II

(Acts whose publication is not obligatory)

COUNCIL

COUNCIL DECISION

of 25 July 1977

on the preparation of public budgets for 1978

(77/492/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community,

Having regard to Council Decision 74/120/EEC of 18 February 1974 on the attainment of a high degree of convergence of the economic policies of the Member States of the European Economic Community [1], and in particular Articles 1 and 3 thereof,

Having regard to the proposal from the Commission,

Whereas the Council agrees with the analysis of the economic situation contained in the Commission communication of 7 July 1977 concerning, in particular, the preparation of public budgets for 1978,

HAS ADOPTED THIS DECISION :

Article 1

Member States shall pursue economic policies complying with the guidelines on the preparation of public budgets for 1978 set out in the Annex.

Article 2

This Decision is addressed to the Member States.

Done at Brussels, 25 July 1977.

For the Council

The President

H. SIMONET

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(1) OJ No L 63, 5. 3. 1974, p. 16.

ANNEX

GUIDELINES FOR ECONOMIC POLICY IN THE COMMUNITY

1. General guidelines

1.1. As insufficient progress has been made with the process of rationalization undertaken by the countries of the Community, the growth and employment objectives adopted in the context of the economic policy guidelines established in March 1977 and in the fourth medium-term economic policy programme [1] are hardly capable of achievement for the Community as a whole. The economic policies conducted by the Member States having an external surplus and those of deficit Member States have not yet produced all of their expected results. The process of adjustment which has begun and the structural changes by which it is inevitably accompanied are occurring slowly and their magnitude has not yet, moreover, been fully appreciated. Nevertheless, impatience is no more appropriate than resignation or pessimism when it relates to the major distortions which have emerged, over a number of years, in the world economy under the influence, notably, of accelerated inflation and the oil crisis. These structural difficulties can be overcome only gradually by putting into action the policies foreseen in the fourth medium-term economic policy programme of the Community.

1.2. It would then be a mistake to abandon efforts to control demand and to coordinate it at Community level on the grounds that, up to the present, the objectives sought have not always been fully attained. The disparity of economic situations within the Community implies, in order to maintain an adequate rate of growth in those Member States where the primary policy objective is to remove inflation and the external deficit, that expansion should continue, and probably accelerate, in those countries where the balance of payments is currently satisfactory. But, on the other hand, expansion in the latter countries is partly dependent upon the success of anti-inflationary policies in the former, since the persistence of sizeable divergences in the rate of price increases is likely to create new uncertainties especially about the medium-term development of export markets and therefore to influence investor's decisions. It is more than ever required that a differentiated regulation of domestic demand, as between the surplus countries and the deficit countries, should be sustained, as provided for, indeed, in the guidelines of November 1976 and March 1977 for economic policy in the Community in 1977.

1.3. All the Member States should try to re-establish or improve conditions conducive to a return to sustained and non-inflationary growth, encouraging, in particular, the propensity to invest of the private sector and assuring an adequate level of public investment. To achieve a healthy and lasting recovery in investment, the reduction in the rate of increase of wage costs, both direct and indirect, of the last few months needs to continue, but in general it must be accompanied by policies to reduce inequalities. At the same time, specific action, both at national and Community level, should be such as to favour the recovery in investment in the context of a Community structural policy. The Community could contribute to this by strengthening existing Community instruments, thereby increasing the multiplier effect. Thus, for example, an increase in the capital of the EIB has been envisaged and a better use of the means of action of the Social Fund, a broadening and diversification of the activities of the Regional Fund and a mobilization of increased financial resources in the energy sector can all be anticipated. In addition, the Commission has proposed that new Community borrowing machinery be created to finance investment of a structural character in line with priority Community objectives in the areas of energy, industries undergoing structural change and infrastructures. This proposal is currently under study.

1.4. Public intervention is not sufficient to overcome the difficulties of adaptation which will arise in coming years and to restore confidence in the medium-term outlook.

A minimum economic and social consensus on objectives to be achieved and the instruments to be used is more than ever necessary.

The third meeting between the social partners, the Governments of the Member States and the Commission on 27 June 1977 confirmed the scale of the tasks to be carried out and of the difficulties to be solved. The measures which have already been taken in all the Member States in connection with employment and professional training, particularly that of young people and

[1] OJ No L 101, 25. 4. 1977, p. 2.

women, ought to be strengthened to the greatest extent possible.

2. Monetary policy guidelines

2.1. Monetary policy has a major contribution to make in consolidating or strengthening the success achieved in the fight against inflation. The pursuit of a steady monetary policy and the publication of quantified guidelines for the relevant monetary aggregates in each Member State will help to reduce inflationary expectations, to strengthen the confidence of management and private consumers and favour the development of a more stable pattern of exchange rates between the currencies of Member States. In its annual report on the economic situation in the Community (1) the Commission has already outlined quantitative guidelines for monetary policy in the Member States for 1977, but target figures were indicated for some Member States only. According to the fourth medium-term economic policy programme for the Community, guidelines for internal monetary policy should be established at a Community level each year. The Commission will again formulate quantitative monetary policy guidelines in its forthcoming annual report on the economic situation in the Community. The quantitative guidelines will have to take account of fairly divergent economic situations and the differing monetary instruments of the Member States and the extent to which the Member States' economies are open towards foreign countries.

2.2. Data available for 1977 (covering, for most countries, only the first quarter) appear to indicate a slow deceleration of monetary growth, but special vigilance is still required in certain Member States, especially in Italy. In Denmark, France and the Netherlands it would appear necessary to maintain the measures taken to limit the expansion of bank credit. On the other hand, in the United Kingdom, where monetary growth has fluctuated widely in the past, a steadier and more sustained expansion of the money supply seems feasible and desirable. In the Federal Republic of Germany, the trend of central bank money was largely consistent with the guidelines during the first four months of 1977.

3. Budgetary and financial policy guidelines

3.1. More than in the past budgetary policy should now be used as an instrument of growth policy. Some strengthening of measures taken to stimulate investment is necessary in order to recover lost ground as far as meeting medium-term targets is concerned and to accelerate the return to full employment. Some Member States have already adopted this approach.

3.2. As far as private investment is concerned, decisions might be made where appropriate, for example, to :

— enlarge the possibilities of fiscal evaluation of company liabilities and assets ;

— increase subsidies for research and development ;

— pay selective subsidies favouring investment designed to create new energy sources or to save energy, to improve the environment and to refurbish regional infrastructures.

In order to harmonize such action and to avoid creating distortions between the Member States, all investment-incentive programmes should be the subject of coordination at Community level.

3.3. An increase in direct investment by public authorities, whether central or local, is also recommended for most countries, within the limits of non-inflationary financing possibilities and taking account of the existing structure of interest rates. The importance and impact of this increase will differ from one country to another, according to public investment needs and the degree of spare capacity existing in the construction industry. Specific programmes to be drawn up should take this into account. In certain Member States the main aim of such measures would be to strengthen overall demand trends, while in others these measures would be aimed more at improving the economic and social infrastructure.

In order to attain these objectives, planning should now begin in most Member States to raise the volume of general government investment above that of recent years without, however, raising the proportion of public expenditure in GDP. The announcement of the implementation of new programmes could well strengthen confidence without producing undesirable 'mechanical' effects if, as is the case in certain countries, unused production capacities are fairly substantial. Integrating such efforts into the five-year public investment programmes, covered by

(1) OJ No L 358, 29. 12. 1976, p. 1.

Council Directive 74/121/EEC of 18 February 1974 on stability, growth and full employment in the Community [1], should increase the chances of achieving a more stable long-term growth.

3.4. Action taken to revive investment using the means described above implies a prolongation of efforts to reduce budget deficits in the surplus countries. Nevertheless, stimulatory action should not bring about, in the longer term, any lasting deterioration in the net borrowing requirement. Where the weakness of investment reflects general under-utilization of productive capacity and entails the risk of persistent reduction or obsolescence of capacity, a deterioration in the budget surplus or deficit would be acceptable.

The favourable effects this should have on economic growth should in time engender additional tax revenue which in its turn should tend to reverse the effect on the budget deficit.

Those Member States whose balance of payments may still be precarious in 1978 or who require a current surplus in order to repay external debt should modulate very carefully the measures taken to stimulate investment, which should not, in any event, bring about a growth in budget deficits or of the monetary aggregates in excess of the limits agreed within the Community context or with the International Monetary Fund.

In those countries whose budget deficit is being financed to a substantial degree by monetary means in 1977, action to get investment moving again should be carefully monitored to prevent the creation of new liquidity from strengthening inflationary expectations.

4. Guidelines country by country

4.1. In *Denmark,* the economy has entered into a phase of very slow growth since the autumn of 1976 brought about by a restrictive policy made necessary by a deterioration in the current balance of payments. Private consumption has scarcely risen at all and total investment (construction and machinery) has experienced a quite marked decline. Industrial exports are the main element supporting activity which remains, however, insufficient to prevent an increase in unemployment. These trends should persist until the end of 1977 and, as a result of a fall in imports, should permit a reduction in the current deficit.

The outlook for 1978 is for a certain pick-up of the economy as a result of a modest recovery of investment and private consumption. Accordingly, imports could be more dynamic and, despite an appreciable performance of exports, the current balance should only improve slightly. Unemployment is likely to increase further. Owing to the moderation of import prices and wage costs the inflation rate will be cut considerably.

Given the size of the external deficit and the growing external debt burden which reduces the authorities' room for manoeuvre, economic policy should, as a priority, be geared towards creating lasting conditions for a return to external equilibrium without which the employment situation can only grow worse.

The incomes policy adopted in the spring of 1977 could contribute to the attainment of this objective in so far as the salary guidelines, which imply a modest growth in real terms in 1978, are strictly adhered to. It should be accompanied by budget measures which, ranged around a policy to reduce the net borrowing requirement of the public sector, could nevertheless permit certain investment incentives. This development would be even more desirable since the maintenance of the high interest rates, necessary to finance the external deficit, could have a negative impact on the propensity to invest. If the salary norms were to be exceeded, the restrictive orientation of budgetary policy would have to be reinforced ; in particular it would be appropriate to have recourse to an increase in indirect taxation in such a way as to maintain private consumption, and consequently imports, at a level compatible with the balance of payments, which must be regarded as the principal objective.

4.2. In the *Federal Republic of Germany,* the upswing, which has been more restrained than in previous expansionary phases, is not sufficiently strong. Taking into account the relative lack of dynamism of economic activity, in the area of private-sector investment in particular, growth will be insufficient to improve the labour market situation substantially.

Owing to the slow rate of growth, efforts to cut the public deficit should be spread over a larger period than foreseen. There may in fact be a need for the public budgets to exert an expansionary influence on the economy. The amended tax bill tabled by the Government and now under examination by Parliament is along these

[1] OJ No L 63, 5. 3. 1974, p. 19.

lines. Under the bill, while the standard VAT rate is to go up from 11 % to 12 % and the reduced rate — applying principally to foodstuffs and services — from 5·5 % to 6 %, child benefits are to be increased, certain basic allowances under income and wage tax raised and some relief granted in respect of corporation and wealth tax. This package is likely to provide an initial stimulus of some DM 1 000 million in 1978. Should the impact of these measures, together with those adopted earlier (the annual shares of the multinannual public investment programme, the measures aiding public housing and the specific programme to maintain employment) is inadequate to restore domestic demand, new stimuli should be applied, particularly with a view to the long-term strengthening of the propensity to invest.

Despite the more expansionary nature of the overall budget, continued efforts should be made to curb the growth of current expenditure, thereby making room for capital expenditure.

Thanks to their improved earnings, local authorities should be able to increase their investment expenditure.

On the monetary side, the Bundesbank should continue its present policy of expanding the money supply in line with potential growth and a further slackening in the rate of price increases. Monetary policy should continue to be applied flexibly so as to avoid temporary strains on the money and capital markets.

4.3. In *France,* where the rate of growth of wage costs has slowed down since the beginning of the year, the economic activity, which is mainly export-led, will remain moderate between now and the end of 1977. The external deficit will shrink further and the terms of trade will go on improving. The upward movement of prices will tend to slacken gradually from the second half of 1977. In 1978, a progressive revival of domestic demand should lead to some quickening in the rate of growth. Even so, the situation of the labour market will experience only a slow improvement.

The economic policy laid down for 1977 is aimed at securing a decisive slowdown in the inflation rate so as to make substantial progress towards restoring equilibrium in the main macro-economic relationships. The State budget, which in the form now adopted shows a deficit of FF 11 800 million, could close with a deficit similar to that of 1976. However, the greater part of this deficit will be financed by non-monetary means. In addition, the authorities have for the first time fixed a goal for money supply growth for 1977 while maintaining control over the increase in the greater part of bank lending. Compliance with these guidelines throughout the current year will make a valuable contribution to the general fight against price and cost inflation.

The efforts to restore equilibrium should be continued in 1978 and, in particular, the more restrained growth of costs seen in 1977 should continue. Economic policy, both monetary and budgetary, should aid in this direction. As care should be taken to avoid any sharp acceleration in the growth of demand as this would be likely to generate an excessive increase in imports, the growth in State expenditure should therefore not be allowed to exceed the increase in output in value terms though spending should be timed to take account of the short-term economic situation. Thus investment in building and construction, which has a low import content but an appreciable effect on employment, might be stepped up to help sustain employment. But in any event a return to budget equilibrium, which should remain the longer-term objective, should not necessarily be sought in 1978.

4.4. In *Ireland,* developments in the second half of 1977 should be reflected in a marginally higher growth rate due to a more sustained performance of exports, private consumption and investment, resulting in a small decrease in unemployment, which will still, however, remain at an historically high level at the end of the year. Consumer prices will moderate and the balance of payments deficit will continue to widen but at a slower pace.

In 1978 these trends should continue, unemployment should fall again moderately and the rate of increase in prices slow down further.

The 1977 budget is likely to have a more stimulatory effect than initially expected. The net borrowing requirement as a percentage of gross domestic product should nevertheless be of the same order of magnitude as last year (11·5 %).

The budget for 1978 should be prepared in accordance with the Council Decision of 15 March 1976 laying down the economic policy condi-

tions to be observed by Ireland (1) in connection with the Community loan, and taking account of the progress made in 1976 and 1977 in reducing the borrowing requirement.

Attention must accordingly be paid to the necessity of not increasing tax pressure on wage incomes, due to incomes policy considerations, and of making an additional budgetary effort in favour of investment and employment. It would be desirable if an attempt could be made to make savings in non-priority current expenditure and to enlarge the tax base on certain incomes, notably agricultural incomes. In addition, the cost of food subsidies also constitutes a burden to the Exchequer and their phasing out could be envisaged when the consumer price index shows a deceleration.

As far as incomes policy is concerned, a continuation of a moderate pay agreement for 1978 is imperative as it will improve the prospects for the development of employment and reduce the risk to the balance of payments of too rapid an expansion in private consumption.

To obtain at the same time a moderate expansion of monetary aggregates and a satisfactory performance of bank lending to the private sector, the authorities should endeavour to finance as much as possible of the public deficit by non-monetary means and encourage the development of the 'non-monetary liabilities' of the banking system.

4.5. In *Italy,* industrial production, particularly because of the stabilization measures adopted in the autumn of 1976, weakened in the first months of the year. The continued high rate of inflation slackened, though only little. At the same time, the deficit on the overall balance of payments for the first four months of the year was slightly smaller than a year earlier. The lira exchange rate remained fairly stable thanks to a substantial increase in the commercial banks' short-term external indebtedness, and to a rapid improvement in May and June in the balance of payments on a settlements basis. The authorities should ensure that economic growth, which might reach 3 % in 1977, is obtained under conditions which are compatible with the objectives for 1977 and 1978 agreed among the terms for the grant of the Community loan.

In the public finance field, the public sector deficit will shrink significantly in 1977, mainly as a result of an increase — already implemented — in certain tax rates and the introduction of a new system of advance tax on non-wage incomes. However, additional measures will probably prove necessary to comply with the limit of Lit 16 450 000 million laid down by the Council in May. Further efforts will also have to be made to keep to the limit of Lit 14 450 000 million for 1978. This is because revenue growth must be expected to decelerate sharply now that tax arrangements are reverting to normal and incomes in money terms expanding a lot less rapidly. Consequently, the growth in public expenditure, and more particularly that in current expenditure, should be kept within strict limits, leaving no room for any increase in real terms. There will also be a need to secure additional revenue, among other things through a further adjustment of public service charges and an increase of local taxes. The reform of the system of financing social security benefits which the Government has undertaken to carry out by 31 January 1978 should result in a better distribution of the tax burden on various types of economic transaction. It should also provide an opportunity for stepping up the fight against tax avoidance.

Domestic credit expansion was much larger during the first quarter of 1977 than had been estimated in April for this period; this was due to the repayment of external trade debts following the abolition of the bankers' deposit and the tax on currency purchases. The Community and international undertakings given on this score for 1977 and 1978 must be strictly complied with by the monetary authorities, failing which the stabilization programme would be liable to lose most of its effectiveness. If necessary, the ceiling controls on bank lending will have to be tightened and extended once more. Interest rates should be kept relatively high, while simultaneously endeavouring to improve their structure.

Lastly, fresh efforts will have to be made to contain the rise in labour costs per unit of output. Success in this field will help to slow down inflation, to improve the competitive position of the Italian economy and to support the level of employment.

4.6. In the *Netherlands,* following sluggish growth and an increase in unemployment in the first half-year, the economy should pick up somewhat in the second half of 1977 and in 1978, although

(1) OJ No L 77, 24. 3. 1976, p. 15.

this is unlikely to produce a rise in employment. The balance of current payments surplus may well remain at the same level, if not increase.

The authorities should continue a policy aimed at medium-term targets of reducing unemployment by means of stimulating private investments, the rise in costs and prices and restraining the growth of the public sector and of the collective burden in relation to GNP. Short-term problems must be considered within this medium-term framework.

Since the outlook for employment and activity in 1978 is not particularly favourable, it would be inappropriate to give budget policy a restrictive bias. However, given the medium-term objectives, the general government borrowing requirement as a proportion of gross domestic product should remain close to the level reached in 1977.

Since unemployment cannot be reduced unless there is a relatively large external surplus, economic policy must continue to provide room for substantial exports of long-term capital, which — given the present outlook — should hardly be an impediment to meeting the general government financing requirements. In any case, there is a special need to check the growth of domestic liquidity so as to avoid any increase in the ratio between domestic liquidity and national income.

4.7. In *Belgium,* in the first half of 1977, unemployment, particularly among women, rose once again, the upward movement of consumer prices slowed down and foreign trade remained in satisfactory balance. In the months ahead and in 1978 the overall economic growth will probably still be too moderate to produce any significant improvement on the labour market. On the other hand, progress made in slowing down the rates of inflation remain precarious. Economic policy should therefore continue to combat both unemployment and inflation, within the limits set by the difficult public finance situation.

The constraints imposed by the pronounced public finance disequilibrium — a disequilibrium which is untenable in the medium term — would leave no room for implementing an economic policy designed to stimulate activity and employment through overall budgetary measures. The Government should therefore pursue a selective and temporary policy of combating unemployment; it should stimulate business investment, notably, where in so far as allowed by the budget, by abolishing VAT on investments and making full use of the scope offered by the existing laws on economic expansion. Care should be taken to avoid an additional increase in public investment, given the narrow margin of spare capacity in the public works sector. There should be a gradual shift in the public investment programmes towards activities which focus more on the quality of life; this shift would also contribute to the required moderation in the growth of current expenditure, which is essential if a rapid increase in the tax burden is to be avoided. The government budget for 1978 should therefore be aimed at a redeployment of the present budgetary resources with a view to holding to borrowing requirement as a percentage of GDP to the level reached in 1977.

In view of the resources available on the capital market, the greatest possible proportion of the budget deficit should be financed through long-term loans on the national market. Monetary policy should restrict the rate of growth of private sector short-term credit to the expected rate of growth in the gross domestic product in money terms so as to reduce the danger of excess liquidity causing inflationary tendencies to get out of hand.

4.8. In *Luxembourg,* the economic situation is still sluggish and the outlook for the second half of 1977 and for 1978 holds out only little hope of a revival in activity. Even so the public finance situation is more favourable than expected.

In preparing the Government budget for 1978, account had to be taken of the imbalances affecting the employment market. In order to counter these imbalances and to stimulate economic growth, the Government adopted, in conjunction with both sides of industry, a plan to maintain economic growth and full employment. Such a policy stance is compatible with maintenance of government net lending at a level of over Flux 2 000 million and holding general government net borrowing, expressed as a proportion of GDP, to the same level as in 1977 (1 %).

4.9. The present outlook for the *United Kingdom* economy is sensitive to the wide range of possible outturns for earnings after stage II expires at the end of July 1977. Until the details of the next wage agreement are known, it must be feared that average earnings could well accelerate beyond the Government's target of about 10 % for the twelve months from August 1977. If this happens, a temporary acceleration in

demand is foreseen. However, by late 1978 economic growth will have weakened and inflation may accelerate.

The forecast is for an increase in gross domestic product (GDP) of about 3 % from 1977 to 1978. As much as 1 % of this growth in GDP will be accounted for by increased production of North Sea oil. The rate of inflation is expected to fall markedly in the outlook period; in the final quarter of 1978, however, the increase over a year earlier may still be more than 10 % if the Government's target with respect to earnings is exceeded. The combined effect of this slowdown in prices and acceleration in earnings could be a strong revival of private consumption. Total gross fixed asset formation will also show an increase from 1977 to 1978, albeit at a lower rate than for private consumption. Strong growth in private sector fixed asset formation (especially in manufacturing industry) will be partly offset by a further substantial decline in public sector investment. There is likely to be little change in public authorities' current consumption. On the external side, there should be a continued and rapid expansion in net exports, because of the contribution of North Sea oil, pointing to a current account surplus of over £ 1 000 million in 1978.

The present developments of the budgetary aggregates suggest that the public sector borrowing requirement (PSBR) for 1978/79 should remain within the figure indicated in the Letter of Intent to the IMF without increasing the tax pressure significantly. However, domestic credit expansion (DCE) is likely to be close to the permitted ceiling.

If the growth in average earnings exceeds the Government's targets then the problems facing the United Kingdom Government, when considering budgetary policy for 1978/79, will be that:

— after reaching a low point in the second half of 1978, the rate of inflation may begin to rise once more;
— the rate of economic growth may not be sufficient to avoid a fall in capacity utilization and a further rise in unemployment;
— the balance of demand between consumption and investment may deteriorate;
— pressures could well arise to use the room for manoeuvre provided by the projected balance of payments surplus to stimulate private consumption.

Despite the strong possibility that economic expansion may slow down, no fiscal or monetary relaxation can be countenanced given the threat posed to the UK economy by the possibility of a further surge in inflation. However, should the authorities still see room for manoeuvre without exceeding the target given to the IMF (a PSBR of £ 8 600 million the equivalent of 5·5 % of GDP), action should be directed towards a lasting increase in investment and employment and a progressive reduction in the inflation rate.