Carter and Brody (1970). His paper related the evolution of relative prices in time to the technical coefficients of the Leontief model.

But stepping back from this, any review of his professional career will never capture the good feelings that he transmitted to everyone who had the fortune to enjoy his company. He greeted everyone who met him in the same way – with a smile on his face, and was not even phased on the occasion a big bird swooped down and stole his dinner at an al fresco meal during an international input-output meeting in Tanzania.

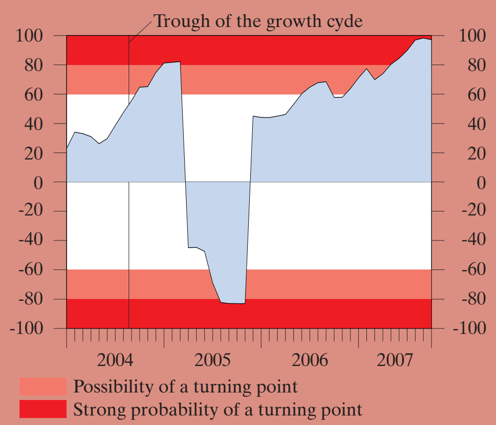
In the word of his granddaughter Ginebra: „*Although most of you will remember him as a great professor and economist, I will always remember him as a great grandfather and a very good person*“.

COE-Rexecode Leading Indicator for the Euro Area

The leading indicator for the Euro area (IARC) passed the 80 threshold last July, sending a strong signal of imminent economic slowdown. In the following months, it continued rising to 97.2 in October. This means that a peak of the growth cycle should have been reached in the third quarter. In other words, the growth rate should recede under the trend growth, which is estimated currently at 2.3 %. This can be expected in the last quarter 2007 or in the first quarter of 2008. It is not sure however whether this will be a cyclical downturn or just a soft patch. All the components of the indicator show a strong probability of a downturn except for the stock index whose probability of a downturn was very high in September but was weakening in October. The confirmation of a lasting economic slowdown in the United States also contributes to the signal.

[1]An economic slowdown occurs when the current GDP growth rate decreases under its trend growth.

IARC zone euro
2004 to 2007



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: October 15, 2007

	06Q4	07Q1	07Q2	07Q3	07Q4	2007	08Q1	2008
jul-06	2,37; 0,37	;	;	;	;			
aug-06	2,48; 0,15	;	;	;	;			
sep-06	2,41; 0,17	;	;	;	;			
oct-06	2,66; 0,26	;	;	;	;			
nov-06	2,81; 0,38	2,78; 0,72	;	;	;			
dec-06	2,68; 0,34	2,61; 0,67	;	;	;			
jan-07	2,78; 0,48	2,86; 0,88	;	;	;			
feb-07	3,01; 0,71	2,85; 0,64	;	;	;	2,51		
mar-07	[3,3; 0,9]	3,00; 0,50	2,86; 0,85	;	;	2,62		
apr-07	[3,3; 0,9]	2,81; 0,31	2,38; 0,57	;	;	2,27		
may-07	;	3,05; 0,55	2,83; 0,78	;	;	2,56		
jun-07	[3,3; 0,9]	[3,0; 0,6]	2,78; 0,68	2,53; 0,35	;	2,61		
jul-07	;	;	2,74; 0,64	2,64; 0,50	2,31; 0,57	2,67		
aug-07	;	;	2,66; 0,46	2,51; 0,45	2,28; 0,67	2,61		
sep-07	[3,4; 0,9]	[3,2; 0,7]	[2,5; 0,3]	2,34; 0,44	2,16; 0,72	2,51		
oct-07	;	;	;	2,41; 0,51	2,13; 0,51	2,56	2,07; 0,75	2,05

The October update of the EUREN/CEPREDE confirms the outcome of the COE-Rexecode-Model presented above. The forecast for 2007Q4, which was revised downward over the recent months, as well as 2008Q1 indicate that the year on year rates can be expected to fall below trend growth. This update was made before EUROSTAT published its Q3 figure. The data release on 14 November shows a year on year rate of 2.6 and a quarter over quarter rate of 0.7. Hence, the EUREN/CEPREDE-Model forecast was slightly to low, but the differences are still inside the error margins.

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Impressum
The European Economic Network (EUREN) is a network of European economic research institutes. which was formed in 1999. Members of EUREN are:

- Centre d'Observation Economique et Recherche pour l’Expansion de l’Economie et le Developpement des Entreprises (COE-Rexecode), Paris, France
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