

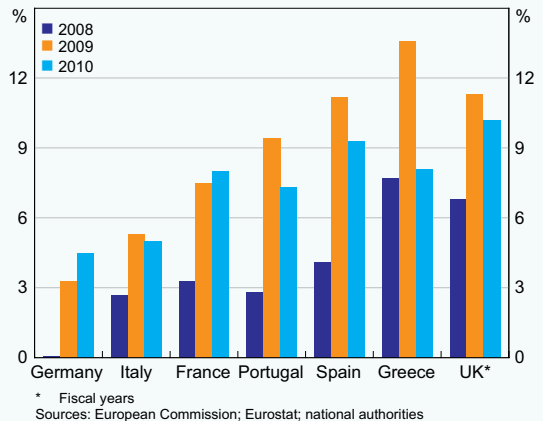
## Box A

# Public Finances in Europe

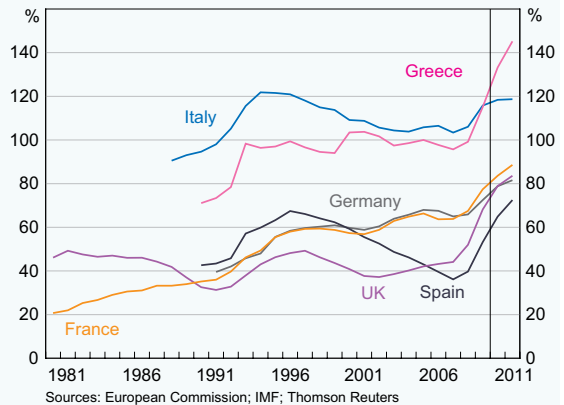
The global economic downturn triggered a sharp deterioration in public finances across Europe. Budget deficits widened significantly, reflecting a combination of falling tax receipts, discretionary stimulus measures aimed at reducing the severity of the downturn, and the costs of providing support to the banking sector (Graph A1). For the euro area as a whole, the aggregate budget deficit exceeded 6 per cent of GDP in 2009 – with a number of countries recording double-digit outcomes – and is projected to be of a similar magnitude in 2010. As a result of these deficits, and of the falls in output that have occurred, general government gross debt as a share of GDP is forecast by the European Commission to exceed 80 per cent in a large number of euro area countries (and in the United Kingdom) by 2011 – an increase of 30 percentage points or more in many cases since the onset of the financial crisis (Graph A2).<sup>1</sup>

These sharp increases in public debt have come on top of already-high debt levels in many European countries prior to the global recession. From the mid 1990s, gross public debt regularly exceeded 60 per cent of GDP in a number of major euro area economies, and in Italy, Greece and Belgium stood persistently at around 100 per cent of GDP. There was also a tendency, even in countries with generally lower public debt levels such as France and Germany, for debt to gradually trend upwards as a share of GDP over the preceding few decades. Under the Stability and Growth Pact, euro area countries were meant to keep their budget deficits below 3 per cent of GDP except in ‘exceptional circumstances’. However, this limit was regularly

**Graph A1**  
**Europe – General Government Budget Deficits**  
 Per cent of GDP



**Graph A2**  
**Europe – Gross Public Debt**  
 Per cent of GDP



<sup>1</sup> For most European countries, the difference between gross and net debt is relatively small.

exceeded even during the previous cyclical upswing, and the penalties for breaches agreed as part of the Pact were never imposed (Graph A3).

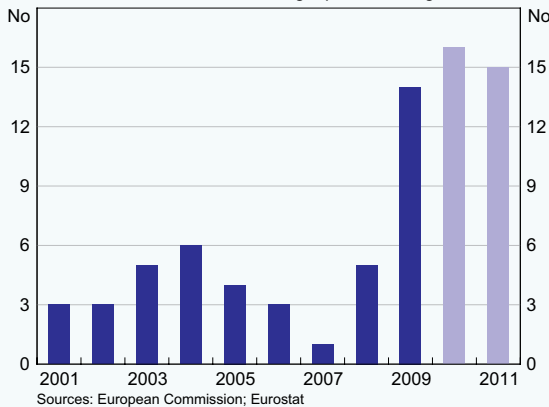
The recent deterioration in the fiscal positions of European governments has seen investors become concerned about the state of public finances in the region. In response, the European Union and member governments have taken action along two lines. First, in May the Council of the European Union, in conjunction with the IMF, announced the

creation of the European Financial Stability Facility (EFSF). The EFSF is a lending facility with funding of up to €440 billion from European governments, together with provision for a substantial additional contribution from the IMF, intended to provide support to euro area countries facing financing difficulties. Access to the EFSF is to be under similar conditions to the separate three-year €110 billion emergency support package for Greece established earlier in May, which required Greece to implement a stringent and closely monitored fiscal consolidation program designed to reduce its budget deficit to below 3 per cent of GDP by 2014.

Second, numerous European governments have announced new or supplementary fiscal consolidation packages, intended to reassure financial markets that their public finances will be restored to a sustainable footing over the medium term (Table A1). In some countries – most notably Greece, Ireland, Portugal and Spain – substantial front-loaded cut-backs are in train, reflecting the more limited fiscal room for manoeuvre in these economies and consequent need to take earlier action to establish credibility with investors. In other

**Graph A3**

**Euro Area – Stability and Growth Pact**  
Number of countries exceeding 3 per cent budget deficit



**Table A1: Discretionary Fiscal Tightening in Europe**

	Share of EU GDP <sup>(a)</sup> Per cent	Tightening announced since late 2009 <sup>(b)</sup> Per cent of GDP	
		For 2010	For 2011
Germany	19	0	½
France	14¼	0	½
Italy	11¾	½	1
Spain	9¼	2½	2½
Greece	2¼	8	4
Ireland	1¼	2½	2
Portugal	1½	2	2½
United Kingdom	14½	½	1½

(a) Shares in 2009 at purchasing power parity exchange rates

(b) RBA estimates, to nearest ½ per cent of GDP

Sources: European Commission; Eurostat; IMF; RBA; national authorities

countries, including the four largest economies (France, Germany, Italy and the United Kingdom), the announced tightenings are smaller in scale or build more gradually over 2011 and subsequent years. In Germany, the impact of recently announced cut-backs also needs to be set against previously enacted stimulus measures still coming into effect in 2010, which provide an expansionary offset. Overall, the aggregate fiscal consolidation in 2010 for both the euro area and the United Kingdom is modest, at around ½ per cent of GDP, before becoming more substantial in 2011 and 2012. While this is expected to have some dampening effect on demand and growth across Europe over the next few years, failure to begin reducing deficits risked a noticeable decline in confidence among market participants, with flow-on effects for banks and the supply of credit.

The announced fiscal consolidation programs entail a combination of expenditure and revenue measures. On the outlays side, Greece, Ireland, Portugal and Spain have all flagged or enacted significant cuts in public-sector wages, especially for those on higher salaries, where the reductions typically range from 5 to 15 per cent. These countries have also instituted hiring freezes or labour shedding rules for the public sector, as well as cuts or freezes in pensions and in public investment. Revenue measures include value-added tax rate increases of between 1 and 4 percentage points in a number of countries, as well as increases in corporate and personal income tax rates and in excise duties on fuel, cigarettes, alcohol and luxury items. Overall, the announced discretionary tightening is heavily weighted towards expenditure reductions in Spain, and spending cuts also make up the bulk of the planned consolidation in the United Kingdom. In Greece, the mix between spending and revenue measures is approximately equal, and the fiscal tightening is complemented by an extensive

privatisation program involving outright sales and the introduction of strategic private-sector partnerships, intended to improve efficiency in the affected sectors.

In the majority of countries implementing fiscal consolidation packages, discretionary cuts are also complemented by other economic and financial reforms aimed at bolstering the long-term sustainability of public finances. In particular, increases in the eligible pension age for both men and women are planned or have been enacted in various euro area countries, including France, Germany, Greece, Italy and Spain, while various countries are also limiting early retirement options for public-sector workers. More broadly, the substantial projected increases in aged dependency ratios across Europe – the ratio of people aged 65 years and over to those aged 15 to 64 years – suggest that pension and healthcare reforms will be important for restraining the long-run growth of public expenditure in many European countries (Graph A4). ✎

**Graph A4**  
**Europe – Aged Dependency Ratio\***

