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Economic Intelligence

Up-to-the-Minute Analysis from
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Seeing the Trees, Missing the Forest: Why Quality of Public Finance Matters for Europe

The public finance situation in Italy and to a lesser extent France has brought the long-simmering issue of the European Union's fiscal rules, their enforcement, and even their ultimate rationale, back to the front burner of euro-area governance.[1] In all of the heated polemic, however, a vital piece of the jigsaw has gone missing. The debate, and most particularly the long, tortuous negotiations between the European Commission and the Italian government over Italy's 2019 budget plans, have focused solely on numerical targets, and, concretely, on decimal points of the nominal and structural deficit ratios over gross domestic product, on the progress (or lack thereof) toward the European Fiscal Compact's medium-term objective, on whether public debt reduction proceeds at the stipulated pace and on the applicability of complex "flexibility clauses" and other provisions set out in the 220 pages of the *Vade Mecum on the Stability and Growth Pact 2018 Edition*.[2] https://ec.europa.eu/info/sites/info/files/economy-finance/ip075_en.pdf

While justified by concerns about the stability and sustainability of public finance, this focus loses sight of a key dimension which is essential to the very stability and sustainability in whose name it is undertaken: namely, the *quality* of the measures underlying the public balance outcome. This is a policy area – and more than that, a policy priority – which euro zone finance ministers should return to today as they meet in Brussels to hear a report on

[1] **Economic Intelligence** is a series of up-to-the-minute policy briefs from Alessandro Leipold, chief economist of the Lisbon Council and former acting director of the European Department and Executive Director for Italy, Greece, Portugal, Malta, Albania and San Marino at the International Monetary Fund. Special thanks to Christophe Barton, Boris Cournède, Paul Hofheinz, Chrysoula Mitta, David Osimo and Alain de Serres.

[2] The Fiscal Compact is the fiscal chapter of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed on 02 March 2012. Twenty-two EU member states have "opted in" (the 19 eurozone members plus Bulgaria, Denmark and Romania).

Europe's growth outlook and begin plotting the key targets of the 2019 European Semester, which will conclude in July with the adoption of country-specific recommendations.

What, then, is the "quality of public finance?" And how do we measure it? These are topics the Lisbon Council examined in depth at **The 2019 Euro Summit** last December, hoping to lay the groundwork for a broader, more sustained period of policy-making attention to this area but also to stimulate public awareness that it is not just the amount of money that governments spend that makes a difference; what matters more is how and on what they spend it, as well as on the structure of taxation. Economic science now has a lot to say about how we can spend public funding to achieve better, more sound, more long-term sustainable and more socially equitable economic and social outcomes. Watch Organisation for Economic Co-operation and Development Chief Economist Laurence Boone – who keynoted The 2019 Euro Summit – describe OECD findings in a recent interview:

The quality of public finance is an elusive concept. It is multi-dimensional in nature, and its many different pieces tend to be studied in isolation. As a result, there is no broad-based conceptual framework of what constitutes quality public finance. Both the European Commission and the OECD have attempted to fill this gap. The European Commission published a comprehensive paper on the subject in September 2008 and work has continued since then.[3] For its part, the OECD has a large, ongoing project called the "Quality of Public Finance."

[3] Salvador Barrios and Andrea Schaechter, "The Quality of Public Finances and Economic Growth," *European Economy* (Brussels: European Commission, 2008). http://ec.europa.eu/economy_finance/publications/pages/publication13101_en.pdf

Both projects – though conducted separately – are coming to some common conclusions, and those conclusions can and should become a more regular, quickly realised element of the public-finance debate (we will recommend a five-point programme for reform on page 8). The projects share a joint emphasis on the effects of the structure of public finance on **growth** and **inequality**. While details vary, quality of public finance studies identify various channels for public finance to impact growth and equality – either positively, with win-win solutions (making for clear-cut "quality" public finances); or with trade-offs (making for a more ambiguous outcome, depending on populations' and policymakers' preference functions); or negatively (making for low-quality or inferior public finances). These main channels are 1) the size of government; 2) the level and sustainability of fiscal positions; 3) the composition and efficiency of expenditure; 4) the structure and efficiency of revenue systems; and 5) the fiscal governance framework. These factors have to be considered interactively since, for example, higher investment spending financed via distortionary taxes or a destabilizing accumulation of debt would not constitute a "quality" measure. That said, the studies find that there is generally considerable scope for public finance reform to support inclusive growth, especially by redirecting spending toward productive expenditure (typically investment, education, research) and restructuring the tax mix in ways that reduce distortions and income disparities. This is after all what the "growth-friendly" orientation of fiscal policy – so often invoked in European Council and other economic summit conclusions – is about.

But, in practice, what takes place can be a sometimes absurdist, almost dadaesque debate. In the disputed case of Italy, for example, the bone of contention with the European Commission was whether a deficit of 1.6%, 2.0% or 2.4% of GDP was an acceptable figure –to finally settle on the manifestly absurd two-decimal point precision of a deficit of 2.04% of GDP. But these are all tiny, tiny numbers when compared to their two determinants: total revenues and total expenditures, ranging respectively around 46% and 48% of GDP. It is of course intuitive that what has the greater impact on a country's macroeconomic performance and the inclusiveness of its growth is the *composition* of the two larger magnitudes, each approaching some 50% of GDP, rather than the comparatively minuscule *difference* between the two. Put simply, *composition* – i.e., the underlying *quality* of a country's public finances – matters more for growth than the deficit.

The current momentous events in Europe (the looming folly of a no-deal Brexit; the street violence and policy U-turn in France; the political strains in Germany; the challenges posed to the EU fiscal framework by the Italian government's plans; the threat to the EU construct coming from nationalist surges in several member states, and more) all have a common thread: the failure of economic policy – and notably of fiscal policy – to deliver inclusive growth in Europe's member states. And it is on such delivery that "the quality of public finance" will ultimately be measured. That quality has been manifestly wanting – and therein lie the roots of disenchantment with the European project.

If European ministers and the governments they represent want to show citizens that they care about growth at least as much as stability, they need to correct this deficiency, leveraging the forthcoming policy calendar. The run-up to the European elections in May will shine the spotlight on the European project generally, culminating in the summit early that month in the historic Romanian town of Sibiu, "earmarked as the symbolic launch of a rejuvenated 27-member EU into its post-Brexit future."[4] That rejuvenation needs to be demonstrated right from the start of this year's European Semester, underway in earnest as from today, with the Council of Economic and Financial Ministers due to formalize the agreement between the European Commission and Italy avoiding the excessive deficit procedure. It is also to adopt conclusions on the Commission's Annual Growth Survey (AGS) and on macroeconomic imbalances in the Member States, and approve a draft recommendation on the economic policies of the euro area. Importantly, it will also discuss the follow-up to the December Euro-summit, when leaders reached an agreement on the key reform features of the economic and monetary union. This will be followed in February by the first actual monitoring of the Italian case, with the issuance on February 27 of individual country reports. Then, in March, the European Council is to adopt the year's economic priorities based on the AGS and, in May, countries' stability programmes are to be assessed. Finally, the ongoing work on a euro area budgetary instrument and on refinements to the precautionary facilities of the European Stability Mechanism (ESM) both provide opportunities to consider the potential role of the quality of public finances as a pre-qualifying criterion.

The Italian Case

The present architecture of European policymaking has little that is specifically designed to promote high-quality public finances.[5] Nor does the issue feature in the ongoing efforts to improve this architecture. On the contrary, it might be said that the EU fiscal framework is in practice agnostic about the quality of underlying measures, and that making progress toward the mother lode (the medium-term objective, MTO, embodied in the fiscal compact) is ultimately more important than *how* one does so.

By way of illustration of the consequences of this setup, let us briefly consider how the differences between Italy and the European Commission on the country's budget plans were, at least temporarily, resolved at the twelfth hour at the end of 2018. In essence, as plainly explained by European Commission Economic and Financial Affairs Directorate Director General Marco Buti himself in a letter published in *Corriere della Sera* on 28 December 2018, **the European Commission approved the "numbers" not the "content" of the Italian government's plans.** More specifically, Director General Buti argued that "it is up to the Commission to monitor the budget balances of the countries of the Union… whereas the composition of the budget (i.e., the specific measures of the manoeuvre) remains under the responsibility of the countries and their national parliaments… The Commission has had no role in defining the specific measures, *nor on their quality* [emphasis added]."[6]

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[4] Michael Peel, "Entry Music," *Financial Times,* 11 January 2019.
https://www.ft.com/content/ebd98a88-1563-11e9-a581-4ff78404524e

[5] The only potential exception is provided by the country-specific recommendations under the European Semester which, however, lack any bite, as discussed in the next section.

[6] See Marco Buti, "Abbiamo Approvato i Numeri, non i Contenuti della Manovra," *Corriere della Sera*, 28 December 2018.
https://www.corriere.it/economia/18_dicembre_28/buti-abbiamo-approvato-numeri-non-contenuti-manovra-07474952-0ae4-11e9-807b-d85edec6e72a.shtml

To be clear: this is a perfectly accurate and candid rendition of the European Commission's and EU member states' respective competencies, and the European Commission could not venture beyond the frontiers set by the reigning EU governance construct. But therein lies the rub. A construct that is ultimately indifferent, or in any event impotent, with regard to the quality of fiscal policy will lead to outcomes such as those now evident in Italy. The country has been given the go-ahead on a budget that has been deemed to observe the numerical fiscal rules. Even this finding requires a good degree of forbearance, but let us accept it as given.[7]

What is however certain is that **the Italian budget does not in any way measure up against the frameworks elaborated by the OECD and the European Commission to assess the "quality of public finances."** It does not include any of the so-called win-win reforms of taxes and spending that simultaneously boost output and enhance income equality as identified by these institutions. The bulk of expenditure measures is concentrated on increased current spending, on income support (with an ill-designed minimum income scheme, which incongruously confuses poverty alleviation with active labour market policy objectives) and an unwinding of pension reforms, with adverse effects on labour force participation, productivity and growth. Capital spending is again the sacrificial lamb. On the revenue side, apart from a limited introduction of a flat tax on some self-employed income, there are a range of new levies that lead to an increase in the overall tax burden, reflected in a rise in the tax-to-GDP ratio.

Italy's observance of the EU rules is furthermore contingent on four highly doubtful outcomes: 1) the achievement of patently optimistic growth forecasts; 2) the realization of unrealistic privatization revenues; 3) the freezing of some 2019 spending in the case of divergence from budgeted targets; and 4) the commitment to a hefty increase in value added tax if public finances deteriorate in 2020 and 2021. In addition to their political cost, and thus unlikely implementation, both of the latter measures would be eminently procyclical.

Unsurprisingly, in this setting, the spread of 10-year Italian bond yields over their German equivalent has remained around an elevated 250 basis points (double that prevailing in the run-up to the Spring 2018 elections) even after the budget's approval by the Italian Parliament – an event that had been presented by the authorities as a likely turning-point for market sentiment. That watershed is nowhere on the horizon.

The **consequences of such benign neglect of quality public finance are dire**. By officially "blessing" policies which, while nominally adhering to the EU's fiscal rules, do not contribute to enhancing growth and reducing inequality, such neglect stands to reinforce the perception of an obtuse framework removed from the everyday needs of Europe's citizens,

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[7] In reaching agreement with the Italian government, the numerical focus was reflected in the European Commission's acceptance of the authorities' clearly implausible two-decimal point precision: "With the sum of the new macroeconomic scenario, the additional measures presented, and the allowance for unusual events, the headline deficit target would be 2.04% of GDP." At the same time, Vice-President Valdis Dombrovskis frankly stated: "Let's be clear – the solution is not ideal. But it avoids opening the excessive deficit procedure at this stage. And it corrects the situation of serious non-compliance with the Stability and Growth Pact." See European Commission, "*College Read-Out and Remarks on the Italian Budget*," 19 December 2018. http://europa.eu/rapid/press-release_SPEECH-18-6886_en.htm

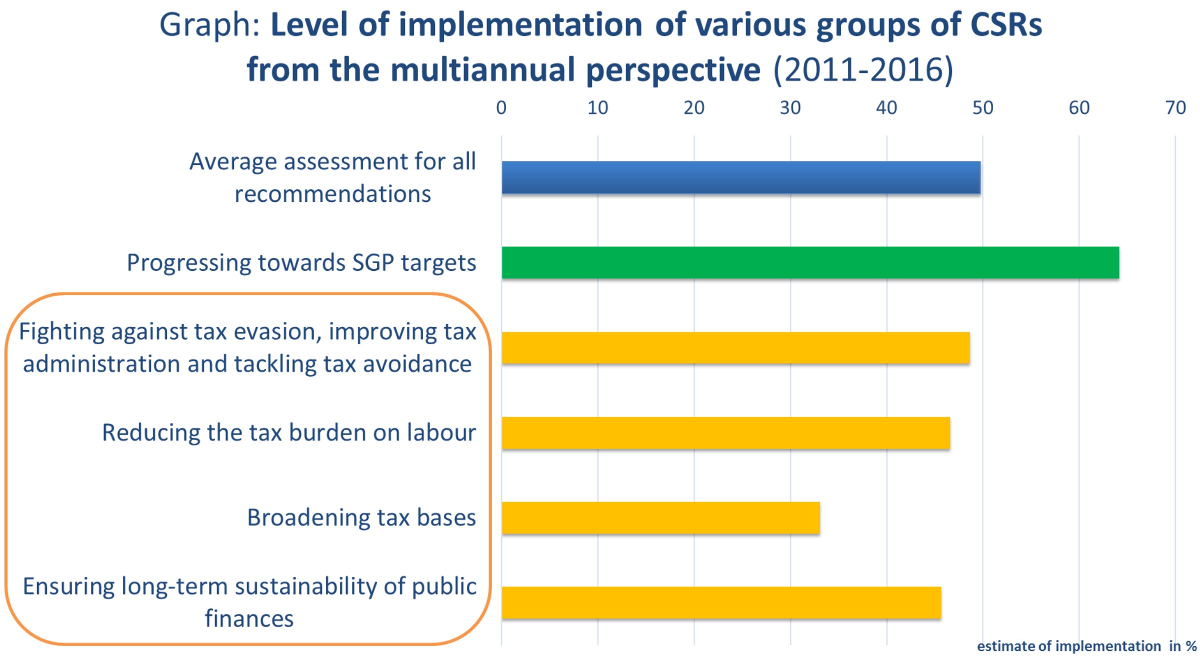
especially of those "left behind." This even more so when, as is the case for some of the measures in the Italian budget, the approved package might ultimately be inimical to long-term per capita output growth. The neglect of quality public finance is all the more deleterious in the case of Italy, already a laggard on this front. In a comparison across countries of the simulated effect of government size, public finance structure and effectiveness on long-term output per capita (all proxies for the quality of public finances), the OECD estimates the effect in the case of Italy to be the furthest below the OECD average, implying the lowest overall quality on this metric.[8]

Missing Teeth

Despite the above shortcomings, the European policymaking process does – at least on paper – provide the opportunity to guide member states' fiscal (and other) policies toward virtuous, "quality" measures – most specifically via the **country-specific recommendations under the European Semester** (See Chart 1 below).

Source: Marco Buti, *Improving the Quality of Public Finance: An Analytical Framework*, The 2018 Ludwig Erhard Lecture, delivered at the Lisbon Council on 17 December 2018

[8] Boris Cournède, Jean-Marc Fournier and Peter Hoeller, "Public Finance Structure and Inclusive Growth," *OECD Economic Policy Papers* (Paris: OECD, 2018). https://doi.org/10.1787/e99683b5-en



The difficulty, however, arises from the fact that the country-specific recommendations, in the way in which they are generated and approved, for the most part lack ownership and accountability, or, in other words, "teeth."

The case of Italy is again instructive. The 2018 country-specific recommendations were endorsed by the European Council heads of state and government on 28-29 June 2018 (the first summit attended by Giuseppe Conte, Italy's new Prime Minister), and formally approved – under the dismissive heading of "Other Items Approved" – by the Council of Economic and Financial Ministers (attended by Finance Minister Giovanni Tria) on 13 July 2018.[9] Even a quick perusal of the recommendations shows that they are in open contrast with the new government's stated policies and priorities, yet they sailed through both Councils. Clearly, no importance was attributed to them, neither then nor now.

Italy is not alone in largely ignoring the country-specific recommendations. As shown above, the average implementation rate for all recommendations comes in at a meagre 50%. While implementation approaches two-thirds for "progressing towards [stability and growth pact] targets" (again highlighting the primacy of the numerical "rules" in the EU policymaking framework), it is appreciably lower for the "quality" recommendations (outlined in orange in the Chart 2 above). Relatedly, the share of "growth-friendly" expenditure has, according to European Commission estimates, remained unchanged at a modest 13.9% of total euro area spending in the decade between 2006 and 2016 – despite repeated calls to favour such outlays, especially in reaction to the great financial and euro area crises.

[9] See European Council Conclusions, 28 June 2018, and Outcome of the Council Meeting, 3631st Council meeting, Economic and Financial Affairs, 13 July 2018.
https://www.consilium.europa.eu/media/35936/28-euco-final-conclusions-en.pdf
https://www.consilium.europa.eu/media/36135/st11122-re01-en18.pdf

Five Steps to a Better Future

How can these opportunities be used to better integrate the "quality of public finances" as a key ingredient of European policymaking and surveillance? We propose a five-step programme.

1. **Give greater "teeth" to the country-specific recommendations**, the most readily available vehicle to advance the quality of public finance. To this end, accountability for their realization should be enhanced by specifying for each country 3-4 actionable reforms for the coming year, listing them in individual country paragraphs as an integral part of European Council Conclusions and requiring individual heads of state or government to subscribe to them in a more specific (and thus accountable) manner than has been the case hitherto. In the eight European Semesters completed to date (from 2011 to 2018), the European Council has simply conferred an overall blanket endorsement to the European Commission's recommendations in too vague and general a manner to entail any real commitment, or any loss of political capital in case of non-observance.[10] Weasel wording for such a key component of EU policymaking and surveillance is simply unacceptable and should not be allowed to persist.

2. **Endow the quality-orientation of this year's Annual Growth Survey with operational content**. The annual growth survey is a key document in the European Semester – it sets out the general economic priorities for the EU and offers member governments policy guidance for the following year. Importantly, the 2019 growth survey contains repeated references to "quality."[11] In particular, the report notes that "improving the quality and composition of public finances is important for ensuring macroeconomic stability and a crucial element of member states' fiscal policy. On the revenue side, efficient tax systems that provide incentives for investment and growth should be established. Efforts are also needed on the expenditure side, through spending reviews and by prioritising expenditure that fosters long-term growth and equity." In March, the European Council is to adopt this year's economic priorities based on the annual growth survey: this will be the occasion to give these words operational content and meaning. The eurogroup could also usefully dedicate one of its "thematic discussions" to the quality of public finance, as a way of making this important deliverable a constant point of reference for ongoing debate and evaluation. Furthermore, as its own contribution, the European Commission could review and update its seminal 2008 European Economy paper on the quality of public finances and growth.[12] More broadly, to further the debate in a tangible

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[10] In the latest rendition, in June 2018, while the wording avoided escape clauses such as "generally" or "broadly" endorsed (used in the past), the formulation remained clearly non-committal: "The European Council endorses the integrated country-specific recommendations as discussed by the Council, thus allowing the conclusion of the 2018 European Semester." European Council, *European Council Conclusions*, 28 June 2018. https://www.consilium.europa.eu/media/35936/28-euco-final-conclusions-en.pdf

[11] It mentions high-quality investment, quality education and training, quality healthcare, high-quality public service, quality of the regulatory environment and the quality of governance. See European Commission, *Annual Growth Survey 2019: For a Stronger Europe in the Face of Global Uncertainty,* 21 November 2018. https://ec.europa.eu/info/sites/info/files/file_import/2019-european-semester-annual-growth-survey_en_1.pdf

[12] Barrios and Schaechter, op. cit.

manner, consideration could be given to organising sectoral deep-dives ('workshops') into different policy areas where quality of public finance issues are relevant, such as The 2018 Euro Summit convened by the Lisbon Council. These discussions should involve the European Commission, the OECD, the International Monetary Fund, think tanks and other organisations, as the quality of public finance spans many policy areas attracting the interest of many stakeholders.

3. **Confer a "positive incentive" role to good behaviour**, with implementation of the country-specific recommendations opening access to certain forms of financing. Success stories – and there are such – deserve appropriate "naming and faming" and a form of favoured treatment at times of possible stress. This holds particularly for the proposed euro area budgetary instrument, whose features – to be agreed in June 2019 – will hopefully go beyond current limited proposals.[13] Similarly, the European Stability Mechanism's precautionary instruments (unused to date) are undergoing a long overdue review, aimed at clarifying the *ex-ante* eligibility criteria and making them more transparent and predictable. The so-called Term Sheet on the European Stability Mechanism reform (dated 04 December 2018) envisages that such criteria be based on "quantitative *and qualitative* [emphasis added] elements related to the economic and fiscal performance of member states."[14] It goes on to note that, in addition to the well-known quantitative fiscal benchmarks, member states will need "to comply with *qualitative conditions* related to EU surveillance." It will be important that these be indeed qualitative in nature and assigned at least equal footing to the quantitative benchmarks.

4. **Assign a prominent role to the quality of public finance in the road to be charted at the Sibiu Summit**. The Sibiu Summit, on 09 May 2019, will take place on the eve of European elections and, as such, acquires an unusual political dimension. It is billed as the culmination of a process leading to "a renewed commitment to an EU that delivers on the issues that really matter to people."[15] Quality public finances that provide quality services, promote sustained per capita income growth and reduce inequalities certainly feature among such issues.

5. **Include an evaluation of the quality of public finance in the mandate of the European Fiscal Board (EFB)**, and encourage similar steps in the case of independent fiscal councils at the national level. While this process would by necessity take time, the EFB could on its own initiative integrate quality of public

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[13] For an overview of the state of debate within the eurogroup on this, see Statement of the Euro Summit, 18 December 2018.
https://www.consilium.europa.eu/en/press/press-releases/2018/12/14/statement-of-the-euro-summit-14-december-2018/

[14] See Council of the European Union, "Term Sheet for the European Stability Mechanism Reform," 14 December 2018.
https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf

[15] Complete with its own hashtag, #EURoad2Sibiu; see European Commission, *Future of Europe,* 14 February 2018.
https://ec.europa.eu/commission/future-europe_en

finances into its own remarkably readable and politically important annual reports, or, possibly, in *ad hoc* communications.

Improving the Quality of Public Finance: A Five-Step Programme

1. Give the quality of public finance greater prominence in the European Semester country-specific recommendations. Above all, endow the recommendations with greater "teeth" to enhance ownership and accountability; individual heads of state and government should underwrite the recommendations individually – personally and politically.

2. Set the quality of public finance as an ongoing agenda item for eurogroup discussions and subsequent economic evaluations, including the country-specific recommendations.

3. Reward good behaviour. There should be a "positive incentive" for getting it right, with implementation of the recommendations giving priority access to certain forms of financing (euro area budgetary instrument, ESM precautionary facilities, growth funds).

4. Permanently assign a prominent role to the quality of public finance on the EU agenda at the May 2019 Sibiu Summit.

5. Expand the mandate of the European Fiscal Board and the independent national fiscal councils to include an evaluation of the quality of public finance.

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