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MEMBER STATES' BUDGETARY POLICIES IN 1985

Communication from the Commission to the Council

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Foreword

This communication relates to the examination of the economic situation in the Commmunity which the Council is to undertake in accordance with Article 3 of the 'convergence' decision 1). At this time, on the basis of a proposal from the Commission, the Council sets quantitative guidelines for the public budgets for next year.

It begins by describing the main features of the economic outlook for the second half of 1984 and for 1985 and the economic problems which it raises. The second part proposes common budgetary policy guidelines for the Member States.

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(1) Council Decision (74/120/EEC) on the attainment of a high degree of convergence of the economic policies of the Member States.

I. Economic situation in the Community and outlook for 1985

1. Improved situation in 1984

According to the Commission's most recent estimates (see attached tables), the economic situation in the Community presents a more favourable picture on the whole than in 1983. The growth of GDP is expected to be between 2 % and 2.5 % in real terms, compared with less than 1 % last year. Furthermore, no member country should see a weakening of activity in 1984; in three member countries, growth is expected to amount to nearly 3%and the spread between growth rates should narrow.

Inflation has eased further; it is slowing down markedly in the member countries in which it has been highest and is tending to stabilise at low levels, or to fall, in the others.

At the same time, external constraints, which were still severe in some countries in 1983, are continuing to ease.

However, unemployment remains a very worrying problem. The rise in unemployment did slow down in 1983 in the Community as a whole and there was even a drop in the numbers out of work in the second half of the year in Germany and the United Kingdom. But more recent trends show the figures edging up again in these two countries and rising rapidly in France and Italy; thus in the six months to May 1984, the seasonally-adjusted number of unemployed increased by 0.4 % in Germany, by 3.1 % in the United Kingdom, by 6.3 % in Italy and by 8.5 % in France.

The acceleration of growth in the Community is partly due to the recovery in world trade (forecast to increase by nearly 7%in volume terms in 1984 as against only 2 % in 1983), which in turn is attributable to the strength of activity in North America and the stabilizing of the developing countries' imports, which had fallen particularly sharply in 1982 and the first half of 1983. Although private consumption has only been growing slowly, there has been a sharp recovery in business investment due to the revival in sales prospects, the improvement in profit margins and the moderate trend of unit wage costs, while the higher level of financing costs has exerted only a limited damping effect.

2. Prospect of a probable continuation of growth in 1985

If economic developments in the Community are not affected by any serious disturbances caused by external factors, the spontaneous development of the present cycle should allow growth to continue, in real terms, at a rate close to that reached in 1984 (2 % to 2.5 %). At the same time, Member States' growth rates are expected to come further into line with one another.

Subject to the uncertainties which will be discussed below, world trade is likely to grow at a still appreciable rate (4 % in volume terms in 1985), with Community exports remaining on a favourable trend, though a little less buoyant than in 1984.

Conditions seem right for 1985 to be a year of recovery for business investment. By contrast, given the decline in the saving ratio in recent years and the employment situation, private consumption is unlikely to provide any stronger stimulus to the economy than in 1984.

The outlook on prices and balances of payments remains good. Because of the moderation in unit costs, the rate of increase in consumer prices is expected to fall further in almost all the member countries, and, helped by better terms of trade, external balances should gradually show an improvement.

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The outlook for employment remains very unsatisfactory. Though the level of employment is expected to stop falling, unemployment will continue to rise because of the natural growth of the labour force and a greater propensity to enter the labour market, encouraged by the improvement in the economic situation.

3. The risks surrounding the economic outlook for 1985 1)

The outlook described above implicitly assumes that there will be a slowdown in the rate of economic activity in the United States during 1985, but that the slowdown will not develop into a recession. This assumption excludes the possibility that the combination of a large public deficit (in the American context) and a tightening of monetary policy might bring about a rise in interest rates that could choke off the strength in investment and in economic activity as a whole.

The sharp rise in interest rates so far in 1984 is worrying in this respect. Even if the effects are tempered in the United States, because of tax arrangements and in a context favourable to increased profits, the rise is placing a considerably heavier interest burden on the developing countries, most of whose liabilities are contracted in dollars at variable interest rates. The rescheduling of debts in 1982 did prevent any defaults on payments but it did not solve the problem of the continuing burden of repayments due during the years ahead.

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1) These risks are described in greater detail in the Commission's communication to the European Council of 25 and 26 June 1984.

The economic forecasts have been drawn up on the assumption that oil prices in dollars will remain fairly stable until 1985. Because of the gradual reduction achieved in the consumption of pretroleum products and the measures taken by various producer countries regarding stocks and transport, the crude oil market will probably escape major disturbances, but the market situation will have to be followed carefully.

Lastly, within the Community itself, there are a number of risks of a deterioration in the situation. The industrial disputes taking place in Germany and the United Kingdom have not so far seriously affected growth, but were they to continue for a long time or raise production costs, they would, in due course, have an impact on the Community's economic situation. The return to a higher level of activity and to better internal and external equilibrium will also depend in several member countries (Belgium, France, Italy and Ireland) on the successful implementation of the stabilization policies being pursued and on consensus between the two sides of industry.

4. Main economic policy problems 1)

Given this outlook, unemployment is undoubtedly the most worrying problem, and reducing it must be the priority objective.

Policies will have to be pursued which, without creating any new inflationary pressures or external disequilibria, will make it possible to raise the growth rate of the economy and increase the employment content of each additional percentage point of growth.

The Commission considers that these objectives could be achieved, by the combined means of :

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1) See also the Commission's communication to the European Council of 25 and 26 June.

- greater labour market flexibility;

- growth of wage costs less rapid than that of productivity;

- a policy aimed at an accelerated expansion of capacity-increasing investment giving the greatest possible employment creation.

In addition, the Community should take precautions against the effects of possible external shocks. One of the obvious means of doing so is to make further progress, notably in those countries where adjustment has been somewhat slower, so that the convergence in economic performances achieved in 1983 and 1984 can continue in 1985.

II. The general guidelines for budgetary policy

Given these problems, the general strategy of Member States' budgetary policies must meet three essential requirements :

- it must provide for a sufficient degree of flexibility to meet any external shocks;

- it must improve convergence within the Community, notably through continued efforts to redress the budgetary situation in a number of countries;

- it must help to achieve a solution to the problem of employment.

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1. <u>The policies pursued in 1983 and 1984</u>

In July of last year it was recommended in particular that budgetary policies should continue to aim for a sounder situation in the medium term, but with the action of the built-in stabilizers not being impeded should economic activity slacken, except in those countries where the expansion of the public debt had become particularly disquieting (1).

Attention was drawn, in particular, to the constraints imposed in a number of member countries, given the need to redress the situation overall, by the growth of public debt interest charges. Tighter control of expenditure was also emphasized, as the favoured means of bringing budgets back into balance.

For 1984, the most recent estimates show :

- a fall in general government net borrowing requirement as a percentage of GDP, except in France where it remains stable and in Italy where it is increasing;

- a marked fall in public expenditure expressed as a percentage of GDP in half of the Member States (Denmark, Germany, Luxembourg, the Netherlands and the United Kingdom), while this ratio is stabilizing in most of the others;

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(1) Cf. Communication from the Commission to the Council of 1 July 1983, relating to Member States' budgetary policy in 1984 (Com (83) 423).

- a continuing deceleration in the growth of tax revenue (including contributions), despite the introduction of new revenue-boosting measures and despite the stability of the GDP nominal growth rate; the relatively weak trend of indirect tax revenue seems to be of predominant importance in this respect;

- the absence of significant progress on the path of restructuring public expenditure in favour of more productive spending.

It appears that, with respect to the budgetary aggregates, the guidelines adopted by the Council last year were generally followed : the developments outlined do, however, still leave the public finances of certain Member States in a precarious position.

2. <u>The general guidelines for budgetary policy in 1985</u>

In 1985 it is still essential to bring down progressively the public deficit as a proportion of gross domestic product in Belgium, Denmark, Greece, Italy and Ireland. The deficit in those countries now stands at a level which, in the longer run, will not permit a steady fall in the inflation rate and a lasting equilibrium on current account. In most of these countries, the liquidity created to finance the budgetary deficit represents an excessive counterpart to monetary growth, which clearly impedes the efforts to moderate inflation.

Except in Greece, where the level of public debt is still relatively low, there is a risk that the budgetary deficits and the excessive volume of interest payments will end in a vicious circle, pushing the public debt to higher levels which could become unsustainable, if continuous firm measures are not taken to reduce the annual increases to the debt outstanding.

Development of public debt of general government

as a % of GDP

	B	DK	D	GR(1)	F	IRL(1)	I	L	NL	UK(2)
1975	59.8	11.9	25.0	22.4	26.8	73.5	66.0	15.4	41.4	71.8
1980	76.2	33.5	31.6	27.7	24.4	89.0	66.9	11.1	46.0	58.2
1983	105.7	75.6	39.9	42.4	32.2	109.3	84.6	18.1	63.3	48.6
1984 fore-cast	112.2	80.2	39.5	44.9	36.9	114.6	89.9	17.2	68.8	48.2

(1) Central government only

(2) 31 March following

Source : European Economy, March 1984, no. 19 and estimates of Commission staff.

In France, approximate stability of net borrowing of general government would be in line with the authorities' objective of restoring equilibrium in the current balance of payments and reducing inflation to about 5 %.

In Germany and the United Kingdom, it does seem likely that in 1985 the budgetary deficits will reach levels which could be considered normal for the expected economic situation. In the Netherlands, the authorities should remain vigilant and continue their efforts to trim the structural deficit.

3. Budgetary flexibility

The policy of prudent management should, however, neither prevent the coming into play of the automatic stabilizers, to the extent that some of the dangers which have been mentioned do materialise, nor rule out the application of measures designed to ensure better economic growth, for example through a simultaneous reduction in expenditure and taxation which would leave the budget balance unchanged.

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Should the economic climate deteriorate appreciably in 1985, it would even be appropriate to envisage that such measures should be programmed or put into effect earlier so as to give maximum support to economic activity at the right time. The conduct to be adopted in such a situation in countries where public deficits still remain high would depend especially on progress made in the fight against inflation, controlling costs and redressing the external imbalances, and on the working of the automatic stabilisers. In any case, budgetary strategies should in such a situation be closely concerted at Community level.

4. Medium-term budgetary policies, their coordination and economic restructuring

An appropriate flexibility in the budgetary aggregates must be matched by the authority having sufficiently firm outlines of medium-term strategies for the public finances.

Such strategies are obviously most useful in countries where the public deficit still represents a handicap to reducing major imbalances. The working out of medium-term financial strategies in all member countries, linked especially with the conduct of monetary policy, could considerably help the coordination of monetary policies and contribute to a better convergence of Member States' economic performance.

The maintenance of economic growth, which has revived in 1984, and particularly the rise in medium-term growth rates, in conditions of stability, require that budgetary policy plays a role quite different from that which was often designated in the past, where its primary function appeared to be the regulation of demand.

The increased flexibility of economic structures, necessary to a large degree for the improvement of growth and employment prospects, requires in certain cases less intervention by the public authorities, both in respect of regulations and of financial aspects. A reduction in the share of public expenditure allowing an easing of taxes and other

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contributions would stimulate private investment and overall demand to a greater extent than a direct stimulus from public spending.

In addition, a gradual transformation of the composition of public expenditure and receipts would also help towards stronger growth.

Such transformations should promote productive public expenditure directly and indirectly, improve the quality of private investment and, as a counterpart, limit spending which has an excessive momentum and which crowds out the most productive expenditure. In this context, the increase in public debt interest charges, even though it is slowing in 1984 and 1985, still poses an acute problem. A better structure could also be achieved by reviewing certain operating aids to public and private enterprises, particularly in traditional sectors, and by controlling certain social transfer payments (health expenditure).

The achievement of growth bringing about greater employment creation would be helped by an easing of taxes and other contributions which weigh heavily on wage costs, while respecting overall budgetary constraints. It would also be appropriate to neutralise budgetary incentives which, in certain cases, tend to excessively encourage business investment in highly capital-intensive production.

Conclusions

1. In many respects (growth, inflation, external equilibrium) the Community's economic situation seems to be distinctly better than in 1983 and the current economic forecasts suggest that the improvement will be maintained in 1985. However, the recent trend in unemployment, and prospects in this respect over the next eighteen months, remain very worrying.

2. The cyclical upturn has, however, hardly been reflected in budget positions. It is true that budget deficits have contracted in relative terms as a proportion of GDP, but tax revenue is taking time to accelerate and the growth of expenditure has been contained only at the cost of sometimes stringent measures. The public debt interest charges and expenditure on transfer payments to households have still been rising markedly.

3. The general line of budgetary policy guidelines for 1984 remains valid : reduction of public deficits as a proportion of GDP, subject to appropriate flexibility in response to the economic trend ; control of expenditure; and continuation of efforts to change the structure of public spending in favour of the most productive expenditure. In addition, a fiscal policy to stimulate employment-creating investment and to ease wage costs as much as possible is an essential element in achieving more sustained growth and an increase in employment.

4. Budget management should be particularly strict in those countries where the public debt is expanding rapidly and where less progress has been made towards internal and external equilibrium than in the rest of the Community. The countries which have advanced farthest in restoring healthier budget positions would be best able to alter the structure of their revenue and expenditure so as to raise the growth of productive potential and to allow demand expansion needed to raise the degree of capacity utilisation.

5. A medium-term financial programme extended to all Member States is essential for economic policy coordination and to define the choices of short-term budgetary policy : it would provide a suitable framework for concerted action in case of threat to the economic growth in the Community.

MAIN ECONOMIC INDICATORS FOR THE EUROPEAN COMMUNITY, UNITED STATES AND JAPAN (1)

TABLE 1 : GROSS DOMESTIC PRODUCT (PERCENT. CHANGE AT CONSTANT PRICES ON PRECEDING YEAR, EC, USA, JAPAN, 1971-1985)

	1971 - 1980	1980	1981	1982	1983	1984	1985
B	3.2	3.2	-1.1	1.1	.0	1.3	.8
DK	2.3	-.4	-.7	3.6	2.5	2.7	3.0
D	2.8	2.0	.0	-1.0	.9	3.0	2.5
GR	4.7	1.6	-.4	.0	.2	1.7	1.6
F	3.6	1.1	.3	1.6	.8	1.1	1.4
IRL	4.1	3.7	1.6	1.2	.5	2.4	2.5
I	3.1	3.9	.1	-.3	-1.3	2.4	2.9
L	3.1	1.7	-1.8	-1.1	-1.4	.3	1.6
NL	3.4	.9	-.8	-1.6	.8	2.1	1.7
UK	1.9	-2.6	-1.3	2.3	3.5	2.7	2.1
EC	2.9	1.1	-.3	.5	1.0	2.2	2.1
USA	2.9	-.2	3.0	-2.4	3.3	5.9	2.6
JAP	4.8	4.9	4.0	3.2	2.9	4.7	3.6

TABLE 2 : DEFLATOR OF PRIVATE CONSUMPTION (PERCENT. CHANGE ON PRECEDING YEAR, EC, USA, JAPAN, 1971-1985)

	1971 - 1980	1980	1981	1982	1983	1984	1985
B	7.1	7.0	8.7	7.5	7.7	6.5	5.0
DK	10.2	9.8	11.7	10.3	6.7	5.3	3.8
D	5.2	5.4	5.7	5.1	3.0	2.9	2.4
GR	13.4	22.1	22.3	21.1	19.1	19.0	18.0
F	9.4	13.1	12.7	11.1	9.3	7.5	5.7
IRL	13.9	18.6	20.1	17.1	10.5	9.0	6.5
I	14.6	20.3	19.2	16.7	14.9	11.3	8.7
L	6.7	7.7	7.7	10.0	8.4	7.7	6.0
NL	7.7	6.7	6.2	5.5	2.5	3.0	2.0
UK	13.3	16.8	11.1	8.3	5.4	5.2	5.6
EC	9.7	11.1	10.1	8.8	6.3	5.1	4.5
USA	6.9	10.3	8.9	5.8	3.9	5.1	5.5
JAP	8.6	6.8	4.8	2.4	1.4	1.4	1.7

TABLE 3 : NUMBER OF UNEMPLOYED AS PERCENTAGE OF THE CIVILIAN LABOUR FORCE (EC, USA, JAPAN, 1971-1985)

	1971 - 1980	1980	1981	1982	1983	1984	1985
B	5.7	9.1	11.2	13.1	13.4	13.7	14.0
DK	3.6	6.7	8.9	9.5	10.5	10.3	10.0
D	2.6	3.3	4.7	6.8	8.4	8.4	8.3
GR	-	-	-	1.5	7.8	8.5	9.2
F	3.6	6.4	7.8	8.8	9.1	10.3	11.0
IRL	7.2	8.3	10.2	12.4	14.2	16.2	17.4
I	5.9	8.0	8.8	10.5	9.7	10.6	11.2
L	.3	.7	1.0	1.3	1.6	1.9	2.1
NL	3.3	6.2	8.8	11.7	15.4	16.5	17.2
UK	4.1	6.3	9.3	10.7	11.7	11.6	11.6
EC	4.0	6.1	7.8	9.5	10.5	11.1	11.4
USA	6.2	5.8	7.6	9.7	9.7	7.5	6.9
JAP	1.8	2.1	2.2	2.4	2.7	2.6	2.6

TABLE 4 : BALANCE ON CURRENT ACCOUNT (PER CENT OF GDP, EC, USA, JAPAN, 1971-1985)

	1971 - 1980	1980	1981	1982	1983	1984	1985
B	.0	-4.5	-4.3	-3.6	-1.6	-.6	.7
DK	-3.0	-3.7	-3.1	-4.1	-2.1	-2.2	-1.7
D	.7	-1.8	-1.0	.6	.7	1.2	1.9
GR	-2.8	.3	.3	-3.7	-4.3	-4.7	-5.3
F	-.4	-1.4	-1.4	-3.0	-1.6	-1.0	-.8
IRL	-4.9	-10.0	-13.1	-8.3	-2.3	-.9	.1
I	-.3	-2.4	-2.3	-1.6	.1	.2	.1
L	22.5	22.6	28.2	40.2	39.0	37.7	35.8
NL	1.1	-1.5	2.2	2.8	2.7	3.5	4.8
UK	-.8	1.8	2.5	2.0	.7	.7	.5
EC	-.2	-1.3	-.6	-.5	.0	.4	.7
USA	.1	.2	.1	-.3	-1.2	-2.5	-2.8
JAP	.7	-1.1	.5	.7	2.0	2.6	2.6

TABLE 5 : GENERAL GOVERNMENT LENDING OR BORROWING (-) AS PERCENTAGE OF GDP (EC, 1971-1985)

	1971 - 1980	1980	1981	1982	1983	1984	1985
B	-4.9	-9.9	-12.6	-11.6	-11.7	-11.1	-
DK	-1.0	-3.3	-7.1	-9.3	-8.0	-6.5	-
D	-1.7	-3.1	-3.9	-3.4	-2.7	-1.6	-
GR	-4.6	-5.4	-10.6	-10.0	-9.7	-9.4	-
F	-.5	.3	-1.8	-2.6	-3.3	-3.3	-
IRL	-9.1	-11.8	-15.8	-15.6	-12.6	-11.3	-
I	-8.7	-8.4	-11.7	-12.7	-11.8	-12.8	-
L	2.0	-.8	-2.3	-1.4	.1	.4	-
NL	-1.6	-4.0	-5.2	-7.0	-6.4	-5.8	-
UK	-3.3	-3.4	-2.7	-2.6	-3.1	-2.6	-
EC	-3.2	-3.5	-5.4	-5.6	-5.5	-5.2	-

TABLE 6 : MONEY SUPPLY M2/M3 (PERCENTAGE CHANGE AT END OF YEAR ON TWELVE MONTHS EARLIER, EC, USA, JAPAN, 1971-1985)

	1971 - 1980	1980	1981	1982	1983	1984	1985
B	10.3	2.7	6.6	5.9	7.1	7.6	-
DK	11.7	10.9	9.6	11.7	24.2	10.0	-
D	10.0	6.2	5.0	7.1	5.3	5.2	-
GR	23.8	24.7	34.3	29.0	20.2	21.9	-
F	14.8	9.7	11.4	10.8	10.9	7.0	-
IRL	18.4	16.9	17.4	12.9	5.6	12.0	-
I	19.5	12.0	16.0	17.2	14.6	12.9	-
L	-	-	-	-	-	-	-
NL	10.8	3.6	5.2	7.6	10.7	9.0	-
UK	14.5	18.6	14.6	9.2	10.2	8.9	-
EC	13.8	10.5	10.8	10.8	10.2	8.5	-
USA	9.5	9.0	10.0	9.2	-	-	-
JAP	16.9	7.2	8.7	7.0	-	-	-

F,NL,USA: M2; D, GR, IRL: M3; B, DK: M2H; UK: STERLING M3 (FISCAL YEAR); I: M2 (71-79), M3 (80-85); JAP: M2 AND CD.

(1) This document does not take account of revisions to the Irish National Accounts published subsequent to the completion of the tables.