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Making public finances more growth and equity-friendly in the euro area

Álvaro Pina

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MAKING PUBLIC FINANCES MORE GROWTH AND EQUITY-FRIENDLY IN THE EURO AREA

ECONOMICS DEPARTMENT WORKING PAPERS No. 1316

By Álvaro Pina

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ABSTRACT/RÉSUMÉ

Making public finances more growth and equity-friendly in the euro area

Across the euro area, the ability of public finances to support equitable growth has tended to deteriorate. Concerns about high and rising public debt, together with market pressure in some cases, led to sharp fiscal consolidation in 2011-13, against the backdrop of a weak economic situation at the time, which is considered to have made the recession deeper and longer. Consolidation has slowed down afterwards, but countries with fiscal space have made limited use of the leeway allowed under EU fiscal rules to support euro area aggregate demand. The expenditure composition has generally become less growth-friendly, with large cuts in public investment. On the revenue side, already high taxes on labour have tended to increase further. Structural reforms with direct positive implications for the composition or efficiency of public finances have stalled.

While most policy levers to improve public finances remain at the country level, European and national policies can be mutually reinforcing in fiscal governance and public investment. To achieve a euro area fiscal stance that fosters the recovery, countries with fiscal space under the Stability and Growth Pact rules should use budgetary support to raise growth, and existing incentives and flexibility should be taken advantage of to pursue reforms of tax and spending policies. At the national level, it is essential to further upgrade budgetary frameworks, including through the adoption of expenditure rules and regular performance of spending reviews. To promote capital formation and make it more effective, EU budget resources for investment should be deployed in a way to crowd in national public funds and private financing, and foster greater investment productivity. At the national level, better coordination of investment across levels of government and upgraded administrative capacity would increase investment efficiency.

This Working Paper relates to the 2016 OECD Economic Survey of the euro area
(www.oecd.org/eco/surveys/economic-survey-european-union-and-euro-area.htm)

JEL classification codes: E62, F45, H20, H50, H54, H61
Keywords: euro area, fiscal consolidation, composition of public finances, Stability and Growth Pact, fiscal rules, fiscal councils, European regional policy, Investment Plan for Europe, public investment

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Rendre les finances publiques plus favorables à la croissance et à l'équité dans la zone euro

Dans la zone euro, la capacité des finances publiques à soutenir la croissance équitable s'est globalement détériorée. Face aux inquiétudes suscitées par le niveau élevé et croissant de l'endettement public, et parfois sous la pression exercée par les marchés, les autorités des pays ont procédé à un effort d'assainissement budgétaire massif en 2011-13 dans un contexte de conjoncture économique défavorable, ce qui est généralement considéré comme ayant contribué à intensifier et à prolonger la récession. Le processus d'assainissement s'est ensuite ralenti, mais les pays disposant d'une marge de manœuvre budgétaire ont peu utilisé la souplesse autorisée par les règles budgétaires de l'UE pour stimuler la demande globale dans la zone euro. De manière générale, la composition des dépenses est devenue moins favorable à la croissance du fait de coupes drastiques dans les investissements publics. Sur le plan des recettes, la fiscalité du travail, déjà élevée, s'est encore alourdie. Les réformes structurelles qui peuvent avoir des retombées positives directes sur la composition ou l'efficience des finances publiques ont marqué le pas.

Si la plupart des leviers d'action permettant d'améliorer les finances publiques restent situés au niveau des pays, les politiques européennes et nationales peuvent se renforcer mutuellement dans les domaines de la gouvernance budgétaire et de l'investissement public. Pour faire en sorte que l'orientation budgétaire de l'ensemble de la zone euro contribue à alimenter la reprise, les pays qui disposent d'une marge de manœuvre budgétaire au sens des règles du Pacte de stabilité et de croissance devraient recourir à l'appui budgétaire pour stimuler la croissance, et il faudra mettre à profit les dispositifs d'incitation existants et la souplesse prévue par les règles en vigueur pour poursuivre la réforme des politiques fiscales et de dépenses. Au niveau national, il est essentiel de poursuivre l'amélioration des cadres budgétaires, y compris en adoptant des règles de dépenses et en procédant à des examens réguliers des dépenses. Pour promouvoir la formation de capital et rendre celui-ci plus efficace, les ressources budgétaires de l'UE disponibles pour l'investissement devraient être déployées de façon à créer un effet d'attraction sur les fonds publics et les financements privés nationaux et à rendre l'investissement plus productif. À l'échelon national, des investissements mieux coordonnés entre les différents niveaux d'administration et des capacités administratives renforcées conféreraient aux investissements une efficience accrue.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de la Zone euro 2016
(http://www.oecd.org/fr/economie/etude-economique-union-europeenne-et-zone-euro.htm)

Classification JEL: E62, F45, H20, H50, H54, H61
Mots clef: Zone euro, assainissement budgétaire, composition des finances publiques, Pacte de Stabilité et de Croissance, règles budgétaires, organismes budgétaires indépendants, politique régionale européenne, Plan d'investissement pour l'Europe, investissement public

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MAKING PUBLIC FINANCES MORE GROWTH AND EQUITY-FRIENDLY IN THE EURO AREA

By Álvaro Pina [1]

There is strong potential to improve growth and equity through better public finances

Public finances matter for growth and equity through multiple channels

Fiscal policies and instruments can help to achieve major socio-economic goals, such as providing cyclical stabilisation, promoting long-term economic growth and addressing redistributive objectives. Sustainability, cyclicality, and composition and efficiency of taxation and spending are crucial, interconnected dimensions of public finances and affect growth and equity through a variety of channels.

Ensuring debt sustainability and smoothing cyclical fluctuations tend to be mutually reinforcing. High levels of debt can hamper the ability to stabilise the economy (Fall and Fournier, 2015). In turn, deep recessions can harm long-term growth and thus compound sustainability challenges through hysteresis effects. Certain changes in the composition of expenditure, such as greater prioritisation of public investment or education, or of revenue, such as shifting taxation from labour to consumption and property, can also support growth (Johansson et al., 2008; Cournède et al., 2013). The same holds for reforms of a more qualitative nature, such as broadening tax bases or greater efficiency in spending.

In advanced economies, reforms of the composition of public finances can lift gross domestic product (GDP) per capita growth by close to 1 percentage point over 5 to 10 years (IMF, 2015a). Among OECD countries, making the composition of expenditure converge to that of the best performers (for instance, by increasing the share of public investment) could yield even larger growth payoffs (Fournier and Johansson, 2016).

Fiscal policy also affects income distribution. Effective cyclical stabilisation tends to decrease inequality by reducing the risk of long-term unemployment. The tax-spending mix of consolidation episodes also matters for inequality, with spending-based episodes generally more harmful than revenue-based ones (Woo et al., 2013). This creates potential trade-offs between equity and other objectives, since spending-based consolidations are often regarded as more favourable to long-term growth and more likely to stabilise debt (Molnar, 2012). At a more disaggregated level, some changes in budget composition may also pose growth-equity trade-offs, such as when shifting taxation from direct to indirect taxes, but others are beneficial on both counts, such as when increasing the share of education in public spending (Fournier and Johansson, 2016). Greater prioritisation of spending on health, childcare and active labour market policies, accompanied by steps to preserve or enhance efficiency levels in those areas, is also likely to benefit both growth and equity (Cournède et al., 2013; OECD, 2015a).

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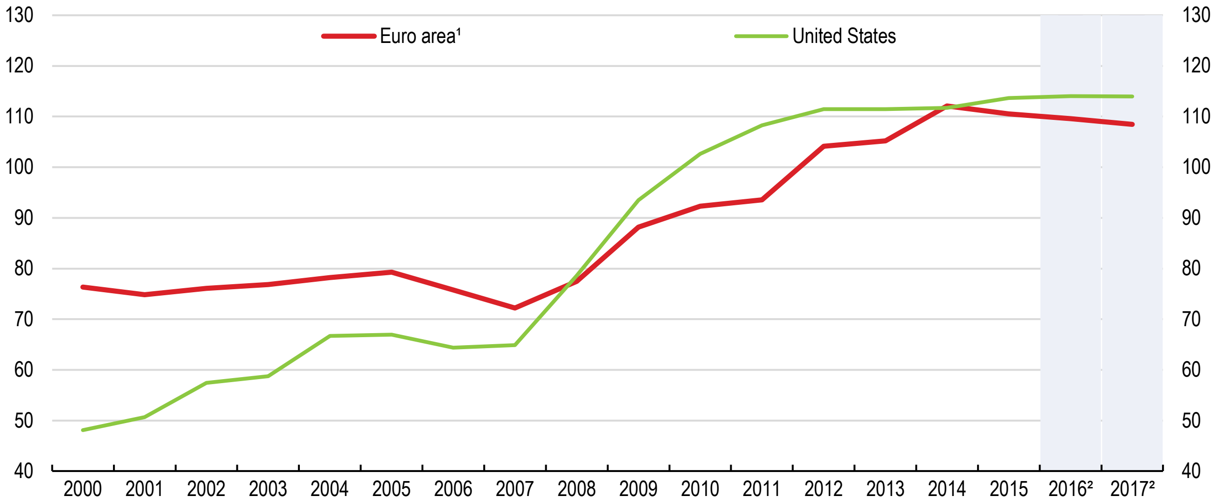
Coordinated action by euro area countries, harnessing national and common institutions and policies, is needed to make fiscal policy more supportive of inclusive growth. Countries with fiscal space within the boundaries of the Stability and Growth Pact should take account of the positive spillover effects of domestic fiscal expansion onto other Member States and contribute to aggregate demand in the euro area. Member states should also further improve their budgetary frameworks, including by adopting expenditure rules, conducting spending reviews and implementing the ensuing recommendations, and exploring the full potential of independent fiscal institutions. This would support debt sustainability and cyclical stabilisation objectives, and would also help the implementation of reforms in the composition and efficiency of taxation and public spending. To tackle persistent investment weakness in Europe, these reforms should include coordinated efforts to increase public investment and make it more efficient, and to create better financial and regulatory conditions for private investment.

The crisis has taken a heavy toll on public finances

On several counts, euro area public finances worsened as a consequence of the global financial crisis. The increase in public debt was substantial and broadly comparable to that in the United States (Figure 1), largely due to the recession and to specific events, such as banking sector rescues (Eyraud and Wu, 2015). Support to the financial sector has also implied sizeable levels of contingent liabilities. High actual and contingent debt can weaken fiscal sustainability: it can notably trigger shifts in market sentiment, which could make debt financing more difficult. High debt levels also tend to be associated with lower growth, though no firm conclusions have been reached on the direction of causality in the empirical literature (e.g. Panizza and Presbitero, 2014).

Figure 1. Evolution of gross public debt in the euro area and the United States

General government gross financial liabilities as a percentage of GDP



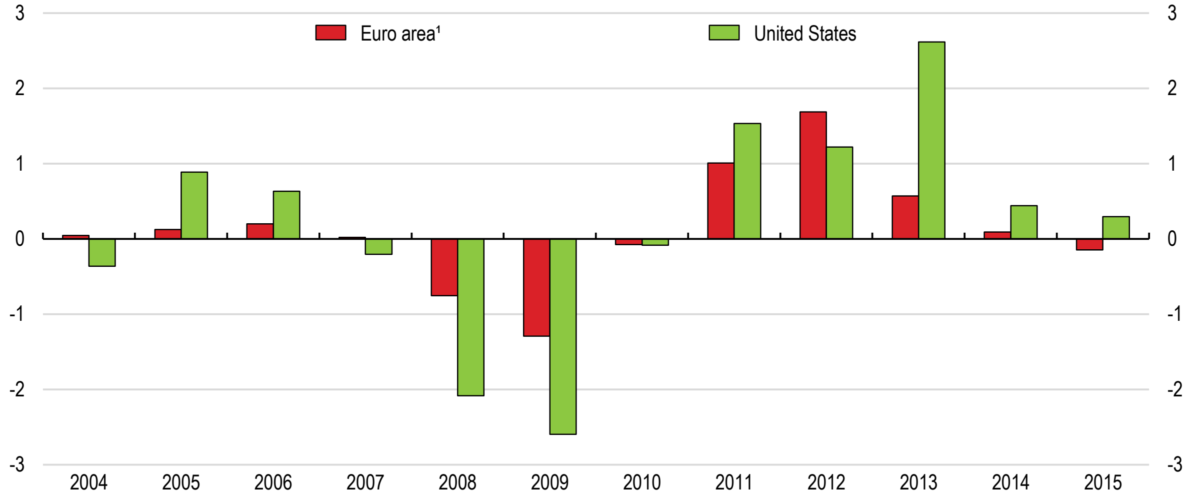
1. Euro area member countries that are also members of the OECD (15 countries).
2. Projections.

Source: OECD (2016), "OECD Economic Outlook No. 99", *OECD Economic Outlook: Statistics and Projections* (database).

Concerns about high and rising debt, together with market pressure in some instances, led to sharp fiscal consolidation, especially in 2011 and 2012, and to a lesser extent 2013 (Figure 2). All euro area countries, including those which are usually considered to have a solid fiscal position, have undertaken consolidation efforts, which in several cases were well above 1 percentage point of GDP per year (Figure 3). Fiscal consolidation in the United States in 2011-13 was even larger, but came after an equally larger fiscal stimulus in 2008-09 and was accompanied by a more supportive monetary policy and a faster resolution of non-performing loans.

Figure 2. The fiscal stance in the euro area and the United States

Change in the underlying balance as a share of potential GDP, percentage points

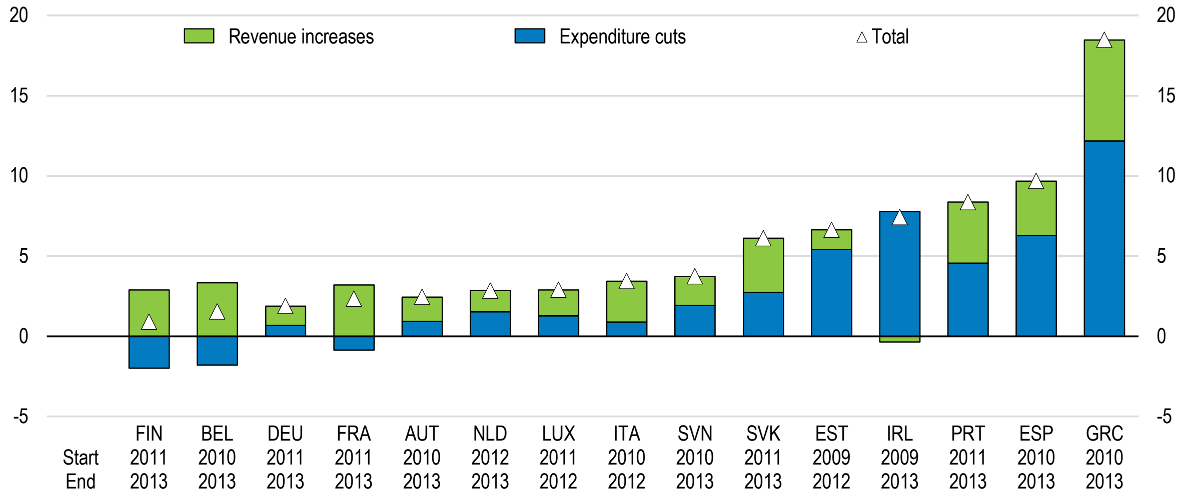


1. Euro area member countries that are also members of the OECD (15 countries).

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

Figure 3. Post-crisis fiscal consolidation episodes: change in the underlying primary balance[1]

Percentage points of potential GDP



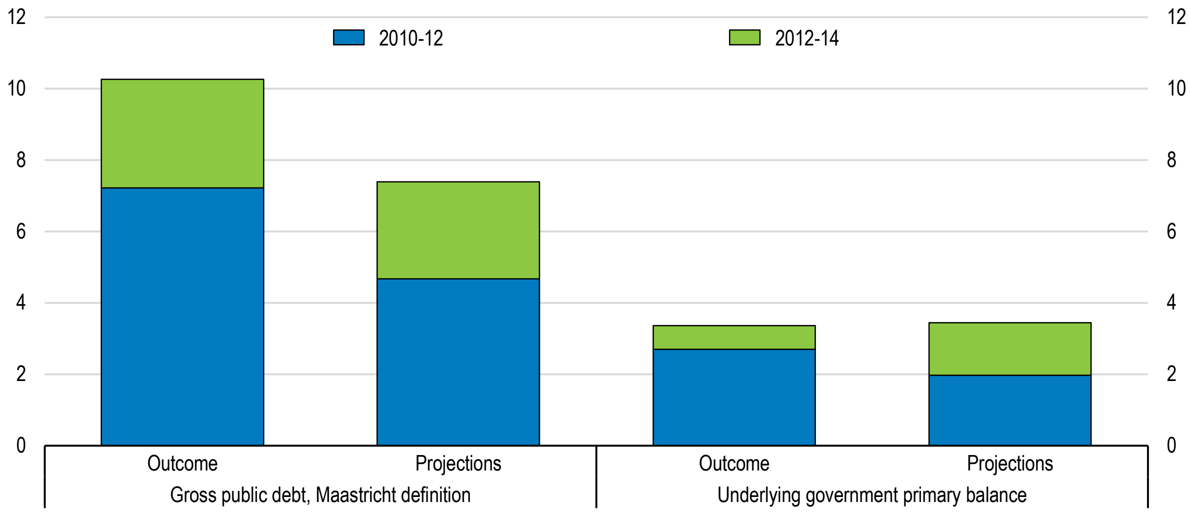
1. A fiscal consolidation episode is a period of consecutive years where the underlying primary balance is improving. A deterioration of this balance in an intermediate year is admissible, provided the balance improves in the sum of any two adjacent years. Episodes considered in the chart are those starting in 2009 or later. Due to data limitations on the composition of consolidation, the final year considered is 2013, though for some countries consolidation efforts have continued afterwards.

Source: D. Gonçalves and Á. Pina (2016), "The composition of fiscal consolidation episodes: Impacts and determinants" and D. Bloch et al. (2016), "Trends in public finance: insights from a new detailed dataset", both *OECD Economics Department Working Papers*, forthcoming.

Even though delivered on a scale broadly comparable to plans, fiscal consolidation had a smaller-than-expected payoff in terms of halting the debt build-up (Figure 4), largely because of weak growth. Although estimates of the magnitude of spillovers vary across studies, fiscal consolidation in one country can have a sizeable negative growth impact on others, especially in bad times (Goujard, 2013; Carnot and Castro, 2015). As a result, the simultaneous fiscal adjustment across the euro area, including in core countries, is considered to have made the recession deeper and longer (Baldwin et al., 2015). Within individual countries, the impact of consolidation on output, which tends to be larger in downturns and for spending cuts, may also have been underestimated, though the evidence is not fully conclusive (Blanchard and Leigh, 2013; Pain et al., 2014).

Figure 4. Fiscal consolidation and debt dynamics: projections and outcomes[1]

Change in percentage points of GDP[2]



1. Projections are taken from the *Economic Outlook* (EO) datasets available at the end of 2010 and 2012: projections for 2010-12 (the difference between projected values for 2012 and 2010) are taken from EO No. 88 and projections for 2012-14 are from EO No. 92. The source for outcomes is EO No. 99.
2. Potential GDP for the underlying primary balance.

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

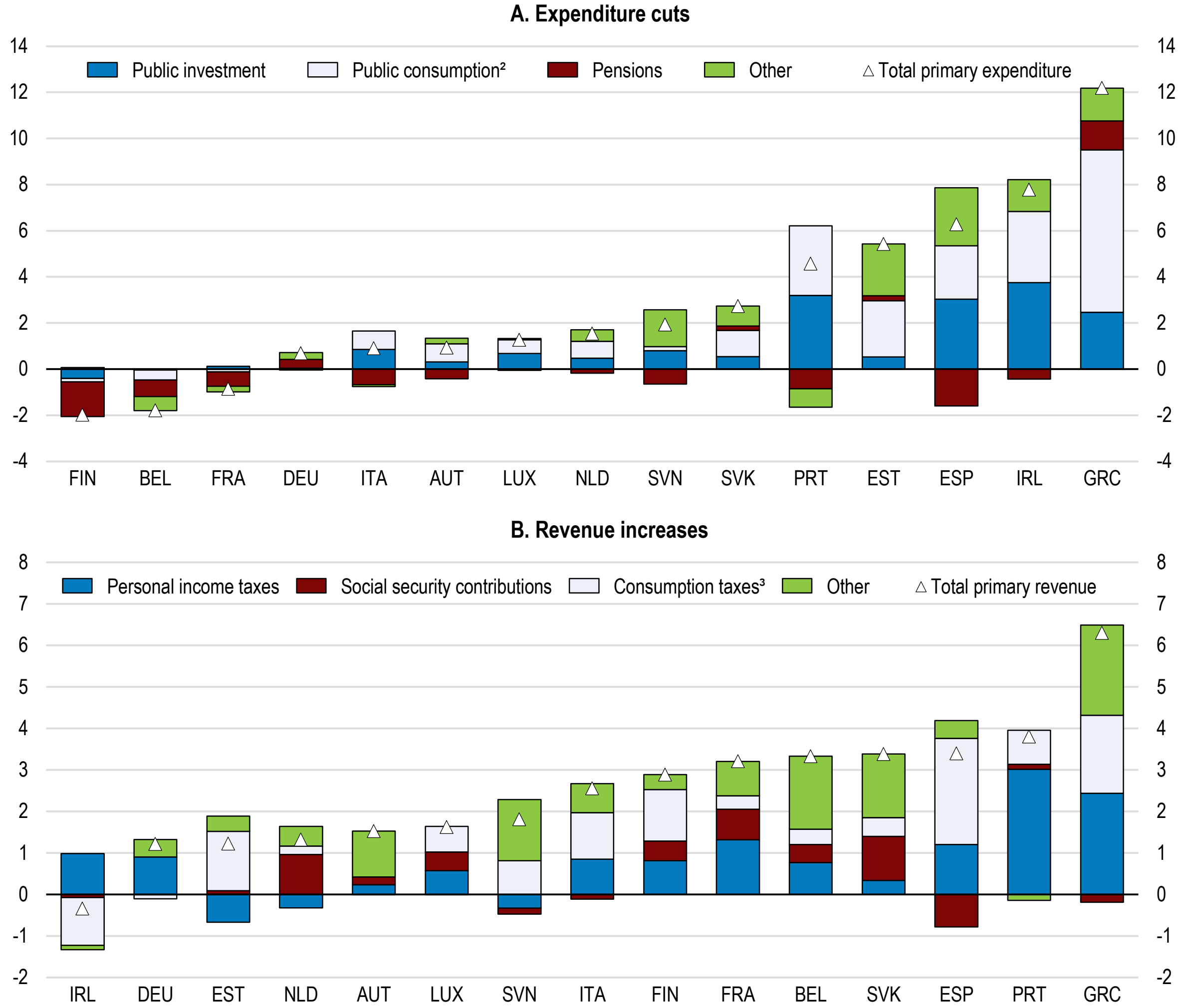
Furthermore, shifts in expenditure composition have generally been detrimental to equity and longer-term growth, especially in the countries carrying out the largest fiscal adjustments. Spending restraint has fallen heavily on public investment (Figure 5), which in the countries hit hardest by the crisis was often more than halved in nominal terms (Table 1), falling as a share of GDP to values below the euro area average. In those countries, public consumption, including for education and health care purposes (Table 1), was also substantially curbed. In contrast, pensions have tended to be spared. Though making modest contributions to overall consolidation, social protection spending on family and children (comprising cash transfers and in-kind services and benefits) has often taken deep cuts (again, mostly in countries making the largest consolidation efforts).

Developments in revenue composition have been less harmful, but still a matter of concern. Often the largest stream of revenue, social contributions have tended to account for a modest share of the adjustment, especially in the countries worst hit by the crisis. This is welcome, given the potential negative impacts of social contributions hikes on both growth and equity (Cournède et al., 2013). The brunt of revenue increases has come from the two other largest items, consumption taxes (other than environmental ones) and especially personal income taxes (Figure 5). Hikes in the latter can make income distribution less unequal but tend to penalise employment and growth, especially when implemented through rate increases.

Labour tax wedges in euro area countries, already high in international comparison, have tended to rise further (Figure 6). More recently, many euro area countries are planning or implementing labour tax reductions, though measures could be more ambitious (European Commission, 2015a). Unlike on the spending side, some positive developments have taken place as regards smaller revenue items, such as property or green taxes (Table 1). Recurrent taxes on immovable property, which tend to be among the least distortive forms of taxation, have often been substantially increased. In some countries, revenue from environmental taxes has also outpaced total primary revenue.

Figure 5. Post-crisis fiscal consolidation episodes: contributions from revenue and expenditure[1]

Percentage points of potential GDP



1. Fiscal consolidation episodes are the same as those in Figure 3. On both revenue and expenditure sides, increases or decreases in cyclically-adjusted budget items do not always relate to discretionary policy measures. For instance, tax elasticities can fluctuate for reasons not captured by the corrections performed for the economic cycle and for one-offs.
2. Education, health, other wages and intermediate consumption.
3. Other than environmental taxes.

Source: D. Gonçalves and Á. Pina (2016), "The composition of fiscal consolidation episodes: Impacts and determinants" and D. Bloch et al. (2016), "Trends in public finance: insights from a new detailed dataset", both *OECD Economics Department Working Papers*, forthcoming.

Table 1. Post-crisis fiscal consolidation episodes: cumulative change in revenue and expenditure items[1]

Cyclically adjusted data in current prices, percentage change over the episode

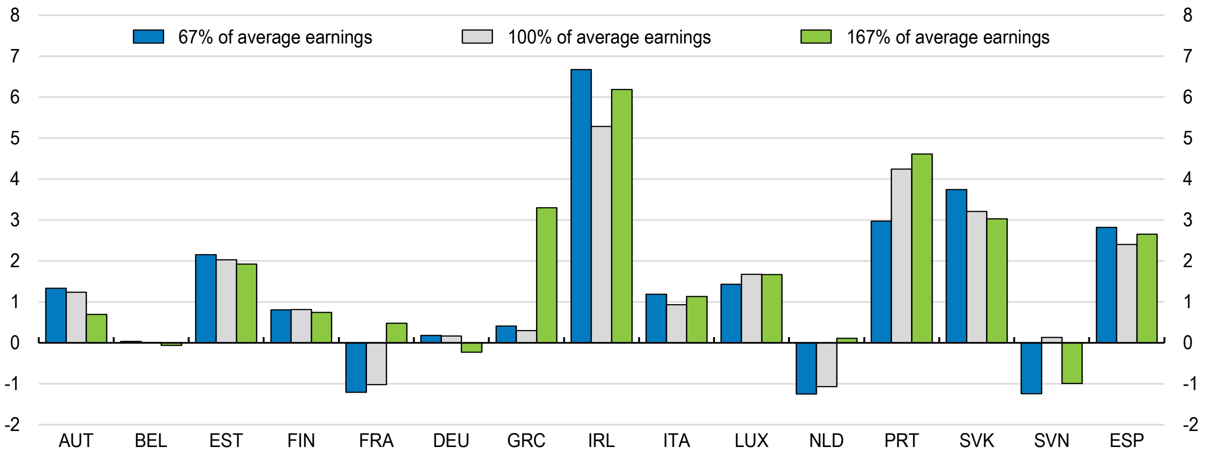
	AUT	BEL	EST	FIN	FRA	DEU	GRC	IRL	ITA	LUX	NLD	PRT	SVK	SVN	ESP
Total primary revenue	**15.6**	**20.1**	**22.6**	**16.2**	**12.4**	**11.6**	**9.1**	**4.6**	**8.4**	**19.5**	**7.6**	**10.9**	**24.3**	**7.6**	**13.2**
Personal income taxes	14.3	19.6	5.2	17.3	23.7	19.7	42.1	17.7	10.9	23.3	-0.1	57.3	26.4	-2.6	21.2
Social security contributions	13.5	15.3	19.6	14.3	9.9	8.5	-7.2	4.2	1.7	19.5	11.3	2.4	22.9	2.1	-3.1
Corporate income taxes	44.8	49.4	7.4	8.9	28.8	27.1	-25.8	-9.8	4.3	8.2	7.9	21.6	34.4	-30.5	0.0
Environmental taxes	8.8	5.1	42.7	19.7	11.1	3.1	42.2	8.3	17.5	13.6	1.5	-9.4	7.0	22.8	20.5
Other consumption taxes	12.0	17.3	36.9	23.2	9.0	7.3	13.7	-8.5	14.7	23.8	7.2	9.6	19.3	11.7	52.0
Taxes on immovable property	7.3	15.7	46.4	20.3	12.0	5.6	357.2	58.6	140.4	24.9	28.1	34.0	26.9	26.7	58.5
Other property taxes	85.1	48.7	. .	39.0	14.5	34.9	-5.4	9.7	-41.9	23.6	-11.7	-6.9	-63.4	-14.3	4.8
Sales of goods and services	13.2	22.8	12.7	12.0	6.5	18.2	-27.5	8.3	9.7	29.0	-1.5	-1.7	43.2	33.4	4.7
Other primary revenue	39.2	32.7	25.2	3.4	2.5	0.7	8.6	-6.4	2.8	5.0	28.2	-17.2	24.5	26.5	-12.5
Total primary expenditure	**9.9**	**16.4**	**3.4**	**14.1**	**7.3**	**6.8**	**-28.2**	**-14.3**	**0.6**	**11.6**	**0.8**	**-8.8**	**5.5**	**-1.2**	**-12.0**
Education	8.2	18.7	-2.3	5.3	4.2	8.5	-15.2	-16.3	-7.7	14.9	-0.2	-8.6	18.3	-1.1	-10.9
Health	10.7	15.4	10.2	14.2	7.5	9.9	-42.5	-10.8	-0.5	8.8	4.5	-12.0	6.4	2.4	-11.2
Other wages and intermediate consumption	5.2	11.4	5.9	10.8	6.2	8.0	-36.3	-11.8	-0.3	9.6	-1.4	-15.3	3.0	4.4	-7.0
Pensions	15.5	20.9	14.9	26.7	10.7	4.8	-14.0	16.6	7.3	14.5	7.2	8.7	10.2	9.5	22.6
Sickness and disability	13.0	19.8	1.7	11.0	10.4	12.6	-32.6	-7.7	-1.5	12.8	-1.5	2.5	12.7	-4.1	-5.5
Unemployment benefits	20.5	4.4	35.2	-1.9	9.7	-21.7	-61.5	28.2	26.9	-2.4	11.0	-7.2	9.4	40.9	-50.2
Family and children	-2.2	15.3	0.9	10.3	8.3	3.3	-48.8	-17.5	-6.7	-7.4	-19.4	-32.6	-4.5	-9.5	-39.9
Subsidies	-6.1	27.9	1.7	1.8	-0.1	-17.8	733.8	-5.5	19.7	-9.5	-15.2	-20.4	-9.4	-43.0	-13.1
Public investment	1.3	14.2	9.4	22.2	2.3	6.7	-49.6	-66.6	-23.8	-2.4	-7.9	-61.0	-4.1	-13.6	-58.7
Other primary expenditure	17.7	15.0	-52.6	15.4	7.7	26.1	-19.2	-8.9	-1.3	45.3	10.1	58.5	3.3	-13.1	-10.4

1. The fiscal consolidation episodes are the same as those in Figure 3. This table shows the nominal change from the year prior to the start of the episode to the last year of the episode. On both revenue and expenditure sides, increases or decreases in cyclically-adjusted budget items do not always relate to discretionary policy measures. For instance, tax elasticities can fluctuate for reasons not captured by the corrections performed for the economic cycle and for one-offs.

Source: D. Gonçalves and Á. Pina (2016), "The composition of fiscal consolidation episodes: Impacts and determinants" and D. Bloch et al. (2016), "Trends in public finance: insights from a new detailed dataset*"*, both *OECD Economics Department Working Papers*, forthcoming.

Figure 6. Change in the labour tax wedge over the post-crisis fiscal consolidation episode[1]

For a single person with no children at different earning levels, percentage points



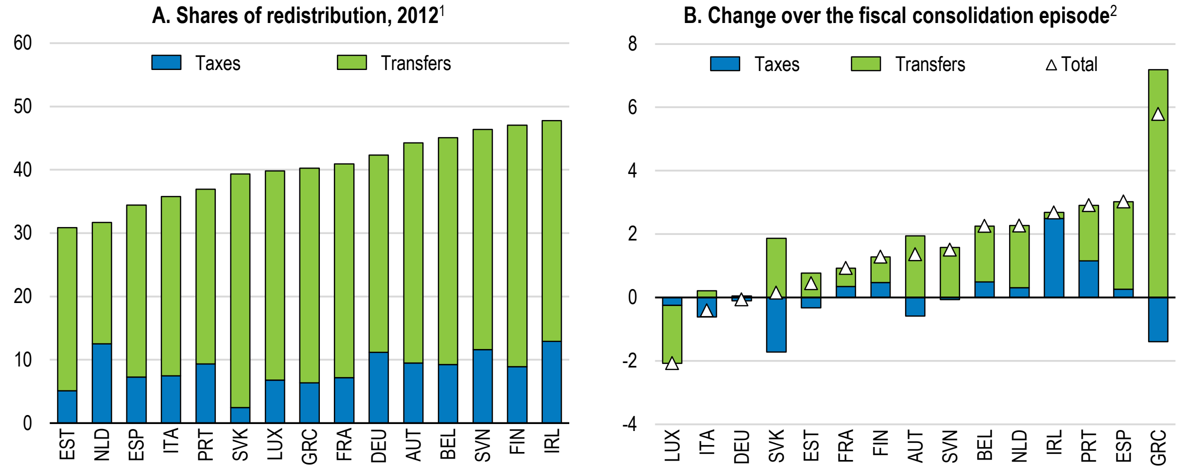
1. The labour tax wedge is measured by income tax plus employee and employer contributions less cash benefits as a percentage of labour costs. Fiscal consolidation episodes (FCE) are the same as those in Figure 3 and the change in the labour tax wedge is measured from the year prior to the start of the FCE.

Source: OECD (2016), "Taxing Wages: Comparative tables", *OECD Tax Statistics* (database).

Tax and benefit systems have generally mitigated the impact of rising inequality in market income (European Commission, 2015b), but available data suggests that this was mainly due to social transfers. In contrast, the redistributive role played by taxes somewhat decreased in several countries in recent consolidation episodes (Figure 7). Further, low incomes have sometimes recorded the highest increases in labour tax wedges (Figure 6).

Figure 7. Income redistribution due to fiscal variables

Reduction in the Gini coefficient due to taxes and transfers, per cent



1. 2013 for Finland and Netherlands.
2. Fiscal consolidation episodes (FCE) are the same as those in Figure 3. The change is measured from the year prior to the start of the FCE to the final year of the FCE (when these are missing, the closest available years are used).

Source: OECD (2015), "Income distribution", *OECD Social and Welfare Statistics* (database).

These developments in the composition of government revenue and spending have gone hand in hand with a modest degree of implementation of structural reforms with direct positive implications for the composition or efficiency of public finances. Action in response to country-specific recommendations, addressed to countries in the context of the European Semester, has on average been relatively low, and below-average in fiscal-structural policy areas (Deroose and Griesse, 2014). For instance, there has been relatively limited progress in reducing taxes on labour and broadening tax bases. On the spending side, reforms to strengthen public administration governance and to improve cost-effectiveness and performance in key domains, such as education and health, have also tended to display below-average implementation.

Reforms at both European and national levels are needed

Most policy levers to make public finances more growth and equity-friendly remain essentially at the country level, despite an important role for European policies in addressing cross-country implications. On the spending side, examples include the organisation of education and healthcare, and the design of social protection systems. On the revenue side, the prime national policy lever is the structure of taxation.

In other domains, European policies exert major impacts on public finances. National budgets, though remaining in the remit of national governments and parliaments, need to comply with the requirements of the Stability and Growth Pact (SGP). Likewise, national public investment strategies are subject to European rules (e.g. those of European regional policy) and have the potential for synergies with policies at the European Union (EU) level, such as the Investment Plan for Europe. This paper focusses on two prime areas where European and national spheres interact and can be mutually-reinforcing: fiscal governance and public investment policies.

Fiscal governance matters for multiple dimensions of public finance overall performance. Especially since the crisis, numerical fiscal rules have often been specified in a way to reconcile sustainability and stabilisation (Schaechter et al., 2012). Other desirable features of fiscal governance, such as a multi-year budget horizon and independent fiscal institutions, can enhance the effectiveness of numerical rules and yield benefits for the composition and efficiency of public finances. For instance, better budget institutions tend to lead to more growth-friendly fiscal consolidation (IMF, 2014a; Gonçalves and Pina, 2016), and multi-year budget frameworks help optimise public procurement and, in particular, public investment (OECD, 2015b; IMF, 2015b).

Public investment is one of the fiscal tools with the strongest impacts on growth, both in the short and the long run, and impacts tend to increase with investment efficiency, in turn underpinned by good governance (IMF, 2015b). Short-run multipliers often exceed unity, especially if an expansion in public investment is coordinated across countries (OECD, 2015c). Due to increases in productive capacity, long-run output gains tend to be even higher (Bom and Ligthart, 2014). A key feature behind them is the ability of sound public investment projects to make the private sector more productive, and hence crowd-in private investment. Increasing investment, both public and private, has particular urgency in Europe, where capital formation is still well below pre-crisis levels.

Improving fiscal governance to promote inclusive growth

Reforming European fiscal rules

The SGP has since its inception a dual structure, with a corrective arm and a preventive arm. The first, also called the Excessive Deficit Procedure (EDP), is based on ceilings for the nominal deficit and debt as a ratio to GDP (3% and 60%, respectively). It has a stronger legal basis, since it is enshrined in the Treaty. The preventive arm is based on the so-called Medium-Term Objective (MTO), which provides a medium-term target for the structural budget balance of each country (i.e. the nominal balance netting out the cyclical component and one-off and other temporary measures).

Some 2011-13 reforms make better allowance for the fiscal and economic situation of countries (e.g. by further modulating the pace of fiscal adjustment as a function of economic conditions). At the same time, SGP rules have become complex due to the proliferation of different numerical targets, procedures, contingency provisions and compliance indicators across the two arms (OECD, 2014a; Eyraud and Wu, 2015). The SGP has nonetheless remained primarily focussed on individual national policies, with scope for further consideration of their aggregate area-wide impacts. Furthermore, despite strengthened enforcement provisions of the preventive arm, those of the EDP remain more visible. As a result, policymakers often focus on the 3% of GDP deficit threshold, risking procyclical policy responses. With Treaty changes unlikely in the coming years (Juncker et al., 2015; European Commission, 2015c), the short-term challenge is to ensure a sound application of the current SGP rules. In particular, degrees of freedom afforded by the rules should be used by countries with fiscal space to contribute to a more supportive joint euro area fiscal stance.

The preventive arm: ensuring an appropriate area-wide fiscal stance

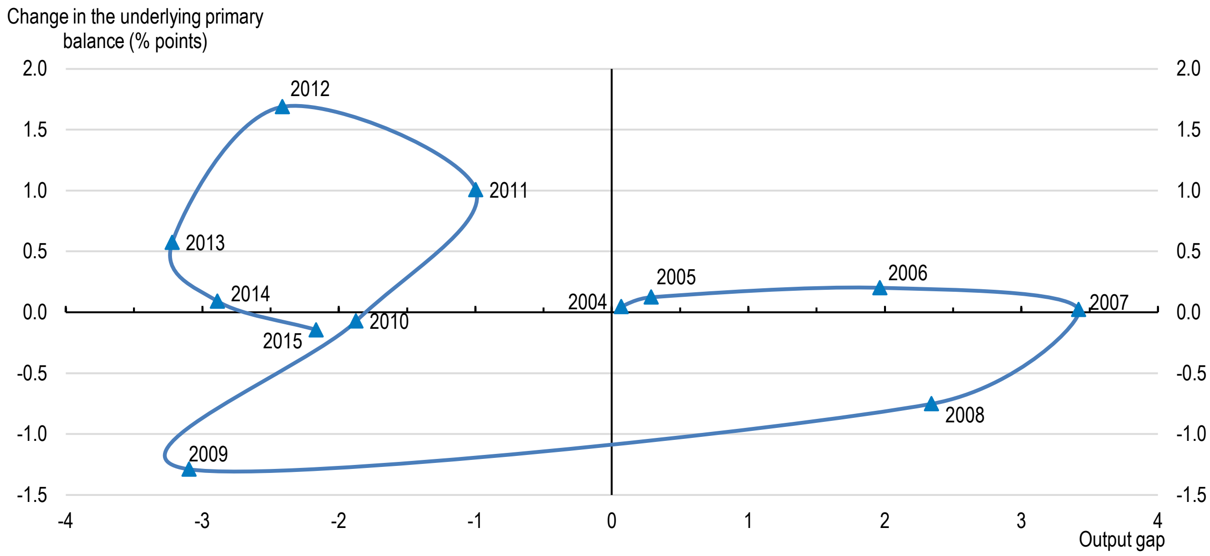
In setting the structural balance trajectory towards the medium-term objective (MTO), the preventive arm contains some welcome flexibility, on which the Commission has recently provided detailed guidance (European Commission, 2015d). The required annual fiscal adjustment depends on cyclical conditions, and can sometimes be waived, such as when real GDP growth is negative. In some cases, there can be temporary deviations from the MTO or the consolidation plan towards it to accommodate the short-term fiscal costs of major structural reforms, including certain kinds of investment. These provisions minimise the extent of pro-cyclical policies and may ease reform implementation (Beetsma and Debrun, 2004). Rule enforcement allows for some margins of tolerance, since a deviation from the MTO or the path towards it is regarded as significant (giving rise to a warning to the country concerned and to subsequent enforcement steps) only if it reaches at least 0.5% of GDP in one year, or 0.25% on average in two consecutive years.

With negative GDP growth, coupling the no adjustment requirement with possible leeway on investment grounds and with the enforcement margin would allow some fiscal expansion, but care would be needed to avoid stretching the margin and thus undermining the credibility of the rules. If medium-term fiscal sustainability is preserved, countries may be allowed to temporarily deviate from the adjustment path towards the MTO in periods of severe area-wide economic downturn. This provision, introduced in 2011 following the coordinated expansion of 2008-09, has never been applied so far, and could offer a legal basis for countercyclical policies were the euro area to fall back into recession.

As cyclical conditions improve and more countries leave the EDP, the need for fiscal adjustment under the preventive arm will increase. In good times, rules should be strictly enforced to help create fiscal space to deal with future downturns. Consolidation should have been done more vigorously in the years before the global financial crisis (Eyraud and Wu, 2015), when the euro area aggregate fiscal stance was essentially neutral (Figure 8; Carnot and Castro, 2015). In bad times, national fiscal policies should take account of cross-country spillovers (Goujard, 2013) and, within SGP rules, contribute to supporting euro area aggregate demand.

Figure 8. Fiscal policy and cyclical conditions in the euro area[1]

As a percentage of potential GDP



1. Euro area member countries that are also members of the OECD (15 countries).

Source: OECD (2016), *OECD Economic Outlook: Statistics and Projections* (database).

In the current weak recovery, countries should take advantage of the flexibility afforded by preventive arm rules to temporarily slow down or halt consolidation efforts and, if fiscal space under SGP rules exists, adopt a temporary fiscal expansion. Adopting structural reforms in tax and spending policies to make public finances more growth-friendly and thus enhance long-term sustainability would be desirable in its own right and would also ease exploitation of the flexibility provisions. In this vein, priorities should include increasing public investment, especially on trans-European networks, and decreasing taxation on low wages.

If the recovery weakens significantly and the risk of a new recession looms, more widespread temporary fiscal expansion under the clause for severe area-wide economic downturns should be considered. Countries where a temporary fiscal easing would not threaten debt sustainability would adopt an expansionary stance, modulated according to fiscal space, while others would aim at a broadly neutral policy stance. In line with its remit (European Commission, 2015e), the recently announced European Fiscal Board would be well placed to advise on the applicability of the clause for severe downturns and, more generally, on the appropriate area-wide fiscal stance and how it should translate into national fiscal stances. A bleaker macroeconomic outlook would only increase the urgency of growth-enhancing reforms in revenue and spending composition.

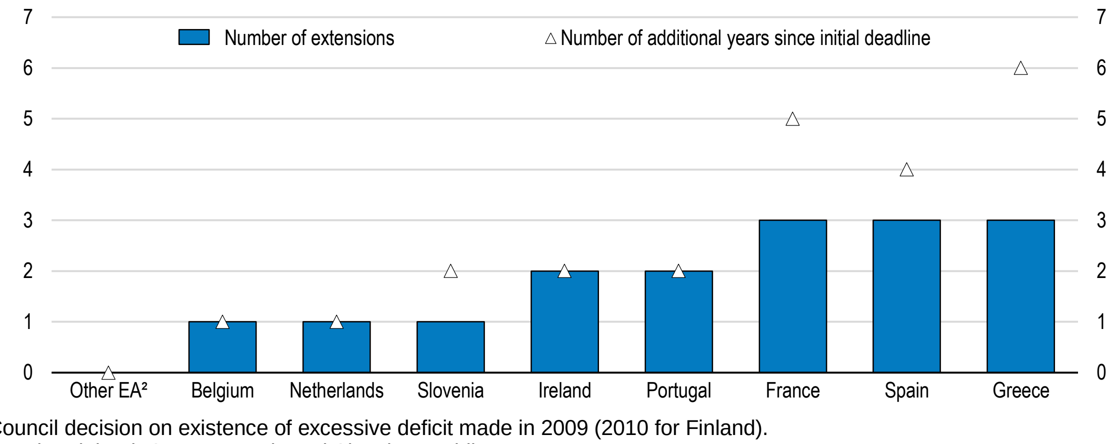
The corrective arm: avoiding excessive adjustment and strengthening incentives for reform

In the corrective arm, large adjustments induced by the debt reduction benchmark should be avoided. The benchmark requires that the excess of the debt ratio over 60% of GDP be reduced at an average 1/20th per year (assessed over three-year periods, and with transitional provisions for countries which were under an EDP in November 2011). For highly indebted countries, these fiscal adjustments can be very large, far exceeding preventive arm requirements. Italy, for instance, would have needed a cumulative structural effort of around 3 per cent of GDP over 2013-15 (European Commission, 2015f), broadly similar to the post-crisis effort (Figure 3), which would have threatened the recovery.

In the cases it has examined so far (Belgium and Italy), the Commission took account of expected compliance with preventive arm requirements and expected implementation of ambitious structural reforms, as well as of unfavourable economic conditions (especially low inflation), and decided not to open an EDP (European Commission, 2015f, 2015g). A similar approach should be taken in forthcoming cases, as other highly indebted countries leave the EDP and become subject to the debt reduction benchmark. In a future SGP revision, the appropriate speed of adjustment towards the 60% of GDP debt threshold should be reviewed (see below).

Compared to the preventive arm, flexibility under the corrective arm is far more limited. The corrective arm requires an annual structural balance adjustment of at least 0.5% of GDP, regardless of cyclical developments and structural reform implementation, and setting a deadline for eliminating the excessive deficit. The adjustment requirement may imply pro-cyclical policies and is only consistent with an *ex ante* deadline if output developments play out as forecast. Longer deadlines are the main provisions for flexibility, and deadline extensions have been used intensively (Figure 9). Though often justified in economic terms, extensions are still a second-best tool, as they potentially undermine the credibility of the SGP.

Figure 9. Extension of deadlines for eliminating excessive deficits[1]



1. Council decision on existence of excessive deficit made in 2009 (2010 for Finland).
2. Austria, Finland, Germany, Italy and Slovak Republic

Source: European Commission (2015), *Report on Public Finances in EMU 2015*, European Economy Institutional Papers, No. 014.

Under these constraints, it is important to strengthen incentives for reforms of spending and tax policies and of national budget frameworks. Building on recent steps (European Commission, 2015d), the Commission could make greater use of longer initial deadlines to provide incentives for major public finance reforms. Deadline extensions could also be granted for this purpose, conditional on satisfactory fiscal adjustment prior to that point. As envisaged, the reforms considered should go beyond those introducing a multi-pillar pension system, which have in practice enjoyed a privileged treatment since the 2005 revision of the SGP (Eyraud and Wu, 2015). Greater emphasis should also be given to the quality of national budgetary frameworks (an aspect already contemplated in current legislation) when taking EDP steps.

Simplifying the assessment of fiscal effort

The concept of structural fiscal adjustment is a key tool for both the preventive and corrective arms, but has become a source of complexity. As it is difficult to agree on a unique definition of “structural”, alternative indicators to measure fiscal adjustment, aiming to complement the structural budget balance, have proliferated. As a result, progress towards the MTO is also reviewed in the light of the so-called expenditure benchmark, which sets a growth rate for a spending aggregate net of discretionary revenue measures (see below). As for the EDP, the assessment of effective action resorts, in more complex cases, to two different measures of adjusted fiscal effort, obtained through top-down and bottom-up approaches. Moving towards a single indicator across both SGP arms would help reduce complexity and increase transparency. Commendably, efforts to this end have recently been announced (European Commission, 2015c).

If well designed, a single indicator along the lines of the expenditure benchmark could have the additional advantage of supporting national expenditure rules. The expenditure benchmark has some welcome features: it preserves national discretion over the size of government (for instance, expenditure is allowed to grow faster if accompanied by revenue-raising measures), and defines expenditure growth with reference to potential rather than actual GDP, which avoids pro-cyclicality. However, it is based on a complex spending aggregate, which nets out not only interest payments (a common exclusion) but also some components of unemployment benefits, public investment and other government expenditure. By comparison, countries like the Netherlands and Sweden, which were among the first to adopt expenditure rules, use spending aggregates with less exclusions. A simpler expenditure benchmark would ease medium-term expenditure programming at national level.

Avenues for medium-term SGP reform

Over the medium term, SGP rules should be improved along two main axes. First, to reduce complexity and asymmetries in enforcement, the preventive and corrective arms could be more closely aligned and possibly merged, giving rise to a single set of targets, procedures and indicators. Second, the current multiplicity of numerical rules could be replaced by a single fiscal anchor underpinned by a single operational rule (Andrle et al., 2015). The natural anchor is the public debt-to-GDP ratio in each country, given its direct link to fiscal sustainability. The appropriate speed of debt reduction could take account of cyclical conditions in each country (as is now the case for fiscal adjustment under the preventive arm) as well as in the euro area as a whole. Countries would then specify their own operational rules (for instance, deficit or expenditure rules) which should include a debt correction mechanism, thus reinforcing national budget frameworks. These reforms would imply very substantial legislative changes, including to the Treaty. The spring 2017 White Paper envisaged in the Five Presidents’ Report (Juncker et al., 2015) offers an opportunity to start preparatory work.

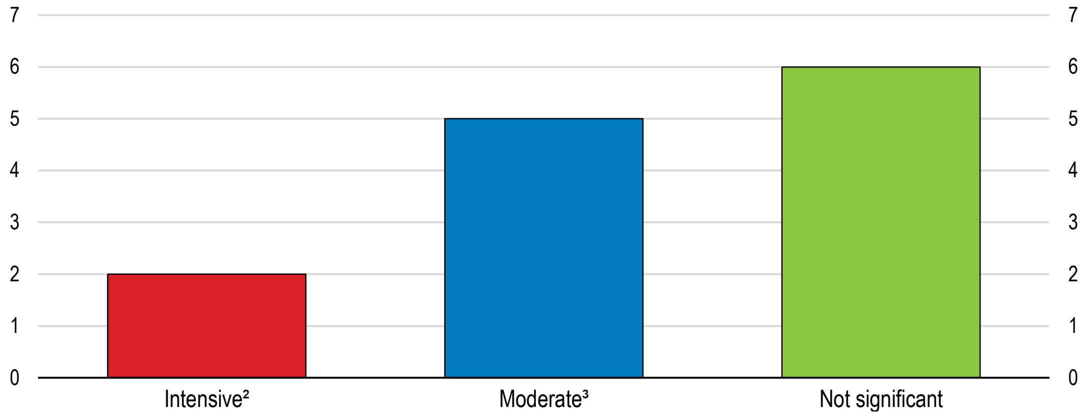
Reinforcing national budgetary frameworks

Budget frameworks at the national level play a key role in making public finances more supportive of equitable growth and the procedures and institutions involved in preparing, approving and executing budgets are highly country-specific. For instance, the effectiveness of numerical rules targeting broad public finance aggregates hinges on their alignment with the medium-term strategic priorities of government (OECD, 2015d), and is fostered by top-down budgeting, a multi-year horizon, and performance-informed allocations and management at programme level.

The SGP reform of 2011-13 included several provisions to strengthen national fiscal frameworks. The Six-Pack Directive on budgetary frameworks (2011) and the Two Pack and Fiscal Compact (2013) set requirements in a broad range of areas, including numerical fiscal rules, independent fiscal institutions, medium-term budgetary frameworks and budget reporting and transparency. Important strides have been made in some areas, such as the coverage and timeliness of budget statistics and the creation of independent fiscal institutions in virtually all euro area countries. However, overall budget reform activity across the euro area since late 2011, as assessed by the OECD, has been generally modest (Figure 10). Though further progress primarily depends on national governments and parliaments, European institutions can foster reform by enforcing legal obligations, such as the correct transposition of relevant EU law, and through peer-pressure and a greater weight given to the quality of national frameworks when applying SGP rules.

Figure 10. Intensity of budgetary reform in euro area countries[1]

Since end 2011, number of countries



1. The degree of budget reform intensity is based on a qualitative assessment, by reference to the principles set out in the OECD "Recommendation of the Council on Budgetary Governance" (18 February 2015) of answers provided by 28 OECD countries to a questionnaire on changes to institutional budgeting frameworks since the end of 2011. Reforms relating primarily to fiscal rules, independent fiscal institutions and parliamentary/civic participation have been discounted relative to those in other areas. Draft assessments were submitted to the Working Party of Senior Budget Officials for discussion in June 2015.
2. Intensive reform activity and/or broadly-based across various aspects of budgetary governance
3. Moderate reform activity and/or focused on specific aspects of budgetary governance

Source: OECD (2015), *The State of Public Finances 2015: Strategies for Budgetary Consolidation and Reform in OECD Countries*.

National expenditure rules and spending reviews should be more widely used

Limited budget reforms are apparent as regards fiscal rules. The 2011 Directive required country-specific numerical rules, and the Fiscal Compact required transposing the medium-term objective and the adjustment path towards it into national law. This last requirement helps to explain why in recent years progress in the adoption of national fiscal rules by euro area countries was strongest for budget balance rules. However, when rules of supranational origin are excluded, several euro area countries are still classified as not having any numerical fiscal rules in place at the level of central government, general government or the public sector (Schaechter et al., 2012; Bova et al., 2015). Modest progress is also apparent if one considers expenditure rules, for which there are no transposition requirements in the SGP: in 2014, only five euro area countries had in place expenditure rules covering more than half of general government finances, compared to four in 2010 (European Commission's Fiscal Governance database).

Expenditure rules strike a balance between sustainability and stabilisation objectives, especially when supplemented with a correction mechanism that reacts to deviations of debt from its target (Andrle et al., 2015). Automatic stabilisers, mostly on the revenue side, are largely allowed to operate. Relative to a structural balance rule, an expenditure rule is simpler, easier to communicate and less vulnerable to real-time measurement error, since potential output is difficult to estimate in real time and estimates have been subject to large *ex post* revisions. Last but not least, aggregate expenditure ceilings can provide a better anchor to the determination of annual spending allocations, and thus facilitate reforms, which are discussed next, to increase the efficiency of public spending at sectoral or programme level. Communication and transparency of the spending rule is important to its credibility, and in this light monitoring of compliance with the rule should be entrusted to an independent fiscal institution, as required by the SGP.

Spending reviews have the potential to yield important gains as regards the composition and efficiency of government outlays. Through systematic scrutiny of baseline expenditure, prioritisation can be improved and spending reductions, if needed, can be made more sustainable, notably through efficiency gains (Robinson, 2014). Furthermore, when integrated into the regular process of budget preparation, spending reviews can support adherence to aggregate spending ceilings, and foster the development of performance-informed budgeting. Successful spending reviews are nonetheless a complex tool, requiring cooperation between finance and spending ministries and sustained high-level political commitment for recommendations to be translated into policy decisions.

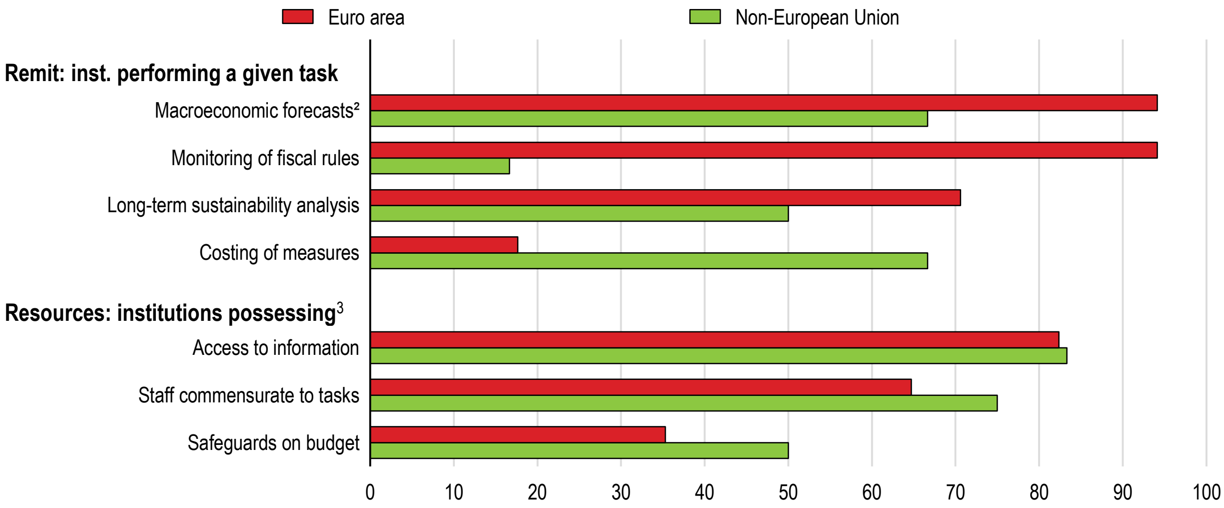
These difficulties help explain why successful implementation of spending reviews remains limited. Resort to this tool has rapidly increased in the wake of the global financial crisis, with about half of OECD countries (and, within these, a similar proportion of euro area members) reporting some sort of spending review in place in 2011 (OECD, 2011; Robinson, 2014). Nonetheless, publicly available information on these reviews, notably on implementation of recommendations and ensuing savings, is fragmented and heterogeneous, and independent monitoring remains relatively scarce (Vandierendonck, 2014), as does the reviews' integration into the regular budget process. Countries should conduct spending reviews on a regular basis, ensuring a systematic link to budget preparation as well as independent monitoring of ensuing results. Peer-review exercises, such as those organised by the European Commission in 2014 (Vandierendonck, 2014), can be a valuable tool to promote the exchange of good practices.

Independent fiscal institutions should be given conditions to operate effectively

Euro area countries are required by the SGP to have independent fiscal institutions that monitor compliance with fiscal rules, with a special emphasis on those enshrining the medium-term objective in national legislation. Independent institutions should also prepare or assess the macroeconomic forecasts used in annual and multi-year fiscal plans. These requirements are strongly reflected in the remit of existing institutions (Figure 11), more than half of which started activity after 2011.

Figure 11. Remit and resources of independent fiscal institutions: selected features[1]

Per cent



1. Only one independent fiscal institution per country is counted in the few cases where more than one exists; a given item is considered to be verified if it holds for at least one of the national insititutions. Institutions considered are those having started activity up to 2014. The number of countries covered by zone are: 17 for the euro area and 12 for non-European Union.
2. Preparation or assessment.
3. Access to information covers the legal obligation to share information essential for the institution's activity. For a detailed description of other features see Box 1 in *IMF Working Paper* No. 14/58.

Source: OECD calculations based on X. Debrun and T. Kinda (2014), “Strengthening Post-Crisis Fiscal Credibility – Fiscal Councils on the Rise. A New Dataset”, *IMF Working Paper*, No. 14/58 and X. Debrun et al., (2013), “The Functions and Impact of Fiscal Councils”, *IMF Policy Paper*, 16 July, International Monetary Fund.

The tasks entrusted to national independent fiscal institutions could be usefully extended beyond those mandated by the SGP. An example is the quantification of budgetary and economic impacts of measures and reforms (costing of measures), as often done by similar institutions outside the EU (Figure 11). Like rule monitoring and forecast production or assessment, carrying out cost estimates of measures is also associated with lower primary deficits (Debrun and Kinda, 2014). Further, it would contribute to a more informed debate on, and potentially better design of, structural reforms with direct budget implications, thereby improving the composition and efficiency of public finances.

It is also essential that independent fiscal institutions be provided with conditions for a credible fulfilment of their mandate, in terms of resources, access to information and the broader institutional environment. Institutions in euro area countries tend to compare unfavourably in terms of having staff commensurate to tasks (Figure 11), and staff needs would generally increase if institutions were tasked with policy costing, as this requires sector and programme-specific expertise. Further, institutions in euro area countries often lack strong safeguards on their budget, such as multiannual funding commitments, which would further enhance the independence of those bodies (OECD, 2014b). Full and timely access to relevant information should also be ensured. Though a legal obligation to share information essential for the institutions’ activity is often in place, less than half of those institutions in EU countries enjoy full access to non-public budgetary information (European Commission, 2014). Finally, relations between the new advisory European Fiscal Board and national independent fiscal institutions should be organised in a mutually-reinforcing way, as planned, thus avoiding to undermine the scope of action and credibility of the latter.

Statistical information can be improved further

Further progress in public sector statistics would reinforce risk analysis and management, which is a key input for assessing debt sustainability. High-quality budget reporting has been highlighted as an important principle of fiscal governance (IMF, 2014a; OECD, 2015d). So has sound fiscal risk analysis and management, which requires comprehensive information on public sector units and on contingent liabilities. Since 2011, considerable progress has been made. Eurostat’s auditing powers have been strengthened and the coverage and timeliness of general government accounts improved, with monthly cash-based or equivalent data now available (quarterly in the case of local government) and a more transparent transition from cash-based to accrual (national accounts) data. As for general government contingent liabilities and non-performing loans, annual reporting has been introduced, but further efforts are needed to improve detail, timeliness (quarterly releases would be desirable) and coverage. Coverage particularly needs to be improved in the case of liabilities of state-owned enterprises (SoEs), where data limitations sometimes reflect a still incomplete delimitation of the public sector (formed by the general government and SoEs), especially at the level of local government. It would also be helpful to have complete accounts (and not just debt) for the public sector as a whole, which would require separate identification of SoEs and private firms in national accounts.

Policies towards more effective public investment

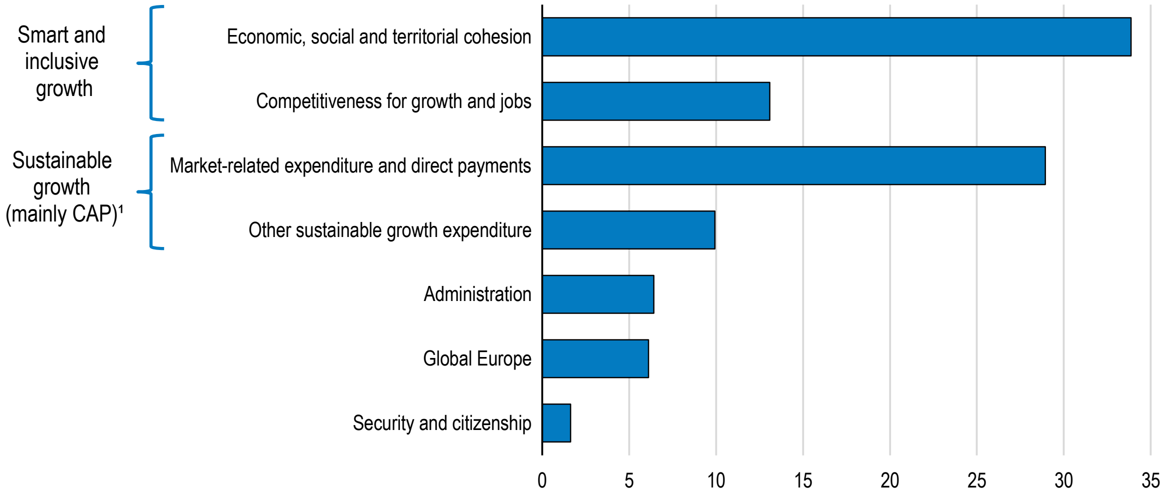
Both European and national policy levers play a key role in ensuring enough and efficient spending on public investment. The EU’s own budget funds for investment and other growth-enhancing expenditure, such as on education and active labour market programmes, stand at 0.5% of EU GDP. This amount is arguably too low if account is taken of the potential for generating economies of scale and positive externalities, for example from research and development (R&D) or infrastructure. However, even these limited resources can have a leveraged impact on the composition and efficiency of public finances if deployed in a way to crowd in national public funds and private investment, and foster greater investment productivity. At national level, better coordination of investment across levels of government and upgraded administrative capacity would increase investment efficiency.

Making EU budget expenditure more growth-friendly

The structure of EU budget expenditure has become more growth-friendly over time, but there remains large scope for improvement. Funds aimed at investment and growth currently account for close to half of total EU-level spending (Figure 12, “Smart and inclusive growth”). Among these, geographically-allocated European regional policy has accounted for about one third of total spending since the turn of the century. “Competitiveness for growth and jobs” programmes are directly managed at European level (there are no country-specific allocations) and include the research and innovation Horizon 2020 and the Connecting Europe Facility (targeted at trans-European networks). Their weight in the budget has roughly doubled since the nineties but is still less than half the share of agricultural subsidies. Resource constraints were well illustrated by the unfortunate need to partly fund the Investment Plan for Europe (discussed below) with allocations taken from Horizon 2020 and the Connecting Europe Facility, streams of spending that are also critical for boosting European growth potential.

Figure 12. European Union budget: structure of expenditure

As a percentage of total commitments appropriations for 2014-20



1. CAP: Common Agricultural Policy.

Source: European Commission (2014), *European Union: Public Finance, 5th Edition*.

In the short term, and in particular in the budget review foreseen for 2017, it is essential to preserve investment and growth allocations in the face of pressures on other fronts, such as the refugee crisis. Unlike spending allocated to countries, investment and R&D programmes managed at EU level become potential targets for savings. In the longer term, post-2020 financial frameworks should continue to increase resources for growth-enhancing expenditure. This can be funded by either reallocation of expenditure or an increase in the overall EU budget size, reversing the unprecedented reduction in real terms agreed for 2014-20.

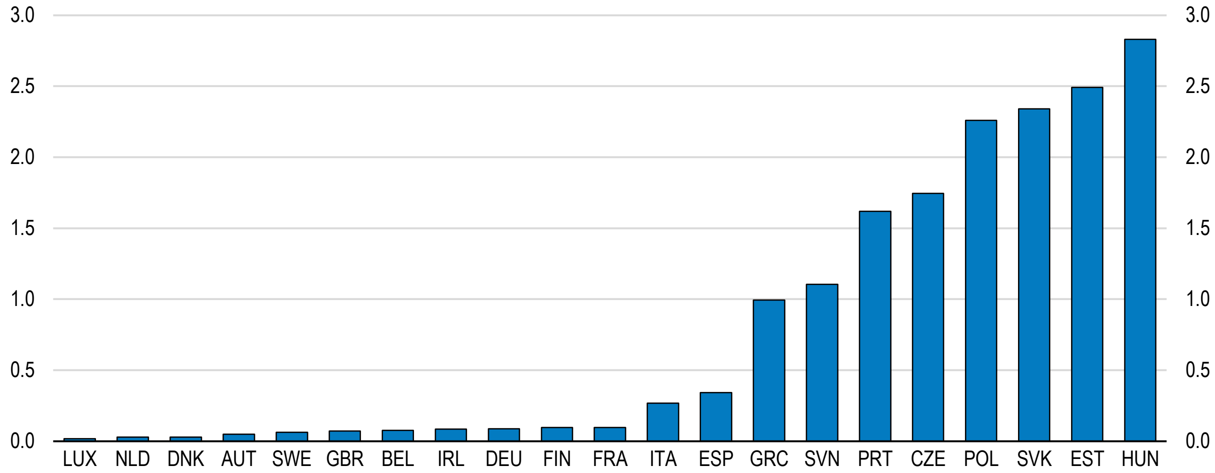
European regional policy: making the best of conditionality requirements

European regional policy can be a powerful tool to increase the quality of public finances in the less prosperous EU countries, where receipts of European structural and investment funds reach macroeconomic significance (Figure 13). Those funds can improve the composition of public spending, since they are targeted to growth and equity-friendly investments, such as on transport and network infrastructures, R&D, education or active labour market policies. Furthermore, support to and compliance with sound institutional frameworks will tend to enhance the efficiency of the expenditure concerned (Rodriguez-Pose and Garcilazo, 2013).

To maximise the benefits, it is essential to ensure that EU funding adds to, rather than replaces, national public spending (the so-called additionality). In the 2014-20 period, compliance with additionality requires that countries achieve minimum levels of public investment. However, enforcement mechanisms have been reinforced only gradually, and remain weak. Possible sanctions appear late in the process (not before 2022 for the 2014-20 period) and are relatively light. For instance, if public investment falls short of the levels required for compliance by 20%, only a modest 1.7% of the structural funds received for the less developed regions of the country concerned may have to be given back. Furthermore, especially for euro area countries, the compliance levels look often unambitious: they imply an increase in the share of European funds in total public investment (Figure 14), and therefore a decline in the relative contribution of national funds.

Figure 13. European structural and investment fund allocations for 2014-20[1]

Average annual allocations as a percentage of real GDP

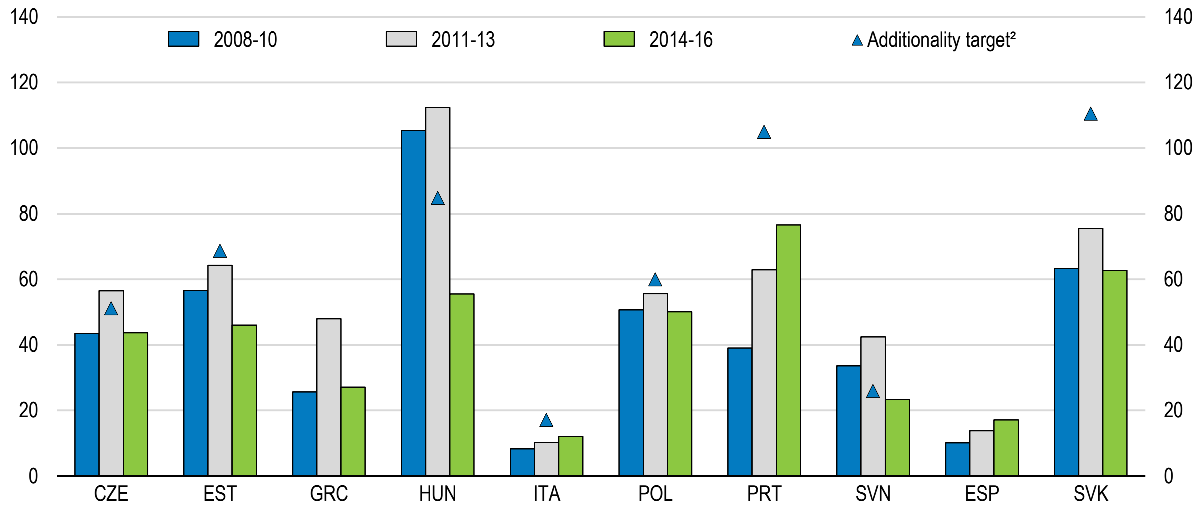


1. Allocations for the European Regional Development Fund, European Social Fund and Cohesion Fund.

Source: OECD calculations based on European Commission (2014), "Annexes to the Commission implementing decision setting out the annual breakdown by Member State of global resources [...]", C(2014) 2082 Final and OECD *Long-term Baseline*, internal database, Economics Department.

Figure 14. European structural and investment funds as a share of public investment[1]

Per cent



1. Allocations for the European Regional Development Fund, European Social Fund and Cohesion Fund as a share of government gross fixed capital formation.
2. Share of European structural and investment fund (ESIF) allocations in public investment if the latter equals the agreed reference levels for additionality verification. The fact that part of ESIF allocations will not fund gross fixed capital formation but rather other spending items (e.g. certain transfers) helps explain why shares can exceed 100%. In Italy and Slovenia the national-wide additionality targets depicted are merely indicative, as additionality will be verified at a regional level.

Source: Calculations based on allocation data from European Commission Decision documents C(2006) 3473, 3474, 3475 and later amendments, C(2014) 2082 final and "Available budget 2014-2020", http://ec.europa.eu/regional_policy/en/funding/available-budget; gross fixed capital formation data from OECD (2015), *OECD Economic Outlook: Statistics and Projections* (database) and *Long-term Baseline*, internal database, Economics Department.

Current rules for additionality should be credibly enforced, starting with the 2018 mid-term verification, where increasing the investment levels required could be considered. In future programming periods, more ambitious levels should likewise be envisaged, and possible sanctions brought to an earlier stage. Compliance indicators could also be improved further. For 2014-20, gross fixed capital formation of general government, as defined in national accounts, has replaced previous *ad hoc* indicators, with gains in terms of simplification and transparency. However, given that a significant part of expenditure supported by structural funds is not classified as gross fixed capital formation of general government, a broader set of indicators could be considered, while preserving the principle of relying on readily available, standardised data.

To support institutional quality and investment efficiency, conditionality requirements have been generally reinforced in the 2014-20 period. Numerous *ex ante* conditionalities need to be met before the disbursement of funds, either of a general nature (such as compliance with public procurement rules) or of a thematic one (such as the existence of national strategies in specific sectors). Further, macroeconomic conditionality aims to reinforce consistency between European structural and investment funding and key elements of EU economic governance. For instance, to better address country-specific recommendations, the Commission may request countries to reprogramme structural and investment funds, and to propose a suspension of payments in the absence of a satisfactory national response. Untested so far, this conditionality could improve the alignment of funds with relevant structural reforms. However, as in the case of *ex ante* conditionalities, preserving national ownership of reforms and other requirements is essential.

In other cases, however, macroeconomic conditionality may be counterproductive. For example, the Commission must propose a suspension of structural funds when the Council assesses that no effective action has been taken to correct an excessive deficit. Though modulated in the light of economic and social conditions, suspended amounts will be at least in the range of 0.25% to 0.5% of GDP (or 25% to 50% of annual structural and investment funding if lower). This suspension will be lifted and re-budgeted as soon as the Member State has adopted the necessary corrective action. Nevertheless, under fiscal stress, these sanctions would likely worsen the composition of public expenditure by compounding downward pressures on public investment and other growth-enhancing items, and should therefore in most cases be avoided.

Leveraging private sector investment

Announced in November 2014, the Investment Plan for Europe aims at generating at least EUR 315 billion (2.2% of 2015 EU GDP) of additional investment over three years, mainly from private sources and with a focus on infrastructure, innovation and small and medium-sized enterprises (SMEs). The Plan's funding pillar, the European Fund for Strategic Investments (EFSI), allows the European Investment Bank (EIB) Group to finance projects that would not have been supported otherwise. The EFSI is endowed with a risk-absorbing capacity of EUR 21 billion: EUR 5 billion from EIB resources, and an EU guarantee of EUR 16 billion. Decisions on the use of this guarantee to support specific projects are made by an independent Investment Committee. No member state made financial contributions to the EFSI, but several have already committed to provide co-financing to investments, mainly via national promotional banks. It will be important to ensure that these commitments represent additional public investment. Under certain conditions, national authorities will also be able to combine European structural and investment funds with EFSI support to enhance risk-bearing capacity and thus the ability to attract private sector financing (European Commission, 2016).

The Plan also comprises pillars of project promotion and technical assistance, and of structural reforms. The European Investment Project Portal will advertise potential investment opportunities submitted by public or private promoters, while the European Investment Advisory Hub, already operational, offers a single point of contact for technical assistance. Structural reforms to create an investment-friendly environment are discussed in Strasky (2016). A case in point, essential to unlock investment and complete the Single Market, is the reduction of regulatory heterogeneity across Europe.

The amount of EFSI-supported investment carried out so far has been small, providing negligible short-run stimulus to activity. Project submission and approval has nonetheless been progressing in line with the target in recent months, and about EUR 12.8 billion of EIB Group resources have already been committed by mid-May 2016, which are expected to trigger total investment of around EUR 100 billion in the coming years.

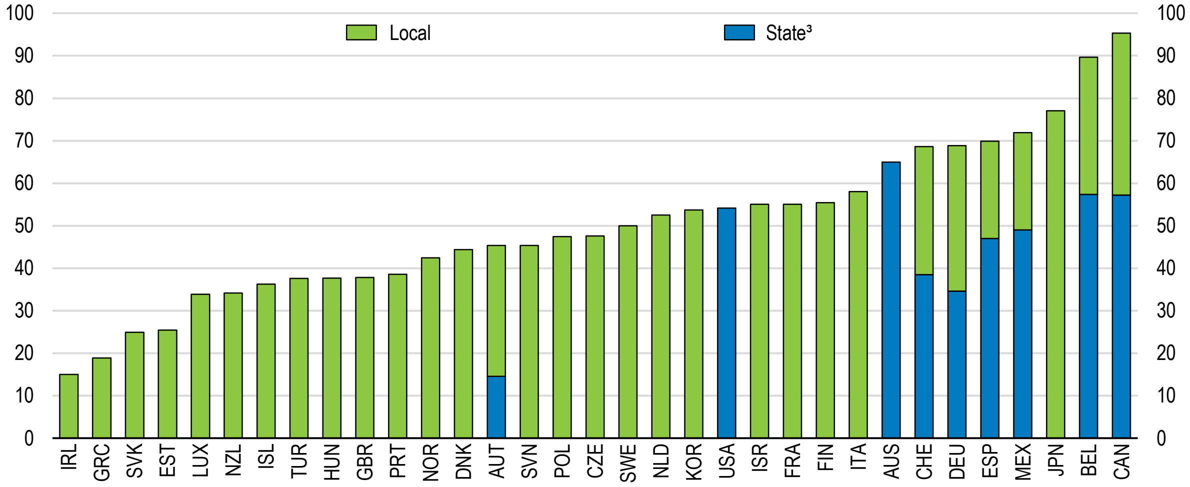
Given limited public resources, the medium-term success of the Plan will hinge on its ability to leverage private investment, for which the EIB Group's lending behaviour and the quality of the projects presented will be key. The EUR 315 billion investment target presupposes a multiplier of 15: the EFSI guarantee should enable three times as much EIB Group funding, which will be used to finance an average 20% of investment projects (the remainder coming from additional investors, with a large role played by the private sector). This requires selecting projects which are attractive for additional co-funding and (to avoid crowding-out) which would not otherwise be carried out. Crowding in private investment on the scale envisaged also requires that the EIB Group depart from its usual very prudent lending practices, characterised by a choice of low-risk projects and negligible levels of non-performing loans (Claeys, 2015). This implies accepting projects with higher risk than in the past, and financing on average a lower share of each (one-fifth, in line with the envisaged multiplier, rather than the traditional one-third to one-half).

Improving public investment governance

At national level, stepping up efforts to coordinate investment among tiers of government is essential. Across the OECD, sub-national governments account for about 60% of total public investment (Figure 15), highlighting the need for vertical and horizontal coordination mechanisms (OECD, 2013; OECD, 2014c). However, for reasons such as informational asymmetries, non-aligned objectives, poor capacity or inadequate funding arrangements, effective coordination is difficult. Among 15 dimensions of institutional quality for efficient public investment management, central-local coordination is the one where advanced economies tend to fare worst (IMF, 2015b). In a recent survey on infrastructure investment, more than three quarters of EU sub-national governments reported coordination challenges across the national and subnational levels. Challenges in horizontal coordination across jurisdictions are also prominent in the survey results (OECD and Committee of Regions, 2015).

Figure 15. Share of sub-national governments in total public investment[1]

Per cent, 2015[2]



1. Gross fixed capital formation.
2. 2014 for Australia, Canada, Israel, Japan, Korea, New Zealand, Switzerland and United States; 2013 for Mexico; and 2011 for Turkey.
3. Includes local government for Australia and the United States.

Source: OECD (2016), "General Government Accounts, SNA 2008", *OECD National Accounts Statistics* (database).

Potential tools to foster coordination include bringing together different jurisdictions in dialogue fora with actual involvement in decision-making, co-financing and conditionality mechanisms, and the promotion of collaboration between sub-national governments through the removal of legal and regulatory barriers, possibly coupled with financial incentives (OECD, 2013; OECD, 2015e). For the 2014-20 period, EU regional policy has developed tools to promote coordination, such as integrated territorial investments, which bring together different funding lines to implement an integrated strategy in a specific territory. Delegation of management tasks to local and regional authorities is allowed, and, in some cases, even mandatory. Better coordination among sub-national governments will also enhance their ability to promote sound investment projects under the Investment Plan for Europe.

Public administration capacity is also essential for efficient investment, but is often inadequate, especially at sub-national level and in particular in lagging regions. There is wide variation in the perceived quality of sub-national governments across the EU, and within some countries (Charron et al., 2012). Capacity challenges have been identified at various stages of the investment cycle, including long-term strategic planning, the ability to involve the private sector (for instance through public-private partnerships) and public procurement (OECD, 2013). Aware of these weaknesses, EU regional policy has included the enhancement of administrative capacity among its *ex ante* conditionalities for the 2014-20 period, with an accompanying increase in financial support for this purpose. A recent proposal for a Structural Reform Support Programme (European Commission, 2015h) will also support capacity building, namely through technical assistance. National authorities should prioritise actions to preserve and develop administrative capacity at different levels of government in response to the main gaps detected and with a special focus on the weakest regions. In times of fiscal restraint, these considerations should inform the design of fiscal consolidation.

Recommendations to make public finances more growth and equity-friendly

Improving fiscal governance and supporting the recovery

Key recommendations

- Countries with fiscal space should use budgetary support to raise growth.
- Ensure that the application of the debt reduction rule of the Stability and Growth Pact does not threaten the recovery.
- Allow longer initial deadlines for correcting excessive deficits if countries implement major structural reforms in spending and tax policies which enhance potential growth and long-term sustainability.
- Adopt national expenditure rules and conduct spending reviews linked to budget preparation.
- Ensure that national independent fiscal institutions have resources to fulfil their mandate.

Additional recommendations

- Include in the remit of national independent fiscal institutions estimating the costs of proposed policies.
- To reduce complexity, adopt a single indicator to measure structural fiscal adjustment under different SGP rules and procedures. Ensure that the chosen indicator does not hamper medium-term expenditure programming at national level.
- Further improve the coverage and timeliness of statistical data on general government contingent liabilities, especially as regards state-owned enterprises.

Protecting public investment and increasing its efficiency

Key recommendations

- As intended in the Investment Plan for Europe, the European Investment Bank should finance higher-risk projects that would not otherwise be carried out.
- Countries should increase targeted public support to investment while enhancing the framework conditions for private investment.

Additional recommendations

- Preserve EU budget resources for investment and growth in the face of short-term pressures on other fronts. In the future, continue to increase growth-enhancing expenditure in the EU budget, if possible by granting higher resources to the European Union.
- Credibly enforce current rules to ensure that EU structural and investment funds add to, rather than replace, national public spending. In the future, make the rules stricter through more ambitious target levels of public investment and the possibility of earlier sanctions.
- Do not suspend EU structural and investment funds to a country under the Excessive Deficit Procedure, as suspension would likely compound downward pressures on public investment.
- At national level, step up efforts to better coordinate investment among different levels of government and upgrade the technical and strategic capacity of the public administration.

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