THE ROLE OF THE "QUALITY OF PUBLIC FINANCES" IN THE CONTEXT OF THE REFORMED STABILITY AND GROWTH PACT

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1. The concept of "quality"

The concept of the "Quality of Public Finance" has gained increased importance in recent years within the framework of budgetary discussions at the national as well as at the EU level. The March 2003 Ecofin Council concluded that "greater attention should be paid, within the overall constraints of the Stability and Growth Pact, to the quality of public finances with a view to raising the growth potential of the EU economies".

The concept of quality pays tribute to the fact that a long term strategy for the consolidation of public finances has to take into account not only *quantitative* aspects of consolidation but also the issue of *qualitative* or *structural* consolidation. The growth-enhancing restructuring and the efficiency-improving design and management of public expenditure (and revenues) can quite clearly be described as a major policy challenge with evident macro- and microeconomic implications, an aspect often neglected in the practice of fiscal policy. It should be asked not only "how much money is spent", but just as well "how is the money spent". In this context, even traditionally accepted indicators of "good expenditures" such as public investment should be reviewed.

At EU level the issue has gained further political importance in view of the Lisbon goals and the "Broad Economic Policy Guidelines" (BEPGs) which emphasise already that "governments can contribute to achieve the Lisbon goals by spending money as efficiently as possible, by redirecting public expenditure towards growth-enhancing cost-effective investment and human capital and knowledge subject to overall budgetary constraints, and by seeking a higher leverage of public support on private investment". Before going into detail in the context of the reform of economic governance in the EU, clarification is needed on what "quality of public finances" really means.

Following recent work by the Commission, with respect to the present focus of the EU fiscal framework on macroeconomic aspects three dimensions of budgeting can be identified:

- ensure fiscal control and fiscal discipline;
- to provide a degree of stabilisation of the economy;

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- to promote allocative and technical efficiency when using public resources.

The issue of quality of public finances refers in particular to the third dimension because of increasing recognition that fiscal policy should contribute more systematically to the Lisbon objectives and that the refocused Lisbon Agenda (to long-term growth and employment) is to be reflected in the budget. Key questions that have to be answered in this context are: Is the allocation of resources in line with the strategic objectives of the government (currently in particular long-term growth)? What is the role of structural reforms in trying to achieve sustainable public finances by enhancing long-term growth? In implementing policies, are public resources used in the most efficient and effective way (value for money)? Which institutional arrangements would help to redirect public expenditures systematically with a view to long-term growth?

The questions of allocative and administrative efficiency draw attention to the composition of public expenditure as well as the structure of the tax system. On the expenditure side, a key issue is that of identifying potentially "productive" or "growth-enhancing" expenditure (covered by categories like R&D, education and infrastructure investment). Additionally an integrated overall cost/benefit and input/output (efficiency and effectiveness) assessment is needed to judge whether the benefits of a particular type of expenditure outweigh the costs, of course answering the question of "market failure" before the brackets. Detailed and country-specific assessments are therefore needed to guide the composition of national public expenditure. An issue relevant to all EU Member States is to closely monitor the expenditure dynamics to prevent productive expenditure from being crowded out by increasing ageing-related expenditure categories or interest payments. On the revenue side, it is important to set up tax structures which strengthen the growth potential by promoting employment creation and investment. In addition, an analysis of tax expenditures (e.g. tax exemptions) as substitutes for direct expenditures may produce significant insights.

These are several important facets of the complex issue of "quality of public finances", while we do not aim at defining the concept once and for all. We rather intend to indicate several questions that are at the core of actual fiscal policy making and that at the same time are underrepresented in the current framework of economic governance in the EU. In the following we aim to discuss the issue of quality in more detail with particular reference to the Stability and Growth Pact.

2. The reform of the Stability and Growth Pact

During the last year an intense and controversial discussion about the reform of the Stability and Growth Pact took place within the EU. A first agreement on fundamental principles of a "reformed" Pact had been reached at the special meeting of the Ecofin Council on 20th of March 2005, while meanwhile also the legal implementation of this agreement in the Council Regulations has been successfully completed. However, the general discussion about the reform of the Stability and

Growth Pact has shown that there is no clear common understanding on how fiscal coordination in the EU should function in detail. Therefore, although the reform of the Pact has been accomplished "on the paper", it remains an open question how exactly the new Pact will be implemented in the future – a consensus on a new "philosophy" of the application of the Pact still needs to be found. In the following we want to analyse in some more detail the role of the "Quality of Public Finances" in this debate.

Before the question of *how* in detail fiscal policy coordination should be organised within the European Monetary Union, the question of why we need a "Stability Pact" at all – *i.e.* what is the core that has to be "regulated" by the instrument of coordination of fiscal policies – needs to be looked at. With respect to this question a widely accepted consensus exists: the key is to achieve and maintain the stability of the common currency (inflation and exchange rate), for fiscal policies this means the securing of sound budget policies to support the common monetary policy. Hence, to avoid in particular negative spillover effects through different channels like e.g. interest rates or inflation, a common currency area needs some sort of "boundaries" for fiscal policy. The Stability and Growth Pact in connection with Article 104 of the Treaty is one such possible boundary, with the well known reference values for the deficit and the debt level, and in particular the clarification and operationalisation of the Excessive Deficit Procedure (EDP) of the Treaty.

We are now able to look back on some years of experience with the Stability and Growth Pact. In our opinion one can identify several problems that result from the initial construction of the Pact and that were also central issues in the debate of its application that eventually led to the reform initiative by the Commission:

- the short-run cyclical development had not been taken into account adequately when assessing the fiscal policies of the member states and when formulating recommendations as part of the EDP. Where monetary policy can consider only the monetary union as a whole, asymmetric shocks can be offset only by letting the automatic fiscal stabilizers work. But this is impossible if the Pact is interpreted too mechanistically;
- structural reforms on the one hand are seen as positive in the overall economic policy approach of the EU-coordination mechanism, however, potential short-run effects of the implementation of structural reforms had not been taken into account systematically in the Stability and Growth Pact. There is widespread agreement that after the abandonment of the real exchange rate as a means to adjust for differences in Member States' relative competitiveness, greater supply-side flexibility is needed. However, the necessary structural reforms may be politically unfeasible if there is no scope for fiscal policy to offset potential adverse effects on output in the short run;
- a too narrow focus on the 3 per cent deficit reference value led in some cases to pro-cyclical fiscal policies and the use of one-off measures, as a deficit had to be corrected in the year after its diagnosis.

The last issue is a major point, as the experience with the application of the Pact during the last years has revealed in particular that the narrow focus on the

3 per cent deficit limit does not adequately take into account the actual complexity of fiscal policy. The philosophy of relying mechanically on quantitative controls as the exclusive decision parameter of the Pact has proved to be very problematic. One could observe that the concept which has so far underlain the application of the Pact is an illusion – namely that the key instrument to prevent and cure excessive deficits is to set detailed consolidation targets down to a fraction of a percentage point.

When decisions under the Stability and Growth Pact are based solely on quantitative indicators rather than primarily on an analysis of the underlying fiscal policy, the danger of economically false recommendations or targets is quite high. As the Pact has been applied, in some cases countries with deficits exceeding 3 per cent have been urged to follow a pro-cyclical fiscal policy in order to achieve a short-term deficit reduction even at the risk of prolonging a period of weak growth – contrary to the Lisbon objectives – and thus making it more difficult to achieve the medium to long term consolidation objectives. In some circumstances countries have equally been impeded from initiating and applying necessary structural reforms which would have strengthened growth, while being obliged to push through one-off measures in order to demonstrate progress in consolidation in the short term. Thus a very mechanical interpretation of the Pact in our view not only undermined the economic rationale of the instrument but would also hamper the credibility of the Pact within the markets or the general public even if accepting a certain credibility trade-off between more sophisticated economic reasoning and a very mechanistic, simplistic but transparent Pact.

What instead is needed in our opinion is to broaden the perspective on the Stability and Growth Pact and in particular taking aspects related to the quality of public finances more seriously. The application of the Pact in this concept has to focus on the “right” policies, *not primarily* on quantitative indicators.

In the context of the reformed Pact, quite often the accusation is made that politicians are mainly interested in a pure deducting, e.g. of expenditure categories or the short term costs of structural reforms, from the official budget figure. For this reason, any discussion in the direction of an “overall assessment” of fiscal policies of the type we support risks being blocked without an unprejudiced look at the underlying argument. In our view, life is more complex: a simple deducting as well as a mechanistic approach to the Pact looking only at 3.0 per cent are both extremes that hamper a proper functioning of the Pact.

Again: of course there is a trade-off between the need for a simple and clear fiscal rule and the degree of discretion that has to be exercised in an individual assessment of the respective country in an EDP. Nevertheless we argue that in the application of the “old” Stability and Growth Pact this balance had been biased too much towards an overly mechanistic approach. It is without any doubt to some extent easier and more transparent to have just one single indicator and judge policy mainly by numbers, but we think that this approach can not ensure an adequate assessment as well as the right recommendations in every case.

3. The role of "quality" in the future application of the Stability and Growth Pact

In the reformulated Stability and Growth Pact the quality aspect is now mentioned explicitly. With respect to the "corrective arm" of the Pact (Council regulation (EC) 1467/97), article 2 states: "The commission, when preparing a report under Article 104 (3) of the treaty shall take into account all relevant factors as indicated in the article. The report shall appropriately reflect developments in the medium term economic position … and developments in the medium term budgetary position (in particular, fiscal consolidation efforts in "good times", debt sustainability, public investment and the overall quality of public finances)".

In line with that we argue that in an individual and overall assessment of fiscal policies in the context of the Pact more qualitative criteria should be used, without questioning the nominal anchor function of the quantitative reference values of the Treaty as the guiding principle of fiscal policy coordination. This would also take account of the fact that as a general rule there exist no blanket, universally applicable "patent remedies" for all cases, although in particular textbook economics often argues along this line.

Now, while the concept of quality certainly is a theoretically appealing concept, how can it be made operational especially in the context of the Stability and Growth Pact? So far there exist no clear cut and established answers, nevertheless some first thoughts shall be offered in the following.

Firstly, an analysis of the quality of the public-sector budgets must take account of the general structure of expenditure and revenue. Expenditure for past obligations should be reduced as much as possible in public budgets (here is a direct connection to the aspect of structural reforms mentioned before), while expenditure on "future-oriented" and growth enhancing items should be strengthened. It should be noted that the conventional concept of public investment is not a suitable measure of the quality of the budget in this respect. Rather, an overall analysis of expenditure and revenue should take into account the effects on growth of these components of the budget. High-quality expenditure in this context may be expenditure on education or Research and Development. This analysis should be made against the background of the type of expenditure and investment which is needed in a particular country – as regards the quality of public-sector budgets, as in other fields, there are no universally valid answers or *a priori* quality items.

Secondly, an assessment of the fiscal policy of a country should take into account if necessary structural reforms have been or are in the course of being implemented. The reformed Stability and Growth Pact now explicitly makes an allowance for possible short-term deficit-raising effects of reforms, e.g. dampened growth due to uncertainty and reticence of investors and consumers in the short term, or a transitional phase of higher expenditures. An important type of measures which should be mentioned here are also tax reforms. Tax reforms may be needed to strengthen growth and improve the competitiveness of a country, an example would be the German tax reform implemented in the year 2000, which was also positively

assessed by the Commission. Altogether a better coordination between the Lisbon Agenda and the Stability and Growth Pact is needed to avoid inconsistencies between the different coordination instruments.

Of course it has to be stressed again that the quality issue is only one aspect in the overall concept of the Stability and Growth Pact – but one that in our opinion had clearly been underrepresented in the "old" Pact, while its recent reform made some improvements in this direction. However, to be able to proceed even further along the lines sketched out very briefly, the following questions have to be addressed.

How can we analyse and assess growth-relevant public expenditures (e.g. on investment, R&D, education) when assessing public budgets in the procedures defined by the preventive as well as the corrective arm of the Stability and Growth Pact? How can a reform process aiming at a quality oriented consolidation be considered in such an assessment? Moreover, within the Lisbon process, how can we take qualitative aspects of expenditure policy into account as "high quality" public expenses help realise the Lisbon targets, while recognising that consolidation policy must not concentrate on quantitative issues alone? In a further perspective how could we succeed in combining the Stability and Growth Pact and the Lisbon agenda to a coherent strategy?

A pragmatic way forward would be to find a non-mechanistic assessment methodology that explicitly links quality-oriented reforms, budget composition and its restructuring, evaluation of effectiveness, efficiency and growth performance with the formal budget constraints of the Stability and Growth Pact.

Last but not least, we should also look closely at the underlying variable for all of these: the institutional arrangement. This means looking at all relevant fiscal rules, budgetary procedures and – especially in federal states – at the intra-federal structures like equalization systems or National Stability Pacts. The Ecofin conclusions on the Stability and Growth Pact reform from March 2005 state: "National budgetary rules should be complementary to the member states commitments under the Stability and Growth Pact. Conversely, at EU level, incentives should be given and disincentives removed for national rules to support the objectives of the Stability and Growth Pact … The implementation of existing national rules could be discussed in stability and growth programmes".

The Ecofin Council and at a more technical level the Economic Policy Committee (EPC) of the EU would be well suited to do a lot of preparatory work along these lines (a first starting point is the work of the newly established "Working Group on the Quality of Public Finances" of the EPC). From that framework general guidelines should be derived that should serve as policy recommendations in this field. The EPC could propose options for the institutional setting of such an assessment and a package of recommendations reflecting the analysis of the relationship between the quality of public finances and the Stability and Growth Pact.