SPEECH

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Challenges for Fiscal Policy from a European Perspective

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Ladies and gentlemen,

First of all, let me express my pleasure at taking part in this conference.

I would like to congratulate the organisers of this meeting for their initiative, and in particular the German authorities. The interest shown by the German Presidency in different aspects of fiscal policy is particularly valuable as it is helping to promote debate on the topic at a crucial juncture for Europe.

This conference is a very concrete manifestation of this interest and is particularly well timed. Two years ago this week, Ministers met to finally approve a reformed version of the Stability and Growth Pact.

I am quite sure that today's presentations and debate will lead to some useful recommendations on how to further improve budgetary policy surveillance at EU level.

Today I would like to consider the main challenges of fiscal policy from a European perspective. I will make three points:

- First, continued efforts are needed to strengthen the preventive arm of the Stability and Growth Pact in order to avoid the resurgence of unsustainable deficits.
- Secondly, we should use the current growth-supportive macroeconomic scenario to speed up fiscal consolidation and effect far-reaching structural reforms to prepare for our ageing societies.
- Finally, improving the quality of public finances is crucial in our efforts to raise growth and create jobs.

Before I develop each of these points one by one, let me first refresh your memory on the basic elements of the SGP reform.

Fiscal policy in EMU and the 2005 reform of the SGP

The reform of the SGP in 2005 aimed to deal with the difficulties of catering for a European Union of increased economic diversity, while preserving the rules-based nature of the EU fiscal framework.

The reform confirmed the 3% and 60% reference values for the deficit and the debt ratios as the key nominal anchors of the system, but important changes were introduced.

In the corrective arm of the Pact, there is now more economic analysis underpinning the application of the excessive deficit procedure. The reasons for a deficit above 3% of GDP will be considered more extensively, but if this deficit is neither small nor temporary it will be deemed excessive.

The importance of structural as opposed to nominal deficits is now embedded in the rules. Realistic deadlines for the correction of deficits can now be established but Member States in excessive deficit have to achieve a minimum fiscal effort of at least 0.5% of GDP per year measured in structural terms, which is net of cyclical effects and temporary measures.

In the preventive arm, there were three key changes:

- Firstly, the common medium-term objective was replaced by country-specific ones based on the debt ratio and potential growth of each Member State.
- Secondly, the reformed Pact emphasises the need to achieve greater fiscal consolidation in good times.

- And finally, the new agreement includes incentives for Member States to embark on structural reforms.

After two years in force, my assessment of the revised SGP is positive. In 2006, the average nominal deficit was reduced for the third year in a row to about 2% of GDP, and the debt ratio declined for the first time since 2002, although the improved economic environment also played a role.

The SGP procedures have been implemented correctly and consistently, while the better economic rationale underpinning decisions and recommendations has led to greater ownership of the Pact on the part of Member States.

Germany in particular did much to promote this increased sense of ownership when a new step of its Excessive Deficit Procedure, leading to enhanced surveillance, was decided. The German authorities embraced the decision, viewing it as backing for the implementation of their fiscal consolidation strategy.

The leadership shown by Germany has helped re-establish a solid consensus for sound public finances among all Member States, giving added weight to the credibility of the reformed SGP.

In part thanks to the very good developments in Germany, the average deficit in the EU as a whole is expected to improve further to 1.4% this year. If present trends continue, only Portugal, Hungary and perhaps Poland will still be in excessive deficit at the end of this year.

The way forward: the improvement of the preventive arm

While the situation regarding excessive deficits has progressed overall quite successfully, the focus must now shift to the preventive part of the pact. Here there is still clear room for improvement.

The current fiscal efforts of countries that are not in excessive deficit do not go as far as they could and should in view of the current favourable cyclical conditions and the challenges posed by ageing.

As you know, the reformed SGP allows each country to have a differentiated medium-term budgetary objective, reflecting country specific circumstances. However, it also expects each Member State to reach rapid convergence towards this specific medium term objective.

As it stands today, the budgetary plans of many of the euro area members could demonstrate more ambition. The requirement to strengthen consolidation efforts in good times is not being respected by all in all years considered.

In fact, evidence suggests that once again, many Member States are not taking advantage of the favourable macroeconomic situation to consolidate their public finances. For example, Germany plans no improvement at all, in structural terms, during 2008.

It is imperative to avoid repeating mistakes made at the peak of the previous cycle in 1999 and 2000, when some EU countries did not take advantage of favourable cyclical conditions to speed up fiscal consolidation.

In this context, this year's Midterm Review of budgetary policies within the Eurogroup gains particular relevance. On top of our annual assessment of the Stability Programmes of the Member States, it will enable Ministers for the first time to determine 'ex ante' the appropriate fiscal policy stance for the euro area in 2008, and especially to commit to ensuring that their national budgetary plans for next year are consistent with these orientations, taking into account the favourable economic prospects.

This should allow an informed and frank discussion of national fiscal strategies which can have a real impact in the budgetary process of each Member State during the next months. I therefore expect this year's Midterm Review of budgetary policies to represent an important step forward in the enforcement of the preventive arm of the Stability and Growth Pact.

Better fiscal governance at national level can also play a significant role. For instance, the adoption of medium-term budgetary frameworks for budgetary planning and monitoring may significantly improve governments' control over budgetary aggregates and increase transparency.

Numerical fiscal rules and strong fiscal institutions at the national level, for example parliamentary budget committees, also support the conduct of sound fiscal policies. As such, they represent an important tool to reinforce the preventive arm of the Stability and Growth Pact.

The long-term sustainability of public finances

Now, we have looked at the main fiscal challenges facing Europe in the short- and the medium-term. But some of the difficulties I have mentioned will become even more serious in the long term due the ageing of Europe's population.

Dramatic changes in the age structure of European populations mean that the old-age dependency ratio is expected to increase from 25% at present to more than 50% by 2050. If measures are not taken soon, this will have a substantial impact on future budgets. Public expenditure is projected to increase by 3% to 4% of GDP on average in the EU by 2050.

So what policy steps are required to counter this trend? Broadly, we need to implement a three-pronged strategy to ensure sustainability, which consists of:

(i) rapidly reducing debt to GDP ratios;

(ii) raising employment rates and productivity; and

(iii) reforming pension and health care systems.

There are a number of supporting steps that need to be taken in order to make this strategy a success:

- First, Member States need to improve their fiscal positions. Recent developments are a step towards sustainability but as I have already stressed, it is now necessary for countries to rapidly attain the medium-term objectives set in the Stability and Convergence Programmes.
- Second, it is important to put the Lisbon strategy into action by increasing productivity, fostering job creation and making economies more adaptable. This will contribute to create more wealth and reduce the demographic impact on our economies.
- Finally, we must control the long-term dynamics of public expenditure. Further reforms in pensions and health care systems will improve government finances over the long term and make Europe's social models more sustainable. For instance, raising the retirement age, as just agreed in Germany, and linking benefits and contributions more closely, can provide substantial relief to the pressures of ageing.

The quality of public finances

An important element of achieving this last objective and countering the spending pressures that arise from ageing will be improving the quality of public finances. This subject is increasingly becoming a key issue in the fiscal policy debate and the German Presidency is attaching high importance to making progress in this field through its inclusion in the agenda of ECOFIN meetings in April and June.

Indeed greater attention must be paid to the quality aspects of public finances to ensure that overall budgetary targets are met, and at the same time growth-enhancing budgetary items are not squeezed out by uncontrolled expenditure costs or by spending growth in inefficient expenditure categories.

Spending items such as education and R&D can bring important social and economic benefits in terms of innovation and human capital accumulation. Indeed, analysis indicates that each extra 1% of public R&D generates 0.17% productivity growth while an extra year at the intermediate level of education immediately increases productivity by about 6.2%.

The growing importance of budgetary quality has been taken up in the objectives of the National Reform Programmes and the Integrated Guidelines, as part of a comprehensive strategy to achieve the Lisbon Agenda.

Needless to say, developments in policy and in our understanding concerning the efficiency of sectors such as R&D and education will be important for identifying best practice for use across countries.

Better understanding should also be applied to other large sectors of public spending. For example, public expenditure amounts to a total of nearly 45% of GDP in the EU-25. 13% of this spending is apportioned to education but 14% is allocated to general public services and 37% to social protection. Extending greater efficiency to these areas will be a fundamental objective.

Finally, in the field of quality of public finances, one also has to consider how the structure and efficiency of taxation systems respond to the needs of our modern and more integrated societies.

Conclusions

Ladies and gentlemen, I believe we have made important progress since the reform of the SGP, on which a consensus was reached just two years ago. But in my presentation this morning I have highlighted challenges that the EU continues to face in the budgetary field.

The current economic good times signal a unique window of opportunity to tackle these challenges head-on and to ensure that we get public finances on a sound and sustainable footing.

As the labour force starts declining and the flow of people retiring increases in the coming decades, our margin of manoeuvre to consolidate government finances will narrow rapidly. Furthermore, risks to our central economic scenario are ever present, as recent financial market turbulence has shown.

Therefore it is now, while the economic situation is favourable, that we should start to work towards a lasting fiscal consolidation based on expenditure restraint and better quality of public finances, while allocating higher-than-expected revenues to deficit and debt reduction. This will not only put us in a better fiscal position to cope with the challenges of ageing but will also create room to preserve the core of our European Social Model.