



## **Public Finance in EMU Report 2016**

### **Frequently asked questions**

#### **What is the Public Finance Report?**

"Public Finances in EMU" is an annual report that provides a detailed overview of key policy developments and analytical findings in selected topics in this area. It contains some of the technical analysis that underpins the Commission opinions on the Draft Budgetary Plans of Member States and intends to feed annual debate in the domain of fiscal policy. The report is prepared by the European Commission's Directorate-General for Economic and Financial Affairs (DG ECFIN).

#### **How is the report structured?**

The report has four parts focusing on: (i) current developments in public finances in the EU and the euro area; (ii) recent developments in fiscal surveillance; (iii) government investments, and (iv) the fiscal stance in the euro area.

#### **Why is important to identify challenges to public finances?**

Governments are the largest economic actors and employers in most economies of the EU, providing essential public goods and services such as infrastructure, transport, schools, pensions and healthcare. On average, public expenditure accounts for almost half of GDP across the EU. Given their size, in certain circumstances governments can also play an important macro-economic role in the stabilisation of the economy. It is therefore important to discuss the role that governments can play in specific circumstances. On the one hand, the stabilisation role. On the other hand, the improvement of the sustainability of public finances and the financial health of the public sector. The latter is critical to the overall health of the economy and secures that the European social model remains functional in a context of population ageing. Carefully designed tax systems and efficient public expenditure can help boost growth, employment and competitiveness, and contribute to a fair distribution of income.

#### **What are the recent trends related to public deficit and debt in the EU?**

The aggregate general government deficit in the euro area is expected to fall by 0.3 pps. to 1.8% of GDP in 2016, thanks to improved growth, lower interest payments and past consolidation. The reduction in deficits is reflected in the lower number of Member States that are subject to an Excessive Deficit Procedure, namely four in the euro area (including Greece which is under a financial assistance programme) and two other EU Member States.

Public debt is receding slightly from its peak of 92% of GDP in 2015, benefiting from historically low interest rates, but debt levels remain very high, particularly in some Member States. Both deficit and debt ratios in the euro area are expected to continue declining in 2017, albeit at a slower pace than in previous years.

### **What are the key challenges and conclusions identified in the report?**

Governments need to strike the right balance between stabilising the economy and promoting growth (stabilisation) and maintaining sustainable public finances (sustainability). While the balancing between these two objectives ultimately requires political judgement, this report provides analytical food for thought by raising relevant methodological questions, listing possible solutions and highlighting their strengths and weaknesses.

The importance attributed to stabilisation and sustainability needs has to reflect country-specific situations. Differentiated national fiscal stances may thus contribute to an appropriate fiscal stance at the euro area level, addressing both stabilisation and sustainability concerns at the same time.

The budgetary composition is also relevant to address both concerns. In particular, an intensification of government investment expenditure would counteract the significant gap in government investment in Europe which, as the report shows, has materialised since the crisis.

### **What are the objectives of fiscal policy in the EU in the current economic context?**

The fiscal stance (measured as the change in the structural primary balance) reflects the orientation that governments give to fiscal policy to contribute to economic developments. A restrictive fiscal stance implies that additional revenues outweigh additional expenditures: *ceteris paribus* it aims to strengthen the sustainability of public finances. An expansionary fiscal stance implies providing stimulus to economic growth.

In response to the sharp increase in public debt during the crisis, the euro area fiscal stance first turned restrictive, with Member States undertaking significant consolidation efforts to safeguard financial stability in unprecedented circumstances and to respond to the risk of contagion across the euro area. In 2014-2015, the fiscal stance was broadly neutral. In 2016 and 2017, more Member States are expected to make their fiscal policy less restrictive.

In the current context of slow recovery and higher economic risks, and close-to-zero interest rates, the fiscal stance in the euro area Member States should promote growth. This can be achieved without damaging the sustainability of public finances in the longer term, provided that an appropriate geographical configuration for the aggregate fiscal stance is chosen.

As, at the Member State level, the stabilisation and sustainability objectives may not always point in the same direction, the question is what their relative weights should be and how trade-offs can be dealt with.

### **What are the criteria to take into account when deciding on the objectives of the fiscal stance in the euro area?**

Three main elements have to be taken into account when deciding on the appropriate balance between the objective of promoting growth and that of preserving the sustainability of public finances. First, whether the fiscal stimulus will be efficient to achieve the desired objective. Specifically in a situation in which monetary policy is already intensively mobilised and stands at the zero-interest floor, fiscal policy would be in a better position than usual to stabilise the economy. The case for consolidation can be made when the economy is booming or when monetary policy is not stretched and can by itself stabilise the economy.

Second, the need to avoid particularly critical developments, either on the macroeconomic side, with long-lasting effects on potential growth, or on the budgetary side, with a risk of losing market access for government bonds.

Third, the benefits of fiscal stimulus in terms of stabilisation need to be assessed against the costs in terms of increased risks to sustainability, and conversely, the benefits of fiscal consolidation in terms of improved sustainability need to be assessed against the costs in terms of risks to the fragile recovery.

Overall, in the current economic context, the absence of immediate risks to fiscal sustainability for the euro area as a whole, coupled with high risks that growth and inflation slow down, lends support to focusing further on stabilisation needs. Moreover, as interest paid on government debt is low and projected to remain so, the cost of rolling debt over is reduced.

### **How does the quality of public expenditure affect the impact of fiscal policy?**

The impact of fiscal policy does not only depend on the sign and size of the budget balance, but also on the quality of government expenditure and its composition. This is important for the fiscal stance to be growth-friendly, to support job creation and ensure social fairness. The report provides a snapshot of the efficiency and performance of public expenditure across Member States and for different functions: education, health, R&D, general public services, public order and safety, and infrastructure.

Zooming into a specific function of public expenditure, the report argues that government investment can provide a double dividend in terms of positive economic impact, boosting demand in the short term as well as supply in the long term.

### **What has been the evolution of public investment in the EU?**

The decline in government investment is not a recent phenomenon as it has been on a downward trend since the 1970s, but its current level is particularly low. Moreover, its recovery in the EU has been far weaker in comparison to previous crisis and stands now at lower levels than in other advanced economies. As a result of cuts during the crisis, euro area government investment in 2015 was 1 pp. of GDP lower than its 2009 level of 3.6% of GDP, as well as noticeably below its pre-crisis average of around 3.2% of GDP. This compares to investment-to-GDP ratios above 3% in both the US and Japan.

At the same time, the evidence presented indicates that the quality of existing infrastructure stocks may be at risk in Europe. The contraction in physical capital investment is also coupled with a reduction in the accumulation of human capital by the government sector. All these facts point to the existence of a wide and deep government investment gap.

### **Why do low investment constitutes a double source of concern, both for the short and the long term?**

First of all, as a component of aggregate internal demand, low investment spending is associated with fragile recoveries in the short term. Governments that base their adjustments on cutting investment may heavily depress growth as from the first year. Similarly, governments that want to boost the internal demand in the short term obtain a better result if they boost investments, as opposed to adopting other stimulus measures.

Secondly, persistently depressed government investment can have adverse long-term economic consequences through lower potential output. Government investments, like other expenditure items such as education expenditure, have a positive impact on the supply and on long-term growth, because they produce goods that are necessary to the developments of private productive investments.

### **How can investment maximise short-term stimulus on demand and boost long-term potential output?**

In some cases, the demand and supply effect may not be simultaneously attainable via increased government investment. This could happen, for example, when permitting procedures for investing in the most productive type of assets take too long. It can also be the case if, given the productive structure of the economy, ensuring an increase in national demand requires the purchase of less productive assets. In these cases, countercyclical fiscal policy should use other types of budgetary instruments, better-suited for generating an immediate flow of funds into the economy, like for example focussing on maintenance of assets.

Government investment strategies can instead focus on maximising their long-term impact on the potential performance of the economy. Member States can rebalance the composition of their public finances, expanding investment while reforming pension, health care and welfare systems. Historically low interest rates also facilitate an intensification of investment efforts.

Attaining the double dividend of short-term stimulus and long-term potential requires, on the one hand, carefully designed and comprehensive investment strategies and, on the other hand, a choice of investment projects for which adequate financing is available. This would not only ensure that adequate levels of public capital stocks are available in the long term but would also provide short-term stimulus at a time when the recovery is slow.

### **What are the possible explanations of the decline in government investment in the past decade?**

First the report rejects the actual capital accumulation hypothesis, which argues that either the durability or the quality of capital has improved. Since the asset mix held by the government sector has changed and the type of activities in which governments' assets are put in use has evolved over time, it can well be that government capital assets have become more durable or that government has become a more efficient investor over time. This does not seem true, as this alone cannot explain the observation that European public capital-to-output ratios are lower than those of other advanced economies.

Second, the report rejects the hypothesis that core infrastructure has reached its saturation point, as there appears to be underinvestment in road and rail infrastructure in certain Member States with lower infrastructure quality. Moreover, considerable further efforts are required to meet several priorities in the EU infrastructure agenda, including the deepening of the internal market and the transition to a low carbon economy.

Finally, the report rejects the hypothesis that spending has been shifted towards other non-capital categories of growth-enhancing spending such as education or R&D, which represent an "investment" in the broad sense in the future productive capacity. Indeed, the crisis led to cuts in both welfare and long-term spending as a share of GDP. However, while the former started to increase already in 2012, mostly related to unemployment benefits, spending for the long term is still on a declining path.

*Download the full publication [here](#)*