# Fiscal rules and public investment: Comments on the presentations of Andy King and Francesco Saraceno

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## Outline

1. Public investment during the crisis – 2 slides
2. Juncker-plan simulations (Saraceno) – 1 slide
3. Comments on the UK golden rule (King and Saraceno) – 1 slide
4. Comments on the new UK framework (King) – 3 slides
5. Public investment in the EU fiscal framework – 2 slides
6. My proposal for an asymmetric golden rule to be incorporated in the EU fiscal framework: – 4 slides
    - *golden rule in a deep recession*
    - *no golden rule during good times*

## 1. Public investment during the crisis

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

| | Greece, Ireland, Portugal, Spain | Italy | United Kingdom | 9 other EU15 | CEE12 | United States |
|---|---|---|---|---|---|---|
| Total expenditure | -9 | 1 | 8 | 9 | 9 | 9 |
| Interest expenditure | 48 | 15 | 79 | 2 | 27 | 89 |
| Primary expenditure | -12 | -1 | 5 | 10 | 8 | 4 |
| Social payments | 1 | 8 | 18 | 11 | 12 | 13 |
| Compensation of employees | -13 | -4 | 3 | 8 | 3 | 3 |
| Other current primary exp. | -18 | -6 | 0 | 10 | 12 | -12 |
| $\boxed{\text{Capital expenditure}}$ | -51 | -24 | -13 | 2 | -7 | 20 |

*Source: Bruegel using the AMECO database. Notes: **EU15** refers to member states before 2004. **CEE12** refers to the member states that joined the EU between 2004-2007.*



## 1. Public investment during the crisis, *cont'd*

### 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)

| | Greece, Ireland, Spain, Portugal | | Italy | | United Kingdom | |
|---|---|---|---|---|---|---|
| | Share (%) | % change | Share (%) | % change | Share (%) | % change |
| **Total** | **100** | **-36** | **100** | **-16** | **100** | **-12** |
| General public services | 6 | -44 | 16 | -16 | 5 | -42 |
| Defence | 2 | -65 | 3 | 42 | 11 | -19 |
| Public order and safety | 3 | -28 | 4 | -26 | 7 | -30 |
| Economic affairs | 46 | -28 | 32 | -15 | 21 | -18 |
| Environment protection | 6 | -40 | 9 | -14 | 5 | 5 |
| Housing and community amenities | 12 | -61 | 11 | -33 | 3 | -33 |
| Health | 7 | -44 | 9 | -13 | 15 | -23 |
| Recreation, culture and religion | 7 | -30 | 7 | -33 | 10 | 2 |
| Education | 10 | -37 | 7 | -14 | 21 | 12 |
| Social protection | 2 | -27 | 2 | 11 | 1 | 5 |

*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, and share in 2009 and the change from 2009 to 2011 in Italy and the UK.*

## 2. Juncker-plan simulations by Saraceno

- Fully agree to motivation: public investment is key

- Fully agree to main conclusions: Juncker plan is too little and too late

- I'm even more critical about the Juncker-plan:
  - No public investment is involved, but €21bn guarantee
  - Private investments will be "new", but not necessarily "additional"

- I'm sceptical if Saraceno's model is useful to assess the impact of the Juncker-plan:
  - Model assumes perfect foresight
  - Does not consider the coordinated fiscal stimulus in the EU in 2008/2009 (1% of GDP)
  - Does not consider the speed of fiscal consolidation in EU and USA
  - His results: when investment in period 2, EU is worse than the US by 3%; when investment in period 8, EU is worse by 11%: inconceivable



## 3. The UK golden rule

- **King and Saraceno disagree:**
  - **King:** previous UK's fiscal framework suffered from problems related to:
    - Dating the economic cycle
    - Backward looking approach
    - Optimistic revenue forecasts
  - **Saraceno:** do not mention these problems, but:
    - Emphasises conceptual advantages a golden rule
    - Quotes SVAR results for the UK, in which public investment is "*less important*" in the 1972-1997 than in the 1997-2004 sample
    - Proposes the same rule for the EU: "*balance the current budget over the business cycles*"
- **Dupont and Kwarteng (2012)** problems with previous UK framework:
  - It failed to bring the budget back into surplus, as it required a balanced current budget over the economic cycle
  - The government could always prolong a deficit as long as it could project surpluses in the near future
  - The rule gave politicians too much flexibility, left no room for error, and spending plans were based on over-optimistic forecasts

## 4. Comments on the new UK framework

- Given the weaknesses of the previous UK fiscal framework involving a golden rule, a change to the framework was needed

- However, none of the criticisms apply to the golden rule in itself (i.e. the exclusion of net public investment from fiscal targets), but to the rule on current budget: "*balance the current budget over the business cycles*"

- In fact, the golden rule remained in the 2010-15 framework, because the current balance remained the scope of the rule

- Augmenting the golden rule with a forward-looking rule for the current balance and the set up of the Office for Budget Responsibility to assess the structural budget position was great improvement

- But 2015 proposed new targets focus on the total balance. Why eliminate the golden rule?



## 4. Comments on the new UK framework, *cont'd*

- Some observations on the post-2007 fiscal frameworks:

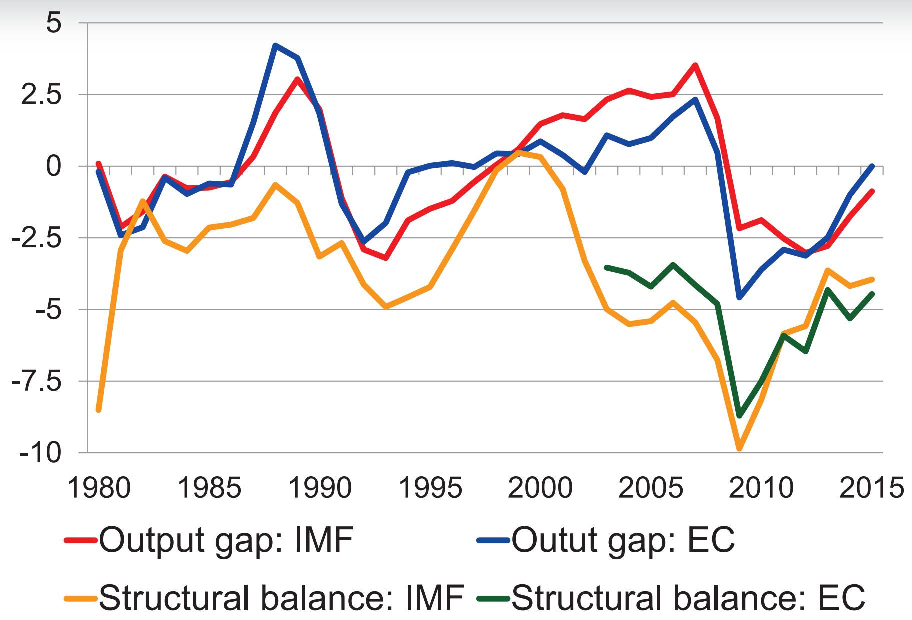
➢ **2008 temporary framework:**

- The stated goals were not well achieved: "*improve the cyclically adjusted current budget each year, once the economy emerges from the downturn*"
  - Previous slides: public investments were significantly cut
  - Next slide: strong fiscal tightening started when the output gap was well below zero

➢ **2010-15 framework:**

- The focus remained on cyclically adjusted budget, which depends on the output gap: an unobserved variable hard to estimate

## UK output gap and structural balance (% GDP)



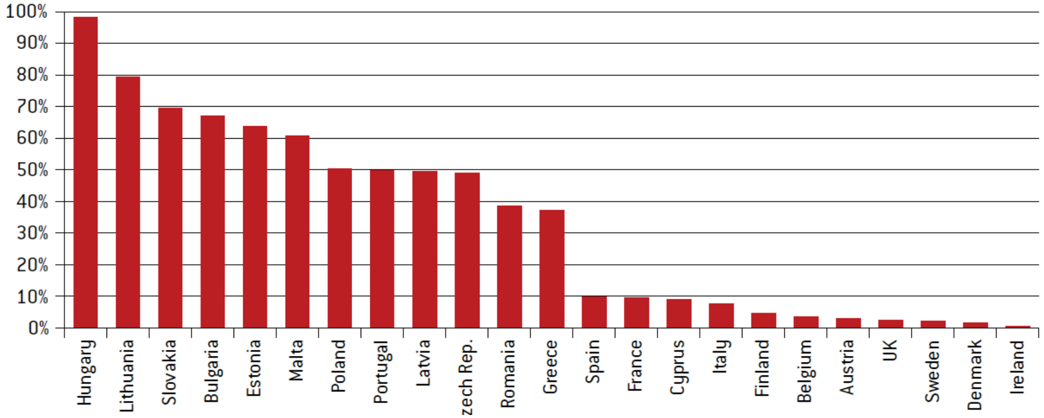



## 5. Public investment in the EU fiscal framework

- 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 these countries were in the corrective arm of the SGP when the recession hit



## 6. An asymmetric golden rule for Europe?

*Arguments against a 'standard' golden rule*

- Recall: "golden rule" = excluding public investment from fiscal rule indicators
- Arguments **against** a 'standard' 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.

## 6. An asymmetric golden rule for Europe?

*Arguments in favour of a 'standard' golden rule*

- Arguments **in favour** of a 'standard' 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).



## 6. An asymmetric golden rule for Europe?

*Net public investment during the crisis*

| | 2000-2009 average | 2008/09 | 2013 |
|---|---|---|---|
| **Greece** | 1.5% | 1.7% | -1.6% |
| **Ireland** | 2.5% | 3.7% | 0.2% |
| **Spain** | 2.1% | 2.7% | -0.7% |
| **Portugal** | 1.5% | 0.9% | -0.3% |
| **Italy** | 0.6% | 0.5% | -0.1% |
| **United Kingdom** | 0.8% | 1.7% | 1.0% |
| **EU15 Core** | 0.5% | 0.6% | 0.3% |
| **CEE12** | 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, Italy, UK and EU15 Core. EU15 Core denotes 11 of the EU15, except Greece, Ireland, Spain and Portugal. CEE12 denotes the 12 member states that joined the EU between 2004 and 2007.

## 6. An asymmetric golden rule for Europe?

*Our proposal*

- **1st best:** revision of EU fiscal rules and a European instrument for cyclical stabilisation
- **2nd best: asymmetric golden rule.** 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; improve the quality of public investment by budgeting, accounting, transparency and assessment reforms