In sickness and in health: protecting and supporting public investment in Europe

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**Based on a joint work with Francesca Barbiero*

Outline

1. Long-term trends in gross public investment

2. Developments during the crisis

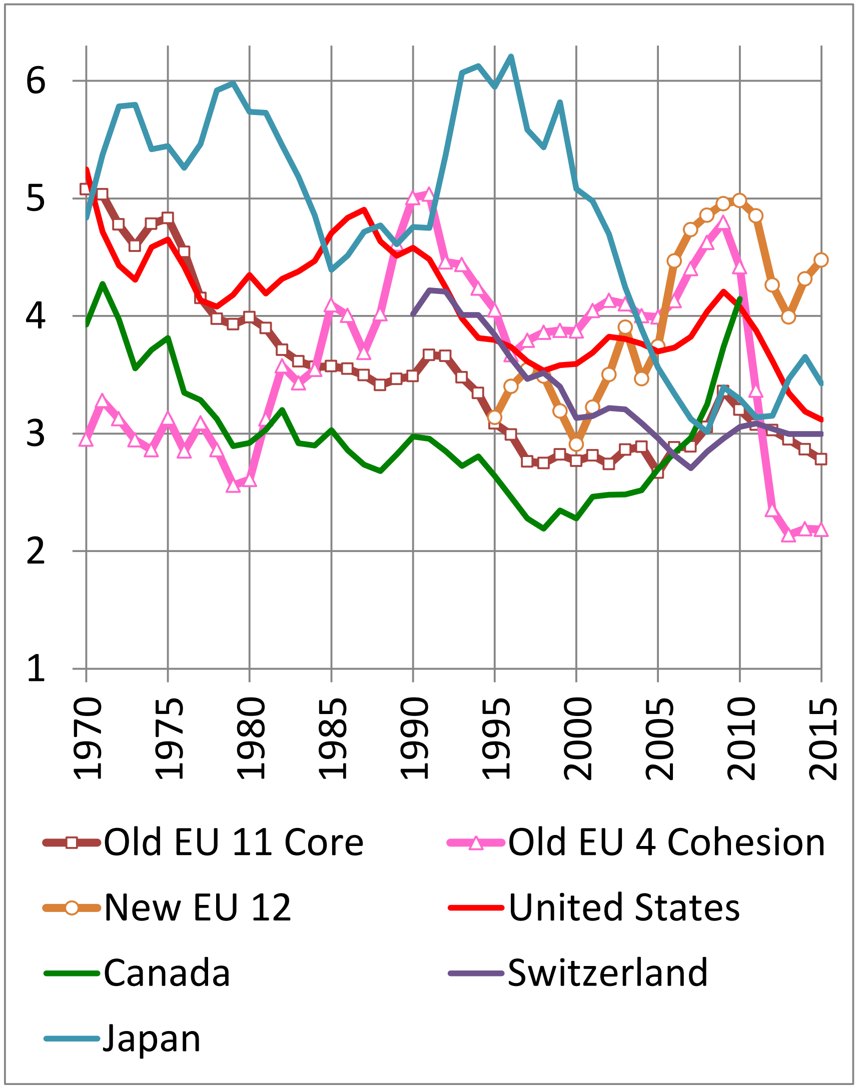
3. Public investment in the EU fiscal framework

4. Proposal for an asymmetric golden rule to be incorporated in the EU fiscal framework:
    - *golden rule in a deep recession*
    - *no golden rule during good times*

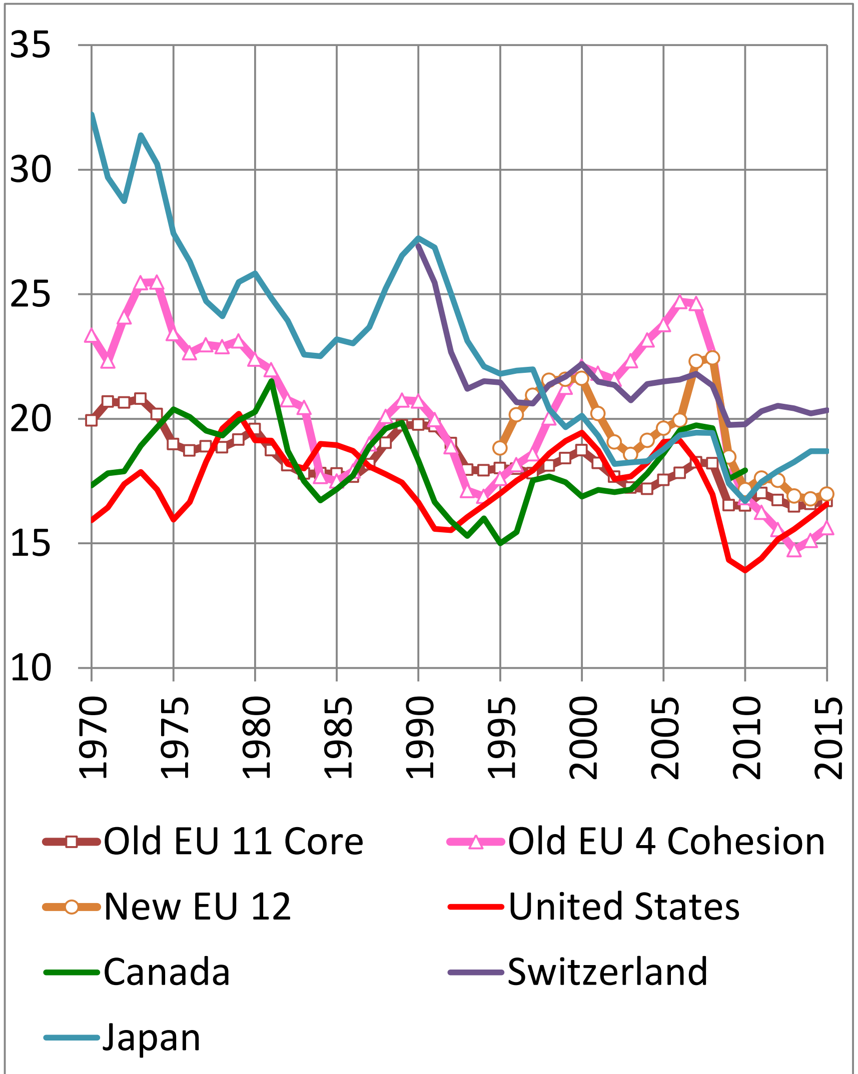
1. Long-term trends in GFCF

Gross fixed capital formation, % of GDP, 1970-2015

General government



Private sector



Reasons for the long-term decline in public investment

- Mehrotra and Välilä (2006): panel cointegration model for 1970-2003 for old EU members. Key findings:
  - Co-movement with output
  - Decline with discretionary fiscal consolidation
  - Decline with high public debt
  - Financing cost is not significant
  - Maastricht dummy is not significant
- But: there were also declines in Switzerland and Canada till the mid-2000s (healthy public sector)
  - Build-up of adequate public capital?
- But: minor decline in US, where gross investment rate above EU-core since 1996
- More recently:
  - Crisis
  - European fiscal rules

2. Public investment during the crisis

Table 1: Fiscal adjustment strategies by main expenditure categories, % change from 2009 to 2013 (in current prices)

	GR, IE, PT, ES	Italy	10 other EU15	EU12	United States	Switzerland
Total expenditure	-9	1	9	9	9	11
Interest expenditure	48	15	15	27	89	-6
Primary expenditure	-12	-1	9	8	4	11
Compensation of employees	-13	-4	7	3	3	10
Current transfers	1	7	12	11	12	11
Other current primary expenditure	-19	-6	8	15	-13	13
Capital expenditure	-51	-24	-1	-7	20	14

Source: Bruegel using the AMECO database. Notes: ***EU12*** *refers to the member states that joined the EU between 2004-2007.* ***EU15*** *refers to member states before 2004.* ***GR, IE, PT, ES*** *= Greece, Ireland, Portugal, Spain.*

2. Public investment during the crisis, *cont'd*

Table 2: Cuts in government gross fixed capital formation by function during the first years of fiscal adjustment, share (%) and % change from 2008/09 to 2011 (current prices)

	GR, IE, PT, ES		Italy	
	Share (%)	Change (%)	Share (%)	Change (%)
Total	100	-36	100	-16
General public services	6	-44	16	-16
Defence	2	-65	3	42
Public order and safety	3	-28	4	-26
Economic affairs	46	-28	32	-15
Environment protection	6	-40	9	-14
Housing/community	12	-61	11	-33
Health	7	-44	9	-13
Recreation/culture	7	-30	7	-33
Education	10	-37	7	-14
Social protection	2	-27	2	11

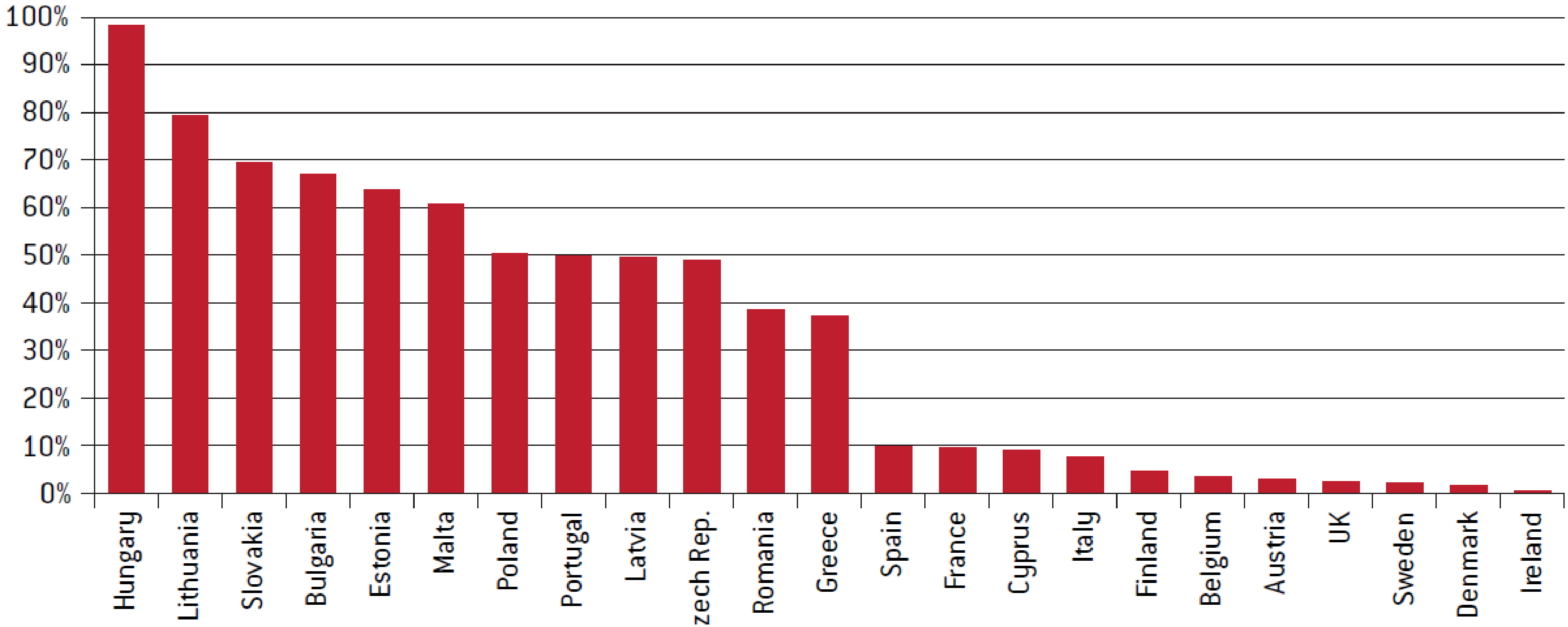
Source: Bruegel using Eurostat's general government expenditure by function (COFOG) database. Notes: Share in 2008 and the change from 2008 to 2011 in the aggregate of Greece, Ireland, Portugal and Spain (GR, IE, PS and ES), and share in 2009 and the change from 2009 to 2011 in Italy.

3. Public investment in the EU fiscal framework

- The EU fiscal framework was unable to foster public investment as a counter-cyclical fiscal stabilisation tool during the deepest crisis since WWII
- Commission repeated suggestion: preserve ”*the ’most’ productive components of public spending (such as public investment, education and research expenditures)*”
- Strengthened Stability and Growth Pact (SGP)
- Public investment is a relevant factor when considering the launch of an excessive deficit procedure (EDP); averaged over a number of years to avoid peaks
- Investment clause (summer 2013, slightly revised in January 2015):
  - In the preventive arm, temporary deviation from the structural adjustment path to the medium-term objective (MTO) to the extent of national co-funding of EU funded projects, if there is economic downturn, 3% budget deficit is are respected, investment is increased, and the temporary deviation later compensated
- Corrective arm: grant extra time to safeguard public investment

The role of structural funds in public investment

Structural funds and national co-financing as percent of the sum of total public gross fixed capital formation and investment grants, 2009-11 average



- The modest investment clause would hardly benefit e.g. Italy, Spain and Ireland; plus they were in the corrective arm of the SGP when the recession hit

4. An asymmetric golden rule for Europe?

Arguments against

- ”Golden rule”: excluding public investment from fiscal rule indicators
- Arguments **against** a golden rule (European Commission, 2004):
  - It could entail maintaining high deficit for long periods;
  - It might create distortions, with physical infrastructure preferred to other forms of capital or current spending that might also be beneficial over the long run;
  - The difficulties in deciding which expenditure categories should be granted special budgetary treatment;
  - Net public investment is the relevant variable for intergenerational equity, but it is just a small fraction of gross investment;
  - There would be significant incentives to record current expenditure as capital spending.

4. An asymmetric golden rule for Europe?

Arguments in favour

- Arguments **in favour** of a golden rule:
  - Intra-generational equity requires that the cost of public investment should be borne by future generations who will benefit from it and therefore capital expenditure should be financed through debt and not by taxes paid by the current generation (Blanchard and Giavazzi, 2004).
  - In corporate accounting, the cost of investment is not charged to a single year when the investment is implemented, but distributed across the years of its use: this principle has merits and should be adopted in public sector fiscal rules by an appropriate golden rule.
  - In the presence of deficit limits, socially desirable public investment projects may not be undertaken (Turrini, 2004), and a golden rule could help to avoid strategic underinvestment (Peletier, Dur and Swank, 1999).

4. An asymmetric golden rule for Europe?

Net public investment during the crisis

Table 3: Net fixed capital formation of the general government (percent of GDP)

	2000-09 average	2008/09	2013
Greece	1.5	1.7	-1.6
Ireland	2.5	3.7	0.2
Portugal	2.1	2.7	-0.7
Spain	1.5	0.9	-0.3
EU11 Core	0.5	0.6	0.3
EU12	1.2	2.2	1.2

Source: Bruegel based on AMECO. **Note:** the column 2008/09 indicates the pre-crisis peak in net public investment: 2008 for Ireland, Greece, Portugal and EU12, and 2009 for Spain and EU11 Core. EU11 Core denotes 11 of the EU15, except Greece, Ireland, Spain and Portugal. EU12 denotes the 12 member states that joined the EU between 2004 and 2007.

4. An asymmetric golden rule for Europe?

Our proposal

- Exclude a measure of (net) public investment form the deficit requirement of the SGP during a recession, but no extra fiscal space in good times
- Note: public investment has a high multiplier during recession
  - ➢ *Such a rule would lead to more growth-friendly composition of fiscal adjustment in bad times, thereby limiting short-term fall in output and employment in the short term, while limiting adverse incentives for excessive public investment in good times*
- Separate investment budget from the current budget

- More ambitious proposal: European instrument for cyclical stabilisation
- Necessary in any case: improving the quality of public investment by budgeting, accounting, transparency and assessment reforms