COMMENTS ON SESSION 1: PUBLIC EXPENDITURE TRENDS

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First of all, I would like to thank the colleagues from the Banca d'Italia for inviting me to this workshop. The success of this series of workshops is reflected in the number of the participants and papers that are presented. Both numbers have increased to very high levels over the years. This slightly complicates the task of the discussants as, now, we only have 15 minutes to comment on eight papers. This would give us less than 2 minutes per paper. That is why a task-sharing arrangement for this session seemed more appropriate to us. I would focus my comments on the first and second paper while Ricardo will mainly discuss papers 3 to 5 and Ivan will tackle papers 6 to 8. This arrangement should avoid the risk that you hear the same comments three times and allow us to give each paper the attention it deserves.

Actually I am quite happy about my share of the pie: both papers that were assigned to me are very interesting and thought-provoking and I hereby congratulate the authors. The papers look at public expenditure trends from different angles. The one by Heller and Hauner focuses on the risks regarding future spending trends and how to cope with them in terms of budgetary policy setting. The paper by Wierts, on the other hand, is not so much concerned with the level of spending but looks at its composition and assesses shifts in spending patterns towards more productive categories. When reading the papers I found it useful to keep in mind the mainstream three-pronged approach to deal with the ageing problem. The first pillar of this approach consists in putting the fiscal house in order before the ageing crisis really hits us and create sufficient budgetary room; the second aims at containing the growth of ageing costs (pension entitlements and health care spending); the third, finally, is about pursuing more growth- and employment-friendly strategies. The paper presented by Peter Heller ties in with the first two pillars while Peter Wierts' paper is about the third pillar (although the connection with ageing is not explicitly made in the paper itself).

I will now discuss the papers in the order in which they were presented. The IMF paper correctly argues that future spending pressures are often underestimated for two reasons: first, there is uncertainty about many of the assumptions used in the projections (and official "baseline" projections are rarely based on the most cautious ones); second, one tends to focus almost exclusively on the ageing crisis and forgets about the possibility of other shocks. At the same time, governments' abilities to cope with these spending pressures are limited. That is why a more ambitious fiscal policy stance, together with structural reforms in the area of health care and

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The views expressed in this discussion are those of the author and do not necessarily reflect the views of the National Bank of Belgium.

pensions, is already needed today in order to safeguard fiscal sustainability. Those who know me will understand that I fully agree with this assessment. Hence, I only have a few minor technical comments on the paper and, later on, I will suggest one possible extension.

The first comment pertains to the sustainability indicators which were used as a starting point to illustrate the size of the problem. These indicators measure the fiscal effort which is needed to generate a debt ratio by 2050 equal to the one that would have prevailed if the budget was balanced throughout the period. In my view this does actually not necessarily imply anything about sustainability as it does not guarantee that the 2050 deficit is limited enough to stabilise or reduce the debt. I am somewhat more sympathetic to the view on sustainability developed in the Comley and McKissack paper. Perhaps it would be more appropriate to calculate for all countries what budget balance would be needed to absorb ageing costs – while assuming that revenue and non-age-related spending remain constant with respect to GDP – and generate a balanced budget or a constant debt ratio in 2050. My second remark concerns the table showing potential savings from non-age-related spending where I found the discussion somewhat gloomy. It is argued that the potential savings are very limited but, actually, a permanent spending cut of 1 to 2 per cent of GDP would significantly contribute to cushioning the blow from ageing. The third remark is about the evaluation of acceptable revenue and expenditure ratios based on historical data. I am not sure whether it is very informative to look at these ratios separately. A primary expenditure ratio of 30 per cent might be acceptable when revenue is also 30 per cent of GDP but most likely not when the latter is 50 per cent of GDP. So perhaps one should assess the acceptability of primary balance ratios instead. Finally, the analysis of expenditure overshooting (in Box 1 of the paper) should ideally distinguish between mistakes in nominal spending and GDP forecasts.

These are really just a few minor technical comments I had when reading the paper. Let's get back to the main message however: future spending trends could be substantially underestimated; hence a more ambitious fiscal policy stance is needed. Suppose for a while that policy makers actually buy this message – especially in this beautiful Umbrian landscape it's not forbidden to dream – then they will obviously want to know more precisely what should be done now or in the coming years to be on the safe side in the "ageing" period. Then I think it could be really helpful if we could give them the kind of sustainability indicators that I mentioned earlier and, which, using the labels of the Comley and McKissack paper, would measure full prefunding: which surplus (and, hence, debt reduction) would be needed to "pre-emptively" finance ageing costs (but just ageing costs, not the non-ageing-related rise in health care spending for instance), *i.e.* to absorb them by a worsening of the primary balance without having to resort to additional consolidation measures or generating fiscal imbalances in the ageing period? Such a "frontloading" or "full prefunding" strategy would in my view be more equitable from an intergenerational point of view and allow future governments to keep their hands free to tackle any non-ageing shocks that might occur. Then one could analyse how this required fiscal effort changes if one modifies the demographic,

Table 1

Extending the Heller and Hauner Analysis: An Example for Belgium

	Scenario 1 (higher real interest rates)	**Scenario 2 (constant employment as of 2003)**	**Scenario 3 (full welfare adjustment for pensions)**	**p.m. baseline**
Net increase in social spending in the 2010-30 period	3.6	4.7	4.9	3.6
2010 primary surplus required for frontloading strategy	5.4	5.9	6.0	5.0
2010 overall surplus required for frontloading strategy	1.2	2.3	2.4	1.4
Public debt in 2030	34.1	27.1	25.4	32.5

Source: Langenus, G. and B. Eugène, "Fiscal Policy Setting in a Forward-looking Perspective: The Case of Belgium", paper prepared for the 16th *Congrès des economistes belges de langue française*, included in the conference volume *Les finances publiques: défis à moyen et long terme* (2005, CIFOP).

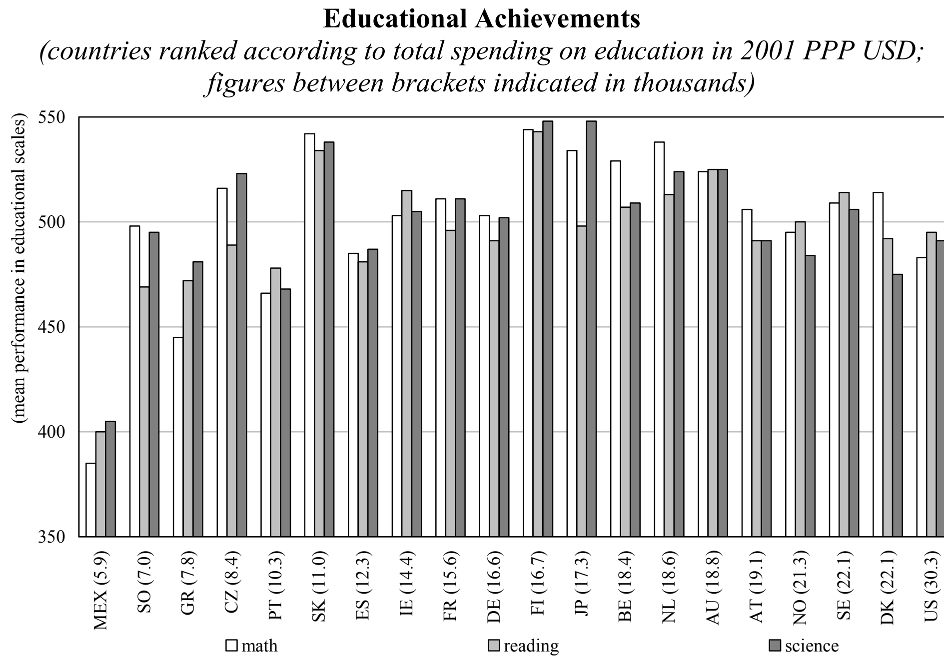
macroeconomic or policy assumptions. We have calculated this in a paper for Belgium. Table 1 taken from that paper adds some further numbers to Peter's general point. If the Belgian government wants to prefund the ageing costs in the way that I described, a surplus of around 1.4 per cent of GDP would be needed by 2010 in the baseline scenario. This would correspond with a primary surplus of some 5 per cent of GDP. However, I personally think that this scenario is too optimistic; it is probably the kind of scenario that made Peter write the book *Who will pay?*. If the macroeconomic or policy environment is slightly less benign, you can see from the table that significantly bigger fiscal efforts are needed. I specifically point your attention to the "scenario 3" column where it is assumed that pensions are indexed to wages (compared to the relatively strong decoupling between pensions and wages in the baseline scenario) as I think that this kind of uncertainty – the one about policy assumptions – could actually have played a more prominent role in the Heller and Hauner paper, especially in view of the rising importance of elderly voters. Generally speaking, I believe that these are the kind of numbers that we should confront policy makers with: which fiscal efforts are needed for full prefunding of ageing costs under different assumptions?

I turn now to the other Peter's paper. This paper provides a very interesting overview of shifts in EU spending patterns and finds that only a few countries have improved the quality of public expenditure. One should point out that Peter has given himself quite a complicated task as the macro data that he uses, two spending classifications, offer a very interesting helicopter view on expenditure trends but

Figure 1

Educational Achievements

(countries ranked according to total spending on education in 2001 PPP USD; figures between brackets indicated in thousands)



Source: OECD.

from a helicopter one can not always discern the details on the ground. The paper is very well written and several of the limitations of this kind of analysis are explicitly acknowledged. My comments will tie in with these limitations and point to some additional ones.

The first comment relates to the breakdown of spending into productive and non-productive items. I can only repeat what Peter already said during his presentation: more money does not necessarily lead to better policy outcomes. In addition, the same accounting labels might cover different things in different countries (and then I am thinking especially about the functional classification). This implies that an analysis based on the distinction between "productive" and "non-productive" money can only provide very rough and not necessarily reliable indications about actual spending quality. Perhaps not all euros attributed to the so-called productive items are well spent. I am sure that most of us have a few examples in mind concerning physical government investment (perhaps even a long list of examples!) but, just for fun, I played around a bit with the data on education spending from the OECD. If you look at an international comparison of education spending and performance indicators regarding educational achievements, you can make rather interesting graphs like the one in Figure 1. On the X-axis I have put the different countries ranked according to education spending per student. I have tried

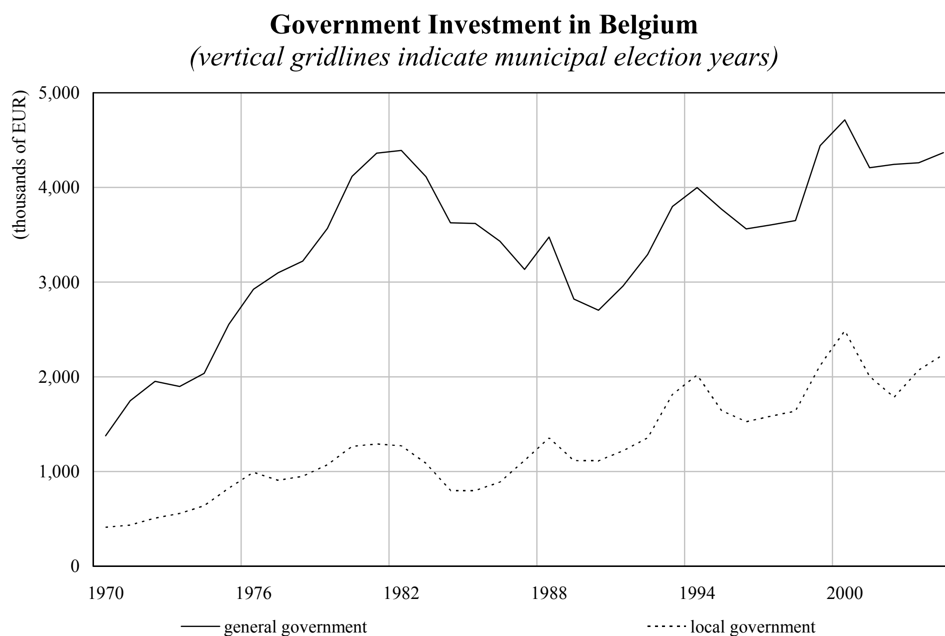
to make this as comparable as possible: taking total spending (including the private part) and only allowing countries for which all data were available in the dataset. On the Y-axis you see three different performance indicators. Instead of a nice upward sloping curve one gets a very erratic pattern. The third discussant of this session, in particular, will be happy to know that the Czech Republic achieves higher average educational standards than the US with only slightly more than a quarter of the American expenditure per student. This was just to show that not only the amount of money invested matters but, perhaps, also the way in which it is invested.

My second point relates to Peter's analysis based on shares in total expenditure. I think this can actually be quite tricky. Take the example of the UK, which gets the best marks in the paper in terms of improving spending quality. In the paper itself it is shown that in four years' time the spending ratio increased by 6 per cent of GDP and Peter could even have added that this contributed to generating an excessive deficit in 2003. I am not sure that this is what the EU leaders had in mind when they agreed on the Lisbon strategy. I would certainly not call this an example to follow and, incidentally, I would also not fully agree with the statement in the paper that "*countries that managed to redirect public expenditure generally respected the EU fiscal rules*".

Figure 2

Government Investment in Belgium

(vertical gridlines indicate municipal election years)



Sources: National Accounts Institute, National Bank of Belgium.

The third remark is that working with "raw" macro data and comparing only two years, as was done in the version of the paper presented at the workshop, can be quite misleading. I refer for instance to the conclusions on investment spending. I noticed the very unfavourable position of Portugal and, to a lesser extent, Italy and Belgium. I would suspect, however, that this is partly or largely explained by one-off real estate sales to comply with fiscal rules. Second, in some cases, conclusions are biased by electoral cycles. Look at the time series of investment by Belgian general and local government, for instance, and you see a clear electoral cycle originating from the local government. By choosing 2000 and 2004 as anchor points, you compare an average point in the cycle with a peak year, as 2000 was a municipal election year. Obviously, you will mechanically register a "drop" in spending quality. In my view, these and other limitations imply that an international comparison based on uncorrected macro data, such as the one by Wierts, can provide valuable indications or tentative conclusions. However, these should then ideally be cross-checked by more focussed country studies.

Then I have three additional comments. First, Peter refers to previous work by the Commission on the long-term decline in government investment. At least in the summary given in the paper the importance of this trend is qualified somewhat as it happened against the background of an already high public capital stock and an outsourcing of investment projects to the private sector. So one could argue that the decrease in government investment isn't all that worrying. I am not sure whether I fully agree with this assessment as, in my view, a third factor referred to in the paper, namely the need for fiscal consolidation, was an even more important driver in many cases. Still, if the Commission assessment is fully accurate, one might wonder if things have changed in the year 2000 as in Peter's paper countries are ranked based on (relative) increases in government investment and chided for further cutting investment spending in the 2000-04 period. I have some trouble connecting the idea that higher government investment in the 2000-04 period improves spending quality with the Commission's rather reassuring statements concerning the drop in government spending observed in previous decades.

Second, I was a bit puzzled by the claim about the positive impact of medium-term expenditure frameworks on spending quality. There is no doubt that those frameworks can help containing the growth of government spending but the intuition behind the coincidence with shifts towards more productive spending should really be spelled out more explicitly in the paper. I can see that medium-term expenditure frameworks make it easier – or more necessary – for governments to clearly determine spending priorities but why should these priorities necessarily be limited to or even include the "productive" items singled out by Peter?

Finally, the argument that there is no contradiction between complying with fiscal rules and improved spending quality is certainly valid in theory. However, in reality rules do not bite for "non-productive" spending only. In addition, the findings in the paper do not really seem to support the claim that countries that have improved spending quality also complied with EU fiscal rules as two of the quality improvers (the UK and the Netherlands) even have exhibited an excessive deficit in the recent past.