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AN INVESTMENT BUDGET FOR THE EURO AREA?

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Directorate General of the Treasury

Commitment, openness, team spirit and loyalty

Outline

1. Public investment suffered during the crisis

2. Investment budget: how can it work?

3. What if it had been implemented at the beginning of the EA?

4. Implications and open questions

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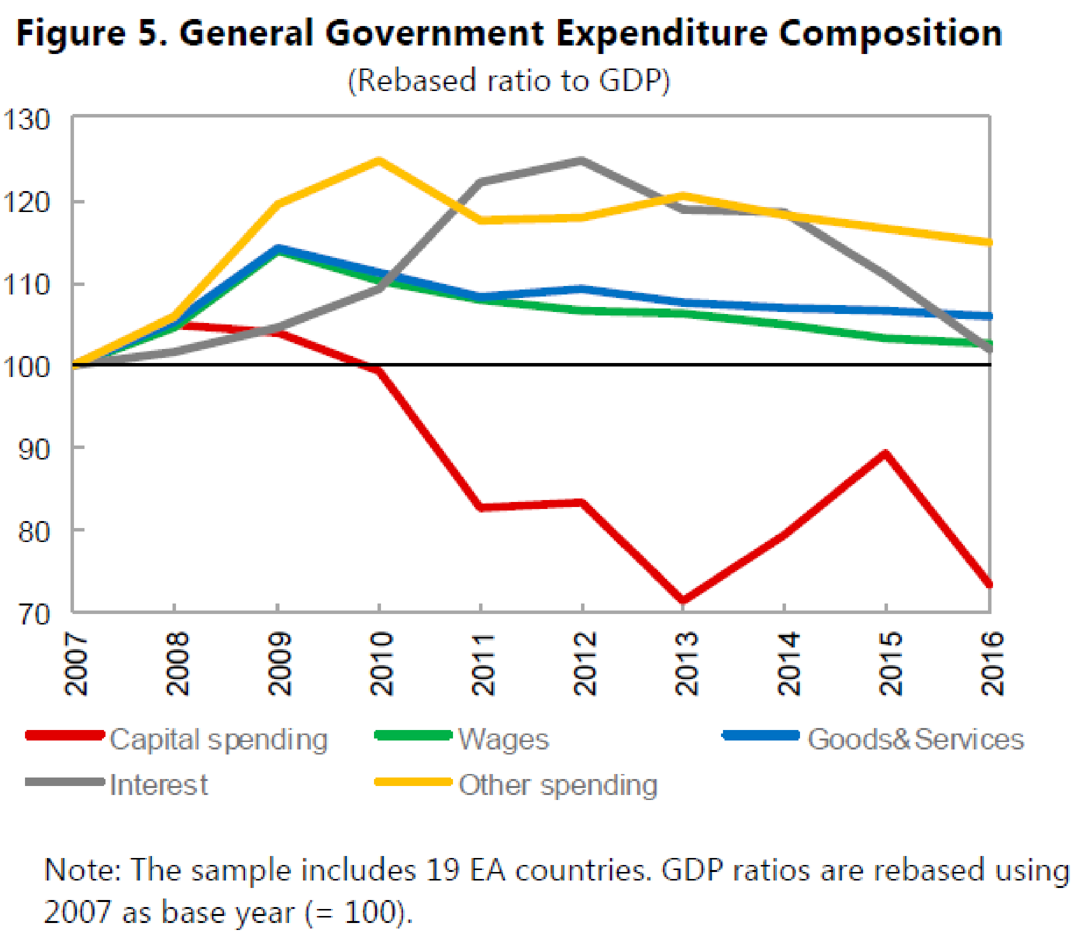
Public investment suffered to a great extent from the crisis



Source: Eyraud *et. al 2017*

Public investment suffered to a great extent from the crisis

- The bulk of expenditure consolidation has been driven by reductions in capital spending

- Countries that have been pressured are more inclined to use investment as adjustment variable
  - *Less costly politically*
  - *Institutional constraints*
  - *Investment is more manageable than pension expenditure or debt charges which are mainly the result of past choices .*

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The problem with consolidation through cut in investment

- An overall review of the literature highlighted a consensus on a positive effect of public investment on growth
  - *in the short term (via an increase in demand)*
  - *in the long term (contribution generally positive to the capital stock, but the effects are much less robust to the model specifications).*
  - *In addition: crowding-in of private investment (cluster effect)*

- Marien Ferdinandusse (ECB) presented an analysis of public investment in Europe, using a DSGE model (2016 Public Finance Network)
  - *The way to finance this investment is crucial: the effect is maximal if the investment is financed by public debt (instead increasing revenues or decreasing other expenditures)*

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The problem with consolidation through cut in investment (2)

- In the medium term, fiscal consolidation through cut in public investment could make it harder for the periphery to catch up with the core countries
  - *With high debt-to-GDP ratios, these countries lack the fiscal space to cope with another recession, while limited public investment capacity threatens to keep productivity sluggish.*
  - *In parallel, private investment is still at a very low level*

- These factors are threatening
  - *entrench structural trends*
  - *in the long term stifle potential growth in these countries*
  - *potentially placing euro area cohesion in jeopardy*

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An investment capacity

- The proposed investment budget would account for at least 2% of euro area GDP and would finance public investment expenditure
- Creating a euro area investment budget, targeting projects most likely to foster potential growth
  - *The EU's structural funds were successful at driving convergence in the periphery before these countries joined the single currency.*
  - *The EU enlargement lead to a decrease of allocations benefiting to Member States at the periphery of the euro area*
- There is a strong case for dedicating part of the euro area budget to enhance productivity and convergence within the bloc.
  - *It would also improve macroeconomic stability by preventing massive cuts in public investment during times of crisis (as seen in the euro area since 2010).*
  - *The funds would be channelled to projects offering the best socioeconomic return, with a particular emphasis on physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training)*

Revenues and expenditures

- The investment budget could be financed by a fixed percentage of two common consolidated tax bases – VAT and corporate tax.
  - *Around 15% of VAT receipts (or 1 percentage point of GDP from VAT receipts) could be allocated to the investment budget.*
  - *allocating around 40% of corporation tax receipts to the investment budget could push up the budget by approximately 1 percentage point of GDP*

    (Assuming that ongoing negotiations around the Common Consolidated Corporate Tax Base (CCCTB) Directive lead to full harmonisation on corporation tax)

- The funds would be channelled to projects offering the best socioeconomic return
  - *particular emphasis on physical capital (especially infrastructure) and human capital (such as R&D, innovation and vocational training).*
  - *this new stream of permanent investment would kick-start lasting economic convergence in the euro area.*
  - *It would improve macroeconomic stability by preventing massive cuts in public investment during times of crisis*

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Balance

- The budget's primary goal would be to support permanent public investment

- In a recession, shaving these tax rates would help to shore up the economy.
  - *in a similar vein, policy-makers could alternatively respond by stepping up expenditure*

- Investment capacity would not be constrained by annual balanced budget requirements
  - *The "revenue" side would be cyclical*
  - *The “expenditure” side would be a-cyclical or even slightly counter cyclical: it would grow in line with potential growth.*

Balance (2)

- The euro area investment budget would need a borrowing capacity to make this possible
  - *The budget would by design, have cyclical revenue streams and stable expenditure*

- Domestic fiscal rules would have to be tightened and central debt to be offset by a lowered national indebtedness.

- Ultimately, an investment budget of this type would partially replace government budgets, albeit to a limited extent.
  - *This could be achieved without increasing the overall tax burden.*
  - *But shifting part of public investment expenditures from national to central level*
  - *It would also help maintain permanent, high-quality public investment (in physical and human capital)*

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Simulation: assumptions

- We simulated how the euro area economy would have behaved if the investment budget had been introduced at the same time as the single currency.

- We used fiscal multipliers from the Mesange model (developed by DG Trésor and Insee) to assess the impact of budget-linked countercyclical fiscal stimulus measures.

- We considered that fiscal multipliers would be higher during a severe crisis episode.
  - *In accordance with the literature, we assumed that recessions reduce potential growth when they have a long-lasting effect on economic activity.*
  - *In our model, "severe crisis" designates any period when the euro area output gap falls below –1.5%.*

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Simulation: impact on GDP

- Up to and including 2007, the impact of the investment budget would have been limited.
  - *No severe crisis episodes in the euro area between 1999 and 2007*
  - *On the contrary, Member States would have further reduced their sovereign debt burden during this period, because of the tougher domestic fiscal rules.*
  - *thanks to additional efforts, the euro area aggregated public deficit would have been lower*

- From 2008 onwards, however, the investment budget would have had a much greater impact
  - *tax relief measures reserved for severe crisis episodes - would have been triggered.*
  - *remain in force each year between 2009 and 2015 (with the exception of 2011).*
  - *investment budget would have cut the VAT levied in Member States*
  - *fiscal expansion of almost 1 GDP point a year during this period.*

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Simulation: impact on GDP (2)

- During crisis Member States would have been exempted from applying further fiscal consolidation measures
  - *the exceptional crisis-related clause built into tighter domestic rules would have been triggered*
  - *Member States would even have contributed to the fiscal stimulus.*
  - *aggregated euro area budget balance more expansionist than what has been observed by 1.4 percentage points of GDP each year of the period 2009-2015*

- Higher level of GDP by 3 percentage points higher in 2016.

- The effect could be even more important:
  - *The simulation does not fully account for the contribution of smoother cyclical fluctuations (particularly on investor confidence).*
  - *the impact of lower pre-crisis debt levels on interest rates is not considered*
  - *simulation looks at aggregate effects only*

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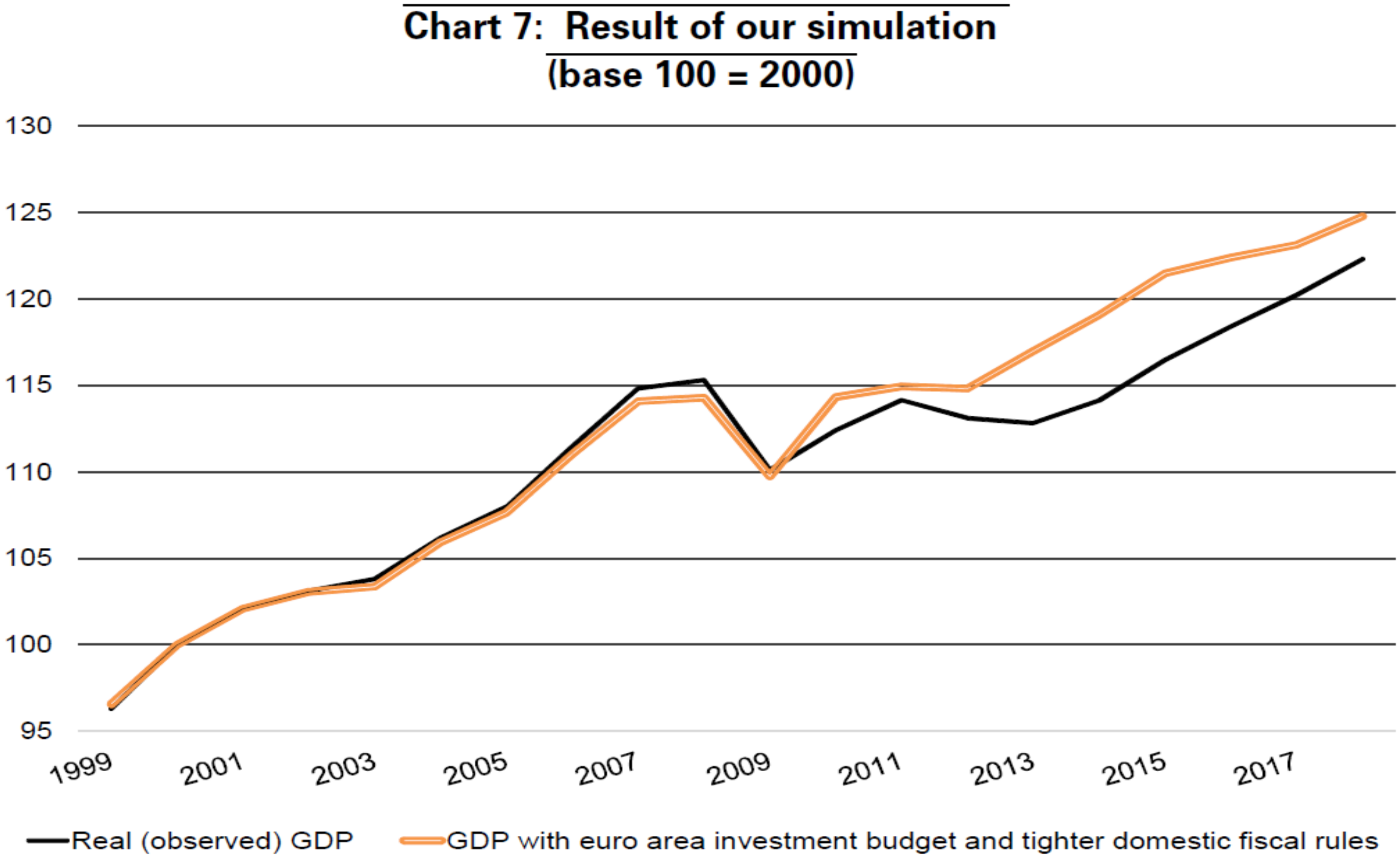
Simulation: impact on GDP (3)



Source: AMECO, DG Trésor calculations.

Simulation: Balance

- Debt associated with the investment budget would have risen during the period, rising from around 0% in 1999-2008 to 7% in 2016.
  - *this additional burden would have been offset by the decline of Member States' debt-to-GDP ratio, which is spread over a longer period of time.*
  - *total debt across the euro area would have been just 2% higher in 2016*
  - *additional debt would have been wiped out by 2018.*

- In our simulation, the euro area would then have had the same debt-to-GDP ratio as it has now

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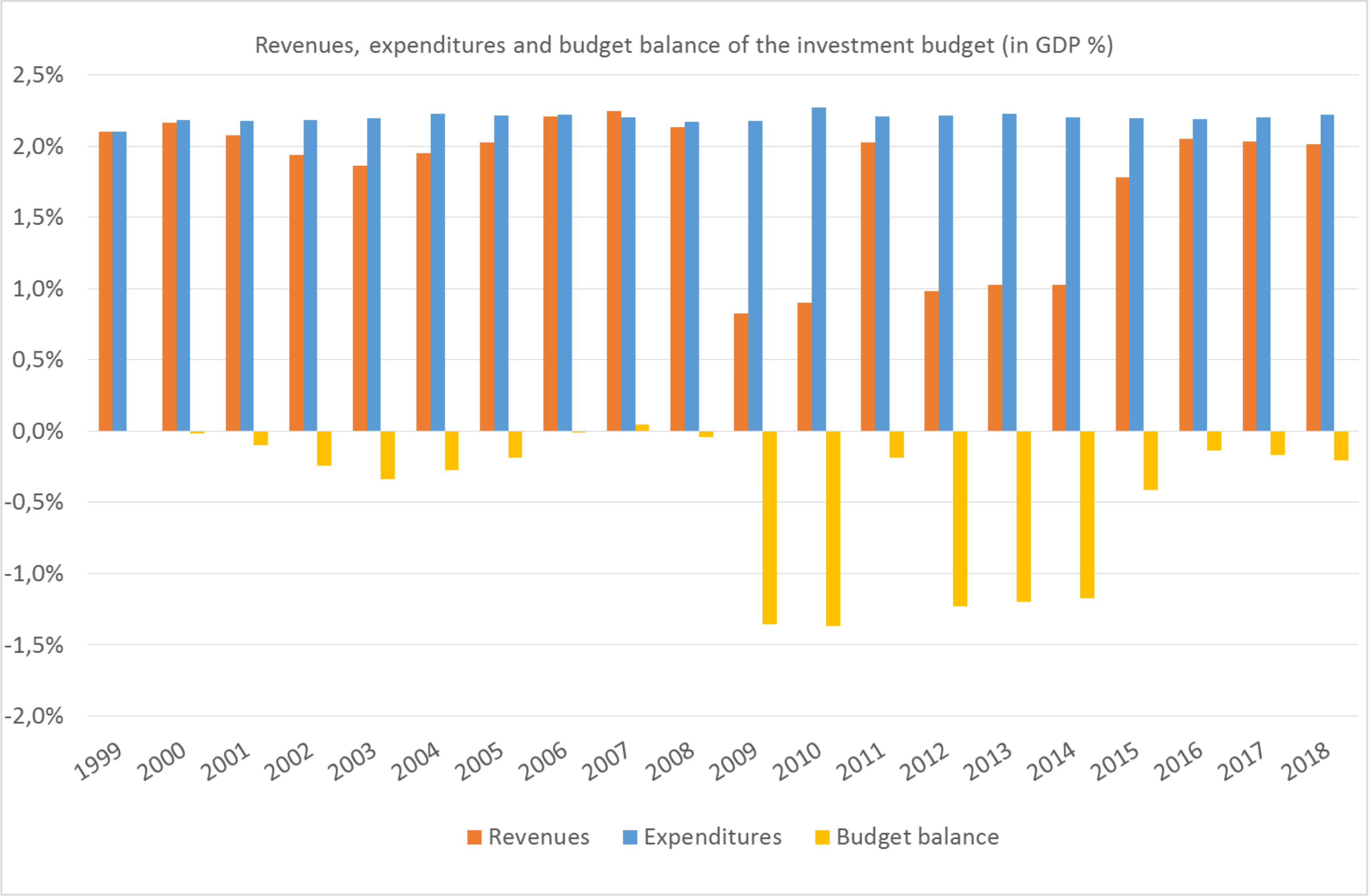
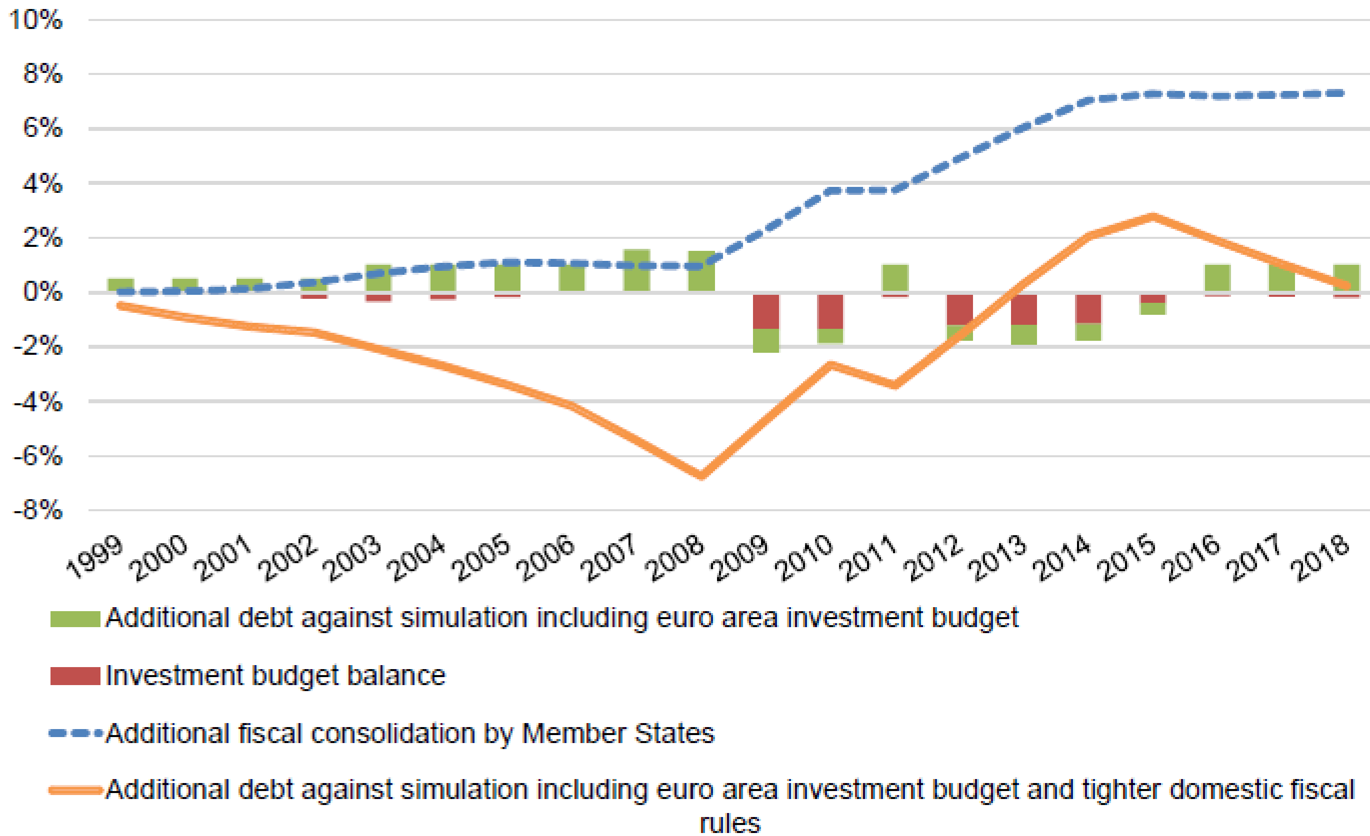
Simulation: Balance (2)



Simulation: Balance (3)

Chart 8: Budget balance and additional debt associated with the investment budget of the euro area (as a percent of the GDP of the euro area)



Source: AMECO, DG Trésor calculations.

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A coherent architecture for the EA

Evolution of the euro area architecture: key proposals

Financial integration	Fiscal integration	Economic integration	Political integration
Completion of the Banking Union	Investment Budget	Symmetrical Macroeconomic Imbalance Procedure	Euro area Ministry of Finance
Building of a Capital Market Union	Unemployment insurance scheme	Coordination of competitiveness policy	Euro area Parliament
	Expanded European Stability Mechanism	Coordination of structural reforms	Eurogroupe as co-lesgislator
	Strengthened domestic fiscal rules		

Significant evolution of EA governance needed

- Euro area Finance Minister
  - *could oversee, under the new governance structure, the euro area budget – including revenue and expenditure planning*
  - *setting the euro area aggregate fiscal stance*
  - *overseeing the MIP, monitoring the euro area financial sector (in tandem with the SSM and the SRM)*
  - *determining and overseeing financial assistance and crisis management programmes (via the ESM enshrined in EU law)*
  - *in the long run, representing the euro area to international financial institutions.*

- « Euro area Parliament » (to be defined) would be associated with these decisions

- Budgetary acts would be submitted for adoption by the Eurogroup

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Open questions

- Physical / Human capital investment?
- What to do in the short run?
- Which conditions? Which transition process?

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