

Fiscal Discipline and Public Investment in Europe

Von einer Gesinnungsethik zu einer Verantwortungsethik² ?

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¹ This paper expresses the personal views of the authors and does not engage the institutions to which they are affiliated. It is a contribution to a complex debate. It does not pretend to be exhaustive or comprehensive, according to academic standards. It focuses deliberately on a narrow topic – how to combine fiscal discipline with the promotion of investment – i.e. on the structural dimension. It does not address the cyclical aspects, nor the question of the treatment of the existing stock of debt. This paper is part of a policy workshop organised in collaboration with Friends of Europe.

² From an ethic of ultimate ends to an ethic of responsibility (from Max Weber, *Politik als Beruf*, München 1919)

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Introduction

The Juncker Plan is a most welcomed shift in European policies. Never before, since the beginning of the crisis, had the centrality of investment been spelt out so clearly.

Whilst the plan concentrates on the promotion of investments from the EU level, European economies need public investments at the national level too. This paper tries to see how national investment could also be encouraged, perhaps through a permanent or temporary adaptation of the EU rules on fiscal discipline. Properly framed, such adaptation might facilitate the needed expansion in Europe's overall investment effort, while making the enforcement of the rules more objective and credible. Amongst others, this would relieve the Commission from having to make increasing use of discretion and "flexibility" (which inevitably give the impression of political bargaining with individual Member States) as the only way to temper the economically counterproductive effects that would derive from the blind application of outdated and somewhat irrational rules. Under the current rules, in fact, whatever "flexibility" is applied is likely to create more room for current, not investment, public expenditure.

In order for the EU, let alone the Eurozone, to remain a "community", there are two essential requirements today: compliance with agreed rules and, at the same time, more growth. We will either achieve both or neither.

1. The value of rules

The European Union is based on the rule of law. Therefore, the euro requires a strong commitment to the rules by all Member States. The Maastricht Treaty, as well as the Stability and Growth Pact (SGP), were all agreed in common, and revised according to democratic, collective procedures.

France, Italy (and more broadly "the South") must not accuse Germany (and more broadly "the North") of being legalistic or technocratic when they insist that rules must be observed, as is the basis of any community. Common rules and the commitment to comply are a sine qua non condition of European integration. They are also – just as legal certainty at the micro level - a key factor for growth, as they provide stability. Without credible rules and enforcement, no single market or single currency is possible.

Many "Anglo-Saxon" experts criticise Europe for its lack of action in a severe situation of "secular stagnation" (Larry Summers). They hide the fact that the EU is not a state, where a central government is equipped with discretionary executive powers and a significant budget, backed by own resources. European institutions, like the European Central Bank or the Commission, can only act within a previously agreed legal framework, within their mandate. They cannot change the rules, enlarge the scope of their competences, nor provide resources without the agreement of the national governments. Compliance is the pre-condition for mutual trust.

On the other hand, the insistence of "the South" on the need to create growth must not be seen by Germany (and "the North") as a sign of profligacy. One of the main objectives of the EU is, according to its own rules, "the wellbeing of its peoples" (article 3 of the Treaty on the European Union). More growth throughout the whole EU is imperative for each country but

also for the very survival of European integration. The success of populist, anti-European and often xenophobic parties, puts integration, as well as democracy, at risk.

2. The current lack of compliance

The Stability and Growth Pact (SGP) is yet to be declared dead, but several attacks against it have weakened its collective credibility. The rules are so complicated, the monitoring procedures so abstruse that the public opinion does not realize that these rules have proven effective for reducing public deficits (from 4.5 % of GDP in 2011 to 3% of GDP in 2014, 23 Member States being in the excessive deficit procedure in 2011, 11 in 2014). Several national leaders pretend that their governments/Parliaments still make decisions on their own, which is no longer true. They refuse to take ownership of their commitments, they ignore the fact that interdependence requires shared sovereignty.

Reality needs to be faced: by and large the SGP is not currently complied with. We cannot speak of compliance when many Member States can easily secure extensions to deadlines for meeting the targets. In the name of “flexibility”, discretionary changes are de facto made to the rules in an opaque manner. We pretend that there is compliance but this is less and less true. If we go further down this road of a somewhat artificial – one could say, “massaged” - compliance, the damage in terms of mutual trust will be significant. The rather acrimonious statements and attitudes that, in the last days and weeks, have been exchanged between none less than the three largest countries in the Eurozone – Germany, France and Italy – do not bode well for the cohesion and harmonious dynamism of the Eurozone, in itself and in the markets’ perceptions.

Discipline is sustainable when it remains enforceable even in hard times. Although, during the crisis, the “6 pack”, the “Fiscal Compact” and the “2 pack” have strengthened the budgetary rules and broadened the scope of control by the Commission (notably with the new Macroeconomic Imbalances Procedure), the Eurozone still lacks a sustainable policy mix. For this flaw, the EU and the Eurozone are paying twice: they are perceived by public opinion, not entirely wrongly, as being very intrusive; yet they do not appear capable of delivering compliance and, ultimately, prosperity.

The budget and debt targets are not respected by all Member States. Structural reforms, a key priority for growth, are not implemented in a satisfactory manner. Europe has lost almost 15 years since the Lisbon Strategy was adopted in 2000, with the goal of boosting European competitiveness.

Figures collected by the European Commission and the European Parliament in 2014⁵ (on the Country Specific Recommendations 2013) show that the percentage of these recommendations fully or substantially implemented, is only around 10%. Some progress has been registered for approximately 45% of them, while broadly speaking an equally large proportion have not been implemented at all, or only in a limited manner.

According to the Treaties, the economic policies of the Eurozone are supposed to be coordinated (art 121 TFEU). Actually they are not, or not sufficiently. Mario Draghi said

⁵<http://www.europarl.europa.eu/document/activities/cont/201410/20141006ATT90562/20141006ATT90562EN.pdf>

recently in Jackson Hole “Unlike in major advanced economies, our fiscal stance is not based on a single budget voted by a single Parliament but on the aggregation of 18 national budgets and the EU budget. Stronger coordination among the different national fiscal stances should in principle allow us to achieve a more growth friendly overall fiscal stance for the euro area”.

Furthermore, there are existing shortcomings, present since its inception, in the SGP. In particular, the assumption within the SGP is that all public spending, even genuine productive investment to expand the potential for growth, is inherently “bad”, and should not be financed by debt, even under EU monitoring; while all private spending, even consumption, is inherently “good”, and can also be financed by debt, without any EU monitoring.

The approach adopted in 1996 when the SGP was created, did not, and still does not, recognize the *nature* of expenditures to a sufficient extent, whereas the *sector* which makes the expenditure receives exaggerated attention.

The composition of the public expenditures and, first of all, the repartition between consumption and investment, is to be looked at carefully.

Some countries of the euro area have experienced difficulties (or are still in trouble) because of excessive public spending and excessive levels of public debts. However some Member States that were compliant with the public deficit and debt rules, got into trouble because of excesses of private debt, allocated to non-productive sectors (in Spain for example where a harmful real estate bubble had emerged).

In the Excessive Deficit Procedure, the Commission is supposed to check if the public deficit exceeds the level of public investment expenditures (article 126.3 TFEU, previously 104.3), it is quite a marginal element however. Yet, because such provision dates back to the Maastricht Treaty, it could be given a more profound significance, namely that in the very foundations of Europe’s fiscal discipline construction, the distinction between current and investment public expenditure was indeed enshrined.

The monitoring of the macroeconomic imbalances, that is one of the major achievements of the reform of the SGP in 2011, means that public investment can be looked at more carefully, as it is one of “the structural aspects” of the public finances discipline.

At this stage, the scoreboard at the disposal of the Commission, consisting of eleven indicators⁶, does not materially take into consideration this parameter, although it is a central one in making fiscal discipline sustainable. When the Commission is checking the general government sector debt and the sustainability of public finances, it is of course possible for it to look at the expenditures inherent in servicing the debt, and indirectly to see if this burden does not reduce the financing flows available for productive investment. But also public investments, which can provide a key contribution in removing bottlenecks impeding the growth of total factor productivity, should deserve a specific treatment.

Furthermore a closer bridge could be built between the “excessive deficit procedure” *stricto sensu* and the assessment of the macro-economic imbalances. Even if the decisions of the

⁶ Such as current account balance, net international investment position, export market shares, nominal unit labor cost, three-year percentage change of the real effective exchange rates, private sector debt and credit flow, general government sector debt, unemployment rate.

Commission on the national budgets do already take into account the structural reforms launched at the national level, they are interlinked and investment is one of the key factors to evaluate if a country moves in the right direction, preparing for the future.

Incidentally the difference made according to the origin of the expenditure (public/private) in the Maastricht treaty and the SGP is not in line with another, and earlier, key pillar of European integration. If we look at the former article 295 (now 345 TFEU - without any change), it stipulates the total neutrality of the EU (and previously the EC), as regards private or public ownership of companies, but imposes on both privately or publicly held companies the obligation to comply with competition and state aid rules. It is only when it came to creating the single currency – and therefore to protecting ourselves from the excesses of public sector absorption of funds, because historically that had indeed been an important factor contributing to monetary and financial instability in many Member States – that a grossly approximated analytical scheme acquired almost exclusive political relevance. This means that, at least in the countries where private investment is low, and the public authorities (State and local) do not play the strategic role they have played in some other parts of the EU to guide, accompany and boost private investment, the common rules are inflicting an anti-growth bias, which currently is rather severe.

When the proposal for the original SGP was being formulated by the European Commission, one of the authors of this paper – at the time a member of the Commission in charge of the Single Market – had proposed that there should be an explicit recognition of the distinction between current and investment public expenditure, building on the above mentioned article of the Maastricht Treaty (See in the appendix the letter he sent in October 1996 to his colleagues). A wide internal and external debate followed, but that view was not endorsed by the President of the Commission and the Commissioner for Economic and Financial Affairs. The letter was also proposing that the Commission and the statistical body of the EU, Eurostat, should develop a common set of criteria which would allow a clearer, more rigorous and economically-based definition of eligible public investment. Even if this work is not an easy task, if it had been started 18 years ago, considerable progress could have been made during the “fair weather” times, before the beginning of the financial crisis.

With the deepening of the crisis, the European Council began to move; the December 2012 conclusions in particular include the following sentence: “While fully respecting the Stability and Growth Pact, the possibilities offered by the EU's existing fiscal framework to balance productive public investment needs with fiscal discipline objectives can be exploited in the preventive arm of the SGP”⁷.

In 2013, the Commission has accepted that the countries in the preventive arm of the SGP could have some deviation from the structural deficit path towards the Medium Term objectives for the national expenditures of projects co-funded by the EU under the Structural and Cohesion policy, Trans European Network and Connecting Europe facility⁸. It has also used the “considerable scope of judgment based on economic analysis and gave deadline extensions to reduce fiscal deficits.”⁹

⁷ Co Eur 19, EUCO 205 / 12, Conclusions of the European Council of December 13 / 14 December

⁸⁸ Letter from Olli Rehn, Vice President of the COM on July, 3, 2013

⁹ Olli Rehn, The Spectre of deflation, Europe's World, Autumn 2014

This recognition is unfortunately insufficient. Firstly, it only concerns the Member States being in the preventive arm of the SGP. Today it would provide a solution for Italy, but not for France for example. Secondly, and more broadly, unless the SGP's shortcomings are addressed soon, the monetary union is at risk of encountering huge difficulties. The very illness policy makers have tried to eradicate from the markets could well return in policy-making: short-termism.

This approach could also have unintended consequences in terms of redistribution between Member States. The money invested at the European level will mainly provide more wealth where the infrastructure is located for example. It might only indirectly increase the revenues of the country making the financial effort. By fair weather, it is positive to encourage the Member States to invest in projects of common interest, without any "I want my money back" approach. In a situation like the one Europe is facing now, where the legacies of the crisis have to be addressed, and as the excessive deficit is based on the calculation of the ratio deficit / national GDP, it might be more appropriate to identify as eligible investments (allowing deduction) only the ones that increase, as directly as possible, the GDP of the Member State providing the money.

A simplistic pact may have been the right thing for the infancy of the euro but Europe can no longer afford to pay the price of such a rudimentary instrument. When the SGP was negotiated in 1996, there was a short term imperative: to reassure German public opinion that the euro would be as strong as the Deutsch Mark. Meanwhile several violations of rules and the sovereign debt crisis have reduced the levels of mutual trust. German public opinion is hungry for reassurance about renewed discipline. Nevertheless, discipline should not only be considered in a short term perspective. The costs of non-enforcement of the rules exist, in terms of credibility, but there are also costs linked to the blanket enforcement of rules in a context of low growth and low inflation or even worse, of fake compliance.

Stability can only be considered to have been achieved if the policies safeguard the interest of future generations; in this perspective productive investment is key, in order to finance innovation and to remain competitive.

Max Weber would say that we should orient our conduct towards an "ethic of responsibility" and not to an ethic "of ultimate ends" or to translate Weber's concept more precisely an ethic of intentions (Verantwortungsethik instead of Gesinnungsethik)¹⁰. The German sociologist identified perfectly well the risks of "pure intentions": *"The believer in an ethic of ultimate ends feels 'responsible' only for seeing to it that the flame of pure intentions is not quenched <...>. To rekindle the flame ever anew is the purpose of his quite irrational deeds, judged in view of their possible success. They are acts that can and shall have only exemplary value."*

It is time to take into account the concrete consequences of intentions when they are followed by misbehavior. Currently, the levels of political instability and unemployment are sufficiently elevated to invite us to reflect upon our practices.

¹⁰ Politics as a vocation, München 1919

3. The value of public investment

If investment is delayed, negative consequences arise; the fact that, for a while, they are not visible does not mean that they do not exist. They are simply postponed. This is what we could call “the hidden cost of non-investment”.

In global competition, there is no chance to remain competitive without catching up with the most dynamic regions of the earth.

As the OECD writes in its recommendation of the OECD Council on Effective Public Investment Across Levels of Government ¹¹ « Public investment shapes choices about where people live and work, influences the nature and location of private investment, and affects quality of life. If well-managed, public investment is a potentially growth-enhancing form of public expenditure. In contrast, poor investment choices waste resources, erode public trust and may hamper growth opportunities »

Fiscal discipline has the merit of protecting future generations from the abuses of current politicians keen on profligacy. But not all investments are well advised however, by not properly recognizing the role of public investments, it has in fact pushed governments to cut them: the short-term objective of reducing expenditure is respected by cutting investment, which is easier (less costly, from a political point of view), than reducing public consumption or social services. These cuts have also an indirect influence on private investment. As a result, the long-term is sacrificed.

In the previously quoted recommendation, the OECD stresses that « Public investment is under pressure following fiscal consolidation strategies. Most OECD governments have moved from large-scale stimulus packages in 2008-2009 to fiscal consolidation in more recent years. Since 2010, consolidation strategies have reduced the resources for public investment, putting public investment onto a downward path, even as private investment in many countries has continued to contract. Being one of the most flexible items in the budget, public investment has been used as an adjustment variable. While investments peaked in 2009 with the stimulus packages, the annual level across the OECD has not yet recovered to pre-crisis levels. Compared to 2007, public investment per capita in 2012 had fallen in 15 out of 33 OECD countries ».

What is actually needed is the introduction of a more *rigorous*, not more *flexible*, rule, allowing well identified public potentially growth enhancing investments. It is not appropriate to ask for “flexibility” to deviate from the rules, but rather for rules that are economically and morally rigorous and make sense, in a medium term perspective.

This is more important than ever because, as the FMI is stating in the World Economic Outlook¹², “the interplay of (...) the crisis legacy proving tougher to resolve than expected and potential growth turning lower has resulted in several downward revisions to the forecast during the past three years”. In the euro area “the recovery has been slowed by the crisis legacies, primarily in the South and by low potential growth nearly everywhere”. “There is a

¹¹ March, 12 2014

¹² October 2014

risk that the recovery in the euro area could stall, that demand could weaken further, and that low inflation could turn into deflation.”

According to several sources, the European Union is suffering today from a huge investment gap. It would be impossible to quote all the scholars or organizations that have tackled this issue. We will only give some examples.

Christine Lagarde, Managing director of the IMF warned in Aix en Provence in July 2014: “the crisis has inflicted a heavy toll on output and investment, which remain well below their long term trends. As of last year, we <IMF> estimate GDP for the G-20 as a whole to be 8 % lower that it could have otherwise been (that is relative to its long run trend); the shortfall in investment in even higher – nearly 20 % below trend¹³.”

For Jean Pisani-Ferry and Henrik Enderlein, who recently wrote a joint report for the German and French ministers for the economy¹⁴, Europe is losing ground in comparison to the rest of the world: “Current investments in almost every country in Europe are too low. In 2013, gross non-residential capital formation in the euro area was still 16% below the level of 2007 (in volume). In the United States, it was back on its 2007 level, and in China total gross capital formation was 50% above the 2007 level.”

The European Commission Communication¹⁵, known as the Juncker Plan, states: “Europe urgently needs an Investment Plan. As a consequence of the economic and financial crisis, the level of investment in the EU has dropped significantly since its peak in 2007, by about 15%”. In a footnote, the Commission gives the following figures: “in some Member States, that dip is even more dramatic. This is notably the case for Italy (-25%), Portugal (-36%), Spain (-38%), Ireland (-39%), and Greece (-64%). »

Prof. Marcel Fratzscher, Head of the German Institute DIW, recalls in his book¹⁶ that Germany has also been impacted: the level of investment was around 23% of GDP at the beginning of the 1990s, reached 20% in 2000 and is now around 17% which is below the average level of investment of OECD countries. According to Prof. Marcel Fratzscher, the lack of investment in Germany represents circa 3% of GDP (i.e. EUR80 billion annually).

Several initiatives aiming at revitalizing investment, both at national and European level, are flourishing throughout Europe.

In Poland, Minister Szczurek developed an ambitious EUR700 billion plan (5,5% of EU GDP) for pan European infrastructure with a particular focus on energy, transportation, ICT and defence. In the European Parliament, the ALDE group is also calling for a “European investment and recovery act” aiming at increasing investment and improving the business climate through initiatives in favor of energy, transport, the digital economy and above all SMEs.

¹³ Investment for the future, Higher Investment for stronger Growth, speech at the Rencontres économiques d’Aix-en-Provence, July 6, 2014

¹⁴ Reforms, Investment and Growth: An agenda for France, Germany and Europe, November 2014

¹⁵ An investment plan for Europe, 2014 (903) final, November 26, 2014

¹⁶ Marcel Fratzscher Die Deutschland Illusion, Hanser 2014

Even Otmar Issing, who cannot be accused of being lax as far as public expenditure is concerned, wrote about Germany in the FT recently¹⁷ “Yet public investment is seen as too low. Infrastructure show signs of decay, streets and bridges need repair. No doubt, these and other efficiencies are strong arguments for increasing public investment. At the same time, Germany is substantially increasing public spending for various social purposes. The obvious advice should be: restructure the budget, increase investment and reduce social spending.”

4. The macroeconomic effect of (sound) public investment

In its last World Economic Outlook, published in October 2014, the IMF dedicates a whole chapter to the “macroeconomic effects of public investment”. It asks “Is it time for an investment push?”, before definitively giving a positive answer.

The IMF takes into consideration the arguments against such a push in advanced economies first of all; the need for further consolidation of public finances and the little fiscal space available given still-high debt-to-GDP ratios.

The analysis of the IMF suggests that, above all for countries needing infrastructures, the time is right for a new boost, because of the current state of aging infrastructures and the very low levels of borrowing costs.

The IMF discusses the basic economics of infrastructure, how it differs from other types of capital: they are “often large, capital-intensive projects that tend to be monopolies”. “They tend to have up-front costs” and returns only long term after the investment is made. But they also “have the potential to generate positive externalities, so that the social return to a project can exceed the private returns it can generate for the operator”.

“Debt –financed projects could have large output effects without increasing the debt to GDP ratio, if clearly identified infrastructure needs are met through efficient investment”. The interesting thing is that the IMF concludes that “an increase in public infrastructure investment affects output both in the short term, by boosting aggregate demand through the fiscal multiplier and potentially crowding in private investment, and in the long term, by expanding the productive capacity of the economy”.

“During periods of low growth,... public investment shocks also bring about a reduction of the public debt to GDP ratio because of the much bigger boost in output.” The results of the IMF's calculations show that the output effects are even larger when public investments are debt financed than when they are budget neutral.

In Germany, the first economy of the Eurozone, the opposite choice was made recently: the German Bundestag has adopted a constitutional “Schuldenbremse” (debt brake) in order to limit the public authorities (Bund and Länder) borrowing money, even if the purpose is for investment.

At a time where a huge majority of economists, in Europe and worldwide, are placing the emphasis on investment, the Germans are giving up their previous “golden rule” that allowed investment linked borrowing to adopt a more stringent, although less focused, one.

¹⁷ Blame Germany for bad policies, not its reluctance to spend more, October 23, 2014

Since the creation of the Bundesrepublik, the German federal constitution (Grundgesetz) as well as the Constitutions of the Länder included a limitation of debt by the Bund and the Länder. This restriction was future oriented however: public borrowing was allowed for public investment only. Germans called it the "golden rule" and initially tried to have it enshrined in the Maastricht Treaty.

These rules have not impeded a skyrocketing increase of public debt in Germany. According to the Bundesbank¹⁸, the level of public debt/GDP of the Bund that was around 20% in the 1950s, reached more than 80% in 2010. Some Länder (Bremen, Saarland, Sachsen-Anhalt or Berlin for example) were highly indebted too. Unfortunately the document of the Bundesbank does not contain elements on the composition of this increasing debt. Debts can be created by other expenditures or be the consequences of inappropriate investment decisions. It does not make any investment financed by debt irrelevant.

The Bundesbank argues that the lack of precise definition of investment and the existence of an excessive "flexibility" in case of macroeconomic imbalances, preventing reimbursements, allowed the Bund to violate the rules too easily. And the margins for interpretation enshrined in the legal text prevented the Constitutional Court being able to effectively control the implementation of the rules.

In order to prevent these deviations, and to make sure that Germany would respect the European rules of the SGP, a revision of the Grundgesetz was launched in 2009. The new rules of article 109.III GG, called "Schuldenbremse" are stricter. They aim at a balanced budget, in structural terms, without allowing special treatment for investment anymore.

For the Bund, they define a maximum threshold of 0,35% debt to GDP (taking into account the effects of the economic cycle), to be respected up to 2016. The cyclical element does exist but it means that in "good times", the Bund must undertake efforts to aim to reduce the amount of debt that could have been created in "bad times". For the Länder, the creation of debt will be forbidden after 2020. For the local level (Gemeinde), there is also a restriction enshrined in the Länder's rules.

By fixing a threshold (and not a goal that can be reached taking into account some other elements), the drafting of the new rules makes it easier for the Constitutional Court to intervene in case of a violation.

In a context of an investment gap, stagnation and very low fixed interest rates, the German authorities have given up the investment linked "golden rule" and chosen a restrictive concept of balanced budget (Schwarze Null), with a debt break (Schuldenbremse).

5. What is to be done?

(1) The EU needs an open debate on what is in the real interest of the future generations.

European policies should again become future oriented. President Juncker announced a large EU investment plan of EUR300 billion. The shift should not be underestimated. Although

¹⁸ Monatsbericht Deutsche Bundesbank, Oktober 2011 Die Schuldenbremse in Deutschland, Wesentliche Inhalte und deren Umsetzung

highly welcome, the plan is unlikely to be large enough nor fast enough to have the needed impact all on its own. Action is required at the national level too.

As we already stressed, it is also a matter of fairness as the discipline is conducted for the national budgets and the positive effects of European investments could be different from a Member State to another.

At the same time, the increased demands for “flexibility” in the implementation of the SGP are, as previously stressed, worrying; the lack of compliance concerning the core rules of the Economic and Monetary Union is creating uncertainty for the public opinions and the markets.

The idea of a more favorable treatment for public investment has been gaining ground. In his plan Juncker announced that “Importantly, in the context of the assessment of public finances under the Stability and Growth Pact, the Commission will take a favorable position towards such capital contributions to the Fund”.

The revision of the SGP should drive reflection about the exclusion of part of public investment from the 3% threshold. It is not a demand for "flexibility" but rather for a change in the rules in order to make them sustainable and stability oriented, also through a more growth-friendly orientation. The analysis should include both the national and the European level.

The new Commission should announce a parallel bold initiative on investment at the national level, along the following lines: 1) Enforce the Stability Pact with no special leniency, but fully applying what was introduced for investment in 2013; 2) Present a proposal for the fiscal discipline instruments to be updated to fully reflect the role of productive public investment. There could be two regimes: an ordinary one, within the 3%, and an exceptional one, allowing a specified excess above the ceiling for a limited period, under strict conditions.

(2) The Commission should also draw lessons from the German experience of the golden rule.

The risk identified by the German authorities, summed up by the Bundesbank in the document on the Schuldenbremse previously quoted, should be taken seriously: a derogation for investment should not increase the level of debt in an appropriate manner by opening the door to all abuses.

The criteria should be conceived in a democratic, transparent way and allow the European Court of Justice to be responsible for its control. One of the elements missing in the current macroeconomic governance of the EMU is actually the lack of judicial action for failure to fulfill obligations (article 258 / 259 TFEU).

The price to be paid by the countries that are asking for more room for maneuver should be to accept the binding jurisdiction of the Court in the implementation of the SGP (it would only require a limited treaty change, consisting in deleting art 126.10 TFEU).

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The Commission should, using Eurostat's expertise, promptly launch a major reflection with a view to providing, within six months, agreed principles on at least certain categories of public expenditure that will qualify as eligible investments.

Of course, to separate investment expenditures from other expenditures is not an easy task, neither in theory, nor in practice but the fact that this work is difficult should not be an argument not to do it.

Seven questions should be examined carefully:

1/The productive character of the investment. How to make sure that the investment's projects fit into the calculations of the IMF and affect output in the short and the long-term?

How can we avoid projects motivated by local political interests, such as having a high speed train railway station in the middle of nowhere but which is in the heart of one Minister's constituency? The reports of the national Courts of Auditors are full of such negative examples.

Can we foresee that an independent authority plays a role in defining the eligible projects? (Should it be the Commission? A board made out of members of the national Councils for public finances?)

2/ The type of investment. Should infrastructures be privileged (as the IMF proposes) or should a bottom up, decentralized approach giving priority to SMEs, be chosen? An approach linked with climate change policy (such as energy efficiency in buildings, local transport, etc.) might make sense and allow all the Member States to be eligible.

3/The nature of investment. Should the EU encourage any kind of infrastructures (or define a very limited framework, for example projects that contribute to a carbon free society)? What about investment in human capital? As we need to move towards knowledge based societies, it seems impossible to exclude investment in human capital, but the definition should be restrictive.

Should **defence** be treated as a specific field? Some Member States provide security for others and are tempted to argue along this line. Furthermore, there are spillovers to the civil branches, deriving from military investments (as in the US).

4/ The origin of the money. Should the leverage/participation of the private sector be a criterion for eligibility? Or should the focus be on public money?

5/ The risks of hijack. How to avoid **subsidies** to sectors that are not future oriented (hidden state aids)?

6/ The accompanying measures (Single Market, Capital Markets Union, structural reforms) are key in order to change the **business climate** and create in the EU **the appropriate scale** which investors can find in the US, in China or in some new large emerging markets; many managers explain the lack of investment less because of the lack of financing, but rather because of doubts about Europe's future and fragmentation of the European markets.

7/ The risk of corruption. How can the EU help the Member States to fight against the corruption that is often linked to public procurements and “big projects”?

Conclusion

A reconciliation is only possible on a solid agreement on substance, not through horse-trading. We propose a future-oriented but deeply concrete approach for Europe to prepare its future, i.e. a decent Europe for future generations, thus triggering growth already for the unlucky current young generations, who are suffering most from Europe’s policy inadequacies and return to dangerous mutual mistrust among Member States. By encouraging productive investment – private and public – at the national level, it would help the Member States to comply with the European rules, reinforce the Juncker plan and build confidence once again.

Under strict circumstances the Europeans would define together what is eligible to be productive spending, investments with long-term positive effects on innovation and growth which should not be treated as consumption. The Member States lacking investment could also be sanctioned.

At the beginning of the 1980s, the European Community was suffering from sclerosis. It was in Milan, in June 1985, after in-depth preparatory work by Jacques Delors, that the governments of 10 Member States (as well as Spain and Portugal who were about to join) launched the boldest project to generate growth and employment: the Single Market. At the time the European leadership advocated the case for integration first and foremost by showing cohesion among each other in front of public opinion.

A new boost for the EU today requires, from both national and European leaders, the same sense of responsibility. Instead of insisting on their divergences and expressing mutual recriminations, national leaders should overcome their divergences regarding policy lines and, more deeply, regarding national cultures. These need to be handled in a responsible manner, not utilised to court the populists on the rise everywhere.

Brussels, 21 October 1996

Dear Mr. President and Dear Yves,

I fully support Yves' proposals. And I would like to take this opportunity to draw the attention of the College on a point which in my view is becoming crucial for EMU.

Last year (Commission of 21 June 1995) I had regretted the fact that no consideration was given to government investment in the context of the excessive deficit procedure. Yves promised to consider this aspect on future occasions. I thank him and his services that they have put government investment into the picture this year. This has been done by means of a specific accompanying table, though no mention is made in the text of the recommendations.

As I indicated last year, there is full legitimacy for considering government investment explicitly. There is legitimacy in terms of the Treaty, in terms of economic common-sense, and finally in terms of political credibility.

Treaty. Article 104c, paragraph 3, states that, "if a Member State does not fulfil the requirements under one or both of these criteria (i.e. the deficit and debt criteria), the Commission shall prepare a report. The report of the Commission shall also take into account whether the government deficit exceeds government investment expenditure (...)". This shows that the Treaty does make a distinction between deficits generated by government consumption and deficits generated by government investment.

Economic common-sense. It is not the total government deficit that subtracts resources from the formation of capital in an economy, but that part of the deficit that finances government consumption or current expenditure. To this extent there is irresponsible behaviour against future generations, because they are left with public debt not compensated by a greater endowment of public capital. A deficit of, say, 3 % of GDP entirely due to public consumption is worse than a 3 % deficit entirely due to public investment.

This is not dangerous progressive economic thinking; it is pure German-style orthodoxy. It is normally known as the "golden rule": government indebtedness is admissible, but only to cover government investment, not current expenditure.

Political credibility. The key problem today is that of achieving EMU on time, with a sufficiently high number of countries, without derogating from the Maastricht criteria and without aggravating unemployment.

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I am very concerned when, in an attempt to lend credibility to all this, it is said that ultimately there will be a "political" decision, implying large doses of flexibility. This situation may easily undermine credibility: either the credibility that the Euro will be achieved on time, or the credibility that the Euro will really be as sound as stipulated at Maastricht.

To avoid this possible erosion of credibility, it would be helpful if the Commission were to focus increasingly its own attention, and that of the public debate, on the important distinction between the consumption and investment components of the deficits.

During the early stages of the Maastricht negotiations, Germany itself had tried to have the "golden rule" introduced as the criterion for public finance. This was not achieved, but this was done indirectly through the provision of Art. 104.c.3. In view of the runup to the decisions to be made in 1998, I think it would be quite reassuring for the German public opinion if explicit and appropriate use were made of that same golden rule that is inscribed in the German culture of stability.

Of course, it has to be genuine public investment, not for example state aids to cover losses of companies. The Commission could play a useful role in further developing common criteria for public accounting and auditing, so as to make sure that what is accounted for as public investment is effectively such.

In conclusion, I welcome the first step made by Yves to introduce government investment in the excessive deficit procedure. I encourage him to go further and to focus more on this important distinction in future reports and in the public debate. This could help in orienting governments and the public debate towards a clear principle of financial orthodoxy and in reducing the dangerous expectation - not infrequent in the debate - of "flexible" political decisions.

Sincerely yours,

M. Monti

Mr. Jacques SANTER
President of the European Commission

Mr. Yves Thibault de SILGUY
Member of the European Commission