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# The Contribution of Public Finances to Growth and Employment: The New Quality Concept

## *Panel Discussion*

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The "quality of public finances" gained higher attention both at national and EU levels against the background of fairly sluggish economic growth during the past four years. The Ecofin Council lately centred several discussions on quality issues of public finances. As a result, the reformed Stability and Growth Pact and the New Lisbon Strategy for Growth and Jobs, outlined in the new Integrated Guidelines (particularly referred to in Guideline 3 in the BEPG), explicitly took account of quality aspects.

While at the end 1990s the definition of quality was still "broader" and covering at least three aspects: (i) the size of the state sector in the economy, (ii) enhancing incentives to take up a job through tax-benefit reforms and (iii) more investment in physical and human capital, the recent EPC progress report based its (expenditure-oriented) concept on three pillars:

1. *The budgets should be refocused more on expenditures*, which are regarded to increase total factor productivity (i.e. the marginal productivity of capital and/or labour in the production function of an economy) inter alia, via a better educated/trained population, good infrastructure, sound environment, spill-overs from innovation and technological progress. Since the mid 1990s interest payments have been declining significantly in EU Member States, providing budgetary room for manoeuvre. Empirical evidence suggests that besides reducing deficits for achieving the Maastricht criteria, public consumption (especially health and education expenditure) and, in part, social transfers were increased in relative terms (see table). Data for investment show a mixed picture, influenced especially by changing institutional boundaries between the public and private sector and an already high stock of physical capital in many highly developed countries. Moreover, in view of future ageing populations, it may be expected that social transfers and health care expenditure will continue to rise, while the pace of falling interest payments is presumed to ebb down

markedly. This indicates that the room may be further reduced for those expenditure categories which are deemed to strengthen the future growth potential.

*Table: Economic Classification of Public Expenditure (% of Total Expenditure)*

| | 1970 | 1980 | 1990 | 1995 | 2000 | 2004 |
|---|---|---|---|---|---|---|
| *Consumption* | 43.9 | 44.2 | 41.5 | 40.3 | 43.6 | 43.6 |
| *Transfers* | 28.7 | 31.2 | 30.9 | 33.6 | 35.1 | 34.4 |
| *Interest payments* | 4.6 | 6.5 | 10.3 | 10.5 | 8.4 | 6.4 |
| *Public investment* | 11.2 | 7.1 | 6.2 | 5.2 | 5.0 | 5.0 |
| *Subsidies* | 3.9 | 4.5 | 3.5 | 3.2 | 2.8 | 2.5 |
| *Other* | 7.6 | 6.6 | 7.5 | 7.3 | 5.1 | 8.2 |

*Source: Commission services. Countries included are BE, DK, DE, EL, ES, FR, IE, IT, LU, NL, AT, PT, FI, SE and UK.*

2. *Financial resources must be used in the most effective and efficient way* in order to actually reinforce the medium and long-term growth and employment perspectives, c.f. also in education or R&D. The key question is here: how does the input impact on the output and finally on outcomes, such as productivity and employment, or as a concrete example, how do higher expenditures for R&D impact on the number of patents? This approach apparently refers to the definition of output objectives, the rationale for government intervention and the final evaluation of measures and programmes. The key bottleneck, however, is here the availability of reasonable data for adequate impact assessments. Notwithstanding these data problems, first striking empirical evidence in this EPC progress report reveals that:
   - in particular, private R&D are crucial for productivity gains in the economy and public R&D should subsequently concentrate on basis research rather than in business research

- and the growth potential of an economy depends, above all, on the quality of the education system rather than the level of public spending.

3. As a result, improving quality combining with efficiency and effectiveness must be embedded in an overall strategy of budgetary discipline and financial sustainability. This is intimately linked with the *role of fiscal institutions and fiscal rules* and goes hand-in-hand with a *coherent setting of economic policy and, consequently, public expenditure priorities.* In many countries, the focus of expenditure re-allocation has been in favour of R&D, education and public investment in recent years. First comparisons have also shown that countries which have introduced performance budgeting and have successfully established a medium-term (expenditure) framework were better off in terms of both growth and budgetary results. These countries have apparently been put in a better position trough improved priority setting and implementation of less myopic economic policies. In this respect, also the New Austrian Budget Framework Law will be fully anchored to performance budgeting and a medium-term expenditure framework (covering four years) and will, thus, be a highly crucial step to help public finances to be more conducive to growth and employment.