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FISCAL POLICY IN THE MEMBER STATES IN 1984

(Commission communication to the Council
with reference to article 3 of the decision
concerning convergence of 18 February 1974)

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FOREWORD

The Commission is transmitting this communication to the Council in connection with the examination of the economic situation in the Community scheduled for 11 July (1), which involves, inter alia, setting quantitative guidelines for public budgets in 1984. It is also submitting, for information, a report on the follow-up to the guidelines laid down in its communication to the Council of the 1 July 1982 on budget discipline and economic convergence, the second part of which deals in particular with restructuring public expenditure towards productive

The first chapter of this communication presents the economic outlook for the remainder of 1983 and for 1984, and identifies the main economic policy problems the Community will be facing over the period. The second chapter outlines the budget policy most appropriate in the present situation.

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(1) Pursuant to Article 3 of Council Decision 74/120/EEC on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community.

I. The macro-economic situation of the Community and forecasts for 1983-84

As the Commission pointed out in its communication to the European Council of 9 June 1983 (1), there has been, since the last quarter of 1982, a small recovery in output in the Community with GDP growing by 2 % at annual rates both in the last quarter of 1982 and the first quarter of 1983. It is however not certain that a durable recovery is under way. A similar rise in gross domestic product in the last two quarters of 1981 heralded only renewed recession in 1982, and some of the reasons for last year's set-back are still valid today.

The international environment over the next two years will be crucial for the recovery in the Community. Whilst the upswing in the USA appears to be confirmed, the burden of external debt in many countries, and falling revenues from oil in the OPEC countries, will limit the growth of world trade, which will be close to zero in 1983, and around 3 1/2 % in 1984. On the other hand it is expected that oil prices will remain stable in nominal terms and the rise in non-oil primary commodity prices will be limited by the slow pace of recovery in demand and the size of free production resources.

Overall it is expected that real GDP in the Community will rise by only 1/2 % in 1983 and 1 1/2 % in 1984. In 1984 there is expected to be considerable disparity between Member States, with Germany, the United Kingdom and Italy growing by more than 2 %, France and the Netherlands by 0,5 % or less. Unemployment continues to rise though at a lower rate over the last few months; the unemployment rate reached 10,8 % in April and is expected to rise throughout the forecast period to reach 11 1/2 % of the civilian labour force in 1984, about 13 1/2 million people. Even if the fall in employment comes to an end as the recovery proceeds, this will be insufficient to turn round the growth of unemployment.

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(1) Commission communication to the European Council on the economic and social situation in the Community of 9 June 1983. The figures in this chapter are revised forecasts, but they do not differ substantially from those in the above-mentionned document.

Marked progress has been made in the fight against inflation: over the last six months the consumer price index (seasonally adjusted) rose by only 7,6 % (annual rate). Moreover there has been a better convergence of inflation rates at the lower average rate. The rise in consumer prices in the Community is expected to fall to 5 3/4 % on overage for 1984, the lowest rate of increase since 1970. Even if inflation differentials remain significant, price rises will moderate in most Member States; this development is due to a substantial reduction in unit labour costs and to a relative stability in import prices.

With the terms of trade moving in the Community's favour in both years and some improvement in the real trade balance from mid-1983 on, the current account deficit will be reduced to approximate balance in 1984.

This forecast has downward risks associated with it. The main concerns are the course of US interest rates and its likely effect on exchange rates, interest rates in Europe and the indebtedness situation of LDCs. A rise in European rates in line with the USA would damage the expected slow recovery in consumption and investment. An increase in the debt-service ratio of LDCs could seriously affect the stability of the international financial system and further weaken Community export markets.

Two major policy issues arise from this outlook:

- First, it needs to be determined whether the speed of the economic recovery of output is appropriate, i.e. as favourable as can be expected in the circumstances.

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This question has in turn two aspects, the relative speed of cyclical recovery as between countries, and the average for the Community as a whole.

There is an undoubted need for growth rates over the next 18 months to be differentiated, to allow certain balance of payments disequilibria to be corrected and further internal budgetary and disinflation adjustments to be pursued.

Moreover, in spite of the constraints on several Member States, where activity cannot be boosted until the measures to put the economy back on a sounder footing have taken effect, it is possible that an average Community growth rate higher than the present forecast may be attainable in 1984. Physical capacity clearly is available, world commodity prices are weak, and there is the urgent need to reverse the rise in unemployment. The issue is whether a development along these lines can be more actively pursued by policy without prejudicing medium-term objectives, i.e. the credibility of stability-oriented monetary policies, reducing the growth of the public debt and restructuring resource allocation between public and private sectors.

- The overall judgment on policy adjustments has to take into account the second major issue, namely the international monetary context. US interest rates have begun slightly to rise again, whereas for the Community the forecast recovery relies in part on reduction in interest rates both in the rest of the world and in Europe. If a combination of circumstances in the USA (a strong cyclical recovery, an unresolved budget deficit problem and a largely non-accomodating monetary policy) led to a more serious rise in US interest rates, the Council reconsider the position.

The spontaneous tendency might be for a parallel upward movement of European interest rates, accompanied by unchanged objectives for budgetary policy, but this would clearly undermine the forecast recovery. For the time being this is no more than a hypothesis, and it is in particular to be hoped that it could be avoided by rapid action in the

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U.S.A. over its budget deficit. If, however, the unfavourable hypothesis proved to be founded, economic policies in Europe would have to be reconsidered.

II. General budget policy guidelines

The follow-up to the guidelines in the Commission communication of 1 July 1982 on budget discipline and economic convergence shows that while encouraging progress was made in 1983 towards controlling public expenditure (1) the problem of excessive public finance deficits is still acute in most of the member countries particularly because of the disappointing trend in public revenue.

Action and risks for 1984

In view of the prospects described briefly above, the task of budget policy in 1984 cannot be defined in simple terms. Some aspects of it will vary from one country to another, and it will need to be sufficiently flexible to be able to adapt to the eventual trends.

Obviously, to consolidate the progress already made in restoring a balanced development to the economy, efforts to reduce the public finance deficit in the medium term must not be relaxed and a particular aim should now be closer control over expenditure.

In most of the Community countries, but particularly Belgium, Denmark, Greece, Italy and Ireland, the deficit is still very high and may well generate either excessive liquidity or higher interest rates, thus directly or indirectly affecting current balance of payments equilibrium. These pressures are the result of a long period of persistent deficits, and the vigorous policies required in these countries in 1984 will, therefore in most cases, represent only an initial stage in an effort which will have to be sustained over several years. The external constraints which appeared in France in 1982 demonstrated that the public deficit needed to be strictly held in check. In the Netherlands, expenditure is so dynamic that the public deficit increases considerably each year, suggesting that a recovery of private demand from its present very depressed level would rapidly lead to the emergence of a serious imbalances.

On the other hand, the reduction in the non-cyclical part of the public deficit in Germany and the United Kingdom - not only desirable, but now actually possible in those countries - should be managed with caution so as to avoid adverse effects on growth.

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(1) See the report on budget discipline and economic convergence and on restructuring public expenditure in favour of productive expenditure (doc.II/198/83 Rev.1)

It is difficult to determine exactly how far the actual deficit is structural, so that its cyclical component could be underestimated; sometimes policies pursued could in effect become more restrictive than was actually intended by the authorities.

Cyclical adaptability

If, over the next few months, the international financial situation and world economic conditions developed less favourably than now forecast, especially if that were in such a way as to force interest rates upwards, and if growth in the Community was consequently slower than predicted, the measures necessary to ensure recovery and to avoid applying a too rigorous monetary policy and too restrictive budget policy simultaneous would have to be taken

In this case, the built-in stabilizers would at all events have to be allowed free rein except in those countries where the expansion of the public debt has become particularly disquieting. In Germany and the United Kingdom, where achievements on the inflation front have been the most remarkable, the reduction in the public deficit should be adapted to economic conditions by reducing the tax burden, while maintaining the medium-term aim of a reduction in the share of public expenditure in national income.

The emphasis on the burden of the public debt

To determine the required extent of budgetary restriction in the countries most seriously affected by fiscal imbalances, the basic criterion should be the expansion of the public debt - particularly the external debt - and of its servicing cost.

The steady rise in the ratio of public debt to national income in many Community countries (Belgium, Denmark, France, Greece, Ireland and Italy) is likely to have an adverse effect on expectations, by pointing to heavier taxation in the future, or a prolonged increase in long-term interest rates.

The burden of debt-interest is now so great that its share in total expenditure is crowding out other items needed both for the development of productive activities in the public and private sectors and to safeguard reasonable levels of social welfare. Such crowding out is especially marked in Belgium, Denmark, Ireland and Italy.

These pressures become even more acute when deficits are partially financed by having recourse to external resources as is the case in Belgium, Denmark, Ireland and, to a lesser extent, France. The resultant servicing costs weigh heavily on the current balance of payments sometimes leading to serious imbalances; furthermore the burden of this debt is increased if exchange rates are adjusted.

The pröblem can be permanently solved only by a substantial reduction in the deficit, but since a high interest burden on the accummulated debt is unavoidable initially, other items of expenditure must be temporarily sacrificed, and in some cases an increase in taxation is inevitable.

Priority must go to measures affecting public expenditure

As was the case last year, the Commission feels that a stable tax burden has an important role to play in economic recovery and therefore prefers solutions which minimise increases in taxation.

From the same point of view, it is important that the structure of public expenditure be changed so as to give priority to expenditure which contributes to developing production potential and improving productivity. The experience of recent years has shown that the relative share of productive expenditure has in fact actually declined in most Community countries. Successful restructuring depends not only on the provisions made for productive purposes when the budget is drafted, but also on closer and more effective control of other expenditure, particularly those items which are virtually automatic; too often, in order to accommodate overruns on these latter items, appropriations for the most productive projects are treated as optional and are sacrificed.

(1) See the report on budget discipline and economic convergence and on restructuring public expenditure in favour of productive expenditure (doc.II/198/83 - Rev. 1).

III. Conclusions

In the light of the points made above, the Commission concludes :

(i) that the forecasts now available point to a recovery of economic activity in the Community; however, in most of the Member States, the rate of expansion will be low or moderate, and continued recovery at a satisfactory rate in 1984 is not guaranteed, both because of the uncertain international climate and because of languishing domestic demand, especially business investment;

(ii) In those countries where the results of policies pursued show sufficient progress towards overall economic balance, some room for manoeuvre exists to assist the recovery. To ensure that such an approach is credible, it should fit in with the medium-term prospects for controlling the public sector deficit and restructuring public finances in favour of productive activities. On the other hand, in most member countries the situation with regard to public finances still requires that priority should be given to a reduction of the budget deficit and of the ratio of public expenditure to national income.

The Commission would ask the Council to agree :

(i) that if economic expansion were to be lower than forecast, the built-in stabilizers should be given a free rein except in the countries where the public debt is especially disquieting; the countries where the budget deficit has been brought back within acceptable limits could consider some reduction in taxation in order to prevent the development of further recessionary pressures.

(ii) that budgetary policies should continue to concentrate on medium-term improvement, but be applied with sufficient flexibility to deal with unpredictable cyclical hazards, thus contributing to the convergence of economic trends in the Community;

(iii) that in each Member State and at Community level, monetary policy and budgetary policy should be closely coordinated so that they do not combine to slow down growth - which is still very modest - and aggravate unemployment in the event of a deterioration in the international monetary situation.