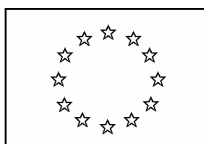


**SESSION 2: PUBLIC FINANCE STRATEGIES FOR GROWTH AND JOBS**

**Euro-Mediterranean network of public finance experts**

**ISSUES AND OPTIONS**

EUROPEAN COMMISSION  
DIRECTORATE GENERAL  
ECONOMIC AND FINANCIAL AFFAIRS



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## **Issues for discussion**

I. Do participants agree with the proposal to create a network of experts in public finances and the coverage put forward, which would be endorsed by the Euro-Med ECOFIN Ministers in Oporto, in September?

II. The aim of the network is to stimulate meaningful and thorough discussions, and to allow for free exchanges of views. Do participants adhere to the idea that the network should be as much technical and informal as possible? The format could also change over time – from a more informal network towards a more institutionalised/formalised forum, depending on the demand.

III. In order to attract the relevant experts and to create economies of scale in the exchange of knowledge, the Euro-Med network could be attached to some existing EU or Euro-Med fora. Do participants have concrete suggestions in this regard?

## 1. Background

Public expenditures represent about half of the economy in the EU Member States and up to 40% in the Mediterranean countries<sup>1</sup>. Therefore, healthy public finances are the bedrock of a strong economy and contribute to low and stable inflationary expectations and lower interest rates. The way they are managed has significant implications for growth, job creation and the reduction of unemployment.

Public finance reform features high in most Action Plans agreed under the European Neighbourhood Policy and has been a prominent topic on the agenda of the two Euro-Med ECOFIN ministerial meetings held so far.

In Rabat-Skhirat (2005), ministers agreed that fiscal consolidation and improving budgetary institutions and systems are among the four priority areas for reform<sup>2</sup> in the Mediterranean countries. Further progress in fiscal consolidation is considered important with a view to improving fiscal sustainability and increasing resilience to external shocks, particularly in those countries facing a combination of a high budget deficit and a high debt-to-GDP ratio.

Last year in Tunis, ministers of finance and economy focused on budget systems and institutions. They reviewed experiences across the region in the field of public finance management and recognized "*comprehensive initiatives undertaken by many countries to achieve tangible progress in developing efficient, transparent and accountable budget management systems and institutions*".<sup>3</sup> They acknowledged that budgetary institutions and systems stand at the crossroads of three important objectives: (i) achieving aggregate fiscal discipline, medium-term sustainability and greater resilience to shocks, (ii) enhancing the efficient use of public funds and their allocation in accordance with strategic priorities and (iii) ensuring transparency and accountability in the use of public funds. Ministers agreed that reforms should focus on the following inter-related areas: (i) increasing budget coverage and transparency, (ii) developing medium-term budget formulation and planning, (iii) improving treasury management and budget execution, (iv) ensuring high quality reporting and public accounting and (v) strengthening accountability through internal control and external audit and oversight. Last but not least, ministers agreed to "*work towards finding best channels to disseminate good practices from both sides of the Mediterranean*".<sup>4</sup>

To some extent, the challenges faced by MED countries are not unlike those in the EU and the issues raised at the two Euro-Med ECOFIN ministerials in Rabat and in Tunis echo the policy debate on public finance reform that is currently ongoing in the EU. In a nutshell, this debate has led to two main conclusions: first, fiscal consolidation should be part of a broader process of structural and institutional change aimed at lifting the obstacles to growth and employment, encompassing the public sector and the product, labour and capital markets; second, fiscal consolidation should go hand in hand with strengthened budget management systems and institutions. As a result, the EU ECOFIN Council invited the Commission in January 2006 to continue working on: (i) the role played by national fiscal rules and institutions in promoting

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<sup>1</sup> In this paper, references to MED countries or region, refer to the South Mediterranean countries part of the Euro-Mediterranean Partnership: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia and the Occupied Palestinian Territory. Libya is an observer.

<sup>2</sup> The four priorities are: (i) improving the business climate; (ii) further liberalizing trade and opening the economy while protecting the most vulnerable groups of the population; (iii) upgrading public institutions and governance systems; and (iv) consolidating macroeconomic stability and public finance management.

<sup>3</sup> Chairs' Conclusions from the 2<sup>nd</sup> Euro-Med ECOFIN Ministerial Meeting in Tunis, June 2006.

<sup>4</sup> Idem.

fiscal discipline and budgetary quality; (ii) monitoring the composition of public expenditure; and (iii) measuring the efficiency of public spending.

As a follow up to the above, this Issues Paper offers, first, a brief overview of the main challenges in fiscal policy facing the Mediterranean countries and, second, puts forward concrete options for the establishment of a Euro-Med network of experts in public finance.

## **2. Main challenges in fiscal policy in the MED region<sup>5</sup>**

Further fiscal consolidation, improving the structure of spending and strengthening budget systems and institutions are the three main challenges in fiscal policy reform in the Mediterranean region.

**2.1 Notable progress has taken place in fiscal consolidation across the MED region. However, in several countries, high levels of deficits and public debt, and large quasi-fiscal deficits and significant contingent liabilities are a threat to macroeconomic stability, put pressure on monetary policy and increase vulnerability to exogenous shocks.**

Over the last few years, most countries in the Mediterranean region have made an important overall progress in consolidating the budget and reducing public debt. The average aggregate general government balance improved from around -4% of GDP in 2003 to -2.8% in 2006. Over the same period, the aggregate government gross debt declined from 88.5% of GDP to 81%<sup>6</sup>.

To some extent, this positive overall trend reflects the increase in oil prices and the significant budget surpluses recorded in Algeria. However, in a welcome development, several oil-importing countries have also been able to reduce deficits and public debt through fiscal consolidation. This is particularly the case of Egypt, Israel, Morocco and Tunisia.

Despite this overall progress, several countries continue to face a combination of a high fiscal deficit and a high debt-to-GDP ratio, which points to the need for further fiscal consolidation and higher economic growth. Reducing public debt to more sustainable levels remains a key medium-term challenge, particularly for Lebanon, Jordan, Egypt and Israel. When combined with a current account deficit, a high share of foreign-denominated debt, an open capital account and an exchange rate peg, the high budget deficit and public debt ratio are a major source of potential macroeconomic instability in case of an exogenous shock (e.g. in Lebanon and Jordan).

Large quasi-fiscal deficits and significant contingent liabilities in some MED countries also increase vulnerability to exogenous shocks. Unreported quasi-fiscal operations of public enterprises and banks in the Mediterranean countries are often associated with indirect subsidies, notably on the sale of energy products, or direct credit by state banks to loss-making state-owned companies. Contingent liabilities, taking the form of various implicit and explicit state guarantees and insurance schemes linked to the activities of the financial sector,

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<sup>5</sup> Some of these issues were discussed in: *Fiscal Performance, Quality of Public Finances and Budget Management in Mediterranean Countries. Issues Paper for Discussion for the 2006 Euro-Med ECOFIN Ministerial Meeting (Tunis)*; European Commission (2006).

<sup>6</sup> Both the budget deficit and the debt figures exclude the Occupied Palestinian Territory.

local authorities and the social security system, increase fiscal risks. A number of them is still not analysed, explicitly recognized nor reported. These include the debts of extraordinary budget funds, social security, non-guaranteed debt of state-owned enterprises and local authorities and the guarantees by the special treasury accounts. In most countries, the budget does not include an estimation of their value and potential cost. Very often, the power of line ministries and the Ministry of Finance to control the emergence of risks and contingent liabilities are minimal. A high share of non-performing loans in the banking sector also increases the vulnerability of public finances (e.g. in Egypt, Algeria and Tunisia).

**2.2 The large share of non-discretionary expenditures in subsidies, interest and the wage bill reduce the scope for higher spending in areas that support growth, employment and poverty reduction. Combined with deficiencies on the revenue side, it also reduces the effectiveness of automatic stabilisers in case of cyclical fluctuations.**

In general, Mediterranean countries devote a considerable share of spending to non-discretionary expenditures, particularly the wage bill, debt service and subsidies. Over the period 1995-2005, compensation of employees (mostly wages and salaries) accounted for 10.3% of GDP on average, the highest share compared to other country groups<sup>7</sup>. Jordan, Morocco and Tunisia are the countries with the largest wage bill. Some countries are launching reforms to reduce this share and increase fiscal space. Morocco, for example, has launched a fundamental restructuring of the public administration, including a voluntary retirement programme, which is expected to lead to a significant reduction of the wage bill.

As a direct result of the overall high debt-to-GDP ratio, the burden of interest expenditures represented 5.8% of GDP on average during the period 1995-2005, more than three times the amount paid by the Eastern-ENP and Russia group over the same period (1.8% of GDP). Unsurprisingly, Lebanon stands out with the highest debt service expenditures as a result of its large public debt.

The budgetary cost of food and oil subsidies is high in most countries, representing 3% of GDP on average in the MED region over the period 1995-2005. The increase in oil prices since 2004 has obviously aggravated the problem. Israel, Jordan and Tunisia are the countries with the highest share of subsidies. In addition to the considerable fiscal burden they imply, subsidies in most MED countries appear largely ill-targeted and have a regressive effect. Also, oil subsidies lead to energy inefficiency and excessive consumption, thus contributing to environmental damage. To address these problems, Jordan and Egypt have started to cut oil subsidies as part of a broader process of fiscal consolidation, but this remains a sensitive political matter in most countries.

The large share of these non-discretionary expenditures reduces the flexibility to face new priority expenditures, particularly in health, education, infrastructure and social safety nets. It also hampers the ability to adjust fiscal policy in case of an exogenous shock that puts pressure on the balance of payments, such as a further increase in energy prices.

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<sup>7</sup> For comparison, compensation of employees represented on average over the same period, 2.7% of GDP in Eastern-ENP countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine) and Russia, 2.3% in Latin America and 4% in the EU-10 eastern member States (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

On the revenue side, a key feature appears to be the low weight of tax revenues, although a major difference exists between oil-producing (Algeria and Syria) and non-oil producing countries. Indeed, the latter record a higher tax-to-GDP ratio than the former due to the importance of oil-related revenue in the budget of oil-producers. For example, direct tax revenues account for only 7% of GDP in Morocco and Tunisia, for around or less than 5% in Egypt, Jordan, Lebanon and Syria, and for 2% in Algeria and Libya. This compares with 11-14% in euro area countries like Germany, France and Italy, and with around 8% in Turkey, which may be a more appropriate benchmark. While indirect taxes provide more revenue than direct taxes in most Mediterranean countries, with a share of around or below 10% of GDP, indirect tax revenues lag for example those of Turkey (around 15% of GDP)<sup>8</sup>. Raising sufficient tax revenue to cover essential public expenditures, while at the same time avoiding an increase in tax rates, remains therefore a challenge in most countries. The way forward rests on broadening the tax base by limiting or eliminating tax exemptions, which are widespread in the region.

The low share of tax revenues, particularly direct taxes, hampers the ability of automatic stabilisers in addressing cyclical fluctuations. The weak role of automatic stabilisers is a major weakness as it reduces the policy choice to mainly two options: (i) to resort to discretionary fiscal policies for stabilisation purposes, which poses severe problems of their own; or (ii) to assign a more active role to monetary policy, which is problematic inter alia as it may at times conflict with price stability as the prime objective of monetary policy, and is not even an option for those countries with a fixed exchange rate<sup>9</sup>.

### **2.3 Budget systems and institutions need to be upgraded in order to improve fiscal outcomes and to increase the effectiveness, transparency and accountability in public intervention.**

The vast majority of Mediterranean countries, albeit to different degrees, are taking steps to improve budget and fiscal management systems. Morocco, Jordan and Tunisia are leading the efforts in this area and have embarked on broad reforms, including the move toward the introduction of medium term expenditure frameworks and performance budgeting. Nevertheless, many countries still display major weaknesses in the degree of transparency and comprehensiveness of their budgets, in the rules and practices applied to budget planning, preparation and execution, as well as in the level of external accountability. Addressing these challenges through active public finance management reforms is crucial, both to maximize the effectiveness of public spending and to ensure better fiscal outcomes in terms of stability, sustainability and resilience to shocks.

As agreed by ministers of finance and economy at the Tunis Euro-Med ECOFIN ministerial meeting (2006), reforms should focus on the following areas: (i) increasing budget coverage and transparency, (ii) developing medium-term budget formulation and planning in relation with clear sector strategies, (iii) improving treasury management, (iv) ensuring high quality reporting and public accounting and (v) strengthening accountability through managerial responsibility, internal control and external audit and oversight.

The strengthening of budget systems and institutions, including the possible introduction of fiscal rules, should be part of a broader process of public sector reform. The ultimate

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<sup>8</sup> *Fiscal Policy in Mediterranean Countries' Macroeconomic Frameworks*; ECB (2007)

<sup>9</sup> *Idem*

objective should be twofold: to ensure the sustainability of fiscal consolidation efforts and to improve public service delivery.

### **3. Options for Euro-Med network of public finance experts**

#### *3.1. Rationale*

The idea of launching a network of experts in public finances builds on the discussions at the Euro-Med ECOFIN Ministerial meetings in Rabat-Skhirat (2005) and in Tunis (2006), during which "the EU Ministers reiterated their willingness to continue supporting Mediterranean partners' efforts to improve their public finances, notably through technical assistance and training projects with the EU public finance administrations, and putting at their disposal the tools of public finance management developed inside the EU".<sup>10</sup>

The idea is additionally supported by the fact that the challenges faced by Mediterranean countries are similar, to some extent, to those in the EU. Indeed, within the EU fiscal framework, ensuring budget discipline and fiscal sustainability are key priorities of economic policy. In support of these goals, the quality of public finances and of budgetary institutions are seen as instruments for ensuring the most effective and efficient use of resources with a view to raising the long-term growth potential of the economy and tackling the deficit bias at its roots.

Consequently, this initiative would aim at:

- bringing together the experience of national authorities in both EU and MED countries on topical issues related to public finance and budget management reforms; and
- creating a platform to exchange knowledge, experience and good practice in the field of public finances – steered by, or with the involvement of, the European Commission.

The creation of a network would allow the development of working contacts between experts in the same field also outside of the meetings. It could also be a useful opportunity to discuss practical issues relevant to the programming of the EC assistance (technical assistance, budget support, and twinning arrangements) in the field of public finance management. Ideas developed by the network could also feed discussions during the bilateral economic dialogues.

#### *3.2 Topical coverage*

The network would be a forum for sharing experience and information, exchange of knowledge and expertise, as well as comparing national strategies in relation to the on-going reforms of public finances in both the EU and the MED countries. The EU MS and the European Commission would share analyses developed on budgetary frameworks, policies and institutions.

Taking into account both the on-going debate within the EU on public finance reform and the main challenges facing the MED region described in section 2 above, the main focal areas for the network would be:

- (i) fiscal consolidation as part of a broader reform agenda for public sector reform, growth and employment;
- (ii) quality of public spending, particularly the efficiency of public expenditures; and

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<sup>10</sup> Chairs' Conclusions from the 2<sup>nd</sup> Euro-Med ECOFIN Ministerial Meeting in Tunis, June 2006.

(iii) budget management systems and institutions.  
Statistical matters could also be discussed.<sup>11</sup>

### 3.3 *Formality of the network*

If the aim of the network is to stimulate meaningful and thorough discussions, and to allow for free exchanges of views, where participants should not be constrained to present agreed official positions, the network should be as much technical and informal as possible. The format could also change over time – from a more informal network towards a more institutionalised/formalised forum, depending on the demand.

### 3.4 *Organisation*

In order to attract the relevant people, to create economies of scale in the exchange of knowledge, and to avoid putting an additional "travelling" burden onto the public administrations, the Euro-Med network could be attached to one of the existing EU or Euro-Med fora, such as:

- the "Network of Public Finance Economists in Public Administrations" (EU MS, informal)<sup>12</sup>;
- the EPC Working Group on the Quality of Public Finances (EU MS, formal)<sup>13</sup>.

### 3.5 *Content*

At each meeting, two or three topics would be discussed. Issues papers for discussion would be prepared in advance, allowing a more effective steering of the discussions. Participants would be invited to share and present their own work and/or home-country experiences.

The network would report to the Euro-Med Economy and Finance Senior Officials' Meeting and to the Euro-Med ECOFIN Ministerial when considered necessary.

### 3.6 *Frequency of events*

The network would start by holding annual meetings but creating a mailing list and/or a virtual restricted internet platform could also be envisaged.

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<sup>11</sup> Fiscal information for the Mediterranean countries is generally fragmented. Data sources used in this paper are multiple, including the Government Finance Statistics (GFS) and the International Financial Statistics (IFS) databases from the IMF, the Article IV consultations conducted by the IMF, and national sources. The cross-country and time comparability of the different data sets is complicated by presentation of data at different levels of aggregation, sudden changes in classification, interruptions in the time series, extra-budgetary accounts and, sometimes, missing information for specific budget items or recent years.

<sup>12</sup> This informal network was launched by DG ECFIN at the request of some MS in 2006 and met for the first time in December 2006. It gathers specialists, at various levels, from public administration working on a broad range of technical issues related to fiscal policy.

<sup>13</sup> The Economic Policy Committee established the Working Group on the Quality of Public Finances (WGQPF) to analyse the role of budgetary institutions in defining and implementing national policy priorities, to look at trends in the composition of public expenditure and at methods to measure the efficiency of public spending. The Working Group recognised that the impact of public expenditure on growth depended crucially on the specific institutional and behavioural context of each individual country and on how efficiently the money is spent. In turn, the revenue side of public budgets (i.e. tax structure) may also have important implications on growth developments.

### 3.7 *Participants*

The targeted participants would be experts' staff from EU and MED countries working on budget planning and analysis in the national administrations. The level of participation would be decided by each country.

Involving IFIs (e.g. World Bank and IMF staff) as well as OECD experts could also be useful. External experts (e.g. academia) might be invited to enrich/steer the discussions.

### 3.8 *Conditions for success*

In order for the initiative to be successful, it is necessary to find and get support from "locomotives" – countries, which would take the driving seat for the entire process. The European Commission should not be the only stakeholder.

Synergies need to be created (or duplication avoided) with other existing initiatives of a similar character, e.g. the Working Group on public finance management under the OECD MENA Governance Initiative and the idea of creating a group of Senior Budget Officials (SBO) from the MENA region following the modus operandi of OECD SBO meetings.<sup>14</sup>

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<sup>14</sup> "The Good Governance for Development (GfD) in Arab Countries Initiative", officially launched in February 2005 under the flagship of the OECD, "aims at modernising public governance in the Middle East and North Africa (MENA)". Its Working Group (WG) on public finance management addresses a wide variety of policy issues related to improving the governance of public finance in all the Arab countries. Efforts are pursued to transform this WG into an MENA SBO, with the support of the OECD secretariat. Its structure and mode of operation would replicate the existing OECD SBO meetings, as it was already the case in Asia and Latin America. The same path has also been followed successfully by SIGMA, the joint EU-OECD initiative to assist reforms in the public finance management in Eastern and Central Europe.