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Capital Constraints: Balancing the EU Fiscal Rules with Ireland's Capital Investment Needs

By Tim Costello

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The Institute of International and European Affairs

Tel: (353) 1-874 6756.

Fax: (353) 1- 878 6880.

E-mail: reception@iiea.com.

Web: www.iiea.com

8 North Great Georges Street,

Dublin 1,

Ireland

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Executive summary

Despite efforts by the European Commission to provide guidance to Member States on the flexibility built in to the existing rules of the Stability and Growth Pact, there remains discourse in Ireland and elsewhere in Europe regarding the constraints of the EU fiscal rules and the need for greater capital expenditure by governments. The objective of this discussion paper is to examine the main arguments that have been made as to whether or not fiscal rules contain an anti-investment bias that deters governments from pursuing large public spending projects. It also outlines a number of the alternative proposals put forward to incentivise capital expenditure within a rules based fiscal framework. This is a topic of particular relevance and importance to Ireland, which saw public capital expenditure significantly cut following the global financial crisis and the subsequent sovereign debt crisis in Europe, and which has a particular need for public investment because of its fast growing economy and emerging demographic pressures.

The paper is structured as follows: **Section 1** discusses public investment in Ireland; **Section 2** outlines the flexibility that is built in to the existing EU fiscal rules; and **Section 3** examines the interplay between public investment and fiscal rules, and details a number of proposals made to make fiscal rules more accommodating to capital expenditure. **Section 4** contains the concluding remarks.

1. Public investment in Ireland

The global financial crisis had a profound effect on the Irish economy and on the financial position of the state. Soaring debt levels and increasing bond yields forced Ireland into a financial assistance programme. The Government cut spending and increased taxation. General government fixed investment, which was 4.6 percent of GDP in 2007 and 5.2 percent of GDP in 2008, fell to 2.4 percent in 2011 and 2 percent in 2012. Ireland's general government fixed investment in 2015 was 1.7 percent of GDP – the lowest such rate in the EU. The average figure for the euro area in 2015 was 2.7 percent.¹

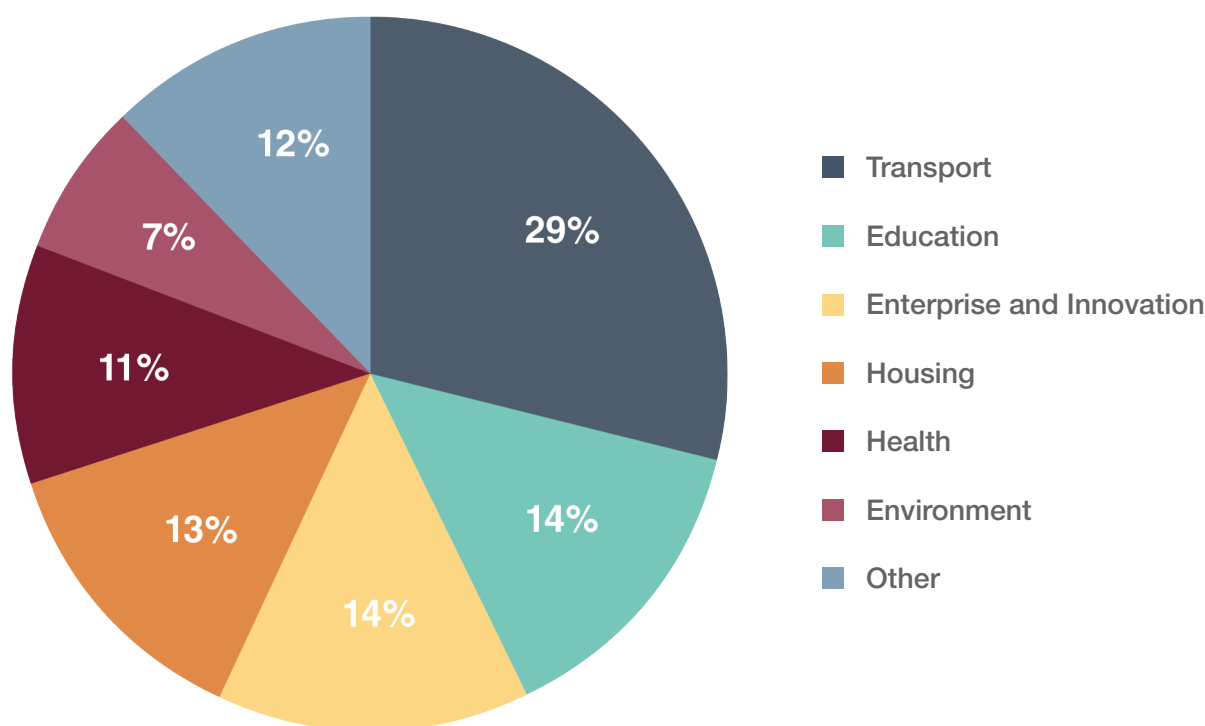
The European Commission's May 2016 Country-Specific Recommendations for Ireland highlighted the low levels of public investment to GDP in the country and warned that Ireland needed to address its infrastructure needs in order to “promote durable and balanced growth in the future”. It noted that the crisis seemed to have resulted in a “structural shift” in the composition of government expenditure towards current spending. The assessment that the reduction in public spending following the crisis had a negative impact on the quality and adequacy of infrastructure in Ireland led to the identification of

¹ Eurostat

“key weaknesses” in housing, water, public transport and climate change mitigation capacity. The recommendations urged the Irish Government to broaden the tax base and to prioritise capital expenditure in R&D and public infrastructure. The Commission’s Country Report for Ireland, published in February 2017, assessed that there had been “some progress” on the 2016 Country-Specific Recommendations to enhance the overall quality of expenditure and prioritise capital expenditure. Nonetheless, it emphasised the need for “coherent spatial planning and infrastructure provision” to support sustainable economic development.

The Government’s Infrastructure and Capital Investment Plan 2016-2021 provides for €42 billion worth of capital investment, and the Government committed in its Summer Economic Statement to seek Dáil approval for adding an extra €5.1 billion to the Capital Plan over its five-year timeframe.² The Capital Plan, in its original €42 billion form, is comprised of direct Exchequer investment of €27 billion (a sector-by-sector breakdown of which is illustrated below), public-private partnership investments of around €500 million and state-owned sector investment of around €14.5 billion.³ The Government announced in January 2017 that it would carry out a review of the capital plan ‘to ensure that capital spending is fully aligned with national economic and social priorities’. In an address to the IIEA on 15 February 2017, An Taoiseach Enda Kenny T.D. said he had asked the Department of Finance and the Department of Public Expenditure and Reform to prepare a new 10-year capital plan.⁴

Share of €27 billion Exchequer capital allocations (2016-2021)



² Summer Economic Statement, Department of Public Expenditure and Reform/Department of Finance (21 June 2016) http://www.budget.gov.ie/Budgets/2017/Documents/_SES/Summer-Economic-Statement-2016.pdf

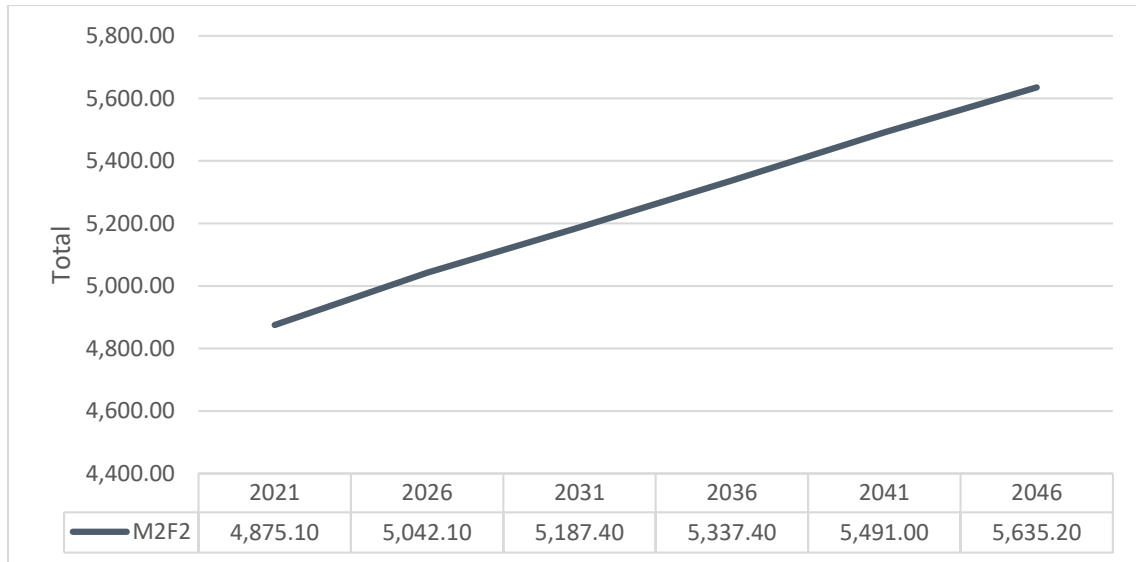
³ Building on Recovery: Infrastructure and Capital Investment 2016-2021, Department of Public Expenditure and Reform (29 September 2015)

⁴ Ireland at the heart of a changing European Union, An Taoiseach Enda Kenny (15 February 2017) <http://www.iiea.com/ftp/Address%20by%20the%20Taoiseach%20to%20the%20Institute%20of%20International%20and%20European%20Affairs%20on.pdf>

Mr Kenny asserted that shifting to a capital plan with a longer-term time horizon, along with the publication later this year of a strategic planning and development framework to 2040, would allow Ireland to better prepare a response to medium-term demographic changes, specifically the expectation that Ireland's population is set to grow and become older.⁵

Population projection

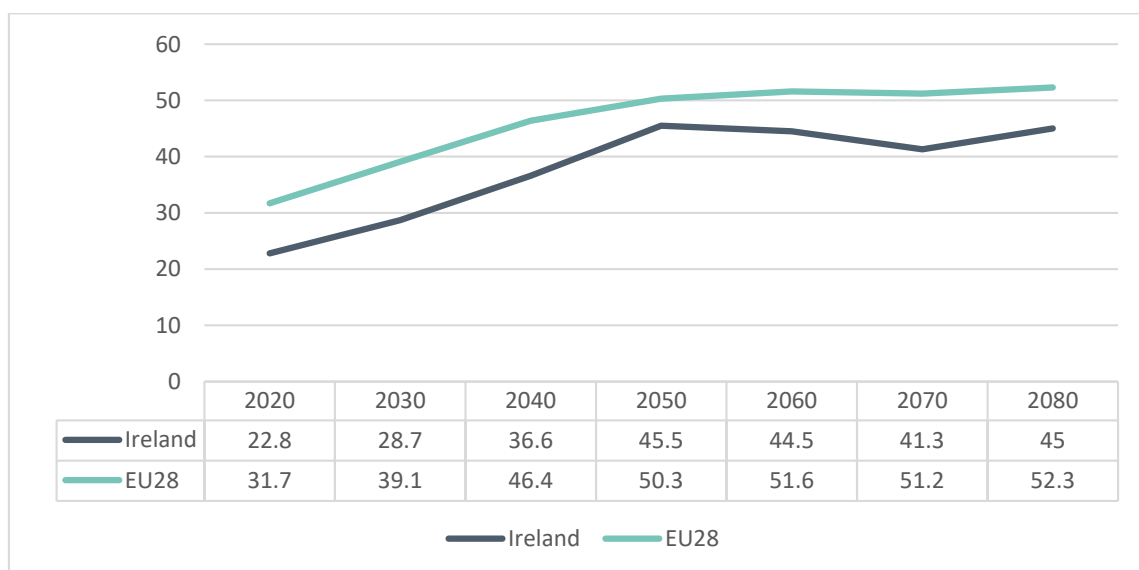
CSO data, Ireland 2021-2046



M2F2 is one of six population projections to 2046 provided by the Central Statistics Office (CSO). M2F2 assumes that the total fertility rate will decrease to 1.8 by 2026 and remain constant thereafter, and that net migration will turn positive by 2018 and rise slowly thereafter. These CSO projections use data from the 2011 census.

Projected old-age dependency ratio

Eurostat data, 2020-2080



⁵ The Irish Government Economic & Evaluation Service (IGEES) estimates an annual demographic cost pressure of €435 million in the short term across social protection, health and education.

Results from the 2016 census show Ireland has a total population of 4,761,865 people, an increase of 3.8 percent on 2011.⁶ The Government says the population could grow by a further 1 million people by 2040, with more than a fifth of the total population over the age of 65. This expected population growth and age profile alteration poses a number of challenges, particularly in terms of infrastructure and services. In the immediate term, the concentration of economic activity in Dublin places a particular strain on the capital city's physical infrastructure – the wider Dublin region accounted for 49 percent of Ireland's economic output in 2016.⁷ A loss of competitiveness in Dublin because of infrastructure failings would thus have significant implications for the wider Irish economy. In the medium to long term, the larger and older population will place added strain on physical infrastructure and will have serious consequences for the provision of education and healthcare.

In addition to the need for capital investment in new projects to sustain and improve Ireland's competitive position, there is also a need to maintain and upgrade Ireland's existing stock of infrastructure. In the pre-crisis years, there was significant progress made in addressing Ireland's capital investment needs. Morgenroth (2014) noted that public capital investment in Ireland between 1970 and 2013 was above the average in the EU15 as Ireland sought to catch-up with its European neighbors. Ireland's extensive, albeit incomplete, motorway network is perhaps the best example of this investment. However, the motorway network, along with other parts of the national infrastructure stock, will depreciate and require maintenance.⁸

In an analytical note for the Irish Fiscal Advisory Council, Kennedy (2016) assessed that, based on historical depreciation rates, public investment over the period covered by the Government's capital plan will be "barely adequate" to cover the estimated cost of public capital depreciation. The previous capital plan, covering the period 2012-2016 stated that 'the key focus of public capital investment over the coming period will...be to protect the value of our existing investments'. While maintaining the existing stock of public infrastructure is vitally important, with Ireland's set population set to grow and the economy currently expanding at a strong pace, there is a clear need for new infrastructure projects to complement the investments made in the pre-crisis years.

The current environment of low interest rates has further fuelled arguments that governments in Europe and around the world should take greater advantage of the availability of relatively cheap borrowing costs. While the unpredictability of the current political and economic landscapes, in addition to the continued high levels of public and private debt, are ample reason to proceed with caution down such a path, these arguments are compelling particularly with regard to return on investment. The European Central Bank (ECB) has consistently urged euro area governments to implement "growth friendly fiscal policies" to complement and amplify the impact of the ECB's easing measures. In its March 2016 *Interim Economic Outlook*, the OECD said countries in the euro area should pursue a more expansionary stance. It assessed that, across the advanced economies, fiscal space created by low interest rates "should be used more actively to catalyse private demand and raise incomes".

Public investment by governments in Europe in the years ahead will be accompanied by projects backed as part of the European Commission's *Investment Plan for Europe*. The plan was first proposed in November 2014 as a way to address low levels of investment in the EU. Its original objective was to mobilise €315 billion worth of additional public and private investment until 2018. A proposal to extend the plan to 2020 and expand the investment target to €500 billion is expected to be approved by mid-2017. Under the European Fund for Strategic Investments (EFSI) element of *Investment Plan for Europe*, the European Investment Bank (EIB) has signed off on seven projects either in Ireland or with an Irish dimension, while a further two projects have been approved but not yet signed. Among the signed deals is a project with €70 million worth of EFSI financing to construct 14 primary care centres. While the *Investment Plan for Europe* is a welcome undertaking in improving conditions for investment in the EU, it is not a substitute for increased inclusive growth-focused capital spending at the national level.

6 Central Statistics Office

7 *Ireland 2014, Our Plan, Issues and Choices*, Department of Housing, Planning, Community and Local Government (February 2017) <http://npf.ie/wp-content/uploads/2017/02/Position-Paper-Issues-and-Choices-Ireland-2040-web.pdf>

8 The *Infrastructure and Capital Investment Plan 2016-2021* provides €6 billion of investment for Ireland's road network, but just €1.6 billion of this is allocated to new projects.

2. Flexibility in the EU fiscal rules

Ireland's post-crisis fiscal policy is shaped by fiscal rules at both the national and European level. The Government has expressed its support for the EU fiscal rules, while also seeking to promote discussions at the European level about simplifying the economic governance framework. The expenditure benchmark rule, which is part of the preventive arm of the Stability and Growth Pact (SGP), states that the annual expenditure growth of a Member State should not exceed the medium-term rate of potential GDP growth unless the excess is matched by discretionary revenue measures. This provides scope for governments to increase public investment levels, on the condition that they increase revenue-raising measures to ensure that such investments are sustainable. However, the tendency of governments to follow the will of the electorate and bow to political pressure can make such a trade-off unappealing and thus lead to governments focusing on current rather than capital spending and tax cuts rather than tax increases.

The expenditure benchmark was introduced in 2011 as part of the 'six-pack' reforms and complements the Medium-Term Budgetary Objective (MTO) by ensuring net expenditure growth is on a sustainable footing. The expenditure benchmark does allow for an adjusted measure of gross fixed capital formation, which enables the cost of public investment to be "smoothed out" over a four-year time horizon. The expenditure benchmark does not apply to countries that have exceeded their MTO, provided the MTO be maintained. Ireland is forecast to meet its MTO, a deficit of 0.5 percent of GDP in structural terms, in 2018.

A degree of flexibility has been built in to the SGP through a matrix that calls for a larger fiscal effort to be undertaken by Member States in good times and a smaller fiscal effort to be undertaken during challenging economic periods. This fiscal effort refers to the annual fiscal adjustment towards the MTO under the preventative arm of the SGP. A temporary deviation from a Member States' MTO, or its adjustment path towards the MTO, is permitted in "exceptional circumstances", defined as "an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government".⁹ Brian Hayes, the MEP for Dublin who is a Member of the European Parliament's Committee on Economics and Monetary Affairs, has called on the Commission to "show some flexibility" to Ireland under the "exceptional circumstances" provision because of Ireland's unique economic exposure to Brexit.¹⁰

Flexibility is also built in to the SGP through the following instruments:

The Investment Clause permits Member States in the preventive arm of the SGP with GDP growth that is forecast to be negative or to remain "well below" its potential, to be granted a temporary deviation from their MTO or the adjustment path towards their MTO to allow for the financing of investments that would have a "positive, direct and verifiable" long term budgetary effect. The allowed deviation cannot exceed 0.5 percent of GDP and the investment in question must be on projects that are co-financed by the EU through the Structural and Investment Funds, the Trans European Network (TEN) or the Connecting Europe Facility (CEF).

The Structural Reform Clause permits Member States in the preventive arm of the SGP to temporarily deviate from their MTO or the adjustment path towards their MTO provided that the proposed "major" structural reforms will raise potential growth and will have positive budgetary effects in the long term. The allowed deviation cannot exceed 0.5 percent of GDP and the application of the structural reform clause is restricted to one single time per period of adjustment towards the MTO.

If a Member State is granted permission to avail of both the investment clause and the structural reform clause, the maximum allowed deviation of both clauses cannot exceed 0.75 percent of GDP. These flexibility instruments were clarified in a *Commonly agreed position on flexibility with the SGP*, which was endorsed by the ECOFIN Council of 12 February 2016. The commonly agreed position aims to offer Member States guidance on how to make the most of the flexibility built in to the

⁹ Article 3, *Treaty on Stability, Coordination and Governance in the Economic and Monetary Union*

¹⁰ *Brexit should be treated as an "exceptional circumstance" under EU fiscal rules*, statement by Brian Hayes MEP (22 January 2017) <https://brianhayesdublin.wordpress.com/2017/01/22/brexit-should-be-treated-as-an-exceptional-circumstance-under-eu-fiscal-rules-hayes/>

existing rules of the SGP. The document also clarifies that national contributions to the EFSI under the *Investment Plan for Europe* will not be taken into account by the Commission in its assessment of a Member States' compliance with the fiscal rules.

3. Public investment and fiscal rules

There have been a number of noteworthy papers published and studies undertaken on the topic of public investment under the constraints of fiscal rules. This section examines proposals put forward to ensure that fiscal rules do not act as a detriment to public investment in capital projects with long-term economic benefits. These proposals include variations on the 'golden rule', targets for capital expenditure, an expansion of the existing investment clause, a stabilisation instrument and an altered expenditure rule.

Barbiero and Darvas (2014) assessed that the EU's economic governance architecture was not conducive to preserving public investment during times of economic distress and described the EU's record with public investment during the financial crisis as "dismal". They argued that the investment clause is of "almost no help" in addressing the investment needs of certain Member States. The pair proposed an asymmetric 'golden rule' that would call for a Member States' permitted structural deficit to increase by the amount of net public investment whenever the negative output gap exceeds a threshold.¹¹ This would mean that a cut in net public investment would reduce the extra room for deficit, thus incentivising politicians to cut current expenditure rather than public investment levels and allowing them to run a larger budget deficit during an economic slump. This extra fiscal space would be phased out over a transitional period when output returns to its potential level.

A World Bank working paper by Mintz and Smart (2006) concluded that the existence of fiscal rules that called for deficits to be fixed to a certain percentage of GDP reduces the political incentive for politicians to pursue capital investments with long-run returns in favour of projects that would provide more immediate results for the electorate. However, they noted the measurement challenges that would exist under a system whereby capital is separated from current revenue and expenditures and where capital expenditure could be financed through debt. Such a system would also be open to abuse by governments. The authors proposed an alternative framework under which there would be constraints placed on the debt financing of a country's capital budget. These constraints would see commercial assets placed in a country's capital account subject to certain conditions whereby capital is only partly debt-financed. Non-commercial debt would be subject to an "overall debt to GDP limitation" that would require tax financing of the public capital expenditure that exceeds the specified limit.

Truger (2015, 2016) proposed a 'golden rule' whereby certain public investments, specifically those with "a substantial future payoff in terms of higher growth" or those that resulted in the avoidance of future costs, could avail of debt financing. Truger stated that the goal of such a rule would be to ensure intergenerational fairness and growth. The rule he proposed, which would at the outset be introduced for 'traditional' public investment minus military spending, would apply to net investment, which would no longer fall under the auspices of the EU fiscal rules.

Bom (2016) also looked at the interplay between fiscal rules and the intergenerational welfare effects of public investment and used modelling to show that a permanent increase in public investment under a balanced budget rule has a negative welfare effect for all living generations. Bom's analysis assumes that governments rely solely on labour income taxes to achieve a balanced budget. "Clearly, the balanced-budget rule distributes the welfare gains of public investment very unevenly, disproportionately benefiting future generations", he wrote. Bom found that implementing some form of 'golden rule' would help to "even out" the intergenerational distribution of welfare gains by smoothing the time profile of labour income tax rates. It would also cause a positive total welfare change for both current and future generations.

¹¹ Barbiero and Darvas (2014) provide the following example: "...if a country's permitted budget balance in 2014 is €10 billion, and net public investment is €2 billion, the permitted budget balance would increase to €12 billion. If in 2015 the permitted budget balance is €7 billion and net public investment is €1 billion, the permitted budget balance would increase to €8 billion".

Quéré, Ragot and Wolff (2016) asserted that excluding net public investment from deficit calculations, as called for under some iterations of a 'golden rule' might not be appropriate in the euro area, as it would, they argued, introduce a bias in favour of physical capital over human capital. As an alternative, they proposed a stabilisation instrument, the parameters of which would be set by the European Fiscal Board (EFB), whereby in challenging economic times, a Member State would be allowed to exclude "some specific" incremental spending (incremental unemployment expenditures and incremental public investment spending) from the measurement of its government deficit. These amounts would be recorded in an adjustment account and would be added back in to the calculation of the deficit when the EFB determines the economic situation to have returned to "good times".

The introduction of a rule that would allow Member States to finance certain capital expenditures through debt makes sense in that future generations, who would benefit most from the investments in question, would bear the bulk of the financial costs. However, it is not without its shortcomings, many of which the European Commission has previously highlighted (2004, 2012). In a 2012 communication on the future of deeper EMU, the Commission said that introducing a 'golden rule' that would allow "a permanent exception to all public investment" had the potential to undermine the sustainability of government debt and could therefore "easily" place the prime objective of the SGP in danger.

Other contentious issues associated with a possible 'golden rule' highlighted by the Commission in a 2004 document include: the potential for distortions to be created in the allocative process; the challenge of identifying which expenditure categories should be subject to the rule and which should not – for example, how to best classify spending on education; and the risk of accounting problems whereby a "sudden introduction" of a 'golden rule' may create incentives for current expenditure to be recorded as capital expenditure. The Commission document argued that the diverse circumstances that exist across Member States would make compliance checks and enforcement a significant challenge.

On the issue of defining, measuring and monitoring net investment under a 'golden rule', Barbiero and Darvas (2014) noted that the EU fiscal rules already contain certain indicators, such as the structural budget balance and potential output, that are difficult to estimate and define yet are still included as part of the economic governance framework. The OECD (2016) suggested that existing Eurostat rules and procedures would provide "some safeguard" against Member State governments reclassifying some spending as capital expenditure. Blanchard and Giavazzi (2004) argued that while putting in place rules that define what can and cannot be counted as public investment would not be an easy task, such a challenge should not be used as an argument to justify the continued use of rules "that may result in worthwhile projects not being undertaken because of cash constraints".

Another proposal put forward to address the issue of underinvestment by governments and their apparent bias towards current expenditure is the introduction of a capital investment target that would complement existing fiscal rules relating to debt and deficits. Portes and Wren (2014) suggested that governments could seek to achieve an overall level of public investment of "at least x% of GDP". The pair argued that such a rule "could ensure that any fiscal retrenchment (by governments in challenging economic times) did not lean too heavily on public investment projects".

A rule of this nature may also serve to encourage countries in a strong fiscal position to boost investment levels. The Commission's Country-Specific Recommendations for Germany in May 2016 urged the federal government to increase public investment in infrastructure, education, research and innovation. It noted that Germany had "sufficient fiscal space for higher public investment, without breaching the rules of the SGP and the national debt brake". On 16 November 2016, the Commission called for the euro area to move towards a positive fiscal stance of up to 0.5 percent of GDP due to the fragile nature of the economic recovery and ongoing uncertainty. Wolfgang Schauble, Germany's Minister of Finance, said on 18 November 2016 that the Commission "has no mandate" to review the euro area's fiscal space.¹²

However, there are notable downsides to a public investment target under the guise envisaged by Portes and Wren. In their efforts to achieve the x percent of GDP target, governments may proceed with some capital expenditure projects for the sake

¹² Schaeuble - EU executive has no mandate to tell us to spend more, Reuters (18 November 2016) <http://www.reuters.com/article/germany-schaeuble-idUSB4N1CC00A>

of meeting the target rather than for legitimate economic reasons. In the long term, such wasteful spending could serve to weaken public appetite for capital investment. One possible alternative could be an agreement to put a minimum share of total expenditure into capital expenditure to offset the current expenditure bias that governments tend to exhibit.

As noted in the previous section, under the current expenditure benchmark rule, investment costs are “smoothed” over a four-year period. In theory, this should help reduce the overall impact of a large one-off investment on a government’s balance sheet in a particular year. In an April 2015 analytical note on operational issues for the expenditure benchmark in Ireland, the Irish Fiscal Advisory Council concluded that the expenditure benchmark for Ireland “as currently specified for 2016” was too restrictive because of technical problems relating to the use of volatile potential output growth estimates in the calculation of the expenditure benchmark and the use of a ten year average period in assessing allowable real expenditure growth (which overlapped with the crisis period in Ireland). The National Competitiveness Council has also expressed concern that, should Ireland’s medium term potential growth be underestimated, the country’s competitive position could be undermined by the limits on the government’s ability to increase capital investment.¹³

Claeys, Darvas and Leandro (2016) proposed a new expenditure rule under which public investment would be treated in a similar manner to corporate or private investment, with the cost of an investment “distributed over future years during the service life of investment”. To address any transparency concerns that may arise from such an arrangement, Claeys et al. proposed that Member States distinguish between their investment budget and their current budget, while also managing public assets in a “transparent holding company”. However, as noted by Portes and Wren (2014), unlike private sector investment, public investment does not normally generate a direct return.

The OECD’s November 2016 *Economic Outlook* examined how fiscal levers could be utilised to help countries escape the low growth trap. On the specific question of how to expand fiscal space under the SGP, the paper proposed an expansion of the existing investment clause “to cover all forms of net investment” and an easing of the conditions imposed on Member States availing of the clause. It asserted that such an approach would create an incentive for governments to use additional fiscal space to boost public investment, which in turn would lead to short and long run multipliers that are “higher than other forms of fiscal expansion”.

In their 2007 report for the European Investment Bank, *A Primer on Public Investment in Europe, Old and New*, Perée and Valila found that the long-term downward trend in public investment in established EU Member States could not be traced back solely to the introduction of the fiscal rules nor to the emergence of financing mechanisms such as public-private partnerships. They concluded that it was instead the result of fiscal adjustment and consolidation that proved necessary because some Member States pursued unsustainable fiscal policies over long periods. Micossi and Peirce (2014) examined the flexibility clauses in the SGP and concluded that demands in some quarters for greater flexibility were “ill-formulated and unnecessary”.

Nonetheless, The European Council decided in June 2014 that there was a need to examine how the *existing* rules of the SGP could be applied more flexibly to increase investment levels and encourage structural reforms. On 30 November 2015, the Council approved a commonly agreed position on this issue. This followed on from a communication issued by the European Commission in January 2015. The Council’s commonly agreed position states that the Commission will carry out a review “on the application of the structural reform and investment clauses” by the end of June 2018. The review will analyse whether the investment clause led to new investments, the extent to which projects eligible for the investment clause were co-funded by the EU, and the implications of the continuation of the investment clause.

Perée and Valila (2007) have urged the focus to shift from safeguarding the level of public investment to safeguarding the productivity of public investment – this is something that was echoed by Paschal Donohoe T.D., Ireland’s Minister for Public Expenditure and Reform, in September 2016. In an address at an infrastructure conference, Minister Donohoe said he did

¹³ Ireland’s Competitive Challenge 2016, National Competitiveness Council (December 2016) <http://www.competitiveness.ie/Publications/2016/Competitiveness-Challenge-2016-NCC1.pdf>

‘not necessarily share’ the view that public investment as a percentage of GDP should be increased to pre-crisis levels. He said it was essential to focus on identifying the right kind of investments and to also consider the need to maintain and upgrade existing infrastructure, rather than solely looking at the level of investment expenditure. While acknowledging the restraints placed on Ireland by the EU fiscal rules, Minister Donohoe emphasised the essential role the EU’s economic governance framework plays in moving Ireland away from pro-cyclical fiscal policies.

If there was to be a change to the fiscal rules to remove any disincentive or bias towards capital investment, the importance of identifying those investments that are growth enhancing and inclusive will increase. The use of high quality, independent cost benefit analyses under a revised fiscal rules framework could help ensure that only the best possible projects are undertaken and that rates of return are maximised. The IIEA Economic Governance Group raised the possibility of establishing an independent, EU-level cost benefit analyses body dedicated to examining national infrastructure projects at a group meeting in March 2017.

4. Conclusion

Economic and political uncertainty, weak demand, low investor confidence and the pre-crisis pursuit of unsustainable fiscal policies have all played a part in the disappointing investment environment in Europe. In this context, the launch of the *Investment Plan for Europe* in 2014, and the current proposals to increase the duration and size of the European Fund for Strategic Investments, are welcome developments. However, there remains a need for greater public investment at the national level and thus there continues to be calls in some quarters for a change to the fiscal rules in order to give governments the ability and reason to pursue high quality investment projects with long-term benefits that could increase potential growth.

The commonly agreed position on flexibility within EU’s fiscal rules, which was finalised in 2015, provided Member States with greater clarity on the working of the cyclical conditions matrix and the availability of the investment and structural clauses. However, there remains uncertainty regarding the interpretation and implementation of these relatively limited flexibility instruments. The question facing EU policymakers is whether more could be done to remove any anti-investment bias from the fiscal rules to ensure that governments are not constrained from proceeding with growth enhancing capital expenditure projects.

As outlined above, there are a number of advantages and disadvantages to some of the proposed alternatives to the current fiscal framework’s focus on balanced budgets and expenditure rules. For Ireland, this is a pressing topic. Strong economic growth and emerging demographic trends call for increased levels of public investment to enable the country to fulfil its long-term potential. Changing the fiscal rules in some of the ways outlined above to make them more accommodating towards capital investment for Member States in circumstances such as those Ireland now finds itself risks making a rules framework that many say requires simplification even more complicated. Yet, with jobs, growth and investment at the top of the EU agenda in 2017, finding a way to better incentivise capital expenditure within a rules based fiscal framework would seem to be a worthwhile undertaking.

Annex: Notable comments by Irish politicians on this topic

While it has highlighted some issues, such as the treatment of smaller Member States and the classification of public private partnerships, the Irish Government is broadly supportive of the EU fiscal rules. However, the strain placed on infrastructure and certain public services from the country's strong economic recovery and subsequent periods of fast growth has led to some political actors and stakeholders questioning the role of the fiscal rules. This annex highlights some notable comments by Irish politicians on this topic.

On 29 September 2016, Michael Noonan T.D., the Minister of Finance, was asked in the Dáil if he was “reviewing” the impact of the EU's fiscal rules in terms of capital investment. He responded as follows:¹⁴

“The fiscal rules - formally known as the Stability and Growth Pact (SGP) - have direct application through a number of EU regulations. Changes to these regulations would have to follow the normal EU approach starting with a proposal from the Commission before consideration by Member States and the European Parliament.

Having said that, it is important to note that there are existing provisions in the fiscal rules that are designed to promote public investment. For instance, within the expenditure benchmark pillar of the rules, public investment is granted favourable treatment - as a result of four-year capital smoothing, only one quarter of the increase in public investment must be funded in the first year from within the fiscal space. This provision means capital spending for housing and other purposes can be leveraged within the EU rules.

It should also be noted that there are also certain more explicit flexibility provisions within the rules, particularly with a view to encouraging public investment. These take the form of what is known as the investment clause and structural reform clause. Specifically, these provisions allow for temporary deviations from the required structural budgetary adjustment if spending on capital investment can be shown to qualify for either the investment clause or the structural reform clause. Both of these provisions are subject to strict conditions; and while Ireland has not yet been in a position to apply given where we are in the business cycle, the situation is kept under constant review by my officials.

The Government is very conscious of the need to boost the supply of critical infrastructure. Investment in public infrastructure is vital for the medium and long-term competitiveness of the economy as well as for underpinning social cohesion through the provision of vital services to people in the form of schools, public transport, housing, etc. The public capital plan provides for €42 billion of capital investment over the 2016-2021 period and the Government remains committed to this. Further to this the Government set out in the SES proposals an additional cumulative €5.1 billion in capital spending over the period 2017-2021. This additional capital spending is aimed at addressing infrastructural bottlenecks, particularly regional infrastructural shortages.

In addition, the Government has been exploring the objective to create ‘off-balance’ mechanisms that bring investment into social housing which is additional to the funding being provided directly by the State. There is ongoing engagement with a broad array of domestic actors and European authorities to explore achievable solutions.

Finally, I would point out that we are still running a deficit and our public debt remains high by international standards. The answer, therefore, is not simply about spending more; it is about getting more from each euro of taxpayers’ money that is spent.”

¹⁴ <https://www.kildarestreet.com/wrans/?id=2016-09-29a.29>

Minister Noonan also addressed the fiscal rules in remarks to the Economic and Monetary Affairs Committee of the European Parliament on 8 November 2016:¹⁵ The Minister said ownership of the fiscal rules in Ireland was strong, but it was essential that the rules were applied consistently regardless of a Member States' size:

“Let me now turn to the other element of my remarks this afternoon that is economic governance in the European Union. At the Tatra summit last weekend I spoke about the fiscal rules. At the outset, let me say that I accept the principle of fiscal rules. Fiscal rules are an absolute necessity within a monetary union to address the ‘free rider’ problem and fiscal rules (at least in ‘normal times’) can also help prevent pro-cyclical policies and thereby contribute to higher living standards.

Ownership of the fiscal rules is strong in Ireland. Let me explain that. Ireland was the only country that acceded to the Treaty on Stability, Coordination and Governance, or the Fiscal Compact as it is also known, to hold a referendum. As a result of this democratic endorsement of the rules and our shared experience of the recent economic and fiscal crisis, the resulting fiscal rules, which mirror the requirements of the Stability and Growth Pact, enjoy public support. Furthermore, the political system in Ireland has internalised the need to work within the fiscal rules. We know this is critical to avoid repeating the mistakes of the past and there is a common understanding that compliance with the fiscal rules will help with this objective.

But there is another side to this. Ireland is sometimes seen as the ‘poster boy’ when it comes to implementation of the fiscal rules – given the substantial consolidation implemented in the 2008-2015 period. And while there is some truth to this, we are seeing evidence that this cannot be taken for granted.

It is also fair to say, in my view, the lack of transparency, predictability, and complexity are also features of the rules. Let me explain. I know many of you share my concerns that the fiscal rules – as currently construed – are excessively complex and extremely difficult to communicate to the population. It is also difficult ex ante to predict how compliance with the rules will be assessed – this as you can imagine is a huge issue for policymakers. The structural balance – which is at the heart of the Stability and Growth Pact – is not widely understood.

But there is another aspect and it relates to inconsistency of treatment, which is an issue for small Member States. In Ireland, we have been defending the fiscal rules and explaining why complying with the rules is a prudent and sensible course of action. However, this defence becomes progressively more difficult when perceptions arise that the rules are not being applied sensibly or consistently; or there is a perception that the rules are being applied differently for small and large Member States. This is a real sensitivity for small Member States.

So while the reforms of the Stability and Growth Pact – adopted by the Commission in early-2015 – are welcome in that they better align the rules with economic circumstances and provide some flexibility regarding investment and structural reforms. We need to continue to work on this.”

Another way in which governments can seek to increase investment is through public private partnerships (PPP) because such arrangements do not fall under the scope of the fiscal rules and are thus considered off balance sheet when calculating a country's deficit. In May 2016, An Taoiseach Enda Kenny T.D. sent a letter to Jean-Claude Juncker, President of the European Commission, raising his concerns about the obstacles being posed by the EU's fiscal rules to certain infrastructure investments - Mr Kenny's letter, which he discussed in the Dáil on 20 July 2016,¹⁶ referred specifically to how Eurostat classifies public-private partnerships.

“I wrote to President Juncker on 26 May, copying to President Tusk and European Council members, highlighting the need for consistency, transparency and predictability in Eurostat accounting treatment of PPP investments.

¹⁵ <http://www.finance.gov.ie/news-centre/speeches/current-minister/minister-noonans-address-economic-and-monetary-affairs>

¹⁶ <http://oireachtasdebates.oireachtas.ie/Debates%20Authoring/DebatesWebPack.nsf/takes/dail2016072000068#N7>

I should make clear that there was no question of Ireland seeking to break the EU fiscal rules. Rather, uncertainty in relation to Eurostat classification decisions had become a source of concern in Ireland and other Member States in terms of the implications for orderly planning of public investments consistent with the fiscal rules. Minister Noonan also raised this issue at ECOFIN on 17 June in the context of its discussion of the EU Investment Plan. In his reply of 27 June, President Juncker acknowledged a large and unprecedented interest in the matters I raised with him and agreed that the Commission needs to go further in terms of available guidance.”

In an address to the IIEA on 7 December 2016 entitled *Ireland, Brexit and the Future of the European Union*, Micheál Martin T.D., the leader of Fianna Fáil, briefly discussed the flexibility in the fiscal rules.¹⁷ Mr Martin and his party have been long-standing supporters of fiscal rules at the national and European level – the Confidence and Supply Arrangement under which Fianna Fáil supports the Fine Gael-led minority government contains a commitment to meeting the requirements of the fiscal rules “in full”.

“I welcome the recent shift of the Commission on how it interprets fiscal rules and the end of the policy of promoting avoidable austerity by encouraging countries to run fiscal policies which damage the shared economy.”

Brendan Howlin T.D., the leader of the Labour Party and former Minister for Public Expenditure and Reform, issued a statement on the need for a change to the fiscal rules on 29 March 2017 after a meeting of the Party of European Socialists (PES) at which the member parties discussed the possibility of introducing a ‘golden rule’ for capital investment.¹⁸

“The rules that govern fiscal policy are rigid, opaque and complex. Worse, they stop us from making investments that our society needs.

The network of financial and economic experts put together by the PES is expected to report before summer 2017.

Today, we discussed a draft report which includes a proposal that productive capital investment would not be calculated as part of public deficits. In Ireland, for example, this could allow us to make much greater and badly needed investment in social housing.”

¹⁷ <https://www.fiannafail.ie/17312/>

¹⁸ <https://www.labour.ie/news/2017/03/29/fiscal-rule-changes-needed-so-we-can-invest-for-gr/>

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Sharing Ideas
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The Institute of International and European Affairs,

8 North Great Georges Street, Dublin 1, Ireland

T: +353-1-8746756 F: +353-1-8786880

E: reception@iiea.com W: www.iiea.com