Public Investment and Fiscal Rules

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Agenda

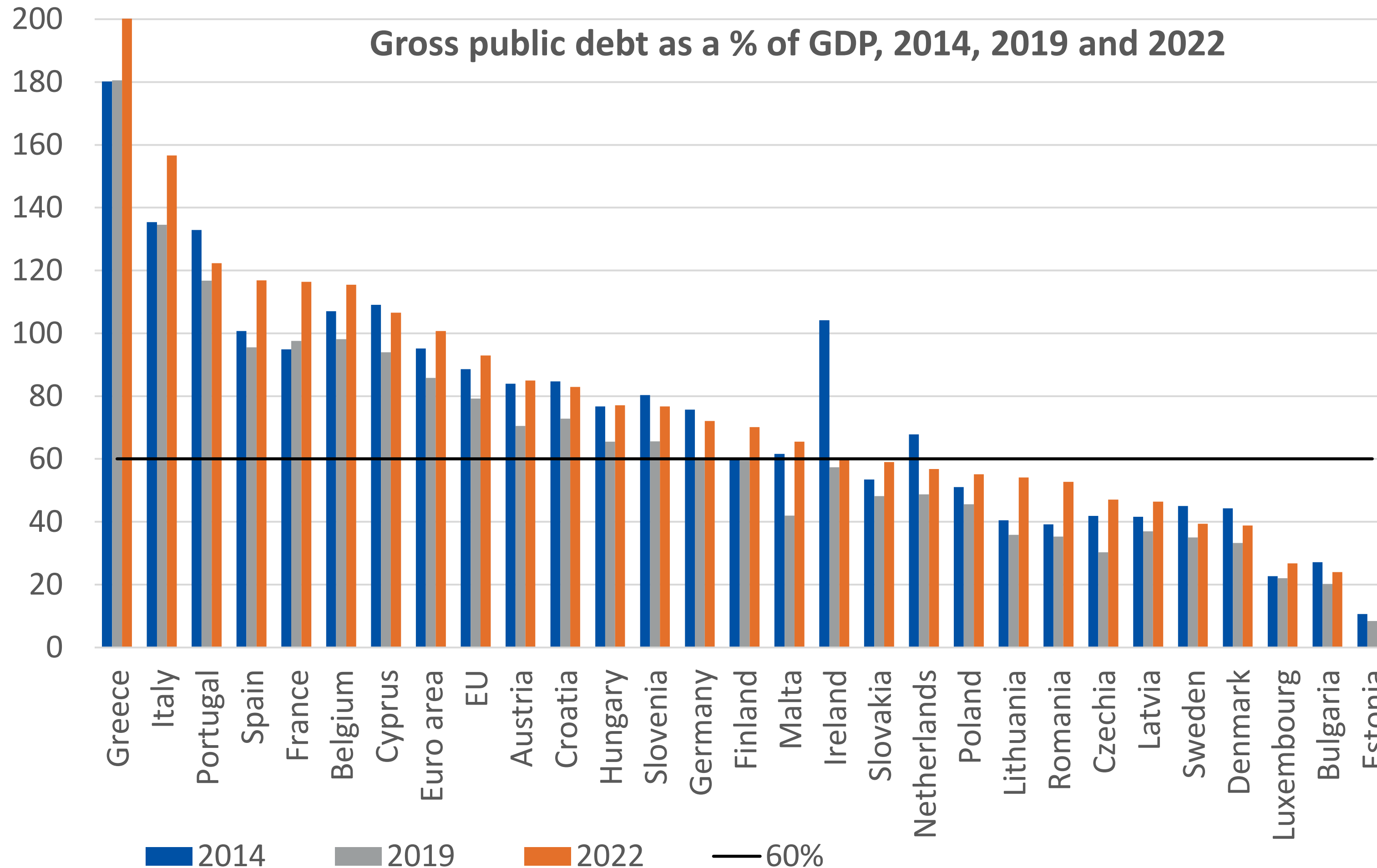
Do we need to protect public investment in Europe from consolidation? What do we need to assure and is there room for instruments like the RRF?

To answer this question I will focus on:

- Where Europe stands in terms of fiscal position, after the pandemic and at times of war and energy shock?
- What does it mean for public and private investment?
- Some reflections on the RRF, which is the first experiment of an EU-coordinated fiscal policy, (a “prequel” of a non-automatic central fiscal capacity)

Large growth in deficits and debt, 14 countries due to exceed 60% limit by 2022

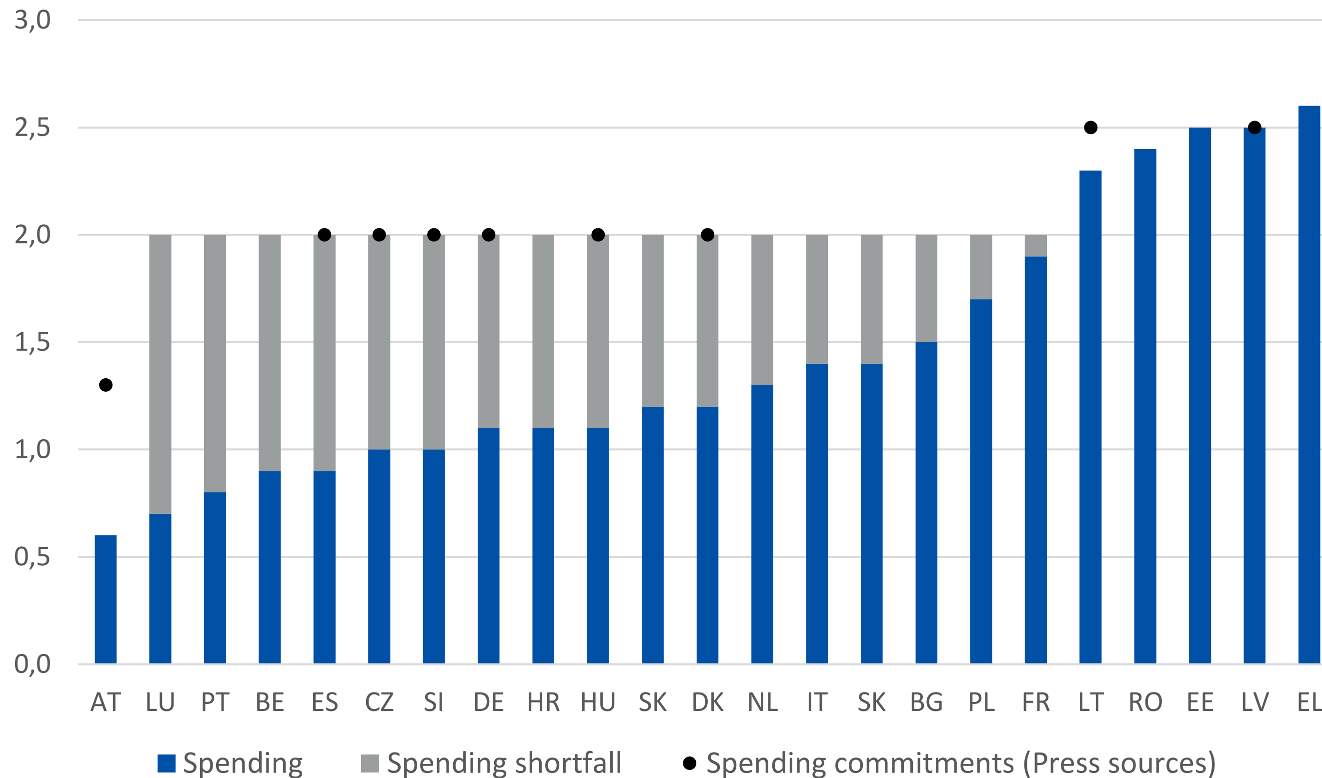
Pandemic erased fiscal consolidation efforts made since 2014



- Peak debt level reached for EU countries in 2014 (after 2008/09 global financial crisis and Eurozone sovereign crisis)
- # of countries exceeding 60% debt limit 15 in 2014, 11 in 2019 (before the pandemic) and forecasted by EC to be 14 2022
- Average EU Public debt to GDP increased from 79.2% in 2019 to estimated 93% in 2022

Russian invasion of Ukraine has increased pressure on budgets

Governments committed to additional spending to counter adverse effects of the war

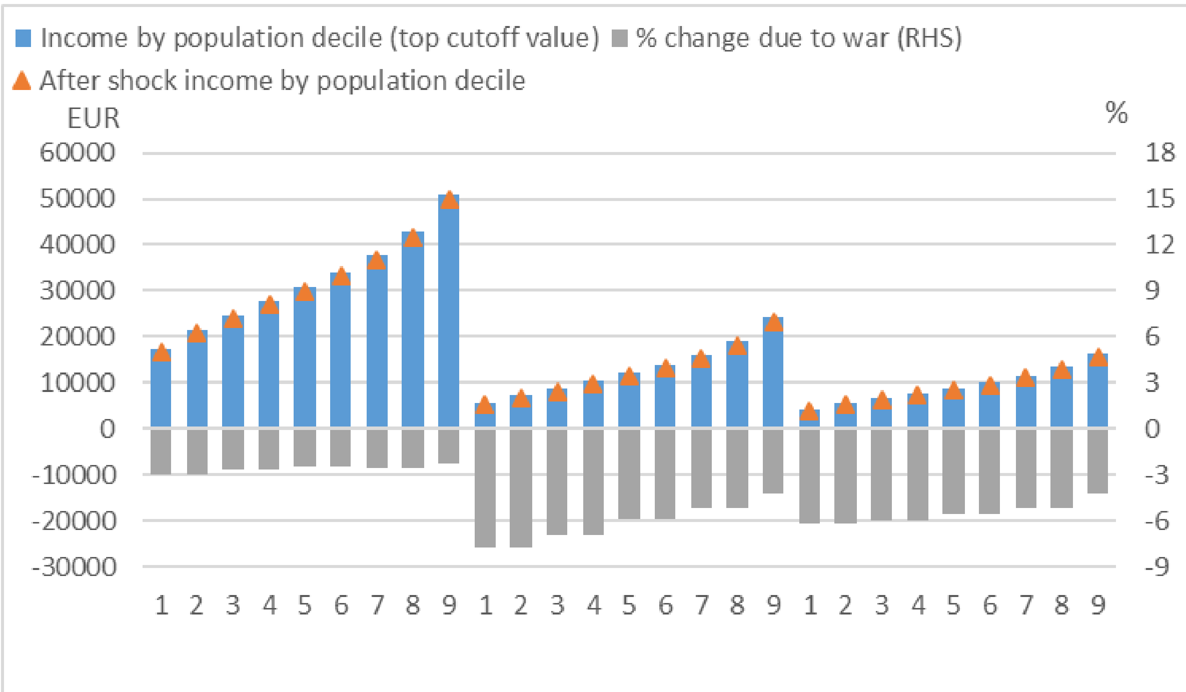


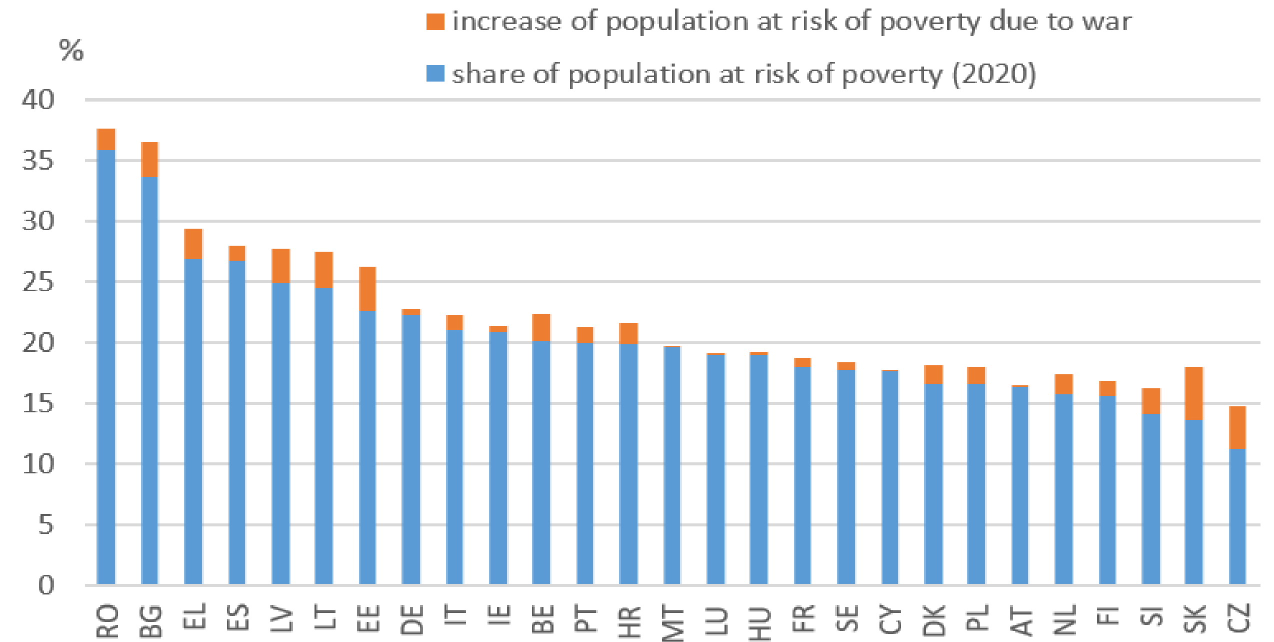
- Measures to shield households and/or firms from the direct impact of rising prices: cost of the packages circa 0.5% of GDP (only partly covered by higher carbon tax revenues)
- Most EU governments have committed to increase their military spending
- The inflow of Ukrainian refugees puts a strain on public finances
- Slowdown in economic growth is expected to generate revenue shortfalls

Direct impact on households: a real disposable income shock

There was an ongoing increase in prices before the war, but the conflict is exacerbating it (particularly on energy and food) hitting disproportionately low income countries and, inside countries, low income people.

Potential impact on the share of population at risk of poverty *(data based on EU-Silk database)*





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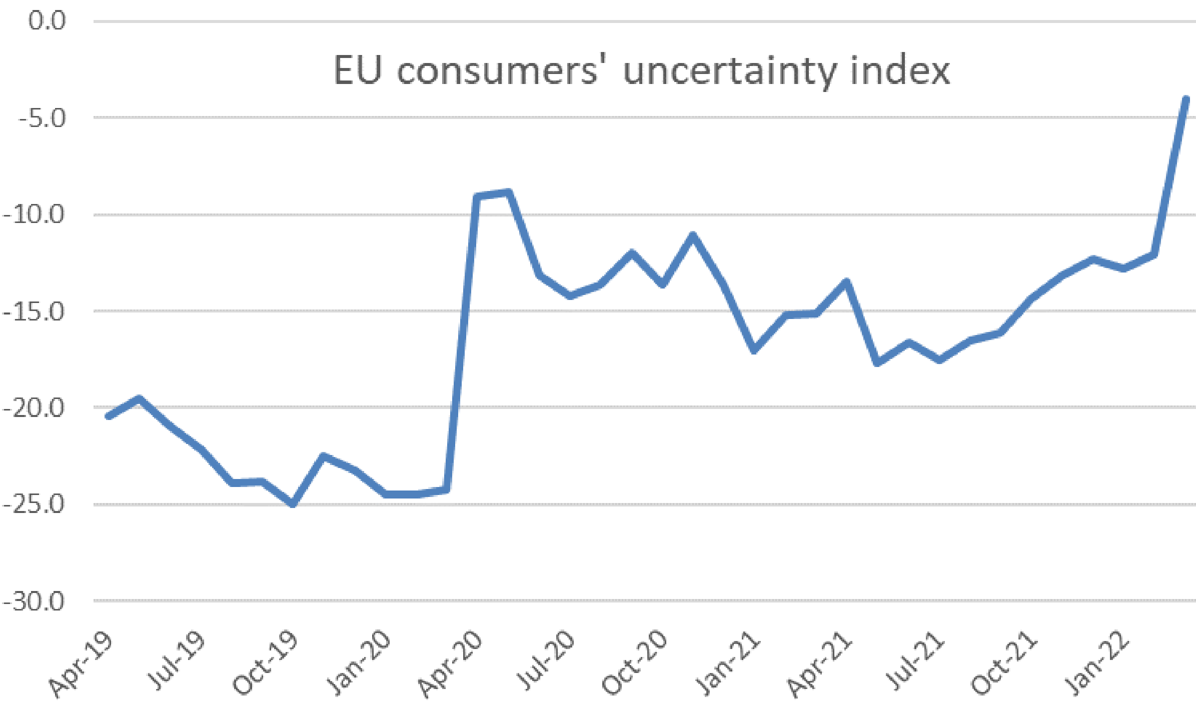
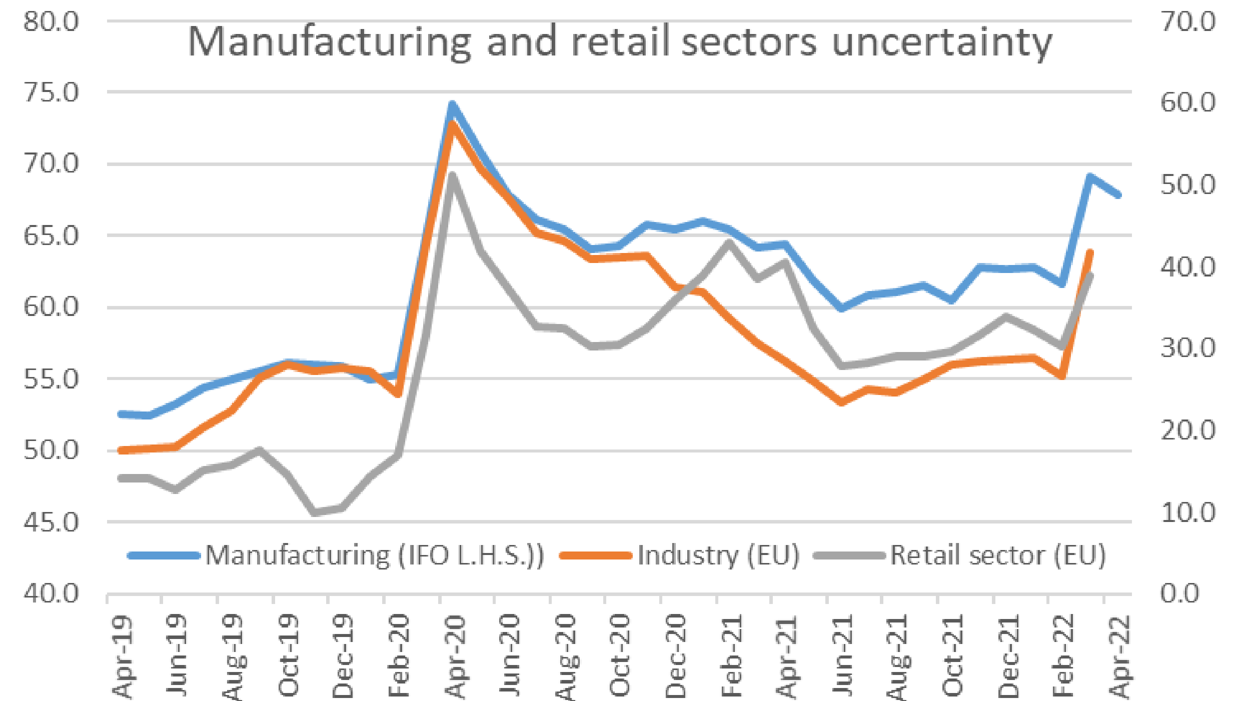
Impact on uncertainty capping private investment?

Uncertainty regarding prices, supply bottlenecks, final demand, financial situation is on the rise

Uncertainty computed as the perception of the difficulty of projecting own business or own situation in the future
(Source: IFO and EC business and consumer surveys)

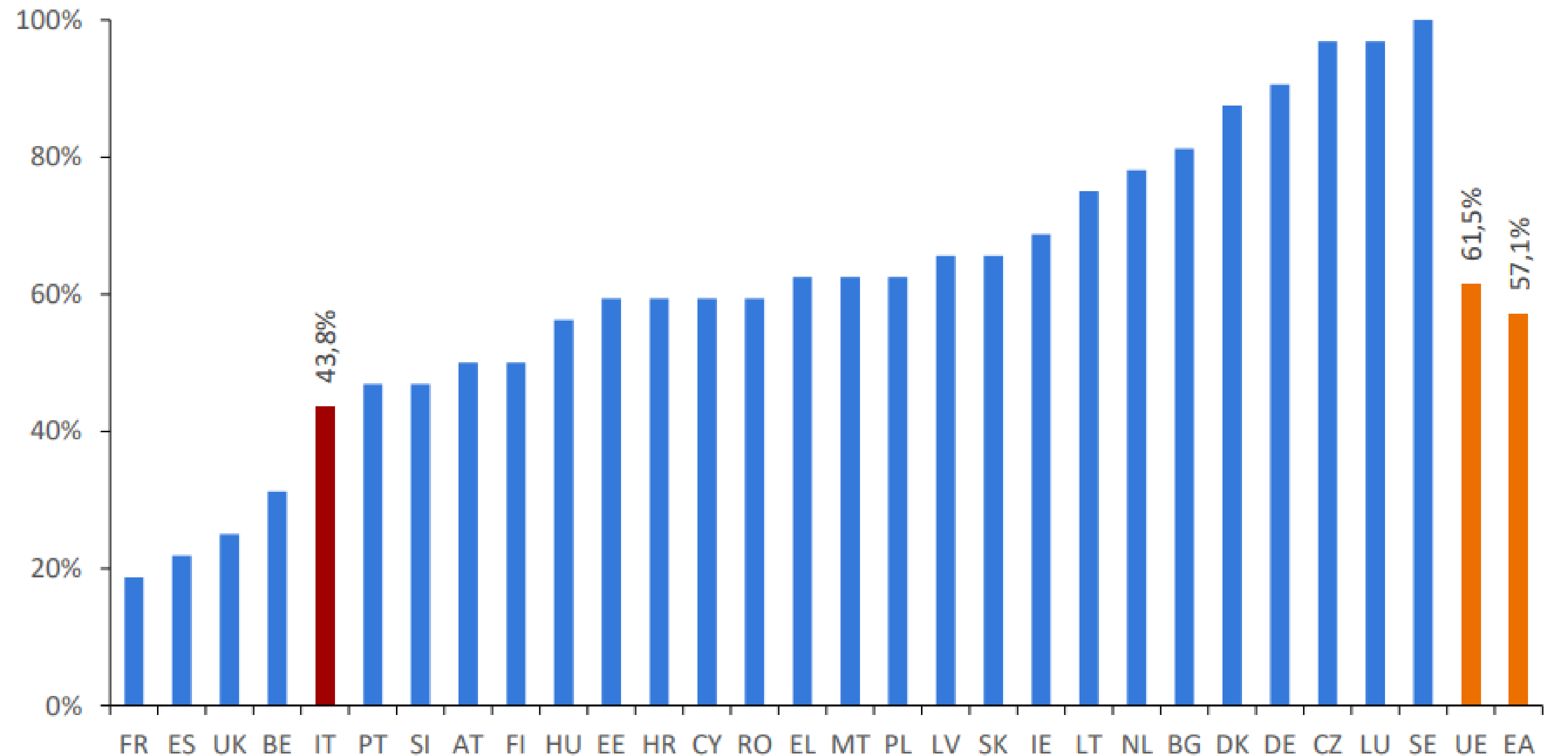




Stability and Growth Pact

Complex set of fiscal rules; often been difficult for EU Member States to fulfil

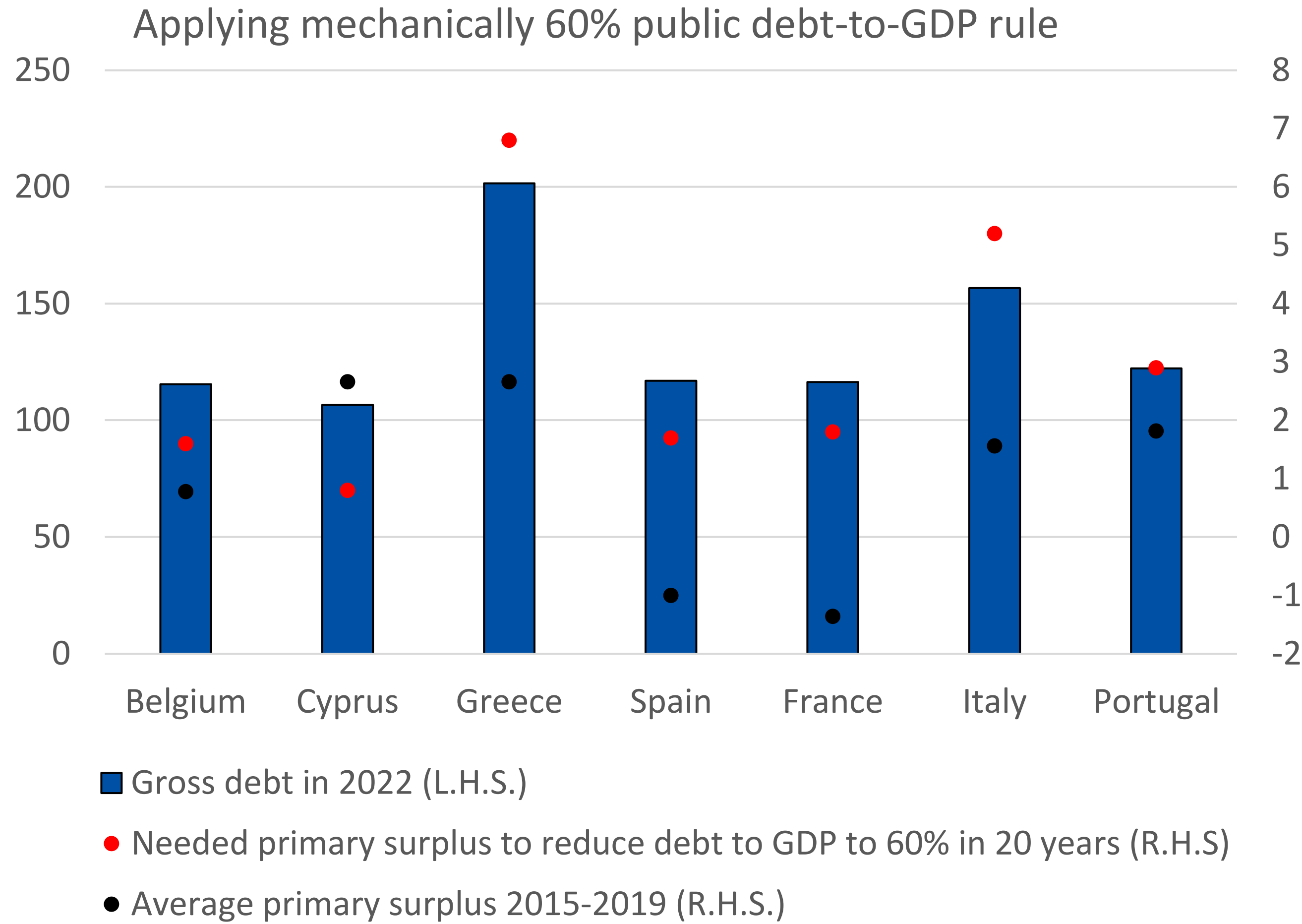
Deficit rule	Overall budget deficit should not exceed 3% of GDP
Debt rule	Gross public debt level should not be over 60% of GDP
Medium-term objective rule	Structural budget balance is at or above the medium-term objective
Expenditure rule	Spending increases of more than a country's medium-term potential economic growth rate must be neutralised by additional discretionary revenue measures
Fiscal effort rule	Decline in structural deficit ratio to be at least 0.5% of GDP in given year when structural deficit exceeded the medium-term objective in the previous year



Note: Average compliance in the years post Six Pack.

Twenty years of high primary surpluses needed for debt to fall below limit

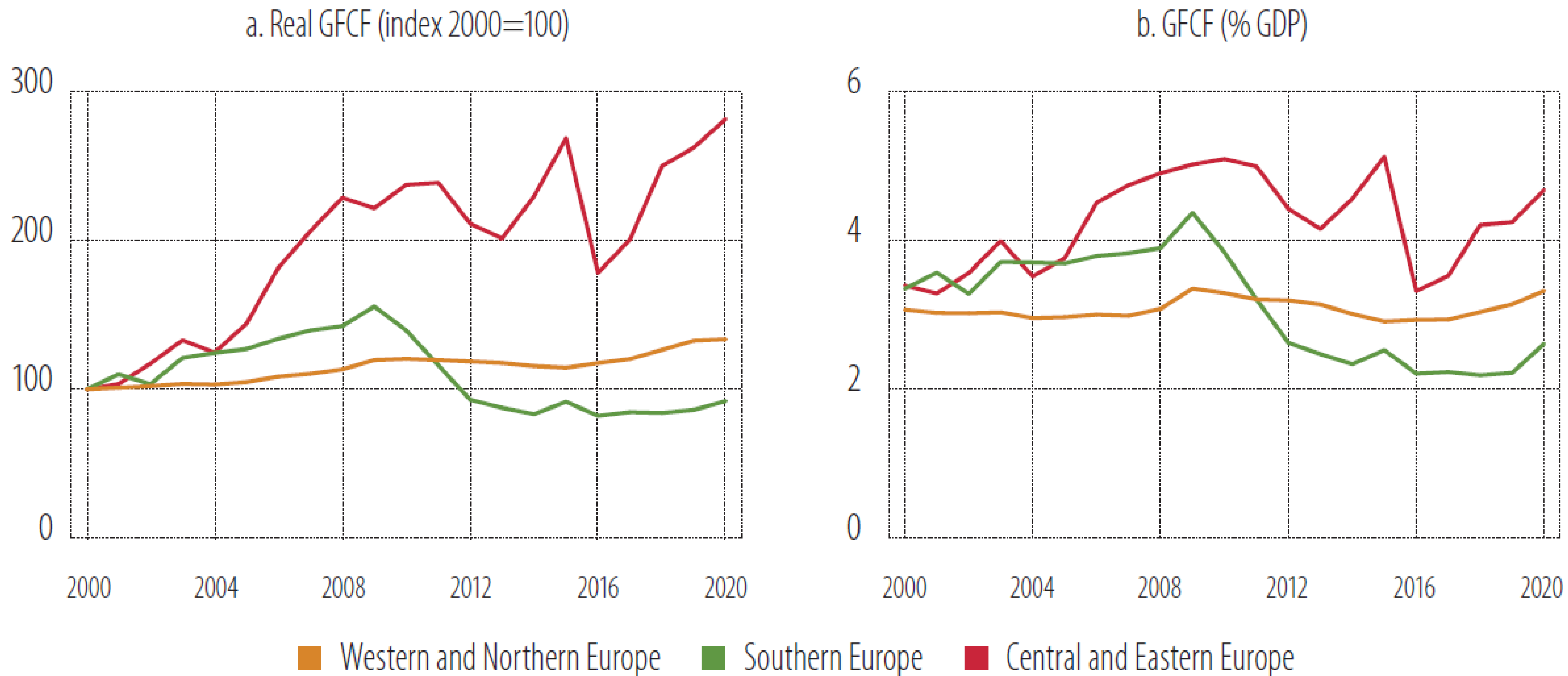
For highly indebted countries, an historic tightening of fiscal policy required for two decades in order for countries to comply with fiscal framework



- Reducing public debt to GDP to 60% in 20 years risks a premature and harsh fiscal consolidation for many countries
- Show here most indebted countries based on projections for 2022
- Calculate required primary surplus to meet the 60% debt limit in 20 years
- Assume a favourable scenario (average cost of debt as over 2015-2019 and average economic growth of 2000-2019)
- **20 years of close to/greater than 2% primary surpluses needed**
- Far above average primary surplus average that occurred over 2015-2019

Falling public investment following the 2008/09 global financial crisis

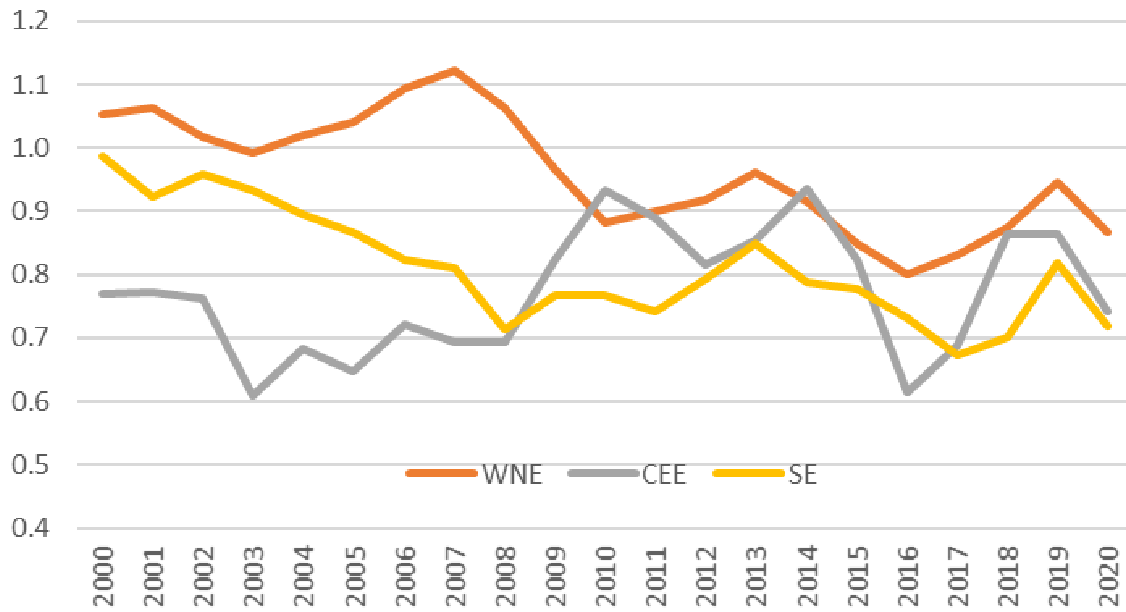
Public investment fell following the 2008/09 global financial crisis in EU economies facing fiscal consolidation pressures

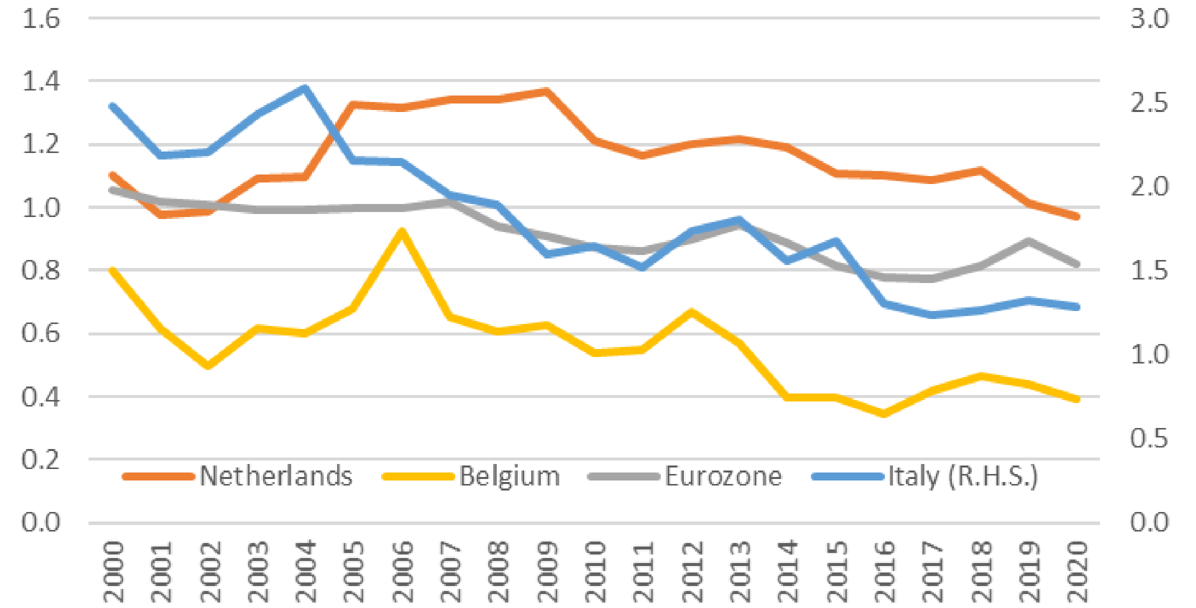


Source: Eurostat National accounts, EIB staff calculations.

Public investment declined particularly for local governments

Share of local government on central government investment, in SE and NWE





Importance for growth in protecting public investment

- **Investment boosts long-term GDP** and has positive spillover effects on GDP of other member states
  - Public investment's output multiplier around 1.4 (Kilponen et al., 2019; Gechert, 2015), i.e. substantially higher than for overall spending multipliers (1.0) and government consumption (0.8)
- Magnitude of the **investment multiplier depends on**:
  - Position in the cycle (Ramey, 2020) and degree of monetary accommodation (Bouakeza et al., 2017)
  - How additional government investment is paid for (de Jong et al., 2017)
  - How efficient processes informing the spending and selecting the projects are (IMF, 2015)
  - The degree of leverage and financial constraint of the corporate sector (Espinoza et al., 2020)
  - **What investment is directed at**:
    - Highway access may improve firm productivity (Holl, 2016), but road infrastructure may have important diminishing returns (Fernald, 1999)
    - Spending on renewable energy significantly more productive (spending multiplier of 1.1-1.5) than comparable fossil fuel investment (0.5-0.6) (Batini et al., 2021)
- Huge **green transition and digital transformation** investment needs; EU countries have committed to higher public investment for decarbonisation and have large investment gaps in digital infrastructure

Importance of the RRF

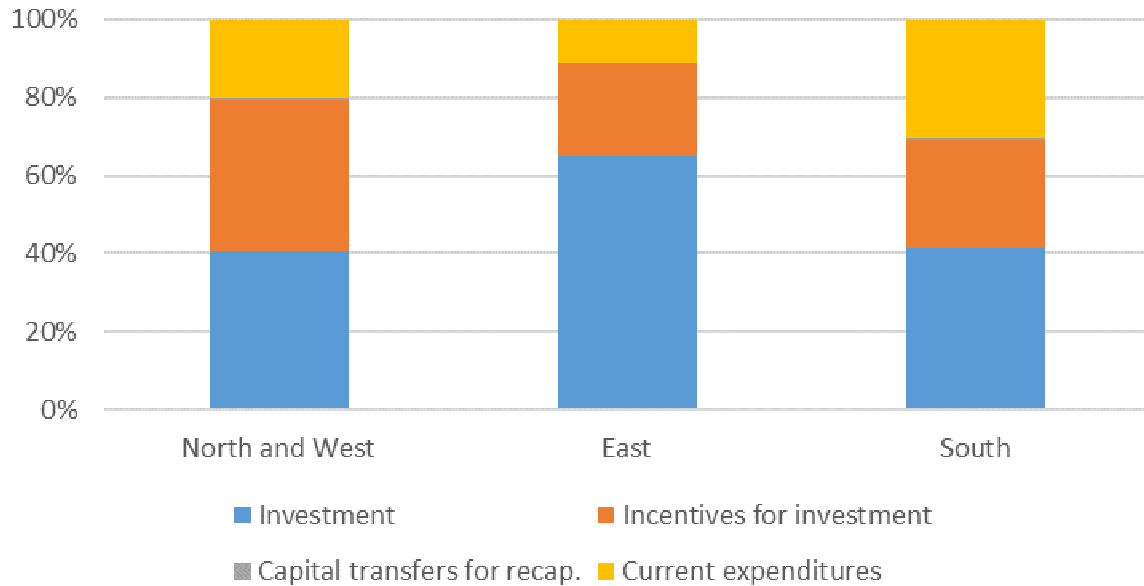
- **Not all is investment and not all has an impact on long term growth**

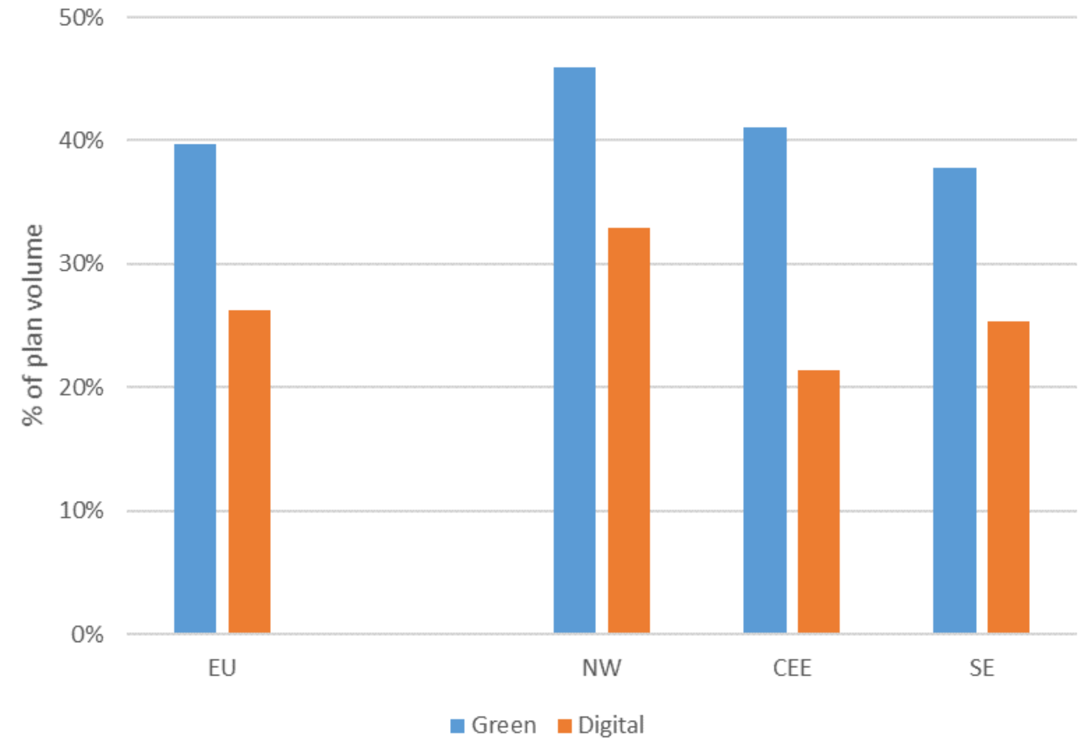
- But it has a potential for long term growth:
  - 5% larger economy in the South, 2.5% in CESEE, 0.7% in North and Western Europe
  - Country and EU agreed and resilient to future consolidation
  - Associated to reforms
  - Stress to administrative capacity of countries, with risks for diversion of resources

- **Implementation is crucial**

Even more important now

- **Not all is investment and not all has an impact on long term growth**





ANNEX: BACKGROUND

Political context: Reforming economic governance

Relaunched review likely to lead to legislative proposal in 1H2022

- **Background**: 19 October 2021 – Relaunch of economic governance reform debate, postponed after March 2020: Fiscal rules/Stability and Growth Pact, European Semester, and Macroeconomic Imbalance Procedure
- Some far-reaching reform proposals: preferential treatment for selected categories of investment; modification of 60% debt criterion, etc.
- European Commission considers **implementing the Recovery and Resilience Facility** as instrumental to building trust and consensus for possible reforms (e.g. supporting green & digital investments), as well as to enhance compliance with fiscal rules.
- **Procedure**:
  - Feb/Mar 2022, the EC will present "fiscal guidance" including first reform directions (too late to impact 2022 national Stability/Convergence Programmes, April)
  - 1H2022: Legislative proposal, depending on support from FR Presidency and DE coalition agreement.
- **EIBG relevance**: Opportunity – Gaining visibility on public investment (research, financing & advisory); Risk: Being marginalized by EC (avoiding preferential treatment for EU financing alone, e.g. RRF loans)

Stability and Growth Pact

General escape clause due to run out in 2023

Maastricht Treaty (1992)	Limits government deficits to 3% of GDP and public debt levels to 60%
Stability and Growth Pact (1997)	Sets out preventative and corrective rules
Medium-term budgetary objectives (2005)	Country-specific objectives are set, targets depend on indebtedness and potential growth rate

- **Main objectives**: Counter bias of governments to run fiscal deficits and ensure fiscal sustainability
- Further exceptions and qualifications to medium-term budgetary objectives added over time
- General escape clause activated in March 2020: Framework of European fiscal rules suspended in response to the pandemic. General escape clause to be deactivated from 2023 and the 2022 cycle of the EU semester back to normality.
- Satisfactory pace of debt reduction defined as a 1/20th decline in debt-to-GDP ratio on average over 3 years

EU Fiscal framework under question prior to Covid-19

Pandemic has underscored the need for reform

EC launched a public consultation on the design and reform of EU fiscal framework just before Covid-19. **Debate/stakeholder consultations re-launched on 19 October**

- **Fiscal sustainability** not ensured by framework
  - Public debt ratios increased above the 60% limit in many countries; a further rise during the pandemic presents an even bigger challenge to reduce debt gradually without impacting on growth
- Increase fiscal framework's **stabilization role across the economic** cycle by ensuring design
  - Fosters countercyclical fiscal policy: most EU countries have had weakly pro-cyclical fiscal policy
  - Builds up large fiscal buffers in good times
- Lack of focus on **protecting public investment**, and improving the composition/quality of public expenditure
  - No protection for capital spending (the most frequent victim of fiscal consolidation)
- **Simplify fiscal framework**; increase coordination, enforcement and national ownership
  - Large number of interpretative provisions added over time, complex set of rules
  - More formal role for national independent fiscal institutions
  - Increase coordination of policy responses at the EU and national levels (esp. for Euro area where a single monetary policy has to be coordinated with multiple fiscal policies)

Likely direction of reforms

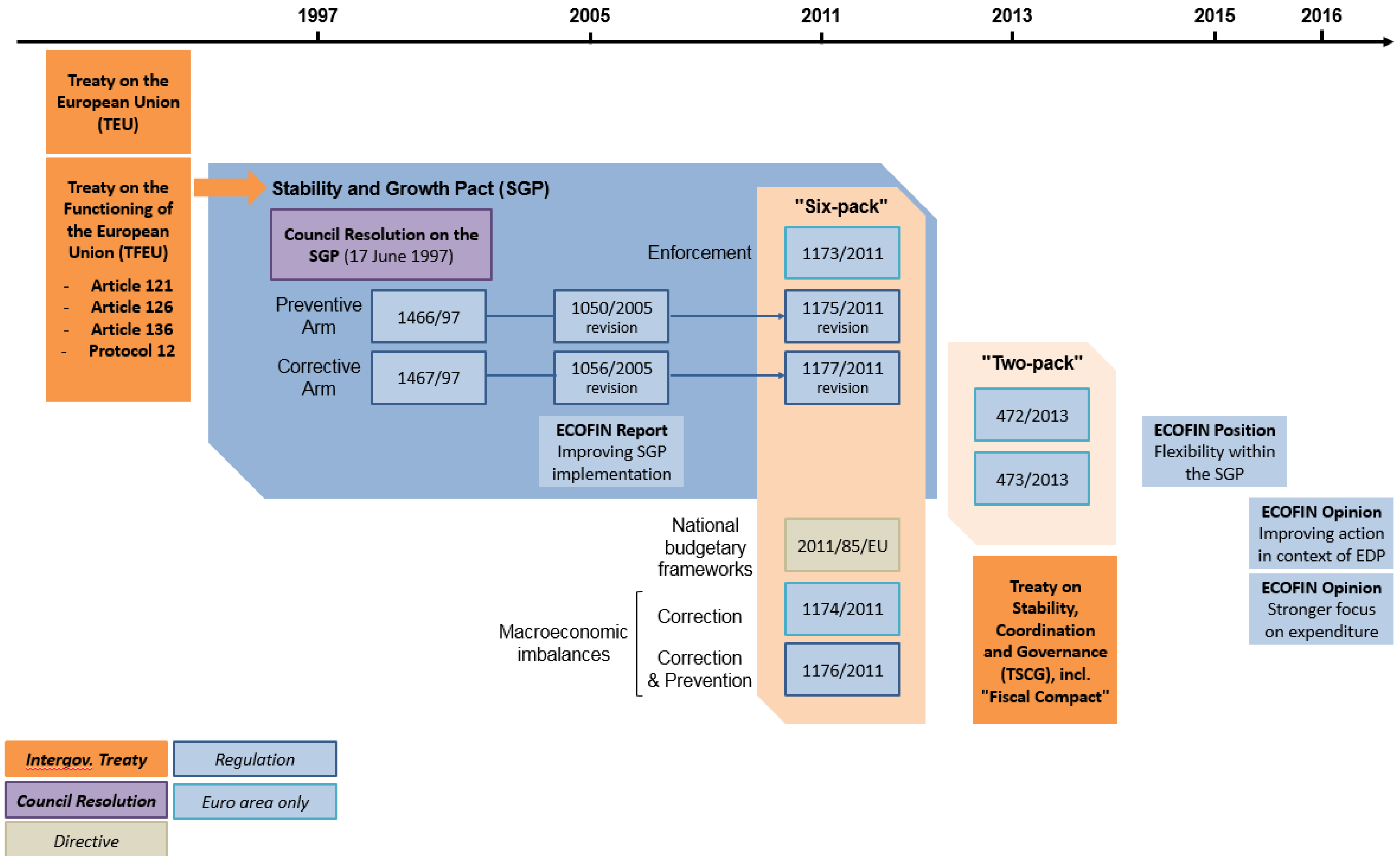
1. **Solution likely to involve simplification of operational rules.** Simpler operational rules (limiting the growth rate of primary expenditures) targeting a declining trajectory for public debt over the medium-term
2. **Incremental rather than fundamental reform** to current framework likely based on past experience
   - 3% Treaty reference value for the budget deficit remains
   - Changes would be likely to be implemented through secondary legislation
3. **Inbuilt mechanism to protect priority public investment**, possibly through Recovery and Resilience Facility-type framework
   - Create fiscal space (waivers) for green and digital investments that boost sustainable growth
   - Use design, governance and operation of the Recovery and Resilience Facility to support these priority public investments and associated reforms
   - Focus on green and digital investment

Timeline

- **19 October 2021** — Relaunch of the public consultation on the EU's economic governance framework
- **23 November 2021** — Autumn European Semester 2021 package (with Annual Sustainable Growth Strategy, Proposal for Euro Area Recommendations, Assessment of Euro Area Member States' 2022 Draft Budgetary Plans, Alert Mechanism Report and Proposal for a 2022 Joint Employment Report)
- **31 December 2021** — Deadline for submissions to the public consultation; online survey for citizens, organisations and public authorities
- **First quarter 2022** — EC will present **guidance for fiscal policy**, *with the purpose of facilitating the coordination of fiscal policies and the preparation of Member States' Stability and Convergence Programmes. The guidance will reflect the global economic situation, the specific situation of each Member State and the discussion on the economic governance framework. The Commission will provide orientations on possible changes to the economic governance framework with the objective of achieving a broad-based consensus on the way forward well in time for 2023.*

Cobweb of waivers introduced to fiscal framework over time

Major overhaul would not fit with past history of marginal changes – a new waiver for “green ” investment more likely



Proposals to reform fiscal framework

- **IMF (Gaspar)**. Simplify by shifting to a single fiscal anchor and a single operational target based, e.g., fiscal policy anchored on a medium-term debt ceiling achieved through a primary balance target or operational (nominal) spending target
  - ➢ Consolidates preventive (ensuring sound budgetary policies over the medium term) and corrective (appropriate policy responses to correct excessive debt) arms
  - ➢ Establish central fiscal capacity (European level) like the recently introduced SURE and Next Generation EU funds
- **Blanchard**. Ditch fiscal rules, develop fiscal standards with more credible enforcement
  - ➢ Base fiscal objectives on country-specific assessments using stochastic debt sustainability analysis, led by national independent fiscal councils and/or the European Commission
- **ESM's Klaus Regling**. 3% deficit limit remains relevant, rethink debt limit given higher debt-carrying capacity of governments than assumed in the Maastricht Treaty
- **European Fiscal Board**. Single anchor of 60% reference value for debt ratio translated into a single operational target of a constant ceiling on the growth rate of primary nominal expenditure net of discretionary revenue measures, for a determined time period taking into account potential growth

Proposals to reform fiscal framework

Authors	Purpose	Target	Tool	Methodology	Fiscal planning horizon	Protection of public investment	Options	Escape clauses / flexibility	Legal Feasibility according to authors	Governance
European Fiscal Board (2020)	Simplification, debt reduction, better enforcement	Debt/GDP ratio	Cap on net expenditure growth [primary expenditures at current prices, net of discretionary revenue measures and cyclical unemployment benefits]	The ceiling on net expenditure growth would be fixed for 3-years. The ceiling is then recalculated in year t+3. Following the new assessment, a new ceiling is set on the basis of the realised stock of debt and an updated macroeconomic scenario, so as to ensure that the 60% debt-to-GDP ratio is reached asymptotically	3 years	A limited golden rule option is explored, but no specific recommendations are provided within the proposed framework	Differentiation of debt targets according to the growth potential and interest rates environment	A general escape clause (possibly applicable for each country separately), parsimoniously applied and triggered on the basis of an IFI opinion and of a more independend DG ECFIN.	From changing the Treaty to adjusting the Code of Conduc, through changing the secondary legislation, depending on the level of ambition and the estambishment of a central fiscal capacity.	Central fiscal capacity, more independent ECFIN, and/or stronger IFIs, Council final decision on compliance
Darvas Z. et Anderson J. (2020)	Debt sustainability and stabilization	Debt/GDP ratio	Cap on net expenditure growth [Multi-year ceilings for primary expenditure corrected for discretionary unemployment expenditure and discretionary revenue changes]	No detailed methodology, but the multi-year target would be set by a "joint effort of the government of the country concerned, the national fiscal council, the European Fiscal Council and the European Commission, and be approved by the Council";	5 to 7 years	Asymmetric golden rule that excludes net public investment from the considered expenditure aggregate only in bad times, in a way to create extra fiscal space. This extra fiscal space would be gradually eliminated as the recovery strengthens	-	A single general escape clause (possibly applied to each member state separately) proposed by the Commission and approved by the Council, based on the opinions of the independent national fiscal council and the European Fiscal Council.	-	Stronger IFIs, enhanced EFB with directive council similar to ECB, sanctions replaced by incentives, political costs of non-compliance.
Hauptmeier S. et Kamps C. (2020)	Promoting a better policy mix by alignign fiscal policy with the ECB monetary policy objective.	Debt/GDP ratio as a symmetric target to reach from below and from above	Primary balance [Agnostic between expenditure rule and structural balance rule, provided that they are consistent with the debt-reduction strategy and with the require primary balance]	Nominal cyclical adjustment of the current debt rule, taking into account a multi-year snowball effects related to cyclical changes in primary balances (empirically rather small) and the impact of cyclical changes in inflation (empirically important).	Undetermined but implicitly left unchanged from current framework	No specific protection for investment, but the symmetry of the debt rule would create fiscal space for investment for the "avarage euro area member state"	Speed of debt reduction reduced from 20 to 30 years to make compliance more feasible	Not mentioned	Keep the current Treaty, but change the secondary legislation to reparametrize the debt rule and the definition of gross errors	-
Blanchard O., Leandro A. et Zettelmeyer J. (2021)	Address the externalities of fiscal policy by ensuring fiscal sustainability with a high probability	The sustainability of public debt	Fiscal standards [qualitative prescriptions that leave room for judgment together with a process to decide whether the standards are met]	Stochastic debt sustainability analysis, leading to the estimation of the probability that the debt-stabilizing primary balance exceeds the actual primary balance, which would require a correction.	No specific proposal, but reference to the New Zealand example, where a 4-year fiscal planning is established	Not mentioned in the latest draft of the paper, investment decisions are made by national authorities	-	Not required	From changing the Treaty to adjusting the Code of Conduc, through changing the secondary legislation, depending on the level of ambition and the estambishment of a central fiscal capacity.	Surveillance could be implemented by either the national IFI or the EFB in connection with the Commission, while a final decision on compliance could be taken by either the Council or the European Court of Justice

Proposals to reform fiscal framework

Authors	Purpose	Target	Tool	Methodology	Fiscal planning horizon	Protection of public investment	Options	Escape clauses / flexibility	Legal Feasibility according to authors	Governance
Martina P., Pisani-Ferry J. et Ragot X. (2021)	Simplification and debt reduction	Debt/GDP ratio	Cap on net expenditure growth [primary expenditures at current prices, net of cyclical unemployment benefits.]	Each government sets a medium-term debt target, assessed by the national IFI, based on estimates of the maximum primary balance and the risks to the interest rate–growth rate differential. The path for primary nominal expenditure net of new discretionary tax measures (and excluding automatic stabilisers on the expenditure side) would be determined accordingly.	5 years	No recommendation, but national IFI would assess impact of investment decisions on potential output	-	Establishment of a common flexibility factors to all MS and ensuring	Change in Protocol 12 of the TFEU, which requires unanimity but no national ratification	The EFB defines common methodology, to assess national fiscal sustainbility, while IFIs check on implementation; each government formally sets targets assessed by the IFIs. The Commission recommends endorsement to Council, then monitors implementation
Truger A. (2016)	Protecting and boosting investment	Unchanged from current framework	Unchanged from current framework, with an additional golden rule	Exclusion of government fixed capital formation as defined in the national accounts (net of military spending on weapons systems, plus grants to firms or non-profit organisations) from expenditures. The rule should apply to net investment, i.e. depreciation should be deducted for the rule to measure properly increases in the net public capital stock.	Unchanged	Golden rule	An upper limit for deductible net investment spending could be set at 1 or 1.5 per cent of GDP	Not mentioned	Change in secondary legislation for the exclusion of investment and change of Protocol 12 for the net investment interpretation	-
Bogaert (2016)	Protecting investment by updating the formula for the MTO calculation to allow for a lower (less stringent) MTO if the government increases the level of net investment sufficiently.	Medium-term objective	Structural balance as defined in the current framework	The new MTO formula foresees a replacement of the 60% debt target with a definition of "net assets", a reparametrization of the needed additional effort depending on the debt ratio, and the exclusion of net public investment	3 years	Through the new MTO formula, taking into account investment expenditure in the national accounts	An upper limit equal to the minimum benchmark could be set for set in the MTO path	Not mentioned	No change in the legal framework, Change in the Code of Conduct	-
IMF (2015)	Simplification and debt reduction	Debt/GDP ratio	Cap on net expenditure growth	Expenditures growth follows the potential outputgrowth adjusted for a debt stabilization component. A feedback mechanism between the anchor and the operational rule can either be formal (explicit), for example, in the form of an automatic debt correction mechanism, or less formal (implicit), for example, based on periodic ad hoc adjustments to correct deviations from the anchor.	Not specified	Not mentioned	Greater automaticity in enforcement. More credible sanctions, Better coordination of fiscal policy monitoring	Frome Treaty change to change in Regulations depending on ambition	Merging the preventing and the corrective arms of the SGP, greater automaticity in enforcement, more credible sanctions.	-

Options to protect investment under EU Fiscal framework

1. Golden rule aims to protect pro-growth capital expenditure
   - Golden rules put a ceiling on the overall deficit net of capital expenditure
   - Under a zero ceiling, borrowing only is allowed to finance investment and all current spending must be covered by revenues
   - Important what capital formation is targeted (net vs. gross, growth enhancing)
2. Variant whereby priority public investments, possibly in specifically high-externality area (like climate-related investment) could be deducted from the computation of total primary expenditures
3. A "Green Golden Rule" entails trade-offs (Darvas and Wolff, 2021)
   - Uncertain growth impact of green public spending; uncertain climate change risks to growth
   - Important role for policy in achieving transition important beyond public investment, particularly regulations and carbon emission pricing = need "Green Fiscal Pact"
4. Expand eligibility for current investment clause or structural reform clause
   - Current investment clause difficult as few countries would fulfill the condition that negative output gap should be greater than 1.5% of GDP
   - Structural reform clause allows a temporary deviation from the medium-term objective adjustment path by 0.5% percent of GDP
   - Exclude permanently all national co-funding of EU-supported investments